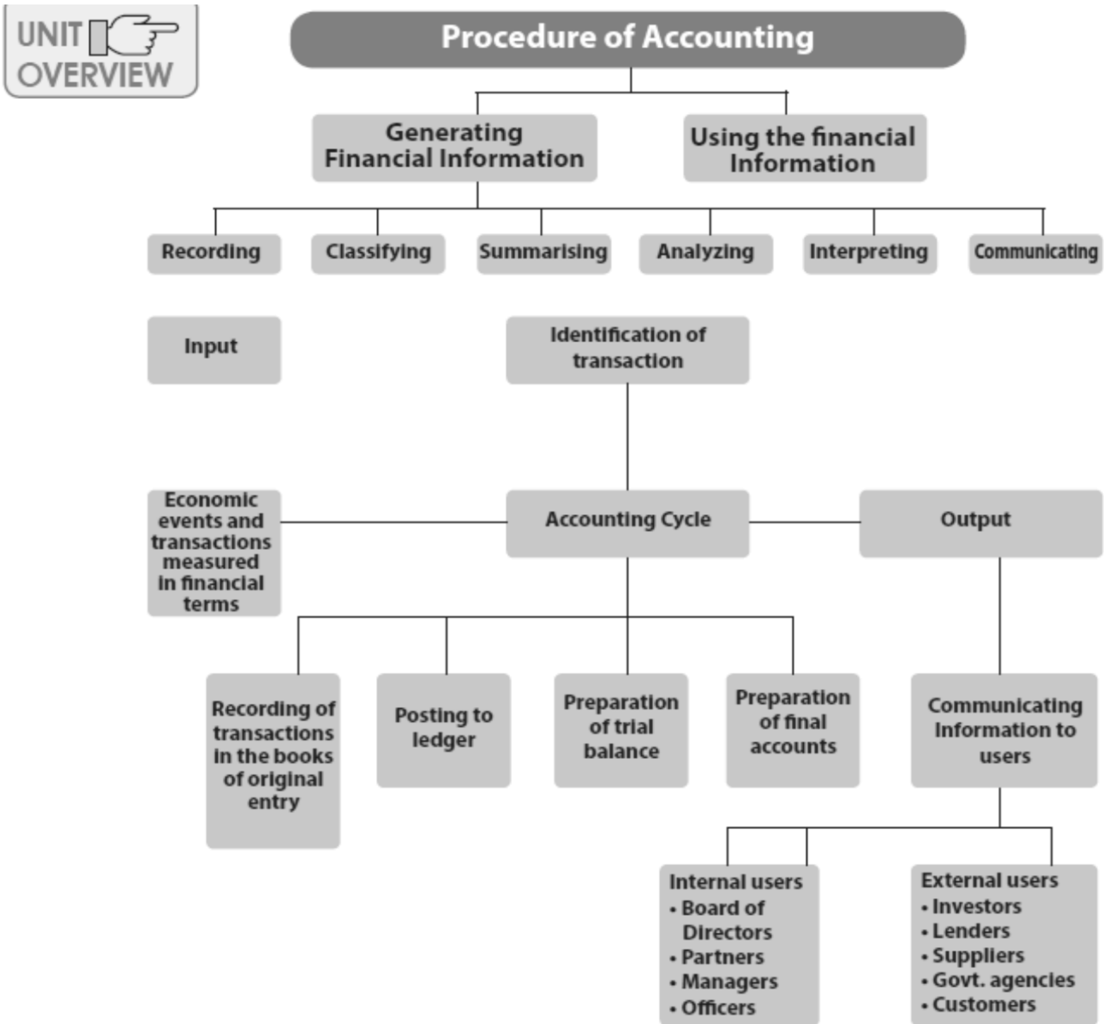
Index

Topic 1 : Theoretical Framework

UNIT 1: MEANING AND SCOPE OF ACCOUNTING



INTRODUCTION

Over the centuries, accounting has remained confined to the financial record-keeping functions of the accountant. But, todayRss rapidly changing business environment has forced the accountants to reassess their roles and functions both within the organisation and the society. The role of an accountant has now shifted from that of a mere recorder of transactions to that of the member providing relevant information to the decision-making team. Broadly speaking, accounting today is much more than just book- keeping and the preparation of financial reports.

An individual invests RS2,00,000 for running a stationery business. On 1st January, he purchases goods for RS 1,15,000 and sells for RsRS 1,47,000 during the month of January. He pays shop rent for the month RsRS 5,000and finds that still he has goods worth RsRS 15,000 in hand. The individual performs an economic activity. He carries on a few transactions and encounters with some events. Is it not logical that he will want to know the result of his activity?We see that the individual, who runs the stationery business, earns a surplus of rs 42,000.

Particulars	Rs	Rs
Goods sold		1,47,000
Goods in hand		15,000
		1,62,000
Less : Goods purchased	1,15,000	
Shop rent paid	5,000	(1,20,000)
Surplus		42,000

Earning of Rs42,000 surplus is an event; also having the inventories in hand is another event, while purchase and sale of goods, investment of money and payment of rent are transactions.

Everybody wants to keep records of all transactions and events and to have adequate information about the economic activity as an aid to decision-making. Accounting discipline has been developed to serve this purpose as it deals with the measurement of economic activities involving in_ow and out_ow of economic resources, which helps to develop useful information for decision-making process.

MEANING OF ACCOUNTING

The Committee on Terminology set up by the American Institute of Certified Public Accountants formulated the following definition of accounting in 1961:

"Accounting is the art of **recording, classifying, and summarising** in a significant manner and in **terms of money, transactions and events** which are, in part at least, of a financial character, and **interpreting** the result thereof."

The American Accounting Association in 1966 defines Accounting as:

"The process of **identifying, measuring and communicating economic information** to permit informed **judgments and decisions by the users** of accounts."

In 1970, the Accounting Principles Board (APB) of American Institute of Certified Public Accountants (AICPA) enumerated the functions of accounting as follows:

"The function of accounting is to provide quantitative information, primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions."

Procedural aspects of Accounting

On the basis of the above definitions, procedure of accounting can be basically divided into two parts:

(i) Generating financial information and

(ii) Using the financial information

Generating Financial Information

1. ***Identification:*** It involves observing activities and selecting those events that are considered of **financial character** and relate to the organisation.

   For example, the value of human resources, changes in managerial policies or appointment of personnel are important but none of these are recorded in books of account.

   However, when a company makes a sale or purchase, whether on cash or credit, or pays salary it is recorded in the books of account.

2. ***Measurement :*** It means quantification of business transactions into financial terms by using monetary unit, viz. rupees and paise as a measuring unit.

   If an event cannot be quantified in monetary terms, it is not considered for recording in financial accounts. That is why important items like the appointment of a new managing director, signing of contracts or changes in personnel are not shown in the books of accounts.

3. ***Recording :*** After the economic events are identified and measured in financial terms, these **are recorded in books of account in monetary terms and in a chronological order**. Recording is done in a manner that the necessary financial information is summarised as per well-established practice and is made available as and whenrequired.

4. **Classifying** – Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place so as to put information in compact and usable form. The book containing classified information is called "Ledger". For example, there may be separate account heads for Salaries, Rent, Printing and Stationeries, Advertisement etc. All expenses under these heads, after being recorded in the Journal,will be classified under separate heads in the Ledger. This will help in finding out the total expenditure incurred under each of the above heads.

5. **Summarising** – It is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as the external users of financial statements. This process leads to the preparation of the following financial statements:(a) Trial Balance (b) Profit and Loss Account (c) Balance Sheet (d) Cash-flow Statement.

6. **Analysing** – The term RsAnalysisRs means methodical classification of the data given in the financial statements. The figures given in the financial statements will not help anyone unless they are in a simplified form.

7. **Interpreting** –It is concerned with explaining the meaning and significance of the relationship as established by the analysis of accounting data. The recorded financial data is analysed and interpreted in a manner that will enable the end-users to make a meaningful judgement about the financial condition and profitability of the business operations. The financial statement should explain not only what had happened but also why it happened and what is likely to happen under specified conditions.

8. ***Communication :*** *The economic events are identified, measured and recorded in order that the important information is generated and communicated in a certain form to management and other* ***internal and external users****. The accounting information system should be designed in such a way that the* ***right information is communicated to the right person at the right time.*** *Reports can be daily, weekly, monthly, or quarterly, depending upon the needs of the users.*

OBJECTIVES OF ACCOUNTING

1. **Systematic recording of transactions** – Basic objective of accounting is to systematically record the financial aspects of business transactions i.e. book-keeping. These recorded transactions are later on classified and summarized logically for the preparation of financial statements and for their analysis and interpretation.

2. **Ascertainment of results of above recorded transactions** – Accountant prepares profit and loss account to know the results of business operations for a particular period of time. If revenue exceed expenses then it is said that business is running profitably but if expenses exceed revenue then it can be said that business is running under loss. The profit and loss account helps the management and different stakeholders in taking rational decisions.

3. **Ascertainment of the financial position of the business** – Businessman is not only interested in knowing the results of the business in terms of profits or loss for a particular period but is also anxious to know that what he owes (liability) to the outsiders and what he owns (assets) on a certain date. To know this, accountant prepares a financial position statement popularly known as Balance Sheet. The balance sheet is a statement of assets and liabilities of the business at a particular point of time and helps in ascertaining the financial health of the business.

4. **Providing information to the users for rational decision-making –** Accounting as a Rslanguage of businessRs communicates the financial results of an enterprise to various stakeholders by means of financial statements. Accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making.

5. **To know the solvency position –** By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise, but also it gives the information regarding concernRss ability to meet its liabilities in the short run (liquidity position) and also in the long-run (solvency position) as and when they fall due.

FUNCTIONS OF ACCOUNTING

(a) **Measurement:** Accounting measures past performance of the business entity and depicts its current financial position.

(b) **Forecasting:** Accounting helps in forecasting future performance and _nancial position prise using past data.

(c) **Decision-making:** Accounting provides relevant information to the users of accounts to decision-making.

(d) **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets anddiscloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparing and evaluating the financial results.

(e) **Control:** Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.

(f) **Government Regulation and Taxation:** Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues

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BOOK-KEEPING

Book-keeping is an activity concerned with the recording of financial data relating to business operations in a significant and orderly manner. It covers procedural aspects of accounting work and embraces record keeping function. Obviously, book-keeping procedures are governed by the end product, the financial statements. The term Rsfinancial statementsRs means Profit and Loss Account and Balance Sheet including Schedules and Notes forming part of Accounts. As discussed earlier, Profit and Loss Account gives result of economic activities for a period and Balance Sheet states the financial position at the end of the period.Book-keeping also requires suitable classification of transactions and events. This is also determined with reference to the requirement of financial statements. A book-keeper may be responsible for keeping all the records of a business.

DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

S. No.	Book-keeping	Accounting
1	It is a process concerned with recording of transactions.	It is a process concerned with summarising of the recorded transactions.
2	It constitutes as a base for accounting.	It is considered as a language of the business.
3	Financial statements do not form part of this process.	Financial statements are prepared in this process on the basis of book-keeping records.
4	Managerial decisions cannot be taken with the help of these records. .	Management takes decisions on the basis of these records.
5	There is no sub-feld of book-keeping	It has several sub-fields like financial accounting,management accounting etc.
6	Financial position of the business cannot be ascertained through book-keeping records.	Financial position of the business is ascertained on the basis of the accounting reports.

SUB-FIELDS OF ACCOUNTING

(i) **Financial Accounting** – It covers the preparation and interpretation of financial statements and communication to the users of accounts. It is historical in nature as it records transactions which had already been occurred. The final step of financial accounting is the preparation of Profit and Loss Account and the Balance Sheet. It primarily helps in determination of the net result for an accounting period and the financial position as on the given date.

(ii) ***Management Accounting*** – It is concerned with internal reporting to the managers of a business unit. To discharge the functions of stewardship, planning, control and decision-making, the management needs variety of information. The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting. A very important component of the management accounting is cost accounting which deals with cost ascertainment and cost control. Management Accounting will be dealt with at higher levels of the Chartered Accountancy Course.

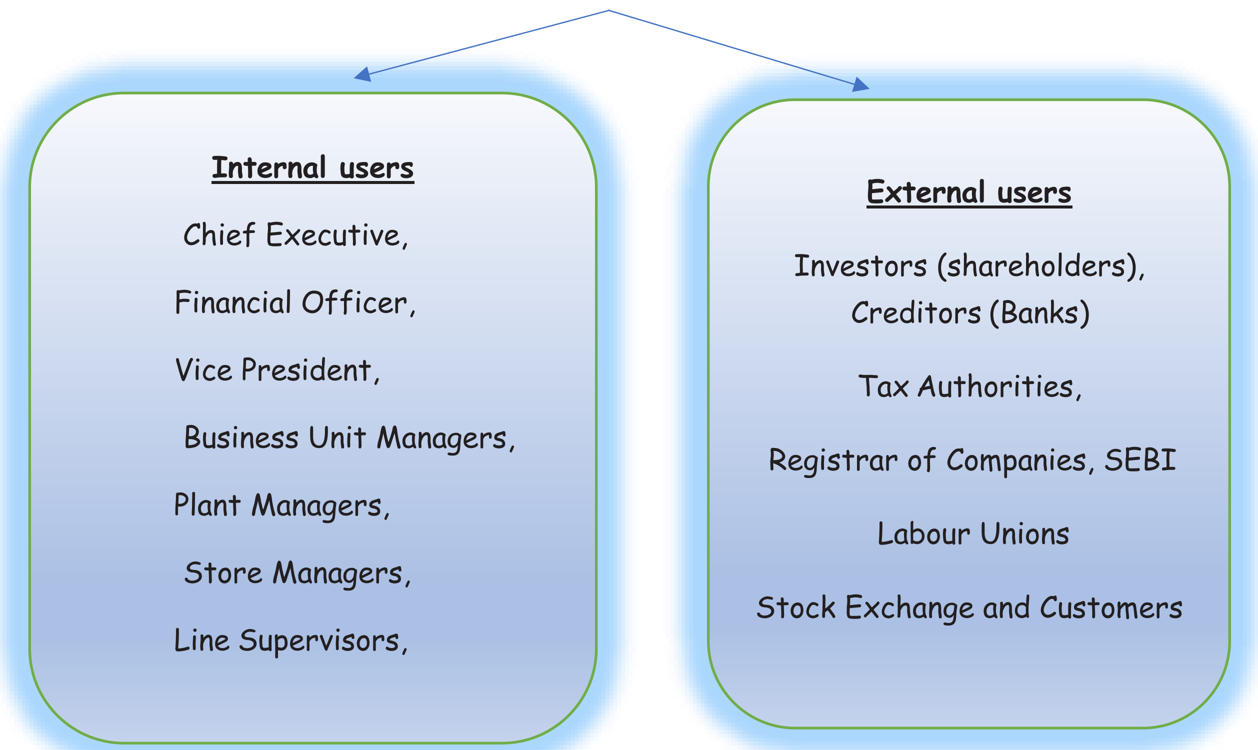
(iii) **Cost Accounting –** The terminology of Cost Accounting published by the Institute of Cost and Management Accountants of England defines cost accounting as:"the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs."

(iv) **Social Responsibility Accounting –** The demand for social responsibility accounting stems from increasing social awareness about the undesirable by-products of economic activities. As already discussed earlier, social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.

(v) **Human Resource Accounting –** Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.

USERS OF ACCOUNTING INFORMATION

Types of User



(i) **Investors:** They provide risk capital to the business. They need information to assess whether to buy, hold or sell their investment. Also they are interested to know the ability of the business to survive, prosper and to pay dividend. In non-corporate sector, where ownership and management are not essentially separated, the owners still need information about performance of the business and its financial position to decide whether to continue or shut down.

ii) **Employees:** Growth of the employees is directly related to the growth of the organisation and therefore, they are interested to know the stability, continuity and growth of the enterprise and its ability to provide remuneration, retirement and other benefits and to enhance employment opportunities.

(iii) **Lenders:** They are interested to know whether their loan-principal and interest will be paid when due.

(iv) **Suppliers and Creditors:** They are interested to know the ability of the enterprise to pay their dues, that helps them to decide the credit policy for the relevant concern, rates to be charged and so on. Sometimes, they also become interested in long-term continuation of the enterprise if their existence becomes dependent on the survival of that business. Suppose, small ancillary units supply their products to a big enterprise, if the big enterprise collapses, the fate of the small units also becomes sealed.

(v) **Customers:** Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods, suppose, a company produces some chemicals used by pharmaceutical companies and supplies chemicals on three monthRss credit. If all of a sudden it faces some trouble and is unable to supply the chemical, the customers will also be in trouble.

(vi) **Government and their agencies:** They regulate the functioning of business enterprises for public good, allocate scarce resources among competing enterprises, control prices, charge excise duties and taxes, and so they have continued interest in the business enterprise.

(vii) **Public:** The public at large is interested in the functioning of the enterprise because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.

(viii) **Management :** Management as whole is also interested in the accounts for various managerial decisions. On the basis of the accounts, management determines the effects of their various decisions on the functioning of the organisation. This helps them to make further managerial decisions.

RELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINES

(a) Accounting and Economics: Economics is viewed as a science of rational decision-making about the use of scarce resources. It is concerned with the analysis of efficient use of scarce resources for satisfying human wants. This may be viewed either from the perspective of a single firm or of the country as a whole.

Accounting overlaps economics in many respects. It contributed a lot in improving the management decision-making process. But, economic theories influenced the development of the decision-making tools used in accounting.

An example may be given to explain the nexus between accounting and economics. Economists think that value of an asset is the present value of all future earnings which can be derived from such assets. Now think about a plant whose working life is more than one hundred years. How can you estimate future stream of earnings? So accountants developed the workable valuation base – the acquisition cost i.e., the price paid to acquire the assets.

(b) Accounting and Statistics: Accounting information is very precise; it is exact to the last paisa. But, for decision-making purposes such precision is not necessary and hence, the statistical approximations are sought.

In accounts, all values are important individually because they relate to business transactions. As against this, statistics is concerned with the typical value, behaviour or trend over a period of time or the degree of variation over a series of observations. Therefore, wherever a need arises for only broad generalisations or the average of relationships, statistical methods have to be applied in accounting data.

In accountancy, a number of financial and other ratios are based on statistical methods, which help in averaging them over a period of time. Several accounting and financial calculations are based on statistical formulae.

Statistical methods are helpful in developing accounting data and in their interpretation. For example, time series and cross-sectional comparison of accounting data is based on statistical techniques. Now-a-days multiple discriminate analysis is popularly used to identify symptoms of sickness of a business firm. Therefore, the study and application of statistical methods would add extra edge to the accounting data.

(c) Accounting and Mathematics: Double Entry book-keeping can be converted in algebraic form; in fact the first known book on this subject was part of a treatise on algebra. The fundamental accounting equation will be discussed in detail under RsDual Aspect ConceptRs of this chapter.

Knowledge of arithmetic and algebra is a pre-requisite for accounting computations and measurements. Calculations of interest and annuity are the examples of such fundamental uses. While computing depreciation, finding out installments in hire-purchase and instalments payment transactions, calculating amount to be set aside for repayment of loan and replacement of assets and calculating lease rentals, mathematical techniques are frequently used. Accounting data are also presented in ratio form.

With the advent of the computer, mathematics is becoming a vital part of accounting. Instead of writing accounts in traditional fashion, the transactions and events can be recorded in the matrix form and the rules of matrix algebra can be applied for classifying and summarising data.

(d) Accounting and Law: An economic entity operates within a legal environment. All transactions with suppliers and customers are governed by the Contract Act, the Sale of Goods Act, the Negotiable

Instruments Act, etc. The entity itself is created and controlled by laws. For example, a company is created by the Companies Act and also controlled by Companies Act.

Similarly, every country has a set of economic, fiscal and labour laws. Transactions and events are always guided by laws of the land. Very often the accounting system to be followed has been prescribed by the law. For example, the Companies Act has prescribed the format of financial statements for companies.

Banking, insurance and electric supply undertakings may also have to produce financial statements as prescribed by the respective legislations controlling such entities.
However, legal prescription about the accounting system is the product of developments in accounting knowledge. That is to say, legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline. In that way accounting infiuences law and is also infiuenced by law.

(e) Accounting and Management: Management is a broad occupational field, which comprises many functions and encompasses application of many disciplines including those mentioned above. Accountants are well placed in the management and play a key role in the management team. A large portion of accounting information is prepared for management decision-making. Although management relies on other data sources, accounting data are used as basic source documents. In the management team, an accountant is in a better position to understand and use such data. In other words, since an accountant plays an active role in management, he understands the data requirements. So the accounting system can be moulded to serve the management purpose.

LIMITATIONS OF ACCOUNTING

1. The factors which may be relevant in assessing the worth of the enterprise donRst find place in the accounts as they cannot be measured in terms of money. The Balance sheet cannot respect the value of certain factors like loyalty and skill of the personnel which may be the most valuable asset of an enterprise these days.
2. Balance Sheet shows the position of the business on the day of its preparation and not on the future date while the users of the accounts are interested in knowing the position of the business in the near future and also in long run and not for the past date. Business dynamics change within the time annual reports reach to the ultimate users. To resolve this, auditors disclose the events occurring after the balance sheet date but before approval of financial statements in the financial reports.
3. Accounting ignores changes in some money factors like infiation etc.
4. There are occasions when accounting principles confiict with each other.
5. Certain accounting estimates depend on the sheer personal judgement of the accountant, e.g., provision for doubtful debts, method of depreciation adopted, recording certain expenditure as revenue expenditure or capital expenditure, selection of method of valuation of inventories and the list is quite long.
6. Financial statements consider those assets which can be expressed in monetary terms. Human resources although the very important asset of the enterprise are not shown in the balance

sheet. There is no generally accepted formula for the valuation of human resources in money terms.

7. Different accounting policies for the treatment of same item adds to the probability of manipulations. Though through various laws and Accounting Standards, efforts are made to reduce these options to minimum but certainly could not be reduced to one.

1.12 ROLE OF ACCOUNTANT IN THE SOCIETY

(i) **Maintenance of Books of Accounts:** An accountant is able to maintain a systematic record of financial transactions in order to establish the net result of the transactions entered into during a period and to state the financial position of the concern as at a particular date. For the fulfillment of the twin objective of ascertaining the profit earned or loss sufiered and the financial position, it is necessary that all transactions be recorded in a systematic manner, which can be done only by an accountant. Proper maintenance of books of accounts assists management in planning, decision-making, controlling functions.

(ii) **Statutory Audit:** Every limited company is required to appoint a chartered accountant or a firm of chartered accountants as their auditor who are statutorily required to report each year whether in their opinion the balance sheet shows a true and fair view of the state of affairs on the balance sheet date, and the profit and loss account shows a true and fair view of the profit or loss for the year. Auditing is not confined to the accounts of companies; other organisations may also have their accounts audited, either because the law so requires (for example, the Cooperative Societies Act, the Income-tax Act, etc.) or because the proprietors wisely decided so (for example, a partnership firm or an individual trader).

(iii) **Internal Audit:** It is a management tool whereby an internal auditor thoroughly examines the accounting transactions and also the system, according to which these have been recorded with a view to ensure the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of management.

Now-a-days internal auditing has developed as a service to management. The internal auditor constructively contributes in improving the operational eficiency of the business through an independent review and appraisal of all business operations.

(iv) **Taxation:** An accountant can handle taxation matters of a business or a person and he can represent that business or person before the tax authorities and settle the tax liability under the statute prevailing. He can also assist in avoiding or reducing tax burden by proper planning of tax afiairs.

Accountants also have a social obligation to express their views on broad tax policy, on the effect of tax rate on business and the economy in general and on all other aspects of taxation in which they have knowledge superior to that of the general public.

(v) **Management Accounting and Consultancy Services:** Management accountant performs an controlling current operations, decision-making on special matters and for formulating long-range plans. His job is to collect, analyse, interpret and present all accounting information which is useful to the management. Accountant provides management consultancy services in the areas of management information system, expenditure control and evaluation of appraisal techniques for new investments and divestments, working capital management, corporate planning etc.

(vi) **Financial Advice:** Many people need help and guidance in planning their personal financial afiairs. An accountant who knows about finances, taxation and family problems is well placed to give such advice.

1.12.2 Chartered Accountant in Industry

An accountant, though he is a part of the highest planning team is not a planner in an industry. He works with the functional departments and translates the organisationRss aims in terms of financial expectations. Therefore, he has to make a thorough study of the business and of individuals in the functional departments, whether they are engineers or salesmen. A quali_ed accountant will be able to play an important role in performing important functions of a business relating to accounting, costing and budgetary control, estimating and treasury.

1.12.3 Chartered Accountant in Public Sector Enterprises

Both in the developed and developing countries, public sector enterprises have become a special feature of the national economy. The system of financial and budgetary control and of accounting, auditing and reporting has, therefore, become a matter of interest and concern to the nation, and does not remain confined merely to a limited number of shareholders. The form of accounting followed by these corporations or companies is different from that of ordinary government accounting. It is the duty of the accountants to prepare the accounts and reports of these public corporations in such a way that they enable the general public to know how far the items appearing in the various types of records and financial statements justify their existence.

1.12.4 Chartered Accountant in Framing Fiscal Policies

Accountants have a positive role to play in the determination of proper fiscal policies and advancement of trade, commerce and industry. They should develop new techniques and prepare themselves for new fields of service towards their commitment to the concept of the public goods and services. A business enterprise can be successful in the commercial sense only if accounting and business knowledge are pooled together. It is a social obligation for both accountants in industry and in practice to disclose greater information regarding the corporate results. The state of a_airs of the economy can be ascertained only when such consolidated corporate information is disclosed.

1.12.5 Chartered Accountant and Economic Growth

In the present times accountants should conceive their duties as broadly as the conditions might require and do not restrict them to only literal compliance of the law. Their aim should be not to allow any individual to gain at the cost of the nation. Accountants have to accept a positive role and do their best to encourage eficiency in individual business units and encourage those social objectives which form the main foundation of a welfare state.

SUMMARY

- "Accounting is the art of recording, classifying, and summarising in a signi_cant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof."
- Accounting procedure can be basically divided into two parts:
  (i) Generating _nancial information and
  (ii) Using the _nancial information.
- The objectives of accounting can be given as follows:
  (i) Systematic recording of transactions
  (ii) Ascertainment of results of above recorded transactions
  (iii) Ascertainment of the _nancial position of the business
  (iv) Providing information to the users for rational decision-making
  (v) To know the solvency position
- The main functions of accounting are as follows:
  (i) Measurement (ii) Forecasting
  (iii) Decision-making (iv) Comparison & Evaluation
  (v) Control (vi) Government Regulation and Taxation
- Objectives of Book-keeping:
  (i) Complete Recording of Transactions and
  (ii) Ascertainment of Financial Effect on the Business
- The various sub-fields of accounting are:
  (i) Financial Accounting (ii) Management Accounting
  (iii) Cost Accounting (iv) Social Responsibility Accounting
  (v) Human Resource Accounting
- The various users of accounting information:
  (i) Investors (ii) Employees
  (iii) Lenders (iv) Suppliers and Creditors
  (v) Customers (vi) Government and their agencies
  vii) Public (viii) Management

Multiple Choice Questions

1. Which of the following is not a subfield of accounting?
   (a) Management accounting.
   (b) Cost accounting.
   (c) Book-keeping
2. Purposes of an accounting system include all the following except
   (a) Interpret and record the effects of business transaction.
   (b) Classify the effects of transactions to facilitate the preparation of reports.
   (c) Dictate the specific types of business enterprise transactions that the enterprises may engage in.
3. Book-keeping is mainly concerned with

(a) Recording of financial data.
(b) Designing the systems in recording, classifying and summarising the recorded data.
(c) Interpreting the data for internal and external users.

4. All of the following are functions of Accounting except
(a) Decision making.
(b) Ledger posting.
(c) Forecasting.

5. Financial statements are part of
(a) Accounting.
(b) Book-keeping.
(c) Management Accounting.

6. Financial position of the business is ascertained on the basis of
(a) Records prepared under book-keeping process.
(b) Trial balance.
(c) Balance Sheet.

7. Users of accounting information include
(a) Creditors/Suppliers
(b) Lenders/ Customers
(c) Both (a) and (b)

8. Financial statements do not consider
a) Assets expressed in monetary terms.
(b) Liabilities expressed in monetary terms.
(c) Assets and liabilities expressed in non-monetary terms

9. On January 1, Sohan paid rent of Rs 5,000. This can be classi_ed as
(a) An event.
(b) A transaction.
(c) A transaction as well as an event.

10. On March 31, 2015 after sale of goods worth Rs 2,000, he is left with the closing inventory of Rs 10,000.This is
(a) An event.
(b) A transaction.
(c) A transaction as well as an event.

Theoretical Questions

1. Define accounting. What are the sub-fields of accounting?
2. Who are the users of accounts?
3. Discuss briefiy the relationship of accounting with
(i) Economics (ii) Statistics (iii) Law
4. Discuss the limitations which must be kept in mind while evaluating the Financial Statements.
5. What services can a Chartered Accountant provide to the society?

ANSWER/HINTS

MCQs

1.	(c)	2.	(c)	3.	(a)	4.	(b)	5.	(a)	6.	(c)
7.	(c)	8.	(c)	9.	(b)	10.	(a)				

"If people are doubting how far you can go, go so far that you can't hear them anymore." – Michele Ruiz

UNIT 2 : ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS

2.1 INTRODUCTION

Let us imagine a situation where you are a proprietor and you take copies of your books of account to five different accountants. You ask them to prepare the financial statements on the basis of the above records and to calculate the profits of the business for the year. After few days, they are ready with the financial statements and all the five accountants have calculated five different amounts of profits and that too with very wide variations among them. Guess in such a situation what impact would it leave on you about accounting profession. To avoid this, a generally accepted set of rules have been developed. This generally accepted set of rules provides unity of understanding and unity of approach in the practice of accounting and also in better preparation and presentation of the financial statements.

It is important that financial statements prepared by different organizations should be prepared on uniform basis. Also there should be consistency over a period of time in the preparation of these financial statements. If every accountant starts following his own norms and notions for accounting of different items then there will be an utter confusion. To avoid confusion and to achieve uniformity, accounting process is applied within the conceptual framework of RsGenerally Accepted Accounting PrinciplesRs (GAAPs). The term GAAPs is used to describe rules developed for the preparation of the financial statements and are called concepts, conventions, postulates, principles etc.

2.2 ACCOUNTING CONCEPTS

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared. The word concept means idea or notion, which has universal application. Financial transactions are interpreted in the light of the concepts, which govern accounting methods

2.3 ACCOUNTING PRINCIPLES

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

Accounting principles must satisfy the following conditions:
1. They should be based on real assumptions;
2. They must be simple, understandable and explanatory;
3. They must be followed consistently;

4. They should be able to reflect future predictions;
5. They should be informational for the users.

2.4 ACCOUNTING CONVENTIONS

Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. These conventions are derived by usage and practice.

In the study material, the terms Rsaccounting conceptsRs, Rsaccounting principlesRs and Rsaccounting conventionsRs have been used interchangeably to mean those basic points of agreement on which financial accounting theory and practice are founded.

2.5 CONCEPTS, PRINCIPLES AND CONVENTIONS - AN OVERVIEW

(a) **Entity concept:** Entity concept states that business enterprise is a separate identity apart from its owner. Business transactions are recorded in the business books of accounts and ownerRss transactions in his personal books of accounts. This basic concept is applied to all the organizations whether sole proprietorship or partnership or corporate entities.

Entity concept means that the enterprise is liable to the owner for capital investment made by the owner. Since the owner invested capital, which is also called risk capital, he has claim on the profit of the enterprise.

Example: Mr. X started business investing rs7,00,000 with which he purchased machinery for rs 5,00,000 and maintained the balance in hand. The financial position of the will be as follows:

Rs

	Rs
Capital	7,00,000
Machinery	5,00,000
Cash	2,00,000

This means that the enterprise owes to Mr. X rs 7,00,000. Now if Mr. X spends rs 5,000 to meet his family expenses from the business fund, then it should not be taken as business expenses and would be charged to his capital account (i.e., his investment would be reduced by rs 5,000). Following the entity concept the revised financial position would be

Liability	RS	RS
Capital	7,00,000	

Less : Drawings	(5,000)	6,95,000
Machinery		5,00,000
Cash		1,95,000

(b) **Money measurement concept:** As per this concept, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions, even if, they affect the results of the business materially, are not recorded if they are not convertible in monetary terms.

For example; employees of the organization are, no doubt, the assets of the organizations but their measurement in monetary terms is not possible therefore, not included in the books of account of the organization.

Entity and money measurement are viewed as the basic concepts on which other procedural concepts hinge.

(c) **Periodicity concept/definite accounting period.** As per Rsgoing concernRs concept an indefinite life of the entity is assumed. For a business entity it causes inconvenience to measure performance achieved by the entity in the ordinary course of business.

If a textile mill lasts for 100 years, it is not desirable to measure its performance as well as ;;financial position only at the end of its life.

So a small but workable fraction of time is chosen out of infinite life cycle of the business entity for measuring performance and looking at the financial position. Generally one year period is taken up for performance measurement and appraisal of financial position.

According to this concept accounts should be prepared after every period & not at the end of the life of the entityWe generally follow from 1st April of a year to 31st March of the immediately following year.

