SELF LEARNING MATERIAL

B.Com. – FINANCIAL ACCOUNTING

COURSE : B.Com - 103

B.Com. (1st Semester)

Directorate of Distance Education

DIBRUGARH UNIVERSITY

DIBRUGARH - 786 004

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BLOCK- 1: FINANCIAL ACCOUNTING

Introduction

There are three units in this block. **Unit 1** focuses on preparation of financial statements for profit organisations.

Likewise, **Unit 2** gives emphasis on accounting of not- for- profit organisations. Related concepts of not for profit organisations have been detailed out with accounting problems.

Unit 3 concentrates on accounts from incomplete records popularly known as single entry system.

While going through the units you will get Self Assessment Questions. At the end of every unit, suggested readings are also given. So, you can refer to these books in case you require deeper and better understanding of related concepts.

Unit 1: Preparation of Financial Statements for Profit Organisations

Structure

1.4 Key Words
1.5 SAQs
1.6 Hints/ Answers of SAQs
1.7 Suggested Readings
1.8 Model Question

1.0 Objectives:

After going through this unit, you will be able to:

- Prepare Trading and Profit and Loss Account
- Prepare Balance Sheet
- Prepare both Trading and Profit and Loss Account and Balance Sheet with adjustments.

1.1 Introduction

Financial Accounting is that field of accounting which is concerned with the classifying, summarizing, analyzing and reporting of financial transactions pertaining to an entity. Accounting is a process of using financial information so as to show the financial position and financial result of an entity at the end of the financial period. For determining the profit and loss position Trading and Profit & Loss Account is prepared. Likewise, for determining the assets, liabilities and capital position, Balance Sheet is prepared.

The entire idea of financial accounting is illustrated with the help of a diagram below:

Financial Accounting

↓

Using financial information to determine

↙ ↘

Financial position	Financial result
↓	↓
Balance sheet	Profit and Loss Account

1.2 Preparation of final accounts

Arithmetical accuracy of maintaining books of accounts can be determined by preparing a Trial Balance with the balances of various ledger accounts at periodical interval. The accounts showing debit balance and accounts showing credit balance are grouped separately and put in one statement. In the credit side (column) of trial balance, items related to both revenue and capital receipts are shown. Contrary to that all the revenue and capital payments are shown in the debit side of trial balance. In other words, the ledger accounts showing credit balance are shown in the credit column and the accounts showing debit balance are shown in the debit column of the Trial Balance. Actually, the Trial Balance is not a formal part of financial accounitng.

All the revenue receipts and payments of the trial balance are shown/ transferred in the Trading and Profit & Loss Account and all the capital receipts and payments of Trial Balance are shown in the Balance Sheet relating to a particular accounting year.

Trading Account includes all the direct income and expenditure. Direct income and expenditure are those which are directly related to production for a manufacturing concern or related to purchase for a trading concern. Likewise, Profit and Loss Account includes all the indirect incomes and expenditure which are neither directly related to production nor with purchase rather these are related to administration and selling and distribution.

1.2.1Trading Account

This account is prepared to know the trading results or gross margin on trading of the business i.e., how much gross profit or loss the business has earned from buying and selling during a particular period. The excess of sales over the cost of goods sold is gross profit. For the purpose of calculating cost of goods sold, we have to take into consideration of opening stock, purchases, direct expenses on purchasing or manufacturing the goods and closing stock. The balance of this account represents gross profit or loss and is transferred to the profit and loss account. The pro-forma of a trading account is given as follows:

Trading Account

For the year ending 31st March, 2018

Dr. Cr.

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Opening stock Purchases Less: Purchase return Direct expenses**:** Carriage inward and freight Wages Fuel and power Manufacturing expenses Motive power Octroi duty Custom duty Consumable stores Foreman/ works manager's remuneration Royalty on manufactured goods ● Profit and Loss Account (Gross profit c/d)		Sales Less: Sales return Closing stock ● Profit and Loss Account (Gross loss c/d)	

●Balancing figure will either be gross profit or gross loss.

Detailed study of the items posted to the debit side of Trading Account:

1. **Opening stock:** It means goods lying unsold with the firm at the beginning of the accounting year. Opening stock consists of raw materials, work in progress and finished goods.
2. **Purchases:** it includes both cash and credit purchases of goods which are for resale. Purchase returns and discount on purchase, if any should be deducted from purchases in the inner column and only net purchases are shown in the outer column. The worth noting points in this respect are:
   a) *Goods purchased but in transit* will not affect the trading account. It is better to debit the goods in transit account and credit suppliers account as a liability in the balance sheet.
   b) *Goods purchased for personal use of proprietor out of business funds* should be first recorded as ordinary purchases debiting purchase account and crediting suppliers/cash account. Then it should be recorded as goods withdrawn by the proprietor for personal use and entry for that will be: Debit Drawing a/c and Credit Purchase a/c.
   c) *Invoice of goods purchased are received in advance before actual receipt of such goods.* For such goods, neither purchase a/c be debited nor goods will be included in closing stock.
   d) *Purchase made under future transactions and goods received on consignment or on behalf of third party* should not be included in purchase.
   e) *Purchase of any fixed assets for business use* such as furniture, machinery, etc should be kept separate.
   f) *Adjusted purchases:* some organizations for comparison purpose prefer to adjust the opening and closing stock through Purchase Account. Entries for this will be as under:

   <u>For adjustment of opening stock</u>
   Purchase A/c - Dr
   To Opening Stock A/c

For adjustment of closing stock
Closing stock A/c - Dr
To Purchases A/c

Due to these adjustments there will be no opening stock in the trial balance. Adjusted purchase a/c is shown on the debit side of Trading Account and closing stock (having debit balance) appears as an asset in the Balance sheet.

3. **Direct expenses:** These include all the expenses which have been incurred before the goods become ready for sale and are shown on the debit side of Trading Account. The examples of direct expenses are:
   a) *Wages:* Amount paid to workers for their services related to factory or may be purchase.
   b) *Octroi Duty:* It denotes tariff paid in order to bring the goods into municipal limit.
   c) *Carriage on Purchase:* Transportation cost incurred to bring the goods into factory/place of business is called as carriage inward/carriage on purchase.
   d) Motive Power, Coal, Gas and Fuel: These are direct expenditure to run the machines and other equipments and are shown to the debit side of Trading Account.
   e) Import duty and dock charges: In case goods are imported from abroad, custom duty, dock charges etc. need to be paid. As these relate to goods purchased, they are shown on the debit side of Trading Account.
   f) Manufacturing expenses: All expenses incurred in manufacturing the goods in the factory such as factory rent, factory insurance, depreciation on factory machinery, factory lighting, etc are debited to Trading Account.
   g) Consumable stores: These are incurred to keep the machine in right condition and include engine oil, soft soap, cotton waste, oil, grease and waste consumed in a factory.

Let us have some illustrations to understand the points better:

Illustration 1.1 Following is the Trial Balance of a sole proprietorship concern. Prepare Trading Account for the year ending 31st March, 2019.

Items	Debit Balance (Rs.)	Credit Balance (Rs.)
Opening Stock Purchase Wages Factory Lighting Octroi Duty Carriage on Purchase Sales	10,000 1, 00,000 5,000 5,000 2,000 1,000	1, 50,000
	1,50,000	1,50,000

 # Note: Here in this sum, it is asked to prepare only Trading account . So all the items mentioned are related to production process.

Solution

Trading and Profit & Loss Account
For the year ended on 31st March, 2019

Dr Cr

Particulars	Rs.	Particulars	Rs.
To Opening Stock	10,000	By Sales	1,50,000
To Purchases	1,00,000		
To Wages	5,000		
To Factory Lighting	5,000		
To Octroi Duty	2,000		
To Carriage on Purchase	1,000		
To Profit and Loss Account (Gross Profit c/d)	27,000		
	1,50,000		1,50,000
		By Trading Account (Gross Profit b/d)	27,000

1.2.2 Profit and Loss Account

This account is prepared to calculate the net profit of the business. There are certain items of incomes and expenses of the business which must be taken into consideration for calculating net profit of the business. These are of indirect nature i.e., considering the whole business and relating to various activities which are done by the business for the purpose of making the goods available to the consumers. Indirect expenses may be selling and distribution expenses, management expenses, financial expenses, extra ordinary losses and expenses in maintaining the assets or expenses on assets to keep it in working condition. This account is prepared by putting the nominal account balances which are either indirect income (credited to profit and Loss Account) or indirect expenses (debited to profit and Loss Account) and its final balance (Net profit/Loss) is transferred to capital account. Since the owners are taking the risk of business they have their right to get the entire profit or loss to their favour as such the final affect is to given to the capital account of the owner. Net Profit will increase the balance in capital and Net Loss will reduce the balance in capital. The specimen of the Profit and Loss account is given as under:

Profit and Loss Account

For the year ending 31st March, 2019

Dr. Cr.

Particulars	Amount (Rs)	Particulars	Amount (Rs)
To Trading Account (Gross Loss b/d) To selling and distribution expenses: Advertisement Traveler's salaries, expenses and commission Bad debts Go down rent		By Trading Account (Gross profit b/d) By Interest received By Discount received By Commission received By Rent from tenants By Income from investments By Apprenticeship premium	

Export expenses Carriage outwards Bank charges Agent's commission Upkeep of motor lorries To Management expenses: Rent, rates and taxes Heating and lighting Office salaries Printing and stationery Telephone charges Legal charges Audit fee Insurance General expenses To Depreciation and Maintenance: Depreciation on fixed assets Repairs and maintenance To Financial expenses: Discount allowed Interest on capital Interest on loan Discount on bills To Extra ordinary expenses: Cash defalcation ●To Capital Account (Net Profit Transferred to capital a/c)		By Interest on debenture By Income from other sources By Miscellaneous revenue receipts ●By Capital Account (Net Loss Transferred to capital a/c)	

● Balancing figure will be either net profit or net loss.

Important points to be kept in mind at the time of preparation of the Profit and Loss Account are shown as below:

a) *Salaries:* These include salaries paid to office, go down and warehouse staff , marketing personnel should be shown on the debit side of profit and loss account.

b) *Rent, rates and taxes:* These include offices and warehouse rent, municipal rates and taxes.

c) *Interest:* Interest paid on loans, overdrafts and bills overdue is an expense and is taken to the debit of the

Profit and Loss Account. Interest received on loans and advanced by the firm on deposits and on securities is a gain/income and is shown on the credit side of profit and loss account. Interest on capital should be shown separately on the debit side and interest on drawings on the credit side of profit and loss account.

d) *Commission:* Commission received for doing the work for other firms may be credited to profit and loss account as a gain and commission payable to the agents employed to sell the firm's goods is debited as an expense.

e) *Repairs:* Repairs and small renewals or replacement relating to the plant and machinery, fixture, fittings, utensils, etc. are generally included under this heading and such expenditure are debited to profit and loss account.

f) *Depreciation:* It is an expense due to wear and tear, lapse of time and exhaustion of assets used in business. This is loss sustained by fixed assets and should be charged to the debit of profit and loss account.

g) *Stable expenses:* These are incurred for the fodder of the horse and wages paid to persons looking after the stable.

h) *Trade expenses:* These are expenses of a varied nature for which it is not worthy to open separate accounts. These are amalgamated under trade or general or sundry or petty expenses.

i) *Samples:* Samples of the goods manufactured by the business concerns are often distributed free of charge to push up sales. Being indirect expense (sales promotion) these are debited to profit and loss account.

j) *Advertisement:* All sums spent on advertising is charged to profit and loss account.

k) *Apprentice premium:* This is the amount charged from a person to whom training is given by the business. It is a gain and should be credited to profit and loss account.

l) *Abnormal losses:* Some abnormal losses like loss on sale of fixed assets, cash defalcations, stock destroyed by fire not covered by insurance, etc should be debited to profit and loss account.

Expenses not be shown in profit and loss account

a) Domestic and household expenses
b) Income tax
c) Life insurance premium

1.2.3 Balance Sheet

A Balance Sheet can be simply described as a statement of assets and liabilities on a specific date. A Balance Sheet has two sides. In the left hand side liabilities and capital are shown; whereas in the right hand side, assets are shown. **Liabilities** are the claims against the assets. Liabilities are divided into: (a) *Fixed liability or non-current liabilities* under which capital, long term liabilities will come & (b) *Current liability* which includes all the short term liabilities like creditors (to whom money is due to pay), outstanding expenses, short term loan etc.

Assets denote the resources acquired by business from the funds made available either by owners of the business or other financiered. Assets are categorized as: (a) *Fixed/ Non-Current assets* include all the assets which are bought for use for a long period not for resale, e.g., buildings, machinery, etc. (b) *Current assets* include short term assets , e.g., closing stock, debtors (from whom money is due to receive), cash, etc.(c) *Intangible assets* are those assets which cannot be touched or seen physically, e.g., goodwill, patents, etc. (d) Fictitious assets are those assets which cannot be represented using any tangible possession or property, e.g., preliminary expenses, some other deferred revenue expenses yet to be written off.

In other words all the capital receipts of the firm are liabilities; whereas all the capital expenditures are assets.

Illustration 1.2 Prepare Trading and Profit & Loss Account for the year ended 31st March, 2019 and Balance Sheet as on 31st March, 2019.

Trial Balance
as on 31st March, 2019

	Debit (Rs.)	Credit (Rs.)
Land & Building	5, 00,000	
Machinery	1, 00,000	
Capital		10, 00,000
Sales		6, 00,000
Creditors		10,000
Opening Stock	10,000	
Purchases	3, 57,000	
Wages	15,000	
Salary	25,000	
Printing & Stationery	2,000	
Freight	1,000	
Cash at Bank	2, 32,000	
Interest		2,000
Investments	1, 50,000	
Goodwill	1, 00,000	
Furniture	1, 00,000	
Debtor	20,000	
	16,12,000	16,12,000

Solution to illustration 1.2

Trading and Profit & Loss account
For the year ending 31st March, 2019

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To Opening Stock	10,000	By Sales	6,00,000
To Purchase	3,57,000		

To Freight	1,000		
To Wages	15,000		
To Profit and Loss Account (Gross Profit c/d)	2,17,000		
	6,00,000		6,00,000
To Salary	25,000	By Trading Account (Gross Profit b/d)	2,17,000
To Printing & Stationery	2,000	By Interest	2,000
To Capital Account (Net Profit transferred)	1,92,000		
	2,19,000		2,19,000

Balance Sheet as on 31st March, 2019

Liabilities		**Rs.**	**Assets**	**Rs.**
Capital	10,00,000		Goodwill	1,00,000
Add: Net profit	1,92,000	11,92,000	Land & Building	5,00,000
Creditors		10,000	Machinery	1,00,000
			Furniture	1,00,000
			Investment	1,50,000
			Debtors	20,000
			Cash at Bank	2,32,000
		12,02,000		12,02,000

Things to learn from the illustration:

In this problem we have recorded all the revenue income and expenditure either in the Trading account or in the Profit and Loss Account. Capital receipts and payments which are referred to as liabilities and assets respectively have been shifted to Balance Sheet. The net profit coming out of the Profit & Loss Account is added with the capital. Capital is the contribution of the owner in the business. And one more thing that is prominent in Balance Sheet is both the sides must tally.

1.2.2 Preparation of Final Accounts with Adjustments

While preparing trading and profit and loss account one point that must be kept in mind is that expenses and incomes for the full trading period are to be taken into consideration. This means that if an expense has been incurred but not paid during that period, a liability for the unpaid amount should be created before the accounts can be said to show the true profit or loss. All expenses and incomes should properly be adjusted through adjustment journal entries. These journal entries are passed at the end of the accounting period are called adjusting entries. Some of the most commonly used adjustments are:

a) Closing stock b) outstanding expenses and income c) prepaid income and expenditure d) depreciation e) bad debts and provision for doubtful debts f) interest on capital and drawings

The illustration 1.3 will give us idea about how adjustments are actually passed in Trading and Profit and Loss Account and Balance Sheet.

Illustration 1.3 Prepare Trading and Profit & Loss Account for the year ended 31st March, 2019 and Balance Sheet as on 31st March, 2019.

Trial Balance
As on 31st March, 2019

	Debit (Rs.)	Credit (Rs.)
Land and Property	5, 00,000	
Machinery	1, 00,000	

Capital		10, 00,000
Sales		6, 00,000
Creditors		10,000
Opening Stock	10,000	
Purchases	3, 57,000	
Wages	15,000	
Salary	25,000	
Printing & Stationery	2,000	
Carriage inward	1,000	
Cash at Bank	2, 32,000	
Interest		2,000
Investments	1, 50,000	
Patents	1, 00,000	
Furniture	1, 00,000	
Debtor	20,000	
	16,12,000	16,12,000

Adjustments:

1. Closing stock Rs. 30,000
2. Appreciate land and property @10% p.a.
3. Depreciate machinery @10% p.a. & furniture @5% p.a.
4. Write off bad debt Rs. 1000 and create a provision for doubtful debts Rs. 1,500.
5. Outstanding wages Rs. 200.
6. Advance interest received Rs. 100.
7. Prepaid salary Rs. 1,000

Solution to illustration 1.3

Trading and Profit & Loss account
For the year ending 31st March, 2019

Dr. **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To Opening Stock	10,000	By Sales	6,00,000
To Purchase	3,57,000		
To Carriage inwards	1,000		
To Wages 15,000		By Closing Stock	30,000
Add: Outstanding 200	15,200		
To Profit and Loss Account (Gross Profit c/d)	2,46,800		
	6,30,000		6,30,000
		By Trading Account (Gross Profit b/d)	2,46,800
To Salary 25,000			
Less: Prepaid 1,000	24,000	By Interest 2,000	
To Printing & Stationery	2,000	Less: Prepaid 100	1,900
To New Bad debts 1,000		By Appreciation in Land & Property	50,000
Add: New Provision 1,500	2,500		
To Depreciation on			
Machinery 10,000			
Furniture 5,000	15,000		
To Capital Account (Net Profit transferred)	2,55,200		
	2,98,000		2,98,700

Balance Sheet as on 31st March, 2019

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital 10,00,000		Patents	1,00,000
Add: Net profit 2,55,200	12,55,200	Land & Building 5,00,000	
Creditors	10,000		5,50,000
Outstanding wages	200	Add: Appreciation 50,000	
Prepaid/advance interest	100	Machinery 1,00,000	90,000
		Less: Depreciation 10,000	
			95,000
		Furniture 1,00,000	1,50,000
		Less: Depreciation 5,000	1,000
		Investments	30,000
		Prepaid salary	
		Closing Stock	
		Debtors 20,000	
		Less: Bad debt 1,000	17,500
		19000	2,32,000
	12,65,500	Less: Provision 1,500	12,65,500
		Cash at Bank	

Things to learn from the illustration:

- In this problem, we have seen that all the adjustments are shown twice. Value of land and property got appreciated. Appreciation in the value of an asset has been shown as an income. So, the appreciated amount is added to its original cost and the same amount is also credited to Profit and Loss account as an income. But contrary to that, value of machinery and furniture got depreciated. Depreciation is a loss. So the amount of depreciation is debited to Profit and loss account.

- Advance interest received is a liability so as the outstanding wages. But prepaid salary is an asset. We must remember, all the prepaid expenses are current assets and all the outstanding expenses are current liabilities. Likewise, all the outstanding incomes are current assets and all the advance incomes are current liabilities.
- Debtor is an entity to whom the business has lent its money or given its assets/ goods on credit. So, debtor is a current asset. Debtors which cannot be recovered or become irrecoverable are called bad debts. As because bad debt is loss on debtors so it is deducted from debtors. As we know as per the convention of conservatism, we have to anticipate all the future losses. So provision for doubtful has also been deducted from the debtor.

1.3 Let Us Sum It Up

So, in this unit we have seen how to prepare the financial statement of a for profit organisation. Basically, we have considered sole proprietorship entity into consideration for preparing financial statements and we have seen that they prepare two statements: 1) Trading and Profit & Loss Account and 2) Balance Sheet.

Trading and Profit & Loss Account includes all direct and indirect income and expenditure for a particular year which depicts the profit and loss position of the business. Likewise, Balance Sheet shows capital as well as assets and liabilities position of the business depicting the financial position on the last day of the financial year.

