

MBA 1303
FINANCIAL ACCOUNTING

স্কুল অব বিজনেস
SCHOOL OF BUSINESS

Bangladesh Open University
বাংলাদেশ উন্মুক্ত বিশ্ববিদ্যালয়

স্কুল অব বিজনেস
SCHOOL OF BUSINESS
বাংলাদেশ উন্মুক্ত বিশ্ববিদ্যালয়

MBA 1303
Financial Accounting

—Course Development Team—

Writer

Dr. Saroj Kumar Saha

Former Professor, Department of Accounting
Dhaka University

Dr. Monjur Morshed Mahmud

Former Professor, Department of Accounting
Chittagong University

Dr. A.T.M. Tofazzel Hossain

Former Professor, School of Business
Bangladesh Open University

Editor and Style Editor

Dr. Qazi Mohammad Galib Ahsan

Professor, School of Business
Bangladesh Open University
And

S.M. Miraj Ahmmod

Former Associate Professor, School of Business
Bangladesh Open University

Coordinator

Dean

School of Business
Bangladesh Open University

—Revised By:—

Dr. Md. Serazul Islam

Professor (Accounting)
School of Business
Bangladesh Open University

This book has been published after being refereed for the students of
School of Business, Bangladesh Open University

MBA 1303

Financial Accounting

Date of Publication:
First Print: 2001
Reprint with first edition: 2004
Reprint with minor edition: 2008
Reprint: 2010
Revised Print: 2024

Cover Design: Monirul Islam
Computer Compose: Md. Wahiduzzaman Howlader
Cover Graphics: Abdul Malek

Printed at:

This book has been published after being referred for the students of the School of Business, Bangladesh Open University

All rights reserved by the School of Business, Bangladesh Open University. No part of this book can be reproduced in any form without proper permission from the publisher.

Preface

A text book titled *Financial Accounting* is designed and developed for the MBA students of Bangladesh Open University. It is written in modular form and is the first of its kind on Financial Accounting in Bangladesh. The lessons have been so designed that learners find them easy to understand.

The book has eight units comprising 49 lessons. We do not claim it to be an original contribution. Rather it should be regarded as a text book of ideas from various renowned authorities in Financial Accounting. We have also quoted from different text books on Accounting usually followed by post-graduate students in our universities. Our endeavor has been to present the lessons in a very lucid manner so that they can be understood and assimilated by an average distance learner of the MBA program within the stipulated period of a semester.

Each unit is almost equivalent to one chapter of a conventional text book and contains four to eight lessons. Each of them starts with unit “highlights”. In fact the lessons are like the lecture notes of a classroom teacher, each starts with “lesson objectives” and ends with “review questions”. The review questions include essay type questions, some real life problems and case studies. We hope that self learners will not find much difficulty in understanding the lessons by themselves and will need only a little help from the tutor.

Because of a severe time constraint, we have had to take the real life problems from conventional text books of western origin. We hope to develop some cases extensively in the context of Bangladesh, so that our MBA students can relate their learning to their immediate environment and reality.

We are grateful to the honorable Vice Chancellor of BOU who gave us the most needed support and enthusiasm to write this book. Prof. Dr. Qazi Mohammad Galib Ahsan, S.M. Miraj Ahmmud, and Prof. Dr. Md. Serazul Islam, School of Business, BOU have made us indebted by their untiring efforts in editing and style editing each and every lesson diligently and meticulously. Our thanks are also due to Mohammad Wahiduzzaman Howlader, WPO of the School of Business, for doing very best to complete the task of desktop processing on time.

We shall feel rewarded for our labor if both general readers and self-learners find this book worthwhile and useful.

Dr. Saroj Kumar Saha
Dr. Monjur Morshed Mahmud
Dr. A.T.M. Tofazzel Hossain

Course: Financial Accounting (MBA 1303)

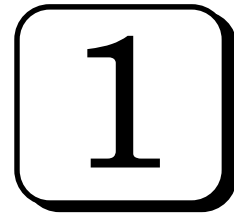
1. **Financial Accounting - Basic Concepts & Process:** The nature and environment of financial accounting; Accounting systems and procedures employed; Debit credit and basic equation; Journalizing & posting to the ledger.
2. **Unadjusted Trial Balance & Adjustments :** Unadjusted trial balance; Adjusting entries, Reversing entries; Inventory and related accounts; closing entries, Post closing trial balance.
3. **Preparation of Financial Statements & Balance Sheet:** The Income Statement & irregular items; Balance Sheet; Merchandise operations; Statement of cash flow.
4. **Accounting for Fixed and Long Lived Assets :** Property, Plant and equipment-characteristics, Acquisition, valuation; Costs subsequent to acquisition; Depreciation-cost allocation methods, Factors involved; Methods of cost apportionment; Special depreciation methods; Selecting a depreciation method; Special depreciation issues, Disposition of plant assets.
5. **Accounting for Current Assets:** Inventory- classification, Management control; Basic issues, Physical goods to be included, Costs to be included; Cost flow assumptions-FIFO, LIFO, average cost; Accounting for Accounts Receivable.
6. **Partnership Accounts- General Outline :** Preparation of partners' capital account & current account; Preparation of profit and loss adjustment account and balance sheet; Valuation and Treatment of Goodwill; Admission and Retirement of a Partner; Dissolution of Partnership.
7. **Company Accounts:** Issue and allotment of shares; Forfeiture and re-issue of forfeited shares; Issue of preference shares and debentures; Issue of bonus shares.
8. **Preparation of Company Final Accounts:** Income statement (Trading and profit & loss account); Retained earning statement (Profit and loss appropriation account); Balance sheet as per provisions of Companies Act- 1994 and SEC Act 1993.

TABLE OF CONTENTS

	Page No.
Unit -1 Financial Accounting - Basic Concepts and Process	01
Lesson - 1 : The Nature and Environment of Accounting	03
Lesson - 2 : GAAP (Generally Accepted Accounting Principles) and Conceptual Framework of Accounting	11
Lesson - 3 : Basic Accounting Equation	20
Lesson - 4 : Fundamentals of the Recording Process	25
 Unit - 2 Accounting Process Journal to Trial Balance	 51
Lesson - 1 : Journal : The Book of Original Entry	53
Lesson - 2 : Special and General Journal	57
Lessons - 3 & 4 : Ledger Accounts	66
Lesson - 5 : Trial Balance	78
Lesson - 6 : Adjusting Entries and Adjusted Trial Balance	94
Lesson - 7 : Closing and Reversing Entries	100
 Unit - 3 Accounting for Merchandising Operations	 111
Lesson - 1 : Merchandising Activities	113
Lesson - 2 : Financial Statements	118
Lesson - 3 : Measuring Merchandising Inventory	123
Lessons - 4, 5 & 6 : Preparing Financial Statements	128
Lesson - 7 : Statement of Cash Flows	163
 Unit - 4 Accounting for Current Assets	 177
Lesson - 1 : Current Assets : Accounts Receivable	179
Lesson - 2 : Estimating Uncollectible Accounts Expenses	182
Lesson - 3 : Writing off an Uncollectible Accounts Receivable	186
Lesson - 4 : Inventories	190
Lesson - 5 : Inventory Valuation Methods	199
Lesson - 6 : Periodic Inventory System	205
 Unit - 5 Accounting for Fixed and Long Lived Assets	 217
Lesson - 1 : Property, Plant, and Equipment : Definition, Classification, and Determination of Cost	219
Lesson - 2 : Depreciation	226
Lesson - 3 : Methods of Computing Depreciation	230
Lesson - 4 : Disposal of plant Assets	238
Lesson - 5 : Accounting for Natural Resources and Intangible Assets	243

Unit - 6	Partnership Accounts	251
	Lesson - 1 : Principles of Partnership Business	253
	Lesson - 2 : Accounts of Partnership Firm : General Principles	259
	Lessons - 3 & 4 : Practical Problems on Partnership	267
	Lesson - 5 : Valuation and Treatment of Goodwill	279
	Lesson - 6 : Admission and Retirement of a Partner	286
	Lesson - 7 : Dissolution of Partnership	294
Unit - 7	Accounting for Issue of Shares and Debentures	313
	Lesson - 1 : Definition and Features of Company	315
	Lesson - 2 : Share Issue	327
	Lesson - 3 : Forfeiture of Share	339
	Lesson - 4 : Pro-rata Allotment of Share	344
	Lesson - 5 : Redemption of Preference Share	350
	Lesson - 6 : Bonus Shares	354
	Lesson - 7 : Debenture Issue	366
	Lesson - 8 : Redemption of Debenture	371
Unit - 8	Final Accounts of Joint Stock Companies	387
	Lesson - 1 : Final Accounts and their Components	389
	Lessons - 2 & 3 : Legal and Professional Guidelines Relevant to Financial Statement	404
	Lessons - 4 & 5 : Practical Problems	422

FINANCIAL ACCOUNTING - BASIC CONCEPTS AND PROCESS



From the discussion of this unit, students will be able to understand:

-  **The nature of accounting**
-  **The users of accounting information**
-  **The types of financial statements**
-  **The Generally Accepted Accounting Principles**
-  **The Accounting Equation**
-  **The fundamentals of recording process**

এই পৃষ্ঠা খালি থাকবে

Unit-1

Lesson-1: The Nature and Environment of Accounting

Lesson Objectives

After you have studied this lesson, you will be able to:

- describe the nature of accounting.
- explain the meaning of accounting.
- state the environment of accounting.
- identify the uses and users of accounting information.

1.1.1 Introduction

Business creates economic values in society through production, distribution, and other activities that helps this process of creating values like banking, insurance, transport, etc. In these ventures, business need to invest financial resources in the form of material, man, and money. All these investments and activities of business houses ultimately create goods and services for the people of the world at large and in turn, help to raise their welfare and living standards. But one of the major objectives of business houses is to earn profit by performing these activities. In terms of business finance, this is the maximization of wealth of the person or persons who made these investments in business houses. Now the resource providers of the business houses must want to know whether the activities of the houses, which involve incoming and outgoing of financial resources, have achieved the objective for which the resources have been invested by them. For this, the business houses felt the need to install a system, which should collect the requisite information, keep a systematic record of this information and process it accordingly, and report to the interested parties about the outcome of all these activities. This system has long been known as an accounting system and is mainly a financial accounting system.

The resource providers of the business houses must want to know the activities of the houses, which involve incoming and outgoing of financial resources and the objectives for which the resources have been invested.

1.1.2 Nature and Environment of Accounting

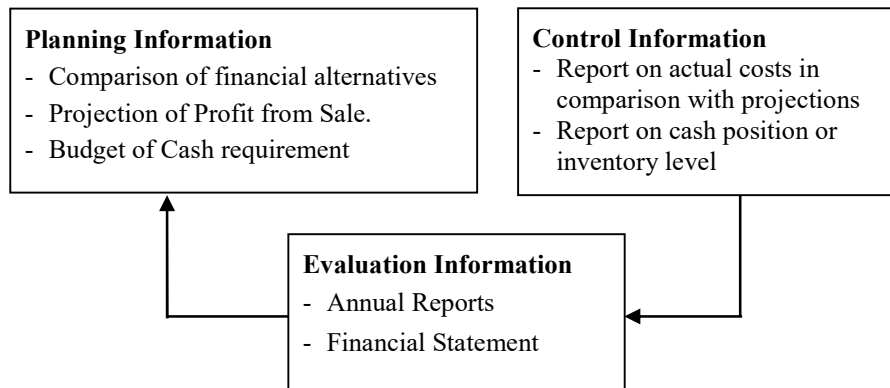
Accounting is a service function. It serves users with accounting information regarding the economic activities of the business. Accounting as a service activity provides managers, taxpayers, directors, or whomever, with the financial information they need to make informed decisions. Whether the nature of activities being performed by accounting is efficient or not, it depends on the level of satisfaction of the users. With continuous change and development in the world business, increase in complexity in business above to globalization of business, rise in competition, the decision making process in a business has become more complicated. In these circumstances, the importance of decision making in proper perspective has increased manifold. Implementation of the decision being taken, needs constant monitoring and control by management, for which constant flow of comparative information is necessary. Moreover, the separation of management from ownership has made the preparation of final reports or statements by the

Accounting as a service activity provides managers, taxpayers, directors, or whomever, with the financial information they need to make informed decisions.

management to show the level of efficiency with which the management performed its functions with resources vested to them with specific objectives. In modern days, accounting must supply all necessary information for the proper functioning of all these management functions. So, the accounting personnel, nowadays must understand what sort of information, when and in what form is necessary for the management in performing their duties in addition to keeping proper records of financial events. This is exhibited in diagram-1. So, the nature of accounting is not a fixed one, it changes with the change in nature of need of the users of accounting information. The user's need for information is mainly being dictated by the environment in which the business is being operated. Besides the need of management, the accounting system should also satisfy the needs of other users, inside or outside the business.

The nature of accounting is not a fixed one, it changes with change in nature of need of the users of accounting information.

Diagram-I: Need of accounting information for different management functions.



Source: Needs, Anderson, Caldwell: Principles of Accounting. 2nd Ed. (Houghton Mifflin, p.4.

1.1.3 Definition of Accounting

Up to 60s, accounting was generally treated as a record keeping system. In 1941, The American Institute of Certified Public Accountants (AICPA) defined accounting as “the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions, and events which are, in part at least, of a financial character, and interpreting the results thereof.¹” This definition of accounting relates to the operational part of accounting function without having any reference to the objectives of keeping records and need of users of information for decision making. As discussed earlier, the decision making process has become more complex and complicated in the modern business world. This decision making process should be based on correct and relevant data. Moreover, due to continuous changes and development in technology, product diversification, constant changes in demand of consumers and competition operating the business activities as per plan

The accountant must not only accumulate, process, store and communicate financial information, but must understand the need of the users, time when the information is needed and the form in which the information to be supplied.

¹ Committee on Accounting Terminology, Accounting Terminology Bulletin No. 2. (New York: American Institute of Certified Public Accountings, 1953) p-9.

has become uncertain. These require continuous flow of information regarding day to day operation of business houses. This needs for regular flow of information in turn influences the design of the accounting system. Taking into consideration these changes, AICPA in 1970 gave a modern definition. As per AICPA, the function of accounting is “to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decision². An economic entity is understood as a unit such as a business that has independent existence. So, accounting, in present days, has already been established as an important sub-system of management system of a business entity. The proper and successful functioning of a business house depends on the effective functioning of its accounting system.

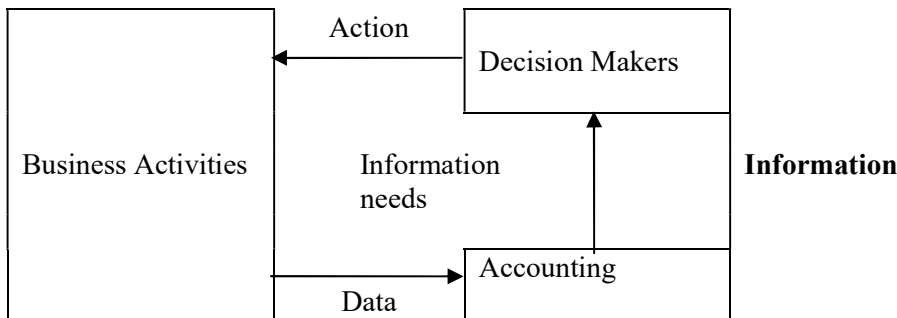
The need for regular flow of information regarding day to day operation of business influence the designing of the accounting system.

A business house is an artificial entity run by human beings. It supplies all information relating to its operation, resources owned, liability, and others through accounting reports and statements. As such, it is also called “the language of business”.

So accounting is not an end in itself. Instead, it is a system that identifies, measures, records, and processes events, mainly of financial nature relating to an identifiable economic entity, and communicates in an understandable form to its interested users.

Though accounting has been discussed mainly in relation to business, but this knowledge can equally be applied in non-business entities and even in households.

Diagram – 2: Accounting as an information system



Accounting is a system that identifies, measures, records and processes events mainly of financial nature relating to an identifiable economic entity and communicates in an understandable form to its interested users.

Source: Ibid, Diagram -1.

All the work of accounting is done with the main objective of scoring the users. So, to perform this function, the accountant must not only accumulate, process, store and communicate financial information, but must understand the need of the users, time when the information is needed and the form in which the information to be supplied. So, in the present day business situation, the nature and scope of an accountant's work have widened both horizontally and vertically. He must understand the process of management function, consequences of improper decision and also the impact of alternative decisions on the business's financial

² Statement of Accounting Principles Board, No. 4 "Basic Concepts and Accounting Principles underlying Financial Statements of Business Enterprises." (New York: American Institute of Certified Public Accountants, 1970), par 40.

position. Moreover, he has to satisfy different groups of users of information with different objectives. As such the accountant's position in the hierarchy of administration has now been elevated to the highest level.

1.1.4 Users and Uses of Accounting Information

Potential investors are also interested to know the past performance of the business and their financial position with an objective to make investment in future.

Accounting information are used by investors, creditors, managers, taxpayers, union representatives, regulatory agencies, potential investors, creditors, and others.

In the business world, there are various groups of users of accounting information. Accounting information is used by investors, creditors, managers, taxpayers, union representatives, regulatory agencies, potential investors, creditors, and others. Each of them has their particular type of relationship and interest in a business entity. So, they need accounting information to satisfy their particular needs. The accountant should be able to identify the user group with a particular kind of decision they want to take and supply accounting information in such an understandable form, so that it satisfies each group of users. The principal users may be grouped as outlined below:

1. Management

Management is a group of people responsible for achieving the entity's goals. They are entrusted with the responsibility to run the business and use the financial resources provided by the investors with the ultimate objectives of earning profit and thereby maximizing the wealth of the owners. This ultimate objective can be achieved by taking a host of various decisions, controlling the activities in such a way that the destined objectives are achieved, and doing everything to enhance the morale of all the employees of the entity. In this competitive business environment, this process of decision making and controlling function can only be efficiently performed by the management if they are supplied with all necessary, timely, and related information. These decisions may relate to product pricing, establishment output target and sales target, evaluating investment decisions, determining appropriate inventory and cash levels, determine financing requirements etc. Moreover, they have to report to their employers as to the stewardship functions performed by them. So, management can be termed as one of the most important users of accounting information and a major function of accounting is to provide management with all relevant, useful, and timely information. Management is also often termed as internal users. So, it has given rise to the expression that accounting information provides the "eyes and ears of management".

2. Users with direct financial interest in the entity

(a) Present and Potential Investors:

A major function of accounting is to provide management with all relevant, useful and timely information.

Present owners/investors are very concerned about the state of their investments in the business. They want to know the level of performance of the business in the past year. They want to know what amount of profit has been earned, what the state of financial position. Whether the business's cash position was satisfactory to make all possible distributions, necessary for the successful operation? What amount of dividends they expect to get? The future potential investors are also

interested to know the past performance of the business and their financial position with an objective to make investment in future. The accounting system is supposed to measure and report financial information about how a business has performed. Most business houses perform this function by publishing periodical general purpose financial statements that report on their success in meeting objectives of profitability and liquidity.

(b) Present and Potential Creditors:

In modern days business is being financed jointly by owners and outside finance providers. Major part of the total investment is being financed by short term and long term borrowing. A part is also being supplied by trade credits. All of these outside creditors are very keen to know the financial position and cash position by assessing the amounts, timing, and uncertainty of prospective cash receipts of the business to make sure whether the business will be able to pay their claims regarding interest and principal in time and their earning capabilities. The suppliers of long term loans like banks, finance companies, mortgage companies, insurance companies etc., shall expect to analyze the profitability and solvency position of the business before making a loan.

3. Users with indirect financial interest

Business flourishes at the cost and co-operation of the society. Business houses use the scarce resources of the nation and convert them into goods and services readily suitable for consumption by the members of the society. So, different groups in the society get interested in the activities from different perspective. These groups may be comprised of customers; Government agencies like tax authority, regulatory bodies, economic planners, agency responsible for competing national income; employees and even the competitors.

1.1.5 Types of Accounting

As stated earlier different groups of users need information relating to an entity for different purposes. But management need considerably great detailed information and almost regularly and in an understandable form for planning and day to day control of the business, whereas the others need information occasionally and for special purposes. This difference in needs of various groups of users has resulted in the development of different branches of accounting to serve the purposes of management and other users.

Management Accounting:

In ordinary language, any system of accounting which assists management in carrying out its functions more efficiently may be termed as Management Accounting.

Management Accounting is concerned with supply of economic information for decision making purposes of management, feedback information regarding the fulfillment of the plan and taking of necessary

Any system of accounting which assists management in carrying out its functions more efficiently may be termed as Management Accounting.

actions for successful implementation of the desired goal of the business. All the necessary information is to be supplied as per desired time, format and frequency, determined by the management. It supplies both historical and estimated data in assisting management solving day-to-day problems and planning for the future. This branch of accounting used to collect, analyze, and present information in special purpose financial statements. These statements are not for outside users.

Financial Accounting:

This particular branch supplies economic information in a general purpose financial statements and for use by all groups of users, interested in the business. The statements, to be prepared in financial accounting, are dictated by the respective law relating to that particular type of business and the professional standards and ethics followed by the professionals in preparing the statements. The statements usually prepared are (i) Balance Sheet, (ii) Income Statement, (iii) Cash flow statement, and (iv) Value-added statement. The collection, processing and presentation of the information under this system is usually guided by GAAP (generally accepted accounting principles), conceptual framework of accounting, accounting standards.

Financial Accounting supplies economic information in a general purpose financial statements and for use by all groups of users, interested in the business.

In addition to these two above mentioned branches of accounting there are other special branches, which deal with special purposes such as

Tax Accounting:

This branch of accounting shows how the business operations comply with tax law and effects of taxes on profit. It includes the preparation of tax returns and the consideration of the tax consequences of proposed business transactions. Sometimes, the normal recording of financial operation in financial accounting may be different from as per tax law. This branch is supposed to prepare statements as per tax law.

Tax Accounting shows how the business operations comply to tax law and effects of taxes on profit.

Auditing:

This particular branch is closely related with financial accounting system. It represents a field of accounting activity that independently reviews general accounting. This branch actually reports as to whether recognition, recording, preparation of statements in financial accounting are done as per GAAP, related law and professional standards, so that these statements reflect the true and fair view of the financial position and operational performance of the business. There might have internal auditing to satisfy the management and other directly interested parties like owners to certify that the recording and reporting are true. In case of business organization where the management is separated from ownership by operation of law, it becomes obligatory to have reports from external auditor. The external auditor used to perform his functions as per law related to that organization.

Cost Accounting:

This branch refers to mainly determination of costs and its control for decision making purposes, control and evaluation. With the advent of supremacy of free market economic system, the importance of this branch has increased manifold as a tool for fulfilling the business's main objective of earning profit. But with the increase in complexity and competition in business, this branch's function has become almost similar to the functions of management accounting, as both the branches are to supply information to management for decision making, control and evaluation of day to day operations of different functional units of an organization. As such this is known as management accounting in modern days.

1.1.6 Financial Statements

Though the accounting is also the process of identifying, measuring and processing of accounting information in the form of journalizing and posting to the ledger, the main function of communicating information is being performed through the preparation of financial statements. The medium used to communicate accounting information about a business enterprise is financial statements. The major financial statements prepared are (i) Balance Sheet; (ii) Income statement; (iii) Statement of owner's equity; (iv) Cash flow statement; and (v) The value-added statement.

(i) Balance Sheet (Statement of Financial Position):

A balance sheet is a statement that reports the assets, held by a particular business concern at a specified date and the corresponding claims against those assets in the form of liabilities and owner's equity.

(ii) Income Statement (Profit and Loss Account):

This particular statement shows the amount of revenues earned by the business entity during a particular period of time and the corresponding expenses incurred to earn the revenues. The net difference between these two is known as net profit earned a net loss incurred by the entity which increases/decrease the owner's equity, the claims of the owner.

(iii) Statement of Owner's Equity:

This statement shows the changes in the owner's equity that have occurred during a specific period of time.

(iv) Cash Flow Statement:

One major deficiency of income statement and comparative balance sheets is that they show the change in financial position, caused by operations of an organization, but does not explain the effects of cash inflows and cash outflows, which is the life blood of business entity. The present day investors are mainly interested in short term benefits like cash dividends or refund of loan money and interest payment. This is being served by cash flow statement which summarizes information

Auditing reports as to whether recognition, recording, preparation of statements in financial accounting are done as per GAAP, related law and professional standards, so that these statements reflect the true and fair view of the financial position and operational performance of the business.

Cost Accounting refers to mainly determination of costs and its control for decision making purposes, control and evaluation.

concerning the cash inflows (receipts) and outflows (payments) for a specific period of time. As the statement shows changes in the financing pattern and investment activities, it seems to be very useful to all user groups.

Cash flow statement summarizes information concerning the cash inflows and outflows for a specific period of time.

Value-added statement analyzes the effects of economic activities performed by business organizations during a particular period of time.

(v) Value-added Statement:

This is a macro-level analysis of the effects of economic activities performed by business organizations during a particular period of time. In other words, how the business activities influence the total economy as a whole is being supplied by this statement. All business organizations create values by transforming gift of nature to goods and services, capable of satisfying human needs. The values are being created by the co-ordinated efforts of various factors of production like land, labor, capital, organization and the government. These factors, in turn, receive a particular part of the total value added in the process of production as their remuneration. And how this value is created, what is the amount and how this total amount is being distributed among these various factors are being shown by this statement. This distributions received by different factors of production form the basis for calculation of national income of a country.

Lesson-2: GAAP (Generally Accepted Accounting Principles) and conceptual Framework of Accounting

Lesson Objectives

After you have studied this lesson, you will be able to:

- understand the meaning of the term GAAP.
- describe influences of GAAP in accounting activities.
- state qualitative characteristics of accounting information.
- explain the elements of accounting.

1.2.1 Introduction

Every profession must develop a body of theory consisting of principles, assumptions and standard for the conduct of their particular activities. This body of theory is essential mainly for a service function, because these activities directly influence the others either materially or immaterially. Accounting is not an exception to this. The work of an accountant directly affects the users materially in decision making. In accounting a large body of theory exists. Philosophical objectives, normative theories, interrelated concepts, precise definitions and rationalized rules comprise this body of theory. This body of theory is known as conceptual framework of accounting. An understanding of this conceptual framework is desirable for forming a better and complete idea about the financial position and operational performance of a business organization, supplied by the accounting system. This body of theory is generally accepted and practiced universally and as such these are known as generally accepted accounting principles (GAAP). These GAAP are being framed by different national and international bodies working in this end. In U.S.A. FASB (Financial Accounting Standard Board) and SEC (Securities and Exchange Commission) are primarily entrusted with this responsibility. Other organizations like AICPA, AAA, GASB are also working in this particular process. In England, ACCA, CIMA, CIPFA, ICAEW, ICAI and ICAS are the main organizations dealing with this ethical side of the profession. In Bangladesh we can name ICAB, ICMAB and SEC which are also engaged in this pursuits. Moreover, International Accounting Standard Board (IASB) is mainly responsible for harmonizing the accounting practices in the world arena.