Thus, the periodicity concept facilitates in:

(i) Comparing of financial statements of different periods

(ii) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business

(iii) Matching periodic revenues with expenses for getting correct results of the business operations

(c) **Accrual concept:** Under accrual concept, the effects of transactions and other events are recognized on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statementsof the periods to which they relate.

For example, (1) Mr. X started a cloth merchandising. He invested rs 50,000, bought merchandise worth Rs 50,000. He sold such merchandise for Rsrs60,000. Customers paid him Rs 50,000 cash and assure him to pay Rs 10,000 shortly. His revenue is rs 60,000. It arose in the ordinary course of cloth business; Mr. X received rs 50,000 in cash and rs10,000 by way of receivables.

Take another example; (2) an electricity supply undertaking supplies electricity spending rs16,00,000 for fuel and wages and collects electricity bill in one month rs 20,00,000 by way of electricity charges.This is also revenue which arose from rendering services.

Lastly, (3) Mr. A invested rs 1,00,000 in a business. He purchased a machine paying RS 1,00,000. He hired it out for RS 20,000 annually to Mr. B. RS 20,000 is the revenue of Mr. A; it arose from the use by others of the enterpriseRss resources.

Expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period.

In the first example, Mr. X spent RS 50,000 to buy the merchandise; it is the expense of generating revenue of RS 60,000. In the second instance RS 16,00,000 are the expenses. Also whenever any asset is used it has a finite life to generate benefit. Suppose, the machine purchased by Mr. A in the third example will last for 10 years only. Then RS 10,000 is the expense every year relating to the cost of machinery. For the time being, ignore the idea of accounting period.

Accrual means recognition of revenue and costs as they are earned or incurred and not as money is received or paid. The accrual concept relates to measurement of income, identifying assets and liabilities.

(e) **Matching concept:** In this concept, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

(f) **Going Concern concept:** The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

(g) **Cost concept:** By this concept, the value of an asset is to be determined on the basis of historical cost/acquisition cost. When a machine is acquired by paying RS 5,00,000, following cost concept the value of the machine is taken as RS 5,00,000. Current cost of an asset is not easily determinable. If the asset is purchased on 1.1.1995 and such model is not available in the market, it becomes difficult to determine which model is the appropriate equivalent to the existing one. Similarly, unless the machine is actually sold, realisable value will give only a hypothetical figure. Lastly, present value base is highly subjective because to know the value of the asset one has to chase the uncertain future.

(h) **Realisation concept:** It closely follows the cost concept. Any change in value of an asset is to be recorded only when the business realises it. When an asset is recorded at its historical cost of RS

5,00,000 and even if its current cost is RS15,00,000 such change is not counted unless there is certainty that such change will materialize.

(i) **Dual aspect concept:** This concept is the core of double entry book-keeping. Every transaction or event has two aspects:

(1) It increases one Asset and decreases other Asset;
(2) It increases an Asset and simultaneously increases Liability;
(3) It decreases one Asset, increases another Asset;
(4) It decreases one Asset, decreases a Liability. Alternatively:
(5) It increases one Liability, decreases other Liability;
(6) It increases a Liability, increases an Asset;
(7) It decreases Liability, increases other Liability;
(8) It decreases Liability, decreases an Asset.

(j) **Conservatism:** Conservatism states that the accountant should not anticipate income and should provide for all possible losses. When there are many alternative values of an asset, an accountant should choose the method which leads to the lesser value. Later on we shall see that the golden rule of current assets valuation - Rscost or market price whichever is lowerRs originated from this concept.

The Realisation Concept also states that no change should be counted unless it has materialised. The Conservatism Concept puts a further brake on it. It is not prudent to count unrealised gain but it is desirable to guard against all possible losses.

For this concept there should be at least three qualitative characteristics of financial statements, namely,

(i) *Prudence,* i.e., judgement about the possible future losses which are to be guarded, as well as gains which are uncertain.

(ii) *Neutrality,* i.e., unbiased outlook is required to identify and record such possible losses, as well as to exclude uncertain gains,

(iii) *Faithful representation of alternative values.*

(k) **Consistency:** In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

The concept of consistency is applied particularly when alternative methods of accounting are equally acceptable. For example a company may adopt any of several methods of depreciation such as written-down-value method, straight-line method, etc. Likewise there are many methods for valuation of inventories. But following the principle of consistency it is advisable that the company should follow consistently over years the same method of depreciation or the same method of valuation of Inventories which is chosen.

An enterprise should change its accounting policy in any of the following circumstances only:

a. To bring the books of accounts in accordance with the issued Accounting Standards.

b. To comply with the provision of law.

c. When under changed circumstances it is felt that new method will reflect more true and fair picture in the financial statement.

(l) Materiality: Materiality principle permits other concepts to be ignored, if the effect is not considered material. This principle is an exception to full disclosure principle. According to materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item which will only increase the work of the accountant but will not be relevant to the usersRs need should not be disclosed in the financial statements.

The term materiality is the subjective term. It is on the judgement, common sense and discretion of the accountant that which item is material and which is not. For example stationary purchased by the organization though not used fully in the accounting year purchased still shown as an expense of that year because of the materiality concept. Similarly depreciation on small items like books, calculators etc. is taken as 100% in the year of purchase though used by the entity for more than a year. This is because the amount of books or calculator is very small to be shown in the balance sheet though it is the asset of the company.

The materiality depends not only upon the amount of the item but also upon the size of the business, nature and level of information, level of the person making the decision etc. Moreover an item material to one person may be immaterial to another person. What is important is that omission of any information should not impair the decision-making of various users.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

There are three fundamental accounting assumptions :

(i) Going Concern

(ii) Consistency

(iii) Accrual

FINANCIAL STATEMENTS

The aim of accounting is to keep systematic records to ascertain financial performance and financial position of an entity and to communicate the relevant financial information to the interested user groups. The financial statements are basic means through which the management of an entity makes public communication of the financial information along with selected quantitative details. They are structured financial representations of the financial position and the performance of an enterprise. To have a record of all business transactions and also to determine whether all these transactions resulted in either Rsprofit or lossRs for the period, all the entities will prepare financial statements viz., balance sheet, profit and loss account, cash flow statement etc. by following various accounting concepts, principles, and conventions which have been already discussed in detaills

Characteristics of Financial Statements

1. **Understandability:** An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence.

2. **Relevance:** To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

3. **Reliability:** To be useful, information must also be reliable, Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

4. **Comparability:** Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

5. **Materiality:** The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

4. **Faithful Representation:** To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

7. **Substance Over Form:** If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentations and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

8. **Neutrality:** To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

9. **Prudence:** The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognized by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.

10. **Full, fair and adequate disclosure:** The financial statement must disclose all the reliable and relevant information about the business enterprise to the management and also to their external users for which they are meant, which in turn will help them to take a reasonable and rational decision. For it, it is necessary that financial statements are prepared in conformity with generally accepted accounting principles i.e the information is accounted for and presented in accordance with its substance and economic reality and not merely with its legal form. The disclosure should be full and final so that users can correctly assess the financial position of the enterprise.

"Magic is believing in yourself. If you can make that happen, you can make anything happen." – Johann Wolfgang Von Goethe

Unit 3:ACCOUNTING TERMINOLOGY

Note: Only the Basic important terminologies which are useful at this level has been explained in the class. Remaining terminologies will be explained as and when classes moves further.

Acceptance

The draweeRss signed assent on bill of exchange, to the order of the drawer. This term is also *used to describe a bill of exchange that has been accepted.*

Accounting policies

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Accrual

Recognition of revenues and costs as they are earned or incurred (and not as money is received or paid). It includes recognition of transactions relating to assets and liabilities as they occur irrespective of the actual receipts or payments.

Accrual/Mercantile Basis of Accounting

The method of recording transactions by which *revenues*, *costs*, *assets* and *liabilities* are reflected in the accounts in the period in which they accrue. The Rsaccrual basis of accountingRs includes considerations relating to *deferrals*, *allocations*, *depreciation* and *amortisation*. This basis is also referred to as *mercantile basis of accounting*.

Accrued Asset

A developing but not yet enforceable claim against another person which accumulates with the passage of time or the rendering of service or otherwise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

Accrued Expense

An expense which has been incurred in an accounting period but for which no enforceable claim has become due in that period against the enterprise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed, and are not yet billable.

Accrued Liability

A developing but not yet enforceable claim by another person which accumulates with the passage of time

Accrued Revenue

Revenue which has been earned in an accounting period but in respect of which no enforceable claim has become due in that period by the enterprise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

Accumulated Depletion
The total to date of the periodic depletion charges on wasting assets.

Accumulated Depreciation
The total to date of the periodic depreciation charges on depreciable assets.

Advance
Payment made on account of, but before completion of, a contract, or before acquisition of goods or receipt of services.

Amortised Value
The *amortizable* amount less any portion already provided by way of *amortization.*

Annual Report
The information provided annually by the management of an enterprise to the owners and other interested persons concerning its operations and financial position. It includes the information statutorily required, e.g., in the case of a company, the *balance sheet, profit and loss statement* and notes on accounts, the *auditorRss report* thereon, and the report of the Board of Directors. It also includes other information voluntarily provided e.g., *value added statement*, graphs, charts, etc.

Appropriation Account
An account sometimes included as a separate section of the *profit and loss statement* showing application of *profits* towards *dividends, reserves*, etc.

Assets
Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

Authorised Share Capital
The number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as **nominal share capital**.

Average Cost
The cost of an item at a point of time as determined by applying an average of the cost of all items of the same nature over a period. When weightages are also applied in the computation, it is termed as **weighted average cost**.

Bad Debts
Debts owed to an enterprise which are considered to be irrecoverable.

Balance Sheet

A statement of the financial position of an enterprise as at a given date, which exhibits its assets, liabilities, capital, reserves and other account balances at their respective book values.
or the receipt of service or otherwise. It may arise from the purchase of services (including the use of money) which at the date of accounting have.

Bill of Exchange
An instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only, to or to the order of a certain person or to the bearer of the instrument.

Bonus Shares
Shares allotted by capitalization of the reserves or surplus of a corporate enterprise.

Book Value
The amount at which an item appears in the books of account or _nancial statements. It does not refer to any particular basis on which the amount is determined e.g., cost, replacement value, etc.

Borrowing costs
Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

Bond/Debenture
A formal document constituting acknowledgment of a debt by an enterprise usually given under its common seal and normally containing provisions regarding payment of interest, repayment of principal and security, if any. It is transferable in the appropriate manner.

Call
A demand pursuant to terms of issue to pay a part or whole of the balance remaining payable on shares or *debentures* after allotment.

Called-up Share Capital
That part of the subscribed share capital which shareholders have been required to pay.

Capital
Generally refers to the amount invested in an enterprise by its owners e.g. *paid-up share capital* in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise.

Capital Assets
Assets, including *investments* not held for sale, conversion or consumption in the ordinary course of business.

Capital Commitment
Future *liability* for capital expenditure in respect of which contracts have been made.

Capital Employed

The finances deployed by an enterprise in its *net _xed assets*, *investments* and *working capital*. Capital employed in an operation may, however, exclude *investments* made outside that operation.

Capital Profit/Capital Loss
Excess of the proceeds realised from the sale, transfer, or exchange of the whole or a part of a capital asset over its cost. When the result of this computation is negative, it is referred to as **capital loss**.

Capital Reserve
A *reserve* of a corporate enterprise which is not available for distribution as *dividend*.

Capital Work-in-progress
Expenditure on *capital assets* which are in the process of construction or completion.

Cash
Cash comprises cash on hand and demand deposits with banks

Cash equivalents
Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash Basis of Accounting
The method of recording transactions by which *revenues* and *costs* and *assets* and *liabilities* are reflected in the accounts in the period in which actual receipts or actual payments are made.

Cash Discount
A reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period.

Cash Profit
The *net profit* as increased by non-cash costs, such as *depreciation, amortization*, etc. When the result of the computation is negative, it is termed as **cash loss**..

Carrying amount
Carrying amount is the amount at which an asset is recognized in the balance sheet, net of any accumulated amortization and accumulated impairment losses thereon.

Charge
An encumbrance on an asset to secure an indebtedness or other obligations. It may be _xed or floating.

Cheque
A *bill* of exchange drawn upon a specified banker and not expressed to be payable otherwise than on demand.

Collateral Security

Security which is given in addition to the principal security against the same *liability* or obligation.

Costs of disposal
Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

Contingency
A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Contingent Asset
An *asset* the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

Contingent Liability
An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

Contra Account
One or two or more accounts which partially or wholly o_-set another or other accounts.
Cost The amount of *expenditure* incurred on or attributable to a specified article, product or activity.

Cost of Purchase
The purchase price including duties and taxes, freight inwards and other *expenditure* directly attributable to acquisition, less *trade discounts*, rebates, duty drawbacks, and subsidies in respect of such purchase.

Cost of Goods Sold
The cost of goods sold during an accounting period. In manufacturing operations, it includes (i) cost of materials; (ii) labour and factory overheads; selling and administrative expenses are normally excluded.

Conversion Cost
Cost incurred to convert raw materials or components into finished or semi-finished products. This normally includes costs which are specifically attributable to units of production, i.e., direct labour, direct expenses and subcontracted work, and production overheads as applicable in accordance with either the *direct cost* or *absorption costing method*. Production overheads exclude expenses which relate to general administration, finance, selling and distribution.

Convertible Debenture
A *debenture* which gives the holder a right to its conversion, wholly or partly, in shares in accordance with the terms of issue.

Cumulative Dividend

A *dividend* payable on *cumulative preference shares* which, if unpaid, accumulates as a claim against the earnings of a corporate enterprise, before any distribution is made to the other shareholders.

Cumulative Preference Shares
A class of preference shares entitled to payment of *cumulative dividends*. Preference shares are always deemed to be cumulative, unless they are expressly made non-cumulative.

Current Assets
Cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business.

Current Liability
Liability including loans, deposits and bank overdraft which falls due for payment in a relatively short period, normally not more than twelve months.

Deferral
Postponement of recognition of a revenue or expense after its related receipt or payment (or incurrence of a *liability*) to a subsequent period to which it applies. Common examples of deferrals include prepaid rent and taxes, unearned subscriptions received in advance by newspapers and magazine selling companies, etc.

Deficiency
The excess of *liabilities* over *assets* of an enterprise at a given date. The debit balance in the *profit and loss statement*.

Deficit
The debit balance in the profit and loss statement.

Depletion
A measure of exhaustion of a wasting asset represented by periodic write o_ of cost or other substituted value.

Depreciation
Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effuxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

Depreciable amount
Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Depreciable assets
Depreciable assets are assets which

(i) are expected to be used during more than one accounting period; and
(ii) have a limited useful life; and
(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others,
or for administrative purposes and not for the purpose of sale in the ordinary course of business.

Depreciation Method

Any method of calculating depreciation for an accounting period.

Depreciation Rate

A percentage applied to the historical cost or the substituted amount of a *depreciable asset* (or in case of *diminishing balance method*, the historical cost or the substituted amount less *accumulated depreciation*).

Diminishing Balance Method

A method under which the periodic charge for *depreciation* of an *asset* is computed by applying a fixed percentage to its historical cost or substituted amount less *accumulated depreciation* (net book value). This is also referred to as **written down value method**.

Discount

A reduction from a list price, quoted price or invoiced price. It also refers to the price for obtaining payment on a bill before its maturity.

Dividend

A distribution to shareholders out of profits or reserves available for this purpose.

Entity Concept

The view of the relationship between the accounting entity and its owners which regards the entity as a separate person, distinct and apart from its owners..

Equity Share

A share which is not a preference share. Also sometimes called **ordinary share**.

Exchange difference

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Expenditure

Incurring a *liability*, disbursement of cash or transfer of property for the purpose of obtaining *assets*, goods or services.

Expense

A cost relating to the operations of an accounting period or to the *revenue* earned during the period or the benefits of which do not extend beyond that period.

Expired Cost

That portion of an *expenditure* from which no further benefit is expected. Also termed as **expense**.

Extraordinary items

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Fair value

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an armRss length transaction.

Fair Market Value

The price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at armRss length who are fully informed and are not under any compulsion to transact.

First Charge

A *charge* having priority over other charges.

First In, First Out (FIFO)

Computation of the cost of items sold or consumed during a period as though they were sold or consumed in order of their acquisition.

Fixed asset

Asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

Fixed Cost

That cost of production which by its very nature remains relatively unaffected in a defined period of time by variations in the volume of production.

Fixed Deposit

Deposit for a specified period and at specified rate of interest.

Fixed or Specific Charge

A *charge* which attaches to a particular *asset* which is identified when the charge is created, and the identity of the *asset* does not change during the subsistence of the *charge*.

Floating Charge

A general *charge* on some or all *assets* of an enterprise which are not attached to specific *assets* and are given as security against a debt.

Financial Instrument

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

Foreign currency
Foreign currency is a currency other than the reporting currency of an enterprise.

Forfeited Share
A share to which title is lost by a member for non-payment of call money or default in fulfilling any engagement between members or expulsion of members where the articles specifically provide therefor.

Free Reserve
A *reserve* the utilization of which is not restricted in any manner.

Functional Classification
A system of classification of *expenses* and *revenues* and the corresponding *assets* and *liabilities* to each function or activity, rather than by reference to their nature.

Fund
An account usually of the nature of a *reserve* or a *provision* which is represented by specifically earmarked *assets*.

Fundamental Accounting Assumptions
Basic accounting assumptions which underlie the preparation and presentation of financial statements. They are *going concern*, consistency and *accrual*. Usually, they are not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

Gain
A monetary benefit, *profit* or advantage resulting from a transaction or group of transaction

General Reserve
A *revenue reserve* which is not earmarked for a specific purpose.

Going Concern Assumption
An accounting assumption according to which an enterprise is viewed as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

Goodwill
An *intangible asset* arising from business connections or trade name or reputation of an enterprise.

Gross Margin or Gross Profit
The excess of the proceeds of goods sold and services rendered during a period over their *cost*, before taking into account administration, selling, distribution and financing expenses. When the result of this computation is negative it is referred to as **gross loss**.

Government

Government refers to government, government agencies and similar bodies whether local, national or international.

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Government grants

Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Gross book value

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

Income and Expenditure Statement

A financial statement, often prepared by non-profit making enterprises like clubs, associations etc. to present their *revenues* and *expenses* for an accounting period and to show the excess of *revenues* over *expenses* (or vice versa) for that period. It is similar to profit and loss statement and is also called **revenue and expense statement**.

Intangible Asset

Asset which does not have a physical identity e.g. *goodwill*, patents, copyright etc.

Inventories are assets:
(a) held for sale in the ordinary course of business;
(b) in the process of production for such sale; or
(c) in the form of materials or supplies to be consumed in the production process or in the rendering of
services.

Investment

Expenditure on *assets* held to earn interest, *income, profit* or other benefits.

Investments

Assets held not for operational purposes or for rendering services i.e. assets other than *fixed assets* or *current assets* (e.g. securities, shares, *debentures*, immovable properties).

Issued Share Capital

That portion of the *authorized share capital* which has actually been offered for subscription. This includes any *bonus shares* allotted by the corporate enterprise.

Joint venture

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

Last In, First Out (LIFO)

Computation of the cost of items sold or consumed during a period on the basis that the items last acquired were sold or consumed first.

Liability

The financial obligation of an enterprise other than ownersRs funds.

Lien

Right of one person to satisfy a claim against another by holding or retaining possession of that otherRss *assets*/property.

Long-term Liability

Liability which does not fall due for payment in a relatively short period, i.e., normally a period not more than twelve months.

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Lease

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Materiality

An accounting concept according to which all relatively important and relevant items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements.

Mortgage

A transfer of interest in specific immovable property for the purpose of securing a loan advanced, or to be advanced, an existing or future debt or the performance of an engagement which may give rise to a pecuniary *liability*. The security is redeemed when the loan is repaid or the debt discharged or the obligations performed.

Net Assets/ShareholdersRs funds/Net Worth

The excess of the *book value* of *assets* (other than _*ctitious assets*) of an enterprise over its *liabilities*. This is also referred to as **net worth** or **shareholdersRs funds**.

Net Fixed Assets

Fixed assets less accumulated depreciation thereon up-to-date.

Net Profit/Net loss

The excess of *revenue* over *expenses* during a particular accounting period. When the result of this computation is negative, it is referred to as **net loss**. The net profit may be shown before or after tax.

Net realizable value

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Obsolescence

Diminution in the value of an asset by reason of its becoming out-of date or less useful due to technological changes, improvement in production methods, change in market demand for the product or service output of the asset, or legal or other restrictions.

Operating Profit

The *net profit* arising from the normal operations and activities of an enterprise without taking account of extraneous transactions and expenses of a purely financial nature.

Paid-up Share Capital

That part of the *subscribed share capital* for which consideration in cash or otherwise has been received. This includes *bonus shares* allotted by the corporate enterprise.

Preference Share Capital

That part of the *share capital* of a corporate enterprise which enjoys preferential rights in respect of payments of fixed *dividend* and repayment of *capital*. Preference shares may also have full or partial participating rights in surplus profits or surplus capital.

Preliminary Expenses

Expenses relating to the formation of an enterprise. These include legal, accounting and share issue expenses incurred for formation of the enterprise.

Prepaid Expense

Payment for expense in an accounting period, the benefit for which will accrue in the subsequent accounting period(s).

Prime Cost

The total *cost* of direct materials, direct wages and other direct production expenses.

Prior Period Item

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Profit/Loss

A general term for the excess of *revenue* over related *cost*. When the result of this computation is negative it is referred to as **loss**.

Profit and Loss Account

A financial statement which presents the *revenues* and *expenses* of an enterprise for an accounting period and shows the excess of *revenues* over *expenses* (or vice versa). It is also known as **profit and loss account**.

Promissory Note

An instrument in writing (not being a bank note or currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

Provision

An amount written o_ or retained by way of providing for *depreciation* or diminution in value of assets or retained by way of providing for any known *liability* the amount of which cannot be determined with substantial accuracy.

Provision for Doubtful Debts
A *provision* made for debts considered doubtful of recovery.

Prudence
A concept of care and caution used in accounting according to which (in view of the uncertainty attached to future events) *profits* are not anticipated, but recognised only when realised, though not necessarily in cash. Under this concept, *provision* is made for all known *liabilities* and losses, even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Redeemable Preference Share
The preference share that is repayable either after a fixed or determinable period or at any time decided by the management (by giving due notice), under certain conditions prescribed by the instrument of incorporation or the terms of issue.

Redemption
Repayment as per given terms normally used in connection with preference shares and debentures.

Reserve
The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a *provision* for *depreciation* or diminution in the value of assets or for a known *liability*. The reserves are primarily of two types: *capital reserves* and *revenue reserves*.

Revaluation Reserve
A *reserve* created on the revaluation of *assets* or *net assets* of an enterprise represented by the surplus of the estimated replacement cost or estimated market values over the *book values* thereof.

Residual value
Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Revenue/Income
Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

Revenue Reserve
Any reserve other than a capital reserve.

Right Share

An allotment of shares on the issue of fresh *capital* by a corporate enterprise to which a shareholder is entitled on payment, by virtue of his holding certain shares in the enterprise in proportion to the number of shares already held by him. (Shares allotted to certain categories of *debenture* holders pursuant to the rights enjoyed by them are sometimes called right shares)

Sales Turnover/Gross Turnover/Gross Sales

The aggregate amount for which sales are e_ected or services rendered by an enterprise. The terms **gross turnover** and **net turnover** (or **gross sales** and **net sales**) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts.

Secured Loan

Loan secured wholly or partly against an asset.

Share Capital

Aggregate amount of money paid or credited as paid on the shares and/ or stocks of a corporate enterprise.

Share Discount

The excess of the face value of shares over their issue price.

ShareholdersRs Equity

The interest of the shareholders in the *net assets* of a corporate enterprise. However, in the case of liquidation it is represented by the residual assets after meeting prior claims.

Share Issue Expenses

Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares.

Share warrants

Share warrants or options are fiancial instruments that give the holder the right to acquire equity shares.

Securities Premium

The excess of the issue price of shares over their face value.

Sinking Fund

A *fund* created for the repayment of a *liability* or for the replacement of an asset.

Straight Line Method

The method under which the periodic charge for *depreciation* is computed by dividing the *depreciable amount* of a *depreciable asset* by the estimated number of years of its useful life..

Subscribed Share Capital

That portion of the *issued share capital* which has actually been subscribed and allotted. This includes any *bonus shares* allotted by the corporate enterprise.

Substance over Form

An accounting concept according to which the substance and not merely the legal form of transactions and events governs their accounting treatment and presentation in _nancial statements.

Sundry Creditors / Trade Creditors/Trade payables

Amount owed by an enterprise on account of goods purchased or services received or in respect of contractual obligations. Also termed as **trade creditors** or **account payables** or **Trade payables**.

Sundry Debtors / Trade Debtors/ Trade Receivables

Person from whom amounts are due for goods sold or services rendered or in respect of contractual obligations. Also termed as **debtors, trade debtors, account receivables, trade receivables**.

Surplus

Credit balance in the *pro_t and loss statement* after providing for proposed appropriations, *e.g.*, *dividend* or *eserves*.

Trade Discount

A reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment.

Unexpired Cost

That portion of an *expenditure* whose benefit has not yet been exhausted.

Unissued Share Capital

That portion of the *authorised share capital* for which shares have not been offered for subscription.

Unpaid Dividend

Dividend which has been declared by a corporate enterprise but has not been paid, or the warrant or *cheque* in respect whereof has not been dispatched within the prescribed period.

Useful life

Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise

QUESTION

Define following terms:

1. Accrual Basis of Accounting

2. Amortisation
3. Contingent Asset
4. Contingent Liability

ANSWER

1. **Accrual Basis of Accounting**

   The method of recording transactions by which *revenues*, *costs*, *assets* and *liabilities* are reflected in the accounts in the period in which they accrue.

2. **Amortisation**

   The gradual and systematic writing o_ of an asset or an account over an appropriate period.

3. **Contingent Asset**

   An *asset* the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

4. **Contingent Liability**

   An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

"Don't be afraid to give up the good to go for the great." – John D. Rockefeller

UNIT 4 : CAPITAL AND REVENUE EXPENDITURES AND RECEIPTS

Revenue Expense relates to the operations of the business of an accounting period or to the revenue earned during the period or the items of expenditure, benefits of which do not extend beyond that period. Revenue expense is incurred to generate revenue for a particular accounting period.

Capital Expenditure generates enduring benefits and helps in revenue generation over more than one accounting period. Capital expenditure contributes to the revenue earning capacity of a business over more than one accounting period whereas Capital expenditure may represent acquisition of any tangible or intangible fixed assets for enduring future benefits.

Therefore, the benefits arising out of capital expenditure last for more than one accounting period whereas those arising out of revenue expenses expire in the same accounting period.

The distinction of transaction into revenue and capital is done for the purpose of placing them in Profit and Loss account or in the Balance Sheet. For example: revenue expenditures are shown in the profit and loss account as their benefit are for one accounting period i.e. in which they are incurred while capital expenditures are placed on the asset side of the balance sheet as they will generate benefits for more than one accounting period and will be transferred to profit and loss account of the year on the basis of utilization of that benefit in particular accounting year. Hence, both capital and revenue expenditures are ultimately transferred to profit and loss account.
Revenue expenditures are transferred to profit and loss account in the year of spending while capital expenditures are transferred to profit and loss account of the year in which their benefits are utilised..

CONSIDERATIONS IN DETERMINING CAPITAL AND REVENUE EXPENDITURES

(a) Nature of business: For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criteria in separating and expenditure between capital and revenue.

(b) Recurring nature of expenditure: If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure.

(c) Purpose of expenses: Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature.

(d) Effect on revenue generating capacity of business: The expenses which help to generate income/ revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure. When expenditure on improvements and repair of a fixed asset is done, it has to be charged to Profit and Loss Account if the expected future benefits from fixed assets do not change, and it will be included in book value of fixed asset, where the expected future benefits from assets increase.

{e} Materiality of the amount involved: Relative proportion of the amount involved is another important consideration in distinction between revenue and capital.

ILLUSTRATION 1

State with reasons whether the following statements are RsTrueRs or RsFalseRs.

[1] Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.

[2] Money spent to reduce working expenses is Revenue Expenditure.

[3] Legal fees to acquire property is Capital Expenditure.

[4] Amount spent as lawyerRss fee to defend a suit claiming that the firmRss factory site belonged to the plaintiff"s land is Capital Expenditure.

[5] Amount spent for replacement of worn out part of machine is Capital Expenditure.

[6] Expense incurred on the repairs and white washing for the _rst time on purchase of an old building are Revenue Expenses.

[7] Expenses in connection

[8] Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready, is Capital Expenditure.

SOLUTION

(1) False: Overhaul expenses are incurred to put second-hand machinery in working condition to derive endurable long-term advantage. So it should be capitalised.

(2) False: It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. It becomes part of intangible fixed assets if it is in the form of technical know-how and tangible fixed assets if it is in the form of additional replacement of any of the existing tangible fixed assets. So this is capital expenditure.

(3) True: Legal fee paid to acquire any property is part of the cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.

(4) False: Legal expenses incurred to defend a suit claiming that the firmRss factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.

(5) False: Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.

(6) False: Repairing and white washing expenses for the first time of an old building are incurred to put the building in usable condition. These are the part of the cost of building. Accordingly, these are capital expenditure.

(7) True: The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalised. Such expenses are amortised over a period of time.

(8) True: Cost of temporary huts constructed which were necessary for the construction of the cinema house is part of the construction cost of the cinema house. Therefore such costs are to be capitalised.

ILLUSTRATION 2

State with reasons whether the following are Capital or Revenue Expenditure:
(1) Expenses incurred in connection with obtaining a license for starting the factory for Rs *10,000.*
(2) Rs *1,000 paid for removal of Inventory to a new site.*
(3) Rings and Pistons of an engine were changed at a cost of Rs *5,000 to get fuel effeciency.*
(4) Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) Rs *8,000 for installing telephone in the once.*
(5) A factory shed was constructed at a cost of Rs *1,00,000. A sum of* Rs *5,000 had been incurred in the construction of temporary huts for storing building material.*

SOLUTION

(1) Money paid Rs 10,000 for obtaining license to start a factory is a capital expenditure. This is an item of expenditure incurred to acquire the right to carry on business.
(2) Rs 1,000 paid for removal of Inventory to a new site is revenue expenditure. This is neither bringing enduring benefit nor enhancing the value of the asset.
(3) Rs 5,000 spent in changing Rings and Pistons of an engine to get fuel efficiency is capital expenditure. This is an expenditure on improvement of a fixed asset. It results in increasing profit-earning capacity of the business by cost reduction.
(4) Money deposited with MTNL for installation of telephone in once is not expenditure. This is treated as an asset and the same is adjusted over a period of time against actual telephone bills.

(5) Cost of construction of building including cost of temporary huts is capital expenditure. Building is fixed asset which will generate enduring benefit to the business over more than one accounting period.Construction of temporary huts is incidental to the main construction. Such cost is also capitalised with the cost of building.

4.4 CAPITAL RECEIPTS AND REVENUE RECEIPTS

Receipts which are obtained in course of normal business activities are **revenue receipts** (e.g. receipts from sale of goods or services, interest income etc.).

Receipts which are not revenue in nature are **capital receipts** (e.g. receipts from sale of fixed assets or investments, secured or unsecured loans, ownersRs contributions etc.).

ILLUSTRATION 3

Good Pictures Ltd., constructs a cinema house and incurs the following expenditure during the _rst year ending
31st March, 2016.

(i) *Second-hand furniture worth* Rs *9,000 was purchased; repainting of the furniture costs* Rs *1,000. The furniture was installed by own workmen, wages for this being* Rs *200.*
(ii) *Expenses in connection with obtaining a license for running the cinema worth* Rs *20,000. During the course of the year the cinema company was _ned* Rs *1,000, for contravening rules. Renewal fee* Rs *2,000 for next year also paid.*
(iii) *Fire insurance,* Rs *1,000 was paid on 1st October, 2015 for one year.*
(iv) *Temporary huts were constructed costing* Rs *1,200. They were necessary for the construction of the cinema. They were demolished when the cinema was ready.*

Point out how you would classify the above items.

SOLUTION

1. The total cost of the furniture should be treated as Rs 10,200 i.e., all the amounts mentioned should be capitalised since without such expenditure the furniture would not be available for use. If Rs 1,000 and Rs 200 have been respectively debited to the Repairs Account and the Wages Account, these accounts willbe credited to the Furniture Account.
2. License for running the cinema house is necessary, hence its cost should be capitalised. But the fine of Rs 1,000 is revenue expenditure. The renewal fee for the next year is also revenue expenditure but pertains to the next year; hence, it is a prepaid expense.
3. Half of the insurance premium pertains to the year beginning on 1st April, 2016. Hence such amount should be treated as prepaid expense. The remaining amount is revenue expense for the current year.
4. Since the temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

ILLUSTRATION 4

State with reasons, how you would classify the following items of expenditure:

1. *Overhauling expenses of* Rs *25,000 for the engine of a motor car to get better fuel efficiency .*
2. *Inauguration expenses of* Rs *25 lacs incurred on the opening of a new manufacturing unit in an existing business.*
3. *Compensation of* Rs *2.5 crores paid to workers, who opted for voluntary retirement.*

SOLUTION

1. Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of endurable long-term advantage. So this expenditure should be capitalized.
2. Inauguration expenses incurred on the opening of a new unit may help to explore more customers This expenditure is in the nature of revenue expenditure, as the expenditure may not generate any enduring benefit to the business over more than one accounting period.
3. The amount paid to workers on voluntary retirement is in the nature of revenue expenditure. Since the magnitude of the amount of expenditure is very significant, it may be better to defer it over future years.