1.4 Keywords

Trading and Profit & Loss Account, Balance Sheet, Income, Expenditure, Assets, Liabilities, Capital

1.5 SAQs

Choose the correct alternative:

1. Which of the following is not an item under Balance Sheet:

a) Furniture b) Cash in hand c) Discount allowed d) Debtors

2. Which of the following is an item under Trading A/C?

a) Commission to salesman, b) Office expenses, c) Factory lighting, d) Interest on investment

3.Depreciation is charged on:

a) Fixed assets b) Current asset

1.6 Answers of SAQs

1. c 2. c 3. a

1.7 Suggested Readings

Ahmed, N (2008) "Financial Accounting", Atlantic Publishers and Distributors Pvt Ltd, New Delhi,

Maheswari S. N., Sharad (2013) "An Introduction to Accountancy" 11th Edition, Vikas Publishing House New Delhi

1.8 Model Question

1. Prepare Trading and Profit & Loss Account for the year ended on 31st March, 2019 and Balance Sheet as on 31st March, 2019.

Trial Balance
as on 31st March, 2019

	Debit (Rs.)	Credit (Rs.)
Land	15, 00,000	
Plant & Machinery	10, 00,000	
Capital		20, 00,000
Sales		25, 30,000
Creditors		40,000
Opening Stock	40,000	
Purchases	13, 57,000	
Wages	15,000	
Salary	55,000	
Petty expenses	2,000	
Carriage outward	1,000	
Cash	2, 32,000	
Commission		18,000

Furniture	30,000	
Investments	1, 20,000	
Goodwill	1, 00,000	
Equipments	1, 00,000	
Debtor	20,000	
Carriage inward	10,000	
Trade expenses	10,000	
Discount received		4,000
	-----------------	------------
	45,92,000	45,92,000

Adjustments:

1) Closing stock Rs. 25,000
2) Appreciate land by 6% p.a.
3) Depreciate machinery @4% p.a., equipment @ 2% & furniture @3 % p.a.
4) Write off bad debt @3% p.a. Provision for doubtful debt @4% p.a .
5) Outstanding salary Rs. 1800.
6) Advance commission received Rs. 1000.

2. Prepare Trading and Profit & Loss Account for the year ended on 31st March, 2019 and Balance Sheet as on 31st March, 2019.

Trial Balance

For the year ending 31st March, 2019

	Debit (Rs.)	Credit (Rs.)
Building	20, 00,000	
Machinery	5, 00,000	
Capital		19, 00,000
Sales		25, 10,000
Creditors		50,000
Opening Stock	40,000	
Purchases	13, 57,000	
Wages	15,000	
Salary	25,000	

Factory manager's salary	12,000	
Carriage outward	1,000	
Bank	2, 32,000	
Commission		10,000
Manufacturing expenses	10,000	
Investments	1, 42,000	
Equipments	1, 00,000	
Debtor	20,000	
Carriage inward	10,000	
Sundry expenses	10,000	
Interest received		4,000
	-----------------	------------
	44, 74,000	44, 74,000

Adjustments:

a) Closing stock Rs. 60,000
b) Depreciate building and machinery at 2%, equipment at 3% p.a.
c) Factory manager's salary outstanding Rs. 1,000.
d) Write off provision for doubtful debts Rs. 500.

Unit 2: Accounting of Not for Profit Organization

Structure

2.0 Objectives

After going through this unit, you will be able to:

- Understand the concept of not for profit organization
- Know the different set of accounts prepared by these organizations
- Differentiate between receipts and payment account and income and expenditure account
- Prepare both receipts and payment account and income and expenditure account.

2.1 Introduction

There are some institutions whose main objective is not to earn profit but to render valuable services to its members and to the society, e.g., clubs, schools, colleges, universities, trade unions, NGOs, etc.

In order to find out their operating financial results and financial position, they prepare the following statements for the purpose of financial reporting:

a) Receipts and Payments Account
b) Income and Expenditure Account
c) Balance Sheet

Let us now discuss in detail about all these three statements prepared by non trading concern:

2.2 Receipts and Payments Account

It is an account which summarizes all the cash receipts and cash payments of the organization. It is the summary/substitute of cash book prepared by trading organizations. It is a real account. All the cash receipts are debited and all the cash payments are credited to the account. For example, cash received from sale of goods is taken as receipt and is debited. Contrary to this, cash paid on purchasing materials are credited because it is a payment. One thing should be noted that credit transactions or non cash items are not recorded in Receipts and Payments Accounts. As a result, items like credit purchase or credit sales can’t be recorded.

2.3 Income and Expenditure Account

Income and Expenditure Account is a nominal account. It is prepared by non-profit organization in lieu of Trading and Profit and Loss Account. Debit all losses or expenses and credit all incomes or gains is followed while preparing this account. Incomes are shown on the credit side and expenses on the debit side. There is no opening balance but closing balance will show either surplus i.e., excess of income over expenditure or deficit i.e., excess of expenditure over income. Only income and expenses which are revenue in nature are taken into consideration in Income and Expenditure Account i.e., capital items are totally excluded. Moreover, income and expenditure of current year are taken into consideration so any arrear, outstanding, advance relating to period other than the current year are excluded while preparing this account. This account is prepared on accrual basis of accounting and thus all adjustments relating to prepaid or outstanding expenses and incomes related to current year, provision for depreciation or doubtful debts etc are to include in the income and expenditure account. Only nominal accounts are taken into consideration for the preparation of Income and Expenditure Account.

Let us now discuss the differences between Receipts and Payments Account and Income and Expenditure Account:

2.4 Differences Between Receipts and Payments Account and Income and Expenditure Account

Basis of difference	**Receipts and Payments A/C**	**Income and Expenditure A/C**
1. Type of account	It is a real account.	It is a nominal account.
2. In lieu of	It is prepared in lieu of cash book.	It is prepared in lieu of Trading and Profit and Loss account.
3. Basis of accounting	It is prepared on cash basis of accounting.	It is prepared on accrual basis of accounting.

4. Period	All the receipts and payments whether relating to current period, succeeding or preceding periods are taken into consideration.	Only current period income and expenditure are taken into consideration.
5. Capital and revenue items	Both capital and revenue items are taken into consideration.	Only revenue items are considered.
6. Necessity for preparation of Balance Sheet	As it includes revenue and capital items, preparation of balance Sheet is ignored.	It includes only revenue items, so for recording the capital items there might be a necessity to prepare Balance Sheet.

Let us now discuss some important concepts having relation with maintaining financial records and for financial reporting to be made by a non trading concern. In this regard we will also discuss about their accounting treatment.

2.5 Treatment of some important items

- **Legacy:** It is the amount which a non trading concern may receive as per the will of a deceased person. It will be shown to the debit side of the receipts and payments account. It should be capitalized being an item of non recurring nature and should be shown on the liabilities side of the balance sheet.
- **Donation:** It is the amount which is given to non trading concern by the members of the society. It is put on the receipts side of receipts and payments account. Donation may be general donation or may be a specific donation. If the amount is small and not for a specific purpose then it is credited to income and expenditure account as a revenue income. But if the amount is huge and received for a specific purpose then it is capitalized and shown as a liability in the balance sheet. All the specific donations are treated capital receipts and are shown as liability.
- **Sale of an asset:** It is shown as a receipt in the receipts and payments account. To show this item in the income and

expenditure account some adjustments are required. The difference between book value and sale proceeds of the asset is required to be shown in the income and expenditure account. If sale value is more than book value, it is profit and taken as income to the credit side of the income and expenditure account. On the other hand, if sale value is less than the book value it indicates a loss on sale so to be treated to the debit side of the income and expenditure account.

- **Sale of newspaper or obsolete items:** It is treated as receipt under receipts and payments account and since it is an income revenue in nature so credited to the income and expenditure account.
- **Entrance fee:** This fee is generally paid by members normally once in life time. Since it is a receipt for such an institution it is shown to the debit side of the receipt and payment account. As a result, it is considered as a capital receipt in general or it may be partially treated as capital receipt as per the policy of the concern. If the entire amount of entrance fees is treated as capital receipt then it is shown to the liabilities side of the balance sheet. But when it is treated partially as capital and revenue receipt then the revenue part of such income is required to be shown as a revenue income to the credit side of the income and expenditure account.
- **Subscription:** It is taken as receipt to the receipt and payment account and it is credited to the income and expenditure account as a revenue income. Only the subscription relating to the current year is required to be shown as revenue income on accrual basis.
- **Life membership fee:** It is a one time fees to be paid by those who want to become life member of the institution. A life member need not pay annual membership fees. It is treated as a capital receipt and shown in the receipt and payment account. Since it is a capital receipt not to show in the income and expenditure account. But required to be shown as a liability in the liability side of the balance sheet. When life membership fees is treated one part as capital and another part as revenue income then the revenue income part is to be shown as income to the credit side of the income and expenditure account. Under receipts and payments account, it is taken as receipt.

- **Honorarium:** any amount paid to a person (who is not an employee of the organization) for rendering his or her services to the concern is called as honorarium. It is a revenue payment and thus is shown on the payments side of Receipts and Payments Account. In the Income and Expenditure Account, it is shown on the expenditure side.
- **Endowment fund:** It is a specific fund created out of contribution as a permanent means of support for any person or institution. Any contribution received for the endowment is to be treated in the fund account and any payment made out of such fund is required to be charged to that fund account only. It is a capital receipt and is shown on the liabilities side of the Balance sheet. Any amount received during the year is to be shown to the receipt side of Receipts and Payments Account

Let us consider some illustrations for better understanding the procedure of preparing receipt and payment account and an income and expenditure account:

Illustration 2.1 From the following information, prepare, Receipts and Payments Account for the year 2019:

	Rs.
Cash at Bank on 1.1.2019	10,000
Furniture purchased	6,000
Subscription received from members	10,000
Entry fee received	5,000
Donation received	50,000
Books purchased for library	6,000
Miscellaneous expenses incurred	5,000
Subscription receivable	2,000

Solution to illustration 2.1 :

Receipts and Payments Account for the year 2019

Dr **Cr**

Receipts	Rs.	Payments	Rs.
To Balance b/d	10,000	By Furniture	6,000
To Subscription	10,000	By Books	6,000
To Entry fee	5,000	By Misc. Exp	5,000
To Donation	50,000	By Balance c/d	58,000
	75,000		75,000

Things we learnt from the illustration:

We have seen all the cash receipts have been debited and all cash payments have been credited in the receipt and payment account. After adjusting receipts and payments, we have found closing cash balance in the credit side at the end of the accounting year and which will be the opening balance of cash in the next year. The item subscription receivable will not appear in the receipt and payment account as cash/bank has not received during the year. This account is prepared on cash basis only.

Illustration 2.2 From the following information, prepare, Receipts and Payments Account for the year 2019:

	Rs.
Cash at Bank on 1.1.2019	25,000
Sports materials purchased	10,000
Subscription received from members	10,000
Entrance fee received	5,000
Honorarium paid to coach	5,000

Donation for renovation of playground	50,000
Maintenance of Playground	6,000
Miscellaneous expenses incurred	5,000
Salary payable to staff	4,000

Solution to illustration 2.2 :

Receipts and Payments Account for the year 2019

Dr **Cr**

Receipts	Rs.	Payments	Rs.
To Balance b/d	25,000	By Sports materials	10,000
To Subscription	10,000	By Maintenance of playground	6,000
To Entrance fee	5,000	By Honorarium	5,000
To Donation for renovation of playground	50,000	By Misc. Expenses	5,000
		By Balance c/d	64,000
	90,000		90,000

Things we have learned from the illustration:

Similar to the earlier problem, here also all the cash receipts have been debited and all cash payments have been credited to the receipt and payment account. After adjusting receipts and payments, we have found closing cash balance in the credit side which will be the opening balance of cash for the next year. Salary payable to staff will not appear in the receipt and payment account as it has not affected in the cash position of the entity.

Illustration 2.3 From the following information prepare Income and Expenditure Account for the year ended on 31st December, 2019 and Balance Sheet as on 31st December, 2019.

Particulars	Rs.	Particulars	Rs.
Books for library	15,000	Donation for building	40,000
Maintenance of library	16,000	Entrance fee	5,000
Salary to librarian	10,000	Interest on bank deposit	6,000
Purchase of furniture	24,000	Sale of newspaper	4,000
Sundry expenses	10,000	Life membership fee	10,000
Salary to staff	5,000	Capital fund at the beginning of the year	35,000
Cash	20,000		

Solution to 2.3 **Income and Expenditure Account**

For the year ending 31st December, 2019

Dr. **Cr.**

Expenditure	Rs.	Income	Rs.
To Maintenance of library	16,000	By Interest on bank deposit	6,000
To Salary to librarian	10,000	By Sale of newspaper	4,000
To Sundry expenses	10,000	By Deficit	31,000
To Salary to staff	5,000	(Excess of expenditure over income)	
	41,000		36,000

Balance Sheet as on 31st December, 2019

Liabilities	Rs.	Assets	Rs.
Capital fund 35,000		Books for library	15,000
Less: Deficit 31,000	4,000	Furniture	24,000
Donation for building	40,000	Cash	20,000
Entrance fee	5,000		
Life membership fee	10,000		59,000
	59,000		

Things to be taken care of:

- All the revenue items are shown in Income and Expenditure A/C and all the capital items are put in the Balance Sheet.
- The Income and Expenditure shows deficit so it is deducted from capital fund.

2.6 Let Us Sum Up

Not for profit organizations, e.g., clubs, schools, colleges, etc. in order to find out their financial position, they prepare:

d) Receipts and Payments Account
e) Income and Expenditure Account
f) Balance Sheet

1.3 SAQs

Choose the correct alternative

1. Receipts and Payment Account is a:

a) Real A/c b) Personal A/c c) Nominal A/c d) Valuation A/c

2. Income and expenditure account includes:

a) Only capital items b) only revenue items c) both revenue and capital items d) None of the above

2.8 Answers of SAQs

1. a 2. b

2.9 Suggested Readings

Ahmed, N (2008) "Financial Accounting", Atlantic Publishers and Distributors Pvt Ltd, New Delhi,

Maheswari S. N., Sharad (2013) "An Introduction to Accountancy" 11th Edition, *Vikas Publishing House New Delhi*

2.10 Model Questions

1. Write down the differences between Receipts and Payments Account and Income and Expenditure Account.

2. Write down the treatments of following items:

a) Legacy b) Life membership fee c) Entrance fee

2. From the following information, prepare Receipts and Payments Account for the year 2019:

	Rs.
Cash at Bank on 1.1.2019	28,000
Billiard table purchased	10,000
Subscription received from members	10,000
Entrance fee received	7,000
Honorarium paid to coach	15,000
General donation	70,000
Newspaper and magazines purchased	6,000

Unit 3: Accounts of Incomplete Records: Single Entry System

Structure

3.0 Objectives

After going through this unit, you will be able to:

- Interpret accounting for incomplete records.
- Understand the salient features of single entry system.
- Distinguish between single entry and double entry system.
- Ascertain profits/loss from single entry records.

3.1 Introduction

In the previous unit, we have understood the accounting of not for profit organization. Prior to that, we learnt how to prepare the final accounts of profit making entity. In this unit, we will learn about the accounting records kept under single entry system or incomplete records.

Basically in double entry system, all the transactions are recorded recognizing their two fold aspects i.e., against every debit there is equal and corresponding credit. But in single entry system the two fold affects of all the transactions are not taken into consideration. Under this system, with respect to some transactions both the aspects debit and credit are taken into consideration; while with respect some transactions only one aspect is recorded and with respect to some transactions no records are maintained. Therefore, it is called a system of double entry, single entry and no entry. As such, we cannot say that it is a system; rather it is a style of maintaining accounting data in an incomplete form.

Under this system, no records are maintained with respect to certain transactions like bad debt, depreciation etc. With respect to cash transactions only the cash aspect is recorded like cash purchase of assets, cash sales etc. Transactions which are credit in nature like credit sales of goods, credit purchase of goods both the aspects are recorded. Only the personal accounts are maintained in its full form and content but so far the nominal and real accounts are concerned no records are made available under the incomplete system of accounting.

3.2 Single Entry System

In this section, you will learn the fundamentals of single entry system.

Firstly, let us have a discussion on salient features of single entry system:

3.2.1 Salient features of single entry system

The salient features of single entry system are as follows:

a) **Maintain personal accounts:** usually under this system, personal accounts are maintained while real and nominal accounts are avoided.

b) **Maintain cash book:** Under this system, cash book is maintained, which unusually takes into account both personal transactions and business transactions.

c) **Dependence on original voucher/evidences:** In order to collect the necessary information one has to depend on original voucher, e.g., the figure of credit purchase may not be readily available. It is required to calculate on the basis of original invoices received from suppliers along with other details available in regard to transactions with the suppliers like returns, discount etc.

d) **No uniformity:** The system may differ from organizations to organizations depending upon their individual requirement.

e) **Suitability:** This system is suitable or normally practiced by small, proprietary concerns or sometime may be suitable to small partnership concerns. Limited companies cannot adopt this system due to legal requirements relating to maintenance of account.

Let us now discuss on the advantages and disadvantages of single entry system:

3.2.2 Advantages of single entry system

a) Simple and easy method of recording transaction: Single entry system does not need any special accounting knowledge or expertise to record financial transaction of the business. It can be maintained easily by the business owner no need to appoint any expert person to do accounting work.

b) Economical: It is less costly system of recording business transactions compared to double entry system. It is economical because of limited number of transactions and limited numbers of books (only personal account and cash account) are maintained.

c) Suitable for small business concerns: Double entry system is very expensive and time consuming because books of accounts are to maintain in a formal way in quite a good number of books of accounts. So, small firms with limited financial transactions prefer single entry system.

d) Time saving: Single entry system is less time consuming because of limited number of books and limited type of transactions are recorded.

3.2.3 Disadvantages of single entry system

The system suffers from certain demerits. Some of those are as follows:

a) **Arithmetical accuracy cannot be checked:** Under double entry system, Trial Balance is prepared to check arithmetical accuracy of books of accounts. Single entry system itself is an incomplete record so it is not possible to prepare trial balance.

b) **True profits cannot be ascertained:** In the absence of complete information for sales, purchases and other expenses, it is not possible to draw a conclusion on the actual operating result of such concern.

c) **Financial position of the business cannot be judged:** In the absence of sufficient figures of profit and adequate information about assets and liabilities of the business, the Balance Sheet cannot reflect true financial position of the business.
d) **Difficulty in planning and decision making:** Since the system doesn't provide accurate details on financial position of the business, it is difficult to take any managerial decision and to make plans for future.

Let us now discuss on the differences between double entry system and single entry system of book keeping:

3.2.3 Difference between double entry and single entry system

The following are the differences between double entry and single entry system:

a) Single entry method of maintaining accounts is an incomplete record of the financial transactions whereas double entry system of accounting is a complete record of financial transactions.
b) In single entry system, only personal accounts are maintained whereas in double entry system in addition to personal account, real and nominal accounts are also maintained.
c) Books maintained by single entry system are not reliable whereas books maintained under double entry system are systematic so reliable.
d) Arithmetical accuracy of recording the transactions cannot be checked under single entry system whereas under double entry system, arithmetical accuracy of the accounting records can be checked by preparing trial balance.

3.3 Profit Determination under Single Entry System

Now let us discuss how the profit determination under single entry system:

The profit or loss in case of single entry system can be computed under two different methods:

a) Net worth method or capital comparison method; and

b) Conversion method

Net worth method/ capital comparison method

According to this method, the profit or loss made by business is computed by comparing the net worth of the business on two different dates. Firstly, Statement of Affairs on two different dates is prepared. Thereafter, to determine the profit/loss position a Statement of Profit/Loss is prepared.

Statement of affairs is a statement showing assets, liabilities and capital of the entity based on records available maintained on the basis of single entry system. Small traders and their firms do not maintain their books of accounts as per double entry system. As such, the number of financial transactions recorded by these firms is limited. However, at the end of the financial year, these firms also want to know the position of the business. For this purpose, statement of affairs is prepared at the beginning and at the end of the period to determine the overall change in the capital during the financial year. To prepare this statement we have to refer some documents available related with purchase of assets and due consideration may be given for depreciation and any addition made to that asset during the current year. Since they maintain records of credit transactions so it is possible to ascertain anything due and receivable from creditors and debtors respectively this can be put in the statement of affairs. After putting the assets and liabilities the capital figure is calculated as a balancing figure of the statement.

As we have learnt the theoretical aspects of single entry system, now let us solve some illustrations to understand the concept better:

Illustration 3.1: Mr. Arun keeps his books under single entry system. His position of assets and liabilities on 1st January, 2019 was:

Cash at bank Rs. 5,000; Cash in hand Rs. 1,000; Stock Rs. 7,000; Sundry debtors Rs. 8,400; Plant & Machinery Rs. 6,500; Bills Receivable Rs. 2,600; Creditors Rs. 2,500; Bills Payable Rs.4,000.

