FINANCIAL ACCOUNTING

B.Com (Gen & CA)., Semester-II

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B.Com (Gen & CA): Financial Accounting

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining 'A' grade from the NAAC in the year 2016, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 443 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the door step of all the sectors of the society. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even to housewives desirous of pursuing higher studies. Acharya Nagarjuna University has started offering B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004 onwards.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers involved respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn be part of country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Academic Coordinators, Editors and Lesson- writers of the Centre who have helped in these endeavours.

Prof. P. Raja Sekhar
Vice-Chancellor (FAC)
Acharya Nagarjuna University

I YEAR B COM (GEN & CA) - SEMESTER – II
Paper title: Financial Accounting

Learning Outcomes:
At the end of the course the student will able to;

- Understand the concept of consignment and learn the accounting treatment of the various aspects of consignment.
- Analyze the accounting process and preparation of accounts in consignment and joint venture.
- Distinguish Joint Venture and Partnership and to learn the methods of maintaining records under Joint Venture.
- Determine the useful life and value of the depreciable assets and maintenance of Reserves in business entities.
- Design an accounting system for different models of businesses at his own using the principles of existing accounting system.

Syllabus
Unit-I: Depreciation: Meaning and Causes of Depreciation - Methods of Depreciation: Straight Line -Written Down Value -Annuity and Depletion Method (including Problems).

Unit-II: Provisions and Reserves: Meaning-Provision vs. Reserve -Preparation of Bad Debts Account-Provision for Bad and Doubtful Debts-Provision for Discount on Debtors-Provision for Discount on Creditors - Repairs and Renewals Reserve A/c (including Problems).

Unit-III: Bills of Exchange: Meaning of Bill-Features of Bill-Parties in the Bill-Discounting of Bill – Renewal of Bill – Entries in the Books of Drawer and Drawee (including Problems).

Unit-IV: Consignment Accounts: Consignment - Features - Proforma Invoice-Account Sales- Del-credere Commission - Accounting Treatment in the Books of Consigner and Consignee - Valuation of Closing Stock

Unit-V: Joint Venture Accounts: Joint Venture - Features - Difference between Joint-Venture and Consignment – Accounting Procedure – Methods of Keeping Records– One Vendor Keeps the Accounts (including Problems).

Reference Books:

1. Ranganatham G and Venkataramanaiah, Financial Accounting-II, S Chand Publications, New Delhi.
2. T. S. Reddy and A. Murthy - Financial Accounting, Margham Publications.
3. R.L. Gupta & V.K. Gupta, Principles and Practice of Accounting , Sultan Chand.
4. SN Maheswari and SK Maheswari – Financial Accounting, Vikas Publications.
5. S.P. Jain & K.L Narang, Accountancy-I, Kalyani Publishers.
6. Tulsan, Accountancy-I, Tata McGraw Hill Co.
7. V.K. Goyal, Financial Accounting, Excel Books
8. T.S. Grewal, Introduction to Accountancy, Sultan Chand & Co.
9. Haneef and Mukherjee, Accountancy-I, Tata McGraw Hill.

10. Arulanandam and Ramana, Advanced Accountancy, Himalaya Publishers.
11. S.N.Maheshwari&V.L.Maheswari, Advanced Accountancy-I, Vikas Publishers.
12. Prof E Chandraiah, Financial Accounting, Seven Hills International Publishers.

Suggested Co-Curricular Activities:

- Quiz Programs
- Problem Solving Exercises
- Co-operative learning
- Seminar
- Group Discussions on problems relating to topics covered by syllabus
- Reports on Proforma invoice and account sales
- Visit a consignment and joint venture firms(Individual and Group)
- Collection of proforma of bills and promissory notes
- Examinations (Scheduled and surprise tests)
- Any similar activities with imaginative thinking beyond the prescribed syllabus

FINANCIAL ACCOUNTING

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Lesson: 1

Bills of Exchange: Trade Bills

1.0 Objective:

After going through the lesson you will be able to understand

1. The definition of Bills of Exchange
2. The definition of Promissory Note
3. The differences between Bills of Exchange and Promissory Note
4. Various terms used in Bills of Exchange
5. Account method of Trade bills in the books of drawer, drawee and endorsee.

Structure:

1.1: Introduction

1.2: Bills of Exchange – Definition

1.3: Important terms in Bills of Exchange

1.4: Promissory Note Vs. Bills of Exchange

1.5: Model Journal entries

1.6: Illustrations

1.7: Try Yourself

1.8: Summary

1.9: Glossary

1.10: Questions

1.1: Introduction:

We all know that in the present modern business world all transactions are not limited to cash alone. When goods are sold, the purchaser may not immediately pay the amount. These credit transactions are inevitable in almost all businesses. In such cases, the purchaser sometimes gives a letter of agreement to the seller agreeing to pay the amount due after a stipulated period. Such letter or instrument is called as bills of exchange. These instruments can be transferred from one person to the other freely.

1.2 Bills of Exchange – Definition:

Section 5 of the Negotiable Instruments Act defines a Bill of Exchange as," an instrument in writing containing an unconditional order, signed by the maker, directing a certain person, to pay a certain sum of money only to, or to the bearer of a certain person or to the bearer of the instrument".

1.3: Important terms in Bills of Exchange:

1. **Drawer:** The person who draws the bill of exchange is called the *drawer*. He is the creditor who sells goods.

2. **Drawee or Acceptor:** The person on whom the bill of exchange is drawn is called *drawee*. He is the debtor who buys goods. The drawee becomes the acceptor when he accepts the bill of exchange.

3. **Payee:** The person named in the bill of exchange, to whom or to whose order the money in the instrument is to be paid, is called the *payee*.

4. **Holder:** The person who is entitled to the possession of the bill of exchange in his own name and who has a right to receive or recover the amount due on the instrument, is called the *holder.*

5. **Holder in due course:** A *holder in due course* is a holder who obtains a negotiable instrument for valuable consideration, in good faith and before maturity. He will have a valid title over the instrument though the title of the transferor may be defective.

6. **Endorsement:** The payee of a negotiable instrument may not himself keep the instrument with him. He may transfer the ownership of the instrument in favour of another person. Such a person can get the payment of the instrument from the drawee. The process of transferring of a ownership of the instrument is termed as *"endorsement*" of the instrument. According to Negotiable Instruments Act, " when the maker or holder of a negotiable instrument signs his name otherwise than as such maker, for the purpose of negotiation, on the back or face thereof, or on a slip of a paper annexed thereto, or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to endorse the instrument. The person endorsing the instrument is called the 'endorser'. The person, to whom the instrument is endorsed, is called the 'endorsee'.

7. **Maturity of bill:** A bill of exchange matures on the date on which it falls due. If the instrument is payable on demand, it becomes due immediately on presentation for payment. If it is payable after the expiry of a particular period of time, the date of maturity will be calculated after adding *three days of grace*.

8. **Dishonour:** Non-payment of the amount of a bill of exchange on the date of maturity is called *dishonour* of the instrument.

9. **Noting:** Noting is authentic and official proof of presentment and dishonour of a bill of exchange. It is a memorandum of a minute recorded by a notary public upon the dishonoured instrument or upon a paper attached thereto or partly upon each. However, noting is not compulsory.

10. Retiring of a bill: If all parties agree, a bill may be withdrawn before maturity either because the acceptor desires its withdrawal to avoid its dishonour or because he is desirous of paying the amount without waiting till its due date.

11. Renewal of bill: When the original bill has been dishonoured or retired (where the drawee is not in a position to pay), if the parties agree, a new bill in place of the original bill may be accepted by the drawee. This is termed as renewal of bill. The new bill may be for the full amount, i.e. of the old bill and noting charges, if any, plus interest.

12. Discounting the bill: The holder of the bill or the drawer need not keep the bill with him till the due date. In case he needs money, he can sell the bill to the bank. This is called as discounting the bill. In such case bank reduces some amount in the bill amount in the form of discount. Generally, discount is mentioned as a percentage.

13. Promissory note: Section 4 of the Negotiable Instruments Act defines a promissory note as, "an instrument in writing (not being a bank note and a 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".

1.4: Promissory note Vs. Bills of Exchange

Promissory note	**Bills of Exchange**
1. It is an unconditional instrument	1. It is only an order to pay the sum.
2. The person who has taken money promises to pay the same.	2. The creditor writes the bill to pay sum due.
3. Debtor need not accept the note.	3. Drawer writes the bill and drawee accepts.
4. There are two parties, creditor and debtor	4. There are three parties, drawer, drawee and payee.
5. Dishonour notice not required.	5. Notice of dishonour not required.
6. The responsibility to pay the sum lies on the debtor or the writer of the note.	6. Responsibility to pay the sum lies On the drawee.

1.5: Model Journal Entries:

Books of Drawer		**Books of Drawee**	
1. When bill is written:			
Bills receivable A/C	Dr	Drawer A/C	Dr
To Drawee		To Bills payable	

2. When bill honoured:

Cash/Bank A/C	Dr	Bills Payable A/C	Dr
To Bills receivable		To Cash/Bank	

3. When bill dishonoured:

Drawee A/C	Dr	Bills Payable A/C	Dr
To Bills receivable		To Drawer	

4. When bill sent for collection:

Bank for collection of bills A/C	Dr	No Entry	
To Bills receivable			

5. When the sent bill honoured:

Cash/Bank A/C	Dr	Bills payable A/C	Dr
To Bank for collection of Bills		To Cash/Bank	

6. When bill sent for collection dishonoured:

Drawee A/C	Dr	Bills payable A/C	Dr
To Bank for collection of Bills		To Drawer	

7. When bill endorsed:

Endorsee A/C	Dr	No Entry	
To Bills receivable			

8. When endorsed bill honoured:

No Entry		Bills payable A/C	Dr
		To Cash/Bank	

9. When endorsed bill dishonoured:

Drawee A/C	Dr	Bills payable A/C	Dr
To Endorsee		To Drawer	

10. When bill discounted at bank:

Cash/Bank A/C	Dr	No Entry	
Discount A/C	Dr		
To Bills receivable			

11. When discounted bill honoured:

No Entry		Bills payable A/C	Dr
		To Cash/Bank	

12. When discounted bill dishonoured:

Drawee A/C	Dr	Bills payable A/C	Dr
Cash/Bank		To Drawer	

1.6: Illustrations:

Illustration: 1:

On 1st July 2007 Srinivas sold goods worth Rs.1,000 to Ramesh and wrote a bill of three months on him. Ramesh accepted the bill and honoured on the due date. Write journal entries in the books of Srinivas and Ramesh.

Solution:

Journal entries in the books of Srinivas:

1-7-2007	Ramesh A/C	Dr	1,000	
	To sales			1,000
	(Being goods to Ramesh)			
	Bills receivable A/C	Dr	1,000	
	To Ramesh			1,000
	(Being accepted bill received from Ramesh)			
4-10-2007	Cash/Bank A/C	Dr	1,000	
	To Bills receivable			1,000
	(Being the sum received on due date)			

Journal entries in the books of Ramesh:

1-7-2007	Purchases A/C	Dr	1,000	
	To Srinivas			1,000
	(Being goods purchased from Srinivas)			
	Srinivas A/C	Dr	1,000	
	To Bills payable			1,000
	(Being acceptance given for the bill)			
4-10-2007	Bills payable A/C	Dr	1,000	
	To cash/Bank			1,000

Illustration 2:

On 1st July 2007 Kumar wrote a bill for Rs.7, 500 on Rajan for 4 months duration. Rajan after acceptance returned the bill. Kumar discounted the bill at the bank at 6 per cent. Write journal entries in the books of both the parties assuming that the bill is honoured on the due date.

Solution:

Journal entries in the books of Kumar:

1-7-2007	Bills receivable A/C	Dr	7,500	
	To Rajan			7,500
	(Being bill received from Rajan)			
	Bank A/C	Dr	7,350	
	Discount A/C	Dr	150	
	To Bills receivable			7,500
	(Being bill discounted (7,500x4/12x6/100))			

Journal entries in the books of Rajan:

1-7-2007	Kumar A/C	Dr	7,500	
	To Bills payable			7,500
	(Being bill accepted)			
4-11-2007	Bills payable	Dr	7,500	
	To Bank			7,500
	(Being bill honoured)			

Illustration 3:

On 1st January 2007 Ramu wrote a bill on Nageswararao for Rs.300 of 3 months duration. On 1st March 2007 Ramu endorsed this bill to Kantharao from whom he purchased goods for the same amount. On the same date Kantharao discounted the bill at the bank at 6 per cent. On the due date bill is honoured. Pass journal entries in the books of all parties.

Solution:

Journal entries in the books of Ramu:

1-1-2007:	Bills receivable A/C	Dr	300	
	To Nageswararao			300
	(Being bill received from Nageswararao)			

1-3-2007	Purchases A/C	Dr	300	
	To Kantharao			300
	(Being goods purchased from Kantharao)			
	Kantharao A/C	Dr	300	
	To Bills receivable			300
	(Being bill received from Nageswararao endorsed to Kantharao)			

Journal entries in the books of Nageswararao:

1-1-2007	Ramu A/C	Dr	300	
	To Bills payable			300
	(Being bill accepted)			
4-4-2007	Bills payable A/C	Dr	300	
	To Bank			300
	(Being the bill honoured)			

Journal entries in the books of Kantharao:

1-3-2007	Ramu A/C	Dr	300	
	To Sales			300
	(Being goods sold on credit)			
	Bills receivable A/C	Dr	300	
	To Ramu			300
	(Being bill received from Ramu)			
	Bank A/C	Dr	298-50	
	Discount A/C	Dr	1-50	
	To Bills receivable			300
	(Being bill discounted (300x1/12x6/100)			

Illustration: 4:

On 1st July 2007 Sridhar sold goods worth Rs.500 to Suresh and got acceptance of the bill. He sent the bill to the bank for collection and the amount is collected. Write the necessary entries in the books of both the parties.

Solution:

Journal entries in the books of Sridhar:

1-7-2007	Suresh A/C	Dr	500		
	To Sales			500	
	(Being goods sold on credit)				
	Bills receivable A/C	Dr	500		
	To Suresh			500	
	(Being accepted bill received)				
4-10-2007	Bank for collection of bills A/C	Dr		500	
	To bills receivable				500
	(Being bill sent for collection)				
	Bank A/C	Dr		500	
	To bank for collection of bills				
	(Being bill collected)				

Journal entries in the books of Suresh:

1-7-2007	Purchases A/C	Dr	500	
	To Sridhar			500
	(Being goods purchased)			
	Sridhar A/C	Dr	500	
	To Bills payable			500
	(Being bill accepted)			
4-10-2007	Bills payable A/C	Dr	500	
	To bank			500
	(Being bill honoured)			

Illustration 5:

On 1st July 2007 Lohith wrote a 3 months bill on Rohit for Rs.3000 and got his acceptance. Write entries to renew the bill before the due date assuming the following circumstances.

a) Got acceptance for the new bill of 3 months in the place of old one with 6% interest.

b) Got cash 1/3rd of the bill, and new bill of 3 months for the remaining amount with 6% interest.

c) Got Rs.1, 500 along with Rs. 15 towards interest and a new bill for the remaining amount.

Solution:

Entries in the books of Lohit:

1-7-2007	Bills receivable A/C	Dr	3,000	
	To Rohit			3,000
	(Being acceptance received)			
	Rohit A/C	Dr	3,000	
	To Bills receivable			3,000
	(Being old bill cancelled)			

a) When the new bill got accepted with 6 % interest:

4-10-2007	Bills receivable A/C	Dr	3,045	
	To interest			45
	To Rohit			3,000
	(Being the bill the renewed at 6% interest)			

b) When 1/3rd cash received and the new bill for the remaining at 6% interest:

4-10-2007	Bank A/C	Dr	1,000	
	Bills receivable A/C	Dr	2,030	
	To Interest			30
	To Rohit			3,000
	(Being new bill received with part payment)			

c) When Rs.1, 500 cash and Rs.15 interest received with a new bill received:

	Bank A/C	Dr	1,515	
	Bills receivable A/C	Dr	1,500	
	To interest			15
	To Rohit			3,000
	(Being new bill received along with interest and part payment)			

Journal entries in the books of Rohit:

1-7-2007	Rohit A/C	Dr	3,000	
	To Bills payable			3,000

	(Being bill accepted)			
4-10-2007	Bills payable A/C	Dr	3,000	
	To Lohit			3,000
	(Being the bill cancelled)			
a)	Lohit A/C	Dr	3,000	
	Interest A/C	Dr	30	
	To Bills payable			3,030
	(Being new bill accepted with 6% interest)			
b)	Lohit A/C	Dr	3,000	
	Interest A/C	Dr	30	
	To Bank			1,000
	To Bills payable			2,030
	(Being 1/3rd cash paid and new bill accepted with interest)			
c)	Lohit A/C	Dr	3,000	
	Interest A/C	Dr	15	
	To Bank			1,515
	To Bank			1,500
	(Being the new bill accepted along with part payment)			

Illustration 6:

On 1st July 2007 Kamalnath sold goods to Vimalnath for Rs.5, 000 and wrote four bills on him. First bill for a month to Rs.700, second bill for 2 months for Rs.1, 500, third bill for 3 months for Rs.2, 000 and the fourth bill for 4 months for the remaining amount. Vimalnath accepted all these bills.

Kamalnath kept the fist bill with him. On July 1st itself, the second bill transferred to Amarnath, the third bill discounted on 1st August at 6% and the fourth bill sent to bank for collection.

All these four bills dishonoured on the due date. Write necessary journal entries in the books of Kamalnath, Vimalnath and Amarnath.

Solution:

Journal entries in the books of Kamalnath:

1-7-2007	Vimalnath A/C	Dr	5,000	
	To sales			5,000

	(Being goods sold on credit)			
	Bills receivable A/C	Dr	700	
	To Vimalnath			700
	(Being a bill of one month due received)			
	Bills receivable A/C	Dr	1,500	
	To Vimalnath			1,500
	(Being a bill of two months due received)			
	Bills receivable A/C	Dr	2,000	
	To Vimalnath			2,000
	(Being a bill of 3 months due received)			
	Bills receivable A/C	Dr	800	
	To Vimalnath			800
	(Being a bill of 4 months due received)			
	Amarnath A/C	Dr	1,500	
	To bills receivable			1,500
	(Being Vimalnath bill endorsed to Amarnath)			
1-8-2007	Bank A/C	Dr	1,980	
	Discount A/C	Dr	20	
	To bills receivable			2,000
	(Being bill discounted)			
4-7-2007	Vimalnath A/C	Dr	700	
	To bills receivable			700
	(Being the first bill dishonoured)			
4-9-2007	Vimalnath A/C	Dr	2,000	
	To Amarnath			2,000
	(Being endorsed second bill dishonoured)			
4-10-2007	Vimalnath A/C	Dr	2,000	
	To bank			2,000
	(Being the discounted third bill dishonoured)			
4-11-2007	Bank for collection of bills A/C	Dr	800	
	To Bills receivable			800
	(Being the fourth bill sent for collection)			
	Vimalnath A/C	Dr	800	
	To Bank for collection of bills			800
	(Being bill sent for collection dishonoured)			

Journal entries in the books of Vimalnath:

1-7-2007	Purchases A/C	Dr	5,000	
	To Kamalnath			5,000
	(Being goods purchased on credit)			
	Kamalnath A/C	Dr	700	
	To Bills payable			700
	(Being first bill accepted)			
	Kamalnath A/C	Dr	1,500	
	To bills payable			1,500
	(Being second bill accepted)			
	Kamalnath A/C	Dr	2,000	
	To bills payable			2,000
	(Being third bill accepted)			
	Kamalnatha A/C	Dr	800	
	To bills payable			800
	(Being fourth bill accepted)			
1-8-2007	Bills payable A/C	Dr	700	
	To Kamalnath			700
	(Being the bill dishonoured)			
4-9-2007	Bills payable A/C	Dr	1,500	
	To Kamalnath			1,500
	(Being the second bill dishonoured)			
4-10-2007	Bills payable A/C	Dr	2,000	
	To Kamalnath			2,000
	(Being the third bill dishonoured)			
4-11-2007	Bills payable A/C	Dr	800	
	To Kamalnath			800
	(Being the fourth bill dishonoured)			

Journal entries in the books of Amarnath:

1-7-2007	Bills receivable A/C	Dr	1,500	
	To kamalnath			1,500
	(Being endorsed bill received)			
4-9-2007	Kamalnath A/C	Dr	1,500	
	To Bills receivable			1,500
	(Being endorsed bill dishonoured)			

Illustration 7:

On 1st July 2007 Sivaprasad sold goods to Ramprasad for Rs.6, 000 and wrote a bill for 3 months and got his acceptance. Later, he discounted the bill at the bank at 8%. On the due date the bill dishonoured due to insolvency of Ramprasad. Bank charged Rs.36 towards noting charges. 25 paise per rupee collected from Ramprasad in full settlement. Write journal entries in the books of both the parties.

Solution:

Journal entries in the books of Sivaprasad:

1-7-2007	Ramprasad A/C	Dr	6,000	
	To Sales			6,000
	(Being goods sold on credit)			
	Bills receivable A/C	Dr	6,000	
	To Ramprasad			6,000
	(Being accepted bill received)			
	Bank A/C	Dr	5,880	
	Discount A/C	Dr	120	
	To bills receivable			6,000
	(Being bill discounted at 8%)			
4-10-2007	Ramprasad A/C	Dr	6,036	
	To bank			6,036
	(Being cash paid to bank with realization expenses due to dishonour)			
	Bank A/C	Dr	1,509	
	Bad debts A/C	Dr	4,527	
	To Ramprasad			6,036
	(Being 25 paise per rupee realized from Ramprasad)			

Journal entries in the books of Ramprasad:

1-7-2007	Purchases A/C	Dr	6,000	
	To Sivaprasad			6,000
	(Being goods purchased for credit)			
	Sivaprasad A/C	Dr	6,000	
	To Bills payable			6,000
	(Being bill accepted)			
	Bills payable A/C	Dr	6,000	
	Realisation expenses A/C	Dr	36	
	To Sivaprasad			6,036
	(Being bill dishonoured)			

4-10-2007	Sivaprasad A/C	Dr	6,036	
	To bank			1,509
	To Deficit account			4,527
	(Being 25 paise in a rupee paid and settled Sivaprasad account)			

1.7: Try yourself:

1. On 1st March 2007 Balumahendra wrote a 3 months bill on Krishnakanth for Rs.2, 400 and got his acceptance. On the same day he discounted the bill with the bank at 5 %. On the due date Krishnakant honoured the bill. Pass the journal entries in the books of both the parties.

2. On 1st July 2007, Srikanth wrote a bill on Srinath for Rs.6, 000 with a due date of 3 months and got his acceptance. Srikanth endorsed this bill to Pramod. On the due date the bill is honoured. Record entries in the books of Srikanth, Srinath and Pramod.

3. On 1st January 2007, Nagarjuna sold goods worth Rs.10, 000 to Prabhakar and wrote a bill on the same date and got his acceptance. You are required to pass journal entries in the books of both the parties assuming the following situations:

    a) When the bill is with Nagarjuna till the date of its maturity.

    b) When Nagarjuna endorses the bill to Chiranjeevi.

    c) When Nagarjuna send the bill to bank for collection.

    d) When Nagarjuna discounts the bill with the bank at 8%.

4. On 1st June 2007, Ramana sold goods worth 8,000 to Prakash and wrote a 2 months bill on him and in return prakash sent his acceptance. But on the due date the bill dishonoured. Write journal entries in the books of both the parties.

5. On March 1st 2007 A wrote a 3 months bill on B for Rs.15, 000 and got his acceptance. On the same day the bill is endorsed to C. On 1st April C discounted the bill with bank at 8%. On the due date the bill is dishonoured and A paid to the bank Rs.15, 100 including realization expenses. You are required to pass journal entries in the books of A, B, and C.

6. On 1st January 2007 Vimal draw on Chaitanya three bills of exchange in full settlement of claim. The first for Rs. 14,000 at one month, the second for Rs.16, 000 at two months and the third for Ts.18, 000 at three months. Chaitanya duly accepted the bills.

Vimal endorsed the first bill to his creditor Tarun on 3rd January 2007, the second bill discounted on 15th January2007 for Rs.15, 900 and the third bill sent for collection to the bank on 4th February 2007. All the bills are honoured on the due date except the second one, which is charged with Rs.240 towards noting charges. Vimal charged Chaitanya Rs.300 for interest and draw on him a new bill for two months for the amount due. This bill is duly met on maturity. Pass journal entries in the books of Vimal.

1.8: Summary:

In the present modern business world, the importance of bills of exchange is more prominent. Besides currency notes, trade bills are also in use as medium of exchange. To meet the short-term necessities these instruments are highly in use.

These as negotiable instruments can be transferred to any one, can be discounted at bank and can be kept as money value for future i.e. up to due date.

1.9: Glossary:

Bills 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.

Promissory Note: An instrument in writing 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.

Noting Charges: The amount charged by the bank on the drawer of the bill when the bill is dishonoured.

Renewal of bill: A new bill in the place of a old bill accepted by the drawee for continuation of the transaction.

1.10: Self Assessment Questions:

1. Define Bills of Exchange. Explain its characteristics.
2. Define Promissory Note. Distinguish between Bills of Exchange and a Promissory Note.
3. Bring out various terms related to Bills of Exchange.