But before going to study this conceptual framework or GAAP, one thing must be kept in mind that these principles are not like principles of natural science and mathematics. They cannot be derived from or proved by the laws of nature, and they are not viewed as fundamental truth or axioms. As accounting is a behavioral science, it is mainly dictated by the continuous changes in the business environment which calls for change in the form of recording, processing and preparation of statements to suit the users under the changed situation. For example, in accounting we have stable money measurement assumption which is in effect, an absurd assumption. So in accounting the changes in the worth of business due to change in money value may be shown through

preparation of a supplementing statement showing the effects of changes in money value in the financial statement.

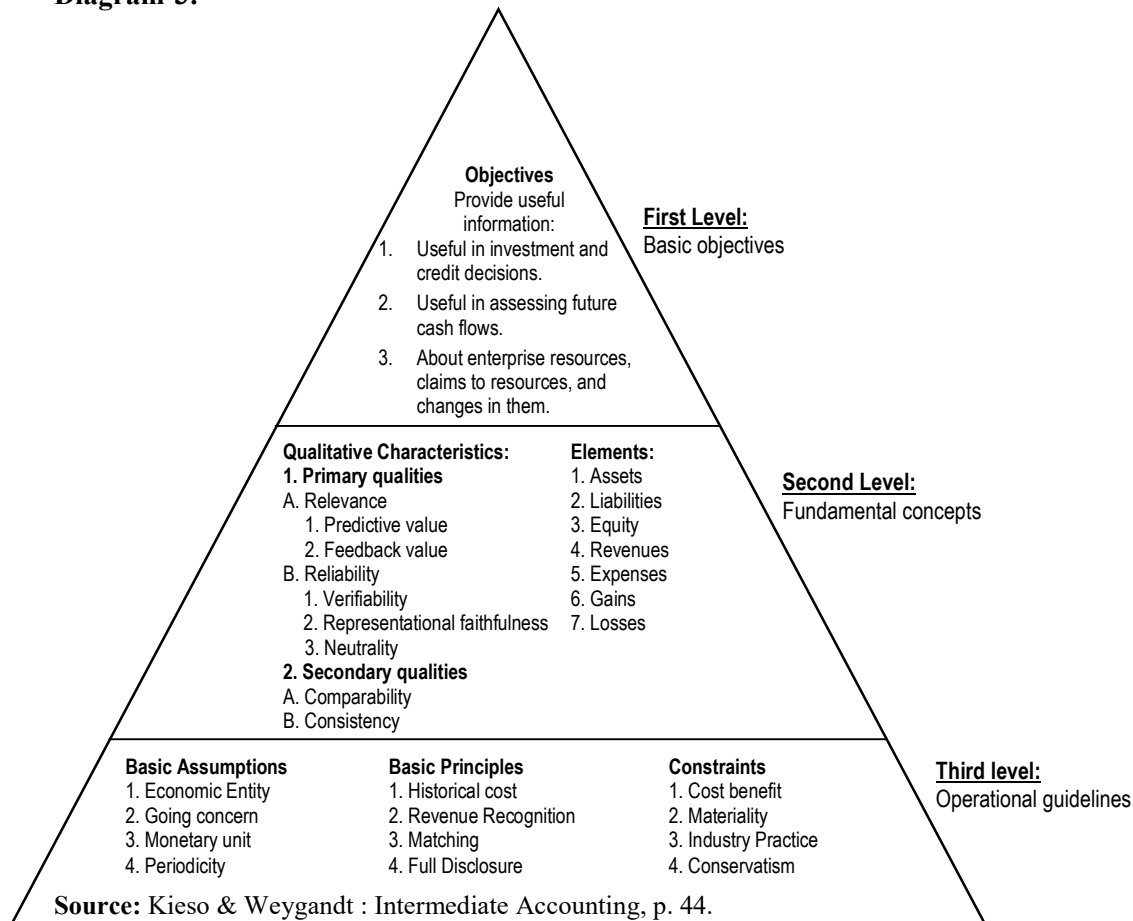
1.2.2 Conceptual Framework

A conceptual framework is like a constitution, it is coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, functions, and limits of financial accounting and financial statements.¹ "This framework will guide the total magnum of activities performed by an accountant starting from the collection of information as an input and its processing into an output through preparation of financial statement to be communicated to the users. The FASB has issued three Statements of Financial Accounting Concepts (SFAC) that relate to financial reporting for business enterprises. These three statements form the first two levels of conceptual framework stating mainly the objectives, nature and the qualitative characteristics of accounting information. These first two levels provide the foundation for developing the third level of conceptual framework, the operational guidelines, that shall help the accountants in performing their activities even in a controversial situations. These operational guidelines comprise of (a) Basic Assumptions of Accounting, (b) Basic Accounting Principles; and (c) Constraints. These guidelines also help the users in understanding the information supplied by the accountant through financial statements and their some inherent limitations. These operational guidelines are the Generally Accepted Accounting Principles (GAAP). The framework is being presented in the diagram No-3.

Conceptual framework guides the total magnum of activities performed by an accountant starting from the collection of information as an input and its processing into an output through preparation of financial statement to be communicated to the users.

¹ Conceptual Framework for financial accounting and Reporting: Elements of financial statements and their measurement." IASB Discussion memorandum (Standard Con: FASB 1976), p.1.

Diagram-3:



FIRST LEVEL: BASIC OBJECTIVES: The basic objective of accounting is to supply information, mainly financial, to different types of users for decision making, control, and evaluation of the operational performance of business organization in using their financial resources in earning profit and thereby to keep the total investments in resources intact so that the business can operate at least in its present form in future.

Decision making in the present day business world has become more complex. It includes setting of goal, finding alternative ways of accomplishing the goal and deciding which alternative is the best course of action. So, the accountant must present a clear statement of financial alternatives.

Whether the operation of a business is being carried out as per plan or not, the management regularly wants to monitor it and in case of deviation, corrective actions must be taken at the right time. So accountant must supply comparative statements regarding the level of actual operational performance as against the plan.

Evaluation of operational performance may be made by different groups of people either directly interested or indirectly interested in the business. It may be made by owners, creditors or even by trade unions. So the

The basic objective of accounting is to supply information, mainly financial, to different types of users for decision making, control, and evaluation of the operational performance of business organization.

necessary statements and supplementary information must be supplied in this respect by accounting system. In providing information to users of financial statements, the accountants generally prepare general purpose financial statements at minimal costs. These statements are being supplemented by all other necessary reports or schedules.

SECOND LEVEL: Fundamental Concepts:

The first level defines the objectives, why accounting is done and the third level shows how the work is being done. But in between these two levels, one user of the information, supplied by the accountants, must understand the qualitative characteristics of these information and must know the meaning and nature of different elements that the financial statements comprise. This level represents the conceptual building block.

To be useful to the users, the accounting statements must fulfil some qualitative characteristics. The statements must be understandable to the users. Understandability is the quality of information presented in an appropriate form, so that its significance is being perceived by the users. True and reliable information presented in a complex form may not be understandable to the users.

To become understandable the accounting information must possess two primary qualities: **Relevance** and **Reliability**.

Relevance - it is potential for accounting information to have the ability to influence the decisions of the users. Relevant information helps the users make predictions about the past (confirmatory relevance), present and future (predictive value). The information to be relevant must be supplied to the users in time before it loses its capacity to influence the decision makers. So, to be relevant, an information must have predictive value and feedback value and it must be supplied in time.

Reliability: It is the quality of information that gives assurance that it is reasonably free from errors and biases and is a faithful representation. An information to be reliable, must possess qualities like **verifiability**, **representational faithfulness**, and **neutrality**. **Verifiability** refers to high degree of consensus among independent measures using the same measurement methods. **Representational faithfulness** refers to correspondence or agreement between accounting records and the source document and the information presented in the statements. Moreover, for information to be reliable, it must be **neutral**, i.e., free from bias. It should not be presented in such a form so that it can influence the decision makers in a predetermined way. To be neutral, an accounting information needs to be objective. Reliable information will be prudent in nature and must be complete, as omissions can mislead a decision maker.

Secondary qualities of accounting information: The accounting information supplied through financial statements and reports should possess the qualities of **comparability** and **consistency**. Information, to be useful, must be comparable with similar information of other enterprise or with similar information of the same organization of

another point of time. To be comparable, information must be measured and reported in a similar manner by different organizations. When the measurement and reporting of an event as per accounting principles can be made applying different methods, the question of consistency in applying the same method in accounting treatment of events shall ensure comparability of information between years, which is essential to evaluate the enterprises performances over years.

Expenses are the scarifies or obligations for future scarifies of resources for earning revenues.

In the second level, another most important aspect of accounting information in the elements or definitions is being stated. Understanding of financial statements depends on the clear knowledge about the elements or items through which these statements are being presented. The primary elements of accounting are:

Assets - Probable future benefits obtained or controlled by a particular entity as a result of past transactions or events. These assets indicate the financial strength of the enterprise which shall yield future revenues to the enterprise.

Liabilities - A business entity is an artificial one created by an agreement or law or statute. So, the assets must be supplied by one. The claims of the supplier of assets over the entity's resources are termed as liability. These are the probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result past transactions or events. Liabilities are contractual debts of the entity which are recognized by law. They have rights over owners inter distribution of assets.

Assets are probable future benefits obtained or controlled by a particular entity as a result of past transactions or events.

Owner's Equity: It is the residual interest in the assets of an entity that remains after the deducting its liabilities. Equity is the owner's claim or interest in the business. Owner's equity is comprised of two elements in, the capital invested by the owner plus the earnings retained in the business. **Equity** can be stated as: **Assets - Liabilities = Owner's equity.**

The claims of the supplier of assets over the entity's resources are termed as liability.

Revenues: Revenues are inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from major operations of the entity which may be delivering or producing goods, rendering of services etc. Revenues are reflected by an increase in owner's equity. All inflows or enhancement of assets may not be a result of a revenue. Such as increase in cash balance due to borrowing from bank is not a source of revenue. Liabilities are not generally affected by revenues.

Owners' equity is the residual interest in the assets of an entity that remains after the deducting its liabilities.

Expenses: Expenses are scarifies or obligations for future scarifies of resources for earning revenues. These are the outflows of assets or in currencies of liabilities (or a combination of both) during a particular period from delivering or producing goods, rendering services, or carrying out other activities that constitute major operations of the organization.

Revenues are reflected by an increase in owners' equity.

Gains: Increases in equity (net assets) from peripheral and incidental activities of an entity other than normal operations.

Losses: Decreases in equity (net assets) from peripheral or incidental transactions of an entity other than normal operations.

Third Level: Operational Guidelines:

Accounting is defined as an information system that measures, processes, and communicates financial information. Now the question arises as to what information is to be measured and processed. That means what shall be the input of accounting? The operational guidelines give answers to all these questions, like what is to be recorded in books of accounts? What should be the value at which the event should be recorded? When should the information be recorded? How is it to be recorded?, etc.

This level has been subdivided into three categories: (1) Basic Assumptions, (2) Basic Principles, and (3) Constraints. All these three together give answers to the above questions relating to the accounting process starting from the identification of input to the output of accounting, ie., supply of financial information through statements and reports.

1. Basic Assumptions

The assumptions provide a foundation for the accounting process. The assumptions help to understand what is being recorded and how the events have been recorded. There are four basic assumptions.

(i) Economic Entity Assumption:

For accounting purposes, a business is treated as a separate entity. As per this assumption, all events that change the financial position of the entity are recorded in the books of accounts. The entity concept assumes that the business is separate not only from creditors and customers but also from its owners. The owner is treated as a creditor for to the extent of his capital. Capital is thus a liability to the business, and an owner is a creditor of the business. Under this assumption, all records and reports are developed from the view point of the particular entity.

The entity concept assumes that the business is not only separate from creditors and customers, but also equally separate from its owners.

(ii) Money Measurement Assumption:

As per this assumption, events or transactions, that are capable of being measured or expressed in terms of money shall be recorded into the books of account. Thus, events may be very important to a business entity, that cannot be objectively translated into money shall not be recorded in the books of account. For example, if all the efficient managers resign at a time from the business, this information will be not be recorded in the books as its effect cannot be objectively translated into money. Under this assumption, the monetary unit is considered to be sufficiently constant over time, which might even be considered as a limitation of accounting information. Thus this assumption ignores the qualitative aspect of things, and the impact of inflationary changes is not adjusted in financial statements due to this assumption.

The events or transactions that are capable of being measured or expressed in terms of money shall be recorded into books of account.

(iii) Going Concern Assumption:

This assumption is frequently called the continuity assumption and assumes that a business entity generally shall continue for an unlimited period of time to carry out its objectives. Though there are some business failures each year, normally a business is established with an objective to carry out its operations for quite a longer period of time. With this aim in view, the business used to invest a huge amount of money in fixed assets with a considerably long life. These assets can only be used in the business to earn profit, as such these are shown at historical cost. Proportionate cost of these assets is charged against revenue to find out the profit earned. So, under this assumption, continuity of activity is assumed and accounting reports are fashioned as a going concern, just as against liquidation.

Revenue is considered to be earned on the date on which it is realized.

Going concern assumption assumes that a business entity generally shall continue for an unlimited period of time to carry out its objectives.

(iv) Periodicity Assumption:

This assumption, in a way, contradicts the going concern assumption. Here the unlimited life of the business is artificially subdivided into time periods which is generally a calendar year. According to this assumption, determination of yearly income is made, though actual business income can exactly be determined by liquidation only. This becomes essential for the distribution of income to the investors, who invested in the business to earn, to pay the loan providers interest, to give income tax on a yearly basis to the government, and also to provide data on production, value addition, cost, and distribution of values for compilation of national income and production statistics. This assumption emphasizes the need for accruals and deferrals basis accounting rather than cash basis accounting. If the demand for frequent interval reports does not arise during the life span of a business, accruals, and deferrals of revenues and expenses could not be essential.

Periodicity assumption emphasizes the need of accruals and deferrals basis of accounting from cash basis accounting.

2. Basic Principles

The basic principles guide how business events and transactions should be recorded into books of account and reported. The principles are based on the above-mentioned basic assumptions. These principles give answer as to at what value and when the transactions should be recorded. The principles comprise of:

(i) Historical Cost Principle: This principle asserts that the assets should be recorded in the books of account and shown in the balance sheet at their original costs, which is nothing but the resources sacrificed or under obligation to sacrifice in the future period for their acquisition. Cost is both relevant and reliable. Cost is reliable as objectively measured. It tends to be a matter of demonstrable fact. It is relevant because it represents the assets sacrificed. Sometimes current value tends to be more relevant and acceptable, but as it is a matter of opinion, the accountant prefers objectivity.

Historical cost principle asserts that the assets should be recorded in the books of account and shown in the balance sheet at their original cost.

(ii) Revenue Recognition Principle: This principle determines the point of time at which revenue should be treated as having been earned. Revenue should be recognized in the accounting period in which it is earned. In practice, it might sometimes become difficult to apply especially when goods are sold on credit. The question arises as to when the revenue is to be recognized and recorded: When the order is received

from the customer or when the goods pass to the customer or when the customer pays for the goods. Generally, as per this principle revenue is considered as being earned on the date on which it is i.e. the date on which the ownership on the goods and services are transferred to customers either for cash or for credit. In case of credit sale, it is recognized when the goods is passed to the customer without giving emphasis of actual cash payment. This principle is important as it prevents business firms from inflating their profits by recording sales and income that are likely to accrue.

Materiality refers to an item's impact on the overall financial position and operations.

Expenses are recognized always in reference to revenue.

(iii) Matching/Expense Recognition Principle: In accounting, expenses are recognized always in reference to revenue. The period in which revenue is recognized and recorded, the sacrifices made or obligations made in the future should be recognized and recorded as expenses in that period. This concept of recognizing expense in reference to revenue is called matching principle. Expenses are thus expired costs, i.e., that part of the cost which has already been sacrificed for earning revenue. The part of the cost which has not yet been sacrificed for earning revenue or shall be used up in the future for earning revenue is called unexpired cost, and is shown as an asset. For example, purchase of merchandise for sale is the cost of acquisition. But only that part of purchased merchandise, which has been sold out is called the cost of goods sold and is treated as an expense against sales revenue. The unsold part is unexpired cost which is shown as inventory in the balance sheet. Thus fixed assets are unexpired costs and depreciation is the expired cost and is treated as an expense.

(iv) Full Disclosure Principle: This principle dictates that the necessary information with regard to a particular element in the financial statement must be supplied to make it self-explanatory for decision-making purposes. Financial statements and their accompanying footnotes or other explanatory materials should contain all of the pertinent data believed essential to the readers' understanding. In compliance with this principle, additional data, explanations, schedules, etc. are attached as supplementary information for the users to make decisions. For example, significant loan agreements against an asset as a mortgage, accounting methods employed, changes in accounting methods, and events subsequent to the date of statements all should be disclosed. Though it is difficult to decide how much disclosure is enough, it is to be judged by the cost-benefit analysis, i.e., the cost of providing such information through statements should be compared with the benefits will accrue to the users.

Full disclosure principle dictates that the necessary information with regard to a particular element in the financial statement must be supplied to make it self explanatory for decision making purpose.

3. Constraints: Constraints in accounting refer to the exceptions/or relaxation in the use of accounting principles in special circumstances. The two main constraints are (i) Materiality and (ii) Conservatism. The other dominant constraints are Industry practice and Cost-benefit relationship.

(i) Materiality: It refers to an item's impact on the overall financial position and operations. An item is a material when it influences the decision of an informed investor and immaterial when it has no impact on that. Materiality, in its essence, is of relative significance. In the

service, some of the unimportant items are either left out or included with other items. For example, a business organization purchased some long-lived assets but of very negligible value. In this case, this event may be treated as an expense rather than an asset, as this treatment either as an asset or as an expense does not affect the operational result or financial position of the business. The determination of what is material and what is unimportant requires the exercise of judgment, precise criteria cannot be applied.

(ii) Conservatism: This constraint refers to situations when two methods are otherwise equally appropriate, the choice should be made for the one that will least likely to overstate assets and income. In accounting, as per this constraint, all probable/expected losses are accounted for, whereas expected income/revenues are not recorded until earned. The attitude of conservatism was frequently expressed in the admonition to "anticipate no profits and provide for all losses." A common application of this constraint is the use of 'cost or market value, whichever is lower' in valuing closing inventory, though the basic principle of valuation of closing stock is cost. Application of this constraint forbids overstatement of income, not yet earned, accounting treatment of which might cause higher outflows of resources in the form of dividends and taxes.

(iii) Industry Practice: This constraint refers to the difference in treatment of an event into accounts from its usual one due to the peculiar nature of some businesses or industry. Cost-benefit relationship dictates the quantum of information to be provided to the users by the accounting system. The accounting system usually prepares general purpose financial statements, which contain all basic financial information in relations to an entity, knowing it fully well that different types of users might need specifically different types of information for making their respective decisions. But from a cost-benefit analysis, it is not feasible to prepare a specific purpose financial statement for specific users. All these guidelines, comprising assumptions, principles, and constraints dictate the operational part of accounting work.

Conservatism constraint refers that all probable/expected losses are accounted for whereas the expected income/revenues are not recorded until earned.

(iv) Cost-Benefit Relationship: Cost-Benefit Relationship: It states:

- The cost of information should not outweigh the benefit derived.
- Costs and benefits are not always derivable, obvious, or quantifiable.
- Sound judgment must be used.

Example: If an organization purchases some waste-paper baskets for the use, it may be used for a couple of years to come, however, the price of these baskets is so negligible that organizations, though it will provide benefits or services for more than a year, charge it as an expense. Office supplies like Pen, Pencil, Eraser, Pin, etc. are to be recorded as expenses, not assets. The cost of recording these as assets (e.g. charging depreciation on eraser) is costlier than its benefit.

Lesson-3: Basic Accounting Equation

Lesson Objectives

After you have studied this lesson, you will be able to:

- understand basic accounting equation.
- analyze the nature of transaction and the effects of transaction on accounting equation.

Introduction

1.3.1 Basic Accounting Equation

Assets = Liabilities + Equity is the basic accounting equation.

In the foregoing discussion, the conceptual framework of accounting has been explained. The elements of accounting and the operational guidelines were also discussed elaborately. We now know that one of the basic assumptions of accounting is "Business Entity Assumption." The end result of accounting activity for an entity is the financial statements that describe the entity. As mentioned earlier, a business is a separate entity created either by law, agreement, or statute. It is separate from its creditors, customers, and even from its owners. As an artificial entity, all the financial resources with which an entity starts to operate are supplied from outside. So, at the start of the business, the financial position of an entity can be expressed in an equation:

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

That is all the resources supplied to an entity, are nothing but equal to claims of the suppliers. This is the basic accounting equation. In the above equation assets represent an enterprise's economic resources, liabilities are its obligations owed to creditors, and equity is the owner's residual interest in the enterprise asset. This equation at any point of time explains the total resources held by an entity and the sources from which these were collected. It is customary to place "liabilities" before "equity" in the accounting equation because creditors have preferential rights to the assets.

Transactions – the Basic Input of Accounting:

Transactions are economic events that affect change the financial position of a business entity.

Transactions are economic events that affect change the financial position of a business entity. A transaction is the occurrence of an event or of a condition that brings changes in an entity's assets, liabilities, or equity. This is the basic input of recording in accounting. Transactions may be external or internal. External transactions involve economic events between the entity and some outside parties or organizations, whereas internal transactions are events that occur entirely within the entity. In the same literature external events are only called transactions.

Analysis of Transactions and Their Effects on the Accounting Equation:

As per definition, a transaction must bring change in the financial position of an entity which refers to the resources it owns and the claims on those resources in the form of liabilities and equity. An accounting equation is nothing but the expression of financial position in equation form. So, a transaction must change or affect the elements of accounting

equation. Analyses of transactions refer to the identification of the changes brought about by a transaction in the elements of the equation. The analysis will show that a transaction might take any form of the following changes:

- (1) Increase in asset and an increase in liability or equity.
- (2) Increase in one asset with a corresponding decrease in another asset without having any change on other side of the equation.
- (3) Decrease in one asset with a corresponding decrease in a liability or equity.
- (4) Decrease in a liability or equity with a corresponding increase in another liability or equity.

This analysis will show that a transaction will always preserve the equality of the accounting equation. Therefore, each transaction must have a dual effect on the equation.

Example:

Transaction – 1

Investment by Owner: Mr. Mojumdar decides to open a firm. On September 1, 2023, he invests Tk.15,000 cash in the business. This transaction results in an equal increase in assets and owner's equity. The effect of this transaction on the basic equation is :

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Cash	=			Capital
T-1: + 15,000	=			+15,000

Transaction – 2

Purchase of Equipment for Cash: The firm purchases computer equipment for Tk. 7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets is changed. The effect of this transaction on the basic equation is :

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Cash + Equipment	=			Capital
Balance: +15,000	=			+15,000
T-2: <u>-7,000</u> <u>+7,000</u>	=			
Balance: 8,000 +7,000	=			<u>15,000</u>

Transaction – 3

Purchase of Supplies on Credit: The firm purchases supplies for the firm for Tk. 1,600 on credit from Acme Suppliers. This transaction results in an equal increase in total assets, and increase in liability. The effect of this transaction on the basic equation is:

<u>Assets</u>				=	<u>Liabilities</u>		+	<u>Owner's Equity</u>
Cash + Supplies + Equipment				=	Accounts Payable		+	Capital
Balance: 8,000		+7,000		=				15,000
T-3:	+1,600			=	+1,600			
Balance: 8,000	+1,600	+7,000		=	+1,600		+	15,000

Transaction – 4

Services Rendered for Cash: The firm receives Tk. 1,200 cash from customers for programming services it has provided. Both assets and owner's equity are increased by this transaction. The effect of this transaction on the basic equation is:

<u>Assets</u>				=	<u>Liabilities</u>		+	<u>Owner's Equity</u>
Cash + Supplies + Equipment				=	Accounts Payable		+	Capital
Balance: 8,000	+1,600	+7,000		=	+1,600			15,000
T-4:	+1,200			=				1,200
Balance: 9,200	+1,600	+7,000		=	+1,600		+	16,200

Transaction – 5

Purchase of Advertising on Credit: The firm receives a bill for Tk.250 from the Daily News for advertising the opening of its business but postpones payment of the bill until a later date. This transaction results in an increase in liabilities and a decrease in owner's equity. The effect on the equation is:

<u>Assets</u>				=	<u>Liabilities</u>		+	<u>Owner's Equity</u>
Cash + Supplies + Equipment				=	Accounts Payable		+	Capital
Balance: 9,200	+1,600	+7,000		=	+1,600		+	16,200
T-5:				=	+250			-250
Balance: 9,200	+1,600	+7,000		=	+1,850		+	15,950

Transaction – 6

Services Rendered for Cash and Credit: The firm provides programming services of Tk. 3,500 for customers. Cash amounting to Tk. 1,500 is received from customers, and the balance of Tk. 2,000 is billed to customers on account. This transaction results in an equal increase in assets and owner's equity. The effect on the equation is:

<u>Assets</u>				=	<u>Liabilities</u>		+	<u>Owner's Equity</u>
Cash + Receivable + Supplies + Equipment				=	Accounts Payable		+	Capital
Balance: 9,200		+1,600	+7,000	=	+1,850		+	15,950
T-6:	1,500	2,000		=			+	3,500
Balance: 10,700	+2,000	+1,600	+7,000	=	+1,850		+	19,450

Transaction – 7

Payment of Expenses: Expenses paid in cash for September are store rent, Tk.600, salaries of employees, Tk.900, and utilities, Tk.200. These payments result in an equal decrease in assets and owner's equity. The effect on the equation is:

<u>Assets</u>				=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Cash + Receivable + Supplies + Equipment				=	Accounts Payable	+	Capital
Bal.: 10,700	+2,000	+1,600	+7,000	=	+1,850	+	19,450
T-7: -1,700							- 600
							-900
							-200
Bal.: 9,000	+2,000	+1,600	+7,000	=	+1,850	+	17,750

Transaction – 8

Payment of Accounts Payable: The firm pays its Daily News advertising bill of Tk.250 in cash. In analyzing the effect of this transaction, we must recall that the bill was previously recorded in Transaction (5) as an increase in Accounts payable and a decrease in owner's equity. The effect on the equation is:

<u>Assets</u>				=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Cash + Receivables + Supplies + Equipment				=	Accounts Payable	+	Capital
Bal.: 9,000	+2,000	+1,600	+7,000	=	+1,850	+	17,750
T-8: - 250					- 250		
Bal.: 8,750	+2,000	+1,600	+7,000	=	+1,600	+	17,750

Transaction – 9

Receipt of Cash on Account: The sum of Tk.600 in cash is received from customers who have previously been billed for services in Transaction (6). This transaction does not change total assets, but it changes the composition of firm's assets. The effect on the equation is:

<u>Assets</u>				=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Cash + Receivables + Supplies + Equipment				=	Accounts Payable	+	Capital
Bal.: 8,750	+2,000	+1,600	+7,000	=	+1,600	+	17,750
T-9: + 600	- 600						
Bal.: 9,350	+1,400	+1,600	+7,000	=	+1,600	+	17,750

Transaction – 10

Withdrawal of Cash by Owner: Mr. Majumdar withdraws Tk. 1,300 in cash from the business for his personal use. This transaction results in an equal decrease in assets and owner's equity. The effect on the equation is:

<u>Assets</u>				=	<u>Liabilities</u>	+	<u>Owner's Equity</u>	
Cash + Receivables + Supplies + Equipment				=	Accounts Payable	+	Capital	
Bal.:	9,350	+1,400	+1,600	+7,000	=	+1,600	+	17,750
T-10:	-1,300							- 1,300
Bal.:	8,050	+1,400	+1,600	+7,000	=	+1,600	+	16,450

Lesson-4: Fundamentals of the Recording Process

Lesson Objectives

After you have studied this lesson, you will be able to:

- explain what an account is and how it helps in the recording process.
- define debits and credits and explain how they are used to record business transactions.
- understand the basic steps in the recording process.
- explain the nature of journal and understand how it helps the recording process.
- explain what a ledger is and how it helps the recording process.
- explain what a posting is and how it helps the recording process.
- explain what is summarizing and how is it done through trial balance and financial statement.