On December 31, 20019, his position was as follows:

Cash at bank Rs. 4,300; Cash in hand Rs. 1,700; Stock Rs. 9,000; Sundry debtors Rs. 6,000; Plant & Machinery Rs. 6,500; Bills Receivable Rs. 3,200; Creditors Rs. 1,600; Bills Payable Rs.3,200. During the year, Mr. Arun introduced further capital of Rs. 2,000 and his drawings were Rs. 800 per month.

Depreciate plant & machinery @ 5% p.a. and create a provision for doubtful debts @5% p.a.

From the above information, prepare a statement showing profit or loss made by Mr. Arun for the year ended on 31st December, 2019.

Solution to Illustration 3.1:

Statement of Affairs of Arun As on 1.1. 2019

Liabilities	Rs.	Assets	Rs.
Capital	24,000	Cash at bank	5,000
(Balancing figure)		Cash in hand	1,000
Creditors	2,500	Bills Receivable	2,600
Bills Payable	4,000	Sundry Debtors	8,400
		Stock	7,000
		Plant & machinery	6,500
	30,500		30,500

Statement of Affairs of Arun As on 31.12.2019

Liabilities	Rs.	Assets		Rs.
Capital	25,275	Cash at bank		4,300
(Balancing figure)		Cash in hand		1,700
Bills Payable	3,200	Bills Receivable		3,200
Creditors	1,600	Debtors	6,000	
		Less: Provision	300	5,700
		Stock		9,000
		Plant & Machinery	6,500	6,175
		Less: Depreciation	325	
				30,075
	30,075			

Statement of Profit of Arun For the year ending 31.12.2019

Particulars	Rs.
Capital as on 31.12.2019	25,275
Add: Drawings made during 2019 (Rs. 800× 12)	9,600
	-34,875
Less: Fresh capital introduced	2,000
Adjusted capital as on 31.12.2019	-32,875
Less: Capital as on 1.1.2019	24,000
Profit made during 2019	8,875

Things to learn from the illustration:

● We know the accounting equation is [Assets - Liabilities=Capital]. So additional capital introduced is deducted from closing capital.

● Drawings represent the amount taken by the owner of the business for his personal use in anticipation of profit. The amount of drawing is added with the capital at the end.

- Since the closing adjusted capital is greater than the opening capital, the entity could earn profit during the year.

Conversion method

Conversion method means converting the accounts from single to double entry. If it is desired to change the system of accounting from single entry to double entry on a given date, the following procedure should be adopted:

●*Preparation of statement of affairs:* The statement of affairs should be prepared on the date on which the shifting from single entry to double entry is to be made.

●*Prepare cash and bank summary:* It should be seen that cash and bank balances shown in the statement of affairs must reconcile with the cash and bank balance as shown by the cash book. Moreover, bank balance as shown by the bank column of the cash book and the pass book are to reconcile if there is any discrepancy is noticed.

●*Prepare total debtors and total creditors account:* Similarly, the amount of debtors and creditors shown in the statement of affairs should agree with the total of debit and credit balance extracted from the individual accounts of debtors and creditors.

●For bringing into books the various assets and liabilities appearing in the statement of affairs, an opening journal entry should be made as follows:

Various Assets A/c –Dr

To Various Liabilities A/c

To Capital A/c (balancing figure)

(Being balances of assets and liabilities brought forward from statement of affairs)

Thereafter, the books can be opened under the double entry. In future, all transactions should be recorded according to the double entry system by maintaining the subsidiary books and then posting the transactions into the ledger accounts in the ledger book.

Now let us solve one numerical problem to have better understanding:

Illustration 3.2 Ranjit commenced business as a cloth merchant on 1.1.2018 with a capital of Rs. 10,000. On the same date, he purchased furniture by paying cash Rs. 3,000. From the following particulars obtained from his books kept under single entry, you are asked to prepare a Trading and Profit & Loss Account for the year ended on 31st December, 2018 and a Balance Sheet as on the same date.

Particulars	Rs.
Sales (inclusive of cash Rs. 7,000)	17,000
Purchases (inclusive of cash Rs. 4,000)	15,000
Ranjit’s drawings	1,200
Salaries to staff	2,000
Bad debts written off	500
Business expenses	700

Ranjit took cloth worth Rs. 500 from the shop for his personal use and paid Rs. 200 to his daughter, but omitted to record these transactions in his books. On 31st December, 2018, his sundry debtors were Rs. 5,200 and sundry creditors Rs. 3,600. Stock in hand on 31st December, 2018 was Rs. 6,500.

Solution to Illustration 3.2:

Trading and Profit & Loss Account of Ranjit

For the year ended on 31st December, 2018

Dr. **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**

To Purchases 15,000 Less: Drawings <u>500</u>	14,500	By Sales	17,000
		By Closing Stock	6,500
Gross Profit c/d	9,000		
	23,500		23,500
To Salaries	2,000	By Gross Profit b/d	9,000
To Bad debts	500		
To Business expenses	700		
To Net Profit	5,800		
	9,000		9,000

Balance Sheet of Ranjit As on 31.12.2018

Liabilities	Rs.	Assets	Rs.
Capital 10,000		Cash Balance	2,800
Less: Drawings <u>1,900</u>		Sundry Debtors	5,200
8,100		Closing Stock	6,500
Add: Net Profit <u>5,800</u>	13,900	Furniture	3,000
Sundry Creditors	3,600		
	17,500		17,500

*Drawings= Rs. 1,200+ Rs. 500+ Rs.200= Rs. 1,900

Working Notes:

1)

Receipts and Payments Account

For the year ending 31.12.2018

Receipts	**Rs.**	**Payments**	**Rs.**
To Capital A/C	10,000	By Furniture	3,000
To Cash Sales	7,000	By Cash Purchase	4,000
To Sundry Debtors	4,300	By Drawings (1200+200)	1,400
(Working Note 2)		By Salaries	2,000
		By Business Expenses	700
		By Sundry Creditors (Working Note 2)	7,400
		By Balance c/d	2,800
	21,300		21,300

2)

Sundry Debtors Account

Dr. **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To credit Sales	10,000	By Cash (Balancing figure)	4,300
		By Bad Debts	500
		By Balance c/d	5,200
	10,000		10,000

3) **Sundry Creditors Account**

Dr. **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To Cash (Balancing figure)	7,400	By Credit Purchases	11,000

To Balance c/d	3,600		
	11,000		11,000

Things to learn from this illustration:

- The money given by Ranjit to his daughter and cloth taken by him from his business is taken as his drawings. The value of cloth taken has been deducted from purchase.
- Figures of cash, debtors and creditors were not directly given. So with the help of preparing concerned accounts in the working notes, we have found the missing figures and by incorporating the figures in the Profit & Loss A/C we have tried to showcase the profit and loss position of the business.
- Unlike net worth method, by following conversion method, we have calculated gross profit, net profit and also found the operating expenses of the business.

3.4 Let Us Sum It Up

The term "single entry" is vaguely used to define the method of maintaining accounts which does not exactly follow the principles of double entry system. It does not mean (as the name goes) that there is one entry for each transaction i.e., only one account is given debit or credit for each transaction. But it simply means that principles of double entry system are not followed under single system. Under this system, only personal accounts are considered for the purpose of generating accounting records whereas real and nominal accounts are ignored under this system.

The profit or loss in case of single entry system can be computed with the help of:

c) Net worth method or capital comparison method

d) Conversion method

3.5 Key Words

Single entry system, Double entry system, Net worth method, Conversion method.

3.6 SAQs

1. Single entry system takes into consideration:

a) Only personal account b) Only nominal account c) Only real account d) All the accounts

2. Statement of Affairs is prepared under:

a) Conversion method b) Net worth method

3.7 Answers of SAQs

1. (a) 2. (b)

3.8 Suggested Readings

Ahmed, N (2008) "Financial Accounting", Atlantic Publishers and Distributors Pvt Ltd, New Delhi,

Maheswari S. N., Sharad (2013) "An Introduction to Accountancy" 11th Edition, Vikas Publishing House New Delhi

3.9 Model Question:

Debasish started business on 1.1.2018 with a capital of Rs. 12,000. On the same date, he purchased machinery by paying cash Rs. 3,000. From the following particulars obtained from his books kept under single entry, you are asked to prepare a Trading and Profit & Loss Account for the year ended on 31st December, 2018 and a Balance Sheet as on the same date.

Particulars	Rs.
Sales (inclusive of cash Rs. 3,000)	14,000
Purchases (inclusive of cash Rs. 2,000)	13,000
Debasish's drawings	1,200

Salaries to staff Bad debts written off Business expenses	1,500 300 700

Debasish spent Rs.500 for his personal use, but omitted to record these transactions in his books. On 31st December, 2018, his sundry debtors were Rs. 5,000 and sundry creditors Rs. 3,600. Stock in hand on 31st December, 2018 was Rs. 6,100.

BLOCK-2: HIRE PURCHASE SYSTEM AND INSTALLMENT ACCOUNTS

Introduction

There are two units in this block. **Unit 1** focuses on basic concepts of hire purchase and installment purchase.

Likewise, **Unit 2** deals with accounting entries in the books of hire purchaser and hire vendor.

Unit 1: Hire Purchase and Installment Account

Structure

1.0 Objectives

1.1 Introduction
1.2 Hire Purchase System
1.3 Installment Purchase System
1.4 Differences between Hire Purchase and Installment Purchase

1.0 Objectives

After going through this unit, you will be able to:

- Understand the concept of hire purchase system.
- Understand the concept of installment purchase system.
- Distinguish between hire purchase and installment purchase system.

1.1 Introduction

This unit focuses on basic understanding of the concepts like hire purchase and installment purchase system. Hire purchase contract is a contract between two parties where one party agrees to buy the asset by not paying the total cost of the asset in full to the seller at a time but he agrees to pay the amount on installment basis over a certain period allowed by seller. The ownership of the asset is retained by the seller till the last installment is paid by the buyer.

Unlike the hire purchase system, where ownership of the asset is retained by the seller till the last installment is paid by the buyer; In case of installment purchase, ownership of the asset is transferred to the buyer straightway after the agreement.

1.2. Hire Purchase System

A hire purchase is a contract where goods are purchased or sold with the stipulations that:

a) The delivery of goods is given by the owner of the goods to the hire purchaser;
b) The payment of the price for the goods to be made in installments;
c) Ownership of the goods passes to the hire purchaser only on payment of all the installments;

d) In the event of hire purchaser's failure to pay any installment, the hire vendor is entitled to seize the goods and adjust the money paid by the hire purchaser against the hire charges for the use of the goods.

In hire purchase contract, there are two parties, i.e., hire vendor means the seller and hire vendee means the buyer. The initial amount paid against the asset by the buyer is termed as initial payment or down payment. Thereafter, installments which are also called as hire charges are paid regularly and preferably along with interest.

For example: a television costing Rs. 15,000 is purchased by A from B under hire purchase contract. A agrees to pay Rs.5, 000 as the initial payment called down payment. He agrees to pay the remaining amount in 3 equal monthly installments plus interest of 5% p.a. So, after paying off all the installments only A can become the owner of the television though he can use the television after taking delivery of the same.

1.3. Installment Purchase System

This system is also termed as deferred installment system. In this system, there is an outright sale of goods with the buyer having the facility to pay the purchase price in certain number of agreed installments. Thus, the installment price includes both the cash price as well as the interest for delayed payment. The possession and legal ownership of the goods passes to the buyer immediately on its delivery.

The following are the essential characteristics of this system:

a) The buyer gets immediate possession and ownership of the goods;
b) The payment of price has to be made by the buyer in agreed installments;
c) In the event of default by the buyer in payment of any installment, the seller can file a suit against the buyer for recovery of unpaid price and damages.

1.4 Differences between the Hire Purchase System and Installment Purchase System

The following are the differences between the two systems:

From Legal View point:

a) **Transfer of ownership:** In case of hire purchase system, the ownership in goods sold passes to the buyer only on payment of the last installment. But in case of installment purchase system, ownership to the buyer is transferred at the time of sale of goods.

b) **Recovery of goods:** In case of hire purchase system, if the buyer fails to pay the last installment, the seller can repossess the goods from the buyer. But in installment purchase system, the seller cannot repossess the goods. He can only sue for recovery of price and damages.

c) **Forfeiture of installments paid**: In case of hire purchase system, in the event of buyer's default in payment, the seller can forfeit all the money paid by the buyer so far, while in case of installment purchase, the money paid by buyer will be taken as part payment made towards the selling price and the seller can only sue for the balance amount.

From Accounting Viewpoint:

a) **Computation of loss of seizure of goods by the vendor:** In case of hire purchase, in the event of seizure of goods by the vendor, due to buyer's default the loss on seizure of goods has to be computed. However, in installment purchase, the vendor cannot seize the goods and henceforth the need for computation of loss on seizure does not arise.

1.5 Let's Sum Up

- Hire purchase contract is a contract between two parties where one party agrees to buy the asset by not paying the total cost of the asset fully to the seller at a time but he agrees to pay the amount on installment basis for a certain period allowed by seller. The ownership of the asset is retained by the seller till the last installment is paid by the buyer.
  - But in installment purchase, the ownership of the asset is transferred straightway after the sales.

1.6 Key Words

Cash Price: It refers to the price at which goods are sold under the contract of sale.

Down Payment/ Cash Down: It refers to the initial amount which is required to be paid by the hire purchaser to the hire vendor against the cash price of the asset.

Hire Vendor: Hire vendor is a person who delivers the goods to the hire purchaser with the intention to sell the goods under hire purchase agreement.

1.7 SAQs

1. Hire Vendor under hire purchase contract is?

a) Buyer of asset b) Seller of asset

2. In hire purchase system, who retains the right of ownership till last installment paid?

a) Vendor b) Vendee

3. In installment system, ownership right is transferred to vendee immediately after sales.

a) True b) False

1.8 Hints/ Answers of SAQs

1. B 2. A 3. A

1.9 Suggested Readings

Harrison Walter T., et al (2009), "Financial Accounting", 8th Edition, Prentice Hall

Ahmed, N (2008) "Financial Accounting", Atlantic Publishers and Distributors Pvt Ltd, New Delhi,

Maheswari S. N., Sharad (2013) "An Introduction to Accountancy" 11th Edition, Vikas Publishing House New Delhi

Jain, S.P & Narang K.L (2014) "Financial Accounting", 2nd Revised Edition, Kalyani Publisher

1.10 Model Questions

1. What is Hire Purchase Contract? Discuss essential characteristics of Hire Purchase System.
2. What is Installment Purchase Contract? Discuss essential characteristics of Installment Purchase Contract.

3. Differentiate between Hire Purchase and Installment Purchase Contract.

Unit 2: Accounting Entries in Hire Purchase System

Structure

2.0 Objectives

After going through this unit, you will be able to:

- Deal with accounting entries in the books of hire vendor.
- Deal with accounting entries in the books of hire vendee.

2.1 Introduction

The previous unit focuses on basic understanding of the concepts like hire purchase and installment purchase system. In this unit, we will try to understand how accounting records are maintained for transactions taking place relating to hire purchase system.

Now, let us discuss and understand the accounting entries of hire purchase in the books of both vendor and vendee:

2.2 Accounting Entries in the books of Hire Purchaser/ Hire Vendee

There are two methods for making accounting entries of the hire purchase transactions in the books of hire purchaser:

a) When asset is recorded at full cash price
b) When asset is recorded at the cash price actually paid.

a) <u>When asset is recorded at full cash price</u>

Here the common notion is that as the hire purchaser has agreed to buy asset so he is considered as the owner of the asset. The following journal entries are recorded in the books of hire purchaser:

i. <u>On the purchase of the asset</u>

Asset A/C -Dr
To Hire vendor A/C
(With full cash price of the asset)

ii. <u>On making cash down payment</u>

Hire vendor - Dr
To Cash/ Bank A/C
(With actual cash down payment)

iii. <u>For interest due</u>

Interest A/C – Dr
To Hire vendor A/C
(Interest is calculated on the outstanding amount when installment becomes due)

iv. <u>On payment of hire purchase installments</u>

Hire vendor A/C – Dr
To Cash/ Bank
(With amount of installment paid)

v. <u>For depreciation of the asset</u>

Depreciation A/C –Dr
To Asset A/C
(At the end of the accounting period)

vi. <u>For transferring of depreciation and interest</u>

Profit and Loss A/c - Dr
To Depreciation A/c
To Interest A/c
(Being depreciation transferred to P/L a/c)

b) When asset is recorded at the cash price actually paid.

Here, it is assumed that the hire purchaser has not become an owner of the asset till he pays the final installment. The following journal entries are recorded:

I. On cash down payment

Asset A/C - Dr
To Cash/ Bank A/C
(With the amount of cash down payment)

II. On hire purchase installment becoming due

Asset A/C - Dr
Interest A/C -Dr
To Hire vendor A/C
(Asset account is debited with the amount of cash price included in each installment. The interest on outstanding cash price is debited to the interest account)

III. On making payment of installment

Hire vendor A/C –Dr
To Cash/ Bank A/C
(With the amount of installment paid)

IV. For depreciation of the asset

Depreciation A/C –Dr
To Asset A/C
(Depreciation is charged on full cash price of the asset)

V. For transferring of depreciation and interest

Profit and Loss A/c -Dr
To Depreciation A/c
To Interest A/c
(Being depreciation and interest transferred to profit and loss account)

2.3 Accounting Entries in the books of Hire Vendor

The following entries are passed in the books of hire vendor:

1) <u>On sale of goods under hire purchase:</u>
   Hire Purchaser A/C - Dr
   To Hire Sales A/C
   (With full cash price)

2) <u>On receiving cash down payment</u>
   Cash/ Bank A/C -Dr
   To Hire Purchaser A/C
   (With the amount of cash down payment)

3) <u>For interest due</u>
   Hire Purchaser A/C – Dr
   To Interest A/C
   (Interest is calculated when installment becomes due)

4) <u>On getting payment of installment</u>
   Cash/ Bank A/C -Dr
   To Hire Purchaser A/C
   (With the amount of installment received)

5) <u>For transferring of interest</u>
   Profit & Loss A/c – Dr
   To Interest A/c
   (Being interest transferred to Profit and Loss A/c)

Let us solve a practical problem to understand it better:

Illustration 2.1: The following are the particulars relating to hire purchase:

Purchaser: Ram & Co. Seller: Shyam & Co. Asset: Machine

Date of Purchase: 1.1.2015

Cash Price: Rs. 12,894

Payments: Rs. 2,000 on signing of agreement and balance in three equal installments of Rs. 4,000 due on 31st December each year.
Rate of interest is 5 %p.a.
Depreciation is 20% p.a. at written down value method.
Make journal entries and prepare necessary ledger accounts in the books of hire purchaser.

Solution to illustration 2.1
Working notes:

1.1.2015 Cash Price	= Rs. 12,894
1.1.2015 Less: Down Payment	= Rs. 2,000
	Rs. 10,894
31.12. 2015 Add: Interest	Rs. 545
	Rs. 11,439
31.12.2015 Less: Installment	Rs. 4,000
1.1.2016 Balance	Rs. 7,439
31.12.2016 Add: Interest	Rs. 372
	Rs 7,811
31.12.2016 Installment	Rs. 4,000
1.1.2017 Balance	Rs. 3,811
31.12.2017 Add: Interest	Rs. 189
	Rs. 4,000
31.12.2017 Installment	Rs. 4,000
1.1.2018 Balance	Nil

Note: [So, we can see that the payment of installment is completed within three years of its purchase]

Calculation of depreciation

1.1.2015 Cost	= Rs.12894
31.12.2015 Depreciation	= Rs. 2578
1.1.2016 Book value	Rs. 10,316
31.12.2016 Depreciation	Rs. 2,063
1.1.2017 Book value	Rs. 8,053
1.1.2017 Depreciation	Rs. 1,611
1.1.2018 Book value	Rs. 6,442

Journal Entries in the books of Ram & Co.