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Lesson 2

Bills of Exchange – Accommodation Bills

2.0 Objective:

After going through the lesson you will be able to understand the following:

1. Meaning and purpose of Accommodation bills
2. Differences between trade bills and accommodation bills
3. Method of writing entries and accounts

Structure:

2.1: Meaning and purpose of Accommodation Bills

2.2: Trade bill vs. Accommodation bill

2.3: Writing accommodation bill for one party purpose

2.4: Writing accommodation bill for mutual purpose

2.5: Writing of bills mutually and discount and share among themselves in agreed ratio

2.6: When bill is drawn for drawer (one party) purpose and drawer fails to send his part to drawee and makes new proposal

2.7: When two bill is drawn for mutual purpose and the drawee fails to honours thebill on due date, even though drawer sends his part

2.8: Try yourself

2.9: Summary

2.10: Glossary

2.11: Self Assessment Questions

2.1: Meaning and purpose of Accommodation Bills:

When two persons for the purpose of meeting temporary money problem act as drawer and drawee and prepare bill and discount at bank for accommodation is called ‘accommodation bill’.

Accommodation bill may be created for accommodation of one of the parties or for mutual accommodation.

In case the bill is created for the purpose of one party, usually he is the drawer of the bill. After getting the acceptance of the drawee, the drawer discounts the bill with the bank. On the due date he sends the amount due under the bill to the drawee to enable the drawee to meet the bill on maturity.

In case the bill is created for mutual purpose, the drawer has to send his part of the amount to the drawee before the due date. After receiving the amount, the drawee, adding his part of the money pays back the amount or honours the bill on due date.

Any bill can be called as accommodation bill, if it does not have the base of business transaction. Bank discounts trade bills easily. But while going for discounting accommodation bills, it considers the credit worthy ness and the financial position of the parties.

2.2: Trade bill vs. Accommodation bill:

The following are the major differences between a trade bill and an accommodation bill.

Trade bill	**Accommodation bill**
1.It comes into existence because of trade transaction i.e. buying or selling.	1. It comes into existence just to accommodate the party or parties.
2. It can either be discounted at the bank or kept with the drawer or endorse to third part.	2. It is created for the purpose of discounting.
3. The main purpose of trade bill is settlement of transaction.	3. The main purpose of this bill is Accommodation.
4. The drawer bears the discount charges.	4. Both parties share the discount proportionately.
5. These are desirable in view of business Transactions.	5. These bills may harm business activities.
6. Discounting of the bill is easy.	6. Discounting depends on the image and financial positions of the parties.

2.3: Writing accommodation bill for one party purpose:

When one party or person in need of money can request the other to accept a bill for accommodation. The needy person as drawer writes the bill on the other and gets his acceptance. Later, he gets the bills discounted and uses money for his own purpose. On the due date he sends money to the drawee to honour the bill. Then, the drawee pays money at the bank and thus honours the bill. In this case, the loss of discount, naturally borne by the drawer of the bill.

Illustration 1:

On 1st July 2007 Prakash for his own purpose wrote a three months bill on kiran fro Rs.6, 000 and got his acceptance. He discounted the bill with the bank at 5 %. Before the due date he sent the bill money to kiran and he honours it on the due date. Write journal entries in the books of Prakash and Kiran.

Solution:

Journal entries in the books of Prakash:

1-7-2007	Bills receivable A/C	Dr	6,000	
	To Kiran			6,000
	(Being accepted bill received from kiran)			
	Bank A/C	Dr	5,925	
	Discount A/C	Dr	75	
	To bills receivable			
	(Being bill discounted at 5%)			
4-10-2007	Kiran A/C	Dr	6,000	
	To Bank			6,000
	(Being cash sent to kiran to honour the bill)			

Journal entries in the books of Kiran:

1-7-2007	Prakash A/C	Dr	6,000	
	To bills payable			6,000
	(Being acceptance given)			
4-10-2007	Bank A/C	Dr	6,000	
	To Prakash			6,000
	(Being cash received from Prakash to honour the bill)			
4-10-2007	Bills payable A/C	Dr	6,000	
	To Bank			6,000
	(Being bill honoured)			

2.4: Writing accommodation bill for mutual purpose:

For mutual accommodation one person draws bill on the other and gets his acceptance. The drawer discounts the bill and both the persons in the agreed ratio will share the money. They also bear the discount in the same ratio. Before or on the due date the drawer sends his part of amount to the drawee to enable him to honour the bill. On the due date the drawee honours the bill with the amount sent by the drawer and with his contribution.

Illustration 2:

On 1st July 2007 Hariharan draws a 2 months bill on Girish for Rs.8, 000 for mutual accommodation. Girish sent his acceptance. Hariharan discounts the bill with the bank at 6% and sends 1/4th of the received amount to Girish. On the due date Hariharan sent his part amount to Girish and he in return honours the bill. Write necessary journal entries in the books of both the parties.

Solution:

Journal entries in the books of Hariharan:

1-7-2007	Bills receivable A/C	Dr	8,000	
	To Girish			8,000
	(Being accommodation bill drawn)			
	Bank A/C	Dr	7,920	
	Discount A/C	Dr	80	
	To Bills receivable			8,000
	(Being bill discounted at 6%)			
	Girish A/C	Dr	2,000	
	To bank			1,980
	To discount			20
	(Being 1/4th of the amount sent to Girish)			
4-9-2007	Girish A/C	Dr	6,000	
	To bank			6,000
	(Being amount sent to Girish to honour the bill)			

Journal entries in the books of Girish:

1-7-2007	Hariharan A/C	Dr	8,000	
	To bills payable			8,000
	(Being bill accepted for mutual accommodation)			
	Bank A/C	Dr	1,980	
	Discount A/C	Dr	20	
	To Hariharan			2,000
	(Being 1/4th of the bill amount received)			
4-9-2007	Bank A/C	Dr	6,000	
	To Hariharan			6,000
	(Being amount received from Hariharan)			
	Bills payable A/C	Dr	8,000	
	To Bank			8,000
	(Being the bill honoured on the due date)			

2.5: Writing of bills mutually and discount and share among themselves in agreed ratio:

In this method two persons for mutual accommodation purpose draw bills and get the acceptance reciprocally. The first person discounts the bill and sends the agreed amount to the second person. Similarly, the second person also does like this. Before the due date they send back the money taken earlier and the two bills honoured.

Illustration 3:

A and B agreed to draw bills for mutual accommodation. On 1st July 2007, A draws a 2 months bill for Rs.4, 000 on B and got his acceptance. He discounted the same in the bank at 6% and returned half the amount to B. Similarly, B draws a 2 months bill for Rs.7, 000 on A and got his acceptance. B discounted the bill with the bank at 6% and returned half the amount to A. Before the due date both the parties sent their part of the used amount and two bills are honoured on the due date. Write journal entries in the books of A and B.

Solution:

Journal entries in the books of A:

1-7-2007	Bills receivable A/C	Dr	4,000	
	To B			4,000
	(Being accepted bill received)			
	B's A/C	Dr	7,000	
	To bills payable			7,000
	(Being acceptance given to A's bill)			
	Bank A/C	Dr	3,960	
	Discount A/C	Dr	40	
	To bills receivable			4,000
	(Being bill discounted with bank at 6%)			
	B's A/C	Dr	2,000	
	To bank			1980
	To discount			20
	(Being half the bill amount sent to B)			
	Bank A/C	Dr	3,465	
	Discount A/C	Dr	35	
	To B's account			3,500
	(Being half the bill amount received from B)			
4-9-2007	Bank A/C	Dr	3,500	
	To B's account			3,500
	(Being B's share received for accepting the bill)			
	Bills payable A/C	Dr	7,000	
	To Bank			7,000
	(Being the bill honoured)			
	B's A/C	Dr	2,000	
	To Bank			2,000
	(Being A's share or used amount sent to B to honour his bill)			

Journal entries in the books of B:

1-72007	Bills receivable A/C	Dr	7,000	
	To A's account			7,000
	(Being acceptance received from A)			
	A's A/C	Dr	4,000	
	To bills payable			4,000
	(Being acceptance given for the bill drawn by A)			
	Bank A/C	Dr	6,930	
	Discount A/C	Dr	70	
	To bills receivable			7,000
	(Being bill discounted at 6%)			
	A's A/C	Dr	3,500	
	To bank			3,465
	To discount			35
	(Being half the amount sent to A)			
	Bank A/C	Dr	1980	
	Discount A/C	Dr	20	
	To A's account			2,000
	(Being half the bill amount received from A)			
	A's A/C	Dr	3,500	
	To bank			3,500
	(Being used amount sent to A)			
	Bills payable A/C	Dr	4,000	
	To Bank			4,000
	(Being accepted bill honoured)			

2.6: When bill is drawn for drawer (one party) purpose and drawer fails to send his part to drawee and makes new proposal:

In this circumstance, the drawee honours the bill and the earlier drawer including interest for the extended period accepts a new bill.

Illustration: 4:

On 1st July 2007 Usha draws a 4 months bill on Sita for Rs.4, 000 and got her acceptance. She discounted the bill immediately with the bank at 9 % interest. On the due date Usha failed to send the amount to Sita. However, Sita honours the bill. Usha agreed to pay Rs. 2,500 and accept a new bill for 3 months along with 12% interest. Sita accepted the proposal and the bill honoured on the due date. Write journal entries in the books of Usha and Sita.

Solution:

Journal entries in the books of Usha:

1-7-2007	Bills receivable A/C	Dr	4,000	
	To Sita			4,000
	(Being accepted bill received from Sita)			
	Bank A/C	Dr	3,880	
	Discount A/C	Dr	120	
	To bills receivable			4,000
	(Being bill discounted)			
4-11-2007	Interest A/C	Dr	45	
	To Sita			45
	(Being interest due to Usha for 3 months at 12%)			
	Sita A/C	Dr	4,045	
	To bank			2,500
	Bills payable			1,545
	(Being part amount paid and accepted for new bill with interest)			
7-2-2008	Bills payable A/C	Dr	1,545	
	To bank			1,545
	(Being the bill honoured on the due date)			

Journal entries in the books of Sita:

1-7-2007	Usha A/C	Dr	4,000	
	To bills payable			4,000
	(Being bill accepted)			
4-11-2007	Bills payable A/C	Dr	4,000	
	To bank			4,000
	(Being accepted bill honoured)			
	Usha A/C	Dr	45	
	To Interest			45
	(Being interest due on 1500 at 12% for 3 months)			
	Bank A/C	Dr	2,500	
	Bills receivable	Dr	1,545	
	To Usha			4,045
	(Being part amount and a new bill received from Usha with interest)			
7-2-2008	Bank A/C	Dr	1,545	
	To bills receivable			1,545
	(Being amount received on due date)			

2.7: When two bill is drawn for mutual purpose and the drawee fails to honours the bill on due date, even though drawer sends his part:

In this case the drawee that dishonours the bill has to pay noting charges to the bank.

Illustration: 5:

On 1st January 2007 for mutual accommodation, Sharma draws a bill on Shastri for Rs.12, 000 a 4 months bill and got his acceptance. On the same day Sharma discounted the bill with the bank at 9% and given 1/3rd of the bill amount to Shastri. On the due date Sharma sent his part of the amount to Shastri to enable him to honour the bill. But Shastri failed to honour the bill and bank chaged Rs. 30 towards noting charges. Pass journal entries in the books of Sharma and Shastri.

Solution:

Journal entries in the books of Sharma:

1-1-2007	Bills receivable A/C	Dr	12,000	
	To Shastri			12,000
	(Being accepted bill received)			
	Bank A/C	Dr	11,640	
	Discount A/C	Dr	360	
	To Bills receivable			12,000
	(Being bill discounted at 9%)			
	Shastri A/C	Dr	4,000	
	To Bank			3,880
	To Discount			120
	(Being 1/3rd of the amount sent to Shastri)			
4-5-2007	Shastri A/C	Dr	8,000	
	To bank			8,000
	(Being 2/3rd of bill amount sent to Shastri to honour the bill)			
	Shastri A/C	Dr	12,030	
	To bank			12,030
	(Being amount paid to bank with noting charges as Shastri dishonours the bill)			

Journal entries in the books of Shastri:

1-1-2007	Sharma A/C	Dr	12,000	
	To bills payable			12,000
	(Being bill accepted)			
	Bank A/C	Dr	3,880	
	Discount A/C	Dr	120	

	To Sharma			4,000
	(Being 1/3rd of bill amount received)			
4-5-2007	Bank A/C	Dr	8,000	
	To Sharma			8,000
	(Being 2/3rd of the bill amount received for honouring the bill)			
	Bills payable A/C	Dr	12, 000	
	To Sharma			12,000
	(Being bill dishonoured)			
	Noting Charges A/C	Dr	30	
	To Sharma			30
	(Being noting charges payable to Sharma)			

Illustration 6:

On 1st July 2007 Arjunarao and Apparao have decided to share the proceeds of an accommodation bill in 4:7 ratio respectively after discounting it. Arjunarao draws a 3 months bill for Rs.3, 410 on Apparao. After getting his acceptance Arjunarao discounted the bill with the bank for Rs.3,300 and send to Apparao the agreed amount. On the due date, Arjunarao failed to send the used amount to Apparao. Even then Apparao honoured the bill. Later, Arjunarao accepted a bill drawn by Apparao for the due amount for three months including an interest of Rs.90. On the due date the bill is honoured. Write journal entries in the books of both the parties.

Solution:

Journal entries in the books of Arjunarao:

1-7-2007	Bills receivable A/C	Dr	3,410	
	To Apparao		3,410	
	(Being the accepted bill received from Apparao)			
	Bank A/C	Dr	3,300	
	Discount A/C	Dr	110	
	To bills payable			3,410
	(Being bill discounted with the bank)			
	Apparao A/C	Dr	2,170	
	To bank			2,100
	To discount			70
	(Being 7/11th part sent to Apparao)			
4-10-2007	Apparao A/C	Dr	1,240	
	Interest A/C	Dr	90	
	To bills payable			1,330
	(Being new bill accepted with interest)			
7-1-2008	Bills payable A/C	Dr	1,330	

	To bank			1,330
	(Being the bill honoured)			

Journal entries in the books of Apparao:

1-7-2007	Arjunarao A/C	Dr	3,410	
	To bills payable			3,410
	(Being bill accepted drawn by Arjunarao)			
	Bank A/C	Dr	2,100	
	Discount A/C	Dr	70	
	To Arjunarao			2,170
	(Being 7/11th of the share received)			
4-10-2007	Bills payable A/C	Dr	3,410	
	To bank			3,410
	(Being bill honoured on due date)			
	Bills receivable A/C	Dr	1,330	
	To Arjunarao			1,240
	To interest			90
	(Being new bill received with interest)			
7-1-2008	Bank A/C	Dr	1,330	
	To bills receivable			1,330
	(Being bill amount received on due date)			

Illustration 7:

On March 1st 2007 Jayapal draws a 4 months bill for mutual accommodation on Mahipal for Rs.15, 200 and got his acceptance. Jayapal discounted the bill with the bank for Rs.15, 000 and sent 3/5th of the amount to Mahipal. On the due date Mahipal honoured the bill despite Jayapal's failure to return his part of the amount. Jayapal accepted a new bill drawn by Mahipal for 3 months adding to the due an interest of Rs.100. Mahipal, after receiving the bill discounted with the bank for Rs.70 less. Before the due date of the bill, Jayapal declared insolvent. Mahipal received 20 % per cent dividend from Jayapal in full settlement. Write journal entries in the books of both the parties and record in ledger books.

Solution:

Journal entries in the books of Jayapal:

1-3-2007	Bills receivable A/C	Dr	15,200	
	To Jayapal			15,200
	(Being accepted bill received)			
	Bank A/C	Dr	15,000	
	Discount A/C	Dr	200	

	To bills receivable			15,200
	(Being bill discounted)			
	Mahipal A/C	Dr	9,120	
	To bank			9,000
	To discount			120
	(Being 3/5th of the bill amount sent to Mahipal)			
4-7-2007	Mahipal A/C	Dr	6,080	
	Interest A/C	Dr	100	
	To Bills payable			6,180
	(Being new bill accepted with interest)			
7-10-2007	Bills payable A/C	Dr	6,180	
	To Mahipal			6,180
	(Being bill dishonoured)			
	Mahipal A/C	Dr	6,180	
	To Bank			1,236
	To discount			4,944
	(Being 20 paise in a rupee paid and settle the account)			

Mahipal Account

1-3-2007	To Bank	9,000	1-3-2007	By Bills receivable	15,200
	To Discount	120	7-10-2007	By Bills payable	6,180
4-7-2007	To Bills payable	6,080			
7-10-2007	To Balance C/D	6,180			
		21,380			**21,380**
	To Bank	1,236		By Balance B/D	6,180
	To Deficit	4,944			
		6,180			**6,180**

Journal entries in the books of Mahipal:

1-3-2007	Jayapal A/C	Dr	15,200	
	To bills payable			15,200
	(Being bill accepted)			
	Bank A/C	Dr	9,000	
	Discount A/C	Dr	120	
	Jayapal			9,120
	(Being 3/5th of the bill amount received)			
4-7-2007	Bills payable A/C	Dr	15,200	
	To bank			15,200

	(Being bill honoured)			
	Bills receivable A/C	Dr	6,180	
	To Jayapal			6,080
	To interest			100
	(Being new bill received with interest)			
	Bank A/C	Dr	6,110	
	Discount A/C	Dr	70	
	To Bills receivable			6,180
	(Being bill discounted with the bank)			
7-10-2007	Jayapal A/C	Dr	6,180	
	To bank			6,180
	(Being amount paid to bank as bill dishonoured by Jayapal)			
	Bank A/C	Dr	1,236	
	Bad debts A/C	Dr	4,944	
	To Jayapal			6,180
	(Being 20 paise in a rupee received in full settlement)			

Mahipal Account

1-3-2007	To Bills payable	15,200	1-3-2007	By Bank	9,000
7-10-2007	To Bank	6,180		By Discount	120
				By Bills receivable	6, 080
				By Balance C/D	6,180
		21,380			**21,380**
	To Balance B/D	6,180		By Bank	1,236
				By Bad debts	4,944
		6,180			**6,180**

2.8: Try yourself:

1. On 1st April 2007 Mahesh and Dinesh draw 3 months bills of Rs.3000 each for mutual accommodation and sent their acceptances reciprocally. They have discounted the bills at 8% and used the proceeds themselves. On the due date both of them honoured the bills. Write journal entries in the books of both the parties.
2. On 1st July 2007 Salim for accommodation purpose wrote a 3 months bill on Syed for Rs. 2500 and got his acceptance. They have agreed to share the amount in 3.2 ratio respectively. Salim discounted the bill at 12 % and send the agreed amount to Syed. Before the due date, to honour the bill, Syed draws a 3 months bill on Salim for Rs. 5000 and Salim accepted the bill. Syed discounted the bill for Rs.4, 925 and after honouring the bill sent the remaining amount as per the agreement sent to Salim. On the due date of the second bill Syed became insolvent, and Salim honours the bill. 30 paise in a rupee is the dividend received by Salim from Syed. Write the required journal entries in the books of both the parties and enter in ledger books.

3. On 1st May 2007 A drew and B accepted a bill at three months for Rs.2000. On 4th May 2007 A discounted the bill at his bank for 6 per cent per annum and remitted half the proceeds by cheque to B. On 1st June 2007 B drew and A accepted a bill at three months for Rs.500. On 4th June 2007 B discounted the bill with his bank at 6% per annum and remitted half the proceeds to A. A and B agreed to share the discounts equally. At maturity A met his acceptance but B failed to meet his and A, therefore, had to pay it. A then drew and B accepted a new bill at three months for the amount of the original bill plus Rs.30 for interest. On 1st November 2007, B became insolvent and paid to his creditors 50 paise in a rupee in full settlement. Write journal entries in the books of A and B.

4. X, for mutual and temporary accommodation of himself and Y; draws upon the latter a bill of exchange at three months for Rs.1, 800 dated 1st January 1980. Y accepts the bill and sends it to X. X discounts the bill immediately at his bank, the rate of discount being 6% per annum and hands over half the proceeds to Y. Y for a similar purpose and at the same time draws a bill at three months on X for Rs.900. X accepts the bill. Y discounts the bill at 6% per annum and hands over half the proceeds to X. Y becomes insolvent on 31st March2007 and as such fails to meet his acceptance on maturity. On 30th June 2007, a first and final dividend of 25 paise in the rupee was paid out of his estate in settlement of his dues.

   Write up the Journal entries in the books of X and Y.

2.9: Summary:

For temporary adjustment and without any business dealings, when two persons draw and accept bills are called accommodation bills. These are to be discounted with the banks compulsorily. When bills are discounted with banks, discounts will also be shared in the ratio of the share of the proceeds. The person that draws the bill has to send the used amount to the drawee on the due date enabling him to honour the bill.

Accommodation bills are not natural bills or created based on business transactions. Generally, banks do not accept for discounting these bills. These are not acceptable for commerce environment.

2.10: Glossary:

Accommodation bills: Bills for the purpose of mere accommodation are called accommodation bills. These are not related to any business transaction. They are just a creation for mutual purpose.

2.11: Self Assessment Questions:

1. What is an accommodation bill? Explain its purpose?

2. Distinguish between a trade bill and an accommodation bill.

Dr.R.Jayaprakash Reddy.

Lesson 3

Consignment Accounts

3.0 Objective

After going through this lesson you will be able to understand

1. Consignment meaning and method of business
2. Distinction between consignment and sales
3. Important terms in consignment
4. Method of writing entries and preparing accounts
5. Valuation of closing stock and losses
6. Proforma invoice and memorandum method of consignment business.

Structure:

3.1: Consignment – Meaning
3.2: Consignment vs. Sales
3.3: Consignment – Important terms
3.4: Books of Consignor
3.5: Books of Consignee
3.6: Valuation of Closing Stock
3.7: Loss of Stock in Consignment
3.7.1: Normal Loss
3.7.2: Abnormal Loss
3.7.3: Loss of Goods Insured
3.8: Proforma Invoice Price
3.9: Memorandum Column Method
3.10: Try Yourself
3.11: Summary
3.12: Glossary
3.13: Self Assessment Questions

3.1: Consignment – Meaning:

When a manufacturer or the wholesaler wants to sell goods in far away places, sends goods to agents and ask them to sell goods on his behalf. The person sending goods are called as consignor, and the agent or the person selling goods on the behalf of the consignor is called as consignee. The whole process is called consignment business. Sending goods is called sending on consignment. When goods are sent to Hyderabad, it is called as Hyderabad consignment.

3.2: Consignment vs. Sales:

There are differences between consignment and sales. They are as follows:

Consignment	**Sales**
1.Consigner and consignee are parties in Consignment.	1. Seller and Buyer are parties in sales.
2. There is owner and agent relationship between consignor and consignee.	2. There is creditor and debtor relation-Ship between seller and buyer.
3. Though goods are sent on consignment, ownership on goods lies with the consignor.	3. When goods are sold, ownership Transfers from seller to buyer.
4. Consignee can return goods to consignor at any time.	4. Unless there is agreement, once sold Goods cannot be taken back.
5. Consignee gets remuneration in the form of Commission.	5. In sale deed seller gets profit or loss.
6. Consignor has to bear for any loss or damage.	6.Once sale is over, seller is not responsible for any loss or damage.
7. Consignee collects all expenses from the consignor relating to consignment.	7.Expenses after sales should be borne By the buyer only.
8. After a specific period consignee sends Account of sales to the consignor.	8. No account sales required here.
9. Sometimes consignor sends goods on proforma invoice basis.	9. Seller sells at general invoice.

3.3: Consignment – Important terms:

1. **Account Sales:** It is a practical statement prepared by the consignee consisting of – details of goods received, sales made, expenses incurred, commission charged, remittances made, and balances due by him to the consignor. The consignee often submits this statement to the consignor to reveal the current position.
2. **Proforma Invoice:** Sometimes consignor sends goods to consignee on proforma invoice. Like ordinary invoice, it is a price fixed by the consignor. But it naturally is higher than the invoice price. However, Consignor records goods at their actual price in his books. Sending goods on proforma basis helps the consignor to sell the goods not less than a minimum price.
3. **Expenses:** Consignment expenses can be divided into two categories direct and indirect. *Direct expenses* are incurred for placing the goods in a saleable condition. All expenses till the goods reach the godown of the consignee come in this category. These expenses are of a non-recurring nature and increase the value of goods. Examples of such expenses are freight, carriage, insurance, loading and unloading charges etc. Indirect expenses incurred after the goods reach the consignee's godown. They are of a recurring nature

and do not increase the value of goods. Examples of such expenses are godown rent, storage charges, advertisement expenses, salaries of salesmen, etc.

The distinction between direct and indirect expenses is of special importance at the time of the valuation of the unsold stock. Direct expenses form a part of the cost and, therefore, a proportion of such expenses is included in the cost of stock, while the indirect expenses do not form part of the cost and, therefore, excluded while valuing the unsold stock.

4. **Commission:** It is the remuneration payable to the consignee for sale made by him. This can be simple, over-riding and del-credre. *Simple commission* is calculated as per terms laid down by the consignor. Usually this is a fixed percentage on total sales. In order to give further incentive, sometimes an extra commission termed as *over-riding commission* is allowed to consignee, in case the sales exceed a specified amount. It is also calculated on total sales. Where the consignee agrees to meet any loss, which the consignor may suffer by reason of bad debts, one more extra commission as *del-credre commission* is given to consignee. This is normally calculated on total sales.
5. **Advance:** The consignor may ask the consignee to deposit some money with him to be kept by him as security in respect of the goods sent by him on consignment. It is usually a certain percentage of the value of goods sent on consignment.