ILLUSTRATION 5

Classify the following expenditures and receipts as capital or revenue:

(i) Rs *10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.*

(ii) Amount received from Trade receivables during the year.

(iii) Amount spent on demolition of building to construct a bigger building on the same site.

(iv) Insurance claim received on account of a machinery damaged by _re.

SOLUTION

(i) Capital expenditure.

(ii) Revenue receipt.

(iii) Capital expenditure.

(iv) Capital receipt.

ILLUSTRATION 6

Are the following expenditures capital in nature?

(i) M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was Rs *20,000.*

(ii) *M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did not pay installments. To recover such outstanding installments, the firm spent Rs 10,000 on account of legal expenses.*

(iii) *M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent 40,000 for transportation of such machinery. The year ending is 31st Dec, 2015.*

SOLUTION

(i) Renovation of cabins increased the number of cabins. This has an effect on the future revenue generating capability of the business. Thus the renovation expense is capital expenditure in nature.

(ii) Expense incurred to recover installments due from customer do not increase the revenue generating capability in future. It is a normal recurring expense of the business. Thus the legal expenses incurred in this case is revenue expenditure in nature.

(iii) Expenses incurred on account of transportation of fixed asset is capital expenditure in nature.

SUMMARY

- Revenue expenditures are shown in the profit and loss account while capital expenditures are placed on the asset side of the balance sheet since they generate benefits for more than are accounting period.
- Prepaid expenses are future expenses that have been paid in advance. These are shown in the balance sheet as an asset.
- Receipts obtained should be classiffied between revenue receipts and capital receipts.
-

Multiple Choice Questions

1. Money spent Rs 10,000 as traveling expenses of the directors on trips abroad for purchase of capital assets is
   (a) Capital expenditures (b) Revenue expenditures
   (c) Prepaid revenue expenditures

2. Amount of Rs 5,000 spent as lawyersRs fee to defend a suit claiming that the firmRss factory site belonged to the plaintiffRss land is
   (a) Capital expenditures (b) Revenue expenditures
   (c) Prepaid revenue expenditures
3. Entrance fee of Rs 2,000 received by Ram and Shyam Social Club is
   (a) Capital receipt (b) Revenue receipt
   (c) Capital expenditures

4. Subsidy of Rs 40,000 received from the government for working capital by a manufacturing concern is
   (a) Capital receipt (b) Revenue receipt

(c) Capital expenditures

5. Insurance claim received on account of machinery damaged completely by fire is
(a) Capital receipt (b) Revenue receipt
(c) Capital expenditures

6. Interest on investments received from UTI is
(a) Capital receipt (b) Revenue receipt
(c) Capital expenditures

7. Amount received from IDBI as a medium term loan for augmenting working capital is
(a) Capital expenditures (b) Revenue expenditures
(c) Capital receipt

8. Revenue from sale of products, ordinarily, is reported as part of the earning in the period in which
(a) The sale is made. (b) The cash is collected.
(c) The products are manufactured
.

9. If repair cost is Rs 25,000, whitewash expenses are Rs 5,000, (both these expenses relate to presently used building) cost of extension of building is Rs 2,50,000 and cost of improvement in electrical wiring system is Rs 19,000; the amount to be expensed is
(a) Rs 2,99,000. (b) Rs 44,000. (c) Rs 30,000.

Theory Questions

1. What are the basic considerations in distinguishing between capital and revenue expenditures?
2. Define revenue receipts and give examples. How are these receipts treated?

ANSWERS/HINTS

MCQs

1: (a), 2 (b), 3 (a), 4(b), 5(a), 6 (b), 7(c), 8 (a), 9 (c)

Theoretical Questions

1. The basic considerations in distinction between capital and revenue expenditures are:
(a) Nature of business. (b) Recurring nature of expenditure.
(c) Purpose of expenses. (d) Effect on revenue generating capacity of business.
(e) Materiality of the amount involved.

2. Receipts which are obtained in course of normal business activities are revenue receipts (e.g. receipts from sale of goods or services, interest income etc.). Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

"Don't limit yourself. Many people limit themselves to what they think they can do. You can go as far as your mind lets you. What you believe, remember, you can achieve." – Mary Kay Ash

UNIT 5 : CONTINGENT ASSETS AND CONTINGENT LIABILITIES

CONTINGENT ASSET

It will be confirmed only after occurrence or non-occurrence of one or more uncertain A contingent asset may be defined as a possible asset that arises from past events and whose existence future events not wholly within the control of the enterprise. It usually arises from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the business entity. For example, a claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset.

As per the concept of prudence as well as the present accounting standards, an enterprise should not recognise a contingent asset. These assets are uncertain and may arise from a claim which an enterprise pursues through a legal proceeding. There is uncertainty in realisation of claim. It is possible that recognition of contingent assets may result In recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset no longer remains as contingent asset.

A contingent asset need not be disclosed in the financial statements. A contingent asset is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise), if an inflow of economic benefits is probable. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

CONTINGENT LIABILITIES

The term RsContingent liabilityRs can be defined as

(a) a possible obligation1 that arises from past events and the existence of which will be conformed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation 2 that arises from past events but is not recognised because:

(i) it is not probable that an out flow of resources embodying economic benefits will be settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made."

A contingent liability is a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events [part (a) of the definition]. A contingent liability may also be a present obligation that arises from past events [(part (b) of the definition)].

An enterprise should not recognise a contingent liability. A Contingent liability is required to be disclosed unless possibility of outflow of a resource embodying economic benefits is remote. These liabilities are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow or future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in financial statements of the period in which the change in probability occurs except in the extremely rare circumstances where no reliable estimate can be made.

DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

. The distinction between a liability and a contingent liability is generally based on the judgement of the management. A liability is defined as the present financial obligation of an enterprise, which arises from past events. The settlement of a liability results in an outflow from the enterprises of resources embodying economic benefits. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

Examples of contingent liabilities are claims against the enterprise not acknowledged as debts, guarantees given in respect of third parties, liability in respect of bills discounted and statutory liabilities under dispute etc. In addition to present obligations that are recognized as liabilities in the balance sheet, enterprises are required to disclose contingent liability in their balance sheets by way of notes.

DISTINCTION BETWEEN CONTINGENT LIABILITIES AND PROVISIONS

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

It is important to know the difference between provisions and contingent liabilities. The distinction between both of them can be explained as follows:

	Provision	**Contingent liability**
(1)	Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	A Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.

(2)	A provision meets the recognition criteria.	A contingent liability fails to meet the same.
(3)	Provision is recognised when (a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and (b) a reliable estimate can be made of the amount of the obligation.	Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated.
(4)	If the management estimates that it is probable that the settlement of an obligation will result in outflow of economic benefits, it recognises a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the form to settle the obligation, it discloses the obligation as a contingent liability.

Let us take an example to understand the distinction between provisions and contingent liabilities. The Central Excise Officer imposes a penalty on Alpha Ltd. for violation of a provision in the Central Excise Act. The company goes on an appeal. If the management of the company estimates that it is probable that the company will have to pay the penalty, it recognises a provision for the liability. On the other hand, if the management anticipates that the judgement of the appellate authority will be in its favour and it is less likely that the company will have to pay the penalty, it will disclose the obligation as a contingent liability instead of recognising a provision for the same.

Mutiple Choice Questions

1. (i) Contingent asset usually arises from unplanned or unexpected events that give rise to

(a) The possibility of an inflow of economic benefits to the business entity.
(b) The possibility of an outflow of economic benefits to the business entity.
(c) Either (a) or (b).

(ii) If an inflow of economic benefits is probable then a contingent asset is disclosed
(a) In the financial statements.
(b) In the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).
c) In the cash flow statement.

(iii) In the case of ___________, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.
(a) Liability (b) Provision
c) Contingent liabilities

(iv) Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation is termed as ________.
a) Provision. (b) Liability.
(c) Contingent liability.

(v) In the financial statements, contingent liability is
(a) Recognised. (b) Not recognised.
(c) Adjusted.

Theoretical Questions

1. Differentiate between:
i) Provision and Contingent Liability.
(ii) Liability and Contingent liability

ANSWERS/HINTS

Multiple Choice Questions.

(i) (a) (ii) (b) (iii) (c) (iv) (a) (v) (b)

Theoretical Questions

1. Provision is a present liability of uncertain amount, which can be measured reliably by a substantial degree of estimation. On the other hand, a Contingent liability is a possible obligation that may or may not crystallize depending on the occurrence or non-occurrence of one or more uncertain future events.
2. A liability is defined as the present financial obligation of an enterprise, which arises from past events. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

UNIT 6 : ACCOUNTING POLICIES

MEANING OF ACCOUNTING POLICIES

Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions. There is no single list of accounting policies, which are applicable to all enterprises in all circumstances. Enterprises operate in diverse and complex environmental situations and so they have to adopt various policies. The choice of specific accounting policy appropriate to the specific circumstances in which the enterprise is operating, calls for considerate judgement by the management.

The areas wherein different accounting policies are frequently encountered can be given as follows:

(1) Valuation of inventories;

(2) Valuation of investments.

Suppose an enterprise holds some investments in the form of shares of a company at the end of an accounting period. For valuation of shares, the enterprise may adopt FIFO, average method etc. The method selected by that enterprise for valuation is called an accounting policy. Different enterprises may adopt different accounting policies. Likewise, different methods of providing depreciation on fixed assets, i.e. Straight line, written down, etc. are available to the business enterprises which will lead to different depreciation amounts.

SELECTION OF ACCOUNTING POLICIES

Choice of accounting policy is an important policy decision which affects the performance measurement as well as financial position of the business entity. Selection of inappropriate accounting policy may lead to understatement or overstatement of performance and financial position. Thus, accounting policy should be selected with due care after considering its effect on the financial performance of the business enterprise from the angle of various users of accounts.
It is believed that no unified and exhaustive list of accounting policies can be suggested which has universal application. Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz.,Prudence, Substance over form, and Materiality. The financial statements should be prepared on the basis of such accounting policies, which exhibit true and fair view of state of affairs of Balance Sheet and the Profit & Loss Account

Examples wherein selection from a set of accounting policies is made, can be given as follows:-

1. Inventories are valued at cost except for finished goods and by-products. Finished goods are valued at lower of cost or market value and by-products are valued at net realizable value.
2. Investments (long term) are valued at their acquisition cost. Provision for permanent diminution in value has been made wherever necessary. .
   Sometimes a wrong or inappropriate treatment is adopted for items in Balance Sheet, or Profit & Loss Account, or other statement. Disclosure of the treatment adopted is necessary in any case, but disclosure cannot rectify a wrong or inappropriate treatment.

CHANGE IN ACCOUNTING POLICIES

A change in accounting policies should be made in the following conditions:

(a) It is required by some statute or for compliance with an Accounting Standard.
(b) Change would result in more appropriate presentation of financial statement.

Change in accounting policy may have a material effect on the items of financial statements. For example, if depreciation method is changed from straight-line method to written-down value method, or if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is changed to inventory which was earlier not the practice, all these may increase or decrease the net profit. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify the effect of change on financial statement items like assets, liabilities, profit/loss.

The examples in this regard may be given as follows:

1. Omega Enterprises revised its accounting policy relating to valuation of inventories to include applicable production overheads.
2. Alpha Enterprises changed the method of depreciation from straight-line method to written-down value method which constitutes change in accounting policy.

SUMMARY

- wAccounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions.
- Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality.
- A change in accounting policies should be made in the following conditions:
  (a) It is required by some statute or for compliance with an Accounting Standard.
  (b) Change would result in more appropriate presentation of financial statement.

Multiple Choice Questions

1. A change in accounting policy is justified
   (a) To comply with accounting standard and law.
   (b) To ensure more appropriate presentation of the financial statement of the enterprise.
   (c) All of the above.

2. Accounting policy for inventories of Xeta Enterprises states that inventories are valued at the lower of cost determined on weighted average basis or net realizable value. Which accounting principle is followed in adopting the above policy?

Rs (a) Materiality. (b) Prudence.
(c) Substance over form.

3. The areas wherein different accounting policies can be adopted are
(a) Providing depreciation. (b) Valuation of inventories.
(c) Both the option.

4. Selection of an inappropriate accounting policy decision may
(a) Overstate the performance and financial position of a business entity.
(b) Understate/overstate the performance and financial position of a business entity.
(c) Overstate the performance of a business entity.

5. Accounting policies refer to specific accounting
(a) Principles. (b) Methods of applying those principles.
(c) Both (a) and (b).

Theoretical Questions

1 . Define Accounting Policies in brief. Identify few areas wherein different accounting policies are frequently encountered.

2. "Change in accounting policy may have a material effect on the items of financial statements." Explain the statement with the help of an example.

ANSWERS/HINTS

Multiple Choice Questions

(1) (c), (2) (b), (3) (c), (4) (b), (5) (c)

Theoretical Questions

1. Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. For details, refer para 6.1.
2. For example, if depreciation method is changed from straight-line method to written-down value method, or if cost formula used for inventory valuation is changed from weighted average to FIFO. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts.

"All our dreams can come true, if we have the courage to pursue them." – Walt Disney

TOPIC 2

ACCOUNTING PROCESS-JOURNAL ENTRIES

DOUBLE ENTRY SYSTEM

- Developed by 'Luca Pacioli' of Italy in 15th Century.
- According to this system every transaction has two aspects & both the aspects should be recorded in the books of accounts.
- For every debit there is a equal & corresponding credit and vice-versa.

Ex. Purchase of computer for cash 50000.
Answer:

Computer A/c	Dr.	50000	
To Cash A/c			50000

ADAVANTAGES OF DOUBLE ENTRY SYSTEM

(i) By the use of this system the accuracy of the accounting work can be established, through the device of the trial balance.

(ii) The profit earned or loss suffered during a period can be ascertained together with details.

(iii) The financial position of the firm or the institution concerned can be ascertained at the end of each period, through preparation of the balance sheet.

(iv) The system permits accounts to be kept in as much details as necessary and, therefore affords significant information for the purposes of control etc.

(v) Result of one year may be compared with those of previous years and reasons for the change may be ascertained.

ACCOUNTS

- Account is the summary of transaction and events of similar nature, recorded sequentially under a particular head is called account.
- Accounts are usually prepared in T-form.

Ledger Account

Date	Particulars	Ref.	Amount	Date	Particulars	Ref.	Amount

DEBIT AND CREDIT

Debit	Credit
Left side of an accounts	Right side of an accounts

s

Particulars	Debit	Credit
Assets	Increase	Decrease
Liabilities	Decrease	Increase
Capital	Decrease	Increase
Income	Decrease	Increase
Expenses	Increase	Decrease

TRANSACTIONS

A transaction is an activity of the business which changes its financial position. For recording transaction, it is very important that they are supported by a substantial document like purchasing invoices, bills, pay-slips, cash-memos, passbook etc.
To analyse the dual aspect of each transaction, two approaches can be followed:

Approaches to analyse Double Entry System

Accounting Equation Approaches | Traditional Approaches

Accounting Equation Approach

The relationship of assets with that of liabilities and owners' equity in the equation form is known as 'Accounting Equation'.

Assets = Liabilities + Capital
or
Assets – Liabilities = Capital

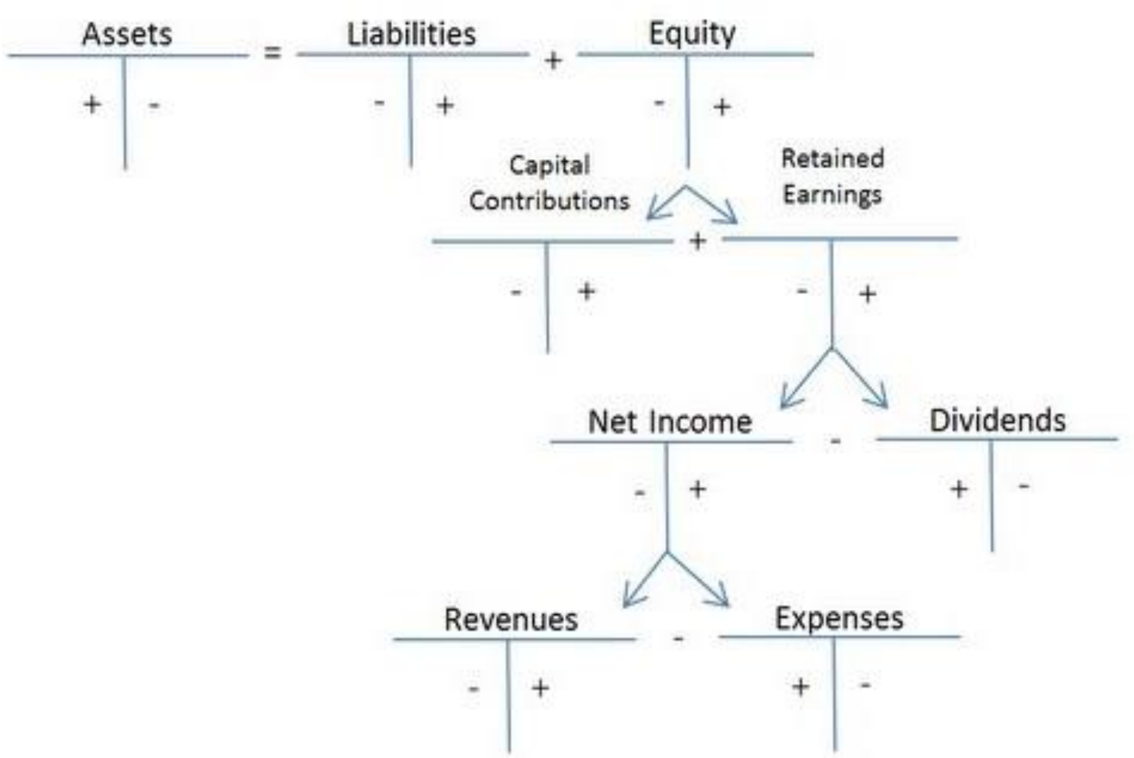
To understand the equation better, let us expand it:-

Assets = Liabilities + Stockholders' Equity

Assets = Liabilities + (contributed capital + beginning retained earnings + revenue - expense - dividends)

Here,
Contributed capital = the original capital introduced by the owner.

Beginning retained earnings = previous earnings not distributed to the shareholders.
Revenue = generated from the ongoing activities of the business
Expenses = cost incurred for the operations of the company.
Dividends = earnings distributed to the shareholders of the company



Class Example.

1. Which of the following represents the accounting equation - Assets = Liabilities + Owner's equity:
   (a) Income Statement
   (b) Statement of Cash flows
   (c) Balance Sheet.

2.

	Transactions	**Total Assets Rs**	**= Liabilities Rs**	**+ Owner's Capital Rs**
(1)	Started business with cash Rs 10,00,000	10,00,000		10,00,000
(2)	Borrowed Rs 5,00,000			
(3)	Withdrew cash from business Rs 2,00,000	+ 5,00,000	+ 5,00,000	
(4)	Loan repaid to the extent of Rs 1,00,000			
		- 2,00,000		- 2,00,000

	- 1,00,000		- 1,00,000	
Balance	**12,00,000**	**= 4,00,000**		**+ 8,00,000**

Traditional Approaches

Transactions in the journal are recorded on the basis of the rules of debit and credit only. For the purpose of recording, these transactions are classified in three groups:

- Personal transactions.
- Transactions related to assets and properties.
- Transactions related to expenses, losses, income and gains.

Classification of Accounts

Personal accounts			Impersonal Accounts	
(Relate to persons, trade receivables or trade payables)			**(All accounts other than the personal accounts)**	
Natural personal Accounts	Artificial personal Accounts	Representative personal Accounts	Real Accounts	Nominal Accounts
Related to Individuals or Natural person.(Alia, Ranbir)	Related to entities recognised by Law. (Government,companies, clubs, societies)	Which represent certain Person or a Group. (capital a/c, drawing a/c).	Which represent Assets of the firm both Tangible and Intangible. (car,FA,cash)	Accounts related to Incomes, Gains, Expenses, Losses

Golden Rules of Accounting

Types of Account	Account to be Debited	Account to be Credited
Personal Account	Receiver	Giver
Real Account	What comes in	What goes out
Nominal Account	Expense and losses	Income and gains

Class Example:

3.The debts written off as bad, if recovered subsequently are

(a) Credited to Bad Debts Recovered Account

(b) Credited to Trade receivables Account.

(c) Debited to Profit and Loss Account.

4.From the following information, state the nature of account and state which account will be debited and which will be credited.**(ICAI)**

1. Started business with a capital of Rs 50,00,000.
2. Wages and salaries paid Rs 50,000
3. Rent received Rs 2,00,000
4. Purchased goods on credit Rs 9,00,000
5. Sold goods for Rs 8,16,000 and received payment in cheque.

SOLUTION

Transaction	ACCOUNTS INVOLVED	NATURE	DEBIT OR CREDIT	Journal Entry
Started business with capital of Rs 50,00,000	Bank account Capital account	Personal Personal	Debit (Receiver) Credit (giver)	Bank A/c Dr. To Capital A/c
Wages and salaries paid	Wages/salaries Bank	Nominal Personal	Debit (expense) Credit (giver)	Wages/ Salaries Dr. To Bank A/c
Rent received	Bank Rent	Personal Nominal	Debit (Receiver) Credit (income)	Bank A/c Dr. To Rent A/c
Purchases made on credit	Purchases Creditor	Nominal Personal	Debit (expense) Credit (giver)	Purchases A/c Dr. To Creditor A/c
Goods sold and payment received in cheque	Bank Sales	Personal Nominal	Debit (Receiver) Credit (gains)	Bank A/c Dr. To Sales A/c

Modern Classification of Accounts

Now, let us see the modern and more acceptable classification of accounts:-

Types of account	Normal balance of account	A Increase to the account	A decrease to the accounts
Asset account	Debit	Debit	Credit
Liabilities account	Credit	Credit	Debit
Capital account	Credit	Credit	Debit
Revenue account	Credit	Credit	Debit
Expenditure account	Debit	Debit	Credit
Drawing account	Debit	Debit	Credit

Class Example:5.

Accounts involved	Nature	Debit/Credit	Reason
Bank	Asset	Debit	Increase
Capital	Liability	Credit	Increase
Wages /salaries	Expense	Debit	Increase
Bank	Asset	Credit	Decrease
Bank	Asset	Debit	Increase
Rent	Revenue	Credit	Increase
Purchase	Expanse	Debit	Increase
Creditor	Liability	Credit	Increase
Bank	Asset	Debit	Increase
Sales	Revenue	Credit	Increase

JOURNAL

It is the First book of accounts in which transaction are originally recorded. It is also known as books of Original Entry or Subsidiary book. All the transactions are recorded in a Chronological order.

JOURNAL

Date (Rs) (1)	Particulars Rs (2)	L.F. (3)	Dr. Amount Rs (4)	Cr. Amount Rs. (5)

ADVANTAGES OF JOURNAL

- Complete recording of all transaction in chronological order.
- Narrations written below each journal entry help to understand the transaction.
- Journal forms the basis for posting the entries in the ledger.

PRACTICAL QUESTION

Question 1 (ICAI MODULE)

Analyse transactions of M/s Sahil & Co. for the month of March, 2017 on the basis of double entry system by adopting the following approaches:

(A) Accounting Equation Approach.

(B) Traditional Approach.

Transactions for the month of March, 2017 were as follows (figures are in '000):

1. Sahil introduced capital through bank of Rs 4,000.
2. Cash withdrawn from the City Bank Rs 200.
3. Loan of Rs 500 taken from Mr. Y.
4. Salaries paid for the month of March, 2017, Rs 300 and Rs 100 is still payable for the month of March, 2017.
5. Furniture purchased Rs 500.

Question 2 (ICAI MODULE)

Journalise the following transactions. Also state the nature of each account involved in the Journal entry.

Following figures are given in ('00)

1. December 1, 2016, Ajit started business with capital Rs 4,00,000
2. December 3, he withdrew cash for business from the Bank Rs 2,000.
3. December 5, he purchased goods making payment through bankvRs 15,000.
4. December 8, he sold goods Rs 16,000 and received payment through bank.
5. December 10, he purchased furniture and paid by cheque Rs 2,500.
6. December 12, he sold goods to Arvind Rs 2,400.
7. December 14, he purchased goods from Amrit Rs 10,000.

8. December 15, he returned goods to Amrit Rs 500.
9. December 16, he received from Arvind Rs 2,300 in full settlement.
10. December 18, he withdrew goods for personal use Rs 1,000.
11. December 20, he withdrew cash from business for personal use Rs 2,000.
12. December 24, he paid telephone charges Rs 110.
13. December 26, amount paid to Amrit in full settlement Rs 9,450.
14. December 31, paid for stationery Rs 200, rent Rs 5,000 and salaries to staff2,000.
15. December 31, goods distributed by way of free samples Rs 2,000.

Question 3 (ICAI MODULE)

Show the classification of the following Accounts under traditional and accounting equation approach:

(a) Building; (b) Purchases; (c) Sales; (d) Bank Fixed Deposit; (e) Rent; (f) Rent Outstanding; (g) Cash; (h) Adjusted Purchases; (i) Closing Inventory; (j) Investments; (k) Trade receivables; (l) Sales Tax Payable, (m) Discount Allowed;

(n) Bad Debts; (o) Capital; (p) Drawings; (q) Interest Receivable account; (r) Rent received in advance account; (s) Prepaid salary account; (t) Bad debts recovered account; (u) Depreciation account, (v) Personal income-tax account.

Question 4 (ICAI MODULE)

Transactions of Ramesh for April are given below. Journalise them.

2017	**Rs**
April 1 Ramesh started business with	10,00,000
" 3 Bought goods for cash	50,000
" 5 Drew cash from bank	10,000
" 13 Sold to Krishna- goods on credit	1,50,000
" 20 Bought from Shyam goods on credit	2,25,000
" 24 Received from Krishna	1,45,000
" Allowed him discount	5,000
" 28 Paid Shyam cash	2,15,000
" Discount allowed	10,000
" 30 Cash sales for the month	8,00,000
Paid Rent	50,000
Paid Salary	1,00,000

Question 5 (ICAI MODULE)

Show the classification of the following Accounts under traditional and accounting equation approach:

a. Rent outstanding
b. Closing Inventory
c. Sales
d. Bank Fixed Deposit
e. Cash
f. Bad Debts
g. Capital
h. Sales Tax Payable
i. Trade receivables
j. Depreciation
k. Drawings

Question 4 (ICAI MODULE)

Pass Journal Entries for the following transactions in the books of Gamma Bros.

(i) Employees had taken inventory worth Rs 1,00,000 (Cost price Rs 75,000) on the eve of Deepawali and the same was deducted from their salaries in the subsequent month.

(ii) Wages paid for erection of Machinery Rs 18,000.

(iii) Income tax liability of proprietor Rs 1,17000 was paid out of petty cash.

(iv) Purchase of goods from Naveen of the list price of Rs 2,00,000. He allowed 10% trade discount, Rs 5,000 cash discount was also allowed for quick payment.

Question 5 (ICAI MODULE)

Calculate the missing amount for the following.

	Assets	Liabilities	Capital
(a)	15,00,000	2,50,000	?
(b)	?	1,50,000	75,000
(c)	14,50,000	?	13,75,000
(d)	57,00,000	- 2,80,000	?

Question 6 (ICAI MODULE)

Show the effect of increase = (+), decrease = (-) and no change=(0) on the assets of the following transactions:

a. Purchased office furniture, payment to be made next month.
b. Collected cash for repair services
c. Goods sold on credit.
d. Withdrawal of cash by the owner for personal use.
e. Hired an employee as sales manager of the north wing.
f. Returned goods worth Rs 50,000.
g. One of our debtors agreed to pay his dues to Mr. C who is a creditor of the company with the same amount being due to him.
h. Entered into an agreement with Mehta & Co. to purchase all raw materials from their company from next year.

Also give reasons for your answers.

Question 7 (ICAI MODULE)

Following is the information provided by Mr. Gopi pertaining to year ended 31st March 2017. Find the unknowns, showing computation to support your answer:

Particulars	**Rs**	**Particulars**	**Rs**
Machinery	1200000	Trade Receivables	B
Accounts payable	100000	Loans	C
Inventory	60000	Closing capital	D
Total liabilities including capital	1415000	Opening capital	1000000
Cash		Loss incurred during the year	35000
Bank	A 80000	Capital introduce during the year	100000

Additional Information: During the year sales of Rs 15,55,000 was made of which Rs 15,00,000 have been received.

(Answer hint: A-20,000, B-55,000, C-2,50,000, D-10,65,000)

TOPIC 3
LEDGERS

LEDGERS

The book which contains all set of accounts (viz. personal, real and nominal accounts), is known as Ledger. It is known as principal books of account in which account-wise balance of each account is determined.

SPECIMEN OF LEDGER ACCOUNTS

Dr.			Account				Cr.
Date	**Particulars**	**J.F.**	**Amount (Rs)**	**Date**	**Particulars**	**J.F.**	**Amount (Rs)**

POSTING

The process of transferring the debit and credit items from journal to classified accounts in the ledger is known as posting.

RULES REGARDING POSTING OF ENTRIES IN THE LEDGERS

- Open the respective ledgers accounts for recording entries recorded in journal.
- Use words 'To' and 'By' on Debit and Credit side respectively.
- The concerned account debited in the journal should also be debited in the ledger but reference should be of the respective credit account.

BALANCING AN ACCOUNT

- The difference between the totals of debits and credit sides is found out as the balance.
- In the ledger Book, the balances of Assets, Liabilities and Capital are carried forward to the next period. Revenue and Expense accounts are closed by transferring their totals to Trading and Profit and Loss A/c.

Debit Balance Write as on right side 'By Balance c/d'

Credit Balance Write as on lift side 'To Balance c/d'

PRACTICAL QUESTION

QUESTION 1. (ICAI MODULE)

Prepare the Stationery Account of a firm for the year ended 31.12.2015 duly balanced of, from the following details:

2015		**Rs.**
Jan. 1	Inventory of stationery	480
April 5	Purchase of stationery by cheque Purchase of stationery	800
Nov. 15	on credit from Five Star Stationery Mart Inventory of stationery	1,280
Dec. 31		240

QUESTION 2. (ICAI MODULE)

Prepare the ledger accounts on the basis of following transactions in the books of a trader.

Debit Balances on January 1, 2015:

Cash in Hand Rs 8,000, Cash at Bank Rs 25,000, inventory of Goods Rs 20,000, Building Rs 10,000. Trade receivables:

Vijay Rs 2,000 and Madhu Rs 2,000.

Credit Balances on January 1, 2015:

Trade payables: Anand Rs 5,000, Capital Rs 55,000

Following were further transactions in the month of January, 2015:

Jan. 1 Purchased goods worth RS 5,000 (payable at later date) for cash less 20% trade discount and 5% cash discount.

Jan. 4 Received Rs 1,980 from Vijay and allowed him Rs 20 as discount.

Jan. 8 Purchased plant from Mukesh for Rs 5,000 and paid Rs 100 as cartage for bringing the plant to the factory and another Rs 200 as installation charges.

Jan. 12 Sold goods to Rahim on credit Rs 600.

Jan. 15 Rahim became insolvent and could pay only 50 paise in a rupee.

Jan. 18 Sold goods to Ram for cash Rs 1,000.

QUESTION 3. (ICAI MODULE)

The following data is given by Mr. S, the owner, with a request to compile only the two personal accounts of Mr. H and Mr. R, in his ledger, for the month of April, 2015.

1 Mr. S owes Mr. R Rs 15,000; Mr. H owes Mr. S Rs 20,000.

4 Mr. R sold goods worth Rs 60,000 @ 10% trade discount to Mr. S.

5 Mr. S sold to Mr. H goods prices at Rs 30,000.

17 Record a purchase of Rs 25,000 net from R, which were sold to H at a profit of Rs 15,000.

18 Mr. S rejected 10% of Mr. R's goods of 4th April.

19 Mr. S issued a cash memo for Rs 10,000 to Mr. H who came personally for this consignment of goods, urgently needed by him.

22 Mr. H cleared half his total dues to Mr. S, enjoying a $\frac{1}{2}$% cash discount (of the payment received,Rs 20,000 was by cheque).

26 R's total dues (less Rs10,000 held back) were cleared by cheque, enjoying a cash discount of Rs 1,000 on the payment mode.

29 Close H's Account to record the fact that all but Rs 5,000 was cleared by him, by a cheque, because he was declared bankrupt.

30 Balance R's Account.

TOPIC 4
TRIAL BALANCE

INTRODUCTION

- Preparation of trial balance is the third phase in the accounting process.

JOURNAL

↓

LEDGERS

↓

TRIAL BALANCE

MEANING OF TRIAL BALANCE

A statement which shows separately the debit and credit balances is known as the trial balance.

OBJECTIVES OF PREPARING THE TRIAL BALANCE

- To check arithmetical accuracy of transactions recorded in book of accounts.
- Helps in preparation of Profit and Loss account and Balance Sheet.
- Acts as a summary of various ledgers accounts.

FORMAT OF TRIAL BALANCE

Trial Balance

as at......................

Sr. No.	**Ledger Accounts**	**L.F.**	**Dr. Amount** (Total or Balance) Rs	**Cr. Amount** (Total or Balance) Rs

LIMITATIONS OF TRIAL BALANCE

Agreement of trial balance dose not mean that accounts are free all types of errors These may be of the following types:

- Transaction has not been entered at all in the journal.