Date	Particulars	L/F	Dr Amount (Rs)	Cr Amount (Rs)
1.1.2015	Machinery A/c - Dr		12,894	
	To Shyam & Co. A/c			12,894
	(Being purchase of machinery on hire purchase)			
31.12.2015	Shyam & Co. A/c – Dr		2,000	
	To Cash A/c			2,000
	(Being down payment made)			
31.12.2015	Interest A/c – Dr		545	
	To Shyam & Co. A/c			545
	(Being interest credited to vendor)			
31.12.2015	Shyam & Co. A/c – Dr		4,000	
	To Cash A/c			4,000
	(Being installment paid)			
31.12.2015	Depreciation A/c - Dr		2,579	
	To Machinery A/c			2,579
	(Being depreciation charged on machinery)			

31.12.2015	Profit and Loss A/c – Dr To Interest A/c To Depreciation A/c (Being balance of interest and depreciation transferred to Profit and loss account)		3,124	 545 2,579
31.12.2016	Interest A/c – Dr To Shyam & Co. A/c (Being interest credited to vendor)		372	 372
31.12.2016	Shyam & Co. A/c – Dr To Cash A/c (Being installment paid)		4,000	 4,000
31.12.2016	Depreciation A/c - Dr To Machinery A/c (Being depreciation charged on machinery)		2,063	 2,063
31.12.2016	Profit and Loss A/c – Dr To Interest A/c To Depreciation A/c (Being balance of interest and depreciation transferred to Profit and loss account)		2,435	 372 2,063

31.12.2017	Interest A/c – Dr To Shyam & Co. A/c (Being interest credited to vendor)		189	 189
31.12.2017	Shyam & Co. A/c – Dr To Cash A/c (Being installment paid)		4,000	 4,000
31.12.2017	Depreciation A/c - Dr To Machinery A/c (Being depreciation charged on machinery)		1,650	 1,650
31.12.2017	Profit and Loss A/c – Dr To Interest A/c To Depreciation A/c (Being balance of interest and depreciation transferred to Profit and loss account)		1,839	 189 1,650

In the books of Ram & Co.
Machinery A/c

Dr. **Cr**

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
1.1.15	To Shyam & Co		12,894	31.12.15	By Depreciation A/c		2,579
				31.12.15	By Balance c/d		10,315
			12,894				12,894
1.1.16	To Balance b/d		10,315	31.12.16	By Depreciation A/c		2,063
					By Balance c/d		8,252
			10,315				10,315
1.1.17	To Balance b/d		8,252	31.12.17	By Depreciation A/c		1,650
					By Balance c/d		6,602
			8,252				8,252
1.1.18	To Balance b/d		6,602				

In the books of Ram & Co.

Depreciation A/c

Dr. **Cr**

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
31.12.15	To Machinery A/c		2,579	31.12.15	By P/L A/c		2,579
			2,579				2,579
31.12.16	To Machinery A/c		2,063	31.12.16	By P/L A/c		2,063
			2,063				2,063

31.12.17	To Machinery A/c		1,650	31.12.17	By P/L A/c		1,650
			1,650				1,650

In the books of Ram & Co.

Shyam & Co. A/c

Dr. **Cr**

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
1.1.15	To cash A/c		2,000	1.1.15	By Machinery A/c		12,894
31.12.15	To Cash A/c		4,000				
31.12.15	To Balance c/d		7,439	31.12.15	By Interest A/c		545
			13,439				13,439
31.12.16	To Cash A/c		4,000	31.12.16	By Balance b/d		7,439
31.12.16	To Balance c/d		3,811	31.12.16	By Interest A/c		372
			7,811				7,811
31.12.17	To Cash A/c		4,000	31.12.17	By Balance b/d		3,811
					By Interest		189
			4,000				4,000

In the books of Ram & Co.

Interest A/c

Dr. **Cr**

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
31.12.15	To Shyam & Co. A/c		545	31.12.15	By P/L A/c		545
			545				545
31.12.16			372	31.12.16	By P/L A/c		372

	To Shyam & Co. A/c		372				372
31.12.17			189	31.12.17	By P/L A/c		189
	To Shyam & Co. A/c		189				189

2.10 Let's Sum Up

There are two methods for making accounting entries of the hire purchase transactions in the books of hire purchaser:

a) When asset is recorded at full cash price;

b) When asset is recorded at the cash price actually paid

The hire vendor takes the sale of goods on hire purchase as ordinary sale.

2.11 Key Words

Hire Purchaser, Hire Vendor, Installment, Cash Down, Cash Price

2.12 SAQs

1. Depreciation is charged by hire vendor:

   a) Yes b) No

2.13 Hints/ Answers of SAQs

1. B)

2.14 Suggested Readings

Harrison Walter T., et al (2009), "Financial Accounting", 8th Edition, Prentice Hall

Ahmed, N (2008) "Financial Accounting", Atlantic Publishers and Distributors Pvt Ltd, New Delhi,

Maheswari S. N., Sharad (2013) "An Introduction to Accountancy" 11th Edition, Vikas Publishing House New Delhi

Jain, S.P & Narang K.L (2014) "Financial Accounting", 2nd Revised Edition, Kalyani Publisher

2.9 Model Question

1. The following are the particulars relating to hire purchase:

Purchaser: Hari & Co. Seller: Varun & Co. Asset: Air Conditioner
Date of Purchase: 1.1.2016
Cash Price: Rs. 25,000
Payments: Rs. 10,000 on signing of agreement and balance in three equal installments of Rs. 5,000 due on 31st December each year.
Depreciation is 10% p.a. at written down value method.
Make journal entries and prepare necessary ledger accounts in the books of hire purchaser.

2. The following are the particulars relating to hire purchase:

Purchaser: Krishna & Co. Seller: Harish & Co. Asset: Refrigerator
Date of Purchase: 1.1.2016
Cash Price: Rs. 15,000
Payments: Rs. 3,000 on signing of agreement and balance in three equal installments of Rs. 4,000 plus interest due on 31st December each year.
Interest charged: 5 % p.a.
Depreciation is 10% p.a. at written down value method.
Make journal entries and prepare necessary ledger accounts in the books of hire purchaser.

BLOCK- 3: PARTNERSHIP ACCOUNTS

Introduction

There are two units in this block. Unit 1 deals with admission, retirement and death of partners.

Unit 2 deals with dissolution of firm and insolvency of partners.

While going through the units you will get Self Assessment Questions. At the end of every unit, suggested readings are given. So, you can refer to these books in case you require deeper and better understanding of related concepts.

Unit 1: Problems Relating to Admission, Retirement of Partners

Structure

1.0 Objectives

After going through this unit, you will be able to:

- Understand the accounting entries to be given on admission of a new partner.

- Understand the accounting entries to be given on retirement of an existing partner.
- Understand the accounting entries to be given on death of an existing partner.

1.1 Introduction

The Indian Partnership Act, 1932, defines "Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."

The document which contains the terms and conditions regarding the conduct of partnership business, is called as Partnership Deed.

The following are the important clauses that are to be incorporated in a partnership deed:

1. The name of the firm.
2. The nature of the business which the firm is supposed to do.
3. The amount of capital and in what way this capital will be contributed by each partner.
4. The proportion in which the partner will share profit and losses.
5. The amount of drawings which a partner can draw from the firm.
6. Whether interest on capital and interest on drawings will be allowed? If so, then what will be the rate of interest on capital and interest on drawings?
7. What will be the authority of each partner? Will some restrictions be imposed on the duties of the partners?
8. What will be the duration of the firm? Whether the firm will be dissolved at will or will continue for a fixed period or till the happening of a particular event or on the completion of a particular venture?
9. How the amount of the goodwill of the firm will be ascertained at the time of change in profit sharing ratio, admission, retirement or death of a partner?
10. Will some salary or remuneration or commission be allowed to any of the partners?
11. How the annual accounts of the firm will be prepared? Will the accounts be audited by an independent Chartered Accountant? How the auditor will be appointed?

12. In case of retirement or death of a partner, how the amount required to be paid to the partner or his legal representative will be ascertained? If the partners have taken joint life policy or individual policies, the premium of which is being charged to the Profit and Loss Account and on the death of a partner, how the amount received from the insurance company and their surrender value will be distributed among the partners.
13. If a partner has given any amount of the loan besides his capital, will interest be allowed to him? If so, what will be the rate?
14. In case a partner becomes insolvent, how the accounts of the firm will be settled? Will the rule Garner vs Murray be applicable in this case?
15. The circumstances in which the firm will be dissolved and the manner in which the accounts will be settled in case of dissolution of a firm.
16. In case some dispute arises among the partners, how will it be settled? Will it be referred to some arbitrator?
17. Any other clause on which the partners may agree at the time of settlement.

    The following rules are applicable in the absence of a partnership deed:

    1. The profits or losses of the firm will be shared equally by the partners.
    2. Interest on capital will not be allowed to any partner. If agreed the interest will be allowed only out of profits of the firm. Similarly, no interest will be charged on drawings of the partners unless agreed upon.
    3. If any partner has given a loan to the firm besides his share of capital, he will be allowed 6% interest on such loan.
    4. No salary or remuneration will be allowed to any of the partners.
    5. Every partner can take part in the management of the partnership business.
    6. No person can be admitted without the consent of all the existing partners.
    7. The partnership books are to be kept at the place of the partnership business and every partner must have access to and inspect and copy any of them.

1.2 Treatment Related to Admission of A New Partner

Whenever a partner is admitted into partnership firm, the new partner contributes capital into the business; so he acquires two rights.

Rights of a new partner

↙ ↘

Right to share In the assets of partnership

Right to share in the Profits of the partnership

The following are the main points which usually require attention at the time of admission of a partner:

- Calculation of new profit sharing ratio
- Revaluation of assets and liabilities
- Treatment of goodwill
- Adjustment of undistributed profits and losses
- Adjustment of capitals in order to bring these in proportion to profit sharing ratio or as agreed upon.

  All these are discussed in details.

1.2.1 <u>Calculation of new profit sharing ratio</u>

The calculation of new profit sharing ratio depends on the agreement between the old partners and the new partner but the following cases may arise while calculating the profit sharing ratio.

1) If the new partner's share is given and nothing else is mentioned in the question, then it is presumed that the remaining partners will share the rest of the profits in the old ratio.
   For example, A and B are partners sharing profits and losses in proportion of 2:1. They admit a new partner C whom they give $1/6^{th}$ share in profits. The new profit sharing ratio will be:
   Suppose the total share is 1
   The new partner C takes 1/6 of 1
   Share of profit left for other partners = 1-1/6= 5/6

A's new share= 5/6×2/3= 10/18

B's new share= 5/6×1/3= 5/18

So, New profit sharing ratio of A:B:C= $\frac{10}{18} : \frac{5}{18} : \frac{3}{18}$

= 10 : 5: 3

2) The new partner, in some cases, purchases his share of profit from the existing partners in a particular ratio. New profit sharing ratio of the existing partners is calculated by deducting the proportion given to the new partner from the shares of existing partners.

For example, A & B are partners sharing profits and losses in the proportion of 7:5. They agree to admit C into partnership who is to get 1/6th share in profits. He acquires this share as 1/24 from A and 1/8 from B. New profit sharing ratio will be calculated as:

The new partner C acquires 1/6th share in profits.

He takes 1/24 from A; 1/8 from B

A's new share = 7/12- 1/24= 13/24

B's new share = 5/12- 1/8 = 7/24

So, A, B, C's new share of profit = 13/24: 7/24: 1/6 (or we can say 4/24) = 13: 7: 4

Sacrificing Ratio

When a new partner is admitted, the existing partner/s sacrifices a fraction of his share in favor of the new partner. It is calculated as:

Sacrificing Ratio = Old Ratio – New Ratio

Say for instance, two partners i.e., A and B shared profits 4/7th and 3/7th respectively. So their old ratio was 4:3 respectively. When a new partner is admitted, their new ratio becomes 2:2:3. In this case the sacrifice ratio of the existing partners will be:

A's sacrifice = 4/7- 2/7= 2/7

B's sacrifice = 3/7 – 2/7= 1/7

So, sacrificing ratio = 2:1

1.2.2 Revaluation of Assets and Liabilities

It is in the interest of all partners the revaluation of assets and liabilities is done at the time of admission of a partner. When a new partner is admitted into the business, it is natural that he should not be benefitted from any appreciation in the value of assets which has taken place nor he should suffer because of any depreciation in the value of assets. Same is the case with liabilities. Therefore, assets and liabilities are revalued at the time of admission of a partner. The changes in the value of assets and liabilities are recorded in revaluation account (also known as profit and loss adjustment account); whatever profit or loss arises from such revaluation is to be credited or debited to the existing partners' capital accounts in their old profit sharing ratio. The following journal entries are passed in the books of the firm when values are to be altered in the books:

1) For any increase in the value of an asset
   Asset A/c - Dr
   To Revaluation A/c

2) For any decrease in the value of an asset
   Revaluation A/c -Dr
   To Asset A/c

3) For any increase in the value of liabilities
   Revaluation A/c -Dr
   To Liabilities A/c

4) For any decrease in the value of liabilities
   Liabilities A/c - Dr
   To Revaluation A/c

5) For profit on revaluation
   Revaluation A/c -Dr
   To Old Partners' Capital A/c

6) For any loss on revaluation
   Old Partners' Capital A/c -Dr
   To Revaluation A/c

An illustration on revaluation of assets and liabilities is given so that you can understand the treatment very easily.

Illustration 1.1 A and B are partners sharing profits in equal proportion. The following is Balance Sheet of the firm as on 31st December, 2018

Liabilities	Rs.	Assets	Rs.
A's capital 50,000 B's capital 50,000 Creditors	1,00,000 40,000 1,40,000	Cash Bank Debtors Furniture Building	10,000 10,000 10,000 10,000 1,00,000 1,40,000

Before C joins the firm as partner, it was found that value of furniture and building was raised to Rs 11,000 and Rs. 1, 10,000 respectively. Value of creditors was devalued at Rs. 35,000. Pass journal entries related to revaluation.

Solution to Illustration 1.1

Journal Entries

Date	Particulars	L/F	Amount (Rs.)	Amount (Rs.)
	Furniture A/C - Dr Building A/c - Dr To Revaluation A/C (Being value of assets increased)		1,000 10,000	 11,000
	Creditor A/C – Dr To Revaluation A/c (Being value of creditor decreased)		5,000	 5,000
	Revaluation A/c – Dr To A's capital A/c To B's capital A/c		16,000	 8,000 8,000

	(Being profit on revaluation distributed between partners)			

Things that we learnt from illustration:

Increase in value of assets is a gain on revaluation so as decrease in the value of liabilities is also a gain. So, the total profit on revaluation arrived at Rs. 16,000 which is distributed between two old partners in their old profit sharing ratio. Since there is no mention about the profit sharing ratio it implies that the partners share profit/losses equally.

1.2.3 Treatment of goodwill

When a new partner admits into partnership, he is likely to contribute certain amount as goodwill amount along with capital. Goodwill is the value of the reputation of a firm in respect of profits expected in future over and above the normal rate of profits. The existing partners with their endeavor made the partnership firm successful and they expect to get more profits than normal which is otherwise called as goodwill. But when a new partner admits into partnership, the existing partners sacrifice their profit sharing ratio. So when the new partner enters into partnership firm, he agrees to pay the premium for goodwill along with capital.

1.2.4 ***Methods of valuation of goodwill***

1) Average Profit Method for valuing goodwill

Under this method, average profit of past few years is multiplied by number of years in which the anticipated profit is available. The formula for average profit method is:

$$\text{Goodwill under Average Profit Method} = \frac{\text{Total profits}}{\text{No. of years}} \times \text{No. of years of purchase}$$

$$= \text{Average profit} \times \text{No. of years of purchase}$$

2) Super Profit Method for valuing goodwill

The super profit is the amount of excess profit earned by an entity over and above the normal rate of return earned by an entity of similar kind and nature or the normal market rate of return can also be considered as normal rate of profit. Therefore, the supper profit= Actual profit of the entity-Normal profit on the investment. To get the value of goodwill under this method, the super profit is multiplied by certain years of purchase. The formula for super profit is:

Super Profit = Actual Profit- Normal Profit
And, Normal Profit= Investment × Normal Rate of Profit.

Goodwill under Super profit Method=Super profit x certain years of purchase

3. Capitalization Method

Under this method, the average profits are capitalized taking into consideration the general expected rate of return in the same industry. The value of goodwill under the capitalization method is:

Goodwill under Capitalization Method= (Actual Profits× Capitalized Rate) – Net Assets

Need for valuing goodwill

1) When profit sharing ratio is changed
2) When a new partner is admitted
3) When a partner dies or retires
4) Who two or more firms are amalgamated
5) When a firm's business is dissolved or sold to a company.

1.2.5 Journal Entries Related to Goodwill on the Admission of New Partner under different situations:

1) *When the amount of goodwill is paid privately*.
   [No journal entry is passed.]

2) *When the goodwill is received in cash and retained in the business:*

Cash A/c -Dr
To Premium for goodwill A/c

(Being cash brought in credited to new partners capital account)

Premium for goodwill A/c –Dr
To Old Partners' Capital A/c (in sacrificing ratio)

Alternatively, by combining both these entries, the entry will be:
Cash A/c - Dr.
To Old Partners' Capital A/Cs (in sacrificing ratio)

3) *When the amount of goodwill is received in cash and withdrawn by old partners:*

Cash A/c -Dr
To Premium for goodwill A/c
(Being cash brought in credited to new partners capital account)

Premium for goodwill A/c –Dr
To Old Partners' Capital A/c (in sacrificing ratio)

Alternatively, by combining both the entries, we can pass the entry:

Cash A/c – Dr
To Old Partners' Capital A/Cs (in sacrificing ratio)

For withdrawal of the amount of goodwill by the existing partners, the entry will be:

Old Partners' Capital A/c – Dr (in sacrificing ratio)
To Cash A/c

4) *When goodwill is raised at full value:*
Goodwill A/c - Dr (in old profit sharing ratio)
To Old Partners' Capital A/c

5) *When the goodwill is already appearing in the books:*

a) In case goodwill is overstated in the books, then goodwill is to be written back by debiting the old partners' capital accounts in the old profit sharing ratio and goodwill account is credited.
b) In case goodwill is understated in the books, then by crediting the old partners' capital accounts in the old profit sharing ratio and goodwill account is debited.

6) Sometimes new partner is unable to bring cash equal to his share and goodwill is also appearing in the Balance Sheet. In this case, first of all write off the amount of goodwill shown in the books debiting the old partners' capital account. The cash brought by new partner for goodwill may be credited to his capital account. Then raise the goodwill account with full value on the basis of new partner by giving corresponding credit to the capital accounts of the old partners in the old profit sharing ratio. This amount of goodwill will be written off in the new profit sharing ratio by giving corresponding debit to the capital accounts of all partners in their new profit sharing ratio. Journal entries are as under:

Old Partners' Capital A/c -Dr
To Goodwill A/c
(Being goodwill written off from the books)

Cash A/c - Dr
To New Partner's Capital A/c
(Being cash brought in by new partner out of his share of goodwill)

Goodwill A/c - Dr
To Old Partners' Capital A/c
(Being raise of goodwill with full value)

All Partners' Capital A/c -Dr (in new profit sharing ratio)
To Goodwill A/c
(Being goodwill written off in new profit sharing ratio)

7) *When goodwill is hidden:*

In case goodwill is not clearly mentioned then amount is calculated using any of the methods of goodwill valuation. Journal entries will be similar.

An illustration will make you understand how to make journal entries on account of goodwill.

Illustration 1.2 Give journal entries to record the following arrangements in the books of the firm.

a) A & B are partners sharing profits in the ratio of 3:2. C is admitted paying of Rs. 2000 as premium for goodwill for 1/4th share of the profits; shares of A & B remaining as before. No goodwill account appears in the books.
b) A &B are partners sharing profits in the ratio of 3:2. Goodwill appears in the books at Rs. 3000. C is admitted into partnership on payment of Rs. 2000 for 1/4th share as premium for goodwill. A & B between themselves sharing future profits and losses equally.
c) A, B & C are partners sharing profits in the ratio of 3:1:1. The goodwill does not appear in the books but it is worth Rs. 3000. The partners will share profits in future equally.