3.4: Books of Consignor:

To know profits or losses on each consignment, consignor opens separate accounts for each consignment. On debit side of the consignment account – the cost of goods sent on consignment, expenses incurred by the consignor and consignee and consignee commission are to be recorded. On credit side of the account - sales of the consignee and closing stock if any need to be shown. The excess of credit over debit will give profit on consignment.

Consignee personal account needs to be opened in consignor books. As consignee is not a debtor to the consignor, when goods sent on consignment they shall not be debited to his account. The sales of consignment are to be debited to his account and consignee advance, expenses and commission are to be credited. The debit balance of the consignee account is the amount to be given to the consignee.

Journal entries:

The following are the entries required in the books of consignor relating to consignment.

1. When goods are sent on consignment:

    Consignment A/C Dr

        To Goods sent on consignment

2. For expenses incurred:

    Consignment A/C Dr

        To bank

3. When cash or bill received from consignee as advance:

Bank/Bills receivable A/C Dr

To consignee

After receiving account sales,

4. For sales made by consignee:

Consignee A/C Dr

To Consignment

5. For expenses incurred by the consignee:

Consignment A/C Dr

To consignee

6. For transferring profit on consignment to profit & loss account:

Consignment A/C Dr

To P & L A/C

7. For transferring loss on consignment to profit & loss account:

P &L A/C Dr

To Consignment

8. When the amount receivable from consignee received:

Bank A/C Dr

To consignee

9.When goods sent on consignment transferred to Trading account treating them as sales:

Goods sent on consignment A/C Dr

To Trading account

3.5: Books of Consignee:

As consignee do not hold any propriety rights on goods received from consignment, he need not write any entries when he receives goods and for consingnor expenses. He writes entries for accepting bill drawn by the consignor or cash sent by him, expenses incurred and commission earned.

Journal entries:

The following are the entries to be written in the books of consignee:

1. When goods received on consignment:

No Entry

2. For expenses incurred by consignor:

No Entry

3. Bill accepted or cash paid as advance:

Consignor A/C Dr

To Bills payable/Cash

4. For expenses incurred by consignee:

Consignor A/C	Dr		
To bank			

5. For cash sales

Bank A/C	Dr		
To Consignor			

6. For credit sales

Debtors A/C	Dr		
To Consignor			

7. For commission earned:

Consignor A/C	Dr		
To commission			

8. For remitting bill or cash due to consignor:

Consignor A/C	Dr		
To bank/bills payable			

To know much about journal entries, consignment account and consignee account in consignor books and journal entries and consignor account in consignee books, let us observe some illustrations.

Illustration 1:

Raman & Co of Waltair sent 50 cases of goods at Rs.200 each to Nadhan & Co of Mumbai on consignment. Consignor paid insurance Rs.200 and travel expenses Rs.300.

As per the account sales received from Nadhan & co., sales are Rs.14, 000, carriage Rs.80, godown rent Rs.100, and freight charges Rs.20. Consignee gets a commission of 3 % on sales. Consignee sents cheque to the consignor for the amount due.

Write journal entries in the books of Raman & Co. and Nadhan & Co and Nadhan & Co account in Raman & Co. and vice versa.

Solution:

Journal entries in the books of Raman & Co:

1. Consignment A/C	Dr	10,000	
To goods sent on consignment			10,000
(Being goods sent on consignment)			
2. Consignment A/C	Dr	500	
To Bank			500
(Being expenses paid)			
3. Nadhan & Co. A/C	Dr	14,000	

To consignment A/C			14,000
(Being sales made as per the account sales)			
4. Consignment A/C	Dr	200	
To Nadhan & Co.			200
(Being expenses paid by the consignee)			
5. Consignment A/C	Dr	420	
To Nadhan & Co.			420
(Being commission at 3% to be paid to the consignee)			
6. Consignment A/C	Dr	2,880	
To P & L A/C			2,880
7. Bank A/C	Dr	13,080	
To Nadhan & Co.			13,080
(Being the due amount received from consignee)			

Mumbai consignment Account

To Goods sent on consignment	10,000	By Nadhan & Co.- sales	14,000
To Bank – expenses	500		
To Nadhan & Co.- expenses	200		
To Nadhan & Co.- commission 3%	420		
To P & L A/C	2,880		
	14,000		**14,000**

Nadhan & Co. Account

To Consignment account	14,000	By Consingment A/C- expenses	500
		By Consignment A/C-commission	420
		By Bank	13,080
	14,000		**14,000**

Journal entries in the books of Nadhan & Co:

1. Raman & Co. A/C	Dr	500	
To bank			500
(Being expenses paid)			
2. Bank A/C	Dr	14,000	
To Raman & Co.			14,000
(Being goods sold on cash)			
3. Raman & Co. A/C	Dr	420	

To commission			420
(Being commission receivable)			
4. Raman & Co. A/C	Dr	13,080	
To bank			13,080
(Being cheque sent to consignor)			

Raman & Co.

To Bank – expenses	500	By Bank – sales	14,000
To Commission	420		
To Bank	13,080		
	14,000		**14,000**

3.6: Valuation of Closing Stock:

By the time account sales are prepared if all the goods received on consignment sold, there won't be any closing stock. But when there is closing stock, its cost should be calculated. While calculating stock, the value of stock and also the expenditure, which adds value, shall be taken into consideration. Transport expenses, customs duty, port duty, transport insurance, expenses of loading and unloading etc., add the value of goods. Therefore, while calculating stock they should be taken proportionately. These non-recurring expenses shall be taken into consideration, irrespective of whether paid by the consignor or consignee. Godown rent, godown insurance premium, advertising expenses, sales personnel salaries, etc., do not add the value to the goods. These are to be excluded while calculating closing stock.

Consignor expenses and expenses up to goods reaching godown adds value to the goods. However, when consignee expenses are not given separately, they will be treated as sales expenses and should not be added to closing stock. The closing stock should be shown on credit side of the consignment account.

Illustration 2:

A consignor from Cochin sends 10,000 boxes of goods to a consignee at Colombo. Their cost of purchase is Rs.18, 000. The expenses paid by the consignor are –freight Rs. 2,000, ocean insurance Rs. 800, transport Rs. 900.

As per the account sales of consignee, 6,000 boxes are sold for Rs.17, 200. The consignee paid this expenses- carriage to godown Rs. 150, import duty Rs. 450, carriage up to godown of the purchaser Rs.500, sales expenses Rs.50. Consignee commission Rs. 1,080. Write consignment account in the books of consignor and ascertain profit.

Solution:

Colombo Consignment Account

To Goods sent on consignment	18,000	By Consignee – Sales		17,200
To Bank- expenses:		By Stock at consignment	8,920	

Freight	2,000		
Insurance	800		
Transport	900	3,700	
To Consignee – expenses:			
Carriage	150		
Import duty	450		
Carriage	500		
Sales exp.	50	1,150	
To Consignee – Commission		1,080	
To P & L A/C – Profit		2,190	
		26,120	**26,120**

Closing Stock:			
Original cost of remaining 4,000 boxes (18,000/10,000x4, 000)			7,200
Add: Proportionate expenditure of consignor (3600/10,000x4000)			1,420
Add: Carriage to godown	150		
Import duty	450	600 (600/10000x4000)	240
			8,920

Note: The carriage up to purchaser godown and selling expenses do not increase the value of stock. Therefore, these should not be included in closing stock.

Illustration 3:

Rajkumar of Mumbai sent Rs.1, 29,000 worth of 140 cases to Velayudhan of Cochin. Velayudhan gets a commission of 5 % on sales and 2% del credre commission.

In Mumbai Rajkumar paid freight Rs.200, loading charging Rs. 210, insurance Rs.3, 290 and other expenses Rs. 40.

Velayudhan sold all 140 cases at Rs.1500 each. Bad debts appeared Rs. 4,310. The expenses paid by Velayudhan are unloading expenses Rs.470, godown rent Rs.1, 300 and packing and sales expenses Rs.1, 580.

Write journal entries and ledger accounts in the books of Rajkumar.

Solution:

Journal entries in the books of Rajkumar:

1. Consignment A/C	Dr	1,29,000	
To Goods sent on consignment			1,29,000
(Being 140 cases of goods sent on consignment)			
2. Consignment A/C	Dr	3,740	

To bank			3,740
(Being various expenses paid)			
3. Velayudhan A/C	Dr	2,10,000	
To Consignment			2.10,000
(Being sales made by consignee)			
4. Consignment A/C	Dr	3,350	
To Velayudhan			3,350
(Being expenses met by consignee)			
5. Consignment A/C	Dr	14,700	
To Velayudhan			14,700
(Being commission payable to consignee)			
6. Consignment A/C	Dr	59,210	
To P & L A/C			59,210
(Being profit on consignment transferred to p&l account)			

Cochin consignment Account

To Goods sent on consignment	1,29,000	B Velayudhan – sales	2,10,000
To Bank – expenses	3,740		
To Velayudhan – expenses	3,350		
To Velayudhan – commission@ 7%	14,700		
To P & L A/C – profit	59,210		
	2,10,000		**2,10,000**

Velayudhan Account

To Consignment account – sales	2,10,000	By Cosnsignment – expenses	3,350
		ByConsignment–commission	14,700
		By Balance C/D	1,91,950
	2,10,000		**2,10,000**
To Balance B/D	1,91,950		

3.7: Loss of Stock in Consignment:

While sending goods to consignee, goods may be subjected to fire accident, theft, damage, leakage etc in transit and that leads to loss to the consignor. Similarly, while downloading or at godown some damage may occur to the goods while they are in the control of consignee. These losses can be divided in two categories: one normal loss and the other abnormal loss.

3.7.1: Normal Loss:

In some situations, loss of stock is inevitable. Depending on the nature of stock, there occurs some depreciation while in transit or while in stock. This is called normal loss. For example, when coal is sent on consignment, it is natural that some part of coal becomes ash while it is loading and unloading. This is a normal loss, and nobody can avoid this. For normal loss, no special entry is required. It reflects in sales automatically. While calculating closing stock, the net stock with the consignee needs to be taken into consideration.

Illustration 4:

On June 1st 2007 Coal company pvt. Ltd. sent 2000 Kgs. of coal at Rs.7.50 per kg. On consignment to Sales company ltd. Transport expenses being Rs.2 per Kg. On June 25th Sales company ltd, send account sales. According to it - sales are 1000 tons at Rs.16 each, sales expenses Rs.880, insurance Rs.120, brokerage 14% and commission 21/2%. Consignee while sending the bill for the amount due informed the consignor that 40 kgs of coal is depreciated. Write Consignment account and consignee account in the books of consignor.

Solution:

Consignment Account

To Goods sent on consignment (2,000x7.50)	15,000	By Sales company ltd.	16,000
To Bank – expenses	4,000	By Consignment stock	9,306
To Sales company ltd- expenses	1,000		
To Sales company ltd-commission (14% + 21/2% = 161/2%)	2,640		
To P & L A/C – Profit	2,666		
	25,306		**25,306**

Sales company ltd Account

To Consignment Account	16,000	By Consignment A/C – expenses	1,000
		By Cosingment A/C - commission	2,640
		By bills receivble	12,360
	16,000		**16,000**

Closing stock = (goods on consignment+ consignor expenses)/(goods reached to consignee – depreciation) x closing stock

= (15,000+4,000)/(2000-40) x960 = 9,306.

3.7.2: Abnormal Loss:

Some losses occur due to accidents or negligence. Loss of goods in accident and theft come under abnormal loss category. This type of loss is not normal loss and does not occur often. This does not show impact on the value of goods. Therefore, it is to be debited to profit &

loss account and credited to consignment account. Otherwise, the profit on consignment looks less. The calculation of abnormal loss should be like the stock that is remaining. The following journal entry is required for abnormal loss:

Profit & Loss A/C Dr

To Consignment

Illustration 5:

Pratap & Co. of Delhi sent 1000 cycles of Rs.500 each to Manian of Ceylon on consignment. It paid Rs. 12,000 for freight. In transit 100 cycles are damaged and they are thrown into the sea. Manian took the delivery of remaining cycles after paying Rs.15, 000 towards customs duty.

Manian sent Rs.3, 00,000 to Pratap & Co. as advance in the form of bank draft. He showed that 800 cycles are sold for Rs.750 each. He paid Rs.3, 000 towards godown rent and advertisements. A credit sale relating to 5 cycles is not received. Manian cleared his account immediately. Prepare consignment account, Manian account and Profit and Loss Account in the books of Pratap & Co.

Solution:

Books of Pratap & Co.

Ceylon Consignment Account

To Goods sent on consignment (1000 X 500)	5,00,000	By Manian A/C- Sales (800X750)	6,00,000
To Bank – expenses	12,000	By P & L A/C – Abnormal Loss.	51,200
To Manian A/C – expenses	18,000		
To Manian A/C- commission	30,000	By Closing stock	52,867
To Manian A/C- bad debts	3,750		
To P & L A/C	1,40,317		
	7,04,067		**7,04,067**

Manian Account

To Consignment – sales	6,00,000	By Bank – advance	3,00,000
		By Consignment – expenses	18,000
		By Consignment – commission	30,000
		By Consignment – bad debts	3,750
		By Bank – full settlement	2,48,250
	6,00,000		**6,00,000**

Profit and Loss Account

To Consignment A/C	51,200	By Consignment	1,40,317

Goods sent on Consignment

To Trading A/C	5,00,000	By Consignment	5,00,000

Calculation of closing stock:

Cycles sent	1,000		
Less: lost	100		
Sold	800		
Remaining	100		
Cost of 100 cycles 100 x 500	50,000		
Proportionate expenses of consignor (100 x 1200/1000)			1,200
Proportionate expenses of consignee			
For 900 cycles	15,000		
For 100 cycles 100/900 x 15,000		1,667	
		52,867	

Calculation of abnormal loss:

Cost of 100 cycles	50,000
Add: Proportionate expenses of Consignor	1,200
	51,200

Note: As there is no del credre commission, the bad debts are to be borne by the consignor only. That is why bad debts are treated as loss and debited to consignment account and credited to consignee account to reduce his payable amount. If there were del credre commission, there would have been no entry in consignment account.

3.7.3: Loss of goods insured:

If goods are insured, the loss will be borne by the insurance company. The amount to be receivable from the insurance company is to be credited to consignment account. The following entry is to be passed:

Insurance claim A/C Dr

Or

Abnormal A/C Dr

To Consignment

When cash comes from insurance company, bank account need to be debited and insurance claim account or abnormal account to be credited. If the insurance company pays only part of the loss, the remaining loss to be debited to profit and loss account. In case the insurance amount is more than the loss, the difference is to be credited to profit and loss account.

Illustration 6:

On April1 2007 Rajani sent 40,000 kgs of castor oil at Rs.2 per kg. to Chakri on consignment. Rajani paid Rs. 10,000 for insurance. 50 kgs. of goods are lost in transit in an accident and Rajani received Rs.900 from the insurance company.

Chakri after receiving the delivery accepted a 3 months bill for Rs.20, 000. On 30th June, Chakri sent an account sales mentioning that he sold castor oil of 35,000 kgs at Rs.3 per kg. He paid Rs.400 towards godown rent, Rs. 2,000 towards advertisements, and Rs. 4,000 towards salesmen salaries.

Chakri is eligible for 3 % commission and 3 more percent of del credre commission. Neelakumari, a customer who purchased for Rs.19, 000 became insolvent and only 50 paise collected from her in full settlement. Prepare necessary accounts in the books of both the parties assuming that the consignee sent the draft to the consignor for the amount due

Solution:

Books of Rajani

Consignment Account

To Goods sent on consignment	80,000	By Chakri – sales	1,05,000
To Bank – expenses	10,000	By Chakri – sales	19,000
To Chakri – expenses	6,400	By Insurance claim – bank	900
To Chakri – commission	7,440	By P & L A/C – Ab. Loss.	225
1,25,125		**1,25,125**	

Chakri Account

To Consignment account	1,24,000	By Bills receivable	20,000
		By Consignment A/C	6,400
		By Consignment A/C	7,440
		By Bank	90,160
	1,24,000		**1,24,000**

Goods sent on consignment Account

To Trading Account	80,000	By Consignment A/C	80,000
	80,000		**80,000**

Calculation of abnormal loss:

Cost of 50 Kgs.	1,000
Add: proportionate expenses	125

(10,000x5000/40,000)

	1,125
Less: Amount received from Insurance Co.	900
	225

Books of Chakri

Rajani Account

To Bills payable	20,000	By Bank – sales	1,05,000
To Bank – expenses	6,400	By Neelakumari –sales	19,000
To Commission	7,440		
To Bank	90,160		
	1,24,000		**1,24,000**

Neelakumari Account

To Rajani account	19,000	By Bank	9,500
		By bad debts	9,500
	19,000		**19,000**

Calculation of commission:

6% on 1,05,000	6,300
6% on 19,000	1,140
	7,440

Note: As there is del credre commission, consignor does not have any relation with bad debts.

3.8: Proforma Invoice Price:

In certain situations, consignor sends goods to consignee showing higher prices than the cost price. This may be sale price or near sale price. It is called as proforma invoice price. The main purpose of this method is to make the consignee not aware of the actual profit on the consignment. In fact, this price does not show any difference in profit or loss of the business. However, while writing journal entries, there are certain differences. These differences appear only in writing journal entries relating to goods sent on consignment.

Journal entries:

1.When goods sent on consignment:

Consignment A/C Dr

To goods sent on consignment

2.To reduce the invoice price to the cost price level:

Goods sent on consignment A/C Dr

To consignment

3.When there is closing stock:

Stock on consignment A/C Dr

To consignment A/C

4. To reduce the invoice price on the closing stock:

Consignment A/C Dr

To Reserve on stock on consignment/suspense account

Except the above, there won't be any changes either in consignor books or in consignee books.

Illustration 7:

On 1st July 2007 Mahesh of Delhi sent goods on consignment to Ramesh of Hyderabad at invoice price of Rs. 3,750 whose cost was Rs.3, 000. He paid freight charges Rs.250 and draws a bill on Ramesh for Rs.1500. Ramesh sold 3/4ths of the stock for Rs.3, 500. He paid for expenses Rs.300. He is eligible for a commission of 6% on sales. He sent a draft to Mahesh for the amount due. Show ledger accounts in the books of Mahesh.

Solution:

Books of Mahesh

Hyderabad Consignment Account

To Goods sent on consignment	3,750	By Ramesh – sales	3,500
To Bank – expenses	250	By Goods sent on consignment	750
To Ramesh – expenses	300	By Stock on consignment	1,000
To Ramesh – commission	210		
To Reserve on stock on consignment	188		
To P & L A/C – Profit	552		
	5,250		**5,250**

Ramesh Account

To Consignment A/C	3,500	By Bills receivable	1,500
		By Consignment A/C	300
		By Consignment A/C	210
		By Bank	1,490
	3,500		**3,500**

Goods sent on consignment

To Consignment A/C	750	By Consignment A/C	3,750
To Trading A/C	3,000		
	3,750		**3,750**

Closing Stock:

Goods sent on invoice prices	3,750
Add: consignor expenses	250

Value of stock	4,000	
Remaining stock after sales 1/4th	1,000	
Reserve on closing stock:		
Excess of invoice over cost price (3,750-3,000)		750
Remaining stock 1/4th (750 x ¼)		188

3.9: Memorandum Column Method:

Instead of showing invoice price and reducing it to the original price, a separate column can also be shown in consignment account to show invoice price. This is called as memorandum column method. This invoice column is useful for information purpose. There won't be any difference in profit or loss of consignment in this method also.

Let us solve the above problem under this method.

Books of Mahesh

Hyderabad Consignment Account

Particulars	Memorandum	Cash	Particulars	Memorandum	Cash
To Goods sent on congnt.	3,750	3,000	By Ramesh	3,500	3,500
To Bank – expenses	250	250	By Closing stock	1,000	812
To Ramesh – expenses	300	300	By Loss	10	
To Ramesh – commission	210	210			
To P & L A/C		552			
	4,510	**4,312**		**4,510**	**4,312**

Goods sent on consignment Account

To Trading Account	3,750	3,000	By Consignment A/C	3,750	3,000
	3,750	**3,000**		**3,750**	**3,000**

3.10: Try yourself:

1. On 1st April 2007, Aditya Mills Ltd. Delhi consigns 500 pieces of shirting costing Rs.5, 000 to Birla Stores, Mumbai. The consignee is entitles to 5% selling commission and 1% del credre commission.

The consignor incurred following expenses:

Carriage	Rs.200
Insurance	Rs.100
Freight	Rs.150

Aditya Mills Ltd. draws a bill of exchange for Rs. 2,000 on Birla stores, Mumbai, which was duly accepted by them. It is discounted for Rs. 1,950.

On 31st May 2007, Birla Stores send the Account Sales, which shows that they have sold goods for Rs.7, 500, and paid expenses amounting to Rs.150. Stock in consignee's hands on 31st May 2007 is valued at Rs.1, 500.

Birla Stores enclose a sight draft with the Account Sales, for the net amount due to Aditya Mils Ltd. Give journal entries and ledger accounts in the books of the consignor.

(Profit on consignment Rs. 2,950)

2. G. Mehta consigns 100 radiograms to H.Singh. Each radiogram costs Rs.800. G. Mehta pays the following expenses:

Freight	Rs.1, 000
Insurance	400
Carriage	500

H.Singh pays the following expenses:

Customs duty	2,000
Dock dues	500
Godown rent	500
Salary to salesman	300

At the end of the year 25 radiograms remained with H. Singh. The market value of each radiogram is Rs.850. You are required to calculate the value of stock lying with H. Singh.

(Value of stock Rs. 21,100)

3. A consigned 2,000 tons of coal @ Rs.50 per ton to B of Delhi. He paid Rs.20, 000 as freight. Due to normal wastage B received only 1950 tons. He also paid Rs.5, 000 as unloading and cartage charges. The goods unsold amount to 650 tons. You are required to calculate the value of closing stock.

4. A consigned to B 100 cases of tea costing Rs.100 per case. He paid Rs.1, 000 as freight and cartage. B could take deliver of only 90 cases since 10 cases were lost in transit. He paid Rs.2, 000 as unloading and carriage charges. At the end of the year he reported that he ahs sold away 80 case at Rs.150 per case. You are required to calculate i) the value of abnormal loss and ii) the value of closing stock.

(Value of closing stock Rs. 1,322, Value of abnormal loss Rs.1, 300)

5. Vyas of Chennai sent on consignment 100 boxes at Rs.30 per box to Sitaram of Hyderabad. He paid for packing Rs.40, transport Rs.20, and railway freight Rs.40. Sitaram took delivery of only 90 boxes as 10 boxes are damaged in transit. Sitaram paid Rs.10 for cartage and Rs.40 for godown rent. He sold the boxes with him at Rs.35 per box. After deducting his expenses and 5% commission, Sitaram sent the money due along with account sales. Vyas received Rs.180 from railways as compensation. Write necessary accounts in the books of Vyas.

(Profit on consignment Rs.152)

6. Davar sent 5,000 kgs. of onions to Swarup at Rs.8 per kg. on consignment. He paid Rs.50 for freight, Rs.25o for transport and Rs.200 for insurance. When 500 kgs. of onions are damaged in transit, the insurance company paid Rs.2, 500 in full settlement to Davar.

After 3 months, Swarup informed that he sold 3,500 kgs of onions at Rs.9.50 per kg and paid Rs.500 as rent and Rs.750 as salary to salesman. Swarup is eligible for a commission of 5% on sales. He also informed that 20 kgs of onions are damaged due to humidity. Prepare necessary accounts in the books of Davar.

(Profit on consignment Rs. 1,857)

7. A Jute mill of Kolkata used to send jute goods to Anuradha & Co of Hoogly on its own risk. For that it receives a del credre commission of 15 % on sales.

Opening stock at the beginning with the agent	20,000 kgs.
Its cost	Rs.50, 000
Goods sent on consignment 1,60,000 kgs. at Rs. 5 per kg.	
Total sales 1,50,000 kgs. at Rs.5 per kg	
Amount received from agent	Rs.60, 00,000
Freight paid by agent	Rs.40, 000

Because of insolvency of a customer, Anuradha & Co. failed to collect Rs. 15,000. Because of damage of 5,000 kgs in transit, the agent collected Rs.8, 000 from railways. The damaged goods are sold for Rs.2 per kg. Record the above transactions in the books of Jute mill and ascertain profit or loss.

(Profit on consignment Rs. 1,24,250)

3.11: Summary:

Consignment is a business where consignor, the owner sends goods and the consignee as agent sells on his behalf of consignor. He is eligible for certain agreed commission for his services. In case consignee is offered for del credre commission, he is responsible for bad debts if any. Normal or abnormal loss has to be borne by the consignor himself. Sometimes goods on consignment will also be priced for proforma invoice.

3.12: Glossary:

Account Sales is a periodical statement prepared and sent by the consignee to the consignor containing details of goods received, sales made, expenses incurred, commission charged, remittances made and balance due by him to the consignor.

Del credre commission is offered to the consignee to meet the risk of bad debts. This normally calculated in addition to the normal commission.

Proforma Invoice is the invoice price fixed by the consignor above the cost price. It is fixed for the purpose of not identifying the original cost price of goods consigned.