- A wrong amount has been written in both columns of the journal.
- A wrong account has been mentioned in the journal.
- An entry has not at all been posted in the ledger.
- Entry is posted twice in the ledger.

METHODS OF PREPARATION OF TRIAL BALANCE

Total Method

- Total of debit & credit Side each ledger account transferred to the Trial Balance.
- This method inconvenient.
- Also called as Gross Trial Balance.

Balance Method

- Differential balance of each ledger account is transferred to trial balance.
- Simple & scientific .
- Also called as Net Trial Balance.

Total & Balance

- Combination of two method.

QUESTION 1. (ICAI MODULE)

Given below is a ledger extract relating to the business of X and Co. as on March, 31, 2016. You are required to prepare the Trial Balance by the Total Amount Method.

Dr. **Cash Account** Cr.

Particulars	**Rs**	**Particulars**	**Rs**
To Capital A/c	10,000	By Furniture A/c	3,000
To Ram's A/c	25,000	By Salaries A/c	2,500
To Cash Sales	500	By Shyam's A/c	21,000
		By Cash Purchases	1,000
		By Capital A/c	500
		By Balance c/d	7,500
	35,500		35,500

Dr. **Furniture Account** Cr.

Particulars	**Rs**	**Particulars**	**Rs.**
To Cash A/c	3000	By balance c/d	3000
	3000		3000

Dr. **Salaries Account** Cr.

Particulars	Rs	Particulars	Rs.
To Cash A/c	2500	By balance c/d	2500
	2500		2500

Dr. **Shyam's Account** Cr.

Particulars	Rs	Particulars	Rs.
To Cash A/c	21000	By balance c/d (credit Purchase)	25000
To purchase returns A/c	500		
To balanced c/d	3500		-
	25000		25000

Dr. **Purchases Account** Cr.

Particulars	Rs	Particulars	Rs.
To Cash A/c (cash purchase)	1000	By balance c/d	26000
To sundries as per purchase book (credit purchase)	25000		-
	26000		26000

Dr. **Purchases Returns Account** Cr.

Particulars	Rs	Particulars	Rs.
To balance c/d	500	By sundries as per purchase return book	500
	500		500

Dr. **Ram's Account** Cr.

Particulars	Rs	Particulars	Rs.
To sale A/c (credit sale)	30000	By sale return A/c	100
		By cash A/c	25000
		By Balanced c/d	4900
	30000		30000

Sales Account

Particulars	Rs	Particulars	Rs.
To balanced c/d	30500	By Cash A/c (cash sales)	500
		By sundries as per sale book (credit sales)	30000
	30500		30500

Sales Returns Account

Particulars	Rs	Particulars	Rs.
To sundries as per sale return book	100	By balance c/d	100
	100		100

Dr. **Capital Account** Cr.

Particulars	Rs	Particulars	Rs.
To cash A/c	500	By cash A/c	10000
To Balance c/d	9500		
	10000		10000

ADJUSTED TRIAL BALANCE (THROUGH SUSPENSE ACCOUNT)

- If two sides of Trial Balance does not agree its implies that there are certain one side errors in recording transaction in books of accounts.
- In such case the difference in Trial Balance is part in a separate account called Suspense Account until the errors are located.
- Suspense Account treated as a temporary Account created to avoid delay preparation of statement.

QUESTION 2. (ICAI MODULE)

Taking the same information as given in QUESTION 1, prepare the Trial Balance by Balance Method.

RULES OF PREPARING THE TRIAL BALANCE

Debit **Credit**

Balance of	**Balance of**
▪ Assets A/c	▪ Liabilities A/c
▪ Losses	▪ Capital A/c
▪ Cash & Bank A/c	▪ Income
▪ Expenses A/c	▪ Profits
▪ Drawings	

QUESTION 3 (ICAI MODULE)

From the following ledger balances, prepare a trial balance of Anuradha Traders as on 31st March, 2016:

Account Head	**Rs**
Capital	1,00,000
Sales	1,66,000
Purchases	1,50,000
Sales return	1,000
Discount allowed	2,000
Expenses	10,000
Trade receivables	75,000
Trade payables	25,000
Investments	15,000
Cash at bank and in hand	37,000
Interest received on investments	1,500
Insurance paid	2,500

QUESTION 4. (ICAI MODULE)

One of your clients, Mr. Singhania has asked you to finalise his accounts for the year ended 31st March, 2016. Tilldate, he himself has recorded the transactions in books of accounts. As a basis for audit, Mr. Singhania furnishedyou with the following statement.

	Dr. Balance (Rs)	**Cr. Balance (Rs)**
Singhania's Capital		1,556
Singhania's Drawings	564	

Leasehold premises	750	
Sales		2,750
Due from customers		530
Purchases	1,259	
Purchases return	264	
Loan from bank		256
Trade payables	528	
Trade expenses	700	
Cash at bank	226	
Bills payable	100	
Salaries and wages	600	
Inventories (1.4.2015)		264
Rent and rates	463	
Sales return		98
	5,454	5,454

The closing inventory on 31st March, 2016 was valued at Rs574. Mr. Singhania claims that he has recorded everytransaction correctly as the trial balance is tallied. Check the accuracy of the above trial balance.

Topic 5
SUBSIDIARY BOOKS

Unit Overview

Meaning

- Subsidiary books are books of original entry.
- In the normal course of business, a majority of transactions are either relate to sales, purchases or cash. So record transactions of the same or similar nature in one place, i.e. the subsidiary book.
- And record these transactions in chronological order.

Advantages of Subsidiary Books

- Division of work
- Saving of time
- Availability of information
- Facilities of checking
- Specialization and Efficiency

Cash Book	It is a book which records the receipts and payment of cash transaction.
Purchase Book	It is a book which records all the credit purchases of goods of the company.
Purchase Return Book	It is a book which records all the return of credit purchases of goods of the company.

Sale Book	It is a book which records all the credit sales of goods of the company.
Sale Return Book	It is a book which records all the return of credit sales of goods of the company.
Bills Receivable Book	It is a book which records all the bills receivable.
Bills Payable Book	It is a book which records all the bills payable.
Journal	All the transactions which are not recorded in the other books are recorded here.

Difference between Subsidiary books & Principal books.

Principal Books	Subsidiary Books
In the Principal Book will contain only the consolidated entry to facilitate the preparation of final accounts.	In the Subsidiary Book all the details of particular transaction are recorded
• Ledgers	• Purchase Book • Sale Book • Purchase Return Book • Sales Return Book • Bills Receivable Book • Bills payable Book • Cash Book • Journal

QUESTION 1. (ICAI MODULE)

The Rough Book of M/s. Narain & Co. contains the following:

Feb. 2016

1. Purchased from Brown & Co. on credit:
   5 gross pencils @ Rs 100 per gross,
   1 gross registers @ Rs 240 per doz.
   Less: Trade Discount @ 10%
2. Purchased for cash from the Stationery Mart;
   10 gross exercise books @ Rs 300 per doz.
3. Purchased computer for office use from M/s. office Goods Co. on credit for Rs 30,000.
4. Purchased on credit from The Paper Co.
   5 reams of white paper @ Rs 100 per ream.
   10 reams of ruled paper @ Rs 150 per ream.
   Less: Trade Discount @ 10%
5. Purchased one dozen gel pens @ Rs 15 each from M/s. Verma Bros. on credit.
   Make out the **Purchase Book** of M/s. Narain & Co.

SOLUTION

Purchases Book

Date 2016	**Particulars**	**Rs**	**L.F.**	**Amount Rs.**
Feb 1.	M/s Brown & Co.			
	5 gross pencils @ Rs 100 per gross,	500		
	1 gross registers @ Rs 240 per doz.	2880		
		$\boxed{3380}$		
	Less: Trade Discount @ 10%	(338)		3042
Feb 4	The Paper Co.			
	5 reams of white paper @ Rs 100 per ream.	500		
	10 reams of ruled paper @ Rs 150 per ream.	1500		
		$\boxed{2000}$		
Feb 5	Less: Trade Discount @ 10%	(200)		1800
	M/s. Verma Bros.			
	1 doz gel pens @Rs 15	180		180
		Total		
				$\boxed{5022}$

Note: Purchases of cash and purchase of computer cannot be entered in the Purchase Book.

QUESTION 2. (ICAI MODULE)

Enter the following transactions in **Purchase Book and post them into ledger**.

2017

April 4 Purchased from Ajay Enterprises, Delhi
100 Doz. Rexona Hawai Chappal
@ Rs 120 per doz.
200 Doz. Palki Leather Chappal
@ Rs300 per Doz.
Less: Trade discount @ 10%

	Freight charged Rs 150.
April 15	Purchased from Balaji Traders, Delhi 50 doz. Max Shoes @ Rs 400 per doz. 100 pair Sports Shoes. @ Rs 140 per paid. Less: Trade discount @ 10%. Freight charged Rs 200.
April 28	Purchased from Tripti Industries, Bahadurgarh 40 pair leather shoes @ Rs 400 per pair 100 doz. Rosy Hawai Chappal @ Rs 180 per doz. Less: Trade discount @ 10%. Freight charged Rs 100.

SOLUTION

Purchase Book

Date 2017	Particulars	Gross Amount	Trade Discount	Net Price	Fright	Total Amount
April 4	Ajay Enterprise 100 doz chappal @Rs 120 per doz –Rs 12000, 200 doz palki leather chappal @ Rs 300 per doz Rs 60000 Less: trade discount @ 10%	**72000**	**7200**	**64800**	**150**	**64950**
April 15	Balaji Traders, Delhi 50 doz max shoes @Rs 400 per doz – Rs 20000 100 pair sport shoes @Rs 140 per pair - 14000 Less: Trade discount @10%	**34000**	**3400**	**30600**	**200**	**30800**
April 28	Tripati Industries, Bahadurgarh 40 pair Leather shoes @ Rs 400 per pair -16000,					

100 doz Rosy Hawai Chappai:@ Rs 180 per doz- Rs 18000

Less: Trade discount @ 10%

34000	**3400**	**30600**	**100**	**30700**
140000	**14000**	**126000**	**450**	**126450**

Ledgers

Dr. **Purchases A/c** Cr

2017		**Rs**	**2017**		**Rs**
April 30	To amount as per purchase book	126000			

Dr. **Freight A/c** Cr.

2017		**Rs**	**2017**		**Rs**
April 30	To amount as per purchase book	450			

Dr. **Ajay Enterprises** Cr.

2017		**Rs**	**2017**		**Rs**
			April 30	By Purchase A/c	64800
				By Fright A/c	150

Dr. **Balaji Traders** Cr.

2017		**Rs**	**2017**		**Rs**
			April 15	By Purchase A/c	30600
				By Fright A/c	200

Dr. **Tripti Industries** Cr.

2017		**Rs**	**2017**		**Rs**
			April 28	By Purchase A/c	30600

By Fright A/c	100

QUESTION 3. (ICAI MODULE)

The following are some of the transaction of M/s Kishore & Sons of the year 2017 as per their Waste Book.

Make out their **Sales Book.**

Sold to M/s. Gupta & Verma on credit:

30 shirts @ Rs 800 per shirt.

20 trousers @ Rs1,000 per trouser.

Less : Trade Discount @ 10%

Sold furniture to M/s. Sehgal & Co. on credit Rs 8,000.

Sold 50 shirts of M/s. Jain & Sons @ Rs 800 per shirt.

Sold 13 shirts to Cheap Stores @ Rs 750 each for cash.

Sold on credit to M/s. Mathur & Jain.

100 shirts @ Rs 750 per shirt

10 overcoats @ Rs 5,000 per overcoat.

Less: Trade Discount @ 10%

SOLUTION

Sales Book

Date	**Particular**	**Details Rs**	**L.F.**	**Amount Rs**
2017	M/s. Gupta & Verma			
	30 shirts @ Rs 800	24000		
	20 trousers @ Rs1,000	20000		
		44000		
	Less : Trade Discount @ 10%	(4400)		
	Sales as per invoice no. dated……			39600
	M/s. Jain & Sons			
	50 shirts @ Rs800			40000
	M/s. Mathur & Jain.			
	Sales as per invoice no. dated……			
	100 shirts @ Rs 750	75000		
	10 overcoats @ Rs 5,000 Less:	50000		

		125000	
	Less: 10%	(12500)	112500
	Sales as per invoice no. dated……	Total	192100

Note: Cash sale and sale of furniture are not entered in Sales Book.

QUESTION 4. (ICAI MODULE)

Post the following into the ledger

Returns Outward Book

Date 2017	**Particulars**	**L.F.**	**Details Rs**	**Amount Rs**
Nov 20	Rajindra Prakash & Sons			
	One 36" Usha Ceiling Fan		200.00	
	Less : Trade Discount @ 10%		(20.00)	180.00
Nov 30	Modern Electric Company			100.00
	Total			280.00

SOLUTION

Ledger

Dr. **Rajindra Parkash & Sons** Cr.

Date 2017	**Particulars**	**Folio**	**Amount**	**Date**	**Particulars**	**Folio**	**Amount**
Nov 20	To Returns Outward A/c		180.00				

Dr. **Modern Electric Co.** Cr.

Date 2017	**Particulars**	**Folio**	**Amount**	**Date**	**Particulars**	**Folio**	**Amount**
Nov 30	To Returns Outward A/c		100.00				

Dr. **Returns Outward Account** Cr.

Date 2017	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
				Nov 30	By sundries as per returns outward A/c		280.00

QUESTION 5. (ICAI MODULE)

From the following transactions, prepare the Purchases Returns Book of Alpha & Co., a saree dealer and post them to ledger :

Date	Debit Note No.	Particulars
04.01.2016	101	Returned to Goyal Mills, Surat - 5 polyester sarees @ Rs 1,000.
09.01.2016		Garg Mills, Kota - accepted the return of goods (which were purchased for cash) from us - 5 Kota sarees @ Rs 400.
16.01.2016	102	Returned to Mittal Mills, Bangalore - 5 silk sarees @ Rs 2,600.
30.01.2016		Returned one computer (being defective) @ Rs 35,000 to B & Co.

SOLUTION

Purchase Returns Book

Date 2016	Debit Note No.	Name of Supplier	L.F.	Amount
Jan. 4	101	Goyal Mills, Surat		5,000
Jan. 16	102	Mittal Mills, Bangalore		13,000
Jan. 31		Purchases Returns Account (Cr.)		18,000

Topic 6 CASH BOOK

CASH BOOK

Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it has also to be treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.

- It records transaction concerning Cash Receipts & Payment.
- Cash book has two side
  Debit side – Record Cash & Cheque received.
  Credit side – Record cash & Cheque payments.

KINDS OF CASH BOOK

Simple Cash Book	Record only Cash transaction
Two column Cash Book	Record transaction (Cash) along with discount allowed & discount received.
Three column Cash Book	Record Cash,Bank,& Discount transaction.

SIMPLE CASH BOOK

Such a cash book appears like an ordinary account, with one amount column on each side. The left-hand side records receipts of cash and the right-hand side the payments.

Balancing of the Cash Book: The cash book is balanced like other accounts. The total of receipts column is always greater than total of payments column. The difference is written on the credit side as 'By balance c/d'.
The totals are then entered in the two columns opposite one another and then on the debit side the balance is written as "To Balance b/d", to show cash balance in hand in the beginning of next period.

Dr.,							Cr.
Date	**Particulars**	**L.F**	**Amount**	**Date**	**Particulars**	**L.F**	**Amount**

Class Example 1.

Enter the following transactions in a Simple Cash Book:

2016		**Rs**
Jan 1	Cash in hand	1200
" 5	Received from Ram	300
" 7	Paid Rent	30
" 8	Sold goods for each	300
" 10	Paid to Shyam	700
" 27	Purchased furniture	200
" 31	Paid Salaries	100
" 31	Rent due, not yet paid for january	30

SOLUTION

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

Date 2016	Receipt	L.F.	Amount Rs	Date 2016	Payment	L.F.	Amount Rs
Jan 11	To Balance b/d		1200	Jan 7	By Rent A/c		30
Jan 5	To Ram A/c		300	Jan 10	By Shyam A/c		700
Jan 8	To Sales A/c		300	Jan 27	By Furniture A/c		200
				Jan 31	By Salaries A/c		
				Jan 31	By Balance c/d		100
							770
			1800				1800

2016

Feb 1	To Balance b/d	770

Note: One can see the following:

(i) In the simple cash book only the cash receipts and cash payments are recorded.

(ii) The total of debit side is always greater than the total of credit side since the payment cannot exceed the available cash.

(iii) The simple cash book is like an ordinary account.

Double Column Cash Book

If along with columns for amounts to record cash receipts and cash payments another column is added on each side to record the cash discount allowed or the discount received, or a column on the debit side showing bank receipts and another column on the credit side showing payments through bank. It is a double-column cash book.

Cash discount is an allowance which often accompanies cash payments.

In the cash column on the debit side, actual cash received is entered; the amount of the discount allowed, if any, to the customer concerned is entered in the discount column. Similarly, actual cash paid is entered in the cash column on the payments side and discount received in the discount column. Also the bank column on the debit side records all receipts through bank and the same column on the credit side shows payment through bank.

Balancing: It should be noted that the discount columns are not balanced. They are merely totaled. The total of the discount column on the receipts side shows total discount allowed to customers and is debited to the Discount Account. The total of the column on the payments side shows total discount received and is credited to the Discount Account. The Cash columns are balanced, as already shown. The bank columns are also balanced and the balancing figure is called bank balance. Thus a double column cash book should have two columns on each side comprising of either cash and discount transaction or cash and bank transactions.

Dr									Cr.
Date	**Particulars**	**L.F**	**Discount**	**Amount**	**Date**	**Particulars**	**L.F**	**Discount**	**Amount**

<u>Class Example 2.</u>

Ganesh commenced business on 1st April, 2017 with Rs 2,000 as capital. He had the following cash transactions in the month of April 2017:

		Rs			**Rs**
April	Purchased furniture and		April	Paid for petty expenses	15
1	paid cash		7		
		250		Cash purchases	
"2	Purchased goods				
		500			150
"4	Sold goods for cash				
		950		Paid for labour	
			13		
				Paid Ali & Sons	1000
"5	Paid cash to Ram Mohan				
		560		They allowed discount	400
			" "		
"6	He allowed discount				
		10			8
"6	Received cash from Krishna & Co.				
			" "		
		600			
	Allowed discount				
		20			

Make out the two-column Cash Book (Cash and discount column) for the month of April, 2017.

SOLUTION

Dr. Date 2017	**Receipts**	**L.F**	**Discount Rs**	**Amount Rs**	**Date 2017**	**Payment**	**L.F.**	**Discount Rs**	**Cr. Amount Rs**

April 1	To Capital A/c		2000	April 1	By Furniture A/c		250
"4	To Sales A/c		950	"2	By Purchases A/c		500
"6	To Krishna A/c	20	600	"'5	By Ram Mohan	10	560
				"7	By Petty Expenses A/c		15
				"8	By Purchases A/c		150
				"13	By wages A/c		1000
				"13	By Ali & Sons	8	400
				"30	By Balance c/d		675
		20	3550			18	3550
May 1	To Balance b/d		675				

To summaries:
(i) the discount columns in the cash book are totalled;
(ii) they are not balanced; and
(iii) Their totals are entered in the discount received/paid account in the ledger.

Note: The person who pays, is credited by both the cash paid by him and the discount allowed to him. Similarly, the person to whom payment is made, is debited with both the amount paid and the discount allowed by him.

THREE COLUMN CASH BOOK

A firm normally keeps the bulk of its funds at a bank; money can be deposited and withdrawn at will if it is current account. Probably payments into and out of the bank are more numerous than strict cash transactions. There is only a little difference between cash in hand and money at bank. Therefore, it is very convenient if, on each side in the cash book, another column is added to record cash deposited at bank (on the receipt side of the cash book) and payments out of the bank (on the payment side of the cash book).

Balancing: The discount columns are totalled but not balanced. The cash columns are balanced exactly in the same manner as indicated for the simple cash book. The process is similar for balancing the bank columns also. It is possible, however, that the bank may allow the firm to withdraw more than the amount deposited i.e., to have an overdraft. In such a case, the total of the bank column on the credit side is bigger than the one on the debit side. The difference is written on the debit side as "To Balance c/d." Then the totals are written on the two sides opposite one another, the balance is then entered on the credit side as "By Balance b/d."

However, the usual case is that payments into the bank will exceed the withdrawals or payments out of the bank. Then the bank columns are balanced just like the cash columns.

Dr. **Cr.**

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

- CONTRA ENTRY – Which involves both Cash& Bank transactions.
  Class Example: 3- Cash withdrawn form bank 10,000.
  Class Example :4- Cash deposited in Bank 25,000.

Answer:

3.	Cash A/c	Dr.	10,000	
	To Bank A/c			10000
4.	Bank A/c	Dr.	25,000	
	To Cash A/c			25,000

Class Example 5.

Enter the following transactions in Cash Book with Discount and Bank Columns. Cheques are first treated as cash receipt.

2016		**Rs**
Jan.1	Chandrika commences business with Cash	20,000
"3	He paid into Current A/c	19,000
"4	He received cheque from Kirti & Co. on account	600
"7	He pays in bank Kirty& Co.'s cheque	600
"10	He pays Rattan & Co. by cheque and is allowed discount Rs 20	330
	Tripathi & Co. pays into his Bank A/c	
"12	He receives cheque from Warshi and allows him discount Rs 35	475
"15		450
	He receives cash Rs 75 and cheque Rs 100 for cash sale	
"20	He pays into Bank, including cheques received on 15th and 20th	
"25	He pays by cheque for cash purchase	1,000
	He pays sundry expenses in cash	
"27		275
"30		50

SOLUTION

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

Date	**Receipts**	**L. F.**	**Discount Rs**	**Cash Rs**	**Bank Rs**	**Date**	**Payment**	**L. F.**	**Discount Rs**	**Cash Rs**	**Bank Rs**
2016						2016					
Jan 1	To capital A/c			20000		Jan 3	By bank A/c	C		19000	
3	To cash	C			19000	7	By bank A/c	C		600	
4	To Kriti & Co.			600		10	By Ratan & Co.				330
7	To cash	C			600		By Bank A/c		20		
12	To Tripathi & Co.				475	25	By purchase A/c	C		1000	
15	To warship		35	450		27	By S Exp. A/c			275	
20	To Sales A/c			175					20		
25	To Cash	C			1000	30				50	

				31	By c/d	Balance		
	35	27225	21075				300	20745
To balance B.d		300	20745				21225	21075

PETTY CASH BOOK

- A book used to record petty cash expenses of the business is called Petty Cash Book.
- Maintained by **petty cashier**.
- A definite sum of money to the petty cashier in the beginning of a period and to reimburse him for payments made at the end of the period& again the fixed amount in the beginning of the new period. Such a system is known as the **Imprest system of petty cash**.

Receipt Rs	Date 2016	V.No	Particulars	Total Rs	Conveyance Rs	Cartage Rs	Stationery	Postage & Telegra	Wages Rs	Sundries Rs

ENTRIES FOR SALE THROUGH CREDIT/DEBIT CARDS

- Now-a-days sales through Credit/Debit Cards are issued by almost every Bank in India either directly orwith collaboration of some other agencies.
- Debit Card is issued by bank to a customer who has an account with the bank, maintaining a minimum balance. Debit card is16 digit number and also the name of the cardholder.
- Credit Card is issued by bank to a prospective customer, after verifying his credibility, which is generally measured by his income sources.Bank charges annual subscription fees from the credit card holder.
- The bank issuing the Card, charges commission for each such transaction, which varies between 1% to 4% and is immediately debited to seller's bank account.

ACCOUNTING FOR CREDIT/DEBIT CARD SALE

From the seller's point of view. Commission charged by thebank will be treated as selling expenses.

The following journal entries will be made in the seller's books ofaccounts.

1. Bank A/c Dr.
   To Sales Account
   (Sales made through Credit/Debit Card)
2. Commission Account Dr.
   To Bank Account
   (Commission charged by bank)

Class example 6

Prepare a Petty Cash Book on the imprest System from the following:

2016		Rs
Jan. 1	Received Rs 100 for petty cash	
" 2	Paid bus fare	50
" 2	Paid cartage	2.50
" 3	Paid for Postage & Telegrams	5.00
" 4	Paid wages for casual labourers	6.00
" 4	Paid for stationery	4.00
" 5	Paid tonga charges	2.00
" 5	Paid for the repairs to chairs	15.00
" 5	Bus fare	1.00
" 5	Cartage	4.00
" 6	Postage and Telegrams	7.00
" 6	Tonga charges	3.00
" 6	Cartage	3.00
" 6	Stationery	2.00
" 6	Refreshments to customers	5.00

SOLUTION

Receipt Rs	Date 2016	V. No	Particulars	Total Rs	Conveyance Rs	Cartage Rs	Stationery	Postage & Telegram Rs	Wages Rs	Sundries Rs
100	Jan 1		To cash							
	2	1	By Conveyance	.50	0.50	2.50				
		2	By cartage	2.50				5.00		
	3	3	By postage and Telegram	5.00						

		4	By wages	6.00					6.00	
	4	5	By stationery	4.00			4.00			
		6	By conveyence	2.00	2.00					
	5	7	By repairs to furniture	15.00						15.00
		8	By conveyance	1.00	1.00					
		9	By cartage	4.00		4.00				
	6	10	By postage & telegram	7.00				7.00		
	"	11	By conveyance	3.00	3.00					
	"	12	By cartage	3.00		3.00				
	"	13	By stationery	2.00			2.00			
	"	14	By general expenses	5.00						5.00
			By balance c/d	60.00	6.50	9.50	6.00	12.00	6.00	20.00
				40.00						
100			To balance c/d							
40			To cash	100.00						
60	8									

PRACTICAL QUESTIONS

QUESTION 1. (ICAI MODULE)

Enter the following transaction in Cash Bank with Discount and Bank columns. Cheques are first treated as cash receipts -

2016		**Rs**
March 1	Cash in Hand	15,000
	Overdraft in Bank	500
2	Cash Sales	3,000
3	Paid to Sushil Bros. by cheque	3,400

	Discount received	100
5	Sales through credit card	2,800
6	Received cheque from Srijan	6,200
7	Endorsed Srijan's cheque in favour of Adit	
9	Deposit into Bank	6,800
10	Received cheque from Aviral and deposited the same into Bank by allowing discount of Rs 50	3,600
12	Adit informed that Srijan's cheque is dishonoured. Now cash is received from Srijan and amount is paid to Adit through own cheque	
	Sales through Debit Card	
15	Withdrawn from Bank	3,200
24	Paid to Sanchit by cheque	1,800
28	Bank charged 1% commission on sales through Debit/Credit Cards	3,000
30		

QUESTION 2. (ICAI MODULE)

Shri Ramaswamy maintains a Columnar Petty Cash Book on the Imprest System. The imprest amount is Rs 500. From the following information, show how his Petty Cash Book would appear for the week ended12th September, 2015:

7-9-2015	Balance in hand	134.90
	Received Cash reimbursement to make up the imprest	365.10
	Stationery	49.80
8-9-2015	Miscellaneous Expenses	20.90
9-9-2015	Repairs	156.70
10-9-2015	Travelling	68.50
11-9-2015	Stationery	71.40

12-9-2015	Miscellaneous Expenses	6.30
	Repairs	48.30

QUESTION 3. (RTP MAY 2018)

Prepare a Triple Column Cash Book from the following transactions and bring down the balance for the start of next month:

Nov. 2017		**Rs**
1	Cash in hand	3,000
1	Cash at bank	12,000
2	Paid into bank	1,000
5	Bought furniture and issued cheque	1,500
8	Purchased goods for cash	500
12	Received cash from Mohan	980
	Discount allowed to him	20
14	Cash sales	5,000
16	Paid to Amar by cheque	1,450
	Discount received	50
19	Paid into Bank	500
23	Withdrawn from Bank for Private expenses	600
24	Received cheque from Parul	1,430
	Allowed him discount	20
26	Deposited Parul's cheque into Bank	
28	Withdrew cash from Bank for Office use	2,000
30	Paid rent by cheque	800

CHAPTER 7 - INVENTORIES

DEFINITION

1. Inventory can be defined as assets held
    - for sale in the ordinary course of business, **(FG)** or
    - in the process of production for such sale, **(WIP)** or
    - Which is in the form of materials/supplies to be consumed in the production of goods or rendering of services. **(RM)**
2. Inventory classified under '**current assets'** generally.
3. Inventory is measured (value Karana) at every '**Balance Sheet'**.
4. Inventories refer to the closing stock of goods a company has at the end of a specific period (usually a financial year).
5. **Accounting standard – 2** covers all the provisions relating to inventory.

Balance Sheet as on

31.3.2021

Liabilities	Amount	Assets	Amount
capital		**Closing stock**	
		cash	
		Assets	

Trading and profit & loss account

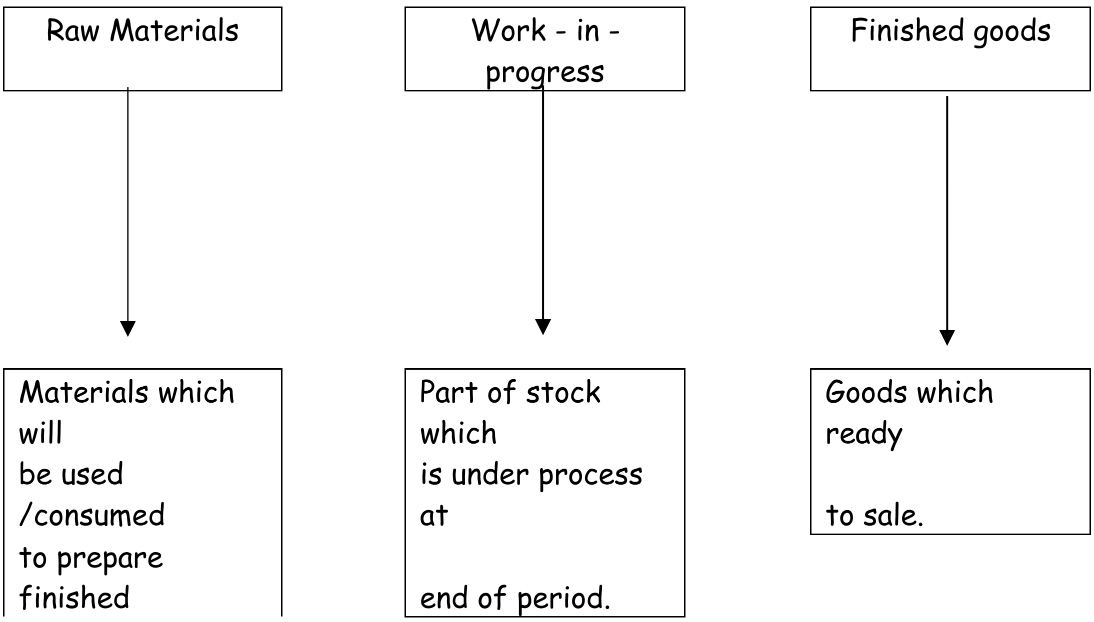
For the year ended 31.3.21

Particulars	amount	Particulars	amount
To opening stock		By sales	
To purchase		**By closing stock**	
To direct expense			
To gross profit			

PURPOSE OF VALUATION OF INVENTORY

- Determination of income.
- Ascertainment of financial position
- Liquidity analysis
- Statutory Compliances

INVENTORY

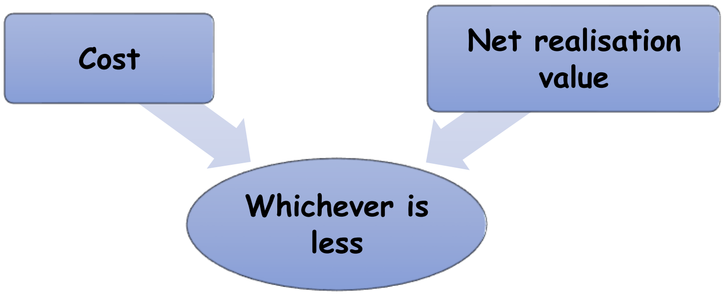


goods.

BASIS OF INVENTORY VALUATION

Inventories should be generally **valued at the lower of cost or net realizable value**.

(*Based on prudence & conservatism)*



COST

Cost includes

- All cost of purchase, *(Nonrefundable taxes, freight)*
- Costs of conversion, *(raw material ko FG main convert Karne ka cost)*
- Other costs incurred in bringing the inventories to their present location & condition.

  (Transportation cost, transit insurance)

Cost of purchase consist of purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining costs of purchase.

Costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of _xed and variable overheads.

Other Costs may include administrative overheads incurred to bring the inventory into present location and condition or any cost specifically incurred on inventory of a specified customer. Interest and other borrowing costs are generally not included in the cost of inventory. However, in some circumstances where production process is longer and it is required to carry inventory for a long period e.g. wine, rice and timber it may be appropriate to consider interest and other borrowing cost also part of cost of inventory.

Cost excludes

- Abnormal losses
- Storage costs
- Administrative overheads that do not contribute
- selling and distribution costs

NET REALIZABLE VALUE

In case of finished goods the estimated price of a finished good after deducting the costs to make the sale.

In the case of raw materials, it will be the replacement cost of the raw materials, i.e. their market price. &

WIP it will be the selling price minus the cost of conversion.