Solution to illustration 1.2

Journal Entries

Date	Particulars	L/F	Amount (Rs.)	Amount (Rs.)
a)	Cash A/c - Dr To Premium for goodwill A/c (Being the amount of goodwill brought in by new partner)		2,000	 1,200 800
	Premium for goodwill A/c –Dr To A’s Capital A/c To B’s Capital A/c (Being amount of goodwill distributed between the existing partners in the sacrificing ratio)		2,000	 1,200 800

b)	A's Capital A/c - Dr B's Capital A/c -Dr To Goodwill A/c (Being existing goodwill written off)		1,800 1,200	3,000
	Cash A/c - Dr To A's Capital A/c To B's Capital A/c (Being the amount of goodwill credited to old partners in sacrificing ratio)		2,000	1,800 200
c)	Goodwill A/c -Dr To A's Capital A/c To B's Capital A/c C's Capital A/c (Being the goodwill raised in the books and credited to capital accounts in old profit sharing ratio)		3,000	1,800 600 600
	A's Capital A/c - Dr B's Capital A/c - Dr C's Capital A/c - Dr To Goodwill A/c (Being goodwill written off in their new profit sharing ratio)		1,000 1,000 1,000	3,000

Things that we learnt from illustration 1.2

Sacrificing ratio is the difference between new ratio and old ratio and we have seen goodwill is distributed between old partners in the sacrificing ratio.

1.2.6 Adjustment of Undistributed Profits and Losses

If some undistributed profits appear in the name of general reserve or profit and loss account (credit balance), these should be divided among old partners in the old profit sharing ratio by passing following journal entry:

General Reserve or Profit & Loss A/c - Dr
To Old Partners' Capital A/c

Similarly, if profit and loss account (debit balance) is appearing on the assets side of balance sheet, it should be closed by transferring the same to old partners' capital accounts in their old profit sharing ratio by passing following journal entries:

Old Partners' Capital A/c -Dr
To Profit & Loss A/c

1.3 Accounting Treatment Related to Retirement of Existing Partners

The only difference between admission and retirement of a partner is that in case of the former, the new partner joins the firm whereas in case of retirement, a partner leaves the firm because of certain reasons as old age, ill health, etc.

The main points which require attention in case of retirement of a partner are:

a) Treatment of goodwill
b) Revaluation of assets and liabilities
c) Calculation of gaining ratio
d) Treatment of undistributed profits or losses
e) Calculation of total amount due to the retiring partner
f) Adjustment of capitals after retirement in order to be proportionate to the new profit sharing ratio
g) Settlement of total amount due to the retiring partner

These above points are discussed in details.

1.3.1 Treatment of goodwill

We have learnt the treatment of goodwill when a new partner is admitted. The following cases are adopted for goodwill when a partner retires:

1) *When the goodwill is raised in the firm's books at full value:*
   Goodwill A/c -Dr
   To All Partners' Capital A/c

2) *When the goodwill is raised in the books but is written off:*

   a) *For raising of goodwill*

   Goodwill A/c - Dr

   To all Partners' Capital A/c

   b) *For writing off the goodwill*

Remaining Partners' Capital A/c - Dr (in new profit sharing ratio)

To Goodwill A/c

3) *When the goodwill account is raised only for the share of the retiring partner in the books and then written off in the gaining ratio:*

   a) *When goodwill is raised*

   Goodwill A/c -Dr

   To Retiring Partners' Capital A/c

   b) *When goodwill is written off:*

   Remaining Partners' Capital A/c - Dr (in gaining ratio)

   To Goodwill A/c

1.3.2 Revaluation of Assets and Liabilities

Revaluation of assets and liabilities is done on the same basis as it is done in case of admission of a partner. The only difference is that profit or loss on revaluation is to be divided among all the partners including the retiring partners in the profit sharing ratio in case of retirement of a partner.

1.3.3 Calculation of Gaining Ratio

This ratio is calculated when a partner retires from the firm. If new ratio of the continuing partners is not given in the question, it is presumed that the remaining partners will continue to share in the old ratio existed between them prior to retirement of a partner, i.e., they gain in the old ratio. If the new profit sharing ratio of the partners is given in the question, the gaining ratio can be calculated by deducting the old ratio from the new ones. This ratio is very important as it helps to determine the amount of compensation to be paid by each of the remaining partners in the firm to the retiring partners.

1.3.4 Treatment of Undistributed Profits or Losses

General reserve or credit balance of profit and loss account is to be distributed by crediting all partners' capital accounts in their profit sharing ratio and will not be shown on the liabilities side of the Balance Sheet. Alternatively, only retiring partners' share of these items may be credited to his capital account and residual amount of such accounts may be shown on the liabilities side of the Balance Sheet after retirement. Reverse treatment will be given if there is debit balance of profit and loss account on the assets side of the Balance Sheet.

1.3.5 Calculation of Total Amount Due to a Retiring Partner

The total amount due to a retiring partner may include: 1) Capital on the date of last Balance Sheet; 2) Interest or salary if any payable to him; 3) Share of profit or loss to the date of retirement. 4) Share in the goodwill of the firm 5) Share in the general reserve or profit and loss account appearing in the Balance Sheet and 6) Share of profit/loss on revaluation of assets and liabilities. Total amount calculated may be transferred to the retiring partners' loan account to be paid over certain number of installments or it may be paid immediately. The entry will be:

Retiring Partners' Capital A/c – Dr
To Retiring Partners' Loan A/c
or To Cash/ Bank A/c (if paid immediately)

1.3.6 Adjustment of Capitals after Retirement in order to make the partners' capital Proportionate the Profit Sharing Ratio

Sometimes after the retirement of a partner, the continuing partners decide to have a certain sum as to be the capital of the firm and that too should be in their new profit sharing ratio. From the total amount of the capital, the capital required by each partner is calculated with reference to his profit sharing ratio and compared with the existing balance in the capital account after making all adjustments. If the balance of capital of any partner shown surplus than what it should have, the amount will be withdrawn by the partner concerned and if the balance is less than the required amount of his share of capital, he will have to bring the difference of amount in cash in firm's books.

1.3.7 Settlement of the Total Amount Due to the Retiring Partner

Retiring partner may demand immediate payment of the balance due to him at the time of retirement but the financial resources of the firm may not permit the firm to pay entire amount due to the retiring partner in one installment. In that situation an agreed amount may be paid immediately and rest may be treated as retiring partner's loan to the firm carrying a certain rate of interest. Partners' loan account will be continuously shown on the liabilities side of the Balance Sheet till all the outstanding amount of loan is paid by the firm to the retiring partner.

1.4Treatment Related to Death of Existing Partners

The problems which arise in case of death of a partner are similar to those of a retiring partner except that the death of a partner may occur at any time whereas the retirement of a partner may be planned, i.e., partner is allowed to retire on the last date of the accounting period. On death of the partner the firm become liable to pay entire amount standing to his favour to the legal heir of the deceased. Such amount payable on death may be the aggregate of many things as stated below. The deceased partner's capital account is credited with the balance of capital at the beginning of the year, interest on capital, share of profit on revaluation of assets and liabilities, share of undistributed profits, share of profit to the date of death, his share of goodwill and the amount which is received from Life Insurance Corporation of India (or surrender value in case of individual policies). The deceased partner's capital account is debited with drawings to the date of death, interest on drawing and anything recoverable from the deceased partner and the final balance in his capital account is transferred to the executor's account of the deceased partner.
Moreover, u/s 37 of the Partnership Act, the executors of the deceased partner would be entitled at their discretion either interest at 6% p.a. on the amount due from the date of death to the date of actual payment or to that portion of the profit that is earned by the firm with the amount due to the deceased partner. Most of the points have already been discussed in the retirement of a partner but the following two points require special attention:

a) Calculation of deceased partner's share of profit
b) Treatment of life insurance policy

These have been discussed in details:

a) <u>Calculation of Deceased Partner's Share of Profit</u>

The deceased partner's share of profit is to be determined either on the basis of time or turnover.

1) *<u>On the basis of time:</u>* In this case, it is assumed that profit during the previous year has been earned uniformly in all months during

the year, provided previous year is taken as base for calculation of profit. Sometimes average profits of the past three or four years are taken as base rather than the previous year. Whatever base may be taken, it is to be multiplied by the period for which the deceased partner remained in the firm and also by his profit sharing ratio at the time of his death. An illustration is shown in this respect.

Illustration 1.3 A, B and C are partners in a firm sharing profits and losses in the ratio of 3:2:1. B dies on 14th March, 2020. The average profit of the last three calendar years is Rs. 30,000. Calculate B's share of profit on the basis of time. The firm is following the English calendar year.

Solution to Illustration 1.3

Average yearly profit = Rs. 30,000

Profit for 73 days (January 1 to March 14, 2020) = $\frac{\text{Rs. } 30{,}000 \times 73}{365}$ = Rs. 6,000

So, B's share = 2/6 × Rs. 6,000= Rs. 2,000

2) *On the basis of turnover:* In this method, the average past profit is divided into two portions, i.e., before the death and after the death on the basis of ratio of turnover to the date of death to average turnover and deceased partner's share is calculated and credited to his capital account. Again an illustration is shown to make the point understandable.

Illustration 1.4 A, B and C are partners in a firm sharing profits and losses in the ratio of 3:2:1. B dies on 14th March, 2020. Turnover from 1st January to 14th March, 2020 is Rs. 42,000. Average turnover of the last three years is Rs. 60,000 and profit is Rs. 30,000. Calculate B's share of profit on the basis of turnover. The firm is following the English calendar year.

Solution to Illustration 1.4

Average turnover = Rs 60,000

Sales to the date of death = Rs 42,000

Profit to the date of death = Rs 42,000×$\frac{30{,}000}{60{,}000}$

= Rs 21,000

B’s share of profit = 1/3 × Rs 21,000 = Rs 7,000

b) <u>Treatment of Joint Life Policy</u>

There are three methods of dealing with joint life policy:

1) <u>When the premiums are written off to profit and loss account</u>

2 *When insurance premium is paid*

Insurance Premium A/c - Dr
To Bank A/c

3 *When charged to profit and loss account*

Profit and Loss A/c - Dr
To Insurance Premium A/c

4 *When the amount is received on the death of a partner*

Bank A/c - Dr
To Joint Life Policy A/c

5 *When the amount received is distributed among partners in their profit sharing ratio*

Joint Life Policy A/c -Dr
To Partners’ Capital A/c

2) <u>When premiums are to be written off through joint life policy reserve account.</u>

6 *When premium is paid*

Joint Life Policy A/c - Dr
To Bank A/c

7 *When a reserve equal to premium paid is created out of profit and loss*

Profit and Loss A/c - Dr
To Joint Life Policy Reserve A/c

8 *When excess of joint policy over surrender value is written off to joint life policy reserve account*

Joint Life Policy Reserve A/c - Dr
To Joint Life Policy A/c

9 *When the amount of joint policy is received*

Bank A/c -Dr
To Joint Life Policy A/c

10 *When the balance of joint policy reserve account is transferred to joint policy account*

Joint Policy Reserve A/c - Dr
To Joint Policy A/c

11 *When balance of joint policy is distributed among the partners*

Joint Life Policy A/c -Dr
To Partners' Capital A/c

3) When surrender value is to be treated as an asset

Under this case, the amount of premium paid is debited to Joint Life Policy Account which is reduced to its surrender value by appropriate debit to the profit and loss account. The balance in joint life policy will be shown as an asset in the Balance Sheet. The amount received on the death of a partner on account of joint life policy from the insurance company is credited to joint life policy account and the balance standing in joint life policy account after the receipt of the amount of the policy is closed by transferring it to Capital Accounts of all partners in their profit sharing ratio. The journal entry for closing the balance of joint life policy account is:

Joint Life Policy A/c - Dr
To Partners' Capital A/c

1.5 Let Us Sum It Up

Whenever in a partnership firm, a new partner enters or an existing partner dies or retires, then it brings changes in profit sharing ratio. Alongside that certain other ratios do emerge like sacrificing ratio in case of admission of a partner or gaining ratio in case of retirement. These are the important critical areas which need to be taken care of in dealing with the accounting treatment for change in the partnership for various reasons.

1.6 Keywords

Profit sharing ratio, gaining ratio, sacrificing ratio, goodwill

1.7 SAQ

1. A & B are partners sharing profits and losses in the proportion of 7:5. They agree to admit C into partnership who is to get $1/6^{th}$ share in profits. He acquires this share as 1/24 from A and 1/8 from B. Calculate new profit sharing ratio.
2. When value of asset increases, revaluation account is credited and asset is debited.

   A. True B. False

1.8 Answer of SAQ

1) 13:7:4 2) True

1.9 Suggested Readings

Jain, S.P & Narang K.L (2014) "Financial Accounting", 2nd Revised Edition, Kalyani Publisher

1.10 Model Questions

Pass journal entries of the following:

a) A & B are partners sharing profits in the ratio of 3:2. C is admitted paying of Rs. 2000 for $1/4^{th}$ share of the profits; shares of A & B remaining as before. No goodwill account appears in the books.
b) A &B are partners sharing profits in the ratio of 3:2. Goodwill appears in the books at Rs. 3000. C is admitted into partnership on payment of

Rs. 2000 as premium for goodwill for 1/4th share. A & B between themselves sharing future profits and losses equally.

c) A, B & C are partners sharing profits in the ratio of 3:1:1. The goodwill does not appear in the books but it is worth Rs. 3000. The partners will share profits in future equally.

Unit 1: Dissolution of Partnership and Insolvency of Partners

Structure

1.0 Objectives

In this unit we will be able to:

- Understand the dissolution partnership and its accounting treatment.
- Understand the insolvency of partners and its accounting treatment.

1.1Introduction

In the previous unit, we have learned about accounting treatment in case of admission, retirement and death of partners. In this unit, concepts on dissolution of partnership and insolvency of partners have been discussed.

1.2 Dissolution of Partnership

The Indian Partnership Act, 1932 recognizes the difference between the 'dissolution of partnership and dissolution of partnership firm'. The definitions of the two terms are as follows:

Under section 39 of the Indian Partnership Act, 1932, "The dissolution of partnership between all the partners of a firm is called the dissolution of the firm." Thus the dissolution of a firm is the complete breakdown of a partnership and partners do not continue the firm. On the other hand, dissolution of the partnership means a reconstitution of the firm due to the retirement of a partner or the insolvency of a partner or the death of a partner and the remaining partners provide for the continuation of the firm in pursuance of an express or implied agreement to that effect. On dissolution of a firm, the firm's assets are realized and liabilities are discharged because the firm is to be closed, whereas on dissolution of a partnership, the share of the outgoing partner is ascertained and the firm is not closed.

1.3.1 Modes of Dissolution of Firm

Section 40 to 44 of the Indian Partnership Act, 1932 deal with the various ways in which a firm may be dissolved. A firm may be dissolved in any of the following ways:

Dissolution by agreement: A firm is dissolved when all the partners agree that it should be dissolved. A partnership firm is the creation of an agreement of an understanding; similarly a firm can be dissolved by an agreement.

Dissolution on the happening of contingency: A firm is dissolved in any of the following ways unless there is a contract between the partners to the contract-

a) By the expiry of the term or duration of the firm
b) On the completion of the adventure for which the firm was constituted.
c) On the death of a partner
d) By adjudicating a partner as insolvent.

Dissolution by notice of partnership at will: When the partnership is at will, the firm may be dissolved at any time by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.

Compulsory dissolution or dissolution by the operation of law: A firm is compulsorily dissolved in any of the following situations:

a) When all the partners except one become insolvent
b) When all the partners become insolvent
c) When the business becomes illegal
d) Where the number of partners exceed twenty in case of ordinary business or ten in case of banking business.

Dissolution by the court: at the suit of a partner, a court may order dissolution of a firm in any of the following ways:

a) When a partner becomes of unsound mind
b) When a partner suffers from permanent incapacity and becomes incapable of performing his duties as a partner.
c) When a partner is guilty of misconduct affecting the business of the firm
d) When the business of the firm cannot be carried on except at a loss.

1.2.2 Entries on Dissolution

A firm is totally closed down on its dissolution, so books of accounts should also be closed. The following journal entries are to be passed on dissolution of firm:

1. <u>For closing assets accounts</u>

Realization A/c - Dr
To Assets A/c (Individually)
(Being transfer of assets at book value to the realization account)

2. <u>For closing the provision of assets</u>
Provision for Doubtful Debts A/c - Dr
Provision for Discount A/c - Dr
Provision for Depreciation A/c - Dr
Joint Life Policy Reserve A/c - Dr
Contingency Reserve A/c -Dr
Investment Fluctuation Fund/Reserve A/c -Dr
To Realization A/c
(Being transfer of various provisions to the realization account)

3. For closing debit balance of profit and loss account representing accumulated losses:
   Partners' Current Accounts (if capitals are fixed) - Dr

Or, Partners' Capital Accounts (if capitals are fluctuating) –Dr
   To Profit & Loss Account
   (Being transfer of accumulated losses)

4. For closing liabilities accounts:
   Sundry Creditors A/c -Dr
   Bills Payable A/c - Dr
   Loan A/c - Dr
   Bank Overdraft A/c - Dr
   Outstanding Expenses A/c - Dr
   To Realization A/c
   (Being transfer of liabilities to third parties)

5. For closing reserve fund and credit balance of profit and loss account:
   Reserve fund A/c –Dr
   P&L A/c - Dr
   To Partners' Capital A/c
   (Being transfer of reserve fund and profit and loss a/c to partners' capital accounts in their profit sharing ratio)

6. For realization assets:
   Assets may either be sold for cash or may be taken over by any of the partners or may be taken over by any creditor in full or part of payment of the amount due to them. If assets are sold for cash, the entry is:
   Cash A/c -Dr
   To Realization A/c
   (Being assets are sold for cash)

   If assets are taken over by any partner:
   Partner's Capital A/c -Dr

To Realization A/c
(Being assets taken over by partners)

7. For payment of liabilities
   Realization A/c – Dr
   To Cash A/c
   (Being payment of liabilities to third parties)

8. For expenses of realization:
   Realization A/c –Dr
   To Cash A/c
   (Being expenses incurred in connection with the dissolution of firm)

9. For closing realization account:
   Realization A/c –Dr
   To Partner's Capital A/c
   (Being profit on realization of assets and liabilities are transferred to partners capital account)
   This entry will be reverse if there is any loss on realization occurs

10. Payment of partner's loan:
    Partner's Loan A/c – Dr
    To Cash A/c
    (Being the payment of partner's loan)

11. Closing of current accounts:
    If current accounts show credit balance:
    Partners' Current Accounts –Dr
    To Partners' Capital Accounts
    (Being transfer of credit balances of current accounts)

    If current accounts show debit balance:

    Partners' Capital Accounts –Dr
    To Partners' Current Accounts
    (Being transfer of debit balances of current accounts)

12. For closing capital accounts:
    If capital account of any partner shows debit balance:
    Cash A/c –Dr
    Partner's Capital A/c
    (Being amount due from the partner received)

    If capital account of any partner shows credit balance:
    Partner's Capital A/c –Dr
    To Cash A/c
    (Being amount due to the partners paid)

1.3 Insolvency of a Partner- Garner vs. Murray

If a partner's capital account shows a debit balance on dissolution of the firm, he is to pay the debit balance to the firm to settle the account. But if such partner is insolvent i.e., unable to satisfy his debt to the firm, then his deficiency which he is not able to bring will be borne by the solvent partners in accordance with the decision in Garner vs. Murray. In this case, it was ruled out that in the absence of any agreement to the contrary, the deficiency of the insolvent partner's capital account must be borne by other solvent partners in proportion to their capital which stood before dissolution of the firm. The effect of this ruling is to make a distinction between an ordinary loss due to trading or realization of assets and loss on account of insolvency of a partner.

Another ruling in Garner vs. Murray case is that the solvent partners should bring in cash equal to their share of loss on realization.

1.3.1 Gradual Realization of Assets and Piecemeal Distribution

In case of dissolution of partnership, it is assumed that all assets are realized immediately on the date of dissolution and accounts of all the creditors and partners are settled on the same date. But this assumption is unrealistic because normally the process of realizing the assets takes a long time and cash can be distributed as and when it is realized. In such case, when there is a gradual realization of assets, it is necessary to avoid the unpleasant consequences of a partner's account being overdrawn to distribute cash against obligations. On a gradual realization of assets, the cash realized is distributed in the following order to avoid any excess payment to any partner:

1. The debts of the firm to third parties must be paid out in full prior to any partner being paid any amount in respect of his loan and capital; secured creditors should get preference over unsecured creditors. But their preference is subject to the realization of asset kept with them as security otherwise they are to be treated like unsecured creditors. Expenses of realization are to get preference over unsecured creditors.
2. After the creditors have been paid off, the amount due to a partner as loan should be paid. When the loans are due to more than one partner, the cash available should be paid proportionately.
3. After the payment of outside liabilities and loans due to partners, the capitals of the partners are paid.