1.4.1 Recording Process

The recording/accounting process constitutes the steps followed in recording, processing, and communicating financial information. This process can be illustrated in the following way:

Step-1	Step-2	Step-3	Step-4	Step-5
Identification of transactions	Analysis of Transactions into Debit & Credit (Journalization)	Posting to the Ledger (Accounts)	Preparation of Trial Balance	Preparation of Financial Statements

The recording process constitutes the steps followed in recording, processing and communicating financial information.

Step-1: Identification of Transactions

It is being done on the basis of basic assumptions of "Economic Entity" and "Money Measurement." The documentary evidence of transactions might take the form of Memo, bills, vouchers, receipts, etc. which give testimony to the fact that a transaction has taken place.

Step-2: Analysis of Transactions into Debit and Credit

The dual effect of a transaction has been shown in the previous lesson. But in a business entity, where a great number of transactions take place in a day, the analysis of transactions showing their effects on the equation becomes impossible. Formally a transaction is analyzed to find out its dual effect on the financial position, as shown in the previous lesson. Then, transactions are recorded in the books of account under double entry system of recording, i.e., one account is debited and another is credited. In this context let us see what is meant by the Double entry system and other related important issues under the double entry system.

Double Entry System of Recording

Double effect of each transaction is recorded under double entry system.

Under this system, the double effect of each transaction is recorded. This system is being evolved by Luca Pacioli, an Italian monk in 1494 in a book on mathematics. This recording is being done by using the term debit and credit. That is the double effect is recorded by debiting one account and crediting the other. So, the amounts of debits and credits should always equal each other.

The Account

An account is a summarized and classified information in relation to a particular transaction.

An account is summarized and classified information in relation to a particular phenomenon or element showing both the increases and decreases in that element due to the transactions taking place during that period and showing the ultimate position of that phenomenon/element at the end of the period. An account usually has three parts: (1) the title of the account, (2) left hand side showing debits and (3) right hand side showing credits. It is illustrated below and it is known as T Account because of its similarity to the letter T.

TITLE			
Debit		Credit	
Left or debit side	Tk.	Right or credit side	Tk.
T Account			

Accounts may be of three types:

1. **Real Accounts:** This category represents the assets/resources of the entity. For example, Land, Building, Plant, Cash, Inventory, etc.
2. **Personal Accounts:** This group constitutes all accounts related to persons or organizations, who, in the form of transactions, are either the debtors or creditors of the entity either for receiving some financial benefits from the entity or for giving some financial benefits to the entity. This category may take the form of the both assets and liabilities and equity.
3. **Nominal Accounts:** This category of accounts is related to revenues, income, or profit of the entity which increases the claim of the owner; and to expenses, losses, etc. which decreases resources of the entity and thereby the claim of the owner.

For facilitating the recording process and ultimate analysis, enterprises maintain a chart of these accounts.

Chart of Accounts

It gives the list of the accounts maintained by an entity showing its number. The number and types of accounts used by an entity differ, for each enterprise, depending on its size, type, and complexity.

Debits and Credits

These are the technical terms used for recording purposes under the double entry system. From an accounting point of view, the debit and credit do actually mean nothing more than their literary meaning of left and right sides respectively. These terms do not mean increase or decrease. As per the double entry system, to record dual aspect of a transaction, one accounts must be debited and another accounts should be credited for equal amount of money. The act of entering an amount on the left side of an account is called debiting and entering an amount on the right side of an account is called crediting the account. At the end of accounting period, when the totals of these two sides of an account is compared, an account will have a debit balance if the debit amount exceeds the credit totals and credit balance when it is vice versa. This rule applies to all accounts. The rules of debit and credits may therefore be stated as follows:

The act of entering an amount on the left side of an account is called debiting and entering an amount on the right side of an account is called crediting the account.

Dr. (Debits)	Name of Account	(Credits) Cr.
Debit signifies:		Credit signifies:
Increase in asset accounts		Decrease in asset accounts
Decrease in liability accounts		Increase in liability accounts
Decrease in capital accounts		Increase in capital accounts

Debit and Credit Procedure

The procedure for debiting and crediting accounts for recording the double effect of a transaction under the double entry system is made by a rule called the golden rule. The rule dictates the process of debiting and crediting each category of accounts related to transactions. The rules for different categories of accounts are as follows:

Real Accounts: Assets increase = debits

Assets decrease = credits

Personal Accounts: Value received by an account = debit
Value paid by an account = credit

Nominal Accounts: All expenses, losses = debits
All revenues, gain, income = credits.

When the logic behind this rule in relation to a particular category of accounts is questioned, none will find any satisfactory answer as it is nothing but a custom/convention. But when this rule is analyzed in relation to the whole group of accounts in an equation, a scientific and logical answer is available. For example, when an asset increases, it is debited. With this increase in assets, a corresponding claim of equal amount increases either in the form of liability or equity which is credited and vice versa. Same is the case when a profit is earned, the asset increases which is debited and the claim in the form of equity increases, which is credited, and the opposite is the case for expenses. In summary form it can be expressed in the following form:

<u>Debits</u>	<u>Credits</u>
Increase in Assets	Decrease in Assets
Decrease in Liabilities	Increase in Liabilities
Decrease in Equity	Increase in Equity
Increase in Expenses	Decrease in Expenses
Decrease in Income	Increase in Income.

Following examples will make the point clear.

Illustration-1:

Transactions	Related Accounting head	Increased or Decreased	Determination of debit and credit
i) Jan. 1, 2024 Rahman started business with Tk.50,000 as capital	Cash Account & Capital Account	i) Cash = Asset → Increased ii) Capital = Liability → Increased	i) As the asset cash has increased it will be debited ii) As liability (capital) has increased, it will be credited
ii) Jan. 2 credit purchase of Goods	Purchase Account & Creditors Account	i) Purchase = Expenditure → Increased ii) Creditors = Liability → Increased	i) As expenses relevant to purchase has increased, it will be debited ii) As liability relevant to creditors has increased, it will be credited
iii) Jan. 5 paid Electricity bill Tk.5,000	Electricity Account & Cash Account	i) Electricity bill = Expenses → Increased ii) Cash = Asset → Decreased	i) As expenses increased it will be debited ii) As cash decreased it will be credited

Journal

In journal transaction is recorded first in chronological order analyzing debit and credit account affected by each transaction.

Journal is the book, where a transaction is recorded first in chronological order analyzing debit and credit accounts affected by said transaction. As such it is referred to as a book of prime entry. Transactions may be recorded directly into accounts, but in that case it will not be possible to keep track of whether each transaction is recorded or not. If the transactions taking place daily are numerous in number, it sometimes may become manually impossible to record all transactions without formal analysis. So, it is better to make formal recording in a journal first

and then post them to the respective account. The journal thus shows transactions for each day and may contain explanatory information concerning the transaction.

A separate journal entry is passed to record each transaction and this process is called journalizing.

A business organization may use different kind of journals but every entity must maintain a basic form of journal which is called general journal or journal proper. The general journal provides the following information about each transaction:

1. Date of the transaction,
2. The accounts to be debited and credited,
3. Amounts debited and credited, and
4. A brief explanation of the transaction.

To illustrate the technique of journalizing we take the first two transactions recorded in the previous lessons viz., 1) investment by Mr. Majumdar of Tk.15,00,000 and 2) the purchase of computer equipment at Tk.7,00,000 cash :

General Journal

Date	Account Titles and Explanation	Ref.	Debit Tk.	Credit Tk.
2023 Sept. 1	Cash	10	15,00,000	
	Majumdar's capital (Owner's investment of cash in the business)	50		15,00,000
1	Computer Equipment	20	7,00,000	
	Cash (Purchase of computer in cash)	10		7,00,000

Ledger

Ledger is a book or file that contains records of all accounts maintained by an entity. It is the principal book of accounts where similar transactions relating to a particular person or thing are recorded. Whether the ledger is a book or file, each page or card of a ledger keeps all the information about an account showing the changes made in the specific account. For locating easily an account in the ledger, accountants often use a number for each account. Recording in ledger in the respective account is made by posting from the journal book.

Ledger is the principal book of accounts where similar transactions relating to a particular person or thing are recorded.

The ledger should be arranged in statement order beginning with the balance sheet account. First the assets accounts should be shown and followed by liabilities, capital, withdrawals, revenues and expenses.

Step-3: Posting to Ledger

The procedure of transferring entries in the journal to respective accounts in the ledger is called posting. This particular step of the accounting process accumulates the effects of transactions, recorded in the journal on each individual accounts.

Form Used for Ledger Account

The traditional form used for preparing account in the ledger is 'T' form. At present, more structured and too somewhat complicated form is used.

To illustrate the previous example used in the journal, the necessary accounts in both the form is shown below:

'T form'**Cash – 10**

Dr.				Cr.			
Date	Explanation	Ref.	Amount	Date	Explanation	Ref.	Amount
2023 Sept. 1	Majumdar Capital	J.1	15,00,000	2023 Sept.1	Computer Equipment	J.2	7,00,000

Majumdar's Capital - 50

Dr.				Cr.			
Date	Explanation	Ref.	Amount	Date	Explanation	Ref.	Amount
2023 Sept. 1				2023 Sept. 1	Computer Equipment	J.1	15,00,000

Computer Equipment - 20

Dr.				Cr.			
Date	Explanation	Ref.	Amount	Date	Explanation	Ref.	Amount
2023 Sept. 1	Cash	J2	7,00,000				

Modern Form of Ledger Account

Cash (based on earlier illustration)

Date	Explanation	Ref.	Debit	Credit	Balance
2023 Sept. 1	Majumdar Capital	J.1	15,00,000		15,00,000
2	Computer Equipment	J.2		7,00,000	8,00,000

Step-4:**Summarizing Transactions and Preparing a Trial Balance**

The next step is the preparation of the Trial Balance which is a summary of debit balances and credit balances of ledger accounts. After the end of the financial or accounting period, which may be six months or twelve months or any other periodical segments, all the ledger accounts are balanced, and the balance figure is taken in the Trial Balance to prove the arithmetical accuracy of the accounts in the ledger and to facilitate the preparation of Final Accounts. The Trial Balance also serves as a summary of the ledger and provides much of the information needed to prepare the balance sheet and the income statement. Here some adjustments may also be made to bring the information up-to-date. These adjusting and closing entries are required to be made before preparing periodic financial statements. Adjusted and post-closing Trial balances can be prepared at this stage.

Based on the previous illustration, the Trial balance, as can be prepared thereof, will be as follows:

Trial Balance

Sl.	Account Titles	L.F	Debit	Credit
1.	Majumdar's capital			15,00,000
2.	Cash		8,00,000	
3.	Computer Equipment		7,00,000	
			15,00,000	15,00,000

Trial Balance, inter-alia, serves as a summary of the ledger and provides much of the information needed to prepare the balance sheet and the income statement.

Step-5: Preparation of Financial Statements

As soon as the agreement of Trial Balance is there, a possible probe into the concealment of errors is made, and the determination of accounting information not recorded currently is completed. The accountants proceed towards the next step of the cycle i.e. preparation financial statements to find out the net result and impact on asset, liability, and owner's equity. At this stage Income Statement and Balance Sheet are also prepared.

After such statements are prepared the results need to be analyzed & communicated to the interested parties. In the next stage, the opening of books for the following accounting year becomes necessary for which opening journal entries required to be given. Then the process goes on repetition and this is called the accounting cycle.

1.4.2 The Accounting Cycle

Business enterprises do not prepare financial statements after every transaction. Each transaction is recorded at the date of occurrence chronologically, accumulated over a period of time, and their effects are shown in financial statement at period end. This accounting process may be considered to be composed of two parts:

i) The recording phase and ii) The summarizing phase. During an accounting period, it is necessary to record transactions in relevant books. At the end of the period these are to be summarized, brought up-to-date

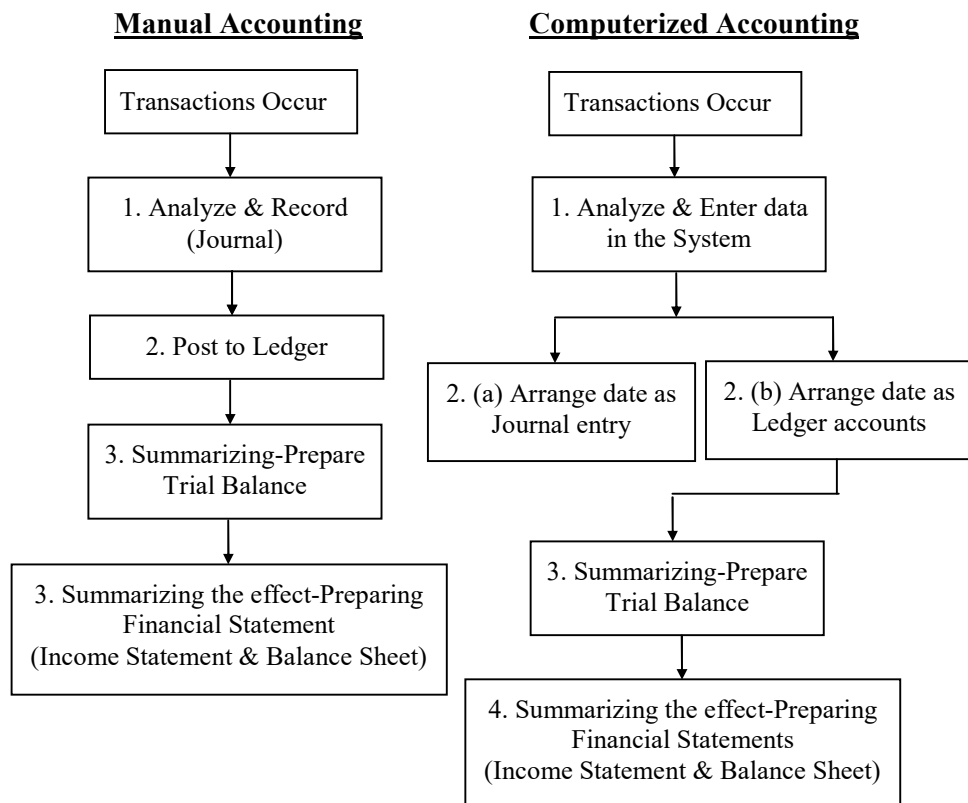
and presented to the concerned interested parties through different financial statements. These are done in phases which is stolidly companies on accounting process or cycle.

The sequences of accounting procedures used to record, classify & summarizing accounting data and information often served as accounting cycle. It begins with the initial recording of business transactions and concludes with the preparation of periodic financial statements summarizing the effects of transactions on the assets, liabilities and owners equity. The cycle indicates that these procedures must be repeated continuously to enable the business to prepare financial statements in intervals based on accounting period.

In this context it may be pointed out that accounting procedures can be performed mainly by accounts personnel or through computer based mechanized system. Here the concepts and procedures involved in the manual and computerized systems are essentially the same. The differences are largely a question of input machination. The following diagram shares the accounting cycle as to Manual and Computer based accounting systems:

The sequence of accounting procedures used to record, classify and summarizing accounting data and information is termed as accounting cycle.

Accounting Process or Cycle



Questions and Exercises

Self-Test Questions

1. The accounting process does not include:
 - a. identification
 - b. verification
 - c. recording
 - d. communication
2. One of the following statements about users of accounting information is incorrect. The incorrect statement is:
 - a. Management is considered an internal user.
 - b. Taxing authorities are considered external users.
 - c. Present creditors are considered external users.
 - d. Regulatory authorities are considered internal users.
3. The cost principle states that:
 - a. assets should be recorded at cost and adjusted when the market value changes.
 - b. activities of an entity be kept separate and distinct from its owner.
 - c. assets should be recorded at their cost.
 - d. only transaction data capable of being expressed in terms of money be included in the accounting records.
4. Which of the following statements about basic assumptions is incorrect?
 - a. Basic assumptions are the same as accounting principles.
 - b. The economic entity assumption states that there should be a particular unit of accountability.
 - c. The monetary unit assumption enables accounting to measure economic events.
 - d. An important corollary to the monetary unit assumption is the stable monetary unit assumption.
5. Net income will result during a time period when:
 - a. assets exceed liabilities.
 - b. assets exceed revenues.
 - c. expenses exceed revenues.
 - d. revenues exceed expenses.

6. The effects on the basic accounting equation of performing services on account are:
 - a. increase assets and decrease owner's equity.
 - b. increase assets and increase owner's equity.
 - c. increase assets and increase liabilities.
 - d. increase liabilities and increase owner's equity.
7. As of December 31, 2023, Stoneland Company has assets of Tk. 3,50,000 and owner's equity of Tk. 2,00,000. What are the liabilities for Stoneland Company as of December 31, 2023?
 - a. Tk. 1,50,000.
 - b. Tk. 1,00,000.
 - c. Tk. 2,50,000.
 - d. Tk. 2,00,000.
8. The financial statement that reports assets, liabilities, and owner's equity is the:
 - a. income statement.
 - b. owner's equity statement.
 - d. balance sheet.
 - c. statement of cash flow.
9. Which of the following items are liabilities of Jewllry Stores?
 - a. Cash.
 - b. Accounts payable.
 - c. Drawings.
 - d. Accounts receivable.
 - e. Supplies
 - f. Equipment.
 - g. Salaries payable
 - h. Service revenue.
 - i. Rent expense.
10. Noor Enterprises had a capital balance of Tk.158,000 at the beginning of the period. At the end of the accounting period, the capital balance was Tk.198,000.
 - a. Assuming no additional investment or withdrawals during the period, what is the net income for the period?
 - b. Assuming an additional investment of Tk. 13,000 but no withdrawals during the period, what is the net income for the period?

11. Presented below is the basic accounting equation. Determine the missing amounts:

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
(a)	Tk.90,000		Tk.50,000		_____?
(b)	_____?		Tk.48,000		Tk.70,000
(c)	Tk.94,000		_____?		Tk.72,000

12. Given the accounting equation, answer each of the following questions:

- The liabilities of Bell Company are Tk.90,000 and the owner's equity is Tk.240,000. What is the amount of Bell Company's total assets?
- The total assets of Dell Company are Tk.170,000 and its owner's equity is Tk.90,000. What is the amount of its total liabilities?
- The total assets of Totul Co. are Tk.700,000 and its liabilities are equal to one half of its total assets. What is the amount of Totul Co.'s owner's equity?

13. At the beginning of the year, Jheel Company had total assets of Tk.700,000 and total liabilities of Tk.500,000. Answer the following questions:

- If total assets increased Tk.150,000 during the year and total liabilities decreased Tk.80,000, what is the amount of owner's equity at the end of the year?
- During the year, total liabilities increased Tk.100,000 and owner's equity decreased Tk.70,000. What is the amount of total assets at the end of the year?
- If total assets decreased Tk.90,000 and owner's equity increased Tk.110,000 during the year, what is the amount of total liabilities at the end of the year?

14. Presented below are three business transactions. On a sheet of paper, list the letters a, b, c with columns for assets, liabilities, and owner's equity. For each column, indicate whether the transactions increased (+), decreased (-) or had no effect (NE) on assets, liabilities, and owner's equity:

- Purchased supplies on account.
- Received cash for providing services
- Expenses paid in cash.

15. Follow the same format as Q.4 above. Determine the effect on assets, liabilities, and owner's equity of the following three transactions:

- Invested cash in the business.

- (b) Withdrawal of cash by owner.
 - (c) Received cash from a customer who had previously been billed for services provided.
16. Indicate whether each of the following items is an asset (A), Liability (L), or part of owner's equity (OE).

_____ Accounts receivable	_____ Office supplies
_____ Salaries payable	_____ Owner's investment
_____ Equipment	_____ Notes payable

Discussion Questions

1. "Accounting is ingrained in our society and it is vital to our economic system." Do you agree? Explain.
2. Identify and describe the steps in the accounting process.
3. (a) Who are internal users of accounting data?
(b) How does accounting provide relevant data to these users?
4. Distinguish between the two types of external users of accounting data and give examples of each.
5. "Bookkeeping and accounting are the same." Do you agree? Explain.
6. What is the monetary unit assumption? What impact does inflation have on the monetary unit assumption?
7. What is the economic entity assumption?
8. What is the basic accounting equation?
9. (a) Define the terms assets, liabilities, and owner's equity.
(b) What items affect owner's equity?
10. Can a business enter into a transaction in which only the left side of the basic accounting equation is affected? If so, give an example.

Exercises

1. The John Cleaners has the following balance sheet items:

Accounts payable	Accounts receivable
Cash	Notes payable
Cleaning equipment	Salaries payable
Cleaning supplies	John Capital.
Rent paid	Interest received

Classify the accounts as to asset, liability, revenue and expenses.

2. Li Wang Computer Timeshare Company entered into the following transactions during May 2024.
- (i) Purchased computer terminals for Tk.19,000 from Digital Equipment on account.
 - (ii) Paid Tk.4,00,000 cash for May rent on storage space.
 - (iii) Received Tk.5,00,000 cash from customers for contracts billed in April.
 - (iv) Provided computer services to Brieske Construction Company for Tk.3,00,000 cash.
 - (v) Paid Southern states power Co. Tk.11,00,000 cash for energy usage in May.
 - (vi) Li Wang invested an additional Tk.32,00,000 in the business.
 - (vii) Paid Digital Equipment for he terminals purchased in (i) above.
 - (viii) Incurred advertising expense for May of Tk.1,00,000 on account.

Instructions:

Indicate with the appropriate letter whether each of the transactions above results in:

- (a) an increase in assets and a decrease in assets,
 - (b) an increase in assets and an increase in owner's equity,
 - (c) an increase in assets and an increase in liabilities,
 - (d) a decrease in assets and a decrease in owner's equity,
 - (e) a decrease in assets and a decrease in liabilities,
 - (f) an increase in liabilities and a decrease in owner's equity,
 - (g) an increase in owner's equity and a decrease in liabilities.
3. The following information relates to Tone Kon Co. for the year 2023.

Tone Kon, Capital, January 1, 2023	Tk.45,000
Advertising expense	1,800
Tone Kon, Drawing, during 2023	5,000
Rent expense	10,400
Fees earned	50,000
Utilities expense	3,100
Salaries expense	28,000

Instructions:

After analyzing the data, prepare an income statement and an owner's equity statement for the year ending December 31, 2023.

4. Rick Stated is the sole owner of Deer Park, a public camping ground near the Lake Mead National Recreation Area. Rick has compiled the following financial information as of December 31, 2023.

Revenues during 2023 – camping fees	Tk.147,000
Market value of equipment	140,000
Revenues during 2023- general store	40,000
Notes payable	60,000
Accounts payable	11,000
Expenses during 2023	150,000
Cash on hand	7,000
Supplies on hand	2,500
Original cost of equipment	115,500

Instructions

- (a) Determine Rick Stead's net income from Deer Park for 2023.
- (b) Prepare a balance sheet for Deer Park as of December 31, 2023.

Problems

- 5.
- (i) On April 1, Laura Seall established the Seall Travel Agency. The following transactions were completed during the month:
 - (ii) Invested Tk.2,00,000 cash in Corner State Bank in the name of the agency.
 - (iii) Paid Tk.4,000 cash for April office rent.
 - (iv) Purchased office equipment for Tk.25,000 cash.
 - (v) Incurred Tk.3,000 of advertising costs in the Chicago Tribune, on account.
 - (vi) Paid Tk.6,000 cash for office supplies.
 - (vii) Earned Tk.90,000 for services rendered: Cash of Tk.10,000 is received from customers, and the balance of Tk.80,000 is billed to customers on account.
 - (viii) Withdrew Tk.2,000 cash for personal use.
 - (ix) Paid Chicago Tribune amount due in transaction (v)
 - (x) Paid employees salaries, Tk.12,000.
 - (xi) Received Tk.80,000 in cash from customers who have previously been billed in transaction (vii).

Instructions:

- (a) Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Office Equipment, Accounts Payable, and Laura Seall, Capital,
 - (b) From an analysis of the column, Laura Seal, Capital, compute the net income or net loss for April.
6. Ivan Izo opened a law office, Ivan Izo, Attorney at Law, on July 1, 2023. On July 31, The balance sheet showed cash Tk.40,000, Accounts Receivable Tk.15,000, Supplies Tk.5,000, Office Equipment Tk.50,000, Accounts Payable Tk.42,000, and Ivan Izo, Capital Tk.68,000. During August the following transactions occurred.
- (i) Collected Tk.14,000 of accounts receivable.
 - (ii) Paid Tk.27,000 cash on accounts payable.
 - (iii) Earned fees for Tk.64,000, of which Tk.30,000 is collected in cash and the balance is due in September.
 - (iv) Purchased additional office equipment for Tk.10,000, paying Tk.4,000 in cash and the balance on account.
 - (v) Paid salaries Tk.15,000, rent for August Tk.9,000, and advertising expenses Tk.3,500.
 - (vi) Withdrew Tk.5,500 in cash for personal use.
 - (vii) Received Tk.20,000 from Standard Bank money borrowed on a note payable.
 - (viii) Incurred utility expenses for the month on account Tk.2,500.