INVENTORY RECORD SYSTEMS

Recording of stock can be done by two different methods

1. **PERIODIC INVENTORY SYSTEM;**

Periodic inventory system is a method of ascertaining inventory by taking an **actual physical count (or measure or weight)** of all the inventory items on hand at a **particular date** on which inventory is valued. It is because of actual physical count that the system is also called physical inventory system. The cost of goods sold is determined as shown below:

Opening inventory (known) + Purchases (known) - closing inventory (physically counted) = Cost of goods sold.

Limitations

(i) Physical inventory taking is required more than once a year for preparation of quarterly or half yearly financial statements thereby making this system more expensive.

(ii) Physical count of goods requires closure of normal operations of business.

(iii) As cost of goods sold is taken as residual figure, it is not possible to identify loss of goods due to pilferage, damage or even fraud.

(iv) Inventory control is not possible under this system.

(v) Books of accounts does not reflect inventory in hand and its value therefore, it is difficult to plan operations e.g. how much or when to order/manufacture.

2. ***PERPETUAL INVENTORY SYSTEM:***

Perpetual inventory system is a system of **recording inventory balances after each receipt and issue.** In order to ensure accuracy of perpetual inventory records, physical inventory should be checked and compared with recorded balances. Under this system, cost of goods issued is directly determined and inventory of goods is taken as residual figure with the help of inventory ledger in which flow of goods is recorded on continuous basis. The basic feature of this system is the maintenance of inventory ledger to have records of goods on continuous basis. Under perpetual inventory system, closing inventory is determined as follows:

Opening inventory (known) + Purchases during the period (known) – Cost of Goods Sold (known) = Closing Inventory (balancing figure)

S. No.	Periodic Inventory System	Perpetual Inventory System
1.	This system is based on physical verification.	It is based on book records.
2.	This system provides information about inventory and cost of goods sold at a particular date.	It provides continuous information about inventory and cost of sales.
3.	This system determines inventory and takes cost of goods sold as residual figure.	It directly determines cost of goods sold and computes inventory as balancing figure.
4.	Cost of goods sold includes loss of goods as goods not in inventory are assumed to be sold.	Closing inventory includes loss of goods as all unsold goods are assumed to be in Inventory.
	Under this method, inventory control is not possible.	Inventory control can be exercised under this system.
5.	This system is simple and less expensive.	It is costlier method.
6.	Periodic system requires closure of business for counting of inventory.	Inventory can be determined without affecting the operations of the business.

7.

HOW TO CALCULTE INVENTORY?

Opening stock @ cost	---------
+ Purchase @ cost	---------
+Direct expenses @ cost	---------
Total cost	--------
Cost of Sale (COGS)	--------

GROSS PROFIT = Sale – COGS

Class ex.1

Cost of opening stock 50000 @cost as on 1 June

Goods purchase in June month 880000 @cost

In June month 62000 cost of goods sold @750000

Calculate Closing stock & gross profit?

Solution

Opening stock @ cost	50000
+ Purchase @ cost	880000
+Direct expenses @ cost	nil
Total cost	930000
-Cost of Sale	(620000)
Value Closing stock	310000

Gross profit = Sale – COGS = 750000- 620000= 130000

Class ex. 2

Opening stock @ cost 75000

Purchase cost 520000

Sold 70% of purchase goods @ 20% above cost

Calculate closing stock & gross profit.

Solution

Opening stock @ cost 75000

+ Purchase @ cost 520000

+Direct expenses @ cost nil

Total cost 595000

-Cost of Sale (364000)

Value Closing stock 231000

Gross profit = sale – COGS = 436800 – 364000=72800

COST + PROFIT =SALE

100 + 20 = 120

364000 = 436800

Class ex.3

Opening stock -100 units @ 50 per unit.

Purchase – 800 units @58 per unit.

Sold 750units (out of which 100 entire opening stock@75 per units.)

Calculate the closing stock & gross profit

Solution

*Opening stock 100*50*	*5000*	
*+ Purchase 800*58*	*46400*	
		51400
-COGS	*42700*	
*(100*50+650*58)*		
Closing stock		*8700*

*Sale value =750*75=56250*

Gross profit = sale – COGS = 56250 - 42700=13550.

METHODS FOR VALUATION OF STOCK

1) Historical Cost Method

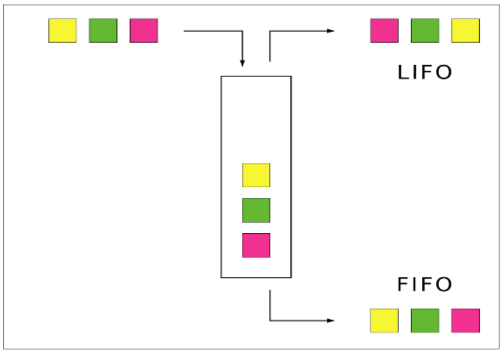
Historical cost means the cost actually paid to acquire material

A) FIFO (First in first out) Method

Goods received first are issued first and the stock includes latest purchase material. Inventory cost under FIFO method will be the cost of latest purchase.

B) LIFO (Last in first out) Method

Latest units are issued first and the stock includes earlier purchased goods. Inventory cost under LIFO method will be the cost of earliest purchases.



Class ex.4

Calculate the closing stock by FIFO AND LIFO

Opening stock = nil

Purchase

1. 1000 books @500 per books.
2. 1500 books @475 per books.
3. 500 books @ 495 per books.
4. 800 books @ 520 per books.

Admission =2500 students.

Solution

1. **FIFO**

= Total units - Units issue

= (1000+1500+500+800)-2500

= 1300 units

1300 units

500*495=247500 800*520=416000

Closing stock = 247500+416000=663500

2. **LIFO**

= Total units - Units issue

= (1000+1500+500+800)-2500

= 1300 units

1300 units

1000*500=500000 300*475=142500

Closing stock = 500000+142500=642500.

Class ex.5

Opening stock 500 @30 per units

Purchase 300@33 per units.

Sale 400.

Purchase 200@35 per units.

Sale 300 units.

Purchase 400 @32 per units.

Calculate closing stock by weighted average method.

Solution

A) 1st issue

Closing stock = Total units of 1st sale – sale

= (500+300)-400= 400

Average price per units= (500*30+300*33)/800=31.12 per units

Value of closing stock =400*31.13=12452/-.

B) 2nd sale

Closing stock =400+200-300=300

Average price per units= (400*31.13) + (200*35)/600=32.42 per units.

Value of closing stock=300*32.42=9726/-

C) Weighted average method

= [(300*32.42+400*32)/700=32.18 per units]

C) Simple Average Price Method

All the different prices of the purchases are added together and divided by the number of prices.

D) Weighted Average Price Method

Under weighted average price method, cost of goods available for sale during the period is aggregated and then divided by number of units available for sale during the period to calculate weighted average price per unit

Weighted average price per unit =

$$\frac{\text{Total cost of goods available for sale during the period}}{\text{Total number of units available for sale during the period}}$$

Closing inventory = No. of units in inventory × Weighted average price per unit

Cost of goods sold = No. of units sold × Weighted average price per unit.

Ex. So if we buy 100 goods at Rs 5/- and 200 goods at Rs 6/-, the weighted average rice will be (100×5) + (200×6) / 300 = 5.667/

Class ex.5

Opening stock 500 @30 per units

Purchase 300@33 per units.

Sale 400.

Purchase 200@35 per units.

Sale 300 units.

Purchase 400 @32 per units.

Calculate closing stock by weighted average method.

Solution

A) 1st issue

Closing stock = Total units of 1st sale – sale

= (500+300)-400= 400

Average price per units= (500*30+300*33)/800=31.12 per units

Value of closing stock =400*31.13=12452/-.

B) 2nd sale

Closing stock =400+200-300=300

Average price per units= (400*31.13) + (200*35)/600=32.42 per units.

Value of closing stock=300*32.42=9726/-

C) Weighted average method

= [(300*32.42+400*32)/700=32.18 per units]

E) Specific Identification Method

Pricing under this method is based on actual physical flow of goods. It attributes specific costs to identified goods and requires keeping different lots purchased separately to identify the lot out of which units in inventories are left.

2) Non-Historical Cost Method

Here purchasing price is not relevant.

A) Adjusted Selling Price Method/ retail inventory method

Stock of Closing Stock = Selling price of Closing stock – Gross profit ratio (Profit amount).

B) <u>Standard Cost Method</u>

Goods are valued at pre-decided standard cost.

INVENTORIES TAKING

Stock taking is reverse calculation of stock many times the value of stock is available few days after the closing date. Thus stock as on year ending date is calculated by reverse calculation called a stock taking.

MULTIPLE CHOICE QUESTIONS

1. The amount of purchase if
Cost of goods sold is Rs 80,700
Opening Inventory Rs 5,800
Closing Inventory Rs 6,000
(a) Rs 80,500 (b) Rs 74,900 (c) Rs 80,900.

2. Average Inventory = Rs 12,000. Closing Inventory is Rs 3,000 more than opening Inventory. The value of closing Inventory = _______.
(a) Rs 12,000 (b) Rs 24,000 (c) Rs 13,500.

3. While finalizing the current year's profit, the company realized that there was an error in the valuation of closing Inventory of the previous year. In the previous year, closing Inventory was valued more by Rs 50,000. As a result
(a) Previous year's profit is overstated and current year's profit is also overstated
(b) Previous year's profit is overstated and current year's profit is understated
(c) Previous year's profit is understated and current year's profit is also understated

4. Consider the following for Q Co. for the year 2015-16:
Cost of goods available for sale Rs 1,00,000
Total sales Rs 80,000
Opening inventory of goods Rs 20,000
Gross profit margin on sales 25%
Closing inventory of goods for the year 2015-16 as
(a) Rs 80,000 (b) Rs 60,000 (c) Rs 40,000

5. Average Inventory = Rs 12,000. Closing Inventory is Rs 3,000 more than opening Inventory. The value of closing Inventory = _______.
(a) Rs 12,000 (b) Rs 24,000 (c) Rs 13,500

6. If the profit is 25% of the cost price then it is
(a) 25% of the sales price
(b) 33% of the sales price
(c) 20% of the sales price

7. Goods purchased Rs 1,00,000. Sales Rs 90,000. Margin 20% on cost. Closing Inventory = ?
(a) Rs 20,000 (b) Rs 10,000 (c) Rs 25,000

8. A company is following weighted average cost method for valuing its inventory. The details of its purchase and issue of raw-materials during the week are as follows:
1.12.2015 opening Inventory 50 units value Rs 2,200.
2.12.2015 purchased 100 units @ Rs 47.
4.12.2015 issued 50 units.
5.12.2015 purchased 200 units @ Rs 48.
The value of inventory at the end of the week and the unit weighted average costs is
(a) Rs 14,200 – Rs 47.33 (b) Rs 14,300 – Rs 47.67 (c) Rs` 14,000 – Rs 46.66

9. The cost of sales is equal to
(a) Opening stock plus purchases
(b) Purchases minus Closing stock
(c) Opening stock plus purchases minus closing stock

10. Inventory is disclosed in financial statements under:
(a) Fixed Assets
(b) Current Assets
(c) Current Liabilities

11. Accounting Standards do not permit following method of inventory valuation
(a) FIFO
(b) Average cost
(c) LIFO

12. Which inventory costing formula calculates value of closing inventory considering that inventory most recently purchased has not been sold?
(a) FIFO
(b) LIFO
(c) Weighted average cost

13. Valuing inventory at cost or net releasable value is based on which principle
(a) Consistency (b) Conservatism (c) Going concern

14. Under inflationary trend, which of the methods will show highest value of inventory?
(a) FIFO
(b) Weighted average
(c) LIFO

15. Which of the following methods does not consider historical cost of inventory?
(a) Weighted average
(b) FIFO
(c)Retail price method

THEORETICAL QUESTIONS

1. Write short notes on:
   (i) Adjusted Selling Price method of determining cost of stock.
   (ii) Principal methods of ascertainment of cost of inventory.

2. Distinguish between:
   (i) LIFO and FIFO basis of costing of stock.
   (ii) FIFO and weighted average price method of stock costing.

3. Define inventory. Explain the importance of proper valuation of inventory in the preparation of statements of the business entity.

PRACTICE QUESTIONS

ILLUSTRATION 1 (ICAI MODULE)

A manufacturer has the following record of purchases of a condenser, which he uses while manufacturing radio sets:

Date	Quantity (units)	Price per unit
Dec. 4	900	50
Dec. 10	400	55
Dec. 11	300	55
Dec. 19	200	60
Dec. 28	800	47
	2600	

1,600 units were issued during the month of December till 18th December. By using FIFO method.

ILLUSTRATION 2 (ICAI MODULE)

A manufacturer has the following record of purchases of a condenser, which he uses while manufacturing radio sets:

Date	Quantity (units)	Price per unit

Dec. 4	900	50
Dec. 10	400	55
Dec. 11	300	55
Dec. 19	200	60
Dec. 28	800	47
	2600	

Record of Issues

Date	Quantity (Units)
Dec. 5	500
Dec. 20	600
Dec. 29	500
Total	1,600

let us calculate the value of closing inventory using LIFO Method

ILLUSTRATION 3

In the same example of a manufacturer of radio sets given earlier, let us calculate the value of closing inventory using Average Price Method

ILLUSTRATION 4 (ICAI MODULE)

A manufacturer has the following record of purchases of a condenser, which he uses while manufacturing radio sets:

Date	Quantity (units)	Price per unit
Dec. 4	900	50
Dec. 10	400	55
Dec. 11	300	55
Dec. 19	200	60

Dec. 28	800	47
	2600	

Record of Issues

Date	Quantity (Units)
Dec. 5	500
Dec. 20	600
Dec. 29	500
Total	1,600

calculate the value of closing inventory using weighted average price method.

ILLUSTRATION 5 (ICAI MODULE)

M/s X, Y and Z are in retail business, following information are obtained from their records for the year ended 31st March, 2016:

Goods received from suppliers	
(subject to trade discount and taxes)	15,75,500
Trade discount 3% and sales tax 11%	
Packaging and transportation charges	87,500
Sales during the year	22,45,500
Sales price of closing inventories	2,35,000

Find out the historical cost of inventories using adjusted selling price method. (ICAI SM)

ILLUSTRATION 6

From the following information, calculate the historical cost of inventories using adjusted selling price method:

	Rs
Sales during the year	2,00,000
Cost of purchases	2,00,000
Opening inventory	Nil
Closing inventory at selling price	50,000

ILLUSTRATION 7

From the following particulars ascertain the value of Inventories as on 31st March, 2017:

	Rs
Inventory as on 1.4.2016	1,42,500
Purchases	7,62,500

Manufacturing Expenses	1,50,000
Selling Expenses	60,500
Administrative Expenses	30,000
Financial Charges	21,500
Sales	12,45,000

At the time of valuing inventory as on 31st March, 2016, a sum of Rs 17,500 was written off on a particular item, which was originally purchased for Rs 50,000 and was sold during the year for Rs 45,000. Barring the transaction relating to this item, the gross profit earned during the year was 20 percent on sales.

ILLUSTRATION 8

A trader prepared his accounts on 31st March, each year. Due to some unavoidable reasons, no inventory taking could be possible till 15th April, 2017 on which date the total cost of goods in his godown came to Rs 5,00,000. The following facts were established between 31st March and 15th April, 2017.

(i) Sales Rs 4,10,000 (including cash sales Rs 1,00,000)
(ii) Purchases Rs 50,340 (including cash purchases Rs 19,900)
(iii) Sales Return Rs 10,000.

Goods are sold by the trader at a profit of 20% on sales.
You are required to ascertain the value of inventory as on 31st March, 2017.

ILLUSTRATION 9

Inventory taking for the year ended 31st March, 2016 was completed by 10th April 2016, the valuation of which showed a inventory figure of Rs 16,75,000 at cost as on the completion date. After the end of the accounting year and till the date of completion of inventory taking, sales for the next year were made for Rs 68,750, profit margin being 33.33 percent on cost. Purchases for the next year included in the inventory amounted to Rs 90,000 at cost less trade discount 10 percent. During this period, goods were added to inventory at the mark up price of Rs 3,000 in respect of sales returns. After inventory taking it was found that there were certain very old slow moving items costing Rs 11,250, which should be taken at Rs 5,250 to ensure disposal to an interested customer. Due to heavy flood, certain goods costing Rs 15,500 were received from the supplier beyond the delivery date of customer. As a result, the customer refused to take delivery and net realizable value of the goods was estimated to be Rs 12,500 on 31st March. Compute the value of inventory for inclusion in the final accounts for the year ended 30th March, 2016.

ILLUSTRATION 10

The following are the details of a spare part of Sriram mills:

1-1-2016	Opening Inventory	Nil
1-1-2016	Purchases	100 units @ Rs 30 per unit
15-1-2016	Issued for consumption	50 units
1-2-2016	Purchases	200 units @ Rs 40 per unit

15-2-2016	Issued for consumption	100 units
20-2-2016	Issued for consumption	100 units

Find out the value of Inventory as on 31-3-2016 if the company follows First in first out basis.

ILLUSTRATION 11

The following are the details of a spare part of Sriram Mills:

1-1-2016	Opening Inventory	Nil
1-1-2016	Purchases	100 units @ Rs 30 per unit
15-1-2016	Issued for consumption	50 units
1-2-2016	Purchases	200 units @ Rs 40 per unit
15-2-2016	Issued for consumption	100 units
20-2-2016	Issued for consumption	100 units

Find out the value of Inventory as on 31-3-2016 if the company follows Weighted Average basis.

Topic 8

CONCEPT AND ACCOUNTING OF DEPRECIATION

INTRODUCTION

- **Depreciation** is the systematic allocation of the depreciable amount of an asset over its useful life.
- The **depreciable amount** of an asset is the cost of an asset or other amount substituted for cost, less its residual value.
- The **useful life** of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity
- Property, plant and equipment are tangible items that:

1. are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes;&
2. are expected to be used during more than a period of twelve months.

These are also called **fixed assets** in common parlance. When a fixed asset is purchased, it is recorded in books of account at it original or acquisition/purchase cost. However fixed assets are used to earn revenues for a number of accounting periods in future with the same acquisition cost until the concerned fixed asset is sold or discarded. It is therefore necessary that a part of the acquisition cost of the fixed assets is treated or allocated as an expense in each of the accounting period in which the asset is utilized. The amount or value of fixed assets allocated in such manner to respective accounting period is called depreciation

Value of such assets decreases with passage of time mainly due to following reasons.

1. Wear and tear due to its use in business
2. Efflux of time even when it is not being used
3. Obsolescence due to technological or other changes
4. Decrease in market value
5. Depletion mainly in case of mines and other natural reserves

Objectives for Providing Depreciation

- Correct income measurement
- True position statement
- Funds for replacement

- Ascertainment of true cost of production.

Further depreciation is a non-cash expense and unlike other normal expenditure (e.g. wages, rent, etc.) does not result in any cash outflow

Main Inputs required to calculate depreciation(IMP):

- **Useful life** – this is the time period over which the organisation considers the fixed asset to be productive. Beyond its useful life, the fixed asset is no longer cost-effective to continue the operation of the asset.

- **Salvage value** – Post the useful life of the fixed asset, the company may consider selling it at a reduced amount. This is known as the salvage value of the asset.

- **The cost of the asset** –

    (a) its purchase price, including non-refundable import duties and purchase taxes, after deducting trade discounts and rebates.

    (b) any cost directly attributable to bring the asset to the location and condition necessary for it to be capable of operating in a manner intended by the enterprise.

    (c) the initial estimate of the costs of dismantling, removing, the item and restoring the site on which an asset is located.

-

Example of Depreciation – If a delivery truck is purchased a company with a cost of Rs. 100,000 and the expected usage of the truck are 5 years, the business might depreciate the asset under depreciation expense as Rs. 20,000 every year for a period of 5 years.

Depletion and amortization

Depletion and amortization are similar concepts for natural resources (including oil) and intangible assets, respectively.

Effect on cash

- Depreciation expense does not require a current outlay of cash.
- However, since depreciation is an expense to the P&L account, provided the enterprise is operating in a manner that covers its expenses

Accumulated depreciation

- Accumulated depreciation is the total amount an asset has been depreciated up until a single point.
- Each period, the depreciation expense recorded in that period is added to the beginning accumulated depreciation balance.
- An asset's **carrying value** on the balance sheet is the difference between its **historical cost** and accumulated depreciation. At the end of an asset's **useful life**,

its carrying value on the balance sheet will match its salvage value

METHODS FOR PROVIDING DEPRECIATION

- Straight line method
- Reducing balance method
- Sum of years of digits method
- Machine hour method
- Production units' method
- Depletion method

Straight Line Method

- Straight-line depreciation is the simplest and most often used method.
- In this method, the company estimates the residual value (also known as salvage value or scrap value) of the asset at the end of the period during which it will be used to generate revenues (useful life). (The salvage value may be zero, or even negative due to costs required to retire it; however, for depreciation purposes salvage value is not generally calculated at below zero.)
- The company will then charge the same amount to depreciation each year over that period, until the value shown for the asset has reduced from the original cost to the salvage value.
- $\text{Straight Line Depreciation} = \dfrac{\text{cost of Asset} - \text{Scrap Value}}{\text{Useful Life}}$
- $\text{Straight Line Depreciation Rate} = \dfrac{\text{Straight Line Depreaciation}}{\text{Cost of Asset}} \times 100$

For example,

A vehicle that depreciates over 5 years is purchased at a cost of 17,000, and will have a salvage value of 2000. Then this vehicle will depreciate at 3,000 per year,

i.e. (17000-2000)/5 = 3.

This table illustrates the straight-line method of depreciation.

Book value at the beginning of the first year of depreciation is the original cost of the asset. At any time book value equals original cost minus accumulated depreciation.

Book value = Original cost - Accumulated depreciation

Book value at the end of year becomes book value at the beginning of next year. The asset is depreciated until the book value equals scrap value.

Depreciation expense	Accumulated depreciation at year-end	Book value at year-end
		(original cost) 17,000
3000	3000	14000
3000	6000	11000
3000	9000	8000
3000	12000	5000
3000	15000	2000(Scarp value)

Reducing balance method/Diminishing balance method

- Also known as Written Down Value Method. (WDV)
- Under this method, the percentage rate of depreciation remains fixed, but we have to reduce the asset's value during every accounting year.
- The Income Tax Act, 1961 has prescribed this method for calculation of depreciation.
- The rate of depreciation under this method may be determined by the following formula:

$$1 - \sqrt[n]{\frac{Residual\ Value}{Cost\ of\ Asset}} X100$$

Where, n=useful life

Class Example.

Assets value -1000

Rate @ 40%

Scrap value 100.

Depreciation rate	Depreciation expense	Accumulated depreciation	Book value at year-end
			original cost 1,000.00
40%	400.00	400.00	600.00
40%	240.00	640.00	360.00
40%	144.00	784.00	216.00

40%	86.40	870.40	129.60
129.60-100.00	29.60	900.00	scrap value 100.00

Accounting Entries under Straight Line and Reducing Balance Methods:

First Alternative

A provision for depreciation account is opened to accumulate the balance of depreciation and the assets are carried at historical cost

1)Depreciation Account Dr.
To Provision for Depreciation Account

2)Profit and Loss Account Dr.
To Depreciation Account

Second Alternative

Amount of Depreciation is credited to the Asset Account every year and the Asset Account is carried at historical cost less depreciation.

Depreciation Account Dr.
To Asset Account
Profit & Loss Account Dr.
To Depreciation Account

Class Example

PQR company bought a machine for 20,000 . The company uses fixed installment method of depreciation and estimates that the machine will have a useful life of 6 years and leave a scrap value of 2,000.

A)

Depreciation Account	Dr.	3000	
To Provision for Depreciation Account			3000
Profit and Loss Account	Dr.	3000	
To Depreciation Account			3000

B)

Deprecation A/c …………………… Dr.	3000	
To Machine A/c		3000
Profit and Loss A/c…………… Dr.	3000	
To Deprecation A/c		3000

QUESTION 1. (ICAI MODULE)

Jain Bros. acquired a machine on 1stJuly ,2015 at a cost of Rs 14,00,000 and spent Rs1,00,000 on its installation. The firm writes off depreciation at10%p.a. of the original cost every year. The books are closed on 31st December every year.

Required
Show the Machinery Account and Depreciation Account for the year 2015 and 2016.

QUESTION 2. (ICAI MODULE)

Ram acquired a machine on 1stJuly,2015 at a cost of Rs14,00,000 and spent Rs1,00,000 on its installation. The firm writes off depreciation at 10%p.a .every year. The books are closed on 31stDecember every year.

Required
Show the Machinery Account on diminishing balance method for the year 2015 and 2016.

Sum of Years of Digits Method

- Under this method, the annual depreciation is determined by multiplying the depreciable cost by a schedule of fractions.
- Sum of the years' digits method of depreciation is one of the accelerated depreciation techniques which are based on the assumption that assets are generally more productive when they are new and their productivity decreases as they become old.
- The formula to calculate depreciation under SYD method is:

$$\text{SYD Depreciation} = \text{Depreciable Value} \times \frac{\text{Remaining useful life (including the present Year)}}{\text{Sum of the years' digits}}$$

Depreciable Value = Cost – Salvage Value

Class Example:

If an asset has original cost of 1000, a useful life of 5 years and a salvage value of 100, compute its depreciation schedule.

Answer:

First, determine the years' digits. Since the asset has a useful life of 5 years, the years' digits are: 5, 4, 3, 2, and 1.

Next, calculate the sum of the digits: 5+4+3+2+1=15

The sum of the digits can also be determined by using the formula $n(n+1)/2$ where n is equal to the useful life of the asset in years. The example would be shown as $(5^2+5)/2=15$

Depreciation rates are as follows:

5/15 for the 1st year, 4/15 for the 2nd year, 3/15 for the 3rd year, 2/15 for the 4th year, and 1/15 for the 5th year.

Depreciable base(a)	Depreciation rate(b)	Depreciation expense (c) =(a)*(b)	Accumulated depreciation (d)	Book value at end of year (e)
				1,000 (original cost)
900	5/15	300	300	700
900	4/15	240	540	460
900	3/15	180	720	280
900	2/15	120	840	160
900	1/15	60	900	100(Scarp value)

QUESTION 3.(ICAI MODULE)

M/s Akash purchased a machine for Rs 10,00,000. Estimated useful life and scrap value were 10 years and Rs 1,20,000 respectively. The machine was put to use on 1.1.2010.

Required

Show Machinery Account and Depreciation Account in their books for2015 by using sum of year's digits method

Machine Hour Method

- This is also known as Service Hours Method.
- This method takes into account the running time of the asset for the purpose of calculating depreciation.
- The method has the advantage of correlating the charge for depreciation, to the actual working time of the machine. However, this method can he used only in case of those assets whose life can be measured in terms of working time.
- The method is particularly suitable for charging depreciation on plant and machinery, air-crafts, etc.

Depreciation for the period = Depreciable Amount $\times \dfrac{\textit{Hours Worked during the period}}{\textbf{Estimated total Hours}}$

Class Example

A machine was acquired on 1st April 2004 at a cost of 45000, the cost of installation was RS. 5000. It is expected that its total life will be 1,00,000 hours. During 2004 , it worked for 8,000 and during 2005 for 12000 hours. Depreciation for 2004 and 2005.

SOLUTION

Hourly Depreciation Rate = Cost of machine + cost of installation / estimated life

HDR= 45000+5000/1,00,000 = Rs.0.50 per hour

Year 2004= 8000*0.50=4000

Year 2005=12000*0.50=6000

QUEZTION 3. (ICAI MODULE)

A machine was purchased for Rs30,00,000 having an estimated total working of 24,000 hours. The scrap value is expected to be Rs 2,00,000 and anticipated pattern of distribution of effective hours is as follows:

Year	
1-3	3,000 hours per year
4-6	2,600 hours per year
7-10	1,800 hours per year

Required

Determine Annual Depreciation under Machine Hour Rate Method.

Production Units Method

Under this method depreciation of the asset is determined by comparing the annual production with the estimated total production. The amount of depreciation is computed by the use of following method:

$$\text{Depreciation for the period} = \text{Depreciatiable Amount} \times \frac{\textbf{Production during the period}}{\textbf{Estimated total production}}$$

The method is applicable to machines producing product of uniform specifications

Class Example:

M/s Cube textiles purchased machinery for ₹200000 on 1st January. It has an estimated useful life of 10 years and an estimated residual value of ₹20000. The firm sells the asset at the residual value at the end of the 10th year. The machine has an expected production of 15000 units during its useful life. Now the production pattern is as follows:

Year	Production(units per year)
1-3	2000
4-7	1500
8-10	1000

Calculate the amount of depreciation using the Units of Production Method. Pass necessary journal entries. Also, prepare Machinery A/c.

Solution:

Calculation of depreciation under Units of Production Method:

Depreciable Value = Original cost – Scrap value = 200000-20000 = 180000

Annual Depreciation=Depreciable Value × Units produced during the year/Estimated total production

YEAR	Annual Depreciation
1-3	180000*2000/15000=24000
4-7	180000*1500/15000=18000
8-10	180000*1000/15000=12000.

QUESTION 4. (ICAI MODULE)

A machine is purchased for Rs2 0,00,000. Its estimated useful life is 10 years with a residual value of Rs 2,00,000. The machine is expected to produce 1.5 lakh units during its life time. Expected distribution pattern of production is asfollows:

Year	Production
1-3	20,000unitsperyear
4-7	15,000unitsperyear
8-10	10,000unitsperyear

Required

Determine the value of depreciation for each year using production units method.

Depletion Method

This method is used in case of mines, quarries etc. containing only a certain quantity of product. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available.
Annual depreciation will be the quantity extracted multiplied by the rate per unit.

Depreciation = Estimated Total Cost – Residual Value /Estimated total output(units)* Actual output during the year .

QUESTION 5. (ICAI MODULE)

M/s Surya took lease of a quarry on 1-1-2013 for Rs 1,00,00,000. As per technical estimate the total quantity of mineral deposit is 2,00,000 tonnes. Depreciation was charged on the basis of depletion method. Extraction pattern is given in the following table:

Year	Quantity of Mineral extracted
2013	2,000tonnes
2014	10,000tonnes
2015	15,000tonnes

Required

Show the Quarry Lease Account and Depreciation Account for each year from 2013 to 2015.

PROFIT OR LOSS ON THE SALE/DISPOSAL OF PROPERTY,PLANT AND EQUIPMENT

- Whenever any depreciable asset is sold during the year, depreciation is charged on it for the period it has been used in the sale year.
- The written down value after charging such depreciation is used for calculating the profit or loss on the sale of that asset.
- The resulting profit or loss on sale of the asset is ultimately transferred to profit and loss account.

Class example

The book value of the asset as on 1st January, 2015 is Rs 50,00,000. Depreciation is charged on the asset @10%. On 1st July 2015, the asset is sold for Rs 32,00,000. In such a situation, profit or loss on the sale will be calculated as follows:

	Rs
Book value as on 1st Jan., 2015	50,00,000
Less: Depreciation for 6 months @10% (from 1st Jan., 2015 to 30th June, 2015)	(2,50,000)
Written down value as on 1st July, 2015	47,50,000
Less: Sale proceeds as on 1st July, 2015	(32,00,000)
Loss on sale of the asset	15,50,000

QUESTION 5. (ICAI MODULE)

A firm purchased on 1st January,2015 certain machinery for Rs 5,82,000 and spent Rs 18,000 on its erection. On July 1,2015 another machinery for Rs 2,00,000 was acquired. On 1st July,2016 the machinery purchased on 1st January,2015 having become obsolete was auctioned for Rs 3,86,000 and on the same date fresh machinery was purchased at a cost of Rs 4,00,000.

Depreciation was provided for annually on 31stDecember at the rate of 10 percent p.a. on written down value.

Required
Prepare machinery account.

CHANGE IN THE METHOD OFDEPRECIATION

- Accounting policies and principles need to be consistently applied while recording the financial transactions. This is the Principle of Consistency. Any change in the method of depreciation implies a change in accounting estimate. Thus, there should be valid reasons for a change in method of depreciation.
- At the end of each financial year, management should review the method of depreciation. When there is a significant change in the pattern of the future economic benefits from the asset then the method of depreciation should also be changed.
- As per the Accounting Standard 1- Disclosure of Accounting Policies, the change in the method of depreciation is a change in the accounting estimate. Thus, it requires quantification and full disclosure in the footnotes. Also, the justification and financial effects of the change needs to be disclosed.
- Thus, the method of depreciation can be changed **without retrospective effect** or **with retrospective effect**.

Without Retrospective effect	**With Retrospective effects**
No adjustment will be made for past entries and only in the future depreciation shall be charged by the new method.	the amount of depreciation to be charged is adjusted from the date of purchase of the asset.

Class Example-

Cost of Machine	1050000
Residual Value	50000
Useful life	10 years

The company charges depreciation on straight line method for the first two years and

there after decides written down value method by charging depreciation@25%.(calculated based on useful life). You are required to calculate depreciation for the 3rdyear.
Depreciation already charged for the first 2 years as per straight line method is Rs 2,00,000.
Therefore, WDV for 2nd year is Rs 8,50,000
Therefore in the profit and loss account of the 3rd year, the depreciation of Rs 2,12,500 (25% of Rs 850,000) should be debited.

QUESTION 6.