There are two methods of piecemeal distribution of cash among partners:

1. Proportionate capital method
2. Maximum loss method

- SOME EXPLANATION OF THESE TWO METHODS HAVE NOT MADE BY THE AUTHOR ALTHOUGH IT WAS SUGGESTED EARLIER BY THE EDITOR.
- IT IS FURTHER OBSERVED THAT THE AUTHOR HAS IGNORED LOT MANY THINGS IDENTIFIED BY THE EDITOR.

1.4 Let Us Sum It Up

There are various ways of dissolution like dissolution by agreement, dissolution by court, etc. Dissolution may happen due to retirement, death or insolvency of partners.

1.5 Keywords:

Dissolution, Insolvency

1.6 SAQs

1. Which of the following is not a way of dissolution of a firm?

a) Dissolution by agreement b) Dissolution on happening of contingency c) Dissolution by operation of law d) Dissolution by order

2. Realization account is a:

   a) Personal account b) Real account c) Nominal account

3. On dissolution of a firm, the firm's assets are realized and liabilities are discharged because the firm is to be closed.

   a) True b) False

1.7 Answer to SAQs

1. D 2. C 3. A

1.8 Suggested Readings

Jain, S.P & Narang K.L (2014) "Financial Accounting", 2nd Revised Edition, Kalyani Publisher

Maheswari S. N., Sharad (2013) "An Introduction to Accountancy" 11th Edition, Vikas Publishing House New Delhi

1.9 Model Question

1. What do you mean by dissolution of a firm? Give entries needed to close the books of the firm upon dissolution.
2. What is Realization Account? How is it different from Revaluation Account?

BLOCK 4- ROYALTY ACCOUNTS

<u>Introduction</u>

In this block there are three units. Unit 1 concentrates on Royalty Accounts. Unit 2 concentrates on Branch Accounts while Unit 3 concentrates on Departmental Accounts.

Unit 1: Royalty Accounts

Structure

1.0 Objectives

In this unit we will be able to:

- Understand various aspects of royalty accounts.
- Understand the accounting treatment of royalty accounts.

1.1 Introduction

Royalty is a periodical payment made based on output or sale for the use of certain asset or right on certain assets like mine, copyright or patent to its owner. In lease contract, royalty is a common terminology. It is termed as the amount paid by the lessee (user of lease asset) for using the property of lessor (owner of lease asset). Likewise, royalty is also paid by the publisher to the author of the book.

1.2 Basic concepts relating to royalty

There are various terminologies which royalty accounts are associated with. We will discuss one by one in details:

a) Minimum Rent/ Dead Rent

Royalty agreements are usually associated with a clause that the lessor or landlord must receive a minimum amount irrespective of the production or sales made by using the lease asset during a particular period. Such minimum amount is known as minimum rent or dead rent or fixed rent. The fixation of such rent is in the interest of landlord because it guarantees him the receipt of the minimum amount in case of low output or sales. Further, it gives incentive to the lessee to increase the production or sales in the initial period of lease agreement .

For example, M/S Kalyani Publishers printed a book on Advanced Accountancy at a minimum rent of Rs. 20,000 p.a. royalty being payable @ Rs. 7.50 per copy sold and the number of copies sold in the first year is 2,000 and in the second year is 4,000. In this case M/S Kalyani Publishers will have to pay Rs. 20,000 to the authors as minimum rent even though royalty works out to be Rs. 15,000 for 2,000 copies @ Rs. 7.50 per copy sold. In the second year Rs. 30,000 as royalty for 4,000 copies @ Rs. 7.50 per copy sold will be paid to the authors even though the minimum rent is Rs. 20,000.

b) Short working

The excess of minimum rent over actual royalty calculated on the basis of output or sales is termed as short working. In the example previous example, there was a short working of Rs. 5,000 i.e., (Rs. 20,000- Rs. 15,000). There was no short working in the second year.

c) Ground/ Surface Rent

It is the fixed yearly or half yearly rent payable by the lessee to the landlord in addition to the minimum rent.

d) Recouping short workings

It means the recovery of short workings of the previous years out of surplus royalty of subsequent years. The following conditions can be there for the recouping of short workings:

- The short workings are always recouped when there is surplus i.e., excess of royalty over minimum rent
- The recouping of short working is to be done within the agreed period as given in the agreement.
- If short workings could not be recouped within the agreed period, it will be transferred to Profit and Loss Account.

e) Nazrana or Lease Premium

In some cases, the lessee may agree to pay lump sum to the lessor in addition to royalty. This extra payment in addition to royalty is known as lease premium.

Royalty is a different concept from conventional rent paid to the landlord. Some of the points related to their differences are mentioned below:

1.3Distinction between Rent and Royalty

Basis of difference	Rent	Royalty
1. Nature of assets	It is the consideration payable for the use of only tangible assets as building, machinery, etc.	It is the consideration payable for the use of special right for both tangible and intangible assets.
2. Basis of payable	It is mostly payable on the basis of time as weekly, monthly or yearly.	It is paid on the basis of production, yield or sale.
3. Fixed or variable	The amount of rent is generally fixed with regard to time.	The amount of royalty is variable and is calculated in accordance with production or sales.

4. Minimum rent	There is no concept of minimum rent.	It generally contains a clause in the agreement to pay minimum rent.
5. Parties	The parties are known as tenant and landlord	Parties are known as lessee/ patent holder/ publisher/ lessor/ author, etc.

1.4Accounting Entries in Royalty Accounts

<u>Accounting entries in the books the lessee</u>

When royalties are less than the minimum rent and the short workings are recoverable in subsequent years when royalties exceed the minimum rent:

If minimum rent account is not opened:

a) Royalties Payable A/c -Dr. (with actual amount of royalties earned)
Short workings Allowable A/c - Dr (Actual Rent- Minimum Rent)
To Landlord (with the minimum rent)

b) Landlord A/c -Dr
To Bank A/c

c) Profit & Loss or Production A/c -Dr
To Royalties Payable A/c (actual amount of royalties transferred)

The debit balance of the short workings account will be carried forward and shown as an asset in the Balance Sheet till it is recoupable.

If minimum rent account is opened in the books:

a) Minimum Rent A/c - Dr
To Landlord A/c

b) Royalties Payable A/c - Dr
Minimum Rent A/c

c) Landlord A/c - Dr
To Bank A/c

d) Profit & Loss A/c or Production A/c -Dr
To Royalties Payable A/c

The only difference between two methods is that entry a) in the first method requires two entries a) and b) in the second method, other entries being same.

2) When royalties exceed the minimum rent and short workings are recouped:

a) Royalties Payable A/c - Dr
To Landlord A/c

b) Landlord A/c -Dr
To Short workings Allowable A/c

c) Profit & Loss A/c or Production A/c – Dr
Royalties A/c

Now look at the journal entries passed in the books of landlord.

<u>Accounting Entries in the Books of Lessor/ Landlord</u>

In the books of the lessor receiving the royalties, the treatment will be the reverse of what we have done so far. The following entries will be recorded:

1) When the royalties received are less than the minimum rent and short workings are recoverable out of future years, the following entries are made:

   a) Lessee's A/c -Dr (with minimum rent)
      To Royalties Recoverable A/c (with actual royalties)
      To Royalties or Short workings Suspense A/c (with the difference)

   b) Bank A/c - Dr (with actual amount received)
      To Lessee's A/c

   c) Royalties Receivable A/c - Dr (with amount of royalties earned)
      To Profit and Loss A/c

      The credit balance of Royalties or Short Workings Suspense Account will be carried forward and shown as a liability in the Balance Sheet till it is recoupable.

2) When the royalties earned exceed the minimum rent and short workings are recovered, the entries are as follows:

   a) Lessee's A/c -Dr (with the amount of royalties earned)
      To Royalties Receivable A/c

   b) Royalties A/c -Dr (with the amount of short workings recovered)
      To Lessee's A/c

   c) Bank A/c -Dr (with the amount due received)
      Lessee's A/c

   d) Royalties Receivable A/c –Dr
      To Profit and Loss A/c

      If any balance of Royalties or Short workings Suspense Account will no longer recoverable, it should be transferred to Profit and Loss Account. The entry will be:

      Royalties/ Short workings Suspense A/c -Dr
      To Profit and Loss A/c

1.5 Lets Sum It Up

Royalty is periodical payment based on output or sale for the use of a certain asset or right like mine, copyright or patent to its owner. It is termed as the amount paid by the lessee (user of lease asset) for using the property of lessor (owner of lease asset). The concepts like minimum rent, short workings, lease premium etc. are important terms used in royalty accounts. The accounting treatment of both lessor and lessee are recorded.

1.6 Key words:

Royalties, Lessor, Lessee, Minimum Rent, Short workings

1.7 SAQs

1. The minimum amount paid to the landlord by the lessee is:
   a) Ground rent c) short workings c) Minimum rent

2. Royalty is payable on both tangible and intangible assets.
   a) True b) False

3. The additional payment in addition to royalty by the lessee is:
   a) Short workings b) Lease premium c) Rent

1.8 Answers of SAQs

1. C 2. A 3. B

1.9 Suggested Readings:

Jain, S.P & Narang K.L (2014) "Financial Accounting", 2nd Revised Edition, Kalyani Publisher

Maheswari S. N., Sharad (2013) "An Introduction to Accountancy" 11th Edition, Vikas Publishing House New Delhi

1.10 Model Question

1. Explain the terms:
   a) Royalty b) Minimum Rent c) Right of Recoupment d) Ground Rent

2. Write down the accounting entries of royalty in the books of both lessor and lessee.

UNIT 2 BRANCH ACCOUNTS

Structure

2.0 OBJECTIVES

After studying this unit you should be able to:

- Describe the need for branch accounting
- Explain the different types of branches from accounting point of view
- Describe three systems of maintaining branch accounts for a dependent branch
- Understand the accounting treatment applicable under all the methods of branch accounts.

2.1 INTRODUCTION

A business may be split up into a number of divisions. The divisions are known as departments if located under the same roof and branches if located at different places of the same town, country or world. For example, Cottage Emporium has various divisions like garments, furniture, gift items, jewellery, etc. They are located in the same building and so are called departments. Snowhite has its showrooms in Connaught Place, Nehru Place, Karol Bagh, South Extension and Kemlanagar. These are all branches of Snowhitc. Similarly, Bata has its branches all over the country and Leventies all over the world. Each branch is treated as a separate profit centre and hence the profit or loss is to be worked out separately for each branch, Moreover, the firm has to keep strict control over various activities of each branch and ensure its smooth functioning. The accountants, therefore, have developed some specialized accounting methods for the recording of transactions at branch level and for incorporating the net effect of all branch transactions in a firm's books.

From accounting point of view, the branches are divided into three categories: (i) Dependent branches (ii) Independent branches, and (iii) foreign branches. In this unit you will learn how the accounts of dependent branches are maintained and how their profit or loss is worked out.

1.2 NEED FOR BRANCH ACCOUNTING

As stated earlier each branch is treated as a separate profit centre. Hence it should record various transactions in such a manner that its profit or, loss can be worked out and incorporated in the firm's overall results at the end of the accounting year. Moreover, the branches conduct all activities under the direction and control of the head office which may need a variety of information from time to time about the functioning of each branch. This becomes possible only if the branches keep proper books of account. Thus, the main reasons of keeping branch accounts can be summarized as follows:

i) To find out the profit or loss of each branch for the accounting period

ii) To ascertain the financial position of each branch at the end of the accounting year

iii) To incorporate the net effect of branch transactions and their assets and liabilities in a firm's final accounts

iv) To estimate requirements of cash and stock for each branch

v) To evaluate the progress and performance of each branch

vi) To calculate the commission for payment to the managers, if based on profit of branch

vii) To assess the prospects for expansion of business in each branch

viii) To meet audit requirements.

1.3 TYPES OF BRANCHES

From accounting point of view the branches can be divided into the following Categories:

1) Branches not keeping full system of accounting;
2) Branches keeping full system of accounting;
3) Foreign branches,

Let us have an idea about their main characteristics.

Branches not Keeping Full System of Accounting: The branches not keeping full system of accounting are also called dependent branches. The main features of such branches are:

i) They sell only those goods which are received from the head office and are not usually allowed to make purchases in the open market except with the permission of the head office.

ii) Goods are supplied by the head office to such branches either at cost price or at invoice price.

iii) All major expenses of the branch are paid by the head office. The branch manager is allowed to incur only petty expenses like cartage, postage, etc. out of the petty cash provided to him for which he is required to maintain a simple petty cash book.

iv) The amount received from cash sales and debtors is either remitted to the head office daily or deposited in the- account of head office in some local bank

v) The branch manager is normally expected to sell the goods for cash, but he may be authorized to sell goods on credit in certain cases.

vi) Such branches do not keep complete account books. They simply maintain reward of sales and prepare debtors accounts, if necessary. They are also required to maintain a stock register and furnish weekly or monthly statements giving complete information about stock position and movement of goods to the head office. This enables the head office to keep proper control over stock at branches.

Branches Keeping Full System of Accounting:
Branches keeping full system of accounting are called independent branches. They are allowed to purchase goods from the market and also supply to the head office, if necessary. They can incur expenses from the cash realized and operate the bank account in their own names. Thus, they operate as independent units for all practical; their only link with the head office is that they are worried by the head office and whatever profit they earn or loss they incur ultimately belongs to the head office. Such branches keep a complete set of books on the double entry system and prepare their own Trial Balance, Trading and Profit & Loss Account and Balance Sheet. Such branches open Head Office Account in their books and record all transactions between the branch and the head office in this account.
Foreign Branches: When a branch is located in a foreign country, it is called foreign branch. Such branches will keep their books of account in foreign currency. The distinctive feature of foreign branches is that financial information received from them will be in foreign currency which has to be converted into the currency of the country of the head office before it can be incorporated in the head office books. For example, if an Indian company has a branch in Nairobi, the branch Trial Balance will be in Kenyan shillings. The Trial Balance must be converted into rupees before it can be incorporated in head office books. For all practical purposes, however, foreign branches are treated as independent branches.

1.4 ACCOUNTING FOR DEPENDENT BRANCHES
You know that the dependent branches do not keep a complete set of books. Most of their transactions are recorded at the head office level. The accounting system adopted by head office for a branch depends up on the size of a branch and the degree of control to be exercised by the head office. The following are the various methods by which the head office usually keeps branch accounts in its books:

a) **Debtors System**: This system is adopted generally for those branches which are fairly small in size. Under this system, the head office simply opens a Branch Account for each branch in which it records all transactions relating to the branch. The Branch Account is prepared in such a manner that it also helps in ascertaining the branch profit or loss.
b) **Final Account System:** Under this system, the head office prepares **a** Trading and Profit and Loss Account in order to find out profit or loss of each branch and a Branch Account to find out the amount due to, or due from, that branch, In this case the Branch Account simply acts as a personal account.

iii) **Stock and Debtors System:** Under this system, the head office does not open any Branch Account. For each branch, it prepares a Branch Stock

Account, a Branch Expenses Account, a Branch Adjustment Account and Goods sent to Branch Account in order to find out the profit or loss of each branch. As stated earlier, under debtors system, the head office simply opens a Branch Account for each branch in which it records all transactions relating to the branch. The Branch Account also helps in ascertaining the profit or loss of the branch. Goods may be invoiced to a branch at cost or at selling price (also called invoice price).

Accordingly, there are two methods of preparing the Branch Account:

a) Cost Price Method and (b) Invoice Price Method. Let us now study the preparation of Branch Account under both of these methods.

1.5.1 Cost Price Method

When goods are invoiced at cost, the following journal entries are passed in the books of the head office to record various transactions relating to the branch.

1) For *goods sent* to branch
Branch A/c Dr.
To Goods Sent to Branch A/c
(Being goods sent to branch)

2) For return of goods to head office
Goods Sent to Branch A/c -Dr
To Branch A/c
(Being goods returned by the branch)

3) For amount sent to branch for expenses
Branch A/c - Dr.
To Bank A/c
(Being cheque sent to branch for expenses)

4) For amount received from branch

Bank ***A/c*** - Dr.
To Branch A/c
(Being cash or cheque received from branch)

5) For closing goods sent to branch account
Goods Sent to Branch A/c -Dr.
To Purchase/ Trading A/c
(Being balance transferred to Trading Account)

6) For closing balances of assets at the branch:

Branch Assets A/c -Dr. (Individually)
To Branch A/c
(Being closing balances of assets brought into account)

7) For closing balances of liabilities at the branch:

Branch A/c -Dr
To Branch Liabilities A/c (Individually)
(Being closing balances of liabilities brought into account)

8) For transferring profit or loss to the General Profit and Loss Account
i) If profit:
Branch A/c - Dr.
To General Profit and Loss A/c
(Being branch profit transferred to General P & L A/c)

ii) If loss

General Profit and Loss *A/c* - Dr
To Branch A/c
(Being branch loss transferred to General P & L A/c)

The closing balances of branch assets and liabilities are shown in the Balance Sheet of the head office. At the beginning of the next year, the entire numbers 6 and 7 are reversed so as to show opening balances in the Branch Account.

Let us now have some illustration to understand this method further.

Illustration 1
From the following particulars relating to Delhi Branch for the year ending December 31, 2000 prepare Branch Account in the books of head office.

	Rs.
Stock at Branch on 1-1-2000	15,000
Debtors at Branch on 1-1-2000	30,000
Petty Cash at Branch 1-1-200	300

Goods sent to Branch	2, 52, 000
Cash sales	60,000
Received from Debtors	2, 10,000
Credit Sales	2, 28,000
Cheque sent to Branch for:	
Salaries	9,000
Rent and Taxes	1,500
Petty Cash	1,100
Goods returned by the branch	2,000
Stock at Branch on 31-12-2000	25,000
Petty cash at Branch on 31-12-2000	200
Debtors at Branch on 31-12-2000	48,000

Solution

Head Office Ledger

Delhi Branch Account

Dr. **Cr.**

	Rs.		Rs.
To Balance b/d		By Cash	
Branch stock	15,000	Cash Sales	60,000
Branch debtors	30,000	Received from debtors	2,10,000
Branch petty cash	300		
		By Goods sent to Branch A/c	2,000
To Goods sent to Branch A/c	2,52,000		
		By Balance c/d	
		Brach stock	25,000
To Bank A/c		Branch Debtors	48,000
Salaries 9,000		Branch Petty Cash	200
Rent and Taxes 1,500	11,600		
Petty Cash 1,100			
	36,300		
To Profit (transferred to General P/L A/c)			
	3,45,200		3,45,200

1.5.2 Invoice Price Method

As in the case of consignment the goods may be invoiced to branches at a price higher than the cost (termed as invoice price). This is done primarily to have in effective control over stock with branches and keep the margin of profit secret from the branch manager. In such a situation, all entries relating to goods are made in the Branch Account at invoice price and necessary adjustments for loading (difference between Invoice Price. and Cost Price) are recorded at the end by passing the following additional journal entries:

1) For adjustment of loading in opening stock at branch

Stock Reserve A/c Dr.
To Branch A/c

2) For adjustment of loading in goods sent to branch less returns

Branch A/C Dr.
To Goods Sent to Branch A/c

3) For adjustment of loading in closing stock at branch

Branch A/c Dr.

To Stock Reserve A/c

Let us solve a sum to understand this method better and see how Branch Account is prepared when goods are invoiced at a price higher than cost.

Illustration 2:

The Vaikuntha Gas Co., Varanasi has a sales branch at Ghaziabad and invoiced goods to the branch at cost price plus 33.33%. It is arranged that all cash received by the branch is to be paid daily to the Head Office Account with the Banaras State Bank Ltd. and the necessary advice sent to the Head Office. From the following particulars, prepare Branch Account and Goods sent to Branch Account in the Head Office ledger showing the actual profit or loss of the branch for the year ending - December 31, 2000.