Instructions:

- (a) Prepare a tabular analysis of the August transactions, beginning with July 31 balances. The column heading should be as follows: Cash + Accounts Receivable + Supplies + Office Equipment = Notes Payable + Accounts Payable + Ivan Izo, Capital.
- (b) Prepare an income statement for August, an owner's equity statement for August, and a balance sheet at August 31.

7. Financial statement information about four different companies is as follows:

	A Company	B Company	C Company	D Company
January 1, 2023:				
Assets	Tk.90,000	Tk.110,000	(g)	Tk.170,00
Liabilities	50,000	(d)	75,000	0
Owner's equity	(a)	60,000	55,000	(j) 90,000
December 31,2023:				
Assets	(b)	150,000	200,000	(k)
Liabilities	55,000	65,000	(h)	80,000
Owner's equity	58,000	(e)	130,000	170,000
Owners equity changes in year:	(c)	15,000	10,000	15,000
Additional investment	25,000	(f)	14,000	20,000
Drawings	350,000	420,000	(i)	520,000
Total revenues	320,000	385,000	350,000	(l)
Total expenses				

Instructions:

- Determine the missing amounts.
- Prepare the owner's equity statement for Petino Company.
- Write a memorandum explaining the sequence for preparing financial statements and the interrelationship of the owner's equity statement to the income statement and balance sheet.

Self-Test Questions

- From the followings statements, pick up the most correct answer:
 - Which of the following statements about an account is true?
 - In its simplest form, an account consists of two parts.
 - An account is an individual accounting record of increases and decreases in specific asset, liability, and owner's equity items.
 - There are separate accounts for specific assets and liabilities but only one account for owner's equity items.
 - The left side of an account is the credit or decrease side.
 - Debits:
 - increase both assets and liabilities.
 - decrease both assets and liabilities.
 - increase assets and decrease liabilities.
 - decrease assets and increase liabilities.

- iii) A revenue account:
 - (a) is increased by debits.
 - (b) is decreased by credits.
 - (c) has a normal balance of a debit.
 - (d) is increased by credits.
- iv) Accounts that normally have debit balances are:
 - (a) assets, expenses, and revenues.
 - (b) assets, expenses, and owner's capital.
 - (c) assets, liabilities, and owner's drawings.
 - (d) assets, owner's drawings, and expenses.
- v) Which of the following is not part of the recording process?
 - (a) Analyzing transactions.
 - (b) Preparing a trial balance.
 - (c) Entering transactions in a journal.
 - (d) Posting transactions.
- vi) Which of the following statements about a journal is false?
 - (a) It is not a book of original entry
 - (b) It provides a chronological record of transactions.
 - (c) It helps to locate errors because the debit and credit amounts for each entry can be readily compared.
 - (d) It discloses in one place the complete effect of a transaction.
- vii) A ledger:
 - (a) contains only assets and liability accounts.
 - (b) should show accounts in alphabetical order.
 - (c) is collection of the entire group of accounts maintained by a company.
 - (d) is a book of original entry
- viii) Posting:
 - (a) normally occurs before journalizing.
 - (b) transfers ledger transaction data to the journal
 - (c) is an optional step in the recording process.
 - (d) transfers journal entries to ledger accounts.

- xi) A trial balance:
- (a) is a list of accounts with their balances at a given time.
 - (b) proves the mathematical accuracy of journalized transactions.
 - (c) will not balance if a correct journal entry is posted twice.
 - (d) proves that all transactions have been recorded.
- x) A trial balance will not balance if:
- (a) a correct journal entry is posted twice.
 - (b) the purchase of supplies on account is debited to supplies and credited to cash.
 - (c) a Tk.100 cash drawing by the owner is debited to Owner's Drawing for Tk.1,000 and credited to Cash for Tk.100.
 - (d) a Tk.450 payment on account is debited to Accounts Payable for Tk.45 and credited to Cash for Tk.45.

Discussion Questions

1. Why is an account referred to as a T account?
2. The terms debit and credit mean increase and decrease, respectively. Do you agree? Explain.
3. State the rules of debit and credit as applied to (a) asset accounts, (b) liability accounts, and (c) owner's equity account.
4. What is the normal balance for each of the following accounts? (a) Accounts Receivable (b) Cash (c) Owner's Drawing. (d) Accounts Payable. (e) Fees Earned. (f) Salaries Expense (g) Owner's Capital.
5. What are the basic steps in the recording process?
6. What are the advantages of using the journal in the recording process?
7. The account number is entered as the last step in posting the amounts from the journal to the ledger. What is the advantage of this step?
(a) What is a ledger? (b) Why is a chart of accounts important?
8. What is a trial balance and what are its purposes?
9. For each of the following accounts, indicate (a) the effect of a debit or a credit on the account and (b) the normal balance.

Accounts Payable

Advertising Expense

Fees Earned.

Accounts Receivable.

Jahan's Capital

Jahan's Drawing.

Exercises

- Transaction for the small company for the month of June are presented below. Identify the accounts to be debited and credited for each transaction.

- June 1 The owner invests Tk.25,000 cash in a small welding business of which he is the sole proprietor.
- 2 Buys equipment on account for Tk.9,000.
- 3 Pays Tk.5,000 to landlord for June rent.
- 4 Bills a customer Tk.3,000 for welding work done.

- Selected transactions for A. Das, an interior decorator, in her first month of business, are as follows:

- (i) Invested Tk.1,00,000 cash in business.
- (ii) Purchased used car for Tk.40,000 cash for use in business.
- (iii) Purchased supplies on account for Tk.5,000
- (iv) Billed customers Tk.18,000 for services performed.
- (v) Paid Tk.2,000 cash for advertising start of business.
- (vi) Received Tk.7,000 cash from customers billed in (iv) above.
- (vii) Paid creditor Tk.3,000 cash on account.
- (viii) Withdrew Tk.5,000 cash for personal use of owner.

Instructions:

For each transaction indicate (a) the basic type of account debited and credited (asset, liability, owner's equity); (b) the specific account debited and credited (cash, rent expenses, fees earned, etc.) (c) whether the specific account is increased or decreased; and (d) the normal balance of the specific account . Use the following format, in which transaction (i) is given as an example:

Account Debited					Account Credited			
	(a)	(b)	(c)	(d)	(a)	(b)	(c)	(d)
Trans action	Basic Type	Specific Account	Effect	Normal Balance	Basic Type	Specific Account	Effect	Normal Balance
(i)	Asset	Cash	Increase	Debit	Owner's Equity	A. Das Capital	Increase	Credit

- Presented below is information related New Era Real Estate Agency:

- Oct. 1 The owner begins business as a real estate agent with a cash investment of Tk.13,00,000.
- 2 Hires an administrative assistant.
- 3 Buys office furniture for Tk.1,90,000 on account.

- 4 Sells a house and lot for B. Majumdar fees due from Majumdar Tk.3,20,000 (not paid by Majumdar at this time).
- 5 Receives cash of Tk.14,000 as fees for renting an apartment for the owner.
- 6 Pays Tk.70,000 on the balance indicated in the transaction of October 3,
- 7 Pays the administrative assistant Tk.96,000 in salary for October.

Instructions:

Prepare the debit-credit analysis for each transaction as illustrated on pages no. 28.

4. Mrs. Karim is a licensed architect. During the first month of the operation of her business, the following events and transactions occurred.
 - April 1 Invested Tk.13,00,000 cash.
 - 2 Hired a secretary receptionist at a salary of Tk.30,000 per week payable monthly.
 - 4 Paid office rent for the month, Tk.80,000.
 - 6 Purchased architectural supplies on account from Halo Company, Tk.1,50,000.
 - 8 Completed blueprints on a carport and billed client Tk.90,000 for services.
 - 10 Received Tk.50,000 cash advance from Rahim for the design of a new home.
 - 15 Received Tk.1,50,000 cash for services completed and delivered to Jalil.
 - 28 Paid secretary receptionist for the month, Tk.1,20,000.
 - 30 Paid Tk.60,000 to Halo company on account.

Mrs. Karim used the following chart of accounts: No. 101 Cash, No. 112 Accounts Receivable, No. 126 Supplies, No. 201 Accounts Payable, No. 205 Unearned Fees, No. 301, Capital, No. 400 Fees Earned, No. 726 Salaries Expense, and No. 729 Rent Expense.

Instructions:

- (a) Journalize the transactions.
- (b) Post to the ledger accounts.

5. The trial balance of Essential Co. on September 30 is shown below:

**Essential Co.
Trial Balance
September 30, 2023**

Account No.	Account Titles	Debit	Credit
101	Cash		Tk.8,50,000
102	Accounts Receivable		2,20,000
103	Supplies		1,70,000
104	Equipment		8,00,000
105	Accounts Payable	Tk. 5,00,000	
106	Unearned Revenue	70,000	
301	Jane Kent, Capital	<u>14,70,000</u>	
		Tk.20,40,000	Tk.20,40,000
		=====	=====

The October transactions were as follows:

- Oct. 5 Received Tk. 90,000 cash from customers on account.
- 10 Billed customers for services performed Tk. 5,50,000.
- 11 Paid employee salaries Tk. 1,20,000.
- 17 Performed Tk. 40,000 of services for customers who paid in advance in August.
- 20 Paid Tk. 1,60,000 to creditors on account.
- 29 Withdrew Tk. 50,000 for personal use.
- 31 Paid utilities Tk. 60,000.

Instructions:

- (a) Enter the opening balances in the ledger accounts as of October 1.
- (b) Journalize the transactions.
- (c) Post to the ledger accounts.

6. The trial balance of Tip Top Dry Cleaners on June 30 is shown below:

Tip Top Dry Cleaners Trial Balance June 30, 2023			
Account No.	Account Titles	Debit	Credit
101	Cash	Tk. 12,53,200	
112	Accounts Receivable	10,53,600	
126	Supplies	4,84,400	
157	Equipment	25,95,000	
201	Accounts payable		Tk.15,87,800
206	Unearned Revenue		1,73,000
301	Capital		36,25,400
		<u>Tk.53,86,200</u>	<u>Tk.53,86,200</u>

The July transactions were as follows:

- July 8 Collected Tk. 4,93,600 in cash on June 30 accounts receivable.
 9 Paid employee salaries Tk. 2,10,000.
 11 Received Tk. 4,32,500 in cash for services rendered.
 14 Paid June 30 creditors Tk. 10,75,000 on account.
 22 Billed customers for services rendered, Tk. 4,70,000.
 30 Paid employee salaries Tk. 3,11,400, Utilities Tk. 1,38,400, and repairs Tk. 69,200.
 31 Withdrew Tk. 70,000 cash for personal use of owner.

Instructions:

- (a) Enter the opening balances in the ledger accounts as of July 1. Write “Balance” in the explanation space and insert a check mark in the reference column. Provision should be made for the following additional accounts: No. 306, Drawing; No. 423 Dry Cleaning Revenue; No. 622 Repair Expense; No. 726 Salaries Expense; and No. 732 Utilities expense.
 (b) Journalize the transactions.
 (c) Post to the ledger accounts.

Case Study

1. Group Decision Case

Royal golf stars, opened the Long-Shot Driving Range on March 1, 2024 by investing Tk.10,00,000 of their cash savings in the business. A caddy shack was constructed for cash at a cost of Tk.4,00,000 and Tk.80,000 was spent on golf balls and golf clubs. The Royal leased five acres of land at a cost of Tk.1,00,000 per month and paid the first month's rent. During the first month, advertising costs totaled Tk.75,000 of which Tk.15,000 was unpaid at March 31, and Tk.40,000 was paid to members of the high school golf team for retrieving golf balls. All revenues from customers were deposited in the company's bank account. On March 15, Royal withdrew a total of Tk.80,000 in cash for personal living expenses. A Tk.10,000 utility bill was received on March 31 but it was not paid. On March 31, the balance in the company's bank account was Tk.7,55,000.

Royal thought they had a pretty good first month of operations. However, their estimates of profitability ranged from a loss of Tk.45,000 to net income of Tk.2,10,000.

Required:

With the class divided into groups, answer the following:

- (a) How could the Royal have concluded that the business operated at a loss of Tk.2,45,000? Was this a valid basis on which to determine net income?
- (b) How could the Royal have concluded that the business operated at a net income of Tk.2,10,000? (*Hint:* Prepare a balance sheet at March 31.) Was this a valid basis on which to determine net income?
- (c) Without preparing an income statement, determine the actual net income for March.
- (d) What was the revenue earned in March?

2. Financial Decision

Instead of hunting for a summer job after completing her junior year in college, Rumni organized a lawn service company in her neighborhood. To start her business on June 1, she deposited Tk.1,50,000 in a new bank account in the name of her company. Tk.1,50,000 consisted of a Tk.1,00,000 loan from her father and Tk.50,000 of her own money.

Using the money in this checking account, she rented lawn equipment, purchased supplies, and hired neighborhood high school students to know and trim lawns of neighbors who had agreed to pay her for the service. At the end of each month, she mailed out bills to her customers.

On September 30, Rumni was ready to dissolve her business and go back to school for the fall quarter. Because she had been so busy, she had not kept any records other than her checkbook and a list of amounts owed to her by the customers. Her checkbook had a balance of Tk.2,25,000, and the amount owed to her by the customers totaled Tk.87,500. She expected these customers to pay her during October. She remembered that she could return unused supplies to the Lawn Care Center for a full credit of Tk.5,000. When she brought back the rented lawn equipment, the Lawn Care Center would also return a deposit of Tk.20,000 she had made in June. She owed the Lawn Care Center Tk.47,500 for equipment rentals and supplies. In addition, she owed the students who had worked for her Tk.10,000, and she still owed her father Tk.60,000. Though Rumni feels she did quite well, she is not sure just how successful she was.

Required:

- (a) Prepare a balance sheet dated June 1 and one dated September 30 for Rumni Lawn Services Company.
- (b) Comment on the performance of Rumni Lawn Service Company by comparing the two balance sheets. Did the company have a profit or loss? (Assume that Beth used none of the company's assets for personal purpose.)
- (c) If Rumni is to continue her business next summer, what kind of information from her record keeping system would help make it easier to tell whether she is earning a profit or losing money?

3. Financial Decision

To start a home repair business, Mahabub engaged an attorney, who helped him start Mahabub Repair Service Company. On March 1, Mahabub invested Tk.10,00,000 cash in the business. When he paid the attorney's bill of Tk.50,000, the attorney advised him to hire an accountant to keep his records. However, Mahabub was so busy that it was March 31 before he asked you to straighten out his records. Your first task will be to develop a trial balance based on a reconstruction of the March transactions. After considerable work, you come up with the information contained in the following paragraphs:

Immediately after the investment and the payment to the attorney, Mr. Mahabub borrowed Tk.4,00,000 from the bank. He later paid Tk.14,000, which included interest of Tk.4,000, on this loan. He also purchased a pickup truck in the name of the company, paying Tk.1,50,000 down and financing the remaining Tk.7,40,000. The first payment on the truck is due April 15. Mahabub then rented an office and paid three months' rent of Tk.90,000 in advance. Cash purchases of office equipment in the amount of Tk.70,000 and repair tools in the amount of Tk.50,000 must be paid by April 10.

During March, Mahabub Repair Service completed home repairs totaling Tk.1,30,000, Tk.40,000 of which were cash transactions. Of the credit transactions, Tk.30,000 was collected during March, and only Tk.60,000 remained to be paid at the end of the month. Wages of Tk.40,000 were paid to employees. In the March 31 mail, the company received a Tk.7,500 bill for March utility expenses and also a Tk.5,000 check from a customer for repair work to be completed in April.

Required:

- (a) Prepare a March 31 trial balance for Mahabub Repair Service Company. To do so, you will first need to record the March transactions and then determine the balance of each T Account.
- (b) Luis Mahabub is not sure how to evaluate the information in your trial balance. He feels that his business is off to a better start than is indicated by the low Cash account. Explain why the Cash account is not an indicator of the earnings of the business. Also cite specific examples to show why it is difficult to determine net income by looking solely at the figures in the trial balance.

4. Cost or Market Values

Andrew, the president of Landco, is concerned about the way generally accepted accounting principles require his firm to present its assets. Landco specializes in the acquisition and resale of land that is under for shopping centers. Landco identifies the likely growth areas in Atlanta, Chicago, Seattle, and Phoenix. Landco then purchases land in these growth areas that it believes will be suitable for shopping centers. After holding the land for three to five years, Landco sells the land to shopping center developers. Because Landco purchases land prior to the time it is considered for use as a shopping center, the selling price is typically four to five times the price that Landco pays for the land.

Andrew argues that the requirement that Landco state its assets at cost misleads users of the balance sheet. Andrew notes that Landco has received bona fide offers to purchase nearly all the parcels of land that it holds for much more than their costs. Andrew argues that Landco should be able to report its inventory of land in the balance sheet at market value rather than cost. Then, Andrew argues, users of the balance sheet would be able to assess much more accurately the value of the firm.

Required:

Why do you suppose generally accepted accounting principles do not permit the kind of accounting Andrew favors?

5. Cash or Accrual Accounting

Queen owns a small business that rents computers to students at the local university. Queen typical rental contract requires the student to pay the year's rent of Tk.90,000 (Tk.10,000 per month) in advance. When Queen prepares financial statements at the end of December, her accountant requires that Queen spread Tk.90,000 over the nine months that a computer is rented. Therefore, Queen can recognize only Tk.40,000 revenue (four months) from each computer rental contract in the year the cash is collected and must defer recognition of the remaining Tk.50,000 (five months) to next year. Queen argues that getting students to agree to rent the computers is the most difficult part of the activity so she ought to be able to recognize all Tk.90,000 as revenue when the cash is received from a student.

Required:

Why do you believe that generally accepted accounting principles require the use of accrual accounting rather than cash-basis accounting for transactions like the one described here?

6. Analysis of Accounting Periodicals

The accounting profession is organized into three major groups: (1) accounts who work in nonbusiness entities, (2) accounts who work in business entities, and (3) accountants in public practice. The periodical literature of accounting includes monthly or quarterly journals that are written primarily for accountants within each of these groups.

Required:

- (a) Visit your library and identify one journal published for each of the three professional groups. Identify the publisher of each journal and describe its primary audience.
- (b) Choose two of the three audiences you have just described. Briefly explain how members of one audience would benefit by reading a journal published primarily for members of the other audience.

ACCOUNTING PROCESS: JOURNAL TO TRIAL BALANCE



From the discussion of this Unit, students will be able to understand:



The accounting process



The Journalizing Transactions



The Posting process to Ledgers



The Preparation of Trial Balance



Process of adjusting and closing entries

এই পৃষ্ঠা খালি থাকবে

Unit-2

Lesson-1: Journal: The Book of Original Entry

Lesson Objectives

After you have studied this lesson, you should be able to:

- describe as to what is meant by journal and what are its utilities.
- understand the form of journal and procedure of recording transactions in journal.

2.1.1 Introduction

An accounting process may be considered to be composed of two parts: (i) Recording phase and (2) Summarizing phase. Journal is the first step of recording transactions. This lesson will deal with different aspects of journal as to recording transactions therein. In fact accurate accounting statements can be prepared only if transactions have been recorded properly.

2.1.2 Book of Original Entry and Journalizing Transactions

A) Meaning of Journal

The book in which information about each business transaction is initially recorded is called a journal. Thus, it is a chronological (day-by-day) record of business transactions. The journal is a permanent chronological record of the debits and credits resulting from transactions, together with all necessary explanations of the transactions. So, the information recorded in the journal relates to the dates of transactions, the debit and credit change in specific "Ledger accounts" and a brief explanation of the transaction. Since the journal is the accounting record in which transactions are first recorded, it is also called the book of original entry or prime entry.

Journal is a chronological record of the debits and credits resulting from transactions, together with all necessary explanation of the transactions.

B) Advantages/Uses of Journal

Technically, it is possible to record transactions directly to a Ledger. But due to some specific advantages, as detailed below, business firms keep books of original entry called journal.

i) Complete Information as to Transaction

In journal, the debit and credit of a transaction is recorded together but when transactions are recorded directly in the ledger, the debits and credits are recorded in different accounts. Further, in journal, a brief explanation as to transaction is recorded.

ii) Chronological Record

In journal, transactions are recorded in day-to-day chronological order. Future and past reference thus becomes helpful.

iii) Prevention of Errors

If transactions are recorded directly in the ledger, errors may creep in which may be difficult or time-consuming to detect. But in a journal, since the offsetting debits and credits for each transaction appear, such errors are less likely to occur and if occur, they can be detected easily.

C) Journalizing

The process of recording a transaction in a journal is called journalizing. The procedure and steps in journalizing can be summarized as follows:

Procedure of recording transactions in a journal is called journalizing.

i) Recording the Dates

(a) Year is inserted in the top column of each page meant for date, except when the year changes.

(b) Month is inserted on the first line of the Date column of each page, except when the month changes.

(c) Day is inserted in the second line of Date column used for each transaction, regardless of number of transactions during the day.

ii) Recording the Debit

Title of account to be debited is inserted at the extreme left of the Description column and amount is entered in the Debit column along that line.

iii) Recording the Credit

Title of account to be credited is inserted below the account debited, moderately indented, and the amount is entered in the Credit column against that line.

iv) Ledger Folio (L.F)/Reference (Ref.)

The ledger folio column to the right of the description column is not filled in when transactions are recorded. In the ledger when debits and credits are posted from journal, the page number of the ledger in which these accounts are appearing is listed in this column.

v) Writing Explanation i.e. Narration

A brief explanation is written below each entry. Some accountants prefer that the explanation be omitted if the nature of the transaction is obvious.

A specimen of the journal is shown below:

General Journal Entries

Date		Account Titles & Explanation	Ledger Folio	Debit Tk.	Credit Tk.

Example-2.01:

Journalize the following transactions in the books of XYZ Ltd. for the month of January, 2024.

- January 1 Started business with Tk.2,00,000 in cash as capital.
 2 Deposited in to bank Tk.1,20,000.
 5 Bought office furniture for Tk.20,00 & paid cheque.
 5 Bought goods with Tk.50,000 cash & Tk.40,000 on credit from Habib.
 8 Sold goods for cash Tk.25,000.
 10 Sold goods on credit to Ali Tk.30,000.
 12 Paid Habib on account Tk.40,000.
 13 Paid for office stationary Tk.1,000.
 15 Received from Ali Tk.15,000.
 20 Paid office rent Tk.20,000.
 25 Paid electricity bill Tk.5,000.
 28 Received from Ali Tk.15,000.
 30 Paid salaries by cheque Tk.20,000.

Solution:

XYZ Ltd.
General Journal Entries

Date	Account Titles & Explanation	L.F.	Debit	Credit
2024 Jan. 1	Cash Owner's Capital (Invested cash as capital)		Tk. 2,00,000	Tk. 2,00,000
2	Bank Cash (Deposited cash in to Bank)		1,20,000	1,20,000
5	Office Furniture Bank (Bought furniture and payment made through cheque)		20,000	20,000
5	Purchase Cash A/C Payable-Habib (Purchased goods Tk.50,000 in cash and on credit Tk.40,000)		90,000	50,000 40,000
8	Cash Sales Revenue (Sold goods in cash)		25,000	25,000
10	A/C Receivable-Ali Sales Revenue (Sold goods on credit)		30,000	30,000

Date	Account Titles & Explanation	L.F.	Debit	Credit
2024 12 Jan.	A/C Payable-Habib Cash (Paid cash to Habib)		40,000	40,000
13	Office Stationary Cash (Stationary purchased)		1,000	1,000
15	Cash A/C Receivable-Ali (Received cash on account from Ali)		15,000	15,000
20	Office Rent Expense Cash (Paid office rent)		20,000	20,000
25	Electricity Expense Cash (Paid electricity bill)		5,000	5,000
28	Cash A/C Receivable-Ali (Received cash on account)		15,000	15,000
30	Salaries Expense Bank (Salary paid through cheque)		20,000	20,000

Lesson-2: Special and General Journals

Lesson Objectives

After you have studied this lesson, you will be able to:

- define special journal and general journal.
- understand the procedure of recording transactions in special and general journal.

2.2.1 Introduction

Many businesses maintain several types of journal instead of one journal due to necessity. The nature of operations and the volume of transactions in the particular business determine the number and types of journal. This lesson will deal with different types of journal that may be found in the business day with the recording process of transactions in those books of original entry.

2.2.2 Special and General Journal

While it would be possible to record every transaction in a single book of original entries, this is hardly ever done. Whenever a number of transactions of the same character take place, special journals may be designed in which such transactions can be conveniently entered and summarized. Special journals include sales journals, purchases journals, cash receipts and disbursements journals, the voucher register, and various other books of original entry designed to summarize special groups of transactions. Regardless of the number and the nature of the special books of original entry, there are always certain entries that cannot be made in the special journals, and these are recorded in the general journal.

In special journals, transactions of the same character can be conveniently entered and summarized.

In this connection, it may be pointed out that a number of special columns, as per requirement, may be drawn in various special journals which facilitate summarizing and subsequent transfer from books of original entry to other books and records. Various special journals to which journal may be divided can be shown as follows:

1. **Purchases Book** for recording all goods purchased on credit;
2. **Purchases Returns Book** for recording all purchases returned to creditors;
3. **Sales Book** for recording all goods sold on credit;
4. **Sales Returns Book** for recording all sales returned by customers;
5. **Bills Receivable Book** for recording all bills receivable;
6. **Bills Payable Book** for recording all bills payable;

7. **Cash Book** for recording all receipts and payments;
8. **Journal Proper** or **General Journal** or **Miscellaneous Journal** for recording residual transactions for which there is no separate book.

1. Purchases Book

In Purchase Day Book or Invoice Book all credit purchases of goods for re-sales are recorded.

This is one of the subsidiary books or books of original entry in which all credit purchases of goods for resales are recorded. Purchase Invoice, after it has been checked as to calculations and also as to the quantity, quality, and price of the goods received, is numbered serially and then entered in the Purchases Day Book which is also known as the Invoice Book. Specimen of the book.

Date	Particulars	Inward Invoice No.	Ledger Folio	Amount

2. Purchases Return Book

Return Outwards Book is maintained for recording returns of goods bought.