M/s Anshul commenced business on 1st January 2011, when they purchased plant and equipment for Rs 7,00,000. They adopted a policy of charging depreciation at 15% per annum on diminishing balance basis and over the years, their purchases of plant have been:

Date	Amount Rs
1-1-2012	1,50,000
1-1-2015	2,00,000

On 1-1-2015 it was decided to change the method and rate of depreciation to straight line basis. On this date remaining use ful life was assessed as 6 years for all the assets purchased before 1.1.2015 and 10 years for the asset purchased on 1.1.2015 with no scrap value.

Required
Calculate the difference in depreciation to be adjusted in the Plant and Equipment Account for the year ending 31st December, 2015.

REVISION OF THE ESTIMATED USEFUL LIFE OF PROPERTY , PLANT AND EQUIPMENT

The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with Accounting Standards.
Whenever there is a revision in the estimated useful life of the asset, the unamortized depreciable amount should be charged over the revised remaining estimated useful life of the asset.

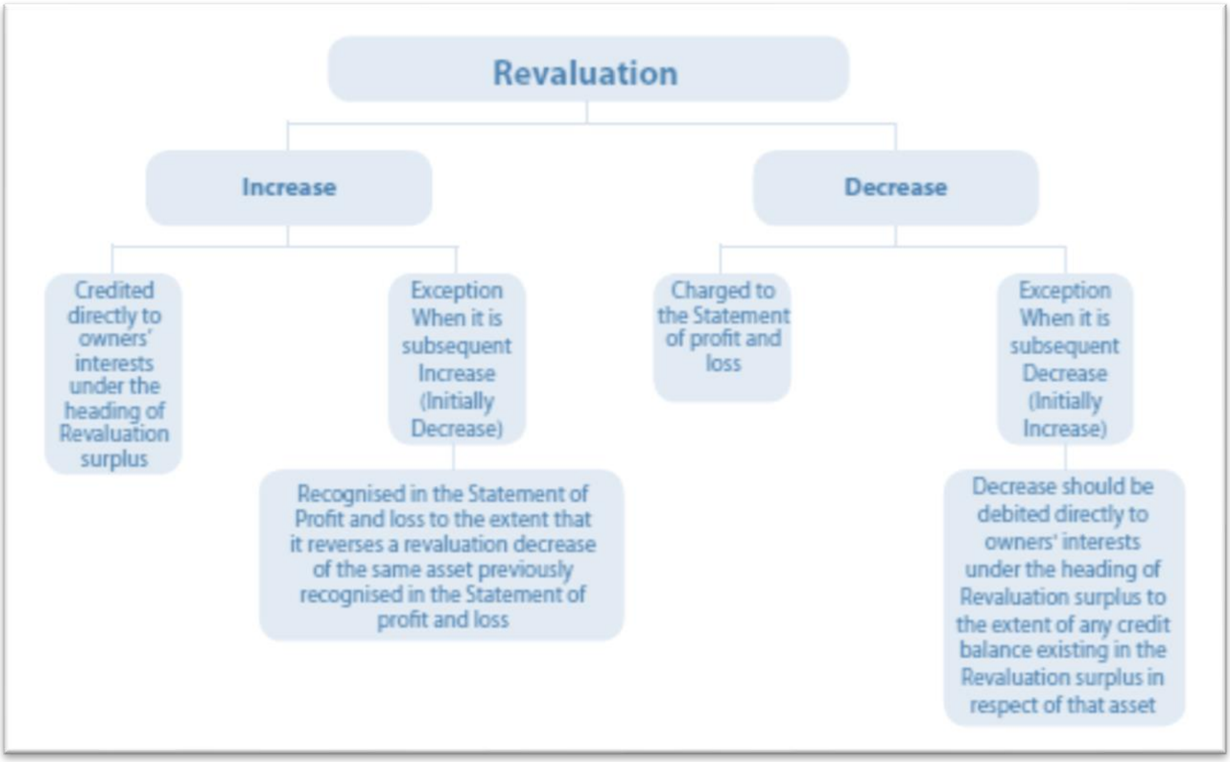
QUESTION 7.

A Machine costing Rs 6,00,000 is depreciated on straight line basis, assuming 10 years working life and Nil residual value, for three years. The estimate of remaining useful life after third year was reassessed at 5 years.

Required
Calculate depreciation for the fourth year.

REVLUATION OF PROPERTY, PLANT AND EQUIPMENT

- If there is an upward revision in the value of asset for the first time, then the amount of appreciation is debited to Asset Account and credited to Revaluation Reserve Account.
- If there is downward revision in the value of asset then Profit and Loss Account is debited and Asset Account is credited.
- If an asset was earlier revalued downward and later on revalued upward then the appreciation to the extent of earlier downfall is credited to profit and loss account.
- If an asset was earlier revalued upward and then later on it was revalued downward then the downfall to the extent of earlier appreciation is debited to Revaluation Reserve Account.
- In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.



QUESTION 8.

A machine of cost Rs 12,00,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. At the end of third year, the machine was revalued upwards by Rs60,000 there maining use ful life was reassessed at 9 years.

Required
Calculate depreciation for the fourth year.

PROVISION FOR REPAIRS AND RENEWALS

- Expenditure incurred for repairs, renewals and maintenance on plant and machinery may vary over the years during the working life. Thus, for equalising the charge of repairs and renewals, sometimes a Provision for Repairs and Renewals Account is opened.
- Total of such expenses that may be incurred over the working life is estimated beforehand. Average of this expenditure is debited to Profit and Loss Account and credited to Provision for Repairs and Renewals Account irrespective of actual expenses incurred.
- Every year Provision for Repairs and Renewals Account is debited and Repairs Account is credited for actual expenses incurred.
- The balance in provision for Repairs and Renewals Account is carried forward and in the end or on sale of the asset, the account is closed by transfer to the Asset Account for any balance left.

QUESTION 14.

The following particulars are available from the books of a public company having a large fleet of vehicles:

	Rs
Balance in Provision for Repairs and Renewals Account as on 31.3.2016	11,50,000
Actual repairs charged/incurred during the year ended 31.3.2016	7,50,000
31.3.2017 The company makes an annual provision of Rs4,00,000 on repairs and renewals.	3,20,000

QUESTION 4. (ICAI MODULE)

A lease is purchased on 1stApril,2012 for 4 years at a cost of Rs 2,00,000. It is proposed to depreciate the lease by the annuity method charging 5 percent interest. A reference to the annuity table shows that to depreciate Rs 1 by annuity method over 4 years charging 5%interest, one must write off amount Rs0.282012 [To write off Rs 2,00,000 one has to write off every year Rs 56,402. 40i.e .0.282012×2,00,000].

Required
Show the Lease Account for four years and also the relevant entries in the profit and loss account.

QUESTION 5. (ICAI MODULE)

On 1st April, 2013, Z Limited purchased the lease of property for Rs 10,00,000. The lease would expire on 31stMarch, 2016. Z Ltd., decided to set up a sinking fund. The Sinking Fund was to be credited (or debited) with an annual contribution from profit, the interest on the investments and any profits (or losses) made on the realization of the sinking fund investments. The sinking fund was to be represented by specific investment, and any sums made available to the sinking fund were to be immediately invested, except at the termination of the fund.

During the three years following transactions took place:

2014 31st March: A contribution from profits of Rs3,20,000 was made and this sum was invested.

2014 13th Oct.: Investments which originally costed Rs 1,10,000 were sold for Rs1,20,000 and the proceeds of sale were re-invested.

2015 31st March: A contribution from profits of Rs3,20,000 was made; interest on investments of Rs 16,000 was received and these amounts were reinvested.

2015 9th August: Investments which originally costed Rs 2,10,000 were sold at a profit of Rs 20,000 and proceeds of sale were re-invested.

201631st March: Interest on investments Rs48,000 was received which was not invested. All existing investments we resold for Rs 6,60,000. A contribution from profit of amount required to make up the sinking fund to Rs 10,00,000 was made and this amount was not invested.

Required

Prepare Sinking Fund and Sinking Fund Investment Account for the years 2013-14, 2014-15, 2015-16.

QUESTION 6. (ICAI MODULE)

On 1st April, 2013, Z Limited purchased the lease of property for Rs 10,00,000. The lease would expire on 31stMarch, 2016. Z Ltd., decided to set up a sinking fund. The Sinking Fund was to be credited (or debited) with an annual contribution from profit, the interest on the investments and any profits (or losses) made on the realization of the sinking fund investments. The sinking fund was to be represented by specific investment, and any sums made available to the sinking fund were to be immediately invested, except at the termination of the fund.

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201631st March: Interest on investments Rs48,000 was received which was not invested. All existing investments we resold for Rs 6,60,000. A contribution from profit of amount required to make up the sinking fund to Rs 10,00,000 was made and this amount was not invested.

Required

Prepare Lease Account and Depreciation Account for the years 1st April, 2013 to 31st March, 2016.

QUESTION 10. (ICAI MODULE)

A firm purchased on 1st January,2015 certain machinery for Rs 5,82,000 and spent Rs 18,000 on its erection. On July 1,2015 another machinery for Rs 2,00,000 was acquired. On 1st July,2016 the machinery purchased on 1st January,2015 having become obsolete was auctioned for Rs 3,86,000 and on the same date fresh machinery was purchased at a cost of Rs 4,00,000.

Depreciation was provided for annually on 31stDecember at the rate of 10 percent p.a. on written down value.

Required

Prepare machinery account.

QUESTION 15. (ICAI MODULE)

The Machinery Account of a Factory showed a balance of Rs 19,00,000 on 1st January, 2015. Its accounts were made up on 31st December each year and depreciation is written off at 10% p.a. under the Diminishing Balance Method.

On 1st June 2015, a new machinery was acquired at a cost of Rs 2,80,000 and installation charges incurred in erecting the machine works out to Rs 8,920 on the same date. On 1st June, 2015 a machine which had cost Rs 4,37,400 on 1st January 2013 was sold for Rs 75,000. Another machine which had cost Rs4,37,000 on 1st January, 2014 was scrapped on the same date and it realized nothing.

Write a plant and machinery account for the year 2015, allowing the same rate of depreciation as in the past calculating depreciation to the nearest multiple of a Rupee.

QUESTION 16.(ICAI MODULE)

The LG Transport company purchased 10 trucks at Rs 45,00,000 each on 1st April 2014. On October 1st, 2016 ,one of the trucks is involved in an accident and is completely destroyed and Rs 27,00,000is received from the insurance in full settlement. On the same date another truck is purchased by the company for the sum of Rs 50,00,000.The company write of 20% on the original cost per annum. The company observe the calendar year as its financial year.

Give the motor truck account for two year ending 31 Dec, 2017.

TOPIC 9
BILLS OF EXCHANGE AND PROMISSORY NOTES

BillsOf Exchange

A Bill of Exchange has been defined as an "instrument in writing containing an unconditional order signedby the maker directing certain person to pay a certain sum of money only to or to the order of a certainperson or to the bearer of the instrument". When such an order is accepted in writing on the face of the order itself, it becomes a valid bill of exchange. Suppose A orders B to pay Rs 50,000 for three months after date and B accepts this order by signing his name, then it will be a bill of exchange.

Parties of Bill of Exchange

- **Drawer-** The party which makes the order.
- **Drawer/ Acceptor-**The party which accepts the order.
- **Payee-** The party to whom the amount has to be paid.
- The drawer and the payee can be the same.

Characteristics of Bill of Exchange

1. It must be in **writing**.
2. It must be **dated**.
3. It must contain an order to pay a **certain sum** of money.
4. The promise to pay must be **unconditional.**
5. The money must be payable to a **definiteperson** or to his order to the bearer.
6. The draft must be accepted for payment by the party to whom the order is made.
7. It should be properly **stamped**.
8. Payment must be in **legalcurrency** of the country.

"Foreign Bill of Exchange".

- A foreign bill of exchange is one which is drawn in one country and is payable in another country.
- A bill of exchange is drawn for foreign trade operations.

The following are examples of foreign bills:

1. A bill drawn in India on a person resident outside India and made payable outside India.
2. A bill drawn outside India on a person resident outside India.
3. A bill drawn outside India and made payable in India.
4. A bill drawn outside India and made payable outside India.

Promissory Note

- A promissory note is an instrument in writing, not being a bank note or currency note containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person.
- Under Section 31(2) of the Reserve Bank of India Act a promissory note cannot be made payable to bearer.

Parties of Promissory Note

- **Maker-** Who signs the notes (the debtors) & pay the amount on the due date.
- **Payee-** To whom the amount is payable (the creditors).

Characteristics of Promissory Note

1. It must be in **writing.**

2. It must contain a clear promise to **pay.**
3. The promise to pay **must be unconditional** "I promise to pay `50,000 as soon as I can" is not an unconditional promise.
4. The promiser or maker must **sign** the promissory note.
5. The **maker** must be a **certain person**.
6. The **payee** (the person to whom the payment is promised) must also be **certain.**
7. The **sum payable must be certain**. "I promise to pay `50,000 plus all _ne" is not certain.
8. Payment must be in **legal currency** of the country.
9. It should **not** be made payable to the **bearer**.
10. It should be properly **stamped**.

Specimen of promissory note

Specimen of a Promissory Note

Rs10,00,000/- only

Rohan
77, Sector-12, Ghaziabad
March 01, 2017

Three months after date I promise to pay Priya or his order the sum of RsTen lakh only, for value received.

To,
Priya
S-11, Rohini, Delhi.

Stamp

(Rohan)

Payee

Maker

DIFFERENCES - BILL OF EXCHANGE AND PROMISSORY NOTE

Bill of Exchange	Promissory Note
A bill contains an unconditional order to pay	A promissory note contains only a promise to paycertain sum of money
There are generally 3 parties (Drawer, Draweeand Payee) in bill of exchange	There are 2 parties (Maker and Payee) in promissorynote
A bill is paid by Acceptor	A promissory note is paid by maker

A bill is drawn by creditor	A promissory note is made by debtor
The drawer and payee may be same person incase of bill of exchange	In promissory note maker and payee cannot be sameperson
In a bill of exchange the liability of drawer issecondary and conditional	In a promissory note the liability of a maker is primaryand absolute
A bill of exchange can be accepted conditionally	A promissory note cannot be made conditionally
In a bill of exchange, notice of dishonor must begiven	Notice of dishonor is not required in case of promissorynote
In case of dishonor, a bill of exchange must benoted and protested	Noting and protest is not required in case of dishonor ofa promissory note.

RECORD OF BILLS OF EXCHANGE AND PROMISSORY NOTES

A party which receives a Promissory Note or receives an accepted Bill of Exchange will treat it as a new asset under the name of Bills receivable. A party which issues a Promissory Note or accepts a Bill of Exchange will treat it as new liability under the heading of Bills Payable. We shall first deal with the entries in the books of the party which receives promissory notes or bills. (When we talk of bills, we include promissory notes also).

On receipt of Bill, the payee makes the following entry in his books of accounts:

Bills Receivable Account Dr.
To Drawee/Maker of the note

(1) A accepts a Bill of exchange drawn on him by B. In the books of B the entry will be:

Bills Receivable Account Dr.
To A

(2) A sends to B the acceptance of D. In this case also, the entry in the books of B will be:

Bills Receivable Account Dr.
To A

The person who receives the bill has three options. These are:

(i) He can hold the bill till maturity. (Naturally in this case no further entry is passed until the date ofmaturity arrives).

(ii) The bill can be endorsed in favour of another party say Z. In this case, the entry will be to debit the party which now receives the bill and to credit the Bills Receivable Account.

Z Dr.

To Bills Receivable Account

(iii) The Bill of Exchange can be discounted with bank. The bank will deduct a small sum of money as discount and pay rest of the money.

Bank Account Dr. (with the amount actually received)
Discount Account Dr. (with the amount of loss or discount)
To Bills Receivable Account

On the date of maturity there will be two possibilities:

(a) The first is that the bill will be paid, that is to say, met or honoured. The entries for this will depend upon what was done to the bill during the period of maturity. If the bill was kept, the cash will be received by the party which originally received the bill. In his books, therefore, the entry will be:

Cash Account Dr.
To Bills Receivable Account

But if he has already endorsed the bill in favour of his creditor or if the bill has been discounted with the bank he will not get the amount; it will be the creditor or the bank which will receive the money. Therefore, in these two cases, no entry will be made in the books of the party which originally received the bill.

(b) The second possibility is that the bill will be dishonoured, that is to say, the bill will not be paid. If the bill is dishonoured, the bill becomes useless and the party from whom the bill was received will be liable to pay the amount (and also the expenses incurred by the party).

Therefore, the following entries will be made:

1. If the bill was kept till maturity then:
   Drawee / Maker of the note Dr.
   To Bills Receivable Account
2. If the bill was endorsed in favour of a creditor, the entry is :
   Drawee / Maker of the note Dr.
   To Bill payables
3. If the bill was discounted with the bank :
   Drawee / Maker of the note Dr.
   To Bank A/c

Thus, it will be seen that in case of dishonour, the party which gave the bill has to be debited (because he has become liable to pay the amount). The credit entry is in Bills Receivable Account (if it was retained) or the Creditor or the bank (if it was endorsed/discounted in their favour).

RENEWAL OF BILL

Transaction	Drawer's Book	Drawee's Book
Cancelling the original bill	Drawee's A/c….. Dr. To Bills Receivable A/c	Bills Payable A/c… Dr. To Drawer A/c
Recording interest for the new period	Drawee's A/c… Dr. To Interest A/c	Interest A/c…. Dr. To Drawer's A/c
New Bill Drawn	Bills Receivable A/c… Dr To Drawee's A/c	Drawer's A/c… Dr. To Bills Payable A/c
Part payment received	Cash/Bank A/c… Dr. To Drawee's A/c	Drawer's A/c… Dr. To Bank A/c

TERM OF A BILL

The term of bill of exchange may be of any duration. Usually the term does not exceed 90 days from the date of the bill.

- When a bill is drawn **after sight**, the term of the bill begins to run from the date of 'sighting', i.e., when the bill is accepted.
- When a bill is drawn **after date**, the term of the bill begins to run from the date of drawing the bill.

EXPIRY / DUE DATE OF A BILL

The date on which the term of the bill terminates is called as 'Expiry/Due Date of the bill'.

DAYS OF GRACE

Every instrument payable otherwise than on demand is entitled to three days of grace.

DATE OF MATURITY OF BILL

The date which comes after adding three days to the expiry/due date of a bill, is called the date of maturity.

The maturity of a promissory note or bill of exchange is the date at which it falls due. Every promissory note or bill of exchange gets matured on the third day after the day on which it is expressed to be payable, except when it is expressed to be payable:

(i) on demand,
(ii) at sight, or
(iii) on presentment

BILL AT SIGHT

Bill at Sight means the instruments in which no time for payment is mentioned. A cheque is always payable on demand. A promissory note or bill of exchange is payable on demand-
(a) when no time for payment is specified, or
(b) When it is expressed to be payable on demand, or at sight or on presentment.

Notes:
(i) 'At sight' and 'presentment' means on demand.
(ii) An instrument payable on demand may be presented for payment at any time.
(iii) Days of grace is not to added to calculate maturity for such types of bill.

BILL AFTER DATE

Bill after date means the instrument in which time for payment is mentioned. A promissory note or bill of exchange is a time instrument when it is expressed to be payable-
(a) After a specified period.
(b) On a specific day
(c) After sight
(d) On the happening of event which is certain to happen

Notes:
(i) The expression 'after sight' means-
  (a) in a promissory note, after presentment for sight
  (b) in a bill of exchange, after acceptance or noting for non-acceptance or protest for non-acceptance.
(ii) A cheque cannot be a time instrument because the cheque is always payable on demand. Though a cheque can be post dated and which can be presented on or after such date. A cheque has validity of 90 days from its date after that it becomes void, normally termed as 'Stale Cheque' as bank will not honour such cheque.

HOW TO CALCULATE DUE DATE OF A BILL

(a) When the bill is made payable on a specificdate.	(a) That specific date will be the due date.
(b) When the bill is made payable at a statednumber of months(s) after date.	(b) That date on which the term of the bill shall expirewill be the due date. For example a bill signed on January 31st payable after 3 months will be due on April 30th.
c) When the bill is made payable at a statednumber of days after date.	c) That date which comes after adding stated numberof days to the date of bill, shall be the due date.

	Note: The date of Bill is excluded.
(d) When the due date is a public holiday.	d) The preceding business day will be the due date. Example:-If due date of the bill falls on 26th January (Republic Day), then its due date will be 25th January.
e) When the due date is an emergency/dueunforeseen holiday.	e) The next following day will be the date. Example:- if the due date of a bill is 25th July and it is declared as an emergency holiday, then the due date will be 26th July.

NOTING CHARGES

- When a Bill of Exchange (BOE) is dishonoured, then in order to prove this fact, the drawer (or the bill holder) may get it noted and protested through a public official known as **'Notary Public'**
- For which it charges its fees which is called **Noting Charges**.
- Such charges are recovered from the **party responsible** for the dishonour.

In the books of Drawer

When Drawer pays	Drawee's A/c … Dr. To Cash A/c
When Bank Pays	Drawee's A/c … Dr. To Bank A/c
When Endorsee's Pays	Drawee's A/c … Dr. To Endorsee's A/c

In the books of Drawee

For all above cases	Noting charges A/c … Dr. To Drawer's A/c.

INSOLVENCY

- Insolvency of a person means that he is **unable to pay his liabilities**.
- This means that bills **accepted** by himwill be **dishonored.**
- The remaining amount will be irrecoverable and, therefore, should be written off as bad debt.
- In the books of drawee of the bill, the amount not ultimately paid by him due to insolvency, should be credited to **Deficiency Account**.

In the Books of Drawer's

Bank A/c ……… Dr.
Bad Debts A/c …… Dr.
To Drawee's A/c.

In the books of Drawee's

Drawer's A/c …… Dr.
To Bank A/c
To Deficiency A/c

Class example:
A sold goods to S worth $20,000, taking a bill of exchange at 3 months, dated 1st July 2005. On the 4th august he discounted the bill at 15% p.a. with his bank. At maturity the bill was returned by the bank dishonored and A had to pay the bill. S paid $8,000 to A and accepted another bill at three months $12,000 and 14% interest. But, before maturity, he became insolvent and only 50% was received as first and final dividend form his estate.
Required: Give journal entries in the books of A and S.

Solution:

A's Journal

Date	Particulars	L.F	Amount (Dr.)	Amount (Cr.)
1.7.2005	S A/C..Dr. To Sales A/C (Goods sold on credit basis)		20,000	 20,000
1.7.2005	Bill receivable A/C..............................Dr. To S A/C (Acceptance received at three months)		20,000	 20,000
4.8.2005	Bank A/C..Dr. Discount A/C.....................................Dr. To Bill receivable A/C (Bill discounted at 15% two months before its maturity)		19,500 500	 20,000
4.10.2005	S A/C..Dr. To Bank A/C (Old bill cancelled and amount paid to bank due to acceptor's inability)		20,000	 20,000
4.10.2005	Cash A/C...Dr. To S A/C (Cash received from acceptor as a part payment)		8,000	 8,000

4.10.2005	S A/C...Dr. To Interest A/C (Interest due from acceptor on the outstanding balance for 3 months)		420	420
4.10.2005	Bill receivable A/C.............................Dr. To S A/C (A new bill received at 3 months)		12,420	12,420
	S A/C..Dr. To Bill receivable A/C (Bill dishonored due to acceptor's insolvency)		12,420	12,420
	Cash A/C.......................................Dr. Bad debts A/C.................................Dr. To S A/C (Cash received from estate of acceptor and the balance written off as bad debts)		6,210 6,210	12,420

S's Journal

Date	Particulars	L.F	Amount (Dr.)	Amount (Cr.)
1.72005	Purchases A/C....................................Dr. To A A/C (Goods purchased on credit)		20,000	20,000
1.7.2005	A A/C...Dr. To Bill payable A/C (Acceptance given at three months)		20,000	20,000
4.10.2005	Bill payable A/C.................................Dr. To A A/C (Bill cancelled for renewal purpose)		20,000	20,000
4.10.2005	A A/C...Dr. TO Cash A/C (Cash paid as part payment)		8,000	8,000
4.10.2005	Interest A/C.....................................Dr. To A A/C (Interest payable to the drawer)		420	420
4.10.2005	A A/C...Dr. To Bill payable A/C (New acceptance given at 3 months)		12,420	12,420

	Bill payable A/C...............................Dr. To A A/C (Bill dishonored due to insolvency)		12,420	12,420
	A A/C...Dr. To Cash A/C To Deficiency A/c (Dividend of 50 cents in a dollar paid and balance transferred to deficiency account)		12,420	6,210 6,210

RENEWAL OF BILL

Sometimes the acceptor is unable to pay the amount and he himself moves that he should be given extension of time and in consideration agrees to bear interest for the extended time period (calculated from the date of renewal till the date of expected settlement). In such a case a new bill will be drawn and the old bill will be cancelled. If this happens entries should be passed for cancellation of the old bill. This is done exactly as already explained for dishonour. When the new bill is received entries for the receipt of the bill will be repeated. The amount of the new bill may represent any of the following:

(i) Where the drawee pays nothing: Total of amount of original bill as well as the interest for the extended time period.

(ii) Where the drawee pays the interest amount at the time of renewal: Amount of the Original bill.

(iii) Where the drawee makes part payment of the original bill or interest amount or both: That part of total of amount of original bill as well as the interest for the extended time period on unpaid amount.

RETIREMENT OF BILLS OF EXCHANGE & REBATE

We have seen that renewal of a bill of exchange is made when a person does not have sufficient fund to pay for the bill of exchange on the due date and he requires a further period of credit. Many a time instances do arise when the acceptor has spare funds much before the maturity date of the bill of exchange accepted by him. In such circumstances he approaches the payee of the bill of exchange and asks him whether the payee is prepared to accept cash before the maturity date. In such cases the acceptor gets a certain **rebate** or interest or discount for premature payment. The rebate becomes the income of the acceptor and expense of the payee. It is a consideration of premature payment.

ACCOMMODATION BILLS

- A bill of exchange which is drawn to oblige a friend or to give him a temporary assistance or to provide him a loan or to accommodate one or more parties, is called an **"accommodation bill of exchange"**.
- Such a bill is drawn and accepted **without** any sale and purchase of goods.

Process of Accommodation Bill

1. The drawer is not able to remit the proceeds to drawee on the due date.
2. In such a case, the drawee may draw a bill on the drawer, and get it discounted with the bank to honour the first bill.
3. If the new drawer (drawee of the first bill) also remits some proceeds of the new bill to new drawee (drawer of the first bill), then the proportion of discount to be borne by the new drawee will be based upon the proceeds remitted as well as the benefit obtained by him on the first bill (i.e., by not paying the amount due to the original drawee on due date)

For example,

Let us suppose A is in need of money, he approaches his friend B and asks him to give him a loan for 5,000. B also shows his inability but agrees that he will accept a bill of exchange. A draws a bill on B which he accepts at three months. A discounts the bill with his bank and gets the money. After three months but before the due date, A sends 5,000 to B in order to meet his acceptance. B receives amount and pays his acceptance

PRACTICE QUESTION

QUESTION 1.(ICAI MODULE) (Renewal of Bill & Interest)

Vijay sold goods to Pritam on 1st September, 2016 for Rs 1,06,000. Pritam immediately accepted a three monthsbill. On due date Pritam requested that the bill be renewed for a fresh period of two months. Vijay agrees provideinterest at 9% was paid immediately in cash. To this Pritam was agreeable. The second bill was met on due date.

Give Journal entries in the books of Vijay and Pritam.

QUESTION 2. (ICAI MODULE) (BILL DISCOUNT WITH BANK)

On 1st January, 2016, Vilas draws a bill of exchange for Rs 10,000 due for payment after 3 months on Eknath.Eknath accepts to this bill of exchange. On 4th March, 2016 Eknath retires the bill of exchange at a discount of12% p.a. You are asked to show the journal entries in the books of Eknath.

QUESTION 3. (ICAI MODULE) (BILL DISCOUNT WITH BANK)

On 1st January, 2016, Vilas draws a Bill of Exchange for Rs10,000 due for payment after 3 months on Eknath.Eknath accepts to this bill of exchange. On 4th March, 2016. Eknath retires the bill of exchange at a discount of12% p.a. You are asked to show the journal entries in the books of Vilas.

QUESTION 4. (ICAI MODULE) (BILL REBATE)

On 1st January, 2016, Ankita sells goods for Rs 5,00,000 to Bhavika and draws a bill at three months for the amount.Bhavika accepts it and returns it to Ankita. On 1st March, 2016, Bhavika retires her acceptance under rebate of12% per annum. Record these transactions in the journals of Ankita and Bhavika.

QUESTION 5. (ICAI MODULE) (DISHONORED)

Journalise the following transactions in K. Katrak's books.

(i) Katrak's acceptance to Basu for Rs 2,500 discharged by a cash payment of Rs 1,000 and a new bill for the balance plus Rs 50 for interest.

(ii) G. Gupta's acceptance for Rs 4,000 which was endorsed by Katrak to M. Mehta was dishonoured. Mehta paid Rs 20 noting charges. Bill withdrawn against cheque.

(iii) D. Dalal retires a bill for Rs 2,000 drawn on him by Katrak for Rs 10 discount.

(iv) Katrak's acceptance to Patel for Rs 5,000 discharged by Patel. Mody's acceptance to Katrak for a similar amount.

QUESTION 6. (ICAI MODULE) (INSOLVANCY)

Mr. David draws two bills of exchange on 1.1.2016 for Rs 6,000 and Rs 10,000. The bills of exchange for Rs 6,000 is fortwo months while the bill of exchange for Rs 10,000 is for three months. These bills are accepted by Mr. Thomas.On 4.3.2016, Mr. Thomas requests Mr. David to renew the first bill with interest at 18% p.a. for a period of twomonths. Mr. David agrees to this proposal. On 20.3.2016, Mr. Thomas retires the acceptance for Rs 10,000, theinterest rebate i.e. discount being Rs 100. Before the due date of the renewed bill, Mr. Thomas becomes insolventand only 50 paise in a rupee could be recovered from his estate.

You are to give the journal entries in the books of Mr. David.

QUESTION 7. (ICAI MODULE) (INSOLVANCY)

Rita owed Rs 1,00,000 to Siriman. On 1st October, 2016, Rita accepted a bill drawn by Siriman for the amount at 3months. Siriman got the bill discounted with his bank for Rs 99,000 on 3rd October, 2016. Before the due date, Ritaapproached Siriman for renewal of the bill. Siriman agreed on the conditions that Rs 50,000 be paid immediatelytogether with interest on the remaining amount at 12% per annum for 3 months and for the balance, Rita shouldaccept a new bill at three months. These arrangements were carried out. But afterwards, Rita became insolventand 40% of the amount could be recovered from his estate.

Pass journal entries (with narration) in the books of Siriman.

QUESTION 8. (ICAI MODULE) (ACCOMMODATION)

On 1st July, 2016 Gorge drew a bill for Rs 1,80,000 for 3 months on Harry for mutual accommodation. Harry acceptedthe bill of exchange. Gorge had purchased goods worth Rs 1,81,000 from Jack on the same date. Gorge endorsedHarry's acceptance to Jack in full settlement. On 1st

September, 2016, Jack purchased goods worth Rs 1,90,000from Harry. Jack endorsed the bill of exchange received from Gorge to Harry and paid Rs9,000 in full settlement ofthe amount due to Harry. On 1st October, 2016, Harry purchased goods worth Rs 2,00,000 from Gorge. Harry paidthe amount due to Gorge by cheque. Give the necessary Journal Entries in the books of Harry and Gorge.

QUESTION 9. (ICAI MODULE) (ACCOMMODATION)

For the mutual accommodation of 'X' and 'Y' on 1st April, 2016, 'X' drew a four months' bill on 'Y' for Rs 4,000. 'Y'returned the bill after acceptance of the same date. 'X' discounts the bill from his bankers @ 6% per annum andremit 50% of the proceeds to 'Y'. On due date 'X' is unable to send the amount due and therefore 'Y' draws a bill for

Rs 7,000, which is duly accepted by 'X'. 'Y' discounts the bill for Rs 6,600 and sends Rs 1,300 to 'X'. Before the bill is duefor payment 'X' becomes insolvent. Later 25 paise in a rupee received from his estate.

Record Journal entries in the books of 'X'.

QUESTION 10. (ICAI MODULE) (INSOLVANCY)

Anil draws a bill for Rs 9,000 on Sanjay on 5th April, 2016 for 3 months, which Sanjay returns it to Anil afteraccepting the same. Anil gets it discounted with the bank for Rs8,820 on 8th April, 2016 and remits one-thirdamount to Sanjay. On the due date Anil fails to remit the amount due to Sanjay, but he accepts a bill for Rs 12,600for three months, which Sanjay discounts it for Rs12,330 and remits Rs2,220 to Anil. Before the maturity of therenewed bill Anil becomes insolvent and only 50% was realized from his estate on 15th October, 2016.

Pass necessary Journal entries for the above transactions in the books of Anil.

QUESTION 11. (ICAI MODULE)

Journalize the following in the books of Don:

(i) Bob informs Don that Ray's acceptance for Rs 3,000 has been dishonoured and noting charges are Rs 40. Bob accepts Rs 1,000 cash and the balance as bill at three months at interest of 10%.Don accepts from Ray his acceptance at two months plus interest @ 12% p.a.

(ii) James owes Don Rs 3,200; he sends Don's own acceptance in favour of Ralph for Rs 3,160; in full settlement.

(iii) Don meets his acceptance in favour of Singh for Rs 4,500 by endorsing John's acceptance for Rs 4,450 in full settlement.