3.13: Self Assessment Questions:

1. What is consignment? How is it different from ordinary business?
2. How normal loss and abnormal loss are treated in consignment?
3. How stock is calculated in the books of consignor?
4. Write about proforma invoice and memorandum column methods in consignment.

- Dr.R.Jayaprakash Reddy.

Lesson: 4

Joint venture Accounts

4.0 Objective:

After going through the lesson you will able to understand the following:

1. Meaning of Joint Venture and its distinction with partnership and consignment
2. Method of recording accounts in Joint venture
3. Method of maintaining joint bank account and other related accounts

Structure:

4.1: Joint Venture –Meaning

4.2: Joint venture and Partnership

4.3: Joint Venture and Consignment

4.4: Accounting Records

4.4.1: When venturer keeps accounts

4.4.2: When all venturers keep accounts

4.4.3: When separate set of books is kept

4.5: Try yourself

4.6: Summary

4.7: Glossary

4.8: Questions

4.1: Joint Venture –Meaning:

A joint venture is an association of two or more than two persons who have combined for the execution of a specific transaction and divide the profit or loss thereof in the agreed ratio. For example if A and B undertake the job of construction of a bridge for a sum of Rs.2 crores their coming together for this specific job will be termed as a joint venture and each one of them will be termed as a co-venturer. The venture will be over as soon as this transaction is over i.e. the bridge is completed.

4.2: Joint venture and Partnership:

There is slight difference between partnership and joint venture. According to Indian Partnership Act, 'partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'. Thus, both in joint venture and partnership there is some business activity whose profit or loss is agreed to be shared by two or more than two persons. In fact, joint venture is also a type of partnership. The main difference between these two is that joint venture is limited to an activity taken up by the co-venturers, whereas the partnership is a continuous activity. Thus, joint venture can be called as 'temporary partnership' or 'partnership for a specific venture' or 'particular partnership'.

4.3: Joint Venture and Consignment:

In joint venture two or more persons join together and do a particular business and they depart after completion of that business. But in consignment there is only one proprietor and he sends goods on consignment to an agent or consignee and do business. He pays commission to the consignee for his services. The consignor enjoys profits and bears losses and it is a sole trade business.

4.4: Accounting Records:

There are three ways in which joint venture accounts are kept. They are as follows:

1. When one venturer keeps accounts: In this case entire work is entrusted to one of the venturers and the rest simply contribute their share of investment and place it at the disposal of the working venturer.

2. When all venturers keep accounts: In this case each venturer keeps accounts of joint venture separately.

3. When separate set of books is kept: When the venture is of big in nature, this type of keeping books separately is followed.

4.4.1: When venturer keeps accounts:

Under this method one of the venturers keeps accounts of joint venture. Other co-venturers contribute capital, participate in management but do not write accounts. The person who writes accounts may be paid some commission or extra amount. After completion of the accounts, he finds the profit and informs the co-venturers and pays the share of their profits and thus closes the accounts.

Model journal entries:

1. When goods bought for joint venture:

   Joint Venture A/C Dr

   To Goods

2. When cash paid for purchases:

   Joint Venture A/C Dr

   To Bank

3. When co-Venturer bought goods for business:

   Joint Venture A/C Dr

Co-Venturer

4. When different expenses paid for joint venture:

Joint Venture A/C	Dr
To Bank	

5. When Co-Venturer pays for expenses:

Joint Venture A/C	Dr
To Co-Venturer	

6.When goods are sold:

Bank A/C	Dr
To Joint Venture	

7. When Co-Venturer sells goods:

Co-Venturer A/C	Dr
To Joint Venture	

8. When bill accepted for Co-venturer:

Co-Venturer A/C	Dr
To Bills payable	

9. When Co-Venturer accepts the bills:

Bills receivable A/C	Dr
To Co-Venturer A/C	

10. When bill discounted with the bank:

Bank A/C	Dr
Discount A/C	Dr
To Bills receivable	

11. When discount transferred to joint venture:

Joint Venture A/C	Dr
To Discount	

12. For commission earned:

Joint Venture A/C	Dr
To Commission	

13.When commission paid to Co-Venturer:

Joint Venture A/C	Dr
To Co-Venturer	

14. When the remaining goods of joint venture taken:

Goods A/C	Dr
To Joint Venture	

15. When Co-Venturer takes remaining goods:

    Co-Venturer A/C Dr

    To Joint Venture

16. When profit earns and shares among venturers:

    Joint Venture A/C Dr

    To P & L A/C

    To Co-Venturer

17. When the account of Co-Venturer settles:

    Co-Venturer A/C Dr

    To Bank

18. When the amount receivable from the co-venturer received:

    Bank A/C Dr

    To Co-Venturer

Illustration 1:

Syam and Santosh decided to run a Joint Venture of cotton business and share profits equally. Santosh receives 4 % commission for his service of selling goods of the business. Syam purchased and sent to Santosh 100 bales of cotton for Rs. 20,000 and paid Rs.1, 000 towards insurance. Santosh also purchased cotton worth Rs.16, 000. He paid Rs.300 towards godown rent and Rs.200 towards miscellaneous expenses. Santosh sold the total cotton for Rs.50, 000 and send the due amount to Syam by a cheque.

Santosh is maintaining books of Joint venture. Show Joint venture entries and accounts.

Solution:

Journal entries in the books of Santosh:

1. Joint Venture A/C	Dr	20,000	
To Syam			20,000
(Being goods purchased by syam for joint venture)			
2. Joint Venture A/C	Dr	1,000	
To Syam			1,000
(Being expenses paid by syam)			
3. Joint Venture A/C	Dr	16,000	
To Bank			16,000
(Being goods purchased for joint venture)			
4. Joint Venture A/C	Dr	500	
To Bank			500
(Being expenses paid)			
5. Bank A/C	Dr	50,000	
To Joint Venture			50,000

(Being goods sold)			
6. Joint Venture A/C	Dr	2,000	
To Commission			2,000
(Being commission payable)			
7.Joint Venture A/C	Dr	10,500	
To P & L A/C			5,250
To Syam			5,250
(Being profit on joint venture shared equally)			
8. Syam A/C	Dr	26,250	
To Bank			26,250
(Being amount paid to Syam)			

Joint Venture Account

To Syam- goods		20,000	By Bank	50,000
To Syam – commission		1,000		
To Bank – goods		16,000		
To Bank – expenses		500		
To Commission		2,000		
To P & L A/C	5,250			
To Syam A/C	5,250	10,500		
		50,000		**50,000**

Syam Account

To Bank	26,250	By Joint Venture – goods	20,000
		By Joint Venture – expenses	1,000
		By Joint Venture – profit	5,250
	26,250		**26,250**

4.4.2: When all venturers keep accounts:

Under this method, all venturers keep accounts relating to their joint venture in their books. Each venturer opens a joint venture account and other co-venturers accounts. Except this, the procedure of writing journal entries and preparation of accounts are same as shown above.

Illustration 2:

Anil and Sunil are joint venturers and share profits equally. Anil purchased goods worth Rs.25, 000 for joint venture and sent to Sunil. He spent Rs.2, 000 for expenses. Sunil purchased Rs.20, 000 worth of goods and spent Rs.2, 000 for expenses. Sunil sold the goods for Rs.60, 000 and he gets a commission of 5 % on sales. After closing the accounts, Sunil sent a draft to Anil for the amount due. Write journal entries and prepare accounts in the books of Anil and Sunil.

Solution:

Journal entries in the books of Anil:

1. Joint Venture A/C	Dr	25,000	
To Bank			25,000
(Being goods purchased for joint venture)			
2. Joint Venture A/C	Dr	2,000	
To Bank			2,000
(Being expenses paid)			
3. Joint Venture A/C	Dr	20,000	
To Sunil			20,000
(Being goods purchased by Sunil for joint venture)			
4. Joint Venture A/C	Dr	2,000	
To Sunil			2,000
(Being expenses paid by Sunil)			
5. Sunil A/C	Dr	60,000	
To Joint Venture			60,000
(Being goods of joint venture sold)			
6. Joint Venture A/C	Dr	3,000	
To Sunil			3,000
(Being 5 % commission payable to Sunil)			
7. Joint Venture A/C	Dr	8,000	
To P & L A/C			4,000
To Sunil			4,000
(Being 50% of profit transferred and the remaining to Sunil account)			
8. Bank	Dr	31,000	
To Sunil			31,000
(Being cheque received from Sunil for full settlement)			

Joint Venture Account

To Bank	25,000	By Sunil	60,000
To Bank	2,000		
To Sunil A/C	20,000		
To Sunil A/C	2,000		
To Sunil A/C	3,000		
To P & L A/C	4,000		
To Sunil A/C – Profit	4,000		
	60,000		60,000

Sunil Account

To Joint Venture A/C-sales	60,000	By Joint Venture A/C –goods	20,000
		By Joint Venture A/C- goods	2,000
		By Joint Venture –commission	3,000
		By Joint Venture - profit	4,000
		By Bank	31,000
	60,000		**60,000**

Journal entries in the books of Sunil:

1. Joint Venture A/C	Dr	20,000	
To Bank			20,000
(Being goods purchased)			
2. Joint Venture A/C	Dr	2,000	
To Bank			2,000
(Being expenses paid)			
3. Joint Venture A/C	Dr	25,000	
To Anil		25,000	
(Being goods purchased by Anil)			
4. Joint Venture A/C	Dr	2,000	
To Anil		2,000	
(Being expenses paid by Anil)			
5. Bank A/C	Dr	60,000	
To Joint Venture			60,000
(Being joint venture goods sold)			
6. Joint Venture A/C	Dr	8,000	
To P & L A/C			4,000
To Anil		4,000	
(Being profit earned and 50% sent to Anil)			
7. Anil A/C	Dr	31,000	
To Bank			31,000
(Being amount sent to Anil in full settlement)			

Joint Venture Account

To Bank	20,000	By Bank	60,000
To Bank	2,000		
To Anil – goods	25,000		
To Anil – expenses	2,000		

To Commission		3,000		
To P & L A/C		4,000		
To Anil – Profit	4,000			
		60,000		**60,000**

Anil Account

To Bank	31,000	By Joint Venture – goods	25,000
		By Joint Venture – expenses	2,000
		By Joint Venture – profit	4,000
	31,000		**31,000**

4.4.3: When separate set of books is kept:

The following three accounts are required under this method:

1. Joint Bank Account
2. Joint Venture Account
3. Venturers Personal Accounts

1. Joint Bank Account: To record cash transactions joint bank account is opened. When joint venturers bring cash into the business, it is debited to joint bank account and credited to their personal accounts. The joint venture payments are credited and receipts are debited to this account.
2. Joint Venture Account: The goods purchased for joint venture and the expenses paid are debited to this account as usual. If the venturers bring goods from their personal resources, they are debited to joint venture account and credited to their personal accounts. Contrary to this, if the ventureres take back goods remaining in the joint venture at the end of the business, their accounts are debited and joint venture account is credited. Thus, profit on joint venture is ascertained. The profit or loss on joint venture is distributed among the venturers according to their agreed ratios.
3. Venturers Personal Accounts: Immediately after the venturers bring cash into joint venture, their personal accounts are opened and credited with those amounts. Their accounts are credited with the amounts when they bring goods and debited if they take back. The profit on joint venture will be credited and loss will be debited to the personal accounts. Finally, the personal accounts are settled through receipts and payments among the joint venturers.

Illustration 3:

A, B, and C decided to start a joint venture and share profits in the ratio of 6:3:1 respectively. They have deposited the following the amounts into joint bank account: A- Rs.12, 000, B- Rs.8, 000, and C – Rs.4, 000. They have purchased goods for Rs. 20,000 from joint funds and sold them for Rs.50, 000. A has taken some damaged goods for Rs.300. A, B, and C paid Rs.1, 000, Rs.500 and Rs.500 respectively for expenses. Write journal entries and joint venture account assuming that the accounts are maintained separately.

Solution:

Journal Entries:

1. Joint Bank A/C	Dr	24,000	
To A's A/C			12,000
To B's A/C			8,000
To C's A/C			4,000
(Being capitals of joint venturers are deposited at joint bank account)			
2. Joint Venture A/C	Dr	20,000	
To Joint Bank			20,000
(Being goods purchased for joint venture)			
4. Joint Bank A/C	Dr	50,000	
To Joint Venture A/C			50,000
(Being goods sold on joint venture)			
5. A's A/C	Dr	300	
To Joint Venture A/C			300
(Being damaged goods taken by A)			
6. Joint Venture A/C	Dr	2,000	
To A's A/C			1,000
To B's A/C			500
To C's A/C			500
(Being expenses met by the joint venturers)			
7. Joint Venture A/C	Dr	28,300	
To A's A/C			16,980
To B's A/C			8,490
To C's A/C			2,830
(Profits of joint venture distributed amount joint venturers)			
8. A's A/C	Dr	29,680	
B's A/C	Dr	16,990	
C's A/C	Dr	7,330	
To Joint Bank A/C			54,000
(Being venturers accounts settled)			

Joint Venture Account

To Joint Bank A/C – purchases	20,000	By Joint Bank A/C- sales	50,000
To A's A/C - expenses	1,000	By A's A/C	300
To B's A/C – expenses	500		
To C's A/C – expenses	500		

To A's A/C – profit	6,980			
To B's A/C – profit	8,490			
To C's A/C – profit	2,830	28,300		
		50,300		**50,300**

A's Account

To Joint Venture A/C	300	By Joint Bank A/C	12,000
To Joint Bank A/C	29,680	By Joint Venture – expenses	1,000
		By Joint Venture A/C	16,980
	29,980		**29,980**

B's Account

To Joint Bank A/C	16,990	By Joint Bank A/C	8,000
		By Joint Venture A/C	500
		By Joint Venture A/C	8,490
	16,990		**16,990**

C's Account

To Joint Bank A/C	7,330	By Joint Bank A/C	4,000
		By Joint Venture A/C	500
		By Joint Venture A/C	2,830
	7,330		**7,330**

Joint Bank Account

To A's A/C	12,000	By Joint Venture A/C	20,000
To B's A/C	8,000	By A's A/C	29,680
To C's A/C	4,000	By B's A/C	16,990
To Joint Venture A/C	50,000	By C's A/C	7,330
	74,000		**74,000**

Illustration 4:

A and B agreed to construct a building on joint venture. The contract amount is Rs.20, 00,000. They opened a joint account and deposited A-Rs.50, 000 and B-30, 000. In the contract amount Rs.1, 50,000 collected in installments. The following are the joint transactions:

Rs.60, 000 paid for wages

Rs. 1,40, 000 paid for goods

A sent Rs.10, 000 worth of goods from his shop.

B sent Rs.8, 000 worth of goods from his shop.

A paid Rs.4, 000 to the architect.

The building construction was completed and received the remaining balance A accepted to take the remaining stock for Rs.20,000 and joint venture closed.

A and B share profits in 3:1 ratio. Show profit or loss of joint venture showing joint venture account. Show cash distribution between them.

Solution:

Joint Venture Account

To Joint bank A/C-goods	1,40,000	By Joint bank A/C	2,00,000
To Joint bank A/C-wages	60,000	By A's A/C-stock	20,000
To A's A/C –goods	10,000	By A's A/c – loss	1,500
To B's A/C-goods	8,000	By B's A/C –loss	500
To A's A/C – architect fee	4,000		
	2,22,000		**2,22,000**

Joint Bank Account

To A's A/C	50,000	By Joint venture A/C	2,00,000
To B's A/C	30,000	By A's A/C	42,500
To Joint venture A/C	2,20,000	By B's A/C	37,500
(Contract amount)			
	2,80,000		**2,80,000**

A's Account

To Joint venture A/C – stock	20,000	By Joint bank A/C	50,000
To Joint venture A/C-loss	1,500	By Joint venture A/C-goods	10,000
To Joint bank A/C-cash	42,500	By Joint venture A/C-exps.	4,000
	64,000		**64,000**

B's Account

To Joint venture A/C-loss	500	By Joint bank A/C	30,000
To Joint bank A/C-cash	37,500	By Joint venture A/C-goods	8,000
	38,000		**38,000**

Illustration 5:

X, Y, and Z entered joint venture to share profits equally. X, Rs.60, 000, Y Rs.60, 000 and Z Rs.70, 000 invested in the venture and deposited in the joint bank. They bought Rs.1, 50, 000 worth of goods from A. They paid Rs.10, 000 towards transport expenses. They sold goods for cash Rs.1, 00, 000 and for credit to B for Rs.80, 000. B accepted a bill for the due amount and the same bill is discounted with the bank for Rs.76, 000. X receives 2% commission for this transaction. Accounts are finalized through cheques. Pass journal entries and prepare ledger accounts assuming that books are maintained jointly.

Solution:

Journal entries:

1. Joint Bank A/C	Dr	1,90,000	
To A's Capital A/C			60,000

To B’s Capital A/C			60,000
To C’s Capital A/C			70,000
(Being amount brought by the venturers deposited in the bank)			
2. Joint Venture A/C	Dr	1,50,000	
To A’s A/C			1,50,000
(Being goods purchased from A)			
3. A’s A/C	Dr	1,50,000	
To Joint Bank A/C			1,50,000
(Being cash paid to A)			
4. Joint Venture A/C	Dr	10,000	
To Joint Bank A/C			10,000
(Being transport expenses paid)			
5. Joint Bank A/C	Dr	1,00,000	
B’s A/C	Dr	80,000	
Joint Venture A/C			1,80,000
(Being goods sold on cash and credit)			
6. Bills receivable A/C	Dr	80,000	
To B’s A/C			80,000
(Being bill received from B for the amount due)			
7. Joint Bank A/C	Dr	76,000	
Discount A/C	Dr	4,000	
To Bills receivable			80,000
(Being bill discounted with the bank)			
8. Joint venture A/C	Dr	4,000	
To Discount A/C			4,000
(Being discount charged to joint venture account)			
9. Joint venture A/C	Dr	3,600	
To X’s A/C			3,600
(Being commission payable to X at 2% on 80,000)			
10. Joint venture A/C	Dr	12,400	
To X’s Capital A/C			4,133
To Y’s Capital A/C			4,133
To Z’s Capital A/C			4,134
(Being profit on joint venture distributed)			
11. X’s Capital A/C	Dr	67,733	

Y's Capital A/C	Dr	64,133	
Z's Capital A/C	Dr	74,134	
To Joint bank A/C			2,06,000

(Being balances due taken by the joint venturers)

Joint Venture Account

To A's Account – goods	1,50,000	By Joint bank A/C	1,00,000
To Joint bank – expenses	10,000	By B's A/C	80,000
To Discount	4,000		
To X's A/C – commission	3,600		
To X's Capital A/C –profit	4,133		
To Y's Capital A/C – profit	4,133		
To Z's Capital A/C - profit	4,134		
	1,80,000		**1,80,000**

A's Account

To Joint bank A/C	1,50,000	By Joint venture A/C	1,50,000
	1,50,000		**1,50,000**

B's Account

To Joint venture A/C	80,000	By Bills receivable	80,000
	80,000		**80,000**

X's Capital Account

To Joint bank A/C	67,733	By Joint bank A/C	60,000
		By Joint venture A/C-comn.	3,600
		By Joint venture A/C-profit	4,133
	67,733		**67,733**

Y's Capital Account

To Joint bank A/C	64,133	By Joint bank A/C	60,000
		By Joint venture A/C – profit	4,133
	64,133		**64,133**

Z's Capital Account

To Joint bank A/C	74,134	By Joint bank A/C	70,000
		By Joint venture A/C – profit	4,134
	74,134		**74,134**

Illustration 6:

Banerjee and Mukherjee agree to import Russian timber into India. On 1st July 2007 they opened a joint bank account with Rs.25, 000 towards which Banerjee contributed Rs.15, 000 and Mukherjee contributed Rs.10, 000. They agree to share profits and losses in proportion to their cash contributions.

They remitted to their agent in Russsia Rs.20, 000 to pay for timber purchases, and later Rs.2, 100 in settlement of his account. Freight, insurance and dock charges amounted to Rs.3, 900. On December 31 2007 the sales amounted to Rs.28, 740 which enabled them to repay themselves with cost originally advanced. They then decided to close the venture and Mukerjee agreed to take over the timber unsold for Rs.1, 260, which is to be deducted from his share of profit.

Prepare the necessary accounts showing the amount of cash available for division by way of profits and how the same is divisible between Banerjee and Mukherjee.

Solution:

Joint Venture Account

To Joint Bank A/C	20,000	By Joint Bank A/C – sales	28,740
To Joint Bank A/C - commission	2,100	By Mukherjee - stock	1,260
To Joint Bank A/C – Freight etc.,	3,900		
To Benerjee – profit	2,400		
To Mukherjee – profit	1,600		
	30,000		**30,000**

Joint Bank Account

To Banerjee	15,000	By Joint venture A/C	20,000
To Mukherjee	10,000	By Joint venture A/C	2,000
To Joint venture A/C	28,740	By Joint venture A/C	3,900
		By Banerjee	17,400
		By Mukherjee	10,340
	53,740		**53,740**

Banerjee Account

To Joint bank A/C	17,400	By Joint bank A/C	15,000
		By Joint venture A/C	2,400
	17,400		**17,400**

Mukerjee Account

To Joint venture A/C	1,260	By Joint bank A/C	10,000
To Joint bank A/C	10,340	By Joint venture A/C	1,600
	11,600		**11,600**

Illustration 7:

Rao and Raja have taken up a contract in July 2006 as a Joint Venture to lay roads in an industrial establishment for Rs.3, 00,000. Rao brought in Rs.40, 000 and Raja Rs.30, 000 as capital; these amounts were deposited in a joint bank account, which was opened for this purpose. They agreed to share profit or loss equally after providing for interest on capital at 8% per annum.

The work was completed on 30th June 2007 and the following expenses were incurred and paid for from the joint bank account:

Materials	Rs.1, 00,000
Wages	Rs.50, 000
Machinery & stores	Rs.30, 000

Payments from the industrial establishment were received periodically and remitted into the joint bank account; but 1% of the contract amount was not paid because of defective work. They agreed to provide depreciation on machinery and stores at 10% for the year ending on 30th June 2007. Half of the machinery and stores was purchased by Raja at book value; the other half was sold at a profit of 10% on the book value to outsiders.

Prepare necessary accounts in the ledger of the Joint Venture.

Solution:

Joint Venture Account

To Joint bank A/C	1,80,000	By Joint bank A/C	2,97,000
To Rao- interest	3,200	(3,00,000-3,000)	
To Raja – interest	2,400	By Raja – machinery	13,500
To Rao – profit	69,875	By Joint bank	14,850
To Raja – profit	69,875		
	3,25,350		**3,25,350**

Joint Bank Account

To Rao	40,000	By Joint venture	1,80,000
To Raja	30,000	By Rao	1,13,075
To Joint venture	2,97,000	By Raja	88,775
To Joint venture	14,850		
	3,18,850		**3,18,850**

Rao Account

To Joint bank	1,13,075	By Joint bank	40,000
		By Joint venture	3,200
		By Joint venture	69,875
	1,13,075		**1,13,075**

Raja Account

To Joint venture	13,500	By Joint bank	30,000
To Joint bank	88,775	By Joint venture	2,400
		By Joint venture	69,875
	1,02,275		**1,02,275**

Working Notes:

Value of Machinery:	Cost at the beginning	30,000
	Less: Depreciation for 1 year (10%)	3,000
	Written down value as on 30th June 2007	27,000
	Less: Machine taken over by Raja ½	13,500
	Value of Remaining ½ machine	13,500
	Add: 10%	1,500
	Selling price of machine	14,850

Contract Price:	3,00,000
Less: deducted for defective	3,000
Cash received	2,97,000

4.5: Try yourself:

1. Rajiv and Shyam enter into a joint venture to import silk. On 1st January 2007, they opened a Joint Bank Account with the Syndicate Bank, Rajiv contributing Rs.20, 000 and Shyam Rs.10, 000. They agreed to share profits in the ratio of the capital introduced by them. On 15th February 2007, they remitted to a manufacturer in Japan Rs.25, 000 for goods received and incurred an expense of Rs.800 for freight, insurance, etc. The goods were sold for Rs.33, 000 for which the selling expenses were as follows:

Godown rent Rs.200; Commission payable to Shyam on the gross amount of sales 10%; and Miscellaneous expenses Rs.300.

Give journal entries and the necessary ledger accounts showing the final distribution of cash among he co-venturers.

(Profit on Joint venture Rs.3, 400, Rajiv gets Rs.22, 267 and Shyam gets Rs.14, 433 in final settlement)

2. Ram and Lakshman were participants in a joint venture, sharing profits and losses in 2:3 ratio. Each party maintains a complete record in his own books. Ram supplies goods to the value of Rs.15, 000 and incurs an expenditure of Rs.600 on them and Lakshman supplies goods to the extent of Rs.12, 000 and his expenses amount to Rs.900. Ram sells all the goods for Rs.36, 000 for which he is entitled to receive a commission at 5%. Accounts are settled by bank draft. Give the necessary journal entries and the ledger accounts in the books of Ram to record the above transactions.

(Profit on Joint venture Rs.5, 700; Amount payable to Lakshman Rs.14, 800)

3. Shaw and Desai joined in a joint venture to make an advertising film to the government. Government will pay Rs.1, 50,000. Shaw bought Rs.30, 000 and Desai Rs.20, 000 for this purpose. This money is deposited in the joint bank account.