This book is also called Returns Outwards Book and is maintained for recording returns of goods bought. A *Debit Note* is made out with a carbon duplicate and sent to the party to whom the goods are returned. Entries are then made in the Purchases Returns Book from the Debit Note Book giving reference to the number of each Debit Note as follows:

Date	Particulars	Debit Note No.	Ledger Folio	Amount

3. Sales Book

Sales Book is maintained to record credit sales.

The use of this book is to record credit sales. The rulings of this book are similar with those of the Purchases Book. An Outward Invoice is made out for each credit sale and checked as to the quantity, quality, and price of the goods before the latter are sent out to the customer. The firm keeps a Duplicate Copy the Invoice and the original is posted to the purchaser. Entries are then made from these copies of Outward Invoices into the Day Book or Sales Book. A specimen of the Sales Book is shown below:

Date	Particulars	Outward Invoice No.	Ledger Folio	Amount

4. Sales Return Book

This book is termed Returns Inwards Book, that is, returns of goods sold to the trader by his customers are recorded in this book. On receipt of the goods, *Credit Notes* with carbon duplicates are made out and sent to these customers who have returned the goods. Entries are then made from Credit Note Book to Sales Returns Book. The specimen of the Sales Return Book is given below:

Sales Return Book is maintained to record returns of goods sold

Date	Particulars	Credit Note No.	Ledger Folio	Amount

5. Bills Receivable Book

This book is maintained to record full particulars of the bills receivable received by the enterprise. For a large enterprise, when numerous bills of exchange are drawn on debtors, it is advantageous to maintain Bills Receivable Book. As soon as each Bill Receivable is received, the necessary particulars connected with it, viz., the names of the drawer and the acceptor, the date of the bill, the amount, the due date etc., are entered in the Bills Receivable Book. A specimen of this book is shown below:

In Bills Receivable Book full particulars of bills receivable are recorded.

Date	From where received	Name of acceptor	Where payable	Terms & Date of payment	Due date	Ledger Folio	Amount	Have disposed of

6. Bills Payable Book

This book is maintained to record full particulars of the Bills Payable accepted by the trader, and to provide a convenient medium for recording Bills Payable transactions.

A Bill Payable is one which has been accepted by a person and the amount of which he is under obligation to pay at some specified future time. In accepting a Bill Payable, full particulars of the same are recorded in the Bills Payable Book. A specimen of this book is shown below:

Bills Payable Book is maintained to record the details of bills payable accepted by the trader.

Date when accepted	By whom drawn	To whom payable	Where payable	Date & Term	Date Due	Ledger Folio	Amount	Have disposed of

7. Cash Book

The object of Cash Book is to keep a record of all receipt and payments of money.

Among the important books of accounts of a business, the Cash Book is very important one. This is also a book of Original Entry. The object of the book is to keep a record of all receipts and payments of money. Cash books with different rulings are used in different types of business based on the nature of the business. In almost every business the number of cash dealings is usually large. Since cash can be easily stolen by dishonest employees, cash records of a business must be up-to-date and must be properly supervised.

Cash Book is kept in the form of a ledger account. The receipts being put on the debit and payments on the credit side.

The advantage of entering all cash transactions in a separate book is well recognized. It is a matter of common knowledge that all business dealings ultimately resolve themselves into cash transactions, and as such, records of cash dealings in any business must naturally be by far the largest. The Cash Book is kept in the form of a ledger account. The receipts are put on the debit side and the payments on the credit side. It is both, in fact, a book of original records and a part of the ledger. It is a book of original records from the view point that all cash and bank transactions are recorded in it as and when they take place, and it is also a part of the ledger because it contains the Cash and Bank Accounts taken out of the ledger and bound separately. The balances of the Cash Book are included in the trial balance and thus, also in the Balance Sheet.

As the Cash Book is a part of the ledger it is balanced like other real and personal accounts. To check the accuracy of the Cash Book and to verify the amount of cash in hand, the Cash Book should be balanced at the close of each day, although the daily balances need not necessarily be entered in it.

Kinds of Cash Book- In order to prevent frauds, it is always desirable to bank all receipts and make all payments by cheques. In a majority of concerns, however, a large floating balance of cash is left in the office, and payments are made either by cheques or cash as deemed convenient.

There are three principal types of Cash Book. Each business would try to have its Cash Book ruled in a manner as would suit its own requirements. Thus, the Cash Book may be ruled so as to incorporate:

- (1) Cash column only in either side;
- (2) Cash and Discount columns only on either side; or
- (3) Cash, Bank, and Discount columns on either side; or
- (4) Bank and Discount columns on either side.

Cash Receipts and Cash Payment Journals

Instead of keeping cash book on the basis of single, Double, or Triple columns, cash book can be divided into two viz., cash receipts and cash payment journals. All transactions that increase the amount of cash are recorded in the cash receipts journal, & all transactions that decrease the amount of cash are recorded in the cash payment journal.

Cash Receipts Journal

In general, it may have five columns over and above date and particulars columns, such as (i) sundry accounts Cr. to record credit to any account for which there is no special column, (ii) Sales Cr. - to record sales of merchandise for cash, (iii) Accounts receivable Cr. - to record payments from customer, (iv) sales discount Dr. - to record amount of cash discount granted and (v) cash Dr. column to show transaction of each of the above mentioned items in net amount. A specimen of the book is shown below:

Cash Receipts Journal

Date	Accounts credited	Post Ref.	Sundry Account Cr.	Sales Cr.	Accounts Receivable Cr.	Sales Discount Dr.	Cash Dr.

Cash Payment Journal

This journal may have four columns over and above the date and particulars columns, such as, (i) Sundry accounts Dr. - to record debits to any account for which there is no special column, (ii) Accounts payable Dr. - to record payment to account payable, (iii) Purchase discount Cr. - to record purchase discount and (iv) Cash Cr. - column to show each transaction in net. A specimen of the book is shown below.

Cash Payment Journal

Date	Accounts debited	Post Ref.	Sundry Account Dr.	Accounts payable Dr.	Purchased Discount Cr.	Cash Cr.

8. General Journal or Journal Proper

In modern accounting, the use of only one journal is very limited. A special journal for different types of transactions is in use. The transactions which cannot be conveniently recorded in any of the other books of Original Entry, are now being recorded in Journal.

Generally, the use of the General Journal, also called Journal proper, is now restricted to the record of the following transactions:

(a) Opening Entries;

The transactions which cannot be conveniently recorded in any of the other books of original entry, are being recorded in Journal Proper.

- (b) Transfers from one account to another;
- (c) Rectification of Errors;
- (d) Adjusting Entries;
- (e) Closing Entries, *i.e.*, transfers from the Nominal Accounts to the Profit and Loss Account;
- (f) Entries relating to dishonor of Bills; and
- (g) Any other transactions which cannot be conveniently passed through any book of Original Entry, such as Consignment Transactions, Joint Ventures, etc.

Against the backdrop of the discussion as to special and general journal following illustration can help the students to under trial the picture clearly.

Example-2.02

Enter the following transaction in the proper books of Abrar Enterprise for the month of January, 2024.

- January 1: **Asset:** Premise Tk.2,00,000, Machinery Tk.20,000, Inventory Tk.5,00,000 Furniture Tk.50,000, Bank Tk.80,000 & Cash Tk.15,000
- Liabilities:** Loan Tk.2,30,000 (interest to be paid @ 12%), Due to Alpha Ltd. Tk.1,00,000
- 5: Drawn from Bank Tk.25,000
- 6: Salaries paid Tk.20,000
- 7: Bought from X & Co.
800 Kg. of Sugar @ Tk.30 per Kg.
400 Kg. of Red Sugar @ Tk.20 per Kg.
Incidental charge Tk.300
- 12: Return 100 Kg. of Red Sugar not being of good quality
- 15: Sold to Y & Co.
500 Kg. of Sugar @ Tk.35 per Kg.
200 Kg. of Red Sugar @ Tk.25 per Kg.
- 15: Bought from deal & Co., 300 Kg. sugar @ Tk.32 per Kg.
- 20: Paid to X & Co. by cheque Tk.29,800 in full settlement of the claim
- 22: Received from Y & Co. by cheque is full settlement at Tk.100 discount
- 24: Advertisement Boards purchase from Z & Co. on credit Tk.6,000

- 25: Paid for repairs of furniture Tk.4,000
 26: Drawn from bank for personal use Tk.25,000
 30: Salaries for the months of Jan. unpaid Tk.20,000
 30: Allow interest @10% on capital
 30: Paid by cheque interest on loan for the month of January Tk.2,300
 30: Payment made to Alpha Ltd. Tk.50,000
 Sugar taken by proprietor Tk.300
 Sale to Beta Ltd:
 200 Kg. sugar @ Tk.36 per Kg.

Solution:

**Abrar Ltd.
General Journal Entries**

Date		Account Titles & Explanation	L.F.	Debit (Tk.)	Credit (Tk.)
2024 Jan.	1	Premise Machinery Inventory Furniture Bank Cash Loan Alpha Ltd. Capital (Opening balance of assets, liabilities & capital)		2,00,000 20,000 5,00,000 50,000 80,000 15,000	 2,30,000 1,00,000 5,35,000
"	24	Advertisement Board Accounts Payable-Z & Company (Purchase of advertisement board vide invoice No. dated)		6,000	6,000
"	30	Salaries Expense Salaries Payable (Amount due for salary of January)		20,000	20,000
"	30	Interest Receivable Capital (Interest on capital @ 10% paid provided for January)		4458.33	4,458.33
"	30	Interest Expense Bank (Paid interest on loan by cheque)		2300	2300
"	30	Drawing Purchase (Sugar taken for personal use)		300	300
		Total		8,98,058.33	8,98,058.33

**Abrar Enterprise
Purchase Book**

Date		Particulars	Inward Invoice	L.F.	Amount	
					Detail Tk.	Total Tk.
2024 Jan.	7	X & Co: Invoice No. 800 Kg. Sugar @ Tk.30 400 Kg. Red Sugar @ Tk.20 Incidental charge			24,000 8,000 300	32,300
	15	Zeal & Co: Invoice No. 300 Kg. Sugar @ Tk.32				
		Total				41,900

**Abrar Enterprise
Sales Book**

Date		Particulars	Outward Invoice	L.F.	Amount	
					Detail Tk.	Total Tk.
2024 Jan.	15	Y & Co: Invoice No. 500 Kg. of Sugar @ Tk.35 200 Kg. Red Sugar @ Tk.25			17,500 5,000	22,500
	30	Beta Ltd. Invoice No. 200 Kg. Sugar @ Tk.36				
		Total				29,700

**Abrar Enterprise
Return Outward Book**

Date		Particulars	Credit Not	L.F.	Amount Tk.
2024 Jan.	12	X & Co: C-N No. 100 Kg. of Red Sugar @ Tk.20 Kg,			2,000
		Total			2,000

Abrar Enterprise
Cash Book

Receipts

Payments

Date		Particulars	L.F.	Disc	Cash	Bank	Date		Particulars	L.F.	Disc.	Cash	Bank
2024 Jan.	1	Balance b/f			15,000	80,000	2024 Jan.	5	Cash (c)				25,000
	5	Bank (c)			25,000			6	Salaries			20,000	
	22	Y & Co.		100		22,400		20	X & Co.		200		29,800
								25	Repair of Furniture			4,000	
								26	Drawing A/c				25,000
								30	Interest on loan				2,300
								30	Alpha Ltd.				50,000
	30	Balance c/d				29,700		30	Balance c/d			16,000	
				100	40,000	1,32,100					200	40,000	1,32,100

(Note: Bank balance shows debit balance of Tk.29,700 indicating over drawn i.e. Bank overdraft facilities availed by the enterprise)

Lessons-3 and 4: Ledger Accounts

Lesson Objectives

After you have studied this lesson, you should be able to:

- state the meaning of ledger & its format.
- understand the process of posting to ledger.
- find out the balance of the accounts.
- interpret the significance of balance.

2.3.1 Introduction

Information as reported on business papers, analyzed & recorded in terms of debits and credits in journal are transferred to accounts in the Ledger. The individual accounts appearing in the ledger are in fact a summary of all the relevant transactions and the net result of this summary is used as a basis for the preparation of accounting statements. This lesson deals with all the relevant aspects of ledger positing, balancing the accounts along with the significance of balance of the accounts.

2.3.2 Meaning of Ledger

The book which contains the accounts of a business in a classified form is called Ledger.

A Ledger account is a means of accumulating in one place, i.e. account all the information about the change in a specific asset, liability, or in owners' equity. In other words, the book which contains the accounts of a business in a classified form is called Ledger. For example, a ledger account titled cash will provide a record of all cash receipts and payments along with the balance. By keeping such account, for instance, management can keep track of the cash available on a date for use and can also use the account for planning and control. In such a context, it can be said that the book which contains all the accounts of an enterprise is known as Ledger. Further, as the financial information pertaining to the financial position of an enterprise emerges only from accounts that are maintained in the Ledger, the ledger is called the principal book or a book of final entry.

2.3.3 Form of Ledger Account

In general, Ledger accounts are prepared in "T" form. Because of its similarity to the letter T, it is known as a T account. A specimen of the "T" form is shown below:

Cash Account

Account No.

Date	Explanation	Ref. / J.F	Debit Amount	Date	Explanation	Ref. / J.F	Credit Amount

Ledger Account, T Form

It may also be drawn in balance form which is also called a running balance form. The specimen of this type of form is shown below:

Cash Account

Account No.

Date	Explanation	Ref.	Debit	Credit	Balance	
					Debit	Credit

Ledger Account, Balance Form

Whatever form is used for accounts, posting to accounts from the journal should be made in chronological order. Moreover, posting should be made on a timely basis to ensure that the ledger is up-to-date. The particulars/explanation column shows why the particular account is debited or credited. The reference column refers to the source of posting showing the journal page. This helps verify whether the posting is made correctly or not. In case of 'T' account, balance of an account can be found out usually at the end of an accounting period. For this balancing of accounts is done by transferring the higher difference in the totals to the other side of the account. Whereas, in the case of Balance Form, the balance is found out at the end of each posting to the account. So, an account in the ledger shows all information relating to that explaining the reasons for increases and decreases in the account and ultimately the final balance. As such ledger is called the king of all books.

Ledger shows all information relating to the reasons for increases and decreases in the account and ultimately the final balance.

2.3.4 Steps for Ledger Posting

In ledger accounts, particulars of a specific account be transferred to that account from records made in the Journal. In this context, the following steps can be taken:

- Find out the account to which posting will be made from the Journal.
- Find out the debit or credit explanation of account and transfer debit to the debit side of the account and vice-versa.
- Write the date in the date column of the Ledger account when the transaction occurred.
- Write the positing reference in the ledger account as to the number or page of the Journal (J.F).
- Balance the account (either debit or credit).

2.3.5 Determining Balance of an Account

The balance of a ledger account is the difference between the total amount of debit and credit of an account.

In fact every Ledger Account is divided into two sides. The left-hand side is known as the *Debit Side* and the right-hand side as the *Credit Side*. If the total of the debit side of any Account in the Ledger is greater than that of its credit side, the account is said to have a *Debit Balance* to

the extent of such difference. In case the credit side of any Account is greater than its debit, the difference is called a *Credit Balance*.

A *Debit Balance* of any Account may represent either an *asset* or an *expense*. If such balance relates to a Personal Account or a Real Account, it is an asset; in case it relates to a Nominal Account it is an expense or a loss. A *Credit Balance* of any Account represents either a *liability* or a *gain*. If such balance relates to a Personal Account, it is a liability; if it relates to a Nominal Account, it is a gain.

The "normal balance" of an account would be as follows:

- i) Asset = Debit balance
- ii) Liability = Credit balance
- iii) Expense - Debit balance
- iv) Income = Credit balance

Occasionally, it may be seen that an asset account temporarily shows a credit balance, either as the result of an accounting error or because of an unusual transaction. For example, an account receivable may acquire a credit balance because of an over payment by a customer. But if it is seen that a building account is showing credit balance, it can be assumed that there is an error in the account.

2.3.6 Proper Grouping of Ledger Accounts

To obtain optimum results from the Ledger without any inconvenience and delay, it is essential that these various accounts be arranged and grouped together in some intelligent manner. So the accounts of customers should be opened in one section of the Ledger, and similarly, the accounts of the suppliers. The asset accounts should also be grouped together, and the nominal accounts should form a different section of the Ledger.

However, in practice, it is seen that accounts are arranged in the ledger in financial statement order i.e. assets first, followed by liability, owner's equity, income, and expenses. A chart of accounts is used for reference. The number, for example may be: 01-30 for assets, 31-50 for liability, 51-60 for equity, 60-80 for income and 81 to 100 for expenses etc.

2.3.7 Sub-division of the Ledger

So far as a small business is concerned, it would not be difficult to accommodate the whole of the transactions of the business in one ledger. But with the increase of business activities and financial transactions, as the transactions become voluminous, the Ledger will have to be sub-divided and the sub-division may be made in the following manner. Thus, there may be:-

- (a) A *Debtors' Ledger* or *Customers' Ledger* or *Sales Ledger* to keep records of the accounts of customers only;
- (b) A *Creditors' Ledger* or *Suppliers' Ledger* or *Purchases Ledger* to containing accounts of suppliers of goods;
- (c) An *Impersonal Ledger* or a *Nominal* or *General Ledger* which would cover all accounts other than those of customers and suppliers; and

(d) A *Private Ledger* which contains Capital Account and Drawings Account of the proprietor or each of the partners. This ledger embodies accounts of private nature.

In the context of above discussion, an attempt is made below to explain the recording process in ledger with an example.

Example-2.03

Salary for the month of January 2024 paid in cash Tk.15,000 on 31st Jan. Show how this will appear in journal and the way it will be posted in relevant accounts in Ledger.

Solution:

Journal Entries

Page-05

Date	Account Titles and Explanation	Ref.	Debit (Taka)	Credit (Taka)
2024 Jan. 31	Salary Expense Cash (To record the payment of salary)	10 16	15,000	15,000

General Ledger

Dr. **Salary Expense** Account No. 10 Cr.

Date	Particulars	Ref.	Amount	Date	Particulars	Ref.	Amount
2024 Jan. 31	Cash	05	Tk. 15,000				Tk.

Journal Entries

Page-05

Date	Account Titles and Explanation	Ref.	Debit (Taka)	Credit (Taka)
2024 Jan. 31	Salary Expense Cash (To record the payment of salary)	10 16	15,000	15,000

General Ledger

Dr. **Cash** Account No. 16 Cr.

Date	Explanation	Ref.	Amount	Date	Explanation	Ref.	Amount
2024 Jan. 31				2024 Jan. 31	Balance (Say) Salary Expense	05	Tk. 20,000 15,000

As we know, instead of T form, Ledger can be prepared in running balance form, the posting in that case will be as follows:

General Journal

Page-05

Date	Account Titles and Explanation	Ref.	Debit (Taka)	Credit (Taka)
2024 Jan. 31	Salary Expense Cash (To record the payment of salary)	10 16	15,000	15,000

General Ledger

Salary Expense Code/Account No. 10

Date	Explanation	Ref.	Debit	Credit	Balance	
					Debit	Credit
2024 Jan. 31	Cash	05	Tk. 15,000	Tk. 15,000	Tk. 15,000	

General Journal

Page-05

Date	Account Titles and Explanation	Ref.	Debit (Taka)	Credit (Taka)
2024 Jan. 31	Salary Expense Cash (To record the payment of salary)	10 16	15,000	15,000

General Ledger

Cash Code/Account No. 16

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Cr.
2024 Jan. 31	Balance (Say) Salary Expense	05	Tk. 15,000	Tk. 20,000	Tk. 5,000	

Example-2.04

From the following particulars of ABC Ltd., prepare Journal entries and Ledger accounts of the company for the period.

Year 2024

- April : 2 Started business with Tk.1,00,00,000, paid into Bank Tk.50,00,000.
- 3 Bought Furniture in cash Tk.10,00,000.
- 5 Bought goods for Tk.30,00,000.

- 8 Sold goods for cash Tk.16,00,000.
 15 Bought Typewriter from R & Co. Tk.18,00,000.
 20 Bought goods from D & Brothers Tk.25,00,000.
 25 Sold goods to XYZ Ltd. Tk.24,00,000.
 27 Paid Advertisement Tk.5,00,000.
 28 Paid Rent and Salaries Tk.10,00,000 and 20,00,000 respectively.
 30 Withdraw from Bank Tk.20,00,000.
 30 Sold goods to XYZ Tk.10,00,000 and received cash Tk.26,00,000.

Solution:

General Journal Entries

Date	Account Titles & Explanation	L.F.	Dr. Tk.	Cr. Tk.
2024 April 2	Cash Capital, ABC (Cash brought in to start business)	01 15	1,00,00,000	1,00,00,000
2	Bank Cash (Cash deposited with bank)	02 01	50,00,000	50,00,000
3	Furniture Cash (Furniture bought for cash)	03 01	10,00,000	10,00,000
5	Purchase Cash (Goods bought in cash)	09 01	30,00,000	30,00,000
8	Cash Sales Revenue (Goods sold for cash)	01 07	16,00,000	16,00,000
15	Typewriter Accounts Payable- R & Co. (Typewriters bought on credit)	05 18	18,00,000	18,00,000
20	Purchase Accounts Payable- D & Brothers (Credit purchase)	04 19	25,00,000	25,00,000
25	Accounts Receivable- XYZ Ltd Sales Revenue (Credit Sales)	25 07	24,00,000	24,00,000
27	Advertisement Expense Cash (Paid for advertisement)	12 01	5,00,000	5,00,000
28	Rent Expense Cash (Paid rent in cash)	13 01	10,00,000	10,00,000
28	Salaries Expense Cash (Salaries paid in cash)	14 01	20,00,000	20,00,000

Date	Account Titles & Explanation	L.F.	Dr.	Cr.
30	Cash	01	20,00,000	
	Bank	02		20,00,000
	(Cash with drawn for office)			
30	Accounts Receivable- XYZ Ltd.	25	10,00,000	
	Sales Revenue	07		10,00,000
	(Credit Sale)			
30	Cash	01	26,00,000	
	Accounts Receivable- XYZ Ltd.	25		26,00,000
	(Cash received from XYZ Ltd.)			

ABC Ltd.
Ledger Accounts (T-Form)

Cash

Code- 01

Dr.

Tk.'00

Cr.

Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024			Taka	2024			Taka
April 2	Capital	15	1,00,000	April 2	Bank	02	50,000
8	Sales	07	16,000	3	Furniture	03	10,000
30	Bank	02	20,000	5	Purchase	09	30,000
30	XYZ Ltd.	25	26,000	27	Advertisement	12	5,000
				28	Rent	13	10,000
				28	Salaries	14	20,000
				30	Balance c/d		37,000
			<u>162,000</u>				<u>1,62,000</u>
May 1	Balance b/f		37,000				

Bank

Code- 02

Dr.

Tk.'00

Cr.

Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024			Taka	2024			Taka
April 2	Cash	01	50,000	April 30	Cash	01	20,000
				30	Balance c/d		30,000
			<u>50,000</u>				<u>50,000</u>
May 1	Balance b/f		30,000				

Furniture

Code- 03

Dr.

Tk.'00

Cr.

Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024			Taka	2024			Taka
April 3	Cash	01	10,000	April 30	Balance c/d		10,000
			<u>10,000</u>				<u>10,000</u>
May-1	Balance b/f		10,000				

Typewriter

Code- 04

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 15	R & Co.		Taka 18,000	2024 April 30	Balance c/d		Taka 18,000
			<u>18,000</u>				<u>18,000</u>
May 1	Balance b/f		18,000				

Sales Revenue

Code- 07

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 30	Balance c/d		Taka 50,000	2024 April 8	Cash	01	Taka 16,000
				25	XYZ Ltd.	25	24,000
				31	XYZ Ltd.	25	10,000
			<u>50,000</u>				<u>50,000</u>
				May-1	Balance b/f		50,000

Purchase

Code- 09

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 5	Cash	01	Taka 30,000	2024 April 30	Balance c/d		Taka 55,000
20	D & Brothers	19	25,000				
			<u>55,000</u>				<u>55,000</u>
May-1	Balance b/f		55,000				

Advertisement Expense

Code- 12

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 27	Cash	01	Taka 5,000	2024 April 30	Balance c/d		Taka 5,000
			<u>5,000</u>				<u>5,000</u>
May 1	Balance b/f		5,000				

Rent Expense

Code- 13

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 28	Cash	01	Taka 10,000	2024 April 30	Balance c/d		Taka 10,000
			<u>10,000</u>				<u>10,000</u>
May 1	Balance b/f		10,000				

Salaries Expense

Code- 12

Dr.				Tk.'00 Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 28	Cash	01	Taka 20,000	2024 April 30	Balance c/d		Taka 20,000
			<u>20,000</u>				<u>20,000</u>
May 1	Balance b/f		20,000				

Capital, ABC

Code- 15

Dr.				Tk.'00 Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 30	Balance b/f		Taka 1,00,000	2024 April 2	Cash	01	Taka 1,00,000
			<u>1,00,000</u>				<u>1,00,000</u>
				May 1	Balance b/f		1,00,000

Accounts Payable- R & Co.

Code- 18

Dr.				Tk.'00 Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 30	Balance c/d		Taka 18,000	2024 April 15	Typewriter		Taka 18,000
			<u>18,000</u>				<u>18,000</u>
				May 1	Balance b/f		18,000

Accounts Payable- D & Brothers

Code- 19

Dr.				Tk.'00 Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 30	Balance c/d		Taka 25,000	2024 April 20	Purchase	09	Taka 25,000
			<u>25,000</u>				<u>25,000</u>
				May 1	Balance b/f		25,000

Accounts Receivable- XYZ Ltd.

Code- 25

Dr.				Tk.'00 Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2024 April 25	Sales	07	Taka 24,000	2024 April 30	Cash	01	Taka 26,000
30	Sales	07	10,000	30	Balance c/d		8,000
			<u>34,000</u>				<u>34,000</u>
May-1	Balance b/f		8,000				

Attention: In this illustration accounts have been coded as: Balance items assets 01 for cash, 02 for Bank, etc. Like wise revenue & expenditure items have been coded as 07 for sales, 09 for purchase, 12 for advertisement and the like. Thus, in Journal post references have been sited against the accounts and in Ledger these have also been shown. This is found in practice.