	Rs.
Stock on 1-1-2000 (At invoice price)	12,000
Goods sent to Branch (At invoice price)	96,000
Debtors on 1-1- 2000	1,500
Cash sent to Head Office	77,100
Sales	77,100
Rent, Rates and Taxes	3,200
Salaries	4,800
Debtors on 31-12-2000	1,600
Goods returned to Head Office (At invoice price)	16,000
Shortage of stock (At invoice price)	200

Solution

Ghaziabad Branch Account

Dr. **Cr**

	Rs		**Rs**
To Balance b/d		By Cash Received	**77**,100
Branch Stock	12,000		
Branch Debtors	1,500	By Goods returned by Branch A/c	16,000
To Goods sent to Branch A/c	96,000		
		By Stock Reserve A/c	3,000

To Bank A/c Rent, Rates and Taxes Salaries and Wages To Stock Reserve A/c (Loading in closing. Stock) To Profit (transferred to General P & L A/c)	 3,200 4,800 3,700 11,300 **1,32,500**	(Loading in opening stock) By Goods sent to Branch A/c (Loading in goods sent less returns) By Balance c/d Branch Stock Branch Debtors	 20,000 14,800 1,600 **1,32,500**

Goods Sent to Branch Account

Dr. **Cr**

	Rs		**Rs**
To Ghaziabad Branch A/c	1,600	By Ghaziabad Branch A/c	96,000
To Ghaziabad Branch A/c (Loading on Rs. 80,000)	20,000		
To Trading A/c (Transfer)	60,000		
	96,000		**96,000**

Notes:

► Branch stock at the end has not given. It can be worked out by preparing Memorandum Branch Stock Account as follows:

► Loading is 25% of invoice price

Memorandum Branch Stock Account

Dr. **Cr**

	Rs		**Rs**
To Balance b/d	12,000	By Goods returned to Head Office	16,000
To Goods received from Head Office	96,000	By Sales	77,000
To Goods returned by Customers	-	By Shortage of Stock	200
		By Balance c/d	14,800
	1,08,000		1,08,000

►It should be noted that all figures in Memorandum Branch Stock Account have been recorded at the invoice price.

1.6 FINAL ACCOUNTS SYSTEM

The profit or loss of a dependent branch can also be worked out by preparing a Memorandum Branch Trading and Profit & Loss Account. This account is prepared on the basis of cost of goods sent to the branch (not the invoice price). Apart from the Branch Trading and Profit & Loss Account, the Head Office also maintains the Branch Account. But, under this system, the Branch Account is in the nature of a personal account which shows only the mutual transactions between the head office and the branch, the balance of Branch Account, therefore, represents the net assets of the branch.

1.7 STOCK AND DEBTORS SYSTEM

Under Stock and Debtors System, the head office does not open a Branch Account in its books. It maintains a few control accounts for recording the various branch transactions. These accounts usually are: (i) Branch Stock Account, (ii) Branch Debtors Account, (iii) Branch Expenses Account, (iv) Branch Cash Account, (v) Goods sent to Branch Account, and (vi) Branch Fixed Assets Account. At the end of the accounting year, it prepares the Branch Adjustment Account and the Branch Profit & toss Account. This system is used only when goods are invoiced at selling price which the branch is not allowed to vary.
Let us now study the working of each account opened by the head office when such a system is followed:

Branch Stock Account: This is the most important account which helps the head office in controlling the branch stock. It shows all branch transactions relating to goods. The goods sent to branches and the sales returns are shown on its debit side, and the sales (both cash and credit) and the goods returned to head office on the credit side. All these items are recorded at the invoice price. Hence, if the figure of any of these items is given at cost, the same should be converted into invoice price before recording it in the Branch Stock Account. The balance of this account would show the unsold goods (stock) lying with the branch. If it is found that the actual stock with the branch is less than the balance shown by the Branch Stock Account, it means that there is a 'shortage' in the stock with the branch. Similarly, if the actual stock with the branch is more than the balance shown by the Branch Stock Account, it would reflect 'surplus'. Both situations warrant investigation. But, so far as their recording goes, the shortage will be shown on the credit side of the Branch Stock Account and if there is surplus, the same will be recorded on its debit side. Then, the balance of the Branch Stock Account will be the exact amount of actual stock with the branch. In other words, while preparing the Branch Stock Account, you will show the actual stock with branch as the balance in this account, and then if the totals of both sides do not tally, you will show the difference as shortage or surplus as the case may be.

Branch Debtors Account: This account shows all transactions relating to branch debtors. The credit sales are shown on its debit side, and cash received from debtors, sales returns, bad debts, discount allowed, etc. on the credit side. The balance of this account represents the closing debtors of the branch.

Branch Expenses Account: This account shows all expenses incurred by the branch. In addition, the items like bad debts, discount allowed, and depreciation on branch fixed assets, etc. are also debited to this account. This account is closed by transfer to the Branch Adjustment Account.

Branch Cash Account: This account shows all cash transactions of the branch where the branch is not required to remit all collection of cash immediately to the head office but use it for branch expenses and remit the balance to the head office from time to time. This account helps the head office to keep control over branch cash. Normally, the dependent branch is not allowed the freedom to retain cash collections. Hence, this account need not be maintained.

Branch Fixed Assets Account: The head office maintains separate account for each type of branch asset such as furniture, equipment, building, etc. These accounts are prepared in the usual manner. The depreciation on branch fixed assets is, however, debited to Branch Expenses Account and credited to the respective account.

Goods Sent to Branch Account: This account is prepared in the same manner as in case of branches to which the goods are sent at the invoice price (Sub-section 1.5.2).Branch Adjustment Account: This account is like a Trading Account of the branch. It is prepared to ascertain the gross profit or gross loss made at the branch by recording the loading (difference between invoice price and cost price) on various items. The loading on branch closing stock and shortage is shown on its debit side while-the loading on branch opening stock, goods sent to branch (less returns) and surplus on the credit side. The balance of this account reflects the gross profit or gross loss which is transferred to Branch Profit & Loss Account.

Branch Profit and Loss Account: This account is prepared to ascertain the net profit or net loss made at the branch. As stated earlier, the gross profit or gross loss ascertained by the Branch Adjustment Account is transferred to this account. It is debited with branch expenses as per the Branch Expenses Account and the loss on account of shortage being the cost of such shortage. In case the Branch Stock Account reveals some surplus, the amount equal to the cost of such surplus will be shown on the credit side of the Branch Profit & Loss Account. The balance of the Branch Profit& Loss Account represents the net profit or net loss made at the branch which is transferred to the General Profit & Loss Account.

Now let us discuss the journal entries that are passed in the head office books for opening the above accounts relating to the various branch transactions:

1) When goods are sent to the branch (at invoice price):

Branch Stock A/c -Dr.
Goods Sent to Branch A/c

2) When goods are returned by the branch to the H.O**.** (at invoice price):

Goods Sent to Branch A/c -Dr.
To Branch Stock A/c

3) When sales are made by the branches:
<u>i) For Cash Sales</u>

Cash A/c - Dr.
To Branch Stock A/c

<u>ii) For Credit Sales</u>

Branch Debtors A/c -Dr.
To Branch Stock A/c

4) When cash is received from debtors

Cash A/c -Dr.
To Branch Debtors A/c

5) For sales returns

Branch Stock A/c -Dr.
To Branch Debtors A/c

6) For discount allowed and bad debts, etc.

Branch Expenses A/c -Dr.
To Branch Debtors A/c
7) For shortage of stock

Branch Adjustment A/c -Dr.
(with amount of loading)
Branch Profit & Loss A/c -Dr.
(with cost of shortage)
To Branch Stock A/c
*For surplus at branch, the reverse entry will be passed.

8) For Branch expenses paid in Cash
Branch Expenses A/c -Dr.
To Cash A/c

9) For closing branch expenses account
Branch Profit & Loss A/c Dr.
To Branch Expenses A/c

10) For adjustment of loading on the opening stock

Stock Reserve A/c Dr.
To Branch Adjustment A/c

11) For adjustment of loading on the closing stock

Branch Adjustment A/c Dr.
To Stock Reserve A/c ,

12) For adjustment of loading of net goods sent to branch
Goods Sent to Branch Alc Dr.
To Branch Adjustment Alc

13) For transfer of gross profit
Branch Adjustment A/ c -Dr.
To Branch Profit & Loss A/ c

14) For transfer of net profit to General Profit & Loss Account

Branch Adjustment A/c Dr.
To General Profit & Loss A/c

*The entry will be reversed if there is net loss.

15) For closing the Goods Sent to Branch Account.
Goods Sent to Branch A/c Dr.
To Trading A/c

1.8 Let Us Sum It Up

From accounting viewpoint, each branch is recorded as a separate profit centre. Hence, accounting for branch transactions are designed in such a way that profit or loss made at each branch can be correctly worked out and proper control can be exercised over their financial activities. For this purpose, branches are divided into three categories: a) branches not keeping full system of accounting (dependent branches); b) branches keeping full system of accounting (independent branches); c) foreign branches.

Where branches do not keep full system of accounting, the head office has to maintain proper record of branch transactions. Three methods can be followed for this viz, a) Debtors system b) Final account system c) Stock and debtor system.

Debtor system is adopted for small branches which rarely act as sales depots. Under the final account system of branch accounts, the head office prepares a Memorandum Profit and Loss Account for each branch from the data provided by the branch and ascertains its profit and loss for an accounting year. Stock and debtors system are followed where goods are invoiced at selling price.

2.9 Keywords

Branch account, branch adjustment account, debtors system, final account system and stock & debtors system.

2.10 SAQs

Fill in the blanks

1. The closing balance of Branch Account under the final account system represents ____________ at the branch.
2. Branch Expenses Account under the stock and debtors system is closed by transfer to____________ Account.

3. The branch expenses paid by head office are ___________ to the Branch Account.
4. The balance in Goods Sent to Branch Account is transferred to ____________ Account.

2.11 Answers to SAQ

1. Net assets 2. Brach Adjustment 3.Debited 4. Trading

2.12 Suggested Readings

Jain, S.P & Narang K.L (2014) "Financial Accounting", 2nd Revised Edition, Kalyani Publisher

Maheswari S. N., Sharad (2013) "An Introduction to Accountancy" 11th Edition, Vikas Publishing House New Delhi

2.13 Model Questions

1. Explain how Branch Stock Account helps in keeping dependent branch describe how profit is ascertained under each system?
2. What are the objectives of keeping branch accounts?
3. Write a note on:
   a) Stock system b) Final account system c) stock and debtor system.
4. What do you understand by the term 'Branch Adjustment Account'? Explain clearly.
5. The Prajapati Traders, Lucknow has a sales branch at Agra and invoiced goods to the branch at cost price plus 33.33%. It is arranged that all cash received by the branch is to be paid daily to the Head Office Account with the Lucknow State Bank Ltd. and the necessary advice sent to the Head Office. From the following particulars, prepare Branch Account and Goods sent to Branch Account in the Head Office ledger showing the actual profit or loss of the branch for the year ending - December 31, 2002.

Rs.

Stock on 1-1-2002 (At invoice price)	14,000
Goods sent to Branch (At invoice price)	98,000
Debtors on 1-1- 2002	1,700
Cash sent to Head Office	81,300
Sales	81,300
Rent, Rates and Taxes	4,200
Salaries	4,900
Debtors on 31-12-2002	1,750
Goods returned to Head Office (At invoice price)	16,800
Shortage of stock (At invoice price)	600

6. From the following particulars relating to Kolkata Branch for the year ending December 31, 2010 prepare Branch Account in the books of head office.

	Rs.
Stock at Branch on 1-1-2010	19,000
Debtors at Branch on 1-1-2010	39,000
Petty Cash at Branch 1-1-2010	900
Goods sent to Branch	2, 72, 200
Cash sales	90,000
Received from Debtors	2, 60,300
Credit Sales	2, 57,200
Cheque sent to Branch for:	
Salaries	13,000
Rent and Taxes	5,500

Petty Cash	4,200
Goods returned by the branch	4,200
Stock at Branch on 31-12-2000	27,700
Petty cash at Branch on 31-12-2000	800
Debtors at Branch on 31-12-2000	56,500

UNIT 2 DEPARTMENTAL ACCOUNTS

Structure

3.0 OBJECTIVES

After studying this unit you should be able to:

- Describe the need for branch accounting.
- Explain the different methods of departmental accounts.
- Understand the differences between departmental accounts and branch accounts.

a. **INTRODUCTION**

When a business sells different types of goods or carries on several activities under one room, it is generally split up into a number of departments. This is generally done for smooth and efficient running of the business. A department is generally a physical part of the rest of the business. When a business is divided into several departments, internal information about operating results of each department is required. This enables the management to take decisions relating to pricing, enclosures, etc. after taking into consideration of the different rates of growth, profitability and degree of risk of different departments.

b. **NEEDS FOR DEPARTMENTAL ACCOUNTS**

When all the divisions of a business are located under one roof and it is desired to ascertain the profit or loss of each department or class of goods separately, then departmental accounts are prepared. The main objectives of preparing such accounts are:

a) To have comparison of the results of a particular department with previous year and also with other departments of the same organization.
b) To help the owner in formulating policy to expand the business on proper lines so as to optimize the profits of the concern.
c) To allow departmental managers' commission on the basis of profits of their departments.
d) To generate information which may be helpful for planning, control, evaluation of performance of each department and for taking various managerial decisions.

c. ADVANTAGES OF DEPARTMENTAL ACCOUNTS

The major advantages of departmental accounts are:

a) The trading results of each department may help to evaluate the performance of each department. The sales of that department which gives maximum profit may be pushed up by special efforts.
b) The profitability of each department may help the management for taking decision whether to drop a department or add a new one.
c) The growth potentials of a department can be evaluated by having comparison with other departments.
d) The users of accounting information can be provided more detailed information like shareholders, investors, creditors, etc.
e) It helps the management to determine the justification of proper use of capital invested in each department.
f) The information provided by departmental accounts may be helpful to the management for future reference and control.

d. METHODS OF DEPARTMENTAL ACCOUNTS

There are two methods of keeping Departmental Accounts:

a) Separate Set of Books for each department
b) Accounting in Columnar Books form

Separate Set of Books for each Department

Under this method of accounting, each department is treated as a separate unit and separate set of books are maintained for each unit. Financial results of each unit are combined at the end of accounting year to know the overall result of the store.

Due to high cost, this method of accounting is followed only by very big business houses or where to do so is compulsory as per the law. Insurance business is one of the best examples, where to follow this system is compulsory.

Accounting in Columnar Books Form

Small trading unit generally uses this system of accounting, where accounts of all departments are maintained together by central accounts department in the columnar books form. Under this method, sale, purchase, stock, expenses, etc. are maintained in a columnar form.

It is necessary that to prepare a departmental Trading and Profit and Loss Account, preparation of subsidiary books of accounts having different columns for the different department is required. Purchase Book, Purchase Return Book, Sale Book, Sales return books etc. are the examples of the subsidiary books.

Specimen of a Sale Book is given below −

Sales Book

Date	Particulars	L.F.	Department A	Department B	Department C	Department D

A Trading account in columnar form is prepared to know the department wise gross profit of the concern.

Function wise classification may also be done in a business unit like Production department, Finance department, Purchase department, Sale department, etc.

<u>Allocation of Department Expenses</u>

- Some expenses, which are specially incurred for a particular department, may be charged directly to the respective department. For example, hiring charges of the transport for delivery of goods to customer may be charged to the selling and distribution department.
- Some of the expenses may be allocated according to their uses. For example, electricity expenses may be divided according to the sub meter of each department.

Following are the examples of some expenses, which are not directly related to any particular department may be divide as −

- **Cartage Freight Inward Account**: Above mentioned expenses may be divided according to purchase of each department.

- **Depreciation**: Depreciation may be divided according to the value of assets employed in each department.
- **Repairs and Renewal Charges**: Repair and renewal of the assets may be divided according to the value of the assets used by each department.
- **Managerial Salary**: Managerial salary should be divided according to the time spent by the manager in each department.
- **Building Repair, Rents & Taxes, Building Insurance, etc.**: All the expenses related to the building should be divided according to the floor space occupied by each department.
- **Selling and Distribution Expenses**: All the expenses relating to selling and distribution expenses should be divided according to the sales of each department, such as freight outward, travelling expenses of sales personals, salary and commission paid to salesmen, after sales services expenses, discount and bad debts, etc.
- **Insurance of Plant & Machinery**: The value of such Plant & Machinery in each department is the basis of the insurance.
- **Employee/worker Insurance**: Charges of a group insurance should be divided according to the direct wage expenses of each department.
- **Power & Fuel**: Power & fuel will be allocated according to the working hours and power of the machine (i.e. Hours worked x Horse power).

Inter-Department Transfer

An inter-department analysis sheet is prepared at a regular interval such as weekly or monthly basis to record all the inter-departmental transfers of goods and services. It is necessary, as each department is working as a separate profit center. Transfer of the prices of such transactions can be cost base, market price, or duel basis.

Following Journal entry will pass at the end of that period (weekly or monthly) −

Journal Entry

Receiving Department A/c	Dr
To Supplying Department A/c	

Inter-Department Transfer Price

There are three types of transfer prices −

- **Cost based transfer price**: Where the transfer price is based on standard, actual, or total cost, or marginal cost is called cost based transfer price.

- **Market based transfer price**: Where the goods are transferred at selling price from one department to another is known as market based price. Therefore, unrealized profit on the goods sold is debited from the selling department in the form of a stock reserve for both the opening and the closing stock.
- **Dual pricing system**: Under this system, the goods are transferred on the selling price by the transferor department and booked at the cost price by the transferee department.

Let us do a practical to understand the treatment of departmental accounts.

Illustration 1

Prepare a Departmental Trading and Profit and Loss Account & General Profit and Loss Account for the year ended 31-12-2014 of M/s Andhra & Company where department A sells goods to department B on Normal selling price.

Particulars	Dept. A	Dept. B
Opening stock	175,000	-
Purchases	4,025,000	350,000
Inter Transfer of Goods	-	1,225,000
Wages	175,000	280,000
Electricity Expenses	17,500	245,000
Closing Stock (at cost)	875,000	315,000
Sales	4,025,000	2,625,000
Office Expenses	35,000	28,000

Combined Expenses for both Department	
Salaries (2:1 Ratio)	472,500
Printing and Stationery Expenses (3:1 Ratio)	157,500
Advertisement Expenses (Sale Ratio)	1,400,000
Depreciation (1:3 Ratio)	21,000

Solution to Illustration 3.1

M/s Andhra & Company

Departmental Trading and Profit and Loss Account

For the year ended 31-12-2014

Particulars	Dept. A	Dept. B	Particulars	Dept. A	Dept. B
To Opening Stock To Purchases To Transfer from A To Wages To Gross Profit c/d	175,000 4,025,000 175,000 1,750,000	-- 350,000 1,225,000 280,000 1,085,000	By Sales By Transfer to B By Closing Stock	4,025,000 1,225,000 875,000	2,625,000 - 315,000
Total	**6,125,000**	**2,940,000**	**Total**	**6,125,000**	**2,940,000**
To Electricity Expenses To Office Expenses	17,500 35,000 315,000	245,000 28,000 157,500	By Gross Profit b/d	1,750,000	1,085,000

To Salaries (2:1 ratio)	118,125	39,375			
To Printing & Stationery (3:1 Ratio)	847,368	552,632			
To Advertisement Exp. (Sales Ratio 40.25 :26.25)	5,250 411,757	15,750 46,743			
To Depreciation (1:3 Ratio)					
To Net Profit					
Total	**1,750,000**	**1,085,000**	**Total**	**1,750,000**	**1,085,000**

General Profit and Loss Account

For the year ended 31-12-2014

Particulars	Dept. A	Particulars	Dept. B
To Stock reserve (Dept. B)	81,667	By Departmental Net Profit b/d	
To Net Profit c/d	376,833	Dept. A Rs. 411,757 Dept. B Rs. 46,743	4,58,500
	4,58,500		4,585,00

Things to be learnt:

- All the items taken are considered from departmental aspects.
- Profits are calculated on departmental basis.

e. **Let Us Sum Up**

When all the divisions of a business are located under one roof and it is desired to ascertain the profit or loss of each department or class of goods separately, then departmental accounts are prepared. There are two methods of keeping Departmental Accounts:

c) Separate Set of Books for each department
d) Accounting in Columnar Books form

3.6 Key Words: Departmental accounts, Inter-Department Transfer, Cost based transfer price, Market based transfer price, Columnar subsidiary books.

a. **SAQs**

Fill in the blank

1. There are two methods of keeping Departmental Accounts namely Separate Set of Books for each department and ______________________________.

2. Where the transfer price is based on standard, actual, or total cost, or marginal cost is called ___________________________________.

3. Under ______________________ system, the goods are transferred on the selling price by the transferor department and booked at the cost price by the transferee department.

f. **Answers to SAQs**

1. Accounting in Columnar Books form 2. Cost based transfer price 3. Dual pricing

b. **Suggested Readings**

Jain, S.P & Narang K.L (2014) "Financial Accounting", 2nd Revised Edition, Kalyani Publisher

Maheswari S. N., Sharad (2013) "An Introduction to Accountancy" 11th Edition, Vikas Publishing House New Delhi

c. **Model Questions**

1. What is Departmental Accounts? Describe their need and advantages.
2. Explain the basis of allocation of expenses over various departments of a departmental organization.