They paid the following from joint bank account:

Wages Rs.40, 000; Materials Rs.25, 000; Camera Rs.5, 000.

Shaw supplied Rs.5, 000 worth of settings. After making the film, the government paid reducing 20% in the agreed amount because of certain defects in the film. Desai took the camera for Rs.2, 000. Shaw takes back the settings for Rs.1, 000.

Show Shaw and Desai accounts along with joint bank account and joint venture account.

(Profit on joint venture: Rs.48,000; Shaw receives Rs.58,000; Desai receives Rs.47, 000)

4. Reddy, Rao and Chowdary jointly undertake to erect a theatre building for Purna Pictures Ltd., at a price of Rs.5, 00,000 to be paid as to Rs.4, 00,000 in cash by installments, and Rs.1, 00,000 in Debentures of the company.

They contribute: Reddy Rs.60, 000, Rao Rs.75, 000 and Chowdary Rs.40, 000. These amounts are deposited in a Joint Bank account.

Reddy gets the plans prepared and pays Rs.7, 000 architect's fees. Rao brings into the venture a concrete mixer of the value of Rs.25, 000 and Chowdary brings into the venture a motor truck of the value of Rs.20, 000.

They buy a plant for Rs.24, 000. Materials worth Rs.2, 40,000 are purchased for cash and Rs.1, 95,000 is paid for wages.

On completion of the venture, Reddy takes over unused materials to the value of Rs.14, 000; Rao takes back the concrete mixer at a valuation of Rs.12, 000; and Chowdary takes back the motor truck at Rs.8, 000. The plant is sold as scrap for

Rs.6, 000. When the contract price was fully received, Reddy took over the Debentures at a valuation of Rs.80, 000.

Show the Joint Venture Account, the Joint Bank Account and the accounts of the Venturers, after the final distribution and the settlement of accounts.

(Profit on Joint venture Rs.9,000; Rao receives Rs.91,000; Chowdary receives Rs.55,000)

4.6: Summary:

Joint venture is also one type of partnership. It is limited to a particular job or work. When the agreed business is over, the joint venture closes and the venturers depart after sharing their profits or losses. Account books are prepared either by one venturer or all the venturers or opening separate books for joint venture along with joint bank account.

4.7: Glossary:

Joint Venture: It is an association of two or more than two persons who have combined for the execution of a specific transaction and divide the profit or loss thereof in the agreed ratio.

4.8: Self Assessment Questions:

1. What is Joint venture? How is it different from Partnership and Consignment?

2. What are the different of accounting in Joint venture?

3. How Joint bank account works in preparing joint venture accounts? Explain with an example.

- Dr.R.Jayaprakash Reddy.

Lesson - 5

DEPRECIATION

OBJECTIVES:

By the sutdy of this Chapter, you will be able to understand the meaning and definition of Depreciation, Concepts & Causes of Depreciaton, Factors influencing depreciation, and various methods of Depreciation.

STRUCTURE:

5.1 Introduction

5.2 Meaning & Definition

5.3 Causes of Depreciation

5.4 Need & Objectives

5.5 Methods of Depreciation

5.6 Methods of Providing Depreciation

5.7 Fixed Instalment Method - Illustrations Advantages & Disadvantages

5.8 Diminishing Balance Method

5.9 Annuity Method

5.10 Depreciation Fund Method

5.11 Insurance Policy Method

5.12 Sum of Degits Method

5.13 Revaluation Method

5.14 Machine Hour Rate Method

5.15 Mileage Method

5.16 Questions

5.17 Exercises

5.1. INTRODUCTION :

The traditional view of depreciation is that it is meant to be a provision for replacing depreciable assets. Therefore, it is left to the management to decide as to when they should provide for it and when they can dispense with it. Some managements provide for depreciation only when the firm made profits and dispense with it during the years when the firm incurres losses. Even the Companies Act of 1956 has made charging of depreciation compulsory only if the company desired to declare dividends. The accounting practice of showing profits before charging depreciation first, and then later profits after charging depreciation, confirms the view that it has to be regarded as an appropriation of profit. But the modern view is different. All the fixed assets are considered to be "future services" to be used by the enterprise over the entire period of the economic life (estimated useful life) of such assets. Therefore, the cost of acquisition must be properly allocated over the period of its useful economic life. The amount charged to each period is called depreciation (the expired portion of the capital expenditue on the asset) and it is a technique employed by the accountants to recover the investment in fixed assets. The effects of charging of depreciation in the accounts are:

(1) it reduces the value of the fixed asset to the extent to which it has been used up;

(2) it reduces the profits of the concern;

(3) it is possible to show a true and fair view of the value of the fixed assets in the balance sheet;

(4) funds are made available to replace the old asset at the end of its useful economic life.

5.2. MEANING & DEFINITION :

Since the cost of fixed asset is nothing but "the price paid for a series of future services", it is necessary to spread it's cost over a number of years during which benefit of the asset is received. This process of spreading the cost of fixed asset is termed as "depreciation". AICPA in its Accounting Research Bulletin No.22, writes that; "depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be group of assets) in a systematic and rational manner. It is a process of allocation not of valuation. Depreciation for the year is the portion of the total cost of the fixed assets that is allocated to the year. Although the allocation may properly take into account occurences during the year, it is not intended to be the measurement of the effect of all such occurrences".

The views of the Institute of Chartered Accountants in Australia are: "depreciation represents that part of the cost of a fixed asset to its owner, which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and it is not dependent upon the amount of profit cleared. J.N. Carter's definition runs as follows; "depreciation is the gradual decrease in the value of an assets from any cause". According to IASC-4 depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. As per the standard, depreciation is to be provided only for assets which (a) are expected to be used during more than one accounting period; (b) have a limited useful life, and (c) and held by an enterprise for use in the production of supply of goods and services, for rental to others or for administratives purposes.

5.3. CAUSES OF DEPRECIATION :

Depreciation may be said to arise from two causes-internal and external. Internal depreciation is that arising from the operation of any cause natural to, or inherent in the asset. External depreciation is that arising from the operation of forces outside the asset itself. These are discussed below.

Internal Causes :

(a) **Wear and Tear:** "Wear and tear" is an important cause of depreciation in the case of tangible fixed assets like buildings, machinery, furniture, fixtures, tools, fitting etc. "Wear and tear" results from friction, vibration, strain, chemical reaction, weathering intensity of the use, care in handling, standard of maintenance, minor accidents inevitable in the handling of plant etc. The term 'depreciation' (not "amortization") in generally used to indicate the expired utility of an asset due reasons mentioned above.

(b) **Depletion:** Depletion is also one of the internal causes of decrease in the value of wasting asets such as mine, quarries, oil-wells and forest-stands; The term "depletion" (neither "amortization" not 'depreciation") is correctly used to refer to the expired utility of the wasting asset.

External Causes :

(a) **Obsolescence:** It is an experience in every day life that many times a particular machine is discharged before it is completely worn-out. This means that there are some external factors too which are responsible for throwing out of use an asset which is in a good condition. Among the external causes, "obsolescence" or "suppression" is the prominent factor. Obsolescence is induced by new investions, improvement, loss of demand due to change in fashion, changes in governmental requirements. Loss in demand, for any reason, has a direct impact on the economic life of the asset. Since the market for the product collapses, the machine, if not adaptable to different uses, goes out of use or is obsoleted.

(b) **Effluxion of Time:** There are some intangible fixed assets which decrease in value as time elapses. For example, if Rs.50,000 are paid for a certain lease (excluding lease of mine) for 10 year, then with the lapse of every year, the value of the asset goes down by Rs.50,000, whether utilised or not. Its value is reduced to zero at the end of the 10th year. Copyrights, patent rights are other examples of intangible fixed assets which decrease in value due to effluxion of time.

5.4. NEED AND OBJECTIVES :

One unfortunate thing about depreciation is that it is not visible like other expenses till the very end. In case of other expenses, the expenditure is patent and hence such expenses are provided for. It is not so with depreciation. Some firms do not deduct depreciation form their gross earnings to ascertain the net profit. This is not correct. Provision for depreciation is necessary firstly, for ascertaining true profit, secondly, for retaining funds in the business so that the asset can be replaced at the proper time, and thirdly, for presenting a true balance sheet. Depreciation of current assets is taken care of by valuing them for balance sheet purposes at cost or market prices which ever is less.

It is necessary that a reasonable amount is provided for as depreciation, every year, on fixed assets owing to the following reasons:

(i) to ascertain correct profits of the period,

(ii) to present financial position in the balance sheet,

(iii) to include the depreciation in cost of production, to arrive at true cost of production,

(iv) to provide funds for replacement of the asset at the end of the life of the original asset,

(v) to recover the cost of the fixed assets spread over their useful life; to keep the capital in tact,

(vi) to conserve the cash resources of the concern (to the extent of depreciation) from being distributed as dividends (profits get reduced when depreciation is charged),

(vii) to save tax payable on profits (as the profits get reduced to the extent of depreciation, which is a permissible deduction as per the Income Tax Act), and

(viii) to get an approximate idea of the amount for which the used asset can be sold in the second-hand market.

5.5. METHODS OF DEPRECIATION :

There are two ways of recording depreciation in the books of account:

First Method: When no provision for depreciation account is maintained :

Under this method, depreciation is directly charged to the asset account by debiting depreciation accont and crediting the asset account. At the end of the accounting period, depreciation account is closed by transferring it to the profit and loss account. In the balance sheet, the asset appears at its written down value (cost less depreciation provided to date). Here, the actual cost of an asset and the total amount of depreciation that has been provided (to-date) cannot be ascertained from the balance sheet. The following are the journal entries passed under the first method:

		Rs.	Rs.
1.	When the asset is purchased :		
	Asset account .... Dr	xxx	
	To cash account		xxx
2.	Installation charges, reconditioning or over handling expenses incurred on second hand machine should also be charged to the asset account. The entry is :		
	Asset account .... Dr	xxx	
	To cash account		xxx
3.	For providing depreciation at the end of the year :		
	Depreciation account ....Dr	xxx	
	To Asset account		xxx

4.	For transfer of depreciation to profit and loss account :		
	Profit and loss account.........................Dr	xxx	
	To Depreciation account		xxx
5.	It the asset is sold, for the amount realised on the sale of asset :		
	Cash account ....Dr	xxx	
	To Asset account		xxx
6.	For depreciation on the asset to the date of sale :		
	Depreciation account ....Dr	xxx	
	To Asset account		xxx
7.	(a) For the profit on sale of asset :		
	Asset account ....Dr	xxx	
	To profit and loss account		xxx
	(or)		
	(b) For the loss on sale of asset :		
	Profit and loss account ....Dr	xxx	
	To Asset account		xxx

Second Method: When Provision for depreciation account is maintained

Under this method (in contrast to the above), depreciation is not directly charged to the asset account. The depreciation for the period is debited to depreciation account and credited to "accumulated depreciation account" or "provision for depreciation account". As in the previous method, depreciaiton account is closed by transferring it to the profit and loss account. In the balance sheet, the asset appears at its original cost and the accumulated depreciation is shown as a deduction from the asset account. Here, from the balance sheet, the original cost of the asset and the totaldepreciation to-date that has been charged on that asset, can be easily ascertained. As the year passes, the balance of the accumulated depreciation goes on increasing since constant credit is given to this account in each accounting year. After the expiry of the useful life, these two accounts are closed by debiting accumulated depreciation account and crediting the asset account - any balabce in asset account is transferred to the profit and loss account. The following are the journal entries passed under the second method.

	Every year accounting period	**Rs.**	**Rs.**
1.	Depreciation account ....Dr.	xxx	
	To provision for depreciation account		xxx
	(Being depreciation written of)		
2.	Profit and loss account ....Dr.	xxx	
	To Depreciation account		xxx
	(Being depreciation charged to profit and loss account)		
	In the year in which the assest is sold :		
3.	Cash account ....Dr.	xxx	
	To Assest account		xxx
	(Being the amount realised on the sale of the asset)		
4.	Depreciation account ....Dr.	xxx	
	To provision for depreciation		xxx
	(Being depreciation on the asset upto the date of sale written off)		
5.	Profit and loss account ....Dr.	xxx	
	To Depreciation account		xxx
	(Being depreciation charged to profit and loss account)		
6.	Provision for depreciation account ....Dr.	xxx	
	To Asset account		xxx
	(Being the transfer of provision to asset account)		
7.	Asset account ....Dr.	xxx	
	To profit and loss account		xxx
	(Being the profit on sale of asset)		
8.	Profit and loss account ....Dr.	xxx	
	To Asset account		xxx
	(Being the loss on sale of asset)		

5.6. METHODS OF PROVIDING DEPRECIATION :

As has been pointed out earlier, the total depreciation to be written off during the life time of the asset is original cost less scrap value or residual value. But there are different medhods of calculating the amount of depreciation to be charged every year. They vary from asset to asset depending on its nature and also from concern to concern. The following are the various methods used for providing depreciation:

(1) Fixed Instalments of Straight Line Method

(2) Diminishing Balances or Reducing Installment Method.

(a) Written Down Value Method

(b) Double Declining Balance Method

(3) Annuity Method

(4) Depreciation Fund or Sinking Fund Method

(5) Insurance Policy Method

(6) Sum of Digits Method

(7) Depletion Method

(8) Revaluation Method

(9) Machine Hour Rate Method

(10) Mileage Method

5.7. FIXED INSTALMENT METHOD :

This method is also known as “Equal Instalment” or “Straight Line” method. According to this method, a fixed and equal amount is charged as depreciation every year during the life time of the asset. When the amount of depreciation is presented on a graph, it would be a straight line. The amount is such that at the end of the useful life of the asset the asset gets reduced to zero or its residual value. This can be calculated using the following formula.

$$\text{Annual depreciation} = \frac{\text{[Cost of asset+Erection charges]-Residual value}}{\text{Life of the asset in terms of years (life period)}}$$

Similarly, the rate of depreciation is calculated as under:

$$\text{Rate of depreciation} = \frac{\text{Annual depreciation}}{\text{[Cost of asset+Erection charges]-Residual value}} \text{x100}$$

ILLUSTRATIONS

Illustration-1:

Calculate the amount of annual depreciation for three years by straight line method when (i) Cost of machinery Rs.30,000 (ii) Expected life of asset 3 years (iii) Scrap value Rs.3,000.

Solution:

Straight Line Method

$$\text{Annual depreciation} = \frac{\text{Original cost - Scrap value}}{\text{Life of asset}}$$

$$= \frac{30{,}000 - 3{,}000}{3 \text{ Years}}$$

$$= \frac{27{,}000}{3} \quad = \text{Rs.}9{,}000$$

Therefore, annual depreciation is Rs.9,000.

Illustration-2:

A company purchased a plant for Rs.50,000; the useful life of the plant is 10 years and the residual value is Rs.5,000. Determine the rate and amount of depreciation to be charged every year.

Solution:

$$\text{Depreciation to be charged every year} = \frac{\text{Original cost-Residual value}}{\text{Life of the plant}}$$

$$= \frac{50{,}000\text{-}5{,}000}{10}$$

$$= \frac{45{,}000}{10} = \text{Rs.}4{,}500$$

$$\text{Rate of depreciation} = \frac{\text{Depreciation}}{\text{Original cost- Residual value}} \times 100$$

$$= \frac{4{,}500}{50{,}000\text{-}5{,}000} \times 100 = \frac{4{,}500}{45{,}000} \times 100 = 10\ \%$$

Illustration-3:

Saicharan purchased a machine by cheque for Rs.1,80,000 on 1st January 1998. Its probable working life was estimated at 10 years and its probable scrap value at the end of that time as Rs.20,000. It was decided to write off depreciation by equal annual instalments. You are required to pass necessary journal entries for first two years and show necessary accounts and the balance sheet:

(a) when no provision for depreciation account is maintained.

(b) when provision for depreciation account is maintained.

[It was decided to close books each year on December, 31st]

Solution:

Annual depreciation= $= \frac{1,60,000}{10}$ = Rs.16,000

(a) When no provision for depreciation account is maintained: $\frac{\text{Rs.1,80,000-Rs.20,000}}{10}$

In the books of Saicharan Journal Entries

Date	Particulars	L.f	Rs.	Rs.
1998 Jan.1	Machinery account..........................Dr		1,80,000	
	To Bank account			1,80,000
	(Being the purchase of machinery by cheque)			
1998 Dec.31	Depreciatoin account.......................Dr		16,000	
	To Machinery account			16,000
	(Being depreciation charged to machinery)			
1998 Dec.31	Profit and loss account ....Dr		16,000	
	To Depreciation account			16,000
	(Being the depreciation transferred to profit & loss account)			

1999 Dec.31	Depreciation account...................Dr	16,000	
	To Machinery account		16,000
	(Being depreciation charged to machinery)		
1998 Dec.31	Profit and loss account ....Dr	16,000	
	To Depreciation account		16,000
	(Being depreciation transferred to profit & loss account)		

Machinery Account

Dr. **Cr.**

Date	**Particulars**	**L.f**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1998 Jan. 1	To Bank		1,80,000	1998 Dec.31	By Depreciation		16,000
				,,	By Balance c/d		1,64,000
			1,80,000				1,80,000
1999 Jan. 1	To Balance		1,64,000	1999 Dec.31	By Depreciation		16,000
				,,	By Balance c/d		1,48,000
			1,64,000				1,64,000
2000 Jan. 1	To Balance b/d		1,48,000				

Depreciation Account

Dr.							Cr.
Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1998 Dec. 31	To Machinery A/c		16,000	1998 Dec.31	By P & L A/C		16,000
1999 Dec.31	To Machinery A/c		16,000	1999 Dec.31	By P & L A/C		16,000

Balance sheet as on 31-12-98

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
			Machinery A/c.	1,80,000	
			Less : Depreciation	16,000	1,64,000

Balance sheet as on December 31, 1999

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
			Machinery A/c.	1,64,000	
			Less : Depreciation	16,000	1,48,000

(b) When provision for depreciation account is maintained:

In the books of Saicharan Journal Entries

Date	Particulars	L.F	Rs.	Rs.
1998 Jan.1	Machinery account..........................Dr		1,80,000	
	To Bank account			1,80,000
	(Being the machinery purchase by cheque)			
1998 Dec.31	Depreciatoin account.......................Dr		16,000	
	To provision for depreciation account			16,000
	(Being depreciation provided for the accounting period)			

1998 Dec.31	Profit and loss account ....Dr	16,000	
	To Depreciation account		16,000
	(Being the depreciation transferred to profit & loss account)		
1999 Dec.31	Depreciation account...................Dr	16,000	
	To provision for depreciation account		16,000
	(Being depreciation provided for the accounting period)		
1998 Dec.31	Profit and loss account ....Dr	16,000	
	To Depreciation account		16,000
	(Being depreciation transferred to profit & loss account)		

Machinery Account

Dr. **Cr.**

Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1998 Jan. 1	To Bank A/c		1,80,000	1998 Dec.31	By Balance c/d		1,80,000
1999 Jan. 1	To Balance b/d		1,80,000	1999 Dec.31	By Balance c/d		1,80,000
2000 Jan. 1	To Balance b/d		1,80,000				

Provision for depreciation Account

Dr.							Cr.
Date	**Particulars**	**L.f**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1998				1998			
Dec. 31	To Balance c/d		16,000	Dec.31	By Depreciation A/c		16,000
1999				1999			
Dec.31	To Balance c/d		32,000	Dec.31	By Balance b/d		16,000
				Dec.31	By Depreciation A/c		16,000
			32,000				32,000
				2000			
				Jan. 1	By Balance b/d		32,000

Depreciation Account

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
31.12.98	To Provision for Depreciation		16,000	31.12.98	By P & L A/C		16,000
31.12.99	To Provision for Depreciation		16,000	31.12.99	By P & L A/C		16,000

Balance sheet as on December 31, 1998

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
			Machinery	1,80,000	
			Less : Provision for depreciation	16,000	
					1,64,000

Balance sheet as on December 31, 1999

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
			Machinery	1,80,000	
			Less : Provision for depreciation	32,000	
					1,48,000

Advantages of Fixed Instalment Method

(1) It is simple to calculate and easy to understand

(2) It can reduce the book value of the asset to zero

(3) The valuation of the asset each year in the balance sheet is resonably fair.

Disadvantages of Fixed Instalment Method

(i) This methods ignores the fact that the service yielding ability of the assets tends to fall but the repairs and maintenance costs increase with passage of time. Thought each year's charge for depreciation is the same, the charge for repairs and renewals goes on increasing as the asset becomes old. Therefore, the charge to the profit and loss account increases over the years.

(ii) If an additional assets is acquired, the amount to be charged as depreciation needs to be recalculated.

5.8. DIMINISHING BALANCE OR REDUCING INSTALMENT METHOD:

The most important defect of the fixed instalment method is that the burden (along with repairs and renewals) on the Profit and loss account of various years is disproportionate. To remedy this defect, the reducing instalment methods of depreciation are devised so that the total burden on the profit and loss account is the same every year, while the depreciation instalments will be decreasing, the repairs and renewal charges will be increasing year after year. There are two important methods under the diminishing balance system. They are:

(i) Written down value method.

(ii) Double-declining balance method

(i) Written Down Value Method: Under this method, depreciation is charged at a fixed rate on the reducing balance of the asset every year. Every year the depreciation charge will get reduced because depreciation is calculated on the opening balance of the asset. Since the depreciation is calculated in the written down value of the asset each year, it is known as written down value method. Under this method also, repairs and renewals have to be separately charged to the profit and loss account and provision for replacement of the asset has also to be made separately.

Current year depreciation=Current year beginning value of the asset x Rate/100.

Here, the calculation of rate of depreciation involves a complex procedure. The formula used for calculating the rate under this method is:

$$\text{Rate of depreciation} = 1 - n\sqrt{\frac{\text{Scrap value}}{\text{Cost of the asset}}}$$

n = the expected useful life in years.

Illustration- 6:

Calculate the amount of annual depreciation for three years by reducing balance method from the following particulars

i. Cost of machinery is Rs. 40,000

ii. expected life is 3 years

iii. rate of depreciation 33 1/3%

iv. Scrap value is Rs. 40,000.

Solution :

	Rs.
Reducing balance Method :	
Original cost	40,000
Less : depreciation for first year (33 1/3% x 40,000)	13,333
Written down value (WDV)	26,667
Less : depreciation for second year (33 1/3% x 26,667)	8,889
Written down value	17,778
Less : depreciation for thrid year (33 1/3% x 17,778)	5,926
Written down value	11,852

Illustration- 7:

A company purchased a machinery on 1.1.1998 for Rs. 1,50,000. It was decided to write off the machinery by using diminshing balance method. The rate of depreciation was 15% p.a., on 1.7.1999 the machine was sold for Rs. 1,00,000 show the Machine account for the year 1998 and 1999.

Solution :

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
1998				1998			
Jan. 1	To cash A/c.		1,50,000	Dec.31	By Depreciation A/c		22,500
				,,	By Balance c/d		1,27,500
			1,50,000				1,50,000
1999				1999			
Jan. 1	To Balance c/d		1,27,500	July 1	By cash A/c.		1,00,000
				,,,	By Depreciation A/c		9,563
				Dec.31	By profit and loss A/c.		17,937
			1,27,500				1,27,500

Illustration- 8:

On 1st April 1998 Sahitya Ltd. purchased a second - hand machine for Rs. 98,000 and spend Rs. 2,000 on its erection. On 1st July. 2000 this machine was sold for Rs. 48,000.

Prepare the machinery account for the first 3 years according to the written down value method taking the rate of depreciation as 10% p.a.

Solution :

Working Notes :

Profit and Loss on sale of Machinery

	Rs.
Book value of the machine as on date of sale (83,250 - 4,162,50)	79,087,50
Less : Sale of machinery	48,000,00
Loss on sale of machinery	31,087,50

In the Bookd of Sahitya Ltd.

Machinery Account

Date	**Particulars**	**L.f**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1998				1998			
April 1	To cash A/c.		98,000	Dec.31	By Depreciation A/c		7,500
"	To cash A/c.		2,000				92,500
			1,00,000				1,00,000
1999				1999			
Jan. 1	To Balance b/d		92,500	Dec.31	By Depreciation A/c		9,250
				Dec.31	By balance c/d		83,250
			92,500				92,500

2000			2000		
Jan. 1	To Balance b/d	83,250	July 1	By Depreciation A/c	4,162,50
			July 1	By cash A/c.	48,000,00
			Dec.31	By profit and loss A/c.	31,087,50
		83,250			83,250

(ii) **Double Declining Balance Method:** Under this method also, depreciation is charged onthe reduced balance at the beginning of the period, but the rate is arrived at by doubling the straight line rate. The rate under this method, is calculated on the residual value of the asset.

Illustration-9:

Sudheer & Co, purchased a plant on January 1, 1997 for Rs. 21,000 and spent Rs. 1,000 on its erection. The asset is expected to last for 4 years, after which its break up value is estimated to be Rs. 2,000. Find out the amount of depreciation to be charged every year under double declining balance method and show how the plant account would appear for the 4 years assuming that it is sold away for Rs. 1,700 at the end.