Summary Illustration of Journalizing and Posting

Example-2.05

On 1st October, 2023 Mr. John entered into a business. Transactions for the month were as follows:

- October 1: John invested Tk.10,00,000 cash in an advertising venture to be known as the Poiner Advertising Agency.
- " 1: Purchased office equipment costing Tk.5,00,000 by signing a 3-month, 12% Tk.5,00,000 note payable.
- " 2: Received Tk.1,20,000 cash in advance from R. Knok a client, for advertising services that are expected to be completed by December 31.
- " 3: Paid office rent for October in cash, Tk.90,000.
- " 4: Paid Tk.60,000 for a one year insurance policy that will expire next year on September 30.
- " 5: Purchased an estimated 3-month supply of advertising materials is on account from Aero Supply for Tk.2,50,000.
- " 9: Hired four employees to begin work on October 15. Each employee is to receive a Weekly salary of Tk.5,00,000 for a 5-day work week, payable every 2 weeks - first payment made on October 26.
- " 20: John withdrew Tk.50,000 cash for personal use.
- " 26: Employee salaries of Tk.4,00,000 are owed and paid in cash.
- " 31: Received Tk.10,00,000 in cash from Copa Company for advertising services rendered in October.

Enter the transactions in Journal and Post them to Ledger which is kept in Balance form.

Solution:

Book of Mr. John
General Journal Entries

Date	Account Titles and Explanation	Ref.	Debit	Credit
2023 October 1	Cash	1	10,00,000	
	John Capital	40		10,00,000
	(Invested cash in business)			
1	Office Equipment	15	5,00,000	
	Notes Payable	25		5,00,000
	(Issued three-month, 12% note for office equipment)			
2	Cash	1	1,20,000	
	Unearned Fees	28		1,20,000
	(Received advance from R. Knok for future services)			
3	Rent Expense	62	90,000	
	Cash	1		90,000
	(Paid October rent)			

Date	Account Titles and Explanation	Ref.	Debit	Credit
4	Prepaid Insurance	10	60,000	
	Cash	1		60,000
	(Paid one-year policy; effective date, October 1)			
5	Advertising Supplies	8	2,50,000	
	Accounts Payable	26		2,50,000
	(Purchased supplies on account from Aero supply)			
20	John, Drawing	41	50,000	
	Cash	1		50,000
	(Withdrew cash for personal use)			
26	Salaries Expenses	60	4,00,000	
	Cash	1		4,00,000
	(Paid salaries to date)			
31	Cash	1	10,00,000	
	Fees Earned	50		10,00,000
	(Received cash for fees earned)			

**Book of Mr. John
General Ledger**

Cash

No. 1

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Cr.
2023						
October 1		J1	10,00,000		10,00,000	
2		J1	1,20,000		11,20,000	
3		J1		90,000	10,30,000	
4		J1		60,000	9,70,000	
20		J1		50,000	9,20,000	
26		J1		4,00,000	5,20,000	
31		J1	100,00,000		15,20,000	

Advertising Supplies

No. 8

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023						
October 5		J1	2,50,000		2,50,000	

Prepaid Insurance

No. 10

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023						
October 4		J1	60,000		60,000	

Office Equipment

No. 15

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023						
October 1		J1	5,00,000		5,00,000	

Notes Payable

No. 25

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023 October 1		J1		5,00,000		5,00,000

Accounts Payable

No. 26

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023 October 5		J1		2,50,000		2,50,000

Unearned Fees

No. 28

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023 October 2		J1		1,20,000		1,20,000

John, Capital

No. 40

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023 October 1		J1		10,00,000		10,00,000

John, Drawing

No. 41

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023 October 20		J1	50,000			50,000

Fees Earned

No. 50

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023 October 31		J1		10,00,000		10,00,000

Salaries Expense

No. 60

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023 October 26		J1	4,00,000			4,00,000

Rent Expense

No. 62

Date	Explanation	Ref.	Debit	Credit	Balance	
					Dr.	Dr.
2023 October 3		J1	90,000			90,000

Lesson-5 : Trial Balance

Lesson Objectives

After you have studied this lesson, you should be able to:

- know the meaning of a trial balance.
- explain the procedure of preparing a trial balance.
- understand usefulness and limitations of a trial balance.
- identify steps to discover errors in a trial balance.
- understand normal balances of the various types of accounts.

2.5.1 Introduction

Since equal amounts of debits and credits are entered in the accounts for every transaction, the sum of all the debits in the ledger accounts must be equal to the sum of all the credits. If computations and recording have been accurate such total of debits must agree with total of credits. Before accounting statements are prepared such proof of accuracy as recording may proceed through the preparation of a Trial Balance. This lesson deal with the different aspects of the preparation of Trial Balance.

2.5.2 Meaning of Trial Balance

Before preparing financial statements at the end of an accounting period and using the accounts balances to that end, it is desired that a proof that the total of debit accounts balances is equal to the total of credit balances is made. The proof that is made on a sheet of paper by the balances of all the accounts is called a Trial balance. Trial balance may also be defined as a statement of debit and credit balances extracted from the ledger with a view to proving the arithmetical accuracy of books. Below is an example of a trial balance based on the balances of accounts shown in the ledgers of ABC Ltd. of Example-2.04.

Trial Balance is a statement of debit and credit balances extracted from the ledger with a view to prove the arithmetical accuracy.

ABC Ltd. Trial Balance

Sl .	Account Titles	L.F	Debit	Credit
1.	Cash		Tk.37,00,000	
2.	Bank		30,00,000	
3.	Furniture		10,00,000	
4.	Typewriter		18,00,000	
5.	Sales Revenue			Tk.50,00,000
6.	Purchase		55,00,000	
7.	Advertisement Expense		5,00,000	
8.	Rent Expense		10,00,000	

Sl .	Account Titles	L.F	Debit	Credit
9.	Salaries Expense		20,00,000	
10.	Capital, ABC			1,00,00,000
11.	Accounts Payable- R & Co.			18,00,000
12.	Accounts Payable- D & Brothers			25,00,000
13.	Accounts Receivable- XYZ Ltd.		8,00,000	
	Total		<u>Tk.1,93,00,000</u>	<u>Tk.1,93,00,000</u>

2.5.3 Preparation of a Trial Balance

After the posting of transactions in particular accounts of a ledger, the debit and credit side of each ledger account would be added up to find out balance, if any, of that account. The balance of the accounts would then be entered in a trial balance. The trial balance of totals could be taken by listing in parallel columns the total of the debits and the total of the credits of each account. In general, a trial balance is prepared in a loose sheet, rules almost similarly as journal. It will have five columns viz., no or the serial code no. of accounts, particulars, or accounts title column, ledger folio columns and debit and credit column. All debit balances will be entered in the debit column and credit balances in credit column. If the books are arithmetically correct, then the total of debit column must agree with the total of the credit column.

2.5.4 Usefulness of a Trial Balance

A trial balance provides proof that the ledger is in balance indicating the following:

- i) Equal debits and credits have been recorded for all transactions
- ii) Balance of each account in the ledger has been correctly computed.
- iii) Posting to a trial balance of the accounts has been rightly performed.
- iv) That is there is an arithmetical accuracy of the journal and ledger.

However, a trial balance will not agree if there is an error in totaling the two columns or there are mistakes with regard to the following:

- i) Mistake is transferring a figure of the balance of an account - balance wrongly written.
- ii) Mistake as to omission regarding transferring the balance of an account.
- iii) Mistake is totaling of subsidiary books.
- iv) Mistake is posting on the wrong side.
- v) Mistake in posting to the ledger account, etc.

2.5.5 Limitations of a Trial Balance

A Trial Balance is not a conclusive proof of the arithmetical accuracy of the postings. A Trial Balance may agree and yet there may exist some errors in the books remaining undisclosed.

The following are those errors that may remain undetected even with the agreement of a Trial Balance:

There may exist some errors in a trial balance which may remain undetected even with the agreement of a trial balance.

(1) Errors of Omission: If an entry has not been made in a subsidiary book, both the debit and credit of that transaction would be omitted and thus the agreement of the Trial Balance will not be affected.

Or if a credit sale of Tk.45 is wrongly entered as Tk.54, such an error will not be revealed in the Trial Balance.

(2) Errors of Commission: If Abu's Account has been debited instead of Habu's account, the Trial Balance will not detect such an error.

(3) Compensating Errors: Some errors may arise from the over or under-debits of Accounts being neutralized by the over or under credits to the same extent of some other accounts. For example, a ledger posting of Tk.50 to the debit may be compensated by one or two postings totaling Tk.50 in credit.

(4) Errors of Principle: If there are fundamental errors as to the treatment of account, i.e. treating a revenue expenditure as capital, this error is of principle and would not be detected in Trial balance.

2.5.6 Discovery of Errors

If a trial balance does not agree to debit and credit total, it will be presumed that there is an error and will have to be detected.

The following steps may be taken to locate errors in Trial Balance.

1. Re-check the totals of the Trial Balance including the lists of Debtors and Creditors and ascertain the exact amount of the difference.
2. Check the inclusion of Cash or Bank Balance in the Trial Balance from being omitted.
3. Check that the opening balances have been correctly brought forward in the current year's books.
4. See there is no mistake in balancing the account
5. Recheck the totals of subsidiary books, especially 1, 10, 100, and so on.

6. Find out the exact difference. Look for such accounts, divide the difference by 2 and this figure may be checked as to the fact that this has been wrongly written in the debit column instead of credit.
7. When the difference happens to be of an amount which constantly recurs in the books, all the postings of this amount may be checked to your advantage.
8. Compare the Subsidiary Records to trace unposted items and check the carry forwards. Simultaneously scrutinize badly written and indistinct figures.
9. When the difference is of a large amount, it would not be a bad plan to compare the Trial Balance with that of the previous year, in order to ascertain whether the figures under the different heads of accounts are very near the same as those of the previous year and whether their balances fall on the same side of the Trial Balance.
10. If the difference is still not traced, posting of accounts will have to be checked.

2.5.7 Normal Balance

The account serves as a mathematical device for recording increases and decreases in monetary terms. The rules of debit and credit and the normal balances of the various types of accounts are summarized below. An idea as to these will help preparation of trial balance and detect errors there to:

<u>Type of Account</u>	<u>Increase</u>	<u>Decrease</u>	<u>Normal Balance</u>
Asset	Debit	Credit	Debit
Liability	Credit	Debit	Credit
Capital	Credit	Debit	Credit
Drawings	Debit	Credit	Debit
Revenue	Credit	Debit	Credit
Expense	Debit	Credit	Debit

In practice, when an account that normally has a debit balance actually has a credit balance, or vice-versa, it is an indication of an error in recording or of an unusual transaction.

Example-2.06:

Following are the ledger balances of Modern Enterprise as on 3-6-2024. Prepare a Trial balance as on that date.

Bank 20,00,000; Cash 5,00,000; Accounts Receivable 4,60,000; Accounts payable 5,00,000; Advertising supplies 5,00,000; prepaid insurance 3,00,000; Furniture 20,00,000; office equipment 2,50,000, unearned fees 2,20,000, Notes payable 5,00,000, Common stock 36,00,000, Retained earnings and reserve 10,40,000, Rent 12,40,000; Salaries 12,10,000; Dividend 2,00,000, Fees earned 28,00,000.

Solution:

Modern Enterprise
Trial Balance
30th June, 2024

Sl. No.	Account Titles	L.F.	Debit (Taka)	Credit (Taka)
1.	Cash		5,00,000	
2.	Bank		20,00,000	
3.	Accounts Receivable		4,60,000	
4.	Advertising supplies		5,00,000	
5.	Prepaid Insurance		3,00,000	
6.	Furniture		20,00,000	
7.	Office Equipment		2,50,000	
8.	Notes Payable			5,00,000
9.	Accounts Payable			5,40,000
10.	Unearned Fees			2,20,000
11.	Common Stock			36,00,000
12.	Retained Earnings & Reserve			10,40,000
13.	Dividends		2,00,000	
14.	Fees Earned			28,00,000
15.	Salaries Expenses		12,10,000	
16.	Rent Expenses		12,40,000	
			<u>86,60,000</u>	<u>86,60,000</u>

Example-2.07

The following transactions occurred during July 2023 to Sagar Ltd. prior to the company beginning its regular business operations:

Year 2023

- July 1 Issued Tk.15,000 shares of capital stock to the owners of the company for Tk.3,00,000 each
- 5 Purchased Land for building Office & factory of the Company worth Tk.2,00,000. A down payment of Tk.50,000 was made and a note payable was issued for the balance
- 15 Purchase in a small portable Building as temporary Office for Tk.1,00,000 cash including Tk.10,000 as installation cost.
- 25 Purchased Office equipment worth Tk.20,000 on credit from Nadia Enterprise.
- 30 Paid Tk.5,000 owed to Nadia Enterprise.

Instructions:

- a) Prepare journal entries.
- b) Post to ledger accounts.
- c) Prepare Trial balance on July 31, 2023.

Solution:

**Sagar Ltd.
General Journal Entries**

Date		Account Titles & Explanation	L.F.	Debit	Credit
2023 July	1	Cash Capital stock (Issued 15,000 shares for cash)		Tk. 1,50,000	Tk. 1,50,000
	5	Land Cash Notes payable (Paid part cash and issued note payable for purchase of land)		2,00,000	50,000 1,50,000
	15	Building Cash (Purchased portable building for cash)		1,00,000	1,00,000
	25	Office Equipment Accounts Payable- Nadia Enterprise (Credit purchase of equipment)		20,000	20,000
	30	Accounts Payable- Nadia Enterprise Cash (Part payment to Nadia enterprise)		15,000	15,000

**Sagar Ltd.
General Ledger
Cash**

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2023 July 1	Capital Stock		Taka 3,00,000	2023 July 5	Land		Taka 50,000
				15	Building		1,00,000
				30	Nadia Enterprise (Accounts Payable)		15,000
				31	Balance		1,35,000
			<u>3,00,000</u>				<u>3,00,000</u>
Aug. 1	Balance		1,35,000				

Office Equipment

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2023 July 25	Nadia Enterprise		Taka 20,000	2023 July 31	Balance		Taka 20,000
			50,000				50,000
Aug. 1	Balance		<u>20,000</u>				

Notes Payable

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2023 July 31	Balance		Taka 1,15,000	2023 July 5	Land		Taka 1,50,000
			1,15,000				<u>1,15,000</u>
				Aug. 1	Balance		<u>1,50,000</u>

**Nadia Enterprise
(Accounts Payable)**

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2023 July 30 31	Cash Balance		Taka 15,000 5,000	2023 July 25	Office Equipment		Taka 20,000
			<u>20,000</u>				<u>20,000</u>
				Aug. 1	Balance		<u>5,000</u>

Capital Stock

Dr.				Cr.			
Date	Explanation	J.F	Amount	Date	Explanation	J.F	Amount
2023 July 31	Balance		Taka 3,00,000	2023 July 1	Cash		Taka 3,00,000
			<u>3,00,000</u>				<u>3,00,000</u>
				Aug. 1	Balance		<u>3,00,000</u>

**Sagar Ltd.
Trial Balance
July 31, 2023**

Sl. No.	Account Titles	L.F	Debit	Credit
1.	Cash		Tk.1,35,000	
2.	Land		2,00,000	
3.	Building		1,00,000	
4.	Office Equipment		20,000	
5.	Notes Payable			Tk.1,50,000
6.	Nadia Enterprise (Accounts payable)			5,000
7.	Capital Stock			3,00,000
			<u>Tk.4,55,000</u>	<u>Tk.4,55,000</u>

Questions and Exercises

Self-Test Questions

1. Which of the following statements about accounting process is correct:
 - (a) The journal shows in one place all information about specific transactions related to particular account
 - (b) The journal is arranged in chronological order
 - (c) A Ledger account shows in one place all information about change in specific asset or liability or in owner's equity.
 - (d) Posting is the process of transferring debit change in account balance from ledger to journal
 - (e) Trial Balance is the balance and final accounting statement.
2. Which of the following account will show normal credit balance?
 - (a) An asset (b) A drawing (c) A Revenue (d) An Expense
3. A receipt of cash from customers in payment of their accounts would be recorded by a:
 - (a) A debit to cash credit to accounts receivable
 - (b) A debit to accounts payable credit to cash
 - (c) A debit to accounts receivable and credit to cash
 - (d) A debit to cash and credit to accounts payable.
4. A payment of cash for the purpose of merchandise would be recorded in the:
 - (a) Purchase Journal (b) Cash Payment Journal (c) Sales Journal
 - (d) Cash Receipt Journal
5. The form listing the balances and titles of accounts in the ledger on a given data is the:
 - (a) Income Statement (b) Capital Statement (c) Retained Earning Statement (d) Trial Balance
6. On 30th June, the ledger of Full Moon Ltd. Consists of the following:

	<u>Tk.</u>		<u>Tk.</u>
Office equipment	27,800;	Capital Stock	20,000
Accounts Receivable	21,000	Automobile	9,500
Accounts payable	15,700	Cash	6,900
Salaries payable	9,600	Supplies	2,600
Retained earning	22,500		

A trail balance prepared on that shows credit column total as:

- (a) 67,800 (b) 93,100 (c) 25,300 (d) 65,300

Which one is correct?

Discussion Questions

1. What is meant by journal? Why to use journal? State the process of journalizing.
2. What is meant by special and general journals? Give description of the special journals that are generally used in business houses.
3. What is a ledger? Classify it and narrate its advantages.
4. Indicate the steps needed for recording business transactions from journal to ledger.
5. Distinguish between: (i) Journal and Ledger; (ii) Account and Ledger.
6. What is a trial balance? Why is it prepared? Has it got any limitations?
7. Why will a trial balance not agree? What steps will you take to locate errors indicated by non-agreement of a trial balance?
8. Is agreement of trial balance a conclusive proof that there are no errors in the books of accounts? Give reasons with suitable example in support of your answer.
9. Does the debit mean increase and credit mean decrease? Explain.
10. Dolphin products maintain special Books of Original Entry. State the books in which each of the following transactions should be recorded:
 - i) Purchase of official supply on account
 - ii) Replenished the petty cash fund
 - iii) Issue a Note to a creditor
 - iv) Allowance for Bad debt
 - v) Purchased merchandise for cash
 - vi) Paid the payroll
 - vii) Sale of capital stock
 - viii) Recording depreciation for the month on machine
 - ix) Sale of product on account
 - x) Traded in delivery equipment for new equipment

Exercises

1. For each of the following transactions, indicate whether the account in parentheses should be debited or credited and give the reasons for your answer.

- i) Purchased Building for cash (cash)
 - ii) Purchased a typewriter on credit, promising to make payment with 30 days (Accounts payable)
 - iii) Sale of photocopier (old) on 15 days credit (office equipment)
 - iv) Obtained a loan of Tk.50,000 from a bank (cash)
 - v) Issue of capital stock to the owners of a corporation in exchange for investment of Tk.1,00,000 cash (capital stock)
2. Record the following transactions completed during the month of May of the current year in a two-column journal in the Book of Kirmini:

2024

- May 1 Paid rent for the month Tk.4,50,000.
- 2 Purchased office equipment on account Tk.8,00,000.
- 8 Paid cash for supplies, Tk.40,000.
- 10 Paid advertising expense, Tk.77,500.
- 15 Received cash from customers on account, Tk.89,00,000.
- 20 Paid creditor on account Tk.1,50,000.
- 24 Withdrew cash for personal use Tk.7,00,000.
- 29 Paid telephone bill for the month Tk.52,000.
- 30 Fees earned and billed to customers for the month, Tk.11,80,000.
- 31 Paid for repairs to office equipment Tk.65,000.
- 31 Paid electricity bill for the month Tk.1,10,000.

3. East-West traders had the following transactions for the month of January, 2024.

2024

- Jan. 1 Paid office rent Tk.2,20,000.
- 5 Purchased equipment on account Tk.35,00,000.
- 10 Received cash from Hasan for Sale of good Tk.50,00,000.
- 12 Paid cash to creditors on account 17,50,000.
- 18 Paid cash for renewal of property Insurance Tk.5,00,000.
- 19 Cash Sale Tk.4,00,000.
- 25 Purchased goods on account from Raihan Tk.60,00,000.

- 28 Paid cash from business bank account for personal and family expenses Tk.6,00,000.
- 29 Paid electricity bill Tk.3,50,000.
- 30 Paid Telephone expenses Tk.6,50,000.
- 30 Paid Raihan Tk.59,50,000 in full settlement of account.

Instruction:

Pass entries in books of original entry and post them to ledger.

4. Mr. Tin Kari established a travel agency titled "Ureka" on April 1, 2024. The following transactions were completed during the month:

2024

- April 1 Invested Tk.20,00,000 cash in City Bank in the name of the agency.
- " 2 Paid Tk.40,000 cash for April office rent
- " 3 Purchased office equipment for Tk.2,50,000 cash
- " 4 Incurred Tk.30,000 of advertising costs in the Tribune, on account
- " 5 Paid Tk.60,000 cash for office supplies
- " 6 Earned Tk.9,00,000 for services rendered: Cash of Tk.1,00,000 is received from customers, and the balance of Tk.8,00,000 is billed to customers on account.
- " 7 Withdrew Tk.20,000 cash for personal use.
- " 8 Paid Tribune amount due in transaction dated April 4.
- " 9 Paid employees salaries, Tk.1,20,000.
- " 10 Received Tk.8,00,000 in cash from customers who have previously been billed in transaction dated April 6.

Instruction:

Journal entries for the above transactions.

5. Hallo established a sole proprietorship, to be known as Hallo Decorators, on July 16 of the current year. During the remainder of the month she completed the following business transactions:

- July 16 Hallo transferred cash from a personal bank account to an account to be used for the business, Tk.5,00,000.
- 16 Purchased equipment on account, Tk.75,000.
- 16 Purchased supplies for cash, Tk.17,500.
- 17 Paid rent for period of July 16 to end of month, Tk.35,000.

- 18 Purchased a truck for Tk.9,00,000, paying Tk.1,50,000 cash and giving a note payable for the remainder.
- 19 Received cash for job completed, Tk.40,000.
- 22 Purchased supplies on account, Tk.12,500.
- 23 Paid wages of employees, Tk.60,000.
- 23 Paid premiums on property and casualty insurance, Tk.41,500.
- 25 Paid creditor for equipment purchased on July 16, Tk.75,000.
- 26 Recorded sales on account and sent invoices to customers, Tk.3,75,000.
- 29 Received cash for job completed, Tk.41,000. This sale had not been recorded previously.
- 29 Received an invoice for truck expenses, to be paid in August, Tk.9,200.
- 30 Paid utilities expense, Tk.10,500.
- 30 Paid miscellaneous expenses, Tk.4,500.
- 31 Received cash from customers on account, Tk.2,25,000.
- 31 Paid wages of employees, Tk.65,000.
- 31 Withdrew cash for personal use, Tk.75,000.

Instructions:

- (1) Open a ledger of two-column accounts for Hallo Decorators, using the following titles and account numbers: Cash, 11; Accounts Receivable, 12; Supplies, 13; prepaid Insurance, 14; Equipment, 16; Truck, 18; Notes payable, 21; Accounts payable, 22; Hallo, Capital, 31; Hallo, Drawing, 32; Sales, 41; Wages Expense, 51; Rent Expense, 53; Utilities Expense, 54; Truck Expense, 55; Miscellaneous Expense, 59.
- (2) Record each transaction in a two column journal, referring to the above list of accounts or to the ledger in selecting appropriate account titles to be debited and credited. (Do not insert the account numbers in the journal at this time.)
- (3) Post accounts from journal to the ledger, inserting appropriate posting references as each item is posted.

6. Mr. J. Carter provides you the following Ledger Balance particulars. Prepare a Trial Balance as at 31st Dec. 2023 at the end of his accounting year.

	Tk.		Tk.
Capital	1,80,000	Inventory (1-1-2023):	
Goodwill	50,000	Raw materials	22,000
Furniture	30,000	Partly manufactured goods	8,000
Freehold land & building	47,000	Finished goods	16,000
Plant & Machinery	30,000	Purchase of raw materials	88,000
Secured loan at 8% interest	30,000	Sales	1,85,010
Return inward	4080	Bills payable	15,000
Debtors	45,000	Manufacturing wages	32,000
Creditors	16,000	Freight and cartage	1,000
Bills receivable	18,000	Factory expenses	9,000
Bank balance	14,000	Salaries & allowance	9,200
Discount allowed	600	Repairs & renewals	4,000
Discount received	1,120	Wages outstanding	450
Bad debts	1,500		
Interest on loan	1,800		

7. In addition to the above information (Exercise-6) as to ledger balances, following additional information supplied. Give adjusting entries for the following and draw up an Adjusted Trial Balance thereof:

- Closing stock of raw materials Tk.20,000; Stock of partly manufactured goods Tk.4,000; Stock of finished goods Tk.14,380.
- Interest is to be provided on secured loan for full year.
- Depreciation on plant and machinery is to be provided @ 10%.
- A provision of 3% on Debtors is to be provided for Bad and doubtful debts.

8. From the following balances of Mr. Robin prepare (i) a Trial balance, (ii) give adjusting entries and (iii) draft an Adjusted Trial balance.

Capital	2,60,000	Inventory (Opening)	15,000
Cash	10,000	Office expenses	5,400
Accounts Receivable	90,000	Insurance	1,000
Accounts payable	26,000	Rent	1,200

Purchase	32,000	Salaries ($\frac{1}{4}$ th sales section)	6,400
Sales	3,70,000	Drawings	1,800
Purchase returns	5,000	Advertisement	10,000
Sales Return	1,200	Freight	4,000
Notes payable	5,000	Building	1,60,000
Furniture	20,000	Note Receivable	20,000

The following adjustment for the year ended on 31st December, 2023 are to be made:

i) Inventory at closing Tk.60,000 (ii) Accrued salaries Tk.2,000 (iii) Unexpired Insurance Tk.400 (iv) Accrued Rent Tk.800, (v) Depreciation @ 5% on Building & 10% on Furniture is required. (vi) Goods costing Tk.500 was taken by Mr. Robin for personal use (vii) The inventory at the end included goods worth Tk. 2,000 for which the bill neither has been received and nor accounted for.

9. Following are the transactions of Zebra enterprise for the month of May, 2024. Enter these in the Books of Original entry of the enterprise assuming that it keeps Special and General Journal:

2024

May 1 Purchased from X Ltd. Goods worth Tk.50,000.

1 Drawn from Bank Tk.50,000.

2 Sold goods in cash Tk.40,000.

8 Purchased Computer in cash Tk.42,000.

12 Purchased from Y Ltd. on 15 days credit: 100 tins of Sun Soyabean @ Tk.200 per tin.

50 tins of Flower brand Butter Oil @ Tk.300 per tin.

18 Paid X Ltd. Tk.49,500 in full settlement through cheque.

20 Returned of 10 tins of Sun Soyabeen being defect in packaging.

25 Sold oil to Z Ltd.:

80 tins of Sun Soyabeen @ Tk.225 per tin

45 tins of Flower Brand Butter Oil @ Tk.350 per tin

28 Paid Y Ltd. full amount @ 2% discount.

30 Paid Salary Tk.20,000 and rent Taka 12,000.

The enterprise had opening Cash and Bank Balance for the month of May at Tk.7,000 and Tk.80,000 receptively. Salaries unpaid for the month was, Tk.5,000 & Depreciation on furniture to be provided @ 16% on W/D/V of Tk.22,000.