BLOCK- 5: INTRODUCTION TO GOVERNMENTACCOUNTING

<u>Introduction</u>

In this block there are two units. Unit 1 concentrates on government accounting-basic understanding whereas Unit 2 concentrates on system of financial administration in India.

Unit 1 Government Accounting- Basic Understanding

Structure

1.0Objectives
1.1 Introduction
1.2 Accounting for Government Grants

1.0Objectives

After going through the unit, you will be able to:

- Evaluate accounting for government grants
- Distinguish between government accounting and commercial accounting
- Interpret general principles of government accounting
- Classify government accounts
- Analyze different forms of government accounts

1.1 Introduction

Government accounting refers to all the financial documents and records of public institutions that relate to the collection of taxpayers' money and the analysis, control of expenditure, administration of trust funds, management of government stores and all the financial responsibilities and duties of the relevant organs.

Government accounting system is the way of accountability through which the established institutions of the public render stewardship on the revenue of the nation and how it has been disbursed.

Government accounting incorporates the process of recording, analyzing, classifying, summarizing, communicating and interpreting financial information about government in aggregate and in details recording all transactions involving the receipt, transfer and disposition of public funds and property.

In this unit we will study about government accounting with regards to government grants, classification of government accounts and interpret the general principles of government accounting.

1.2 Accounting for Government Grants

Government accounting is an important concept as it gives us the idea about how much of tax and non tax revenue has been generated by government and also highlights the areas in which disbursement of public money has been taken place.

Objectives of Government Accounting

The various objectives of government accounting can be summarized as follows:

1. **Providing information about revenue:** Government accounting aims to provide information about the revenues of the government during the year. The government revenues can be classified into two categories: a) tax revenue and b) non tax revenue
2. **Providing information about expenditure:** Government accounting aims to provide information about the expenditure on different items. This is necessary because Parliament or State Legislature, as the case may be, would like to know whether the amounts spent the government on different activities are within the limits sanctioned by it or not.
3. **Providing information about loans and deposits:** Government accounting provides information about loans and deposits which the government has to pay to its creditors and also debts due by others to the government.
4. **Information about cash availability:** Government accounting provides information on availability of cash in present situation.

1.3 Difference between Government Accounting and Commercial Accounting

The differences between the two can be summarized as follows:

1) **System of accounting:** The accounts of a commercial concern are usually kept on accrual system and according to the double entry system of book keeping. In case of a manufacturing concern, appropriate cost records are also maintained to ascertain the cost of production of each product so that its selling price may appropriately be fixed. The overall objectives of maintain accounts of a commercial concern is to prepare the Profit and Loss Account and Balance Sheet so as to show the financial position and profitability of the business for a given period.

On the contrary, government accounts are mostly kept on cash basis. And most importantly, there is no scope for profit and loss in government accounting. Instead, it focuses on the areas in which government can collect funds and disburse the funds.

2) **Final Accounts:** In case of government accounts two statements are mostly prepared. These are: Government Account & Statement of Balancing Account.

   In commercial organizations, they prepare Trading and Profit and Loss Account and Balance Sheet.

3) **Classification of Accounts:** in case of commercial undertakings, all transactions are broadly classified into three categories- Real, Nominal and Personal Accounts.

   In government accounting, there involves broadly three accounts: a) Consolidated Fund b) Public Account and c) Contingency Fund.

   Even the Consolidated Fund has three divisions: a) Revenue and Expenditure Heads b) Capital Receipts and Disbursement Heads and c) Public Debt and Loans and Advances.

4) **Independence of Accounts and Audit Function**: In case of commercial accounting, audit function is independent of the accounts function; while in case of government accounting, in most cases, the function both of maintenance of accounts and their audit are handled by the Indian Audit and Accounts Department.

1.4 General Principles of Government Accounting

1. Charges or expenditure on a new project like constructions, new equipment, plant & machinery installation, maintenance, improvement, and service should be allocated to the capital account as per the rule made by competent authority.

2 Working charges of the project should be allocated to the revenue account.

3 In case of renewal and replacement and cost of the genuine replacement should be charged to capital account.

4 In case of damage due to extraordinary calamities, charged should be debited from the capital account or revenue account or from both. However, it will be determined by the government according to the case and circumstances.

5 Capital receipts during the new project should be credited to the capital account to reduce the capital expenditure of the project.

Comptroller and Auditor General of India

Comptroller and Audit General (CAG) is an independent Constitutional body. Special status has been given to safeguard his independence and enable him to discharge his duty without fear or favor.

As per the Article 148 of the Constitution of India, the comptroller and Auditor-General will be appointed by the President of India. The provision of removal of CAG is the same as of the judges of the Supreme Court. He can be removed only on the basis of proven misbehavior or incapacity.

As per the Article 150 of the Constitution of India — the accounts of the Union and of the States shall be kept in such form as the President may prescribed, on the advice of the Comptroller & Auditor General.

Article 151 of the Constitution provides that the audit reports of the Comptroller & Auditor General relating to the accounts of the Union shall be submitted to the President, who shall cause them to be laid before each House of Parliament.

5.1 Classification of Government Accounts

Government of India has following three types of Funds for marinating the records of all sorts of financial transactions −

- Consolidated Funds of India
- Contingency Funds of India
- Public Account

Let's discuss each of them succinctly −

Consolidated Funds of India

As per the Clause 1 of the Article 266 of the Indian Constitution −

"All revenues received by the Government by way of taxes like Income Tax, Central Excise, Customs and other receipts flowing to the Government in connection with the conduct of Government business i.e. Non-Tax Revenues are credited into the Consolidated Fund constituted. Similarly, all loans raised by the Government by issue of Public notifications, treasury bills (internal debt) and loans obtained from foreign governments and international institutions (external debt) are credited into this fund. All expenditure of the government is incurred from this fund and no amount can be withdrawn from the Fund without authorization from the Parliament."

Contingency Funds of India

As per the Article 267 of the Indian Constitution −

"The Contingency Fund of India records the transactions connected with Contingency Fund set by the Government of India. The corpus of this fund is Rs. 50 crores. Advances from the fund are made for the purposes of meeting unforeseen expenditure which are resumed to the Fund to the full extent as soon as Parliament authorizes additional expenditure. Thus, this fund acts more or less like an imprest account of Government of India and is held on behalf of President by the Secretary to the Government of India, Ministry of Finance, and Department of Economic Affairs."

Public Account

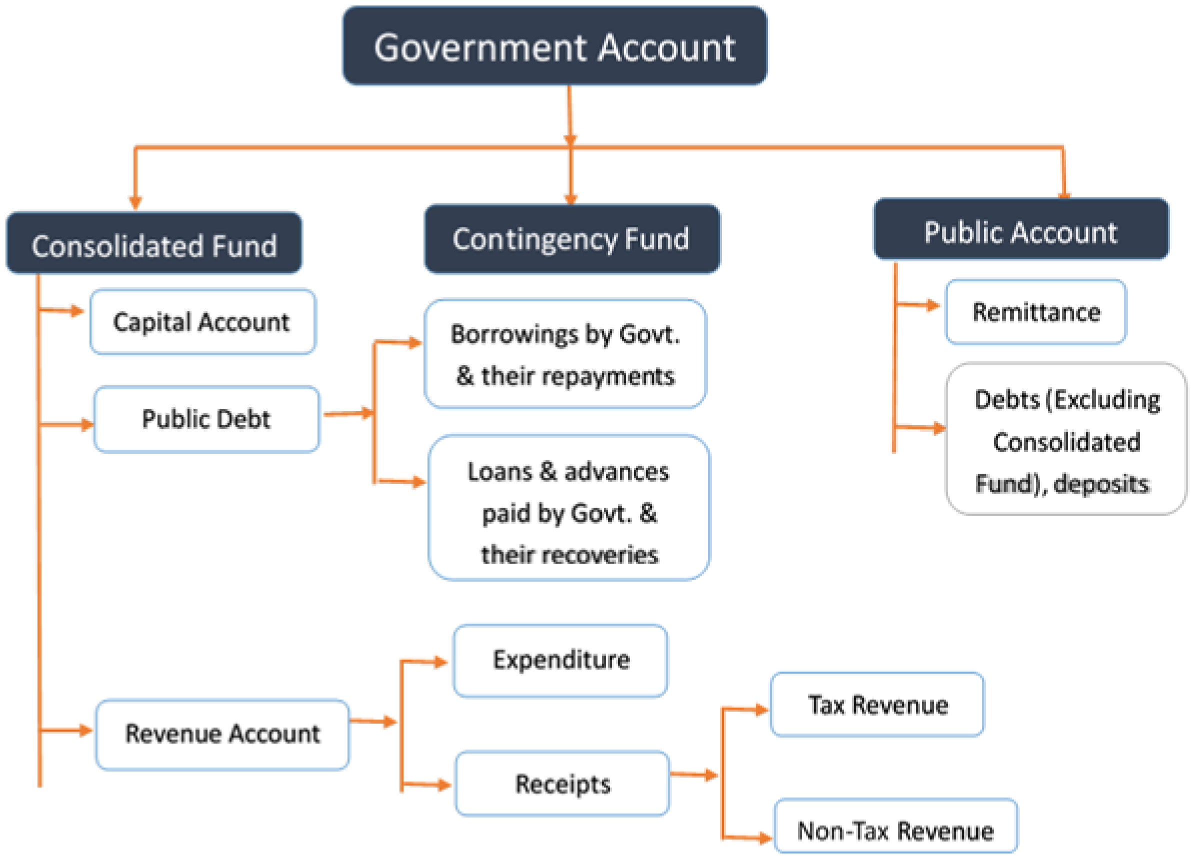
The Public Account is constituted under Clause 2 of Article 267 of the Indian Constitution, which says −

"The transactions relate to debt other than those included in the Consolidated Fund of India. The transactions under Debt, Deposits and Advances in this part are those in respect of which Government incurs a liability to repay the money received or has a claim to recover the amounts paid. Transactions relating to Remittance and Suspense shall embrace all adjusting heads. The initial debits or credits to these heads will be cleared eventually by corresponding receipts or payments. The receipts under Public Account do not constitute normal receipts of Government. Parliamentary authorization for payments from the Public Account is therefore not required."

Similarly, all 29 states of India have the same structure as described above.

General Structure of Government Accounts

The general structure of the government accounts is illustrated below −



5.2 Form of Government Accounts

Treasury and other government departments, initially compile their receipt and payment accounts on monthly basis for central government and state government separately and then send to respective Accountant General of India.

Collection of revenue and disbursement are directly made by Railway, Defense, Post & Telegraphs, Forest, and public departments and lump sum payments are made by treasury through the departmental officers. Detail of accounts on monthly basis is maintained by the departmental Accounts officers.

Monthly accounts submitted by the treasury and account officer are compiled by the Accountant General, for the central government as a whole and for each state separately. The compiled report shows progressive figure of each month from 1st April to 31st March of every year. Complied accounts along with appropriation accounts are submitted by Comptroller and Auditor General of India to the President of India, to the Governor of each state, or to the Administrator of the Union Territory accordingly.

1.7 Let Us Sum Up

Government accounting refers to all the financial documents and records of public institutions that relate to the collection of taxpayers' money and the analysis, control of expenditure, administration of trust funds, management of government stores and all the financial responsibilities and duties of the relevant organs.

Government accounting is different from commercial accounting in respect of preparation of final accounts and system of accounts. Government accounts are mostly cash based accounts where commercial accounts are accrual based. Likewise, double entry system is followed in commercial accounting but same kind of accounting is not practiced under government accounting.

The primary classification of government accounts are: consolidated fund, public account and contingency fund.

1.8 Key Words: consolidated fund, public account and contingency fund.

1.9 SAQs

1. Government accounting advocates for preparation of Profit and Loss Account. (True or False)
2. There are three classifications of government accounts: Consolidated Fund, Public Account and ______________________________. (Fill in the blank)
3. All loans raised by the Government by issue of Treasury bill, loans will come under ____________________________. (Fill in the blank)

1.10 Answers to SAQs

1. False 2. Contingency Fund 3. Consolidated Fund

1.11 Suggested Readings

Sahaf, M. A. (2009) "Management Accounting: Principles and Practice", Second Edition, Vikash Publishing House, New Delhi

Ahmed, N (2008) "Financial Accounting", Atlantic Publishers and Distributors Pvt Ltd, New Delhi,

1.12 Model Questions

1. What is Government Accounting? Discuss how is it different from Commercial Accounting?
2. Discuss the classification of Government Accounts.

Unit 1 System of Financial Administration in India

Structure

1.0Objectives

After going through this unit, you will be able to :

- Understand the system of financial administration in India.
- Familiarize with various terminologies related to government accounts.

1.1 Introduction

In the last unit, we have learnt about government accounting and essence of maintaining government accounts. We have also learnt about various classifications of government accounts. Here in this unit, we will focus on system of financial administration in India.

1.2 System of Financial Administration in India

The system of financial administration in India can be summarized as:

1. **Maintenance of Funds/ Accounts:** Under the present financial set up, the Central Government and each State Government have to maintain the following funds/ accounts:

a) **Consolidated Fund:** This fund is credited with all the revenues received by the central or state government, as the case may be. It is charged with all expenditure as authorized by the appropriate legislative authority.
b) **Public Account:** this account is credited with all receipts accrued received by the state or central government from debt, deposits and remittances. Disbursements are made out of this fund in accordance with the rules.
c) **Contingency Fund:** this fund is at the disposal of the Governor of the State/ President of India, to enable them to make advances for meeting unforeseen expenditure pending authorization of such expenditure by the Parliament or the State Legislature, as the case may be. Such fund is financed by such sums as the case may be determined by the appropriate legislature.

2. **Presentation of Budget:** Budget is the most important element as it is the forecast of government's probable receipts and disbursements. According to Article 122 of the Constitution, the President of India has to see that a Statement of Estimated Receipts and Expenditure for every financial year is presented before the Parliament by the Government. Such annual financial statement is also known as Government Budget. At present, the financial year is from 1st April to 31st March. Regarding expenditure, the budget needs to show separately the following:
   - The sums required to meet expenditure charged upon the Consolidated Fund
   - The sums required to meet other expenditure proposed to be made from the Consolidated Fund.

     It may be noted that the expenditure 'charged upon' does not require the Vote of Approval of the Parliament. Of course, the parliament may discuss such expenditure but it has no right to reduce it. Some of the examples of 'charged upon' expenditure are the emoluments and expenditure relating to the office of the President/ Governor, salaries and allowances of Vice President, Speaker of the Lok Sabha, Deputy Speaker of Lok Sabha/ Legislative Assembly, Judges of Supreme Court and High Courts, etc. The expenditure, other than 'charged upon' expenditure are called as ‘demand for grants’. ‘Demand for grants’ of the central government is submitted to Lok Sabha.

3. **Appropriation Act:** As soon as the Lok Sabha votes demand for grant proposed in the budget, an Appropriation Bill is introduced in the Lok Sabha. Such bill is introduced to provide for appropriations out of Consolidated Fund for the following reasons:
   - Meeting the demands for grant
   - The expenditure charged upon the Consolidated Fund of India.

   It may be noted that no amendment can be proposed in either House of Parliament i.e Rajya Sabha and Lok Sabha which can have any effect on varying the amount of purpose of demand for grants or charged expenditure. The passing of Appropriation Act is necessary because without it no expenditure can be incurred out of Consolidated Fund.
4. **Communication of Grants to Appropriate Ministries:** The grants as appropriated are communicated to appropriate ministries. This is an indication to the concerned authorities that they should incur expenditure within limits allocated to them. The Finance Minister in consultation with CAG (Comptroller and Auditor General of India makes appropriate rules both for receipts and expenditure which ministries and authorities must obey.

1.3 Classification of expenditure in Government Accounts

Each Government whether Union or State keep three distinct funds or accounts:

a) Consolidated Fund
b) Public Account
c) Contingency Funds

In the Consolidated Fund, there are three divisions:

1. Revenue receipt head comprise the following:
   - ➢ Tax revenue
   - ➢ Non tax revenue
   - ➢ Grants in aid and contribution.

   The expenditure heads comprise of:
   - ➢ General Service e.g., fiscal services, interest payment and servicing of debt, administrative services, defence services, etc.

- Social Service e.g., education, sports, arts and culture, health and family welfare, information and broadcasting, etc.
- Economic Service e.g., agriculture and allied services, energy, transport, communication, etc.
- Grants in aid and contribution.

2. Capital Division: this division consists of capital receipts and capital disbursements. Here the capital expenditure includes expenditure of considerable magnitude incurred with the object of increasing tangible assets or reducing recurring liabilities e.g., capital outlay on large project or major portion of payments in the form of commutation and pensions.
3. Public Debt, Loans and Advances Division: This division consists of loans raised by the government whether temporary or permanent and also loans and advances made by the government together with the repayment of the former and recovery of the later. Under each of these heads, expenditure is further classified as "voted" and "charged".

b) Public Account

The Public Account is meant for receiving all other public money received by or on behalf of the government, which does not come under Consolidated Fund. It has two divisions:

- Debt and Deposit Division: This division deals with the receipts and payments other than those falling under the "debt heads" of the Consolidated Fund in respect of which the government incurs liability to repay the money e.g., earnest money, deposits of contractors, court deposits, etc or as a claim to recover the amounts paid e.g., advances of pay and travelling allowances to government servants on transfers.
- Remittance Division: This division deals with merely adjusting heads e.g., cash remittances from one treasury to another, transfer between different accounting circles, etc.

  The classification of government expenditure is done in a manner that it has a close reference to department in which expenditure occurs rather than its objective. The President or the Governor has the power to issue general or special orders as to the head of the account, under which a particular transaction or a class of transaction is included. This is done by the President or Governor in consultation with Comptroller and Auditor General of India.

1.4 Important Terms

- **Public Accounts Committee**: It is appointed by the Parliament to securitize the appropriation of accounts of Union Government and the report of the Comptroller and Auditor General of India. Examination by the PAC is similar to post-mortem of the reports. Members of the PAC are appointed from the Opposition Parties of the Parliament. Member of the ruling party cannot be part of this committee, as this committee is working as a watchdog to look after the affairs of ruling party.
- **Vote on Account:** In addition to the prescribed procedure regarding provisions of funds to meet the expenditure and liabilities of the government for the entire financial year, the Constitution also provides for the grant of funds and advances by the Legislature for a part of the financial year before completion of the said procedure. Such grants are called as "Votes on Account".
- **Supplementary Grant**: In case the amount authorized by the Parliament or State Legislature for a particular service for the current financial year is not found to be sufficient for the purposes of that year or where a need arises during the current financial year or supplementary or additional expenditure, for some new service not contemplated earlier, the statement showing the estimated amount of expenditure is presented to both the Houses of the Parliament. Such estimates are called supplementary or additional demands for grant.

- **Appropriation Act** − After the approval of the budget proposal in the Parliament or Legislature, an Appropriation Bill has to be introduced, when this Bill is passed, it becomes Appropriation Act. Now, money can be withdrawn from the Consolidated Fund of India or the concerned State to meet the grants.

- **Treasuries** − Treasuries are the units of fiscal system in India. Every Indian States and Union Territory is divided into different districts' headquarters and every district headquarters has one or more than one treasury. Treasuries are conducted by the State Bank of India as an agent of the Reserve Bank of India. Central Government and State Government keep their separate accounts and differences of Central and State Govt. are adjusted by the Reserve Bank of India.

1.5 Let Us Sum Up

Government follows some procedure for the smooth conduct of financial administration of a country or state like maintaining funds, presenting budget, Appropriating Acts, etc.

1.6 Key Words: Vote on Accounts, Demand for Grants, Public Accounts Committee, Comptroller and Auditor General of India.

1.7 SAQs

1. The passing of Appropriation Act is necessary because without it no expenditure can be incurred out of Consolidated Fund. (True/ False)
2. Public Accounts Committee is appointed by the Comptroller and Auditor General of India.

1. 8 Answers to SAQs

1. True 2. False

1.9 Suggested Readings

Sahaf, M. A. (2009) "Management Accounting: Principles and Practice", Second Edition, Vikash Publishing House, New Delhi

Ahmed, N (2008) "Financial Accounting", Atlantic Publishers and Distributors Pvt Ltd, New Delhi,

1.10 Model Questions

1. Discuss the system of financial administration in India.

2. Describe the classification of expenditure in government accounts.