Solution : 22,000 4

The rate can be arrived at as follows :

Cost of the assest to be depreciated	Rs. 22,000
(including erection charges)	
Estimated life	4 year
Depreciation per annum =	Rs 5,500

Rate of depreciation under straight line method ; $\frac{100x5,500}{22,000}$ = 25%

Rate of depreciation under double declining balance method 2 x 25 = 50% [of the balance at the beginning of each year]

The amount charged as depreciation during the 4 years of life would be as follows :

	Balance at the beginning	Rate	Depreciation
	Rs.		Rs.
1st Year	22,000	50%	11,000
2nd Year	11,000	50%	5,500
3rd Year	5,500	50%	2,750
4th Year	2,750	50%	1,375
Balance left at the end of assets - life	1,375		

Dr **Plant Account** **Cr**

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
1997				1997			
Jan. 1	To cash A/c.		21,000	Dec.31	By Depreciation A/c		11,000
"	To cash A/c. (erection charges)		1,000		By balance c/d		11,000
			22,000				22,000
1998				1998			
Jan. 1	To Balance b/d		11,000	Dec.31	By Depreciation A/c		5,500
				Dec.31	By balance c/d		5,500
			11,000				11,000
1999			1999				
Jan. 1	To Balance b/d		5,500	Dec.31	By Depreciation A/c		2,750
				Dec.31	By balance c/d		2,750
			5,500				5,500

2000			2000		
Jan. 1	To Balance b/d	2,750	Dec.31	By Depreciation A/c	1,375
Dec.31	To P& L A/c	325	Dec.31	By cash c/d	1,700
		3,075			3,075

Advantages of Diminishing Balance Method

1. As the decreasing charge for depreciation cancels out the increasing charges for repairs over the years, it gives a fair charge for depreciation.
2. No recalculation is necessary when additional assets are purchased.
3. This method is applicable for income tax purposes.

Disadvantages:

1. This method lacks simplicity - the ascertainment of the percentage to be applied.
2. This method cannot be applied for assets with a very short life.
3. The assets is never fully depreciated.

Illustration-10:

A plant is purchased for Rs. 20,000. It is depreciated at 5% p.a. on reducing balance method for five years when it becomes obsolete due to new method of production and is therefore scrapped. The scrap produces Rs. 5,385. Show the plant account in the ledger.

Plant Account

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
I yrs.	To cash A/c.		20,000	II yrs.	By Depreciation A/c (20,000x 5/100)		1,000
					By balance c/d		19,000
			20,000				20,000
II yrs.	To balance A/c.		19,000	II yrs.	By Depreciation A/c (19,000x 5/100)		950
					By balance c/d		17,147
			19,000				19,000

III yrs.	To balance A/c.	18,050	III yrs.	By Depreciation A/c (18,050x 5/100)	903
				By balance c/d	18,050
		18,050			18,050
IV yrs.	To balance A/c.	17,147	IV yrs.	By Depreciation A/c (17,147x 5/100)	857
				By balance c/d	16,290
		17,147			17,147
V yrs.	To balance A/c.	16,290	V yrs.	By Depreciation A/c	815
			"	By cash A/c	5,385
				By P & L A/c (loss on sale of plant)	1,090
		16,290			16,290

5.9 ANNUITY METHOD :

This method takes into account not only the shrinkage in the utility value of the asset (depreciation) but also the loss by way of interest on the capital invested in the purchase of the asset. The amount invested in the asset would have earned some interest if it was not invested in that particular asset. Thus, the loss of interest foregone also has to be taken into account. The asset account is debited every year with the annual interest on the (diminishing) value of the asset account appearing at the beginning of each year, and the value of the asset plus interest is sought to be completely written off during a given period by this method. Thus, the amount written off as depreciation is the same each year, but the interest to be debited will diminish year after year. The fixed amount to be charged every year as depreciation is calculated from the annuity table, an extract of which is given below:

Amount required to be written off Re.1 by annuity method

Year	Interest on 3%	Interest on 4%	Interest on 5%	Interest on 6%
1	1.0300	1.0400	1.0500	1.0600
2	0.5226	0.5302	0.5378	0.5454
3	0.3535	0.3603	0.3672	0.3741
4	0.2690	0.2755	0.2820	0.2885
5	0.2184	0.2246	0.2310	0.2374
6	0.1846	0.1908	0.1907	0.2034
7	0.1605	0.1666	0.1728	0.1791
8	0.1425	0.1485	0.1547	0.1610
9	0.1284	0.1345	0.1407	0.1470
10	0.1172	0.1233	0.1295	0.1359
15	0.0838	0.0899	0.0963	0.1030
20	0.0672	0.0736	0.0802	0.0872
25	0.0574	0.0640	0.0710	0.0782

This method of depreciation can only be applied to an asset, the life of which will extend to a known period, e.g., a lease. Since the depreciation charge is same and the interest charges decrease each year (because interest is calculated on reducing balance). The net charge for depreciation (depreciaton less interest) gradually decreases.

	Accounting entries	Rs.	Rs.
1.	Asset A/c ....Dr.	xxx	
	To Interest A/c.		xxx
	(Being interest debited to asset A/c.)		
2.	Depreciaton A/c........................Dr.	xxx	
	To Asset A/c.		xxx
	(Being deprecaition charges)		

Illustration-14:

Bhargavi Ltd., took a lease on 1st January, 1995, costing Rs.1,00,000 for a period of 5 years. The company decided to amortise the lease by annuity method, interest at the rate of 5% p.a. being charged. If annuity of Re.1 for 5 years at 5% is 0.230975, show lease account for the whole period.

Solution:

Annual instalment=1,00,000 x 0.230975 = Rs.23,097.50

In the Books of Bhargavi Ltd. Lease Account

Dr. **Cr.**

Date	Particulars	L.f	Rs.	Date	Particulars	L.F.	Rs.
1995				1995			
Jan. 1	To cash A/c.		1,00,000	Dec.31	By Depreciation A/c		23,097.50
Dec.31	To interest A/c.		5,000	"	By balance c/d		81,902.50
			1,05,000				1,05,000
1996				1996			
Jan. 1	To Balance b/d.		81,902.50	Dec.31	By Depreciation A/c		23,097.50
Dec.31	To interest A/c.		4,095.13	"	By balance c/d		62,900.13
			85,997.63				85,997.63
1997				1997			
Jan. 1	To Balance b/d.		62,900.13	Dec.31	By Depreciation A/c		23,097.50
Dec.31	To interest A/c.		3,145.00	"	By balance c/d		42,947.63
			66,045.13				66,045.13
1998				1998			
Jan. 1	To Balance b/d.		42,947.63	Dec.31	By Depreciation A/c		23,097.50
Dec.31	To interest A/c.		2,147.38	"	By balance c/d		21,997.51
			45,095.01				45,095.01

1999			1999		
Jan. 1	To Balance b/d.	21.997.51	Dec.31	By Depreciation A/c	23,097.50
Dec.31	To interest A/c.	1,099.99			
		23,097.50			23,097.50

Note: (difference between last year opening balance and annual installment = last year interest).

We give below a table showing the amount of interest and depreciation charged each year and net debit to profit and loss account:

Year	**Depreciaton (debited P&L A/C)**	**Interest (credited to P&L A/C)**	**Net (debited to P&L A/C)**	**Remarks**
1995	23,097.50	5,000	18,097.50	Note that:cost
1996	23,097.50	4,095.13	19,002.37	of lease and
1997	23,097.50	3,145.00	19,952.50	interst is
1998	23,097.50	2,147.38	20,950.12	equal to the
1999	23,097.50	1,099.99	21,997.51	total depreciation
Total	1,15,487.50	15,487.50	1,00,000.00	

Illustration-15:

A trader takes a lease of 5 years for Rs.5,000. He decided to write off lease by annuity method presuming the rate of interest at 5% p.a. The annuity table shows that annual amount necessary to write off Re.1 in 5 years at 5% p.a. is Re.0.230975.

Show the lease account for 5 years.

Solution:

Annual instalment =5,000 x .230975=1,154.88

Lease Account

Dr. **Cr.**

Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
I Yr.	To Cash		5,000.00	I yr	By Depreciation A/c		1,154.88
	To Interest		250.00		By Balance c/d		4,095.12
			5,250.00				5,250.00

II Yr.	To Balance b/d	4,095.12	II yr	By Depreciation A/c	1,154.88
	To interest	204.76		By balance c/d	3,145.00
		4,299.88			4,299.88
III Yr.	To Balance b/d	3,145.00	III yr	By Depreciation A/c	1,154.88
	To interest	157.25		By balance c/d	2,147.37
		3.302.25			3.302.25
IV Yr.	To Balance b/d	2,147.37	IV yr	By Depreciation A/c	1,154.88
	To interest	107.37		By balance c/d	1,099.86
		2,254.74			2,254.74
V Yr.	To Balance b/d	1,099.86	V yr	By Depreciation A/c	1,154.88
	To interest	55.02			
		1,154.88			1,154.88

Notes: (i) The amount of depreciation is fixed for all the years.

(ii) The amount of interest is reduced every year for the reason it is calculated on the written down balance.

(iii) The toal charge to profit and loss account can be found out by striking out the balance of depreciaton and interest. The net amount to be charged to the profit and loss account in the above example has been given in the following list:

Year	**Depreciation debited** **Rs.**	**Interest credited** **Rs.**	**Net charge against profit** **Rs.**
1	1,154.88	250.00	904.88
2	1,154.88	204.76	950.12
3	1,154.88	157.25	997.63
4	1,154.88	107.37	1,047.51
5	1,154.88	55.02	1,099.86
	5,774.40	774.40	5,000.00

(iv) It should be noted that net charge against profit increase year after year for the reason depreciation is a fixed amount while interest credited reduces every year.

(v)	Cost price of the asset	Rs.5,000.00
		Rs. 774.40
	Total Depreciation	Rs.5,774.40

5.10. DEPRECIATION FUND METHOD :

This method is also known as "Sinking fund" method. This method is followed when provision for replacement of the asset has to be made. Under this method, a fixed amount is charged for depreciation to the profit and loss account every year and credited to 'depreciation fund' account and on equal amount of money is invested in outside securities every year. These investments are allowed to accumulate at compound for replacement of the used asset through the realisation of the securities. The asset account will remain at its original value in the ledger till the end of its life and closed at the end, by tranferring the balance in the 'depreciation fund' account to the asset account.

Since the securities always earn some interest, it is not necessary to write off the full cost of the asset as depreciation. Something less will be adequate. Ultimately, the total depreciation written off and interest earned on securities should be equal to the original cost of the asset. Hence, under this method the depreciation charge will be less than what it would be under other methods. In addition, this method has an added advantage of providing ready funds for replacement of the old asset at the end of its life.

It is necessary to refer to sinking fund table to arrive at the depreciation to be provided every year, as the interest (at a fixed rate) eanred on the proposed investments is also to be takne into account. An extract of sinking fund table is given below:

Sinking Fund Table

Periodic deposit which will amount to Re.1

Years	1%	2%	3%	4%	5%	6%
1	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000
2	0.4975	0.4951	0.4926	0.4902	0.4878	0.4854
3	0.3300	0.3268	0.3235	0.3203	0.3172	0.3141
4	0.2463	0.2426	0.2390	0.2355	0.2320	0.2286
5	0.1960	0.1922	0.1884	0.1846	0.1810	0.1174
6	0.1625	0.1585	0.1546	0.1508	0.1470	0.1434
7	0.1386	0.1345	0.1305	0.1266	0.1228	0.1191

8	0.1207	0.1165	0.1125	0.1082	0.1047	0.1010
9	0.1067	1.1025	0.0984	0.0945	0.0907	0.0870
10	0.0956	0.0913	0.0872	0.0833	0.0795	0.0759
15	0.0621	0.0578	0.0538	0.0499	0.0463	0.0430
20	0.0454	0.0412	0.0372	0.0336	0.0302	0.0272
25	0.0354	0.0312	0.0274	0.0240	0.0219	0.0182

Accounting Treatment

The entries to be recorded under this method are as follows:

I. At the end of first year:

		Rs.	**Rs.**
(a)	For providing annual depreciation :		
	Depreciation A/c ....Dr.	xxx	
	To Depreciation fund A/c.		xxx
(b)	For investing the amount of depreciation:		
	Depreciation Fund investmensts A/C...Dr.	xxx	
	To Bank A/c.		xxx
(c)	For transferring depreciation to profit and loss A/c :		
	Profit and Loss A/c ....Dr.	xxx	
	To Depreciation A/c.		xxx

II. At the end of second and subsequent years upto last but one year:

(a)	For interest received on investments purchased out of depreciation fund :		
	Cash A/c ....Dr.	xxx	
	To Depreciation fund A/c.		xxx
(b)	For annual instalment of depreciation :		
	Depreciation A/c ....Dr.	xxx	

	To Depreciation fund A/c.		xxx
(c)	For investing the amount of depreciation of this year and interest earned on investment of fund :		
	Depreciation fund investments A/c .....Dr.	xxx	
	To cash A/c.		xxx
(d)	For transferring depreciation to profit and loss A/c :		
	Profit and Loss A/c ....Dr.	xxx	
	To Depreciation A/c.		xxx

III. At the end of the last year of the life of the asset :

(a)	For annual instalment of depreciation :		
	Depreciation A/c ....Dr.	xxx	
	To Depreciation fund A/c.		xxx
(b)	For transferring depreciation to profit and loss A/c :		
	Profit and Loss A/c ....Dr.	xxx	
	To Depreciation A/c.		xxx
(c)	For sale of investments :		
	Cash A/c ....Dr.	xxx	
	To Depreciation funds investments A/c.		xxx
(d)	For profit earned on sale of investments :		
	Depreciated Fund Investments A/c ....Dr.	xxx	
	To Depreciation funds A/c.		xxx

(If there is a loss reverse entry has to be passed)

(e)	For writting off the old asset :		
	Depreciation Fund A/c ....Dr.	xxx	
	To Asset A/c.		xxx

(f)	For transferring the balance of depreciation fund account :		
	(i) If it shows credit balance :		
	Depreciation Fund ....Dr.	xxx	
	To profit and loss A/c.		xxx
	(ii) If it shows debit balance :		
	Profit and loss A/c. ....Dr.	xxx	
	To Depreciation Fund A/c.		xxx
(g)	For purchasing new asset :		
	New Asset A/c ....Dr.	xxx	
	To Bank A/c.		

Illustration-16:

A company purchased 3 years lease on January, 1997 for Rs.1,00,000. It has decided to provide for the replacement of the lease at the end of 3 years by setting up a depreciation fund. It is expected that investments will fetch interest at 5%. Sinking fund table shows that 0.317208 at 5% will accumulate to Re.1 in 3 years.

Investments are sold on 31.12.1999 at the book value. Pass necessary journal entries and record for three years in the books of the company.

Solution:

Depreciation (annual contribution)

=Rs.1,00,000 x 0.317208 = Rs.31,720.80

Journal Entries in the books of company

Date	Particulars	L.F	Rs.	Rs.
1997				
Jan.1	Lease A/c.........................Dr		1,00,000	
	To Cash A/c			1,00,000
	(Being the purchase or lease for 3 year)			
Dec.31	Depreciatoin A/c......................Dr		31,720.80	
	To Depreiation Fund A/c			31,720.80
	(Being depreciation written off)			

Dec.31	Depreciatoin Fund investments A/c..Dr	31,720	
	To Cash A/c		31,720
	(Being the amount invested in Securities)		
Dec.31	Profit and loss account ....Dr	31,720.80	
	To Depreciation account		31,720.80
	(Being transfer of depreciation to profit & loss account)		
1998			
Dec.31	Cash A/c...................Dr	1,586	
	To Depreciation Fund A/c.		1,586
	(Being the interest on depreciation fund investments received)		
Dec.31	Depreciatoin A/c.....................Dr	31,720.80	
	To Depreiation Fund A/c		31,720.80
	(Being depreciation written off)		
Dec.31	Depreciatoin Fund investments A/c..Dr	33,306	
	To Cash A/c		33,306
	(Being depreciation written off)		
Dec.31	Profit and loss account ....Dr	31,720.80	
	To Depreciation account		31,720.80
	(Being transfer of depreciation to profit & loss account)		
1998			
Dec.31	Depreciatoin A/c.....................Dr	31,720.80	
	To Depreiation Fund A/c		31,720.80
	(Being depreciation written off)		
Dec.31	Profit and loss account ....Dr	31,720.80	
	To Depreciation account		31,720.80
	(Being transfer of depreciation to profit & loss account)		

Dec.31	Cash A/c ....Dr	65,026	
	To Depreciation fund investments A/c.		65,026
	(Being the sale of investment)		
Dec.31	Depreciation Fund A/c ....Dr	99,999.82	
	To Lease A/c.		99,999.82
	(Being writing off the old lease)		
Dec.31	Profit and loss A/c ....Dr	0.18	
	To Lease A/c.		0.18
	(Being transfer of the balance of lease A/c. to profit and loss A/c.)		

Ledger Account in the books of the company
Depreciation Fund Investments Account

Dr. **Cr.**

Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1997				1997			
Dec.31	To Cash A/c		31,720	Dec.31	By Balance c/d		31,720
			31,720				31,720
1998				1998			
Jan. 1	To Balance b/d		31,720	Dec.31	By balance c/d		65,026
Dec.31	To Cash A/c		33,306				
			65,026				65,026
1998				1998			
Jan. 1	To Balance b/d		65,026	Dec.31	By cash A/c. (sale of investments)		65,026
			65,026				65,026

Depreciation Fund Account

Dr. **Cr.**

Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1997				1997			
Dec.31	To Balance c/d		31,720.80	Dec.31	By Depreciation		31,720
			31,720.80				31,720.80
1998				1998			
Jan. 1	To Balance b/d		65,027.64	Dec.31	By balance c/d		31,720.80
				Dec.31	To Cash (interest) A/c.		1,586.04
					By Depreciation A/c.		31,720.80
			65,027.64				65,027.64
1999				1999			
Jan. 1	To Lease A/c		1,00,000.00	Dec.31	By balance b/d		65,027.64
				Dec.31	To Cash (interest) A/c.		3,251.56
					By Depreciation A/c.		31,720.80
			1,00,000.00				1,00,000.00

Lease Account

Dr. **Cr.**

Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1997				1997			
Jan. 1	To cash A/c		1,00,000	Dec.31	By Balance c/d		1,00,000

1998			1998		
Jan. 1	To Balance b/d	1,00,000	Dec.31	By Balance c/d	1,00,000
1999			1999		
Jan. 1	To Balance b/d	1,00,000	Dec.31	By Depreciation Fund A/c	1,00,000
		1,00,000			1,00,000

Depreciation Account

Dr. **Cr.**

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
1997				1997			
Dec.31	To Depreciation Fund A/c.		31.720.80	Dec.31	By Profit and loss A/c.		31.720.80
1998				1998			
Dec.31	To Depreciation Fund A/c.		31.720.80	Dec.31	By Profit and loss A/c.		31.720.80
1999				1999			
Dec.31	To Depreciation Fund A/c.		31.720.80	Dec.31	By Profit and loss A/c.		31.720.80

5.11. INSURANCE POLICY METHOD :

This is similar to the sinking fund method but, instead of investing the money in securities, the amount is used in paying premium on a policy taken out with an insurance company. The policy should mature immediately after the expiry of the useful life of the asset. The money that is received from the insurance company is used to replace the asset. Though the interest received is lower than could be obtained by investing in securities, the risk of loss on realization of securities is avoided. To be more conservative, some accountants are of the opinion that the policy account should be adjusted, at the year end, at its surrender value, because the policy is for a fixed sum and there is no intention of surrendering it.

The following are the journal entries passed under this method:

During the first and sebsequent years, except in the last year:

(a)	For payment of yearly premium	Rs.	Rs.
	Depreciation insurance policy A/c...........Dr.	xxx	
	To Bank a.c.		xxx
(b)	For yearly depreciation:		
	Depreciation A/c...................................Dr.	xxx	
	To Depreciation fund A/c.		xxx
	or		
	To Insurance fund A/c.		
(c)	For transfering to profit and loss A/c.		
	Profit and Loss A/c. ....Dr.	xxx	
	To Depreciation A/c.		xxx

During the last year:

(d)	For realisation of insurance policy:		
	Cash A/c...Dr.	xxx	
	To Depreciation insurance policy A/c.		xxx
(e)	For the excess amount transferred to depreciation fund account:		
	Depreciation insurance policy A/c...........Dr.	xxx	
	To Depreciation fund A/c.		xxx
	or		
	To Insurance fund A/c.		
(f)	For writing off the old asset:		
	Depreciation fund A/c ....Dr.	xxx	
	or		
	Insurance fund A/c................................Dr.		
	To Old asset A/c.		xxx
(g)	For purchase of new asset:		
	New Asset A/c. .... Dr.	xxx	
	To Cash A/c.		xxx

Illustration-19:

On 1st January 1996, a lease of premises was purchased four years for Rs.1,00,000 and decided to make provision for the replecement of the lease by means of an insurance policy purchased for an annual premium of Rs.24,000. Show depreciation fund A/c. lease on premises A/c. and depreciation insurance policy A/c. for four years.

Solution:

Depreciation Fund Account or Insurance Fund A/c.

Dr.							**Cr.**
Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1996				1996			
Dec.31	To Balance c/d		24,000	Dec.31	By Deprciation		24,000
			24,000				24,000
1997				1997			
Dec.31	To Balance c/d		48,000	Jan.1	By Balance c/d		24,000
				Dec.31	By Depreciation A/c.		24,000
			48,000				48,000
1998				1998			
Dec.31	To Balance b/d		72,000	Dec.31	By balance c/d		48,000
				Dec.31	By Depreciation A/c.		24,000
			72,000				72,000
1999				1999			
Dec.31	To Lease on premises A/c		1,00,000	Dec.31	By balance b/d		72,000
				Dec.31	By Depreciation A/c.		24,000
					By Depreciation insurance policy A/c.		4,000
			1,00,000.				1,00,000

Depreciation Insurance Policy Account

Dr. **Cr.**

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
1996				1996			
Jan. 1	To cash A/c		24,000	Dec.31	By Balance c/d		24,000
1997				1997			
Jan. 1	To balance b/d		24,000	Dec.31	By Balance c/d		48,000
Jan. 1	To cash A/c		24,000				
			48,000				48,000
1998				1998			
Jan. 1	To balance b/d		48,000	Dec.31	By Balance c/d		72,000
Jan.1	To cash A/c		24,000				
			72,000				72,000
1999				1999			
Jan. 1	To balance b/d		72,000	Dec.31	By cash A/c		1,00,000
Jan.1	To cash A/c		24,000				
Dec. 31	To Depreciation Fund A/c		4,000				
			1,00,000				1,00,000

Lease on Premises Account

Dr. **Cr.**

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
1996				1996			
Jan. 1	To cash A/c		1,00,000	Dec.31	By Balance c/d		1,00,000
1997				1997			
Jan. 1	To balance b/d		1,00,000	Dec.31	By Balance c/d		1,00,000
1998				1998			
Jan. 1	To balance b/d		1,00,000	Dec.31	By Balance c/d		1,00,000
1999				1999			
Jan. 1	To balance b/d		1,00,000	Dec.31	By Depreciation Fund A/c		1,00,000

5.12. SUM OF DIGITS METHOD :

This method is an improvement over written down value method. In this method also, the depreciation charge gets reduced year after year, but the depreciation is not calculated on the balance at the beginning of each year. Since a constantly declining rate is applied to the original cost (plus erection charges minus residual value, if any), the asset value is reducible to zero. Under this method, the individual years (in the asset's life) in reverse order is taken as numerator and the total life of the asset in years is taken as the denominator. The cost is multiplied with this factor.

For example: The cost of the asset to be depreciated is Rs.30,000. Life of the asset is 3 years.

Sum of the years=1+2+3=6 will be taken as denominator, individual years, i.e., 1, 2 & 3 (in reverse order) will be taken as numerator. Thus, depreciation to be charged in each of the years will be:

	Rs.		Rs.
1 st year	30,000 x	=	15,000
2 nd year	30,000 x	=	10,000
3 rd year	30,000 x	=	5,000

Illustration-20:

Sainath & Co., purchased a cold storage plant on January 1, 1996 for Rs.10,500 and spent Rs.500 on its erection. The asset is expected to last for 4 years, after which its break up value is estimated to be Rs.1,000. On 31st December, 1999 the plant was sold for Rs.850. Find out the amount of depreciation to be charged every year under sum of digits method and show the plant account for 4 years.

Solution:

Sum of the year=1+2+3+4=10 will be taken as denominator.

Individual years i.e., 1, 2, 3 & 4 (in reverse order) will be taken as numerator. Thus depreciation to be charged in each of the years will be:

	Rs.	Rs.		Rs.
1st year	[10,500+500-1,000]	10,000 x	=	4,000
2nd year		10,000 x	=	3,000

3rd year	10,000 x	=	2,000
4th year	10,000 x	=	1,000

Plant Account

Dr. **Cr.**

Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1996				1996			
Jan. 1	To cash A/c		10,500	Dec.31	By Depreciatoin		4,000
"	To cash A/c. (erection charges)		500	"	By Balance c/d		7,000
			11,000				11,000
1997				1997			
Jan. 1	To Balance b/d		7,000	Dec.31	By Depreciation A/c.		3,000
					By Balance c/d		4,000
			7,000				7,000
1998				1998			
Jan. 1	To Balance b/d		4,000	Dec.31	By Depreciation A/c.		2,000
					By Balance c/d		2,000
			4,000				4,000
1999				1999			
Jan. 1	To Balance b/d		2,000	Dec.31	By Depreciation A/c.		1,000
					By Cash A/c.		850
					By Loss on sale of asset A/c.		150
			2,000				2,000

Depletion Method:

This method is specially suited to mines, quarries, oil-wells, timber stands etc., from which a certain quantity of out put is expected to be raised. For example, the value of a mine depends upon the quantity of mineral that is obtained. Hence, it can be said that the mine depreciates according to the quantity of mineral mined. It is advisable in such cases not to calculate the depreciation in terms of years. Rather it is most appropriate to compute the cost per unit by dividing the total cost with total qunatity of units that can be obtained and charge the depreciation every year based on the number of units obtained. For example, if the unit cost is Re.1 and in a year 1,000 units are obtained, the depletion value will be 1,000 units x Re.1 = Rs.1,000. The following illustration will clarify the position further:

Illustration-21:

Sai Timber Company acquired a timber tract for Rs.7,500 and spent Rs.1,500 on developing the tract. The tract was estimated to contain 5 lakh board feet of timber. It was estimated that the cut over land could to be sold for Rs.500.