10. The following business transactions were completed by Sonali Theatre Corporation during June, 2024:

2024

- June 1 Received and deposited in a bank account Tk.50,00,000 cash for capital stock.
- 2 Purchased the Twin Theatre for Tk.100,00,000, allocated as follows: land, Tk.30,00,000; buildings, Tk.37,50,000; equipment, Tk.32,50,000. Paid Tk.40,00,000 in cash and gave a mortgage note for the remainder.
- 3 Paid premiums for property and casualty insurance policies Tk.3,00,000.
- 4 Purchased supplies Tk.85,000, and equipment Tk.2,45,000, on account.
- 6 Paid for June billboard and newspaper advertising Tk.1,00,000.
- 9 Cash received from admissions for the week, Tk.30,40,000.
- 11 Paid miscellaneous expenses, Tk.2,20,000.
- 15 Paid semi-monthly wages Tk.22,40,000.
- 16 Cash received from admissions for the week Tk.33,00,000.
- 18 Paid miscellaneous expenses Tk.1,75,000.
- 21 Returned portion of supplies purchased on June 4 to the supplier, receiving full credit for the cost Tk.41,000.
- 22 Paid cash to creditors on account Tk.2,09,000.
- 23 Cash received from admissions for the week Tk.24,15,000.
- 24 Purchased supplies for cash, Tk.1,70,000.
- 26 Paid for advertising leaflets for June Tk.1,50,000.
- 29 Recorded invoice of Tk.45,00,000 for rental of film for June. Payments is due on July 10.
- 30 Paid electricity and water bills, Tk.6,00,000.
- 30 Paid semimonthly wages Tk.22,45,000.
- 30 Cash received from admissions for remainder of the month Tk.33,70,000.

Instructions:

- (1) Record the transactions in a journal
- (2) Post the journal to the ledger, extending the month-end balances to the appropriate balance columns after all posting is completed
- (3) Prepare a trial balance as of June 30.

- (4) Determine the following:
- (a) Amount of total revenue recorded in the ledger
 - (b) Amount of total expenses recorded in the ledger
 - (c) Amount of net income for June, assuming that additional unrecorded expenses (including supplies used, insurance expired, etc. totaled 10,00,000).
11. From the following transactions of Alef Mia for the month of March, 2024, you are required to show Journal Entries, Ledger Accounts and a Trial Balance:
- 2024
- March 1 Started business with cash Tk.1,50,000 & Furniture Tk.60,000.
- 2 Opened account in Excellent Bank with Tk.1,00,000.
- 3 Purchased goods for cash Tk.40,000.
- 8 Sold goods to Kamal Hossain on account Tk.60,000.
- 12 Sold goods for cash Tk.20,000.
- 18 Received Tk.59,000 from Kamal Hossain in full settlement and deposited the amount in to the bank.
- 25 Purchased goods on account Tk.30,000.
- 28 Sold goods to Sun-Moon & Co. on account Tk.40,000.
- 29 Paid salaries through bank Tk.25,000.
- 29 Withdrew from bank Tk.10,000 for office and Tk.5,000 for personal use.
- 30 Paid office rent Tk.12,000.

Lesson-6: Adjusting Entries and Adjusted Trial Balance

Lesson Objectives

After you have studied this lesson, you should be able to:

- understand the meaning and significance of adjusting entries.
- know the procedure for treating adjusting entries.

2.6.1 Introduction

While preparing financial statements at the end of an accounting period it will be necessary to consider the period in respect of which expenses have been incurred and income has been earned. Only the expenses and income relevant to the period will be taken into account. Expenses and income prior and subsequent to that period cannot be shown in the financial statement of the concerned period. Thus adjustment may have to be made if such expenses have been incurred or income received. Entries made for this purpose is called adjusting entries. So, the entries required at the end of a fiscal period to record internal transactions so that the financial statements properly include the correct amount for the current period are called adjusting entries.

2.6.2 Rules for Adjusting Entries

Following steps need to be taken for giving adjusting entries:

- i) Identify the two accounts that are to be affected by adjusting entry.
- ii) The account that shows the debit balance will have to be debited if it is to be increased by adjusting entry and be credited if it is to be decreased.
- iii) If an asset is increased due to adjustment, it will be debited, and if it is decreased due to adjustment, it will be credited. The reverse will happen for liability.
- iv) Financial statements shall be prepared after passing the adjustment entries.

The usual Adjusting Entries that may be necessary can be enumerated as follows:

- i) *For bringing Outstanding Liabilities & unpaid expenses into account:*

Particular Expense	Dr.
Expense Payable	Cr.
(Representing the expenses owing and not paid)	

- ii) *For adjusting advance payment:*

Particular Expense	Dr.
Prepaid Expense	Cr.
(In respect of which the advance payments have been made)	

- | | | |
|-------|--|-----|
| iii) | For adjusting income received in advance: | |
| | The Particular Nominal Account | Dr. |
| | Unearned Revenue | Cr. |
| | (Amount showing the income received but not earned) | |
| iv) | For bringing accrued income into account: | |
| | Outstanding Debtors or accrued Income | Dr. |
| | The Particular Nominal | Cr. |
| | (in respect of which the income has accrued) | |
| v) | For writing off bad debts: | |
| | Bad Debts Expense | Dr. |
| | Accounts Receivable-Debtor | Cr. |
| vi) | For making provision for bad & doubtful debts: | |
| | Profit and Loss Account | Dr. |
| | Provision for Doubtful Debts | Cr. |
| vii) | For making provision for discount on debtors: | |
| | Discount Expense | Dr. |
| | Provision for Discount on Debtors | Cr. |
| viii) | For making provision for discount on creditors: | |
| | Provision for Discount on Creditors | Dr. |
| | Discount Revenue | Cr. |
| ix) | For adjusting interest on capital (if any to be provided for): | |
| | Interest Receivable | Dr. |
| | Capital | Cr. |
| x) | For adjusting interest on drawings (if any to be provided for): | |
| | Capital or Drawings | Dr. |
| | Interest Payable | Cr. |
| xi) | For bringing the closing inventory into account at period end: | |
| | Inventory (Stock) | Dr. |
| | Trading/Cost of Goods Sold | Cr. |
| | (This stock-in-trade will appear as an Asset in the Balance Sheet) | |
| xii) | For providing for depreciation on asset: | |
| | Depreciation Expense | Dr. |
| | Accumulated Depreciation- Asset | Cr. |

For clear understanding and easy grasp, following examples will be helpful to the learners.

Example-2.08:

Accounting year of Ghali & Sons ends on 31st December each year. Following adjustments are necessary for the preparation of final account for the year ended on 31-12-2023.

1. Outstanding salary for December Tk.15,000; House rent Tk.10,000 paid for January next.
2. Interest accrued on investment Tk.12,000.
3. Accounts receivable amounts to Tk.20,000, 5% Bad debt is to be maintained on it.
4. Wages paid for installation of machine Tk.4,000 included in the wage account.
5. Depreciation Tk.500 is to be charged on furniture.
6. Goods worth Tk.5,000 has been included with ending inventory for which bill has not yet been paid.
7. Ending inventory amounted to Tk.10,000.

Required: Prepare adjusting journal entries.

Solution:

Ghali & Sons
Adjusting Journal Entries

Date	Account Titles & Explanation	L.F.	Debit	Credit
2023 Dec.			Tk.	Tk.
31	Salaries Expense Salaries Payable (outstanding salaries adjusted)		15,000	15,000
31	Prepaid Rent Rent Expense (Advance rent adjusted)		10,000	10,000
31	Interest Receivable Interest Revenue (Interest accrued accounted for)		12,000	12,000
31	Bad debt Expense Accounts Receivable (Bad debt taken into account)		1,000	1,000
31	Machinery Wages Expense (Wages paid for machines adjusted)		4,000	4,000
31	Depreciation Expense Accumulated Depreciation-Furniture (Depreciation on Furniture charged)		500	500
31	Purchase Accounts Payable (Credit purchase of goods accounted for)		5,000	5,000
31	Ending Inventory Purchase/Cost of Goods Sold (Closing stock taken account for Financial Statement)		10,000	10,000

Example-2.09:

X Co. closes its book on 31st December. As on that date it was observed that:

- Goods worth Tk.1,000 purchased from A Co. has been entered in the purchase day book and credited to the Co. but were not delivered until 5th January.
- Goods (cost Tk.12,000 minimum sale price Tk.16,000) had been consigned to Barishal but were still unsold.
- Tk.2,000 paid to an injured workman has been debited to wages A/C pending settlement of the claim against the Accident Insurance Co. Ltd.
- Materials from store Tk.500 has been used in making Loose tools for use in the Co.'s factory but no entry has been made in the books.
- Goods costing Tk.1,000 pilfered by employees & not covered by insurance.

Solution

Date	Account Titles & Explanation	L.F.	Debit Tk.	Credit Tk.
a.	No adjustment entry required if title passes at the end of financial year but the goods should be included in closing stock. If, however, title does not pass, following adjustment entry will be required A Co. Purchase (Goods not taken to closing stock, passed through purchase day book now cancelled)		1,000	1,000
b.	Consignment stock Consignment to Barishal (Value of unsold goods in the hands of consignee adjusted at minimum sale price)		16,000	16,000
c.	Insurance claim Wages (Compensation paid to injured A/c debited to wages A/c adjusted)		2,000	2,000
d.	Loose tools Purchase (Cost of material chargeable to loose tool adjusted)		500	500
e.	a) Pilferage Cost of Goods Sold (Cost of goods pilfered not covered by insurance taken into account) b) Profit & Loss A/c Pilferage (Pilferage not covered by Insurance charged P/L A/c)		1,000 1,000	1,000 1,000

Example-2.10: Adjustments & Adjusted Trial Balance

Following is the Trial balance of Progoti Traders as on 31-12-2023

Account Titles	Ref.	Dr. Tk.	Cr. Tk.
Cash		Tk.30,00,000	
Accounts Receivable		60,000	
Advertising/Supplies		5,00,000	
Prepaid Insurance		3,00,000	
Office Furniture		12,50,000	
Notes payable			Tk.4,00,000
Accounts payable			12,40,000
Unearned fees			1,20,000
Common Stock			46,00,000
Dividends		1,00,000	
Fees earned			23,00,000
Salaries		32,10,000	
Rent		2,40,000	
		Tk.86,60,000	Tk.86,60,000

Adjustments are to be given for the following:

- Advertising supplies used during the year 2023: Tk.1,00,000.
- Insurance expired during the year 2023: Tk.1,00,000.
- Depreciation of office equipment Tk.50,000.
- Unearned fees includes Tk.30,000 earned in December 1999.
- Fees earned but not billed or collected Tk.40,000.
- Interest accrued on notes payable Tk.20,000.
- Salaries accrued on December 31, 2023: Tk.1,20,000.

Give adjusting entries & prepare an Adjusted Trial balance.

Solution:

Progoti Traders
Adjusting Entries

Date		Account Titles & Explanation	L.F.	Debit Tk.	Credit Tk.
2023 Dec.	31	Advertising Supplies Expense Advertising Supplies (To record supplies used)		1,00,000	1,00,000
	31	Insurance Expense Prepaid Insurance (To record insurance expired)		1,00,000	1,00,000
	31	Depreciation Expense Accumulated Depreciation-Office Equipment (To record annual depreciation)		50,000	50,000

Date	Account Titles & Explanation	L.F.	Debit Tk.	Credit Tk.
31	Unearned Fees Fees Earned (To record Fees earned)		30,000	30,000
31	Accounts Receivable Fees Earned (To record accrued fees earned but not billed or collected)		40,000	40,000
31	Interest Expense Interest Payable (To record accrued interest on notes payable)		20,000	20,000
31	Salaries Expense Salaries Payable (To record accrued salaries)		1,20,000	1,20,000

Progati Traders
Trial Balance
December 31, 2023

Account Titles	Before Adjustment		After Adjustment	
	Dr.	Cr.	Dr.	Cr.
Cash	Tk.30,00,000		Tk.30,00,000	
Accounts Receivable	60,000		1,00,000	
Advertising Supplies	5,00,000		4,00,000	
Prepaid Insurance	3,00,00		2,00,000	
Office Furniture	12,50,000		12,50,000	
Accumulated Depreciation-Office Furniture				Tk.50,000
Notes Payable		Tk.4,00,000		4,00,000
Accounts Payable		12,40,000		12,40,000
Interest Payable		--		20,000
Unearned Fees		1,20,000		90,000
Salaries Payable		--		1,20,000
Common stock		46,00,000		46,00,000
Dividends	1,00,000		1,00,000	
Fees Earned		23,00,000		23,70,000
Salaries	32,10,000		33,30,000	
Advertising Supplies Expense	--		1,00,000	
Rent Expense	2,40,000		2,40,000	
Insurance Expense	--		1,00,000	
Interest Expense	--		20,000	
Depreciation Expense	--		50,000	
	Tk.86,60,000	Tk.86,60,000	Tk.88,90,000	Tk.88,90,000

Lesson-7: Closing and Reversing Entries

Lesson Objectives

After you have studied this lesson, you should be able to:

- understand the meaning and significance of closing entries.
- know the procedure for treating closing entries.
- understand the meaning and significance of reversing entries.

2.7.1 Introduction

At the end of an accounting period, it is necessary to prepare final accounts for closing all the nominal accounts in the ledger by transferring them into the Income Statement and further for closing the Income statement the net profit or loss needs to be transferred to Retained earnings account or such balance can be transferred to the capital account in case of sole proprietorship and partnership and to the Balance sheet in case of corporation i.e. companies. These entries are known as closing entries. It is called so because their effect is to close the books of account for the year concerned. These closing entries are relevant to nominal, i.e. temporary accounts.

2.7.2 Closing the Temporary Accounts: The Necessity

Revenues, Expenses, and Dividends are called nominal or temporary accounts, because they accumulate the transactions of only one accounting period.

Revenue increases retained earnings and expenses and dividends decrease it. Revenues, expenses, and dividends are called nominal or temporary accounts, because they accumulate the transactions of only one accounting period. In this connection, it is to be noted that the retained earnings and other Balance sheet accounts are called real or permanent accounts, because their balances continue to exist beyond the current accounting period.

At the end of an accounting period, the change in retained earnings as accumulated through temporary i.e. nominal accounts needs to be transferred to the Retained earnings statement. This process of transfer is called closing the accounts and the journal entries made in this regard are called closing entries.

At year-end, for the purpose of preparing financial statement, revenues and expenses are transferred to an account called Income Summary or Income Statement. When, through such transfer, the credit balance of revenue account and debit balance of expenses account are transferred to the summary account, the balance of that account will be net income or net loss. This is consistent with the rule that the increase in owners' equity is recorded by credits and decrease is recorded by debits.

2.7.3 Rules for Closing Entries

Following steps are necessary for closing entries:

- i) close the revenue accounts by transferring their balances into the Income Summary accounts.

- ii) close the expenses accounts by transferring their balances into the Income Summary accounts.
- iii) close the income summary account by transferring its balance into the Retained Earning Account.
- iv) close the dividend account by transferring the balance into the Retained Earning Account.

2.7.4 Usual Closing Journal Entries

i) Closing Entries for Revenue Account Items

These accounts have credit balances. These credit balances are be transferred to the Income Summary Statement as follows:

Individual items of revenue	Dr.
Income Summary	Cr.
(such as Interest received , commission received)	

ii) Closing Entries for Expenses Items

These accounts have debit balances. The balances are to be transferred to Income Summary Statement as:

Income Summary	Dr.
Individual items of expense	Cr.
(such as , salary, advertisement, etc.)	

iii) Closing Income Summary Account

This account may show a credit or debit balance. If revenue (credit balance) exceed expenses (debit balance) the Income Summary Account will have a credit balance representing net income. Conversely, if expenses exceeds revenue, it will have a debit balance representing net loss. In the case of net income the closing transfer entry will be:

Income Summary	Dr.
Retained Earnings/Capital	Cr.

If the Income Summary shows a net loss the entry will be reverse.

iv) Closing the Dividends Account

Payment of dividend to stockholders cannot be treated as expense, & this is not taken into account in determining the net income/loss of the business. As a result, this account is not closed through transfer to Income Summary Statement. Instead, it is closed directly by transferring to Retained Earnings Account. The entry will be as follows:

Retained Earnings	Dr.
Dividends	Cr.

2.7.5 After Closing Trial Balance

After the revenue and expenses accounts have been closed through closing entries, it is possible and also considered necessary to prepare an "After Closing Trial Balance", which thus of course will consist solely of Balance Sheet items. This, after closing or sometimes called post closing trial balance will be prepared based on ledger accounts and the transfer effects of closing entries. It gives assurance that the accounts are in balance and is also arithmetically accurate.

2.7.6 Reversing Entries

Some of the adjusting entries recorded at the end of an accounting period may have a significant effect on otherwise routine transactions that occur in the succeeding (i.e. following) year. A typical example is the adjusting entry for accrued salaries. In fact, the salary expenses of an enterprise and the accompanying liability to employees accumulates day by day during any part of the year. Thus when salaries are paid weekly, it will be recorded 52 or 53 times a year. In such a case, if there has been an adjusting entry for accrued salaries at the end of the year, the payment of salary at year-end may include a part for the current and a part for next year. As such it will be necessary to debit salary payable for the amount owed for the earlier year and the salary expense for the portion of the payroll that represents expense for the later year. The following example will make the point clear.

Example-2.11:

- i) Salaries are paid on Thursday for 5 day a week.
- ii) The balance in salaries expense as of Thursday day, December 27, is Tk.60,000.
- iii) Salary accrued for Sunday & Monday, December 30 & 31 amounts to Tk.1,000.
- iv) Salary paid on Thursday, January 3 amounts to Tk.4,000.

The adjusting entry to record accrued salary payable for Sunday & Monday will be:

Salaries Expenses	Tk.1,000
Salaries Payable	Tk.1,000

After this adjusting entry has been passed the salaries expense will have a debit balance of Tk.61,000 (60,000+1,000) & Salaries payable will have a credit balance of Tk.1,000. At this stage now it will be necessary to record Tk.4,000 payroll on January 3, as a debit of Tk.1,000 to salaries payable & a debit of Tk.3,000 to salaries expense. This requires the employee who records payroll to determine the amount of Tk.4,000 payment to distinguish and debit to each of the two accounts.

But the need to refer to earlier entries and to decide the debit between two accounts can be avoided by an optional procedure of recording a reversing entry as of the first day as follows:

Salaries Expense

Date	Explanation	Ref.	Debit	Credit	Balance	
					Debit	Credit
2023 Dec.27	.....	.....				
31	Adjusting		1,000		61,000	
31	Closing			61,000	—	—
2024 Jan. 1	Reversing			1,000		1,000
3					3,000	

Salaries Payable

Date	Explanation	Ref.	Debit	Credit	Balance	
					Debit	Credit
2023 Dec.31	Adjusting			1,000		1,000
2024 Jan. 1	Reversing		1,000			

After reversing entry is posted, salary payable comes into balance. The entire amount of first payroll in January will be debited to salaries expenses & the balances of the accounts will thus automatically represent the expenses of the new period.

Questions and Exercise

Self-Test Questions

1. If the supplies account before adjustment on 31st Dec., indicate a balance of Tk.2,250 and an inventory supplies on hand on that date totaled at Tk.950, the adjusting entry would be:
 - (a) Debit supplies Tk.950 and credit supplies expenses Tk.950
 - (b) Debit supplies Tk.1,300 and credit supplies expenses Tk.1,300
 - (c) Debit supplies expenses Tk.950 and credit supplies Tk.950
 - (d) Debit supplies expenses Tk.1,300 and credit supplies Tk.1,300
2. If the estimated amount of depreciation on Machinery for a period is Tk.2,000, the adjusting entry to record depreciation would be:
 - (a) Debit Depreciation Tk.2000 and credit machinery Tk.2,000
 - (b) Debit Depreciation expenses and credit Accumulated depreciation Tk.2,000
 - (c) Debit Machinery and credit Depreciation Tk.2,000
3. Which of the following accounts would be closed to Income Summary account at the end at a period:
 - (a) Sales (b) Salary expenses (c) Both sales and salary (d) Neither sales or salary expenses.

Discussion Questions

1. Are the adjusting and closing entries in the journal dated as of the last day of accounting period or as of the day the entries are actually made? Explain.
2. What is meant by adjusting entry? Point out the rules of adjusting entries and give some examples of adjusting entries with specimen entry.
3. What is meant by closing entry? Why is it necessary? How would you close revenue and income items?
4. What is reversing entry. Explain it with example.
5. List the following in logical sequence to illustrate the flow of accounting information:
 - a) Debits and Credits posted from Journal to Ledger
 - b) Preparation of Trial balance
 - c) Information entered in journal

- d) Occurrence of business transaction
- e) Preparation of financial statement
- f) Adjusting entries made

Exercises

1. Pass the suitable adjusting entries in respect of the following
 - (i) Closing inventory was valued at Tk.20,00,000 as on 31st December 2023.
 - (ii) On 20th December, 2023 there was fire in the godown of Karim and goods worth Tk.10,00,000 were destroyed. Karim had a fire insurance policy up to 75% of the goods destroyed.
 - (iii) Investment Tk.10,00,000 in Government promissory Notes 10% p.a. On the date of year ending, six months interest was due to be received from the Government.
 - (iv) On 1-1-2023 Rahim & Co. received Tk.3,00,000 as Apprentice premium covering 3 years of training.
 - (v) Goods costing Tk.1,00,000 distributed as sample by way of advertisement.
 - (vi) Furniture which stood at Tk.60,000 in the books on 1st January, 2023 was disposed off at Tk.29,000 on 30th June in part exchange for new furniture costing Tk.52,000. A new invoice at Tk.23,000 was passed through the purchase day Book.
 - (vii) The reserve for doubtful debts at 1st January, 2023 was Tk.1,20,000. The bad debts during the year amounted to Tk.1,05,000. The debtors at 31st December, 2023 was Tk.27,00,000. The reserve for doubtful debts is to be raised to 5%.
2. Give adjusting entries for the following
 - (i) Advertisement supplies used during the year Tk.5,000.
 - (ii) Depreciation of Office equipment Tk.1,000.
 - (iii) Fees earned but not billed for Tk.3,000.
 - (iv) Interest accrued Tk.500 on notes payable.
 - (v) Salaries accrued Tk.2,000.
 - (vi) Goods costing Tk.1,500 destroyed by fire and Insurance company admitted to pay compensation claim to the extent of Tk.1,000.
 - (viii) Provide 5% provision for doubtful debt on Tk.30,000.

Case Study

Sun Shine Textile Mills Ltd.

1. Background

The General Manager of Sun Shine Textile Mills Ltd. while discussing about audit report of the company expressed dissatisfaction about accounting system and internal check thereof. He was very much worried about the unveil of some irregularities and misappropriation of fund mainly from provident fund section. He emphatically asserted the necessity of sound and appropriate accounting system and thus requested the accounts chief to review the existing system and recommend a comprehensive accounting system for the mill.

2.1 Growth and Development of the Mill

The mill was set up by Mr. X with other 8 promoters in 1998 as a public limited company and that Mr. X was duly appointed as Managing Director of the mill. It was listed in Dhaka Stock Exchange in March, 1999. The authorized capital of the mill was Tk.15 crores and paid up capital was Tk.10 crores with share of Tk.100 each.

2.2 Management

The management of the company is vested to the Board of Directors who formulates policy, give guidelines and supervise the affairs of the company. The day-to-day management is vested to Managing Director. There are five divisions to run the company viz., production, sales, procurement, finance and accounts and personnel division, each division is headed by a manager.

3.1 Organisation of Accounts Functions

The accounts department is headed by Manager Finance and Accounts who works directly under the Managing Director of the company. He also works as finance officer of the Mill. There are two Accounts Officer under him charged with :

- i) General accounts and Financial statements and
- ii) Cost and Budget.

Under the general accounts four Assistant Accounts Officers work who are entrusted with (a) Wages and salary, (b) Accounts and Report, (c) Provident Fund and (d) Insurance and Tax. Accounts Officer charged with cost and budget has under him one Assistant Accounts Officer. He is in charge of data compilation and statement preparation. Each Assistant Accounts Officer has some staffs under them. The organogram of Accounts Section is shown in the Appendix-I.

The functions of accounts department is to record business transactions, prepare statements and meet audit objections. The department also needs to prepare necessary budget and cost reports. Some of the reports are to

be prepared daily, some are weekly, some are monthly and some are annually. The reports are to be transmitted to higher authorities in time. There is an internal audit department which as per plan examine the working and finance activities of the concern.

3.2.1 Organisation and Functions of Provident Fund Section

As mentioned earlier, it is seen that provident fund is a section under accounts department and is headed by one Assistant Accounts Officer. This section computes P.F. deductions from salary and wages of the Officers, staffs and workers, record the same in the Ledger, deposit the amount in bank under respective account head, compute interest on P.F. and balance of the employees, record the same in the respective account of the employees, transmit statements of balance in account to respective employee, arrange for sanction of loan from the accounts of employees on application, make deductions from salary against such loans and such other relevant works.

3.2.2 Management of Provident Fund

The Management of P.F. has been entrusted with a Board of Trustees. The Finance and Accounts head is the ex-officio Chairman of the Trustee Board and Accounts Officer (General Accounts) is the Member-Secretary. Two types of members are included in the board representing officers including staff and workers as follows:

Officers' representatives	Workers' representatives
i) Deputy Manager (Admin.)	i) Deputy Manager (Labor & Welfare)
ii) Deputy Manager (Accounts)	ii) Deputy Manager (Accounts)
iii) Three other representatives	iii) Three other representatives

The board frame the policy of fund management and ensure its implementation. It sits half yearly to review the fund position and other matters relevant to the fund.

3.2.3 Advance from the Fund

An advance or loan may be granted to a subscriber twice a year subject to his application for loan on prescribed form and availability of balance to his account. The advance may be granted on account of the following

(a) to pay expenses on account of prolonged illness of self, wife/husband dependent sons/daughters, father/mother;

(b) to pay expenses inconnection with marriage and funneral;

(c) to purchase plot of land for residential purpose or construction of residential building;

(d) To pay off deferred dower claim.

The advance is sanctioned by Accounts head or head of the enterprise subject to limitation of power as to the amount for Accounts head. The

advance is recovered in monthly installments to be deducted from salaries and wages as per fixed monthly installment in accordance with rules of provident fund.