(iv) Ray's acceptance in favour of Don retired one month before due date, interest is taken at the rate of 6% p.a.

QUESTION 12.

Calculate the due dates of the bills in the following cases:

	Date of the Bills	*Period*
I.	1st February, 2017	2 months

II.	31st January, 2017	3 months
III.	30th September, 2017	2 months
IV.	30th September, 2017	3 months
V.	29th December, 2017	2 months
VI.	31st December, 2017	2 months
VII.	15th July, 2017	30 days
VIII	27th January, 2016	1 month

TOPIC 10

SALE OF GOODS ON APPROVAL OR RETURN BASIS

INTRODUCTION

- Goods sent on 'approval' or 'on return' basis means goods are delivered to the customers with the option to retain or return them within a specified period.
- Generally, these transactions take place between a manufacturer (or a wholesaler) and a retailer.
- As per the definition given under the Sale of Goods Act, 1930, in respect of such goods, the sale will take place or the property in the goods pass to the buyer:

1. When he signifies his approval or acceptance to the seller;
2. When he does some act adopting the transaction;
3. If he does not signify his approval or acceptance to the seller but retains the goods without giving notice of rejection, on the expiry of the specified time (if a time has been fixed) or on the expiry of a reasonable time (if no time has been fixed).

FEATURE OF SALE OF GOODS ON APPROVAL OR RETURN BASIS

- Change in possession of goods without change in ownership.
- Ownership in transferred after approval is received from buyer for acceptance.
- No liability incurred to liability to customer in case of return since right of refund given by the seller.

ACCOUNTING RECORDS

Casually	Frequently	Numerously

WHEN THE BUSINESS SENDS GOODS CASUALLY ON SALE OR RETURN BASIS

- When the transactions are few, the seller on sending the goods treats them as an ordinary sale.

- If the goods are accepted or not returned or the business receives no intimation within the specified time limit, no extra entry is required to be passed because the entry for sale (passed at the time of sending goods) becomes the usual entry after the expiry of the specified period.
- If the goods are returned within a specified time limit, a reverse entry is passed to cancel the previous transaction.

When goods are sent on sale or return basis	Trade receivable /customer A/c ---- Dr. To Sales A/c [Invoice Price]
When goods are rejected or returned within the specified time	Sale/Return Inward A/c ----- Dr. To Trade receivable /customer A/c [Invoice Price]
When goods are accepted at invoice price	No Entry.
When goods are accepted at a higher price than invoice price	Trade receivable /customer A/c ---- Dr. To Sales A/c [Difference in price]
When goods are accepted at a lower price than the invoice price	Sales A/c -------- Dr. To Trade receivable /customer A/c [Difference in price]
At the year-end, when goods are lying with customers and the specified time limit is yet to expire	Sales A/c -------- Dr. To Trade receivable /customer A/c [Invoice price]
Goods should be considered as Inventories with customers	Inventories with Customers on Sale or Return Account ------------ Dr. To Trading A/c [Cost price or market price whichever is less]

No entry is to be passed for goods returned by the customers on a subsequent date.

Class Example 1.

CE sends goods to his customers on Sale or Return basis. The following transactions took place during 2016:

Sept. 15 Sent goods to customers on sale or return basis at cost plus33 1/3% Rs 1,00,000

Oct. 20 Goods returned by customers Rs 40,000

Nov. 25 Received letters of approval from customers Rs 40,000

Dec. 31 Goods with customers awaiting approval Rs 20,000

CE records sale or return transactions as ordinary sales. You are required to pass the necessary Journal Entries in the books of CE assuming that accounting year closes on 31st December, 2016.

SOLUTION

In the books of CE

Journal Entries

Date	Particulars	L.F.	Dr. (Rs)	Cr. (Rs)
Sept. 15	Trade receivables A/c Dr		100000	
	To Sales A/c			100000
	(Being the goods sent to customers on sale or return basis)			
Oct. 20	Return Inward A/c (Note 1) Dr.		40000	
	To Trade receivables A/c			40000
	(Being the goods returned by customers to whom goods were sent on sale or return basis)			
Dec. 31	Sales A/c Dr.		20000	
	To Trade receivables A/c			20000
	(Being the cancellation of original entry of sale in respect of goods on sale or return basis)			
Dec. 31	Inventories with customers on Sale or Return A/c Dr.		15000	
	To Trading A/c (Note 3)			15000
	(Being the adjustment for cost of goods lying with customers awaiting approval)			

ILLUSTRATION 2(ICAI SM)

S. Ltd. sends out its goods to dealers on Sale or Return basis. All such transactions are, however, treated as actual sales and are passed through the Day Book. Just before the end of the accounting year on 31.03.2016, 200 such goods have been sent to a dealer at Rs 250 each (cost Rs 200 each) on sale or return basis and debited to his account. Of these goods, on 31.03.2016, 50 were returned and 70 were sold while for the other goods, date of return has not yet expired.

Pass necessary adjustment entries on 31.03.2016.

ILLUSTRATION 3(ICAI SM)

Caly Company sends out its gas containers to dealers on Sale or Return basis. All such transactions are, however, treated as actual sales and are passed through the Day Book. Just before the end of the financial year, 100 gas containers, which cost them Rs 900 each have been sent to the dealer on 'sale or return basis' and have been debited to his account at Rs 1,200 each. Out of this only 20 gas containers are sold at Rs1,500 each.
You are required to pass necessary adjustment entries for the purpose of Profit and Loss Account and Balance Sheet.

ILLUSTRATION 4 (ICAI SM)
E Ltd. sends out its accounting machines costing Rs200 each to their customers on Sales or Return basis. All such transactions are, however, treated like actual sales and are passed through the Day Book. Just before the end of the financial year, i.e., on March 24, 2016, 300 such accounting machines were sent out at an invoice price of Rs 280 each, out of which only 90 accounting machines are accepted by the customers Rs250 each and as to the rest no report is forthcoming. Show the Journal Entries in the books of the company for the purpose of preparing Final Accounts for the year ended March 31, 2016.

ILLUSTRATION 5 (ICAI SM)
A sends out goods on approval to few customers and includes the same in the Sales Account. On 31.3.2016, the Trade receivables balance stood at Rs 1,00,000 which included Rs 7,000 goods sent on approval against which no intimation was received during the year. These goods were sent out at 25% over and above cost price and were sent to-

Mr. X – Rs 4,000 and Mr. Y - Rs3,000.

Mr. X sent intimation of acceptance on 30th April and Mr. Y returned the goods on 10th April, 2016.

Make the adjustment entries and show how these items will appear in the Balance Sheet on 31st March, 2016. Show also the entries to be made during April, 2016. Value of closing Inventories as on 31st March, 2016 was Rs60,000.

WHEN THE BUSINESS SENDS GOODS FREQUENTLY ON SALE OR RETURN BASIS

- When a business sends goods on sale or return on a frequent basis, an immediate sale does not take place.
- A separate book is maintained to record the goods sent, received back, sold etc. Called as "SALE OR RETURN DAY BOOK".

- The property does not pass to the buyer, the seller does not record it as a sale.

Underthismethod,recordofgoodssentismaintainedinaspeciallyruledSaleorReturnJournal/DayBoo k insteadofpassingentryforsaleofgoods.

Goods sent on approval				Goods returned				Goods approved				Balance
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**
Date	Particulars	Fol.	Amt.	Date	Particulars	Fol.	Amt.	Date	Particulars	Fol.	Amt.	Amt.

- **When goods are sent out for sale on approval,**
  - Entriesaremadeonlyincolumn1to4,
  - Thesalepriceof goodsbeingenteredincolumn4.
  - Thesalepriceisalsopostedtothedebitofthecustomers'account in'GoodsonApprovalLedger',andperiodicallytotalofcolumn4ispostedtothecreditofGoods on ApprovalTotalAccountinthesameledger.
- **If goods are returned,**
  - Entriesaremadeincolumns5to8,thepriceofgoodsreturnedbeingenteredto column8.
  - TheindividualamountsarecreditedtotheCustomers'Accounts,inthe'GoodsonApproval' LedgerandthetotalofthiscolumninperiodicallypostedtotheTotalGoodsonApprovalAccount.
- **If the goods are retained by the customer,**
  - Entries are made in columns 9 to 12.
  - The individual amounts are then posted to the debit of customer's accounts in the Sales Ledger and their total is credited to Sales Account in the General Ledger.
  - Further the customer's accounts in the Goods on Approval Ledger are credited with the individual amounts of goods sold and periodically, the total of the amount is posted to the debit of Goods on Approval TotalAccount.
- **The value of goods sent out but not sold or returned till the close of the year is extended to column 13. The total of this column, afterwards, will show the value of goods with customers at the saleprice.**

The balance amount is calculated as follows:
Balance Value of Goods Sent on Sale or Return Less Value of Goods Returned Less Value of Goods Approved. Information relating to goods delivered and goods returned is kept on Memorandum basis.

However, information relating to goods approved and balance is duly accounted for by passing journal entries relating to sales and Inventories on approval basis.

The amount, after eliminating the element of profit, is included in the Trading Account representing the value of Inventories with customers at cost price. Like an ordinary closing Inventories, such goods are considered as Inventories lying with customers on behalf of seller and are valued at cost or net realisable value whichever less is.

(i) **At the time ofapproval**	Customer's A/c------ Dr. To Sales A/c
(ii) **AtthetimeofpreparingofFinalAccounts** (An adjustment entry is required for balance goods which is as follow)	Goods with customers on Sale or Return A/c--------Dr. To Trading A/c [Cost or NRV whichever is Less]

WHEN THE BUSINESS SENDS GOODS NUMEROUSLY ON SALE OR RETURN

- A separate subsidiary book is maintained i.e. "Sale or Return Sales Book"and "Sale or Return Sales Return Book". These are memorandum books.
- The entries for the approved goods are shown below:

In the Memorandum Sale orReturnLedger	Sale orReturnAccount Dr. To Individual Customer's Account
In the regular Generalledger	IndividualCustomer'sAccount Dr. To Sales A/c

- At the year end, in the Sale or return Ledger, the sum of the debit balances of the Individual Customers' Account must be equal to the credit balance of the Sale or return Account. It represents Inventories with customers waiting for approval at invoice price.
- To adjust the cost of such goods with customers in the Final Accounts, the following entry ispassed:

Inventories with Customers on Sale or Return Account----- Dr.
To Trading A/c
[Cost or Net Realizable Value whichever is less]

Practice Question

Q1 A firm sends goods on sale or return basis. Customers having the choice of returning the goods within a month. During May 2016, the following are the details of goods sent:

Date (May)	2	8	12	18	20	27
Customers	P	B	Q	D	E	R
Value (Rs)	15,000	20,000	28,000	3,000	1,000	26,000

Within the stipulated time, P and Q returned the goods and B, D, and E signified that they have accepted the goods.

Show in the books of the firm, the Sale or Return Account and Customer- P for Sale or Return Account on 15th June, 2016.

Q2 On 31st December, 2016 goods sold at a sale price of Rs3,000 were lying with customer, Ritu to whom these goods were sold on 'sale or return basis' were recorded as actual sales. Since no consent has been received from Ritu, you are required to pass adjustment entries presuming goods were sent on approval at a profit of cost plus 20%. Present market price is 10% less than the cost price.

Q3 X supplied goods on sale or return basis to customers, the particulars of which are as under.

Date of dispatch	**Party's name**	**Amount Rs**	**Remarks**
10.12.2016	M/s. ABC	10,000	No information till 31.12.2016
12.12.2016	M/s. DEF	15,000	Returned on 16.12.2016
15.12.2016	M/s. GHI	12,000	Goods worth Rs2,000 returned on 20.12.2016
20.12.2016	M/s. DEF	16,000	Goods Retained on 24.12.2016
25.12.2016	M/s. ABC	11,000	Good Retained on 28.12.2016
30.12.2016	M/s. GHI	13,000	No information till 31.12.2016

Goods are to be returned within 15 days from the dispatch, failing which it will be treated as sales. The books of 'X' are closed on the 31st December, 2016.

Prepare the following accounts in the books of 'X'.

(a) Goods on "sales or return, sold and ret

Goods on sales or return total account

TOPIC-11

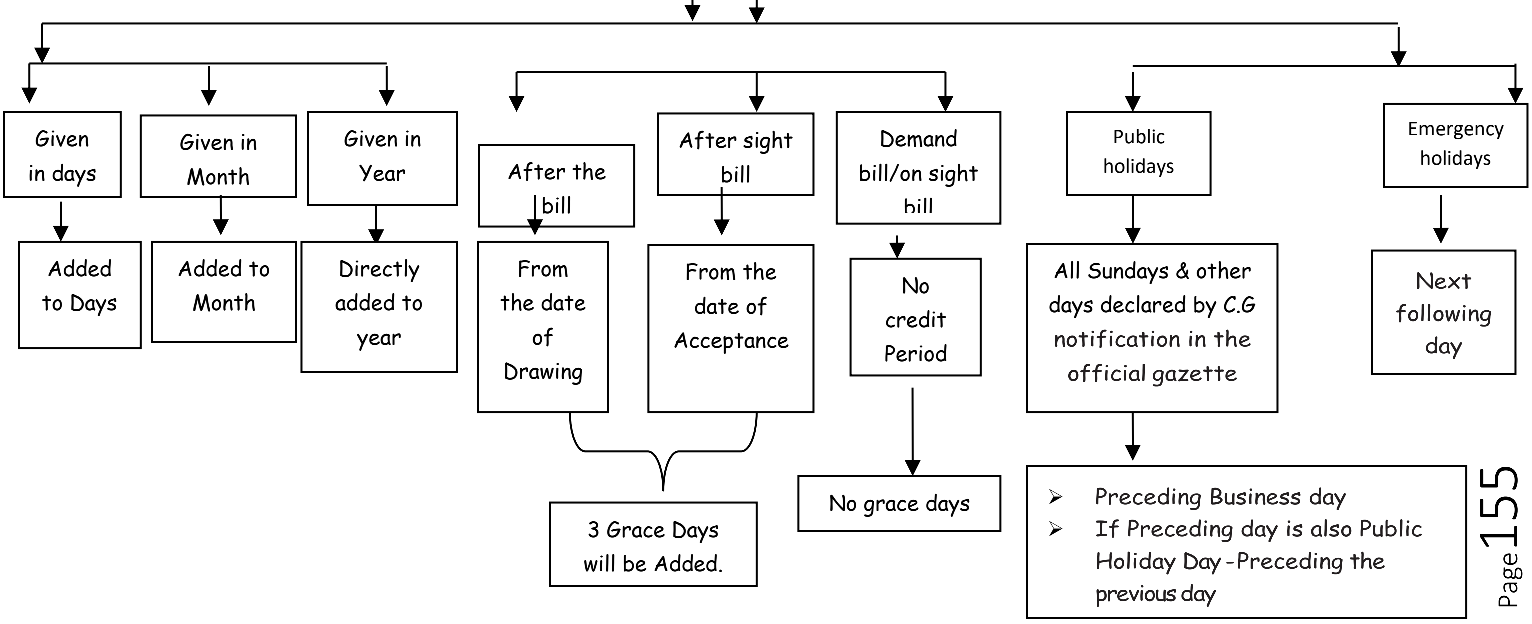
AVERAGE DUE DATE

INTRODUCTION

- Average due date is a single equivalent date on which a person can pay all amounts due from him without any loss or gains of interest.
- It is weighted average of due dates with equal and unequal amount.
- Circumstances where average due dates is used:
  - For calculating interest on drawings of partners;
  - For settling accounts between principle and agent;
  - For settling contra accounts e.g. where parties sell goods to each other;
  - For making lump sum payment against various bills drawn on different dates with different due dates;
- Where payment is not made on the average due date, the party receiving the amount charges interest for as many days as the payment is delayed from the average due date.

CONCEPT OF DUE DATE (DATE OF MATURITY)

How to find Due Date



TYPES OF PROBLEMS

Case 1: Learn calculation of average due date where one Party is involved

Under this type of problem, average due date is calculated as follows :

a. Take the earliest due date as starting day or base date or "O" day for convenience. Any date whatsoever, may also be taken as "O" day.

b. Consider the number of days from base date up to each due date. Calculations may also be made in month.

c. Multiply the number of days by the corresponding amounts.

d. Add up the amount and products.

e. Divide the "Product total" by "Amount total" and get result approximately upto a whole number.

f. This number is added in the base date to find the average due date. Thus the formula for the average due date can be under.

Average due date = Base date + Total of Product / Total Amount

Note: For calculation of no. of days, no. of days in each respective month involved are to be considered individually.

Due Dates	Amount	No. of Days from Base Day	Products

Case 2: Learn calculation of average due date Where inter transactions between 2 Parties are involved (Contra Account)

When more than one party is involved where one party purchase and also sells to other party. That means one party receivable and other party payable.

1. For Receivable:
   (i) Select the one date as base date.
   (ii) Calculate the number of the from the base date.
   (iii) Multiply the amount by the number of days. (product)
2. For Payable:
   (i) Take same date as base date.

(ii) Calculate the number of the from the base date.

(iii) Multiply the amount by the number of days. (product)

Average due date = Base date +\- Difference in Product /Difference in amount

Case 3: Learn calculation of average due date where amount is repaid in Installments

Calculation of average due date in a case where the amount is lent in one installment and repayment is done in various installments (opposite to what we have done in the first case). The problem takes a different shape. The procedure for calculating average due date can be summarized as under:

Step 1: Calculate number of days/monthly/years from the date of lending money to the date of each repayment.

Step 2: Find the total of such days/months/years.

Step 3: Quotient will be the number of days/months/years by which average due date falls away from date of commencement of loan.

As explained earlier, if installment are same, we can use Simple mean concept . Divide days by number of items and no need for product.

Thus, the formula for the average due date can be written as under:

Average due date=
Date of Loan + Sum of days or month or years from the date of lending to the date of Repayment of installment / Number of installments

Case 4: Calculation of average due date for calculating interest on drawings.

In the case of drawings, the owners draw the amounts from the business on various dates. They can settle it on one date. When different amounts are due on different dates and ultimately settled on one day the interest is calculated by means of Average Due Date.

PRACTICAL QUESTION

Question 1. (ICAI MODULE)

The followings are the amounts due on diVerent dates in between the same parties:

Amount`	Due Date
500	3rd July
800	2nd August
1,000	11th September

Suggest a date on which all the bills may be paid out without any loss of interest to either party.

Question 2. (ICAI MODULE)

The following amounts are due to X by Y. Y wants to pay oV (a) on 18th March or (b) on 14th July. Interest rate of 8% p.a. is taken into consideration.

Due Dates	`
10th January	500
26th January (Republic Day)	1,000
23rd March	3,000
18th August (Sunday)	4,000

Determine the amount to be paid in (a) and in (b).

Question 3. (ICAI MODULE)

Calculate Average Due date from the following information:

Date of the bill	Term	Amount
August 10, 2015	3 months	6,000
October 23, 2015	60 days	5,000
December 4, 2015	2 months	4,000
January 14, 2016	60 days	2,000
March 14, 2016	2 months	3,000

(Assume February of 28 days)

Question 4. (ICAI MODULE)

A trader having accepted the following several bills falling due on diVerent dates, now desires to have these bills cancelled and to accept a new bill for the whole amount payable on the average due date :

Sl. No.	Date of bill	Amount	Usance of the bill
1	1st March 2016	400	2 months
2	10th March 2016	300	3 months
3	5th April 2016	200	2 months
4	20th April 2016	375	1 month
5	11th May 2016	500	2 months

You are required to find the said average due date.

Question 5. (ICAI MODULE)

Two traders X and Y buy goods from one another, each allowing the other one month's credit. At the end of 3 months the accounts rendered are as follows:

	Goods sold by X to y		Goods sold by Y to X
April 18	60.00	April 23	52.00
May 15	70.00	May 24	50.00
June 17	80.00		

Calculate the date upon which the balance should be paid so that no interest is due either to X or Y.

Question 6. (ICAI MODULE)

Manoj had the following bills receivables and bills payable against Sohan. Calculate the average due date, when the payment can be received or made without any loss of interest.

Date	Bills Receivable`	Tenure	Date	Bills Payable `	Tenure
01/06/2016	3,000	3 month	29/05/2016	2,000	2 month
05/06/2016	2,500	3 month	03/06/2016	3,000	3 month
09/06/2016	6,000	1 month	9/06/2016	6,000	1 month
12/06/2016	1,000	2 month			
20/06/2016	1,500	3 month			

15 August, 2016 was a Public holiday. However, 6 September, 2016 was also declared as sudden holiday.

Question 7. (ICAI MODULE)

Mr. Green and Mr. Red had the following mutual dealings and desire to settle their account on the average due date:

Purchases by Green from Red:	
6^{th} January, 2016	6,000
2^{nd} February, 2016	2,800
31^{st} March, 2016	2,000
Sales by Green to Red:	
6^{th} January, 2016	6,600
9^{th} March, 2016	2,400
20^{th} March, 2016	500

You are asked to ascertain the average due date. (28 days in feb.)

Question 8. (ICAI MODULE)

10,000 lent by Dass Bros. to Kumar & Sons on 1st January, 2011 is repayable in 5 equal annual instalments commencing on 1st January, 2012. Find the average due date and calculate interest at 5% per annum, which Dass Bros. will recover from Kumar & Sons.

Question 9. (ICAI MODULE)

A and B, two partners of a firm, have drawn the following amounts from the firm in the year ending 31^{st} March, 2015:

Date	A	Date	B
1^{st} July	500	12^{th} June	1,000
30^{th} September	800	11^{th} August	500
1^{st} November	1,000	9^{th} February	400
28^{th} February	400	7^{th} March	900

Interest at 6% p.a. is charged on all drawings. Calculate interest chargeable by using

(i) ordinary system

(ii) (ii) Average due date system. (assume 1 year = 365 days)

Question 10. (ICAI MODULE)

Mr. Yash and Mr. Harsh are partners in a firm. They had drawn the following amounts from the firm during the year ended 31.03.2016:

Date	Amount	Drawn by
01.05.2015	75,000	Mr. Yash
02.07.2015	20,000	Mr. Yash
15.08.2015	60,000	Mr. Harsh
31.12.2015	50,000	Mr. Harsh
04.03.2016	75,000	Mr. Harsh
31.03.2016	15,000	Mr. Yash

Interest is charged @ 10% p.a. on all drawings. Calculate interest chargeable from each partner by using Average due date system. (Consider 1st May as base date)

Question 12. (ICAI MODULE)

Anand purchased goods from Amirtha, the average due date for payment in cash is 10.08.2016 and the total amount due is ` 67,500. How much amount should be paid by Anand to Amirtha, if total payment is made on following dates and interest is to be considered at the rate of 12% p.a.

(i) On average due date.

(ii) On 25th August, 2016.

(iii) On 30th July, 2016.

TOPIC-12
ACCOUNT CURRENT

An Account Current is a running statement of transactions between parties for a given period of time and includes interest allowed or charged on various items. It takes the form of a ledger account.

Some of the situations when account current is prepared are:

1. When frequent transactions regularly take place between two parties, they prepare Account current.
2. In the case of consignment, consignee prepares it.
3. When frequent transactions occur between Bank and customers.
4. In case of a joint venture and each co-venture is entitled to interest.

- ***An Account Current has two parties - one who renders the account and the other to whom the account is rendered.***
- ***This is indicated in the heading of an Account Current, which is like the following: "A in Account Current with B". It implies that A is the customer, and the account is being rendered to him by B.***

PREPARATION OF ACCOUNT CURRENT

There are three ways of preparing an Account Current:

1. With help of interest table
2. By means of products
3. By means of products of balances

Method 1: Preparation of Account Current with the help of Interest Tables-Individual Method

Under this method two additional columns are made to either sides of accounts for recording

- Number of days form due date to date rendering accounts
- Interest to be charged.

Date 2015	Particulars	Due date	Amount Rs	Day	Interest	Date 2015	Particulars	Due date	Amount Rs	Day	Interest

Method 2: Preparation of Account Current by means of Products; Product Method

- Under this method interest column is substituted with product column which show product of amount with number of day for which it was outstanding.
- Product in this case is the amount multiplied by the number of days for which it has been outstanding.
- The balance of the product is then multiplied with given interest rate and resulting figure is entered.
- Enter interest on the appropriate side in the amount column. This entry is made on the side other than that on which the balance of products appears.

Method of Computing the numbers of Days

Usually any of the following two methods is used for calculating the number of days.

1. **Forward Method**- Under this method the number of days are calculated from the due date of the transaction to the date of closing the account.
2. **Backward (or Epoque Method)**- Under this method, the number of the days are calculated from the opening date of statement to the due date of transaction.

Red - Ink Interest:

Sometimes due date of a particular transaction may fall after the closing of accounts current. In such case interest form date of closing the account till due date was noted with Red Ink in old times and is now called as Red Ink Interest. It is also called as *negative interest.*

Date 2016	Particulars	Due Date	Amount Rs	Days	Product	Date 2016	Particulars	Due Date	Amount Rs	Days	Product

Method3: Preparation of Account Current by Means of Product of Balances in case of Banks.

- This method, also known as periodic balance method, is usually adopted in the case of banks where the balance of account is taken out after every transaction.
- In this case, the number of days written against each transaction are the days counted from its date or due date to the date of the following transaction. In the case of the last transaction, the number of days is counted to the close of the period.
- Each amount is multiplied with the number of days. If the amount represents a debit balance, the product is entered in the Dr. Product column; and if it represents a credit balance, the product is written in the Cr. Product column.
- Interest is calculated on each total at the given rate of interest; and the net interest is ascertained. If net interest is payable to the customer, it will appear as "By Interest A/c", and if it is due from the customer, it will appear as "To Interest A/c".

Date	Particular	Dr.	Cr.	Dr.	Balance	Days	Dr.	Cr.

				or Cr.			Product	Product

PRACTICAL QUESTION

Question 1. (ICAI MODULE)
Prepare Account Current for Nath Brothers in respect of the following transactions with Shyam:

2015		**Rs**	
September 16	Goods sold to Shyam	200	due 1st Oct.
October 1	Cash received from Shyam	90	
October 21	Good purchased from Shyam	500	due 1st Dec.
November 1	Paid to Shyam	330	
December 1	Paid to Shyam	330	
December 5	Goods purchased from Shyam	500	due 1st Jan.
December 10	Goods purchased from Shyam	200	due 1st Jan.
2016			
January 1	Paid to Shyam	600	
January 9	Goods sold to Shyam	20	due 1st Feb.

The account is to be prepared upto 1st February. Calculate interest @ 6% per annum. (1 year = 365 days)**(Individual Method)**

Question 2. (ICAI MODULE)
Prepare Account Current for Nath Brothers in respect of the following transactions with Shyam:

2015		**Rs**	
September 16	Goods sold to Shyam	200	due 1st Oct.
October 1	Cash received from Shyam	90	
October 21	Good purchased from Shyam	500	due 1st Dec.
November 1	Paid to Shyam	330	

December 1	Paid to Shyam	330	
December 5	Goods purchased from Shyam	500	due 1st Jan.
December 10	Goods purchased from Shyam	200	due 1st Jan.
2016			
January 1	Paid to Shyam	600	
January 9	Goods sold to Shyam	20	due 1st Feb.

The account is to be prepared upto 1st February. Calculate interest @ 6% per annum. (1 year = 365 days)(**Product Method)**

Question 3. (ICAI MODULE)

From the following particulars, make up an Account Current to be rendered by Mr. X to Mr. Y on 31st December,2016 taking interest into account at the rate of 18% p.a.

01.07. 2016	Balance owing by Mr. Y	Rs600
30.07. 2016	Goods sold to Mr. Y (Credit Period allowed 1 month)	Rs300
01.08. 2016	Good purchased from Mr. Y (Credit Period received 1 month)	Rs200
01.09. 2016	Cash received from Mr. Y	Rs100
01.09. 2016	Mr. Y accepted Mr. X's Draft at 3 Months date	Rs400

You are required to prepare the Account Current according to interest on individual transaction under **the Forward and Backward methods.**

Question 4. (ICAI MODULE)

From the following particulars prepare the account current to be rendered by Mr. Singh to Mr. Paul as on 31stAugust, 2016. Interest must be calculated @ 10% p.a. (1 year = 365 days) **(Product Method)**

2014		**Rs**
June 11	Goods sent to Mr. Paul	1,020
June 15	Cash received from Mr. Paul	500
June 20	Goods sent to Mr. Paul	650
July 7	Goods sent to Mr. Paul	700

Aug 8	Cash received from Mr. Paul	1,100

Question 5. (ICAI MODULE)

From the following particulars make up an Account Current to be rendered by S. Das gupta to A. Halder at 31st Dec. reckoning interest at 5% p.a. (assume 1 year = 365 days) **(Product Method)**

2016		Rs
June 30	Balance owing by A. Halder	520
July 17	Goods sold to A. Halder	40
Aug. 1	Cash received from A. Halder	500
Aug. 19	Goods sold to A. Halder	720
Aug. 30	Goods sold to A. Halder	50
Sept. 1	Cash received from A. Halder	400
Sept. 1	A. Halder accepted Dasgupta's Bill at 3 month date for	300
Oct. 22	Goods bought from A. Halder	20
Nov. 12	Goods sold to A. Halder	14
Dec. 14	Cash received from A. Halder	50

Question 6. (ICAI MODULE)

From the following prepare an account current, assent by A to B on 30thJune,2016 by means of products method charging interest@6% p.a: **(Product Method)**

2016		Rs
Jan. 1	Balance due from B	600
Jan.11	Sold goods to B	520
Jan. 18	B returns Goods	125
Feb 11	B Paid by cheque	400
Feb 14	B accepted a bill drawn by A for one month	300
Apr. 29	Goods sold to B	615
May 15	Received cash from B	700

Question 7.(ICAI MODULE)

Following transaction took place between X and Y during the month of April, 2016.

April		Rs
1	Amount payable by X to Y	10,000
7	Received acceptance of X to Y for 2 months	5,000
10	Bills receivable (accepted by Y) on 7.2.2016is honoured on this due date	
10	X sold goods to Y (invoice dated 10.5.2016)	15,000
12	X received cheque form Y dated 15.5.2016	7,500
15	Y sold goods to X (invoice dated 15.5.2016)	6,000
20	X returned goods sold by Y on 15.4.2016	1,000
20	Bill accepted by Y is dishonoured on this due date	5,000

You are required to make out an account current by products method to be rendered by X to Y as on 30.4.2016, taking interest into account @ 10% p.a. (assume 1 year = 365 days)(**Red - Ink Interest)**

Question 8.(ICAI MODULE)

On 2nd January, 2016 Vinod opened a current account with the Allahabad Bank Limited; and deposited a sum of Rs 30,000.

He further deposited the following amounts:	**Rs**
15th January	12,000
12th March	8,000
10th May	16,000

His withdrawals were as follows :	
15th February	26,000
10th April	30,000
15th June	14,000

Show Vinod's a/c in the ledger of the Allahabad Bank. Interest is to be calculated at 5% on the debit balance and 2% on credit balance. The account to be prepared as on 30th June,2016. Calculation may be made correct to the nearest rupee.(assume1year=365days)(

Question 9

From the following particulars prepare a account current, as sent by Mr. Ram to Mr. Siva as on 31st October 2016 by means of product method charging interest @ 5%p.a.

2016	**Particulars**	**Rs**
1st July	Balance due from Siva	750
15th August	Sold goods to Siva	1250
20th August	Goods returned by Siva	200
22nd Sep	Siva paid by cheque	800
15th Oct	Received cash from Siva	500

Topic 13-
CONSIGNMENT

MEANING OF CONSIGNMENT ACCOUNT

To consign means to send. In Accounting, the term "consignment account" relates to accounts dealing with a situation where one person (or firm) sends goods to another person (or firm) on the basis that the goods will be sold on behalf of and at the risk of the former. The following should be noted carefully:

(ii) The party which sends the goods (consignor) is called principal.

(iii) The party to whom goods are sent (consignee) is called agent.

(iv) The ownership of the goods, i.e., the property in the goods, remains with the consignor or the principal
- the agent or the consignee does not become their owner even though goods are in his possession. On sale, of course, the buyer will become the owner.

(v) The consignor does not send an invoice to the consignee. He sends only a **proforma invoice**, a statement that looks like an invoice but is really not one. The object of the proforma invoice is only to convey information to the consignee regarding particulars of the goods sent.

(vi) Usually, the consignee recovers from the consignor all expenses incurred by him on the consignment. This however can be changed by agreement between the two parties.

(vii) It is also usual for the consignee to give an advance to the consignor in the form of cash or a bill of exchange. It is adjusted against the sale proceeds of the goods.

(viii) For his work, the consignee receives a commission calculated on the basis of gross sale. For ordinary commission the consignee is not responsible for any bad debt that may arise. If the agent is to be made responsible for bad debts, he is to be paid a commission called del-credere commission. It is calculated on total sales, not merely on credit sales until and unless agreed.

(ix) Periodically, the consignees ends to the consignor a statement called Account Sales. It sets out the sales made by the consignee, the expenses incurred on behalf of the consignor, the commission earned by the consignee and the balance due to the consignor.

(x) Firms usually like to ascertain the profit or loss on each consignment or consignments to each consignee.

Consignment Account relates to accounts dealing with such business where one person sends goods to another person on the basis that such goods will be sold on behalf of and at the risk of the former.