Calculate the depletion charge if 50,000 board feet were cut in 1999.

Solution:

Depletion=

Depletion per 1000 Board Feet= x 50,000= Rs.850/-

For the year 1999 depletion (i.e., depreciation) is = 850/-

5.13. REVALUATION METHOD :

This method is also known as “inventory method”. It is adopted where the assets to be depreciated consist of a large of small and diverse items of small unit cost. Example are loose tools, sacks, bottles etc., when there are large numbers of items of small value, too much clerical work will be necessary to maintain individual accounts.

Under this method, the asset in question are revalued at the end of every year. Usually the value at the end of the period will be less than at the beginning of the period. The difference, i.e., the fall in the value is charged as depreciation by debiting the profit and loss A/c. and crediting the asset A/c.. It may be noted that the depreciation amount is not accumulated and credited to depreciation fund account.

Illustration-22:

M/s. Raj Bros., has loose tools valued at Rs.10,000 on the 1st January 1999. On July 1, 1999 they purchased additional tools to the tune of Rs.6,000. On December 31, 1999 the entire stock of tools are revalued at Rs.11,000. Pass the necessary journal entries and show the asset account for 1999.

Solution:

Journal Entries

Date	Particulars	L.F	Dr. Amount . Rs.	Cr. Amount Rs.
1999				
Dec.31	Depreciation A/c...........Dr.		5,000	
	To Loos tools A/c			5,000
	(Being the depreciation on revaluation of loose tools written off)			
	Profit and Loss A/c.......Dr.		5,000	
	To Depreciaton A/c.			5,000
	(Being transfer of depreciaton to profit and loss A/c.)			

Loose Tools Account

Dr.							Cr.
Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
1999				1999			
Jan. 1	To Balance b/d		10,000	Dec.31	By Depreciation A/c.		5,000
July . 1	To Cash A/c.		6,000	Dec.31	By Balance c/d		11,000
			16,000				16,000

5.14. MACHINE HOUR RATE METHOD

This method is useful in the case of machines. The life of machine is sometimes fixed in terms of number of hours it can work. Then the cost of the machine is divided by the estimated total number of hours the machine can work and the hourly rate of depreciation arrived at. This rate is multiplied with the number of hours the machine has worked in a given period, to arrive at the depreciation charged for that period. For example: a machine costing Rs.50,000 is expected to be used for 24,000 hours in all. It has a scrap value of Rs.2,000. Then the hourly rate of depreciation is

$$\frac{\text{Rs.50,000-Rs.2000}}{24{,}000} = \frac{48{,}000}{24{,}000} = \text{Rs.2}$$

If the machine has worked for 2,000 hours in a year total depreciation to be written off that year would be Rs.2 x 2,000 = Rs.4,000.

5.15. MILEAGE METHOD :

This method is used in the case of buses, cars, trucks, rolling stock etc., whose working life depends upon the number of kilometers they are driven. Suppose a car costing Rs.75,000 was purchased and its useful life was estimated to be 50,000 km. Then the rate of depreciation would be Rs.1.50 per km. During a given period if the car is driven for 10,000 km, the depreciation to be charged for that period will be 1.50 x 10,000= Rs.15,000.

5.16 QUESTIONS :

I. Short Answer Type:

1. Define depreciation. Explain the reasons for providing depreciation.
2. What are the causes of depreciation?
3. What is an annuity?
4. What is meant by sinking fund?

II.Essay Type:

1. What is depreciation? Why is it needed?
2. Define depreciation and explain the objectives and causes there of?
3. Discuss the various methods of depreciation
4. Why is the straight line method so called? What are its advantages and disadvantages?
5. What are the methods based upon diminishing balances? Discuss the differences between these methods in calculating depreciation?
6. What do you understand by the annuity method? How is it different from the depreciation fund method?

EXERCISES :

1. Sridhar & Co., purchased a machinery on January 1, 1996 at 72,000. The Scrap value in ten years time is expected to be Rs.17,000. If depreciation is written off by equal installments every December 31, show the machinery account for the first three years. Calculate rate of depreciation.

   [Ans: Balance at the end of third year Rs.55,500 rate 7.64%]

2. A machine was purchased on 1st January 1997. Depreciation was written off at 10 percent per annum on diminishing balance method. At the end of 1999 the depreciated value of asset was Rs.72,000. Find out the cost price of the asset.

   [Ans: Rs.1,00,000]

3. Prasad purchased machinery for Rs.60,000. The asset has estimated life of 10 years and the residual value of Rs.10,000. If depreciation has to be provided on straight line basis, what would be the annual depreciation to be provided in percentage terms?

[Ans: Rate of depreciation 10%]

4. On 1st January, 1996 Ganga purchased a plant for Rs.1,00,000. Rate of depreciation is 10% p.a. Prepare plant account for 4 years under strength line method of depreciation.

[Ans: Balance Rs.60,000]

Straight Line Method

1. A machinery was purchased on 1.1.1997 for Rs.3,00,000. 10% depreciation is to be calculated every year. Prepare machinery account for three years assuming the method of depreciation. (Calculation followed is diminishing balance method and straight line method.)

[Ans: S.L.M. balance Rs.2,10,000: D.B.M. balance Rs.2,18,700]

2. An asset was purchased for Rs.50,000 on 1st January 1996. What would be its value after 3years when the method of depreciation is straight line method and written down value method at the rate of 10% p.a. Prepare a ledger account.

[Ans: S.L.M. balance Rs.35,000, W.D.V. balance Rs.36,450]

3. On 1st January, 1996 Chandra purchased a machinery for Rs.80,000. Again on July 1, 1997 he purchased an additional machinery worth Rs.20,000. On 1st April, 1998 he bought another machinery for Rs.10,000. Accounts are closed 31st December every year. Write off depreciation @ 10% p.a. as per diminishing balance method. Prepare machinery account for first 3 years and find out the balance of machinery account as on 31.12.1998.

[Ans: Machinery A/c. balance as on 1.4.1999 Rs.84,670]

4. A truck costing Rs.40,000 was purchased on 1.1.1998 and used for two years. 10% depreciation was provided on diminishing balance method and sold for Rs.24,000 at the end of the second year. Show the truck account for two years.

[Ans: Loss on sale of Truck Rs.84,00]

5. A company purchased a plant for Rs.8,000 on January 1, 1995. It further spent on it for installation and other capital expeneses Rs.1,000. It was brought in use from Ist of May, 1995. You are required to draw the following ledger accounts for the first four years when the rate of depreciation is 10% p.a. on straight line method; (a) Asset account and (b) provision for depreciation account the accounts of the company are closed on December 31 each year.

[Ans: Provision for depreciation account credit balance Rs.3,300]

6. Madhu Ltd., purchased a machine on the 1st of March, 1996 for Rs.80,000 and spent Rs.4,000 on it erection, which was completed on 31.3.1996. The machine was put to use on 1.4.1996. If the machine is tobe depreciated under the fixed instalment method at Rs.8,400 per annum, show the asset account for the first 4 years.

[Ans: Balance Rs.52,500]

7. On 1.1.1996 Nitish bought a machine for Rs.42,000 and installed it by incurring Rs.4,000 towards installation expenses. On 1st July 1996 he purchased additional machinery worth Rs.24,000. On 31.12.1997 he sold the machinery purchased on 1st July 1996 for Rs.22,000. Nitish decided to write off depreciation @ 10% p.a. as per fixed instalment method. Prepare machinery account for 2 years assuming that the accounting year closes on 31st December every year.

[Ans: Machinery A/c. balance as on 1.1.1998 Rs.36,800]

8. Chakravarthi purchased a second hand machine for Rs.18,000 on 1st April, 1996. He spent Rs.2,000 on its overhaul and installation. Depreciation is written off at 10 per cent annum on the original cost. On 30th June 1999, the machine was found to be unstuitable and sold for Rs.8,000. Prepare the machine account from 1996 to 1999 assuming that the accounts are closed on 31st December every year.

[Ans: Loss on sale of machine Rs.5,500]

9. Ranga purchased on 1st January, 1998 a machine for Rs.6,000. On 1st July. 1998 he purchased another machine for Rs.5,000. On 1st July, 1999 he sold the machine purchased on 1st January 1998 for Rs.4,000. It was decided that depreciation @ 10% p.a. was to be written off every year under the diminishing balance method. Assuming the accunts were closed on 31st December every year, show the mahcine account for the year 1998 and 1999.

[Ans: Balance Rs.4,275]

10. On 1.1.1999, balance of machinery A/c. was Rs.48,600. On 1.7.1999, a new machinery was purchased for Rs.24,000, installment cost Rs.1,000. On 1.9.1999 machinery was sold for Rs.6,000. The original cost of the machinery sold was Rs.10,000 On 1.1.1997. Machinery is depreciated at 10% p.a. under the diminishing balance method. Show machinery A/c. for the year 1999. The books are closed on 31st December every year.

[Ans: Machinery A/c. balance Rs.60,200]

11. A limited company bought a machinery for Rs.12,000 on 1st January, 1997. On 30th June, 1998 another machinery was purchased for Rs.2,000. On 31st March, 1999 the company sold a machine from those acquired on 1st January 1997 costing Rs.500 (Actual price) for Rs.50 as it is found to be defective.

On the same day another new machine is bought or Rs.800.

Assuming that the depreciation is written off @ 15% p.a. as per diminishing balance method. Prepare machinery account for first 3 years.

[Ans: Machinery A/c. balance as on 1.1.2000 Rs.9,345]

Annuity Method

12. A Lease is purchased on 1st January 1996 for 5 years at a cost of Rs.50,000. It is proposed to depreciate the lease by annuity method charging 5% interest. A reference to the annuity table shows but to depreciate Re.1 by annuity method over 5 years, chrging 5% interest, the amount to be written off is 0.230975. Show the lease A/c. for five years.

13. A firm purchased a lease hold property for a period of five years for Rs.1,00,000 on 1.1.1995. It was decided to write off the lease by annuity method presuming the rate of interest 5% p.a. The annuity table shows that the annual amount necessary to write off Re.1 at 5% is 0.230975. You are required to prepare lease account for the five years show the net amount to be charged to profit and loss account for these five years.

14. Ram & Co., Ltd., acquired a seven-year lease for a sum of Rs.60,000. It is proposed to depreciate it under the annuity method after charging interest at 4% p.a. Reference to the annuity table indicated that 0.1666091 at 4% p.a. is required to write off Rs.1 in seven years. You are required to show lease account for the first five yers.

[Ans: Balance at the end of fifth year Rs.18,854.59]

15. A plant is bought on 1.1.1995 for a sum of Rs.1,00,000 which has got a useful life of 5 years. It is estimated that it will fetch a scrap value of Rs.16,000 at the end of 5 years. It is decided to charge depreciation according to depreciation fund method. The investments are expected to earn 5% interest. Sinking fund table shows that Rs.0.180975 invested yearly at 5% produces Re.1 at the end of 5 years.

The investments are sold at the end of 5th year for Rs.64,000. The scrap realised Rs.17,000.

Show the necessary accounts.

[Ans: Loss on sale of investments Rs.14002.49]

16. M. Ltd. purchased machnery costing Rs.25,000 on 1st January, 1995. The company establishes a depreciation fund, investment are expected to realize 4% interest and the expected life of the machinery is 10 years. Table shows that to produce Re.1 at the end of 10 years at 4%, an annual investment of Rs.0.08329 is required.

At the end of fifth year the machinery has to be sold off as scrap. It realised Rs.7,000, investments were realized at 5% less then the book value. New machinery costing Rs.35,000 was purchased.

Show the necessary accounts.

[Ans: Loss on sale of machinery Rs.7,163.93]

17. Ram & Co., purchased a four years lease an January 1, 1995 for Rs.50,000. It is decided to provide for the rental of the lease at the end of four years by setting up a depreciation fund. It is expected that investments will fetch interest at 4% p.a. Sinking fund table shows that 0.235490 invested each year will produce Re.1 at the end of four years at 4% p.a.

On 31st December, 1998, the depreciation fund investments are sold for Rs.36,455.22. Prepare the necessary ledger accounts.

[Ans: Loss and sale of investments Rs.300.06]

Insurance Policy Method

18. A firm purchases a lease for 3 years for Rs.30,000 on 1.1.1996. It has decided to provide for its replacement by means of insurance policy for Rs.30,000. The annual premium is Rs.9,500. On 1.1.1999 the lease is renewed for a further period of three years for Rs.30,000. You are required to show the necessary ledger accounts.

[Ans: Profit on realisation of policy Rs.1,500]

19. Sri Ram has acquired manganese mines on payment of Rs.1,00,000 on 1st April, 1995. The lease period is five years. He proposes to provide for its replacement by means of an insurance policy for Rs.1,00,000. The annual premium is Rs.9,750. In 1st April, 2000 the lease is renewed for a further period of five years for the same amount. Show the necessary ledger accounts.

[Ans: Profit on the realisation of policy Rs.51,250]

Sum of Years Digits Method

20. Mahesh purchased an asset for Rs.8,400. Estimated life of the asset is 6 years, You are requested to open the asset account for the first three years when depreciation is charged by sum of years digit method.

[Ans: Balance at the end of third year Rs.2,400]

Depletion Method

21. Avinash Timber Co., acquired a timber tract for Rs.21,000 and spent Rs.1,000 on its development. The tract is estimated to contain 5 lakh board feet of timber, is expected that the cut over the land can be sold for Rs.2,000. Calculate the depletion per hundred board feet: and depletion if 80,000 board feet were cut in 1998.

[Ans: Rs.4 per 100 board feet Rs.3,200]

Revaluation Method

22. Rakesh Bearings Ltd., purchased tools on the 1st of January, 1997 for Rs.4,000. During the year additions were made to the extent of Rs.800. On the 31st December, 1997 the tools were valued at Rs.4,400 and at the end of 1998 at Rs.3,600. Prepare the loose tools account for 1997 and 1998.

[Ans: Depreciation under revaluation method 1st year Rs.400;

2nd year Rs.800]

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Lesson - 6

PROVISIONS AND RESERVES

OBJECTIVES:

By the study of this Chapter, you will be able to understand the classification of Reserves & Provisions. Secret Reserve, Provision for Bad & Doubtful Debts, Provision for Discount on Debtors & Creditors etc.,

STRUCTURE:

6.1 Introduction

6.2 Provisions and Reserves Distinguished

6.3 Classification of Reserves and Provisions

6.4 Secret Reserves

6.5 Provision for Doubtful Debts

6.6 Provision for Discount on Debtors

6.7 Provision for Discount on Creditors

6.8 Questions

6.9 Exercises

6.1. INTRODUCTION

'Reserves' refer to undistributed profits set aside for the purpose of meeting some liability, contingency of some other commitment. Creation of reserves reduces the profits available for distribution to the owners. The presence of reserves strengthens the financial position of the organisation. As they are created out of profits, reserves show a credit balance and posted on the liabilities side of the balance sheet. When a reserve is represented by some specific investment made outside the business, the word 'fund' is added to denote the same, however, when no such outside investment is made the account is merely called a reserve. The word 'provision' refers to the amounts set aside as a charge against the profits. Reserve and reserve funds, generally speaking, refer to amounts set apart out of the profits. The purpose of creating them may be any one of the following:

(i) For meeting future (anticipater anticipated) liabilities or losses; eg., provisions for repairs, provision for doubtful debts etc.,

(ii) For fulfilling some specific purpose e.g., equalisation of dividednd

(iii) For redemption of liabilities e.g., repayment of redeemable preference shares or debentures etc.,

(iv) For replacing assets e.g., depreciation fund for replacement of machinery, lease etc., and

(v) For strengthening the financial position of the organisation e.g., general reserve.

6.2. PROVISIONS AND RESERVES DISTINGUISHED :

Provisions :

The term, “provision”, refers to any amount retained for meeting any known liability or loss amount of the liability may not be accurately known. However, if the amount of the liability can be accuretely ascertained, it will be considered a liability and not a provision. The uncertainty regarding the amount makes it necessary to create some provision which makes it possible to meet any liability as and when it actually occurs. Thus, the provision made may be less than adequate or more than adequate to meet the actual purpose for which it has been created. However, as the amount of the estimated provision is based on what the most experience indicates, it should generally be sufficient to meet any liability or loses in respect thereof. The exmple of “provision” are provisions for depreciation; provision for doubtful debts; provision for taxation; provision for repairs and renweals; provision for contingencies etc.

Reserves :

The term “reserve” is used to denote any sum which is created by appropriating profit for the purpose of meeting any contingency commitment etc. Creation of reserves generally improves financial strength of the business concern. Usually, the amount represented by the reverse is retained within the business and thus adds to the working capital available for conducting the operations. Sometimes, the reserve amount is not invested within the business, but is taken out and invested outside the business e.g., purchase of securities. The purpose of investing the amount outside the business is to ensure that when the amounts are actually needed the outside securities can be readily disposed off and the amounts realised in cash. On the contrary, if the amounts are reinvested within the business, it may be difficult to have adequate cash readily available for meeting the particular purpose for which the reserve is created. Whenever, a reserve is represented by amounts invested outside the business, it is called “reserve fund”. Thus the suffix “fund” generally denotes the presence of specific outside investments.

Distinction :

The following are the important points of distinction between a provision and a reserve:

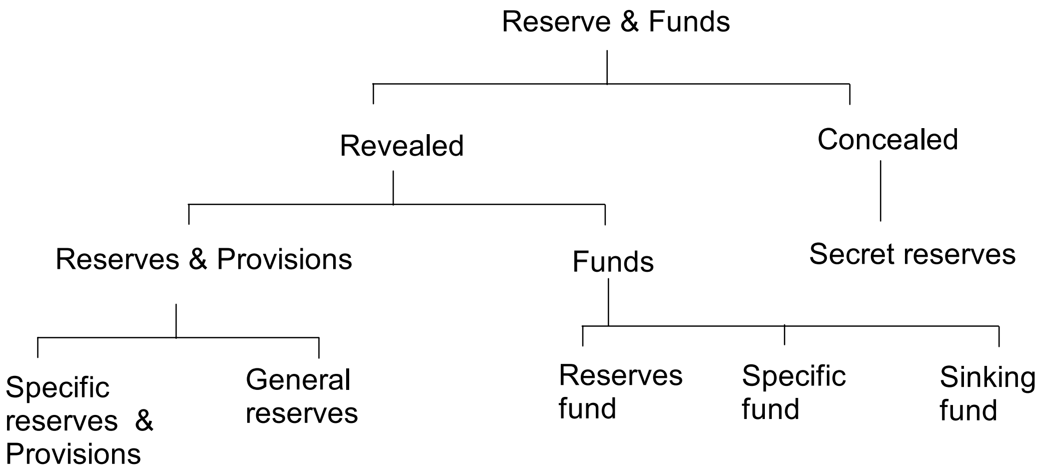
(1) A provision is a charge to the profit and loss A/c and is created whether profits exist or not. A reserve is an appropriation of profit. Which is otherwise available for distribution as dividends to owners, Provisions are created by debiting the profit and loss A/c before clculating the net profit or loss; reserves are created by debiting profit and loss appropriation A/c whch means that reserves can be created only when there are profits.

(2) Creation of provisions is usually a matter of necessity; but creation of reserves is a matter of business prudence.

(3) Provisions are generally shown as deductions from the concerned asset item on the asset side of the balance sheet. This helps the showing of asset items at the expected realisable values. Reserves are shown on the liabilities side of the balance sheet, but are not to be treated as a liability. Reserves represent accumulations from divisible profits which otherwise belongs to the owners and hence a part of the net profit.

6.3. CLASSIFICATION OF RESERVES AND PROVISIONS :

The reserves and funds may be created for a short or specified period or may remain in existence continuously for long periods. Further, such a reserve might have been created for meeting a know liability or for an unknown liability, i.e., contingency. Again the reserves created may be revealed in the books of accounts or may remain concealed. Keeping in view these points, the reserves and funds can be classified as follows:


Reserve & Funds
Revealed
Concealed
Reserves & Provisions
Funds
Secret reserves
Specific reserves & Provisions
General reserves
Reserves fund
Specific fund
Sinking fund

The basic purpose of creating reserves and provisions is to meet with greater cofidence the uncertainties and unforeseen commitments that are natural in the conduct of any business.

Reserves can be classified as:

(i) Statutory reserves;

(ii) Capital reserves; and

(iii) Revenue reserves.

(i) Statutory Reserves: Statutory reserves are those whose creation has become an obligation on account of certain provisions in the relevant statues; e.g., statutory reserve required under the provisions of Section 17, Banking Companies Act, 1949.

(ii) **Capital Reserves:** Sometimes, a concern acquired certain capital profits. These capital profits cannot be considered to have been earned in the context of day to day trading operations and hence cannot be treated as readily available for distribution amongst the shareholders. When reserves are created out of such capital profits, they are called capital reserves. Examples of such reserves are; premium on the issue of shares and debentures; profits made on the reissue of foreited shares; profits, if any, earned prior to incorporation. Profit on sale of a part of the business profit on redemption of debentures etc.

(iii) **Revenue Reserves:** These are reserves which are created out of revenue surpluses only and are thus otherwise available for distribution as dividends to the share holders. Example of revenue reserves are general reserve, debebture redemption reserve, investment fluctuation reserve, contingency reserve, dividend equalisation reserve etc.

Reserve can also be classified as -

(a) General reserve, and

(b) Specific reserves.

(a) **Genral Reserves:** General reserves, as the name implies are not created for any specific purpose. Thus, they must be considered available for meeting unexpected future losses or any other contingencies. So long as the amounts are available, they can be utilized for financing the expansion of the business. Thus, they generally represent the provisions of additional working capital and help in strengthening the financial position of the business.

(b) **Specific Reserves:** Specific reserves are those which are created for a definite or specific purpose and are generally utilized to meet that definite purpose. Stirctly speaking, nothing prevents the owners from utilising the unspent balances on these reserves. But in practice, it is considered as a self imposed restriction and acts as a restrainst or check on making use of funds for any other purpose other than the originally intended one. Examples are dividend equalisation reserves and debenture redemption reserves.

Sinking Fund:

A Sinking fund is a fund that is created to have some money readily available at the end of a specific period for replacement of an asset or redemption of a liability.

6.4. SECRET RESERVES :

A secret reserve is a reserve whose existence is not revealed in the balance sheet. Thus, the amount with which the secret reserve exists is also not disclosed in the balance sheet. The creation of secret reserves is prohibited under the provisions of the Companies Act 1956 (except in the case of banks) such a prohibition is to ensure that all material facts regarding the financial position of the concern are fully disclosed or made known in the final accounts. Secret reserves are created in the following ways:

(i) By charging excessive depreciation: Though the asset is appearing at a very low or nominal value. The business continues to have the fullest advantage of the asset in question.

(ii) By undervaluing good will or stock in trade: Profits are understated and the real strength/ success of the concern remains concealed.

(iii) By creating certain accounts like provisions for bad debts with for larger amounts than are needed or warranted by circumstances. This step also results in the suppression of profits.

(iv) By charging capital expenditure as revenue expenditure to profit and loss account. Installation charges have to be capitalised along with the cost of machinery. But by writing them off to the profit and loss account the profits get understed and this measure results in the creation of secret reserves because the asset also now gets understated. Certain other measures that are resorted to for the creation of secret reserves can be stated as:

(a) suppressing the sales:

(b) showing some contingent liability as a real liability

(c) grouping certain free reserves along with creditors.

Advantages of Secret Reserves: Secret reserves are permitted only when it is important for the concern to enjoy the public confidence without interruption. The presence of secret reserves ensures the following advantages:

1. The financial position of the concern is strengthened.
2. As profits and financial position are both understated, the presence of secret reserves discourages potential competitors, thereby ensuring continuous market share and profits.
3. It helps to tide over unfavourable times i.e., lower profits in any year can be manipulated and the payment of a regular dividend becomes possible.

Objections to the Creation of Secret Reserves

1. As the method of creating secret reserves is by understating or omitting the assets and by overstating the liabilities, the balance sheet does not furnish a true picture of the financial position of the concern.
2. As the charging of excessive depreciation is one of the methods of creating secret reserves, the profit and loss account will not disclose the true profit earned and thus the published accounts do not reveal the correct position.
3. The presence of secret reserves may encourage mismanagement, conceal the inefficiency or cover up the manipulations by the management, as it is only they who are aware of the existence and size of the secret reserves.

Classification of Provisions :

The provisions may be classified as -

(i) Provision for doubtful debts, and

(ii) Provision for discount on debtors and creditors.

6.5. PROVISION FOR DOUBTFUL DEBTS :

When credit sales are made, some of the amounts might not have been realised by the end of the year and so would appear as sundry debtors. As both cash sales and credit sales (including the unrealised portion of credit sales) are taken on the credit side of the trading and profit and loss account. The profit is determined on accrual basis i.e., the porfit might have not yet been actually realised in cash and the profit figure represents “profit earned” and not “profit received or realised”. Further it is possible that all the sundry debtors may not pay the amounts due from them. When some of them become insolvent, either the whole amount may be lost or only a part of it is realised and thus the remaining part must be considered as bad debts. Business experience dictates that as the determination of the profits during the current year are based on the unrealised credit sales it would be prudent to set aside a part of the current year’s profits as provision for doubtful debts to meet the probable loss that might arise in the ensuring period on account of some of the debts becoming bad.

The creation of a provision for doubtful debts from out of the profits of an accounting period simultaneously achieves the following two purposes:

(a) Brings down the profits for the year to a more reasonable level;

(b) Helps the sundry debtors to appear at an expected realisable level on the assets side of the balance sheet.

It is true that no one can accuratley determine the actual loss that would arise in the next accounting period and that is why an estimate is made. The sundry debtors are classified into good and doubtful debtors and as regards the doubtful, the amount is estimated as a probable loss of account of bad debts. However for all practical purposes the provision to be made is given as a specified percentage of the total sundry debtor’s amount.

Accounting Treatment

			Rs.	**Rs.**
1.	For creating a provision for doubtful debts A/C.			
	Profit & Loss A/C	Dr	xxx	
	To provision for doubtful debts A/C			xxx
	(Being the provision for doubtful debts)			

2. When ever a bad debts occur the following entry is passed

Bad debts A/C Dr xxx

To concerred debtors A/C xxx

(Being bad debts written off)

3. When a provision for doubtful debts account exists, the bad debts account balance is transferred to the provision account. The entry being-

Provision for doubtful debts A/C Dr xxx

To Bad debtors A/C xxx

(Being bad debts written off against the provision)

The debit balance on bad debts A/c represent the total loss on account of bad debts in that year, whereas the provision was created at the end of the previous year to meet bad debts losses that might arise from out of the sundry debtors receivable at the end of the year. Thus, if some debtors of the ccurent year also became bad during the current year then such bad debts losses also would get transfereed to the provisions for doubtful debts account. After transferrring bad debts to "provision for doubtful debts account". The provision for doubtful debts accunt may show;

(a) a credit balance, which means that the provision made last year is more than the loss incurred during the current year, or

(b) a debt balance indicating that the loss on account of bad debts is more than the provisions made.

After ascertaining the balance on the provision for doubtful debts account, debit or credit balance, the amount of provision required to be created the end of the year so as to be carreid forward to the next year, is again estimated. Now the balance on the provision for doubtful debts account is adjusted against the new provision required to be made. This implies that

(a) if a credit balance appears on the provision account (after transferring the bad debt losses) it would be compared with the provision required for the coming year usually. The available credit balance would be less than the amount required for the new provision. Hence for the difference which is needed to be provided , now the entry No.1 given above will be passed;

(b) if the credit balance appearing on the provision account is more than adequate to cover the provision for the coming year also leaving a balance, it would represent surplus, i.e., the provision made in the previous year is more than adequate to meet the combined amount of current years bad debts losses and the new provision required for the coming year. This surplus amout will be transferred back to the profit and loss account by means of the following entry

Provision for doubtful debts A/c Dr. To Profit and Loss A/c (Being the surplus amount credited back)			xxx

Though the surplus amount is credited back to profit and loss accounts till a new provision account exists and this new provision account has to be deducted from sundry debtors on the asset side of the balance sheet.

Illustration-1:

A Trader's book showed sundry Debtors as Rs.1,00,000 as on the 31st Dec. 1997. He has decided to open a provision for doubtful debts A/c at 5% on the debtors. During the year 1998 bad debts amounted to Rs.8,000; his sundry debtors on the 31st December 1998 was Rs.3,00,000; he wanted to continue maintaining a provision for doubtful debts account at 5% on debtors. During the year 1999 his bad debts amounted to Rs.3,000; his sundry debtors as on the 31st December 1999 was Rs.2,00,000; he desired to continue the policy of maintaining a provision account at 5% on Debtors.

Show the journal entries and the necessary ledger accounts and also how these items appear in the final accounts during the 3 years period.

Solution :

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Date	**Particulars**	**L.f**	**Rs.**	**Rs.**
1997				
Dec.31	Profit and loss A/C..........................Dr		5,000	
	To provision for doubtful debts A/C			5,000
	(Being the provision for doubtful debts)			
1998				
Dec.31	Bad debts A/C..........................Dr		8,000	
	To Sundry debtors A/C			8,000
	(Being bad debts written off)			
1998				
Dec.31	provision for doubtful debts A/C....Dr		8,000	
	To Bad debts A/C			8,000

	(Being the transfer of bad debts)		
1998 Dec.31	Profit and loss A/C...................Dr	3,000	
	To Sundry debtors A/C		3,000
	(Being bad debts written off)		
1998 Dec.31	Provision for doubtful debts A/C....Dr	3,000	
	To Bad debts A/C		3,000
	(Being the transfer of bad debts)		
1998 Dec.31	Provision for doubtful debts A/C....Dr	2,000	
	To Profit and loss A/C		2,000
	(Being the transfer of surplus amount to profit and loss account the excess amount on provision account after meeting both the bad debt loss and the amount required for a new provision for the coming year.)		

LEDGER

Bad debts Account

Dr. **Cr.**

Date	**Particulars**	**L.F.**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1998				1998			
	To sundry debtors A/C		8,000	Dec.31	By provision for doubtful debts A/C		8,000
			8,000				8,000
1999				1999			
	To sundry debtors A/C		3,000	Dec.31	By provision for doubtful debts A/C		3,000

Provision for Dobtful Debts Account

Dr. Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
1997				1997			
Dec. 31	To Balance c/d		5,000	Dec.31	By P&L A/C		5,000
			5,000				5,000
1998				1998			
Dec.31	To bad debts A/C		8,000	Jan .1	By Balance b/d		5,000
Dec.31	To Balance c/d		15,000		By P&L A/C		18,000
			23,000				23,000
1999				1999			
Dec.31	To bad debts A/C		3,000	Jan .1	By Balance b/d		15,000
Dec.31	To P&I A/C		2,000				
Dec.31	To Balance c/d		10,000				
			15,000				15,000

Profit & Loss Account

Dr. Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
1997							
	To provision for		5,000				
1998							
	To Bad debts 8,000 Provision required 15,000 23,000		5,000				

Less : Provision at the beginning 5,000	18,000			
		1999	By provision for doubtful debts at the beginning	15,000
			Less : Bad debts 3,000	
			Less:Provision requires 10,000 13,000	2,000

Balance sheet as on December 31, 1997

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
			Sundry debtors	1,00,000	
			Less : Provision for doubtful debts	5,000	95,000

Balance sheet as on December 31, 1998

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
			Sundry debtors	3,00,000	
			Less : Provision for doubtful debts	15,000	2,85,000

Balance sheet as on December 31, 1999

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
			Sundry debtors	2,00,000	
			Less : Provision for doubtful debts	10,000	1,90,000

Note: The bad debts entry will be passed whenever bad debts occur. Thus the bad debts appearing in the trial balance represent the amount already written off from the sundry debtors. Sometimes in addition to the debts given in the trial balance additional bad debts are given in the adjustments below the trial balance. This means the relevant entry for writing off the bad debts amount is required to be passed now. Thus, when the entry is passed, bad debts amount, given in the trial balance, will be increased by the additional bad debts given in the adjustments and the sum of sundry debtors given in the trial balance will stand decreased by the additional bad debts given in the adjustments. It is on this reduced balance of sundry debtors the required new provision has to be estimated.

In the illustration worked out above it was assumed that sundry debtors given is the amount after bad debts were written off. However, in order to show clearly the journal entries regarding the writing off bad debts, their transfer to provision A/c etc., the journal entries are given.

6.6. PROVISION FOR DISCOUNT ON DEBTORS :

Just as the expected bad debt losses are provided out of the year's profits, so also the estimated loss likely to arise on account of allowing of some cash discount as an incentive to encourage prompt payment to the debtors is created by having 'a Provision for discount on debtors A/c'. Broadly speaking, the treatment of provision for discount on debtors account is similar to that of provision for doubtful debts A/c. Some books usually refer to this item as 'Reserve for discount on debtors' eventhough it is appropriate to call it a provision. The point is that the provision for discount on debtors is always calculated after deducting the provision for doubtful debts from the sundry debtors. The following are the entries to be passed.

(i) When a provision for discount on debtors is created:

		Rs.	**Rs.**
Profit and Loss A/c....................	Dr.	xxx	
To Provision for discount on debtors			xxx
(Being the creation of a provision for discount)			

(ii) You are awre that cash discount will be allowed for prompt payment by the debtors. Whenever cash is received, the entry would be:

Cash A/c...................................	Dr.	xxx	
Discount A/c..............................	Dr.	xxx	
To Debtors A/c.			xxx
(Being the receipt of cash and discount allowed)			

(iii) The total discounts allowed during the year get posted from the cash book debit side to the debit of discount allowed account in the ledger. Now that a provision for discount on debtors account exists, the discount allowed account is transferred to the provision account by means of the following entry.

Provision for discount on debtors........	Dr.	xxx	
To Discount allowed A/c.			xxx
(Being the trasfer of discount allowed to provision A/c.)			

(iv) As explained in the context of provision for doubtful debts account the balance on provision for discount on debtors account, show either a credit balance representing excess provision or a debit balance thereby indicating that the provision is less than adequate to meet the loss. The provision required for the coming year will be estimated and the provision for discount on debtors account will have this amount appear on its debit side as 'To Balance c/d'. Now this provision account would reveal whether (a) any amount is required to be tranaferred from P & L A/c or (b) if any surplus is existing on the provision account, the amount required to be transferred to the P & L A/c.

(1) When situation (a) stated above exists:

		Rs.	Rs.
Profit & Loss A/c........................	Dr.	xxx	
To Provision for discount on debtors A/c			xxx
(Being the provision of the amount required for maintaining the new reserve after adjusting the loss on account of discount)			

(2) When situation (b) stated above exists:

Provision for discount on debtors A/c.....	Dr.	xxx	
To Profit and loss A/c.			xxx
(Being the transfer of excess amount on provision account after meeting the requirements of current years loss and the new provision required)			

6.7. PROVISION FOR DISCOUNT ON CREDITORS :

When timely payments are made by the trader to his creditors, he is likely to receive some discount which will be a gain to him. Thus, the amount of sundry creditors appearing at the end of the year may represent a higher amount than he is likely to pay in the coming year. The probable gain, estimated to be obtained, is taken into account by creating a 'Provision for discount on creditors A/c'. Except for the fact that this provision account represnets a debit balance in all other respects, the treatment is similar to what is explained above in the context of provision for discount on debtors account.

The following are the entries to be passed:

(i) When a provision for discount on creditors is created:

Provision for discount on creditors.......	Dr.	xxx	
To Profit & Loss A/c			xxx
(Being the creatio of provision for discount)			

(ii) You are aware that the creditors allows cash discount to trader when the latter makes prompt payment. Whenever cash is paid the entry would be:

Creditors..	Dr.	xxx	
To Cash A/c			xxx
To Discount A/c			xxx

(Being the payment of cash and discount received)

(iii) The total discount received during the year gets posted from cash book credit side to the credit of discount received account in the ledger. As a provision for discount on creditors account exists, the discount received account is transferred by means of the following entry:

Discount received A/c..........................	Dr.	xxx	
To Provision for discount on creditors A/c			xxx

(Being the transfer of discount received to provision A/c)

(iv) As explained earlier the balance on provision for discount on creditors A/c now shows either a debit balance signifying excess provision or a credit balance suggesting that the provision was less and that the gain made was more. The provision required for the coming year will be estimated and the provision for discount on creditors account will have this amount appear on its credit side as By Balance c/d. Now the provision A/c would reveal whether any amount is required (a) to be credited to profit and loss account or (b) to be debited to profit and loss account.

(1) When situation (a) stated above exists:

Provision for discount on creditors A/c...	Dr.	xxx	
To Profit and loss A/c			xxx

(Being the transfer of amount from provision A/c
after taking care of the current year gain and the
new provision made)

(2) When situation (b) stated above, exists:

Profit and loss A/c....................	Dr.	xxx	
To Provision for discount on creditors A/c			xxx

(Being the transfer of excess amount from
provision account to profit and loss A/c)

The following illustration shows a situation where the accounts of both provisions are maintained.

Illustration-2:

A trader's book showed the following balances on the 1st of January, 1998.

	Rs.
Provision for discount on debtors	3,000
Provision for discount on creditors	2,000

During the year 1998 discounts allowed by him amounted to Rs.5,000 and discounts received by him Rs.4,000. He finds that on the 31st of December 1998 his sundry debtors and creditors were Rs.2,00,000 and Rs.1,20,000 respectively. He decided to provide a provision for discount on both debtors and creditors at 2%. During the year 1999, discount allowed by him amounted to Rs.1,000 and discounts received by him, Rs.800. He finds that on the 31st of December 1999 his Sundry Debtors and Creditors stood at Rs. 1,00,000 and Rs.60,000 respectively. He decided to provide a provision for discount on both debtors and creditors at 2%.

You are required to show the journal entries and the provision for discount on debtors and creditors account besides indicating how these items appear in the final accounts during the two years.

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Date	Particulars	L.f	Rs.	Rs.
1998				
Dec.31	Provision for discount on debtors A/C..Dr		5,000	
	To Discount allowed A/C			5,000
	(Being the transfer of discount allowed to the provision A/c)			
Dec.31	Discount received.............................. .Dr		4,000	
	To Provision for discount on Creditors A/C			4,000
	(Being the transfer of discount received to the provision A/c)			
Dec.31	Profit and loss A/C		6,000	
	To Provision for discount on debtors A/C			6,000
	(Being the amount required for meeting the new provision and the excess of discounts allowed over the provision)			
Dec.31	Provision for discount on Creditors A/C...Dr		4,400	
	To Profit and loss A/C			4,400
	(Being the transfer of excess amount discounts received over the provision along with the new provision)			

Dec.31	Provision for discount on debtors A/C...Dr	1,000	
	To Discount allowed A/C		1,000
	(Being the transfer of discounts allowed to the provision A/c)		
Dec.31	Discount received.............................. .Dr	800	
	To Provision for discount on Creditors A/C		800
	(Being the transfer of discount received to the provision A/c)		
Dec.31	Provision for discount on debtors A/C...Dr	1,000	
	To Profit and loss A/C		1,000
	(Being the transfer of excess provision to the profit and loss A/c)		
Dec.31	Profit and loss A/C	400	
	To Provision for discount on creditors A/C		400
	(Being the transfer of excess provision to the P&L A/c)		

Note : Journal entries required for recording the discounts allowed and received have not been passed separately as these amounts are considered to have been passed through the cash book. Thus, only the entries required to transfer these sums to the respective provisions account have been shown above.

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Discounts Allowed Account

Dr. **Cr.**

Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1998				1998			
	To sundrys debtors A/C		5,000	Dec.31	By provision for discount on Debtors A/c.		5,000
			5,000				5,000

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
1999				1999			
	To sundrys debtors A/C		1,000	Dec.31	By provision for discount on Debtors A/c.		1,000
			1,000				1,000

Discount Received Account

Dr. **Cr.**

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
1998				1998			
Dec. 31	To Provision for discount on Creditors A/c		4,000	Dec.31	By sundry Creditors A/c		4,000
			4,000				4,000
1998				1998			
Dec.31	To Provision for discount on Creditors A/c		800	Dec.31	By sundry Creditors A/c		800
			800				800

Provision for Discount on Debtors Account

Dr. **Cr.**

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
1998				1998			
Dec. 31	To Discount allowed A/c		5,000	Dec.31	By balance b/d		3,000
Dec. 31	To Balance C/d		5,000	Dec.31	By P& L A/c		6,000
			9,000				9,000

1999				1999		
Dec. 31	To Discount allowed A/c	1,000		Dec.31	By balance b/d	4,000
Dec. 31	To P& L A/c	1,000				
Dec. 31	To Balance C/d	2,000				
		4,000				4,000
				2000		
				Jan.1	By Balance b/d	2,000

Provision for Discount on Creditors Account

Dr. **Cr.**

Date	**Particulars**	**L.F**	**Rs.**	**Date**	**Particulars**	**L.F.**	**Rs.**
1998				1998			
Jan. 1	To Balance b/d		2,000	Dec.31	By Discount received A/c		4,000
Dec. 31	To P & L A/c		4,400	Dec.31	By Balance C/d		2,400
			6,400				6,400
1999				1999			
Jan. 1	To Balance b/d		2,400	Dec.31	By Discount received A/c		800
				Dec. 31	By P & L A/c.		400
				Dec.31	By Balance C/d		1,200
			2,400				2,400
2000							
Jan.1	To Balance b/d		1,200				

Dr.						Cr.			
Date	Particulars		L.F	Rs.	Date	Particulars		L.F.	Rs.
1998					1998				
	To Provision for discount on					By Provision for discount			
	debtors A/c					on creditors A/c			
	Discount allowed	5,000				Discount received	4,000		
	Add : New Provision	4,000				Add : New provision	2,400		
		9,000					6,400		
	Less : Old provision	3,000		6,000		Less : Old provision	2,000		4,400
1999					1999				
	To Provision for discount					By Provision for discount			
	Creditors A/c					on Debtors A/c			
	Old provision	2,400				Old provision	4,000		
	Less : Discount received 800					Less : Discount allowed	1,000		
	Less :								
	New provision 12,00	2,000		400			3,000		
						Less: New provision	2,000		1,000

Balance sheet as on December 31, 1998

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Sundry debtors	1,20,000		Sundry debtors	2,00,000	
Less : Provision for discount on debts	2,400	1,17,600	Less : Provision for discount on debtors	4,000	1,96,000

Balance sheet as on December 31, 1999

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Sundry Creditors	60,000		Sundry debtors	1,00,000	
Less : Provision for discount on Creditors	1,200	58,500	Less : Provision for discount on debts	2,000	98,000

6.8. QUESTIONS :

I. Short Answer Type

1. Explain the following :

   (a) Reserve Vs Provision

   (b) Secret reserve-statutory reserve

   (c) Define reserve state different types of reserves

II. Essay Type

1. Define reserve. Explain the purpose of creating different types of reserves.
2. What is reserve? Distinguish between a reserve and provision.
3. What is a secret reserve? How is it created? What are its advantages and limitations?
4. Distinguish between secret reserves and specific reserves.
5. Distinguish between general reserves and specific reserves.
6. Explain the accounting treatment concerning the maintenance of a provision for doubtful debts.

6.9 EXERCISES :

1. A businessman’s books showed sundry debtors at Rs.10,00,000 as on the 31st December 1997, on which date he decided to maintain a provision for doubtful debts A/c at 5% on the debtors.

During the year 1998 his bad debts amounted to Rs.1,00,000. His sundry debtors stood at Rs.25,00,000 as on the 31st December, 1998. He desired to continue the provision for doubtful debts A/c at the same rate of 5% on debtors. During the year 1999 his debtors amounted to Rs.25,000. On the 31st December, 1999 his debtors stood at Rs.18,00,000. He desired to continue the provision A/c at 5%.

Give the journal entries and show the necessary ledger accounts, besides indicating how the relevent accounts would appear in the final accounts during the three year period.

(**Ans:** Amount debited to the profit and loss A/c in 1997 Rs.50,000; 1998 Rs.1,75,000) (Amount credited to P & L A/c in 1999 Rs.10,000)]

2. In the year 1997 the books of M/s. B.R. Ltd. showed bad debts to the true of Rs.30,000. The provisions for doubtful debts at the commencement of the year stood at Rs.40,000; The debtors stood at Rs.2,90,000. The firm adopts a policy of maintaining a provision for doubtful debts A/c at 5%.

During the year 1998 bad debts amounted to Rs.40,000 and on 31st of December of the year debtors amounted to Rs.5,00,000.

During the year 1999 bad debts were Rs.10,000 and the sundry debtors at the end of the year stood at Rs.1,00,000. The policy of maintaining a provision A/c was continued.

Show the provision for doubtful debts A/c for all the three years and also show how this account appears in the profit and loss A/c and in the balance sheet.

[Ans: Amount debited to P & L A/c in 1997 Rs.4,500 in 1998 Rs.50,500; Amount credited to P & L A/c in 1999 Rs.10,000]

3. The following is an extract of the trial balance of Grandlay Plastic Ltd.

Trial Balance	**Dr.**	**Cr.**
	Rs.	**Rs.**
Sundry debtors	3,20,000	
Bad debts	8,000	
Provision for doubtful debts		9,000

Outside the trial balance, adjustments are given as under:

1. Write off further bad debts Rs.3,000
2. Maintain a provision for doubtful debts @5% on debtors.
3. Create a provision for discount on debtors at 2%

Write up necessary ledger accounts and show their position the profit and loss account and in the balance sheet.

[Ans: Amount debitd to P & L A/c towards provision for doubtful debts; Rs.17,850; Provisions for discount on debtors Rs.6,023)]

4. The following figures appear in the books of RRR and Bros.

1998

Jan.1	Provision for discount on debtors	1,200
Dec.31	Discount allowed during the year	3,000
Dec.31	Debtors	80,000

It was desired to maintain a provision for discount on debtors at 2%.

Show the provision A/c and also indicate how it appears in the final accounts.

[Amount debited to P & L A/c Rs.3,400]

5. Provision for discount on creditors appears at Rs.1,000 on 1.1.98 inthe books of a trader. During the year 1998 he receives discounts to the extent of Rs.900. On Dec. 31, 1998 his creditors amounted to Rs.2,00,000. He desired to maintain a provision for discount A/c at 2% on the creditors.

Give the necessary journal entries and show how the provision A/c appears in the ledger and also in final A/cs.

[Ans: Amount credited to P & L A/c Rs.3,900]

6. The following balance were extracted from the books of a trader:

1998

Jan.1	Provision for doubtful debts	10,000
Jan.1	Provision for discount on debtors	3,000
Jan.1	Provision for discount on creditors	2,000
Dec.31	Bad debts during the year	16,000
Dec.31	Discounts allowed during the year	5,000
Dec.31	Discounts received during the year	2,800
Dec.31	Sundry debtors	5,06,000
Dec.31	Sundry creditors	2,00,000

You are required to (i) write off further bad debts amounting to Rs.6,000; (ii) Maintain the provision for discount on debtors at 2% and (iii) maintain the provision for discount on creditors A/c at 1% (iv) maintain the provision for doubtful debts at 5% on sundry debtors.

Give journal entries and ledger accounts and show how these items appear in the final accounts.

[Ans: Amount to be debited to P & L A/c towards the provison for

DD: Rs.37,000; provision for discount on drs: Rs.11,500;

Provision for discounts on crs: Rs.2,800]

7. Atlas industries Ltd., maintains a provision for bad debts at 5% and provision for discout at 2% debtors. It also maintains a provision for discount on creditors at 2%. From the following particulars write up the provision A/c for all the three years. The floowing were the balances as on the 1st of January 1998.

	Rs.
Provision for bad debts	9,000
Provision for discount on debtors	8,000
Provision for discount on creditors	6,000

Other particulars are as follows:

Year	**Debtors**	**Creditors**	**Bad debts written off**	**Discount allowed**	**Discount received**
	Rs.	**Rs.**	**Rs.**	**Rs.**	**Rs.**
1998	2,00,000	2,00,000	5,000	6,000	5,000
1999	1,40,000	1,78,000	21,000	3,500	2,000
2000	1,70,000	1,52,000	6,000	7,000	4,600

Show also how the items would appear in the final accounts.

Ans.

	1998 P&L A/c		**1999 P&L A/c**		**2000 P&L A/c**	
	Debited	**Credited**	**Debited**	**Credited**	**Debited**	**Credited**
	Rs.	**Rs.**	**Rs.**	**Rs.**	**Rs.**	**Rs.**
Towards Prov. for DD	6,000	---	18,000	---	7,500	---
Towards Provision for discount on Debtors	1,800	---	2,360	---	7,570	---
Towards Provision for discount on Creditors	---	3,000	---	1,560	---	4,080

8. The provision for doubtful debts A/c in the books of M/s. Nirman Erectors Ltd., appeared at Rs.4,000 on the 1st of January 1997. The company dicided to maintain a provision of 5% on debtors towards doubtful debts end provisions for discount on debtors and creditors at 2% respectively. The following further information is available.

	1997 **Rs.**	**1998** **Rs.**	**1999** **Rs.**
Bad debts written off	500	2,000	4,000
Debtors at the end	60,000	80,000	1,00,000
Creditors at the end	50,000	75,000	80,000
Discount allowed	600	1,000	1,800
Discount received	5,000	1,100	1,600

You are required show the provision accounts for doubtful debts, discount of debtors, discount on creditors and also indicate how the items will appear in the profit and loss accounts and balane sheets of all the three years.

Ans.

	1997		1998		1999	
	P&L A/c		P&L A/c		P&L A/c	
	Debited	Credited	Debited	Credited	Debited	Credited
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
Towards Prov. for DD	---	500	3,000	---	5,000	---
Towards Provision for discount on Debtors	1,740	---	1,380	---	2,180	---
Towards Provision for discount on Creditors	---	6,000	---	1,600	---	1,700

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