CONSIGNMENT AND SALE

S.No.	Consignment	Sale
1.	Ownership of the goods rests with the consignor till the time they are sold by the consignee, no matter the goods are transferred to the consignee.	The ownership of the goods transfers with the transfer of goods from the seller to the buyer.
2.	The consignee can return the unsold goods to the consignor.	Goods sold are the property of the buyer and can be returned only if the seller agrees.
3.	Consignor bears the loss of goods held with the consignee.	It is the buyer who will bear the loss if any, after the transfer of goods.
4.	The relationship between the consignor and the consignee is that of a principal and agent.	The relationship between the seller and the buyer is that of a creditor and a debtor.
5.	Expenses done by the consignee to receive the goods and to keep it safely are borne by the consignor unless there is any other agreement.	Expenses incurred by the buyer are to be borne by the buyer itself after the transfer of goods.

DISTINCTION BETWEEN COMMISSION AND DISCOUNT

	Commission	Discount
	Commission may be defined as remuneration of an employee or agent relating to services performed in connection with sales, purchases, collections or other types of business transactions and is usually based on a percentage of the amounts involved. Commission earned is accounted for as an income in the books of accounts, and commission allowed or paid is accounted for as an expense in the books of the party availing such facility or service.	The term discount refers to any reduction or rebate allowed and is used to express one of the following situations: An allowance given for the settlement of a debt before it is due i.e. cash discount. An allowance given to the whole sellers or bulk buyers on the list price or retail price, known as trade discount. A trade discount is not shown in the books of account separately and it is shown by way of deduction from cost of purchases.

ACCOUNTING FOR CONSIGNMENT TRANSACTIONS AND EVENTS IN THE BOOKS OF THE CONSIGNOR

For ascertaining profit or loss on any transaction (or series of transactions) there is one golden rule; open an account for the transaction (or series of transactions) and (i) put down the cost of goods and other expenses incurred or to be incurred on the debit side; and (ii) enter the sale proceeds as also the cost of goods remaining unsold on the right hand side or the credit side. The difference between the total of the two sides will reveal profit or loss. There is profit if the credit side is more.

The consignor often dispatches goods to various consignees and he would be interested to ascertain the profit or loss from each consignment separately. Therefore, a separate consignment account has to be prepared for each consignment. Each consignment account is a nominal-cum-personal account and constitutes a profit an loss account in respect of the transactions to which it relates.

The consignor records the following transactions in his book of accounts:

1. When goods are consigned or dispatched: it is to be reiterated that when goods are sent to the consignee, the transaction does not result in a sale and only the possession of the goods changes. Therefore, the personal account of consignee is not debited and also sales account is not credited. The following entry is recorded by the consignor:
   Consignment (say to Star trading) Account Dr.
   To Goods Sent on Consignment Account
2. Expenses incurred by consignor: when consignor incurs some expenses relating to the consignment following entry is recorded:
   Consignment (say to Star trading) Account Dr.
   To Supplier Account/Bank/Cash
   Unlike normal practice to debiting expense accounts first and then transferring to profit and loss account, expenses are directly debited to consignment account.
3. When advance is received from the consignee: The consignee may remit some advance to consignor. The following entry is recorded:
   Bank/Cash Account Dr.
   To Consignee's Personal Account
4. On receipt of account sales from the consignee: Account sales contains details of sales made by consignee, expenses incurred by consignee. Following entries are recorded
   For sales proceeds

Consignee's Personal Account Dr.
To Consignment Account

For expenses incurred by consignee

Consignment Account Dr.
To Consignee's Personal Account

5. Cash or cheque or bank draft or bill of exchange/promissory note received from the consignee as settlement:

   Cash/Bank/Bills Receivable Account Dr.
   To Consignee's Personal Account

6. For bad debts: The accounting entry for bad debts will depend on whether del-credere commission is paid to the consignee
   i. When del-credere commission is not paid to the consignee Consignment Account Dr.
      To Consignee's Personal Account
   ii. When del-credere commission is paid to the consignee
   No entry is recorded as bad debts is to be borne by consignee.

7. For the goods taken over by the consignee Consignee's Personal Account Dr.
   To Consignment Account

8. For unsold consignment stock: In case some of the goods sent on consignment are still unsold at the time of preparing final accounts, the unsold inventory is recorded as consignment stock with followingentry:

   Consignment Stock Account Dr.
   To Consignment Account

9. For commission payable to consignee

   Consignment Account Dr.
   To Consignee's Personal Account

ILLUSTRATION 1

Exe sent on 1st July,2016 to Wye goods costing Rs 50,000 and spent Rs 1,000 on packing etc. On 3rd July,2016, Wye received the goods and sent his acceptance to Exe for Rs30,000 payable at 3 months. Wye spent Rs 2,000 on freight and cartage, Rs500 on godown rent and Rs 300 on insurance. On 31st December, 2016 he sent his Account Sales (along with the amount due to Exe) showing that 4/5 of the goods had been sold for Rs 55,000. Wye is entitled to a commission of 10%. One of the customers turned insolvent and could not pay Rs 600 due from him. Show the necessary journal entries in the books of consignor. Also prepare ledger accounts.

VALUATION OF INVENTORIES

The principle is that inventories should be valued at cost or net realizable value whichever is lower, the same principle as is practised for preparing final accounts. In the case of consignment, cost means not only the cost of the goods as such to the consignor but also all expenses incurred till the goods reach the premises of the consignee. Such expenses include packaging, freight, cartage, insurance in transit, octroi, import duty etc. But expenses incurred after the goods have reached the consignee's godown (such as godown rent, insurance of godown,

> **Note:** Sometimes an examination problem states only that the consignor's expenses amounted to such amount and that consignee spent so much. If details are not available, then for valuing inventories the expenses incurred by the consignor should be treated as part of cost while those incurred by the consignee should be ignored.

delivery charges,salesman salaries) are not treated as part of the cost of purchase for valuing inventories on hand. That is why in the case given above, inventories has been valued ignoring godown rent and insurance.

If the expected selling price of inventories on hand is lower than the cost, the inventories should be valued at expected net selling price only, i.e. expected selling price less delivery expenses, etc.

GOODS INVOICED ABOVE COST

Sometimes the proforma invoice is made out at a value higher than the cost and entries in the books of the consignor are made out on that basis – even the inventories remaining unsold will initially be valued on the basis of the invoice price. It must be remembered, however, that the profit or loss can be ascertained only if sale proceeds (plus) inventories on hand, valued on cost basis, is compared with the cost of the goods concerned together with expenses. Hence, if entries are first made on invoice basis, the euect of the loading (i.e., amount added to arrive at the invoice price) must be removed by additional entries. Suppose in the example given above, if the invoice is cost plus 20%, i.e., ` 60,000 for the goods sent to Wye. The entries will be initially:

	Particulars		Rs	Rs
(i)	Consignment to Wye A/c	Dr.	60,000	
	To Goods sent on Consignment A/c Consignment to			60,000
(ii)	Wye A/c	Dr.	1,000	
	To Bank			1,000

(iii)	Bills Receivable A/c To Wye	Dr.	30,000	
	Bank A/c			30,000
(iv)	To Bills Receivable A/c	Dr.	30,000	
	Wye			30,000
(v)	To Consignment to Wye A/c Consignment to Wye A/c	Dr.	55,000	
	To Wye			55,000
(vi)	Consignment to Wye A/c To Wye	Dr.	3,400	
				3,400
(vii)	Consignment to Wye A/c To Wye	Dr.	5,500	
	Bank A/c			5,500
	To Wye	Dr.	16,100	
	Inventories on Consignment A/c To Consignment to			16,100
	Wye A/c	Dr.	12,600	
	[1/5 of 60,000 + 1/5 of (1,000 + 2,000)]			12,600

[Students will see that except for difference in the amounts in entries (i) and (ix), these and other entries are the same as those already given.]

Additional entries (before ascertaining profit) to remove the effect of loading:

(a) Goods sent on Consignment A/c Dr. 10,000
To Consignment to Wye A/c 10,000
[Entry (i) reversed to the extent of loading in order to debit the Consignment A/c on cost basis].

(b) Consignment to Wye A/c Dr. 2,000
To Inventory Reserve Account 2,000

(The amount of loading included in the value of the closing Inventories is unrealised profit – hence reserve is created by debit to the Consignment Account).

The Consignment Account will now reveal a profit of Rs 5,700 the same as before. It will be transferred to the P&L A/c. Similarly entry given in 8 in the earlier illustration will be made to transfer the balance in the Goods sent on Consignment Account in the earlier illustration` 500,000) after entry in (a) above to the credit of Trading Account. The accounts (except for Wye whose account will be the same as already shown) are given below:

Consignment to Wye Account

2016	Particulars	Rs	2016	Particulars	Rs
1-Jul	To Goods sent on Consignment A/c	60,000	Dec. 31	By Wye Sales proceeds	55,000

	To Bank A/c – expenses	1,000		By Inventories on Consignment A/c	12,600
Dec. 31	To Wye-expenses & bad debt	3,400		By Goods sent on Consignment A/c(loading)	10,000
"	To Wye-commission	5,500			
	To Inventory Reserve A/c	2,000			
"	To Profit and Loss A/c transfer of profit	5,700			
		77,600			77,600

Goods sent on Consignment Account

2016		Rs	2016		Rs
Dec. 31	To Consignment to Wye A/c – loading	10,000	1-Jul	By Consignment to Wye A/c	60,000
	To Trading A/c transfer (bal.fig.)	50,000			
		60,000			60,000

Inventories on Consignment Account

2016		Rs	2016		Rs
Dec. 31	To Consignment to Wye A/c	12,600	Dec. 31	By Balance c/d	12,600
2017 Jan. 1	Balance b/d	12,600			

Inventory Reserve Account

2016		Rs	2016		Rs
Dec. 31	To Balance c/d	2,000	Dec. 31	By Consignment to Wye A/c	2,000
			2017 Jan. 1	By Balance b/d	2,000

The last two accounts will be carried forward to the next year and their balance will then be transferred to the Consignment Account – Rs 12,600 on the debit side and Rs 2,000 on the credit. This year in the balance sheet the net amount of Rs 10,600 will be shown on the assets side as shown below:

	Rs
Inventories on consignment	12,600
Less: Inventory Reserve	2,000
	10,600

What would be the situation if the commission to Wye includes del-credere commission also?

In that case Wye would not be able to charge the bad debt of ` 600 to Exe; he will have to bear the loss himself. The student can see that then the profit on consignment will be Rs 6,300.

In this regard it is to be noted that when del – credere commission is paid to the consignee, the consignee account is debited in the books of consignor for both cash and credit sales. But if no such del – credere commission is paid then consignee account cannot be debited for credit sales and in that case the following entry is passed in the books of consignor for credit sales.

Consignment Trade receivables A/c Dr.
To Consignment A/c

The difference is because in case del-credere commission is paid to consignee then consignee is responsible to bear any loss of bad debts and he will have to pay full amount of sales to consigner. Accordingly, in the books of consignor, whole amount (cash sales plus credit sales) is shown as receivable from consignee. On the other hand if del-credere commission is not paid than consignor is responsible to bear loss of bad debts, therefore, till the time consignee has not received money from customers, it is not shown as receivable from consignee.

NORMAL LOSS

If some loss is unavoidable, it would be spread over the entire consignment while valuing inventories. The total cost plus expenses incurred should be divided by the quantity available after the normal loss to ascertain the cost per unit. Suppose 10,000 kg of apples are consigned to a wholesaler, the cost being Rs 30 per kg, plus Rs 40,000 of freight. It is concluded that a loss of 15% is unavoidable. The cost per kg will be Rs 3,40,000/8,500 or Rs 40. If the unsold inventory is 1,000 kg its value will be Rs 40,000.

Accordingly, no entry is recorded for normal loss and same is considered as expense which is considered for valuation of remaining inventory.

ABNORMAL LOSS

If any accidental or unnecessary loss occurs, the proper thing to do is to find out the cost of the goods thus lost and then to credit the Consignment Account and debit the Profit and Loss Account – this will enable the consignor to know what profit would have been earned had the loss not taken place.

Suppose 1,000 sewing machines costing Rs2,500 each are sent on consignment basis and Rs10,000 are spent on freight etc. 20 machines are damaged beyond repair. The amount of loss will be:

Cost = 20 × 2500	Rs 50,000
Expenses = (20×10,000)/1000	Rs 200
	Rs 50,200

This amount should be credited to the Consignment Account and debited to the P&L A/c. If any amount, say, Rs 40,000 is received from the insurers, then debit to the P&L A/c will be only Rs 10,200. But the credit to the Consignment Account will still be Rs50,200. Rs40,000 will have been debited to the Bank Account.

Students shall note that abnormal loss is valued just like inventories in hand.

Students should be careful while valuing goods lost in transit and goods lost in consignee's godown. Both are abnormal loss but in case of former consignee's non-recurring expenses are not to be included whereas it is to be included in latter case.

Further, for the purpose of valuation of inventory in hand, it should be noted that while normal loss is considered as part of cost of remaining goods, whereas abnormal loss is ignored. In the example given above assume that 10,000 Kg apples were sent in 10 different trucks and out of which one truck met an accident and 500Kg apples were destroyed. In such case cost of remaining apples will be computed as below:

	Qty.	**Amount (Rs)**
Total apples shipped	10,000	3,40,000 (@ Rs 34 per Kg including freight)
Apples lost in accident	500	17,000 (@ Rs 34 per Kg including freight)
Remaining apples	9,500	3,23,000 (@ Rs 34 per Kg including freight)
Normal loss (15%)	1,425	Nil
Remaining saleable apples	8,075	3,23,000 (@ Rs 40 per Kg)

It is clear from above example that abnormal loss will not have impact on per unit cost, however, per unit cost will change due to normal cost as the remaining quantity will absorb cost of normal loss whereas abnormal loss will be immediately expensed off to profit or loss.

Distinctions between normal and abnormal loss

Normal loss	Abnormal loss
Normal loss occurs due to inherent nature of the goods being shipped e.g. leakage, evaporation, loss of perishable goods etc.	Abnormal loss occurs mainly because of unforeseen events e.g. accident or natural calamity etc.
Normal loss is not accounted for immediately and is loaded on the remaining goods. It gets accounted for as cost of remaining goods as and when they are sold.	Abnormal loss is accounted for immediately in profit and loss account.
As normal loss is added to cost of remaining goods, it impact gross profit. Insurance companies generally do not cover normal loss as it is expected to be incurred on each consignment or storage of goods.	Abnormal loss does not impact gross profit. Insurance is generally available for abnormal losses.
Normal loss is almost certain however it may vary from time to time.	Abnormal loss is because of unforeseen events and is not certain.

Following entry is recorded for abnormal loss:
Abnormal Loss Account Dr.
To Consignment Account
If abnormal loss is recoverable from the insurance company
Insurance Company's Account Dr.
To Abnormal Loss Account
If abnormal loss is recoverable from the consignee
Consignee's Personal Account Dr.
To Abnormal Loss Account
If abnormal loss is not recoverable, Abnormal Loss Account is transferred to Profit & Loss Account.

COMMISSION

Commission is the remuneration paid by the consignor to the consignee for the services rendered to the former for selling the consigned goods. Three types of commission can be provided by the consignor to the consignee, as per the agreement, either simultaneously or in isolation. They are:

Ordinary Commission

The term **commission simply denotes ordinary commission**. It is based on fixed percentage of the gross sales proceeds made by the consignee. It is given by the consignor regardless of whether the consignee is making credit sales or not. This type of commission does not give any protection to the consignor from bad debts and is provided on total sales.

Del-credere Commission

To **increase the sale and to encourage the consignee to make credit sales,** the consignor provides an additional commission generally known as **del-credere commission.** This additional commission when provided to the consignee gives a protection to the consignor against bad debts. In other words, after providing the del-credere commission, bad debts is no more the loss of the consignor. It is calculated on total sales unless there is any agreement between the consignor and the consignee to provide it on credit sales only.

Over-riding Commission

It is an extra commission allowed by the consignor to the consignee to promote sales at higher price then specified or to encourage the consignee to put hard work in introducing new product in the market. Depending on the agreement it is calculated on total sales or on the diuerence between actual sales and sales at invoice price or any specified price. In order to encourage the consignee to earn higher margins, it can also be in the form of share of additional profits made by consignee on sale of goods.

RETURN OF GOODS FROM THE CONSIGNEE

Consigned goods can be returned by the consignee because of many reasons like poor quality or not up to the specimen or destroyed in transit etc. In such a situation, the question arises what is the valuation of returned goods. Consigned goods returned by the consignee to the consignor are valued at the price at which it was consigned to the consignee. Expenses incurred by the consignee to send those goods back to the consignor are not taken into consideration while valuing it because the goods were already in a salable conditions and location and changing the location back from consignee to consignor is not a cost which must have to be incurred to sell the goods. This is generally called secondary freight in accounting terms.

ACCOUNT SALES

An account sale is the periodical summary statement sent by the consignee to the consignor. It contains details regarding –

(a) sales made,
(b) expenses incurred on behalf of the consignor,
(c) commission earned,
(d) unsold inventories left with the consignee,
(e) advance payment or security deposited with the consignor and the extent to which it has been adjusted,
(f) Balance payment due or remitted.

It is a summary statement and is different from Sales Account.

ACCOUNTING IN THE BOOKS OF THE CONSIGNEE

The consignee is not concerned when goods are consigned to him or when the consignor incurs expenses. He is concerned only when he sends an advance to the consignor, makes a sale, incurs expenses on the consignment and earns his commission. He debits or credits the consignor for all these as the case may be. Following entries are recorded in the books of consignee:

1. On making sales
   Cash/Bank Account/Debtors Dr.
   To Consignor's Personal Account
2. For expenses incurred and his commission
   Consignor's Personal Account Dr.
   To Bank Account
3. For advance paid to consignor
   Consignor's Personal Account Dr.
   To Bank Account
4. For recording bad debts
   Bad Debts Account Dr.
   To Customer's Account
5. For writing off bad debts
   (a) When del-credere commission is not allowed Consignor's Personal Account Dr.
   To Bad Debts Account
   (b) When del-credere commission is allowed
   Commission Account Dr.
   To Bad Debts Account

ILLUSTRATION 2

Exe sent on 1st July, 2016 to Wye goods costing Rs 50,000 and spent Rs 1,000 on packing etc. On 3rd July,2016, Wye received the goods and sent his acceptance to

Exe for Rs30,000 payable at 3 months. Wye spent Rs2,000 on freight and cartage, Rs 500 on godown rent and Rs300 on insurance. On 31st December, 2016 he sent his Account Sales (along with the amount due to Exe) showing that 4/5 of the goods had been sold for Rs 55,000. Wye is entitled to a commission of 10%. One of the customers turned insolvent and could not pay Rs600 due from him. Show the necessary journal entries in the consignee's book.

ADVANCE BY THE CONSIGNEE VS SECURITY AGAINST THE CONSIGNMENT

Generally the consignor insist the consignee for some advance payment for the goods consigned at the time of delivery of goods. This advance payment is adjusted in full against the amount due by the consignee on account of the goods sold.

But if the advance money deposited by the consignee is in the form of security against the goods consigned then the full amount is not adjusted against the amount due by the consignee to the consignor on account of goods sold if, there is any unsold inventory left with the consignee. In that case proportionate security in respect of unsold goods is carried forward till the time the respective goods held with the consignee are sold.

ILLUSTRATION 3

Miss Rakhi consigned 1,000 radio sets costing Rs 900 each to Miss Geeta, her agent on 1st July,2016. Miss Rakhi incurred the following expenditure on sending the consignment.

Freight	Rs 7,650
Insurance	Rs 3,250

Miss Geeta received the delivery of 950 radio sets. An account sale dated 30th November,2016 showed that 750 sets were sold for Rs 9,00,000 and Miss Geeta incurred Rs 10,500 for carriage.

Miss Geeta was entitled to commission 6% on the sales euected by her. She incurred expenses amounting to Rs 2,500 for repairing the damaged radio sets remaining in the inventories.

Miss Rakhi lodged a claim with the insurance company which was admitted at Rs 35,000. Show the Consignment Account and Miss Geeta's Account in the books of Miss Rakhi.

ILLUSTRATION 4

Vikram Milk Foods Co. Ltd. of Vikrampur sent to Sunder Stores, Sonepuri 5,000 kgs of baby food packed in 2,000 tins of net weight 1 kg and 6,000 packets of net weight 1/2 kg for sale on consignment basis. The consignee's commission was fixed at 5% of sale proceeds. The cost price and selling price of the product were as under:

	1 kg. tin	**1/2 kg. packet**
	Rs	**Rs**
Cost Price	10	6
Selling Price	15	7

The consignment was booked on freight "To Pay" basis, and freight charges came to 2% of selling value. One case containing 50 (1kg. tins) was lost in transit and the transport carrier admitted a claim of Rs 450.

At the end of the first half-year, the following information is gathered from the "Account Sales" sent by the consignee:

(i) Sale proceeds:	1,500	1 kg. tins
	4,000	1/2 kg. packets

(ii) Store rent and insurance charges Rs 600.

Find out the value of closing inventory on consignment.

Show the Consignment A/c and the Consignee's A/c in the books of Vikram Milk Food Co. Ltd. assuming that the consignee had paid the amount due from him.

ILLUSTRATION 5

Shri Mehta of Mumbai consigns 1,000 cases of goods costing Rs 1,000 each to Shri Sundaram of Chennai. Shri Mehta pays the following expenses in connection with consignment:

Carriage	10,000
Freight	30,000
Loading charges	10,000

Shri Sundaram sells 700 cases at Rs 1,400 per case and incurs the following expenses:

Clearing charges	8,500
Warehousing and storage	17,000
Packing and selling expenses	6,000

It is found that 50 cases have been lost in transit and 100 cases are still in transit.

Shri Sundaram is entitled to a commission of 10% on gross sales. Draw up the Consignment Account and Sundaram's Account in the books of Shri Mehta.

ILLUSTRATION 6

Ajay of Mumbai consigned to Vijay of Delhi, goods to be sold at invoice price which represents 125% of cost. Vijay is entitled to a commission of 10% on sales at invoice price and 25% of any excess realised over invoice price. The expenses on freight and insurance incurred by Ajay were Rs 10,000. The account sales received by Ajay shows that Vijay has affected sales amounting to Rs 1,00,000 in respect of 75% of the consignment. His selling expenses to be reimbursed were Rs 8,000. 10% of consignment goods of the value of Rs 12,500 were destroyed in fire at the Delhi godown and the insurance company paid Rs 12,000 net of salvage. Vijay remitted the balance in favour of Ajay. Prepare consignment account and the account of Vijay in the books of Ajay along with the necessary calculations.

SUMMARY

- In Consignment one person (consignor) sends goods to another person (consignee) to be sold on behalf of and at the risk of the former.
- In the case of consignment, cost means not only the cost of the goods as such to the consignor but also all expenses incurred till the goods reaches the premises of the consignee. Such expenses include packaging, freight, cartage, insurance in transit, octroi, etc.
- Expenses incurred after the goods have reached the consignee's godown (such as godown rent, insurance of godown, delivery charges) are not treated as part of the cost of purchase for valuing inventories on hand.
- If the expected selling price of inventories on hand is lower than the cost, the value put on the inventories should be expected net selling price only, i.e. expected selling price less delivery expenses, etc.i.e. expenses necessary for sales.
- Proforma invoice is made to show the high value of goods consigned than the cost and entries in the books of the consignor are made out on that basis. Even the inventories remaining unsold will initially be valued on the basis of the invoice price.
- Hence, if entries are first made on invoice basis, the euect of the loading (i.e., amount added to arrive at the invoice price) must be removed by additional entries to ascertain profit or loss.
- Abnormal loss is valued just like inventories in hand. Students should be careful while valuing goods lost in transit and goods lost in consignee's godown. Both are abnormal loss but in case of former consignee's non-

recurring expenses are not to be included whereas it is to be included in case of latter.

- Normal loss, is an unavoidable loss and be spread over the entire consignment while valuing inventories. The total cost plus expenses incurred should be divided by the quantity available after the normal loss to ascertain the cost per unit.
- Commission is the remuneration paid by the consignor to the consignee for the services rendered to the former for selling the consigned goods. Three types of commission can be provided by the consignor to the consignee, as per the agreement, either simultaneously or in isolation. They are:
  - Ordinary commission
  - Del-credere commission
  - Over-riding commission
- For accounting of consignee, he is concerned only when he sends an advance to the consignor, makes a sale, incurs expenses on the consignment and earns his commission. He debits or credits the consignor for all these as the case may be.
- It has been assumed that final payment received from Vijay.
- Abnormal loss is always calculated at cost even if invoice price of goods is given.
- Value of inventories always valued at invoice price if invoice price is given.

Multiple Choice Questions

1. P of Delhi sends out 1,000 boxes of toothpaste costing Rs 200 each. Each box consists of 12 packets. 600 boxes were sold by consignee at Rs 20 per packet. Amount of sale value will be:
   (a) Rs 1,44,000 (b) Rs 1,20,000 (c) Rs 1,32,000

2. X of Kolkata sends out 2,000 boxes to Y of Delhi costing Rs 100 each. Consignor's expenses Rs 5,000. 1/10th of the boxes were lost in consignee's godown and treated as normal loss. 1,200 boxes were sold by consignee. The value of consignment Inventories will be:
   (a) Rs 68,333 (b) Rs 61,500 (c) Rs 60,000

3. Which of the following statement is not true:
   (a) If del-credere commission is allowed, bad debt will not be recorded in the books of consignor
   (b) If del-credere commission is allowed, bad debt will be debited in consignment account

(c) Del-credere commission is provided by consignor to consignee

4. X of Kolkata sent out 2,000 boxes costing 100 each with the instruction that sales are to be made at cost + 45%. X draws a bill on Y for an amount equivalent to 60% of sales value. The amount of bill will be:
   (a) Rs 1,74,000   (b) Rs 2,00,000   (c) Rs 2,90,000

5. Which of the following statement is wrong:
   (a) Consignor is the owner of the consignment Inventories
   (b) Del-credere commission is allowed by consignor to protect himself from bad debt
   (c) All proportionate consignee's expenses will be added up for valuation of consignment Inventories.

6. Out of the following at which point the treatment of "Sales" and "Consignment" is same:
   (a) Ownership transfer.
   (b) Money receive.
   (c) Inventories outflow.

7. If del-credere commission is allowed for bad debt, consignee will debit the bad debt amount to:
   (a) Commission Earned A/c
   (b) Consignor's A/c
   (c) Trade receivables (Customers) A/c

8. A proforma invoice is sent by:
   (a) Consignee to Consignor
   (b) Consignor to Consignee
   (c) Customer/Debtors to Consignee

9. Which of the following statement is correct:
   (a) Consignee will pass a journal entry in his books at the time of receiving goods from consignor.
   (b) Consignee will not pass any journal entry in his books at the time of receiving goods from consignor.
   (c) The ownership of goods will be transferred to consignee at the time of receiving the goods.

10. Consignment Inventories will be recorded in the balance sheet of consignor on asset side at:

(a) Invoice Value
(b) At Invoice value less Inventories reserve
(c) At lower than cost price

11. Which of the following expenses of consignee will be considered as non-selling expenses:
    (a) Advertisement
    (b) Insurance on freight inward
    (c) Selling Expenses

12. The consignment accounting is made on the following basis:
    (a) Accrual
    (b) Realisation
    (c) Cash Basis

13. Which of the following item is not credited
    (a) Cash sales made by consignee
    (b) Credit sales made by consignee
    (c) Inventories Reserve on closing consig

Theory Questions

Q1. Write short notes on:
(i) Del-credere commission.
(ii) Account sales.
(iii) Over-riding commission.

Q2. Distinguish between:
(i) Consignment sale and Normal sale.
(ii) Commission and Discount.

Practical Questions

Q1. X of Delhi purchased 10,000 metres of cloth for Rs 2,00,000 of which 5,000 metres were sent on consignment to Y of Agra at the selling price of Rs30 per metre. X paid Rs5,000 for freight and Rs 500 for packing etc. Y sold 4,000 metre at Rs 40 per metre and incurred Rs 2,000 for selling expenses. Y is entitled to a commission of 5% on total sales proceeds plus a further 20% on any surplus price realised over Rs30 per metre. 3,000 metres were sold at Delhi at Rs30 per metre less Rs3,000 for expenses and commission. Owing to fall in market price, the inventories of cloth in hand is to be reduced by 10%.

Prepare the Consignment Account and Trading and Profit & Loss Account in books of X.

Q2. D of Delhi appointed A of Agra as its selling agent on the following terms:

Goods to be sold at invoice price or over. A to be entitled to a commission of 7.5% on the invoice price and 20% of any surplus price realized over invoice price. The principals to draw on the agent a 30 days bill for 80% of the invoice price.

On 1st February, 2016, 1,000 cycles were consigned to A, each cycle costing Rs 640 including freight and invoiced at Rs 800.

Before 31st March, 2016, (when the principal's books are closed) A met his acceptance on the due date; sold off 820 cycles at an average price of Rs930 per cycle, the sale expenses being Rs12,500; and remitted the amount due by means of Bank draft.

Twenty of the unsold cycles were shop-spoiled and were to be valued at a depreciation of 50% of cost.

Show by means of ledger accounts how these transactions would be recorded in the books of A and find out the value of closing inventory with A to be recorded in the books of D at cost.

Q3. Mr. Y consigned 800 packets of toothpaste, each packet containing 100 toothpastes. Cost price of each packet was Rs900. Mr. Y Spent Rs100 per packet as cartage, freight, insurance and forwarding charges. One packet was lost on the way and Mr. Y lodged claim with the insurance company and could get Rs 570 as claim on average basis. Consignee took delivery of the rest of the packets and spent Rs39,950 as other non-recurring expenses and Rs22,500 as recurring expenses. He sold 740 packets at the rate of Rs 12 per toothpaste. He was entitled to 2% commission on sales plus 1% del-credere commission.

You are required to prepare Consignment Account. Calculate the cost of inventories at the end, abnormal loss and profit or loss on consignment.

Q4 A of Agra sent on consignment goods valued Rs1,00,000 to B of Mumbai on 1st March, 2016. He incurred the expenditure of Rs 12,000 on freight and insurance. A's accounting year closes on 31st December. B was entitled to a commission of 5% on gross sales plus a del-credere commission of 3%. B took delivery of the consignment by incurring expenses of Rs3,000 for goods consigned.

On 31.12.2016, B informed on phone that he had sold all the goods for Rs 1,50,000 by incurring selling expenses of Rs 2,000. He further informed that only Rs 1,48,000 had been realized and rest was considered irrecoverable, and would be sending the cheque in a day or so for the amount due along with the accounts sale.

On 5.1.2017, A received the cheque for the amount due from B and incurred bank charges of Rs260 for collecting the cheque. The amount was credited by the bank on 9.1.2017.

Write up the consignment account finding out the profit/loss on the consignment, B's account, Provision for expenses account and Bank account in the books of the consignor, recording the transactions up to the receipt and collection of the cheque.

ANSWERS/HINTS

MCQs

1	2	3	4	5	6	7	8	9	10	11	12	13
(a)	(b)	(b)	(a)	(c)	(c)	(a)	(b)	(b)	(b)	(b)	(a)	(c)

Theoretical Questions

1 (i) Del-credere commission is an additional commission paid by the consignor to the consignee for undertaking responsibility of collection of debts. Generally, the consignee gets ordinary commission for sales made by him as a percentage of gross sales, over and above, he may get del- credere commission for the additional responsibility of debt collection. Sometimes it is agreed that del-credere commission shall be allowed on credit sales only. However, in the absence of any such agreement the consignor allows del-credere commission on total sales and not merely on credit sales. If the consignee is entitled to del-credere commission, he has to bear the bad debts; if any, arising, out of credit sale of consignment goods.

(ii) Account sales is a periodic statement furnished by the consignee to the consignor stating therein, the quantity sold, price charged, expenses incurred on behalf of the consignee and commission payable to him in respect of a particular consignment, and the net amount due from him and remittance received if any. It also sho
and still held as stock.

(iii) Over-riding commission is an extra commission allowed to the consignee in addition to the normal commission. Such additional commission is generally allowed:-

To provide additional incentive to the consignee for the purpose of introducing and creating a market for a new product.

To provide incentive for supervising the performance of other agents in a particular area.

To provide incentive for ensuring that the goods are sold by the consignee at the highest possible price.

2. (i) In case of consignment, the property in the goods remains with the consignor until the goods are actually sold. The consignee acts only as a custodian of goods sent by consignor. In consignment, the ownership of goods does not pass on to the consignee in any case. In case of ordinary sale, the ownership of goods passes to the buyer immediately after sale. In case of consignment, the risk attached to the goods remain with the consignor even after sending the goods to the consignee. However, in case of ordinary sale, as soon as the property in the goods passes on to the buyers, the risk attached to the goods also passes at the same time. The relationship between consignor and consignee is that of principal and agent. In case of credit sale, the relationship between the buyer and the seller is that of a debtor and a creditor.

   (ii) Commission may be defined as remuneration of an employee or agent relating to services performed in connection with sales, purchases, collections or other types of business transactions and is usually based on a percentage of the amounts involved.

   Commission earned is accounted for as an income in the books of accounts, and commission allowed or paid is accounted for as an expense in the books of the party availing such facility or service.

   The term discount refers to any reduction or rebate allowed and is used to express one of the following situations:

   An allowance given for the settlement of a debt before it is due i.e. cash discount.

   An allowance given to the whole sellers or bulk buyers on the list price or retail price, known as trade discount. A trade discount is not shown in the books of account separately and it is shown by way of deduction from cost of purchases.