4. Some Audit Findings in matters of Wage and Provident Fund

The present wage computation, payment and record system has the following deficiencies:

i) There is no adequate system of personal record keeping for permanent workers.

ii) Personal record of all workers does not show the rates of pay which give rise to difficulties to check payment of right wages, deduction of P.F. and other matters.

iii) In the last year deductions for advance against loan was not made and accounted for 5 employees of finishing section and one staff in accounts section.

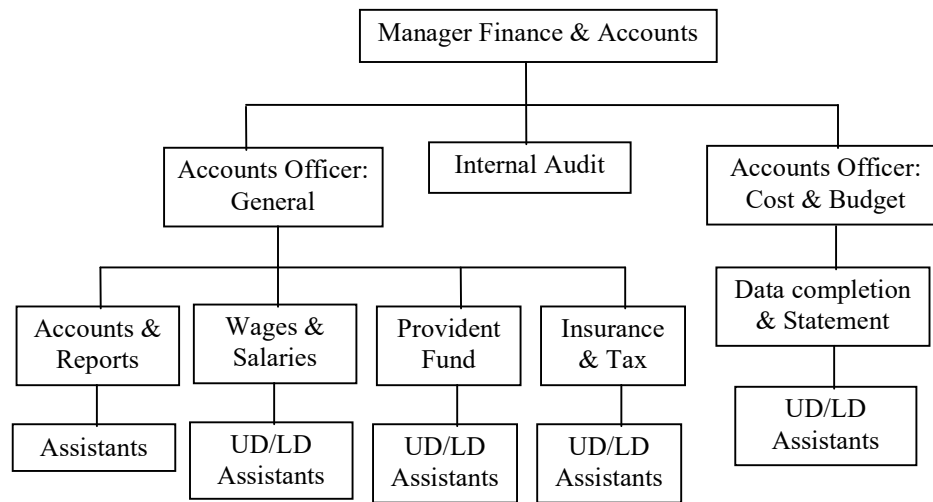
iv) Workers and some staffs reported not to have received annual statements as to the P.F. balance position at year end although P.F. rules of the organization have a provision for providing annual statement to each subscriber at year end.

v) An amount of Taka 38,500.00 has been misappropriated by one staff in P.F. section by not depositing the P.F. deduction made from salary and wages of the staffs and workers by manipulating false pay-in-slip. The internal audit detected the same. The employee is under suspension. This warrants strengthening internal check for which a review of the whole internal check system is warranted.

Questions:

1. Evaluate the accounts keeping system and P.F. management system of the mill and identify the flows thereto.
2. Give an outline of accounting system based on deficiency and showing flow chart of recording and transmission of statements and reports.

Appendix-1
Organogram of Accounts Section



ACCOUNTING FOR MERCHANDISING OPERATIONS

3

From the discussions of this unit, students will be able to learn:



Merchandising Activities



Financial Statements



Measurement of Merchandising Inventory



Preparation of Financial Statements

এই পৃষ্ঠা খালি থাকবে

Unit-3

Lesson-1: Merchandising Activities

Lesson Objectives

After you have studied this lesson, you will be able to:

- explain the operating cycle of a merchandising company.
- describe the different components of income statement of a merchandising company.
- narrate the term of transaction.

3.1.1 Introduction

The total business segment of society is classified into three broad types of enterprises: (i) service, (ii) manufacturing, and (iii) merchandising. Banks, insurance companies, commercial airlines, physicians, lawyers, etc. are examples of *service enterprises*. *Manufacturing enterprises* convert raw materials into finished products through the application of skilled labor and machine operations. Lastly, *Merchandising companies* in contrast earn their revenue by selling goods. Merchandising companies include both retailers and wholesalers.

Service, Manufacturing and Merchandising enterprises are the three broad types of enterprises in business segment.

Goods that a merchandising company sells to its customers are called *inventory* or *merchandise*. Most merchandising companies purchase their inventories from other business organizations in a *ready-to-sell* condition. The accounting records of a merchandising firm must accommodate many transactions for the purchase of products and payment at the related accounts. Moreover, the accounting reports should indicate whether the difference between the acquisition price and the sales price to customers covers the cost of storing, advertising, selling, delivering, and collecting the merchandise. Finally, the accounting records must reflect not only cash sales but also credit sales which create accounts receivable. Accounts receivable are amounts owed to an entity by its customers.

Goods sold by a merchandise company are called inventory or merchandise.

Accounts receivable represents amounts owned to an entity by its customers.

3.1.2 Operating Cycle of a Merchandising Company

Merchandising companies follow a similar, somewhat rhythmic, pattern of economic activity during which income is measured. The series of transactions through which a business generates its revenues and its cash receipts from customers is called the *operating cycle*. An *operating cycle*, is also known as *cash cycle* or *earning cycle*. *An operating cycle is the average length of time span between the purchase of merchandise inventory and the realization of cash from the sale of the merchandise.* The operating cycle of a merchandising company consists of the following phases:

An operating, cycle or earning cycle is the average length of time between the purchase of merchandise inventory and sale of the merchandise.

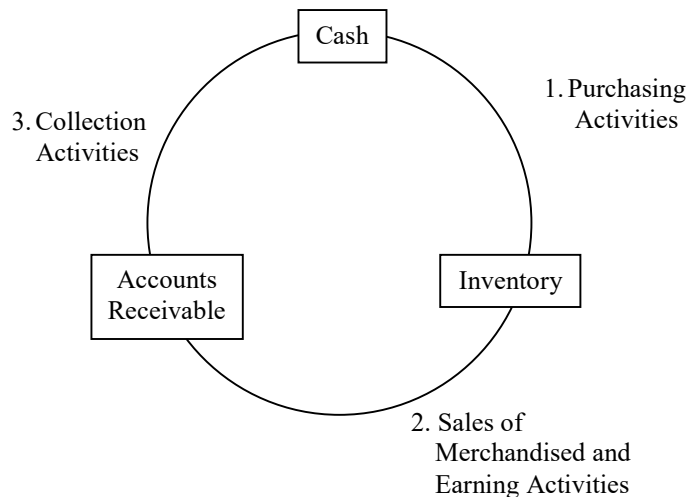
- (i) purchase of merchandise inventory,

- (ii) sales of merchandise inventory on account, and
- (iii) collection of cash from the accounts receivable from customers.

Flows in a business are continuous. The business has a pool of cash that it has obtained from investors or from past profitable operations. It uses this cash to acquire inventories and to meet other costs. It sells goods to customers. The customers either pay cash or agree to pay later, thus creating accounts receivable. When customers pay, the pool of cash is replenished.

As the word cycle suggests, this sequence of transactions repeats continuously. A portion of the cash collected from the customers is used to purchase more merchandise, and the cycle begins a new.

This continuous sequence of merchandising transactions is illustrated below:



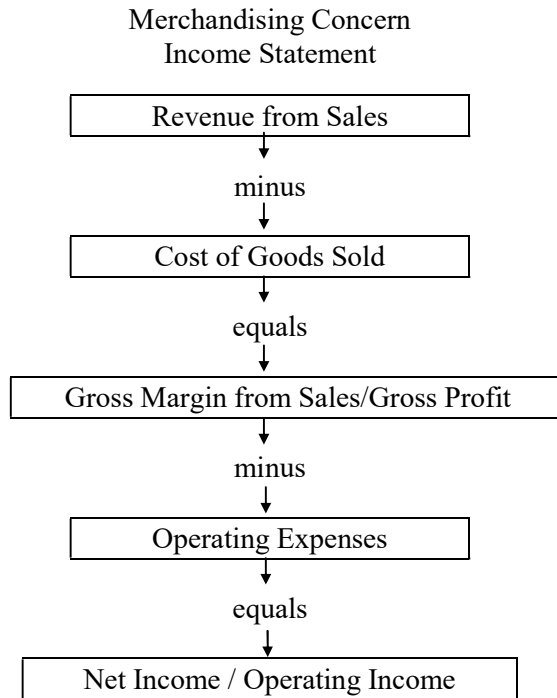
Source: Robert F. Meigs, *Financial Accounting*, Trwin-McGraw-Hill, Boston, Massachusetts, 1998, p.214.

3.1.3 Income Statement of a Merchandising Company

Merchandising companies, whether wholesale or retail, attempt to earn income by buying and selling merchandise. The income statement of a merchandising company consists of five elements: (1) revenue from sales, (2) cost of goods sold, (3) calculations of gross margin, (4) Operating expenses, and (5) net income. The major difference between the income statement of a merchandising firm and that of a service business is the inclusion of an amount for the *cost of goods sold* to customers in the merchandising firm's statement. It is important to understand each component and step of an income statement.

Merchandising company earns income by buying and selling merchandise.

Figure 3.1: Components of Income Statement of a Merchandising Concern:



The elements of an Income Statement for a Merchandising Company are exhibited below with imaginary figures:

Exhibit 3.1

Gift Fashion Ltd.	
Condensed Income Statement	
For the year ended December 31, 2023	
Revenue from sales	Tk.4,500,000
Less: Cost of goods sold	<u>2,700,000</u>
Gross Profit-Gross Margin	Tk.1,800,000
Less: Operating expenses	<u>1,350,000</u>
Net Income-Operating Income	<u><u>Tk.450,000</u></u>

Revenue from sales arises from the sale of goods by the merchandising company, and the *cost of goods sold* shows how much cost incurred by the merchandising company for purchasing goods that were sold. For profitable operation, merchandise needs to be sold at a price higher than the cost of goods sold. If the sale price is higher than the cost of good,

Though gross profit is a useful means of measuring the profitability of sales transactions, but it does not represent the overall profitability.

sold it will be termed as **gross margin or gross profit**. Further gross profit margin needs to be great enough- to meet operating expenses and have an adequate income left over. Gross profit is a useful means of measuring the profitability of sales transactions but does not represent the overall profitability of the business. *Operating expenses* are all those expenses necessary to run the business, other than the cost of goods sold. In a merchandising company, operating expenses are similar to the expenses of a service company. Examples include salaries, rent, advertising, insurance, selling expenses, depreciation, etc. To determine the net income for a merchandising company, the cost of goods sold is subtracted from the revenue represented by the sale of that merchandise; the difference is *gross profit*; also called *gross margin*. From gross profit, the operating expenses are deducted to determine net operating income.

3.1.4 Terms of Purchase & Sales Transactions

Merchandising activities may ordinarily be classified as wholesale or retail. Merchandise may be purchased and sold either on credit terms or for cash on delivery. Most merchandise transactions today are made on account rather than on cash terms. The credit terms are stated in the seller's bill, or *invoice*. When goods are sold on account, a period of time called the *credit period* is allowed for payment. The length of the credit period varies among business firms and may even vary within firms, depending on the type of product. One common example of credit terms is "net 30 days," or "n/30," meaning full payment is due in 30 days. Manufacturers and wholesalers usually allow their customers 30 or 60 days as a credit period within which payment for credit purchases should be made.

The period during which the discount is available is termed as discount period.

To encourage early payment of bills, most business firms, offer their customers a discount called a *cash discount*. The most common credit terms offered by merchandising companies are 2/10, and n/30. This expression is read "2, 10, net 30" and means that full payment is due in 30 days, but that 2% may be deducted if payment is made within 10 days. The period during which the discount is available is termed the *discount period*. Because the discount provides an incentive for the customer to make an early cash payment, which is called a *cash discount*. Most well-managed companies maintain a good cash position so that they can take advantage of cash discounts. Buyers, however, refer to these discounts as *purchase discounts*, while sellers called them *sales discounts*. One should know that trade credit is normally a costly source of finance. To illustrate, assume that Shamoli Ltd. sells goods amounting

to Tk. 80,000 to Rahman Co. on 25.10.2023 on terms 2/10, n/30. Rahman Co. makes payment on 04.11.2023. In this case, the journal entry in the books of Shamoli Ltd. would be:

2023			
October 25	Accounts Receivable	Tk.80,000	
	Sales		Tk.80,000
(To record sales to Rahman Co. terms 2/10, n/30)			
November 04	Cash	Tk.78,400	
	Sales Discount	1,600	
	Accounts Receivable		Tk.80,000
(To record the collection from Rahman Co. from October 25 sales, less 2% cash discount.)			

In order to avoid printing catalogues and the price lists every time there is a price change, some merchandise companies quote prices of merchandise at a discount (usually 30 percent or more) off the list or catalogue price. Such discounts are called *trade discount* or the *chain discount*- the amount the retailers deduct from the price listed in the catalogue to determine their cost. Suppose that the seller of a tape recorder quoted a list price of Tk.20,000 for each tape recorder, less a discount of 30% if purchased in lots of 25 or less and 40% if purchased in lots of more than 25. If the company received order for 15 recorders, it would calculate its invoice cost as follows:

List Price (Tk.20,000 × 15) =	Tk.300,000
Less 30%	<u>90,000</u>
Invoice Price	<u><u>Tk.210,000</u></u>

The list price and related trade discounts are used only for the convenience of arriving at the agreed upon the price and do not appear in the accounting records of either the purchaser or the seller of merchandise. So, trade discounts are not recorded in the books of account; they are used only as a means of arriving at the selling price.

Lesson-2: Financial Statements

Lesson objectives

After you have studied this lesson, you will be able to:

- define the financial statements.
- describe the income statement.
- explain how gross sales revenue and net sales revenues are calculated.
- understand the concept of cost of goods sold.

3.2.1 Introduction

Although many business enterprises prepare interim financial statements on a monthly or quarterly basis, a complete cycle of business operations is usually assumed to recurring twelve months. However, a business, depending on its nature of operation, can divide its accounting period. Thus, during the interim or complete accounting period, it must summarize and report to the interested parties, viz., owners, managers, creditors, government agencies, the effect of its operation through financial statements. This lesson is devoted to stating different parts of financial statements along with the process of preparation of an Income Statement.

3.2.2 Financial Statements

Financial statements are used as output summary reports of the accounting system. Business entities communicate their financial information to different interested users (investors, creditors, managers, etc.) through published financial statements. The three *primary financial statements* are the *income statement*, the *balance sheet*, and the *statement of cash flows*. These *statements provide* users with the answers to the following essential questions about a business entity:

Income statement, balance sheet and statement of cash flows are the three primary financial statements.

1. What were the company's operating results for the period?
2. What is the company's current financial status?
3. How did the company obtain and use cash during the period?

The income statement reports the results of operations for a period of time. The balance sheet shows an organization's financial position on the last day of the accounting period. The statement of cash flows shows the inflows and outflows of cash for the accounting period. In addition to these, a statement called the *statement of retained earnings* is also prepared which shows the changes in retained earnings that have occurred during the period. This statement links the period's income

statement to the beginning-of-the-period and end-of-the-period balance sheets by completing the explanation of the net change in retained earnings between those two balance sheet snapshots.

3.2.3 The Income Statement

The measurement of income is one of the most important and controversial topics in accounting. Almost all of us have a reason for learning about how accountants measure income. Income is a measure of accomplishment—a means for evaluating an entity's performance over a period of time. Although income could be measured in many ways, accountants have agreed to use the accrual basis in reporting an entity's net income. An alternative, the cash basis, has supporters, and accountants prepare another statement, the statement of cash flows, to provide more direct information about cash. The *accrual basis* recognizes the impact of transactions on the financial statements in the time periods when revenues and expenses occur. That is, revenue is recorded as it is earned, and expenses are recorded as they are incurred—not necessarily when cash is received paid. In contrast, the *cash basis* recognizes the impact of transactions on the financial statements only when cash is received or disbursed.

Accrual basis recognizes impact of transactions in the financial statements in the period when revenue and expenses occur. However, Cash basis recognizes only when cash is received or disbursed.

The *income statement*, or *statement of earnings*, shows the results of an enterprise's operations for a period. It summarizes the revenues generated and the costs incurred (expenses) to generate those revenues. The "bottom line" of an income statement is *net income* or *net loss*, the difference between revenues and expenses. The measurement of income is a reflection of many established assumptions and principles (standards) in accounting, such as the periodicity assumptions, the revenue recognition principle, and the matching principle. To help you understand an income statement, we must first define its elements—revenues, expense, and the net income or net loss.

Net income or net loss is the difference between revenues and expenses.

3.2.4 Revenue from Sales

The first part of the merchandising income statement is revenues from sales. The term *revenues* refers to increases in the resources of an entity from the sale of goods. This section requires *net sales* (or *net sales revenue*), which consist of gross proceeds from sales of merchandise less sales returns and allowances and sales discounts. If a business is to succeed or even survive, net sales must pay for the cost of goods sold and operating expenses and provide an adequate net income. For example, the net sales figure of an organization can be computed as follows:

Revenue refers to increases in the resources of an entity from the sale of goods.

Example No. 3.01:

Partial Income Statement

For the Year Ended December 31, 2023

Revenues from Sales

Gross Sales		Tk.760,000
Less: Sales Returns and Allowances	24,500	
Sales Discounts	<u>15,500</u>	<u>40,000</u>
Net Sales		<u><u>Tk.720,000</u></u>

3.2.5 Gross Sales

Gross sales is the total invoice price of the goods shipped or services rendered during the accounting period. Under the accrual accounting system, revenues from the sale of merchandise are considered to be earned in the accounting period in which the title of the goods passes from the seller to the buyer. Gross sales consist of total sales for cash and total sales on credit during a given accounting period. Even though the cash for the sale may not be collected until the following period, the revenue is recognized as being earned at the time of sale.

Gross sales consists of total sales for cash and total sales on credit during an accounting period.

The journal entry to record a sale of merchandise for cash is as follows:

Cash	Tk.65,000
Sales	Tk.65,000
(To record sale of merchandise for cash.)	

If the sale of merchandise is made on credit, the entry is as follows:

Accounts Receivable	Tk.72,500
Sales	Tk.72,500
(To record sale of merchandise on cash.)	

3.2.6 Sales Returns and Allowances

Sales return and allowances represent the sales value of goods that were returned by customers and allowances that were allowed to customers because the goods were defective or for some other reason. In other words, if a customer receives a defective or otherwise unsatisfactory product, the seller will usually try to satisfy the customer. The business may allow the customer to return the item for a cash refund or credit on account, or it may give the customer an allowance off the sales price. A good accounting system will provide management with information for determining the reason for sales returns and allowances because such transactions may reveal a number of dissatisfied customers. An example of such a transaction follows:

Sales return and allowance represent the sale value of goods that were return by customers and allowances that were allowed.

Sales Returns and Allowances Tk.24,500

Accounts Receivable (or Cash) Tk.24,500

(To record return or allowance on unsatisfactory merchandise.)

Sales Returns and Allowances is a *contra debit balance revenue account* and is accordingly deducted from gross sales in the income statement. By the term contra account, we mean an account that has a balance opposite the normal balance.

Contra account is the account that has a balance opposite the normal balance.

3.2.7 Sales Discounts [Cash Discount]

Sales discounts are the amount of discounts taken by customers that encourage early payment. For example, Gift Fashion sells merchandise to a customer on September 15 for Tk.25,000 on terms of 2/10, n/30. At the time of sale, the entry would be:

Accounts Receivable Tk.25,000

Sales Tk.25,000

(To record the sale on credit terms 2/10, n/30.)

If the customer takes the advantages of sales discount and makes payment on September 24, the entry in Grit Fashion's record is:

Cash Tk.20,500

Sales Discount 500

Accounts Receivable Tk.25,000

(To record collection of accounts receivable subject to 2/10, n/30 credit.)

Sales discounts show the discounts taken by customers to encourage early payment.

At the end of the accounting period, the sales discount account will accumulate all the sales discounts for the period. Because sales discounts reduce revenues from sales, they are considered a contra revenue account and deducted from gross sales in the income statement. Sales Discount, like Returns and Allowances, is a *contra-revenue account*, and it also has a debit balance.

3.2.8 Cost of Goods Sold

The cost of goods sold section of the income statement combines the figures for the beginning and ending inventory with all the figures related to purchases in order to determine the cost of the merchandise that was sold during a given accounting period. The amount of inventory not sold - the inventory on hand at the end of an accounting period - is called the *ending inventory*. This year's inventory that is on hand at the end of the accounting period is simply the *beginning inventory* of the next accounting period. The amount of goods on hand at any one time is known as *merchandise inventory*. The cost of goods available for sale during the year is the sum of all the merchandise purchased during the accounting period, as well as the merchandise in inventory at the

The cost of goods available for sale is the sum of all the merchandise purchased, as well as merchandise inventory at the beginning of the period.

beginning of the period. To find out the cost of goods sold for the period, the ending inventory is subtracted from the goods available for sale. The following example with imaginary figures will help understand fully the concept of the cost of goods sold.

Example No. 3.02

Partial Income Statement: Cost of Goods Sold			
Year Ended December, 31			
Cost of Goods Sold:			
Merchandise Inventory, January, 1 (Opening balance)			Tk.275,000
Add: Purchases		Tk.987,000	
Add: Freight in	45,000		
Import Duty	<u>245,000</u>	<u>290,000</u>	
Gross Purchases		1,277,000	
Less: Purchase Returns & Allowances	60,000		
Purchase Discounts	<u>25,000</u>	<u>85,000</u>	
Net Purchase			<u>1,192,000</u>
Goods Available for Sale			1,467,000
Less: Merchandise Inventory, Dec. 31 (closing balance)			<u>1,22,000</u>
Cost of Goods Sold			<u><u>Tk.1,345,000</u></u>

3.2.9 Gross Profit on Sales

The difference between the net sales revenue and cost of goods sold is the *gross margin* or *gross profit*. The figure is highly important because all operating expenses are deducted from it to determine the *net income* of a merchandise enterprise. If a business is to earn a net income, the gross profit on sales must be large enough to cover the operating expenses and have a surplus.

Gross margin or gross profit is the difference between net sales revenue and cost of goods sold.

Lesson-3: Measuring Merchandising Inventory

Lesson Objectives

After you have studied this lesson, you will be able to:

- discuss the perpetual inventory system.
- narrate the periodic inventory system.
- explain the difference of entries between perpetual inventory system and periodic inventory system.

3.3.1 Introduction

The goods that a merchandising company sells to its customers are called inventory or merchandise. Either of the two approaches, viz., either (1) Perpetual inventory system or (2) Periodic inventory system may be used in accounting for merchandising transactions. However, most business especially large ones prefer perpetual inventory system. In this lesson, both the system will be examined covering relevant important aspects.

3.3.2 Measuring Merchandising Inventory

Merchandise inventory is the one account that appears on both the income statement and the balance sheet. As inventories in many businesses are relatively large and their sizes fluctuate, correct accounting for inventories is important in determining net income properly. Merchandising inventory measurement plays an important role in matching costs with revenues of the period. Other things being equal, changing the taka amount of ending inventory changes net income taka for taka (ignoring any income tax effects). There are two principal repetition systems of merchandise inventory accounting: (1) a *perpetual inventory system* and (2) a *periodic inventory system*. In past decades, both systems were in widespread use. Today, however, most large businesses (and many small ones) use perpetual systems. Periodic systems are used primarily in small businesses with manual accounting system. The effects of two merchandising inventory systems on the computation of the costs of merchandise will be discussed in this lesson.

Perpetual Inventory system and Periodic Inventory system are the two principal merchandise inventory accounting systems.

3.3.3 Perpetual Inventory System

Perpetual Inventory Method is a system of accounting for inventory in which detailed records of the number of units and the cost of each purchase and sales transactions is prepared on a day-to-day basis. The Perpetual Inventory System employs accounting records that continuously or perpetually disclose the amount of inventory on hand. Perpetually updating the inventory account requires (i) that at the time of purchase, merchandise acquisitions be recorded as debits to Inventory accounts, and (ii) that at the time of sale, the cost of goods sold be determined and recorded by debit to a Cost of Goods Sold account and a

credit to the Inventory account. A perpetual inventory system uses an *inventory subsidiary ledger*. This ledger provides company personnel with up-to-date information about each type of product that the company sells, including the per-unit cost and the number of units purchased, sold, and currently on hand. The accounting features of a perpetual inventory system are:

- i) Purchase of merchandise for resale is debited to Inventory rather than to Purchases.
- ii) Freight-in, purchase returns and allowances, and purchase discounts are recorded in Inventory rather than in separate accounts.
- iii) Cost of goods sold is recognized for each sale by debiting the Cost of Goods Sold, account, and crediting Inventory.
- iv) Inventory is a control account that is supported by a subsidiary ledger of individual inventory records. The subsidiary records show the quantity and cost of each type of inventory on hand.

Perpetual Inventory method eliminates the need to count inventory physically.

In theory, the perpetual inventory method should eliminate the need to physically count inventory. However, normal inventory shrinkage usually causes some discrepancies between the quantities of merchandise shown in the inventory records and the quantities actually on hand. *Inventory shrinkage* refers to unrecorded decrease in inventory resulting from such factors as evaporation, breakage, spoilage, employee theft, and shoplifting. In order to ensure the accuracy of their perpetual inventory records, most businesses take a complete physical count of the merchandise on hand at least once a year. Making a physical count of all merchandise on hand at the end of an accounting period is referred to as *taking a physical inventory*. After the inventory has been counted, the perpetual inventory records are adjusted, if necessary, to correct the balance in the Inventory account. For example, if the perpetual inventory record shows 5,450 units @ Tk.50 each on hand at December 31, but the physical count reveals 5,200 units, the adjusting entry to record the shortage is:

Cost of Goods Sold	Tk.12,500	
	Inventory	Tk.12,500

To adjust the perpetual inventory records to reflect the result of the year-end physical count.

3.3.4 Periodic Inventory System

A periodic inventory system is an alternative to a perpetual inventory system. Most companies rely on an actual count of goods on hand at the end of an accounting period to determine ending inventory and indirectly, the cost of goods sold. *Periodic inventory method* is a system of accounting for inventory in which the cost of goods sold is determined

and inventory is adjusted at the end of the accounting period, not when merchandise is purchased or sold.

Under a periodic system, the quantity of merchandise on hand is determined, as its name implies, only periodically. When merchandise is purchased during the accounting period, its cost is debited to an account entitled *Purchases*, rather than to *Inventory* account. When merchandise is sold, an entry is made to recognize sales revenue, but no entry is made to record the cost of goods sold or to reduce the balance of the inventory account. As the inventory records are not updated as transactions occur, there is no subsidiary ledger. The total in the purchases account at the end of the accounting period is added to the cost of beginning merchandise inventory of the period to determine the total cost of the goods available for sale. The cost of the ending merchandise inventory is deducted from goods available for sale to determine the cost of goods sold. The procedure for determining the ending merchandise inventory under the periodic inventory method can be summarized as follows:

In periodic inventory method, cost of goods sold is determined and inventory is adjusted at the end of the accounting period, not when merchandise is purchased or sold.

- i) Make a physical count of merchandise on hand at the end of the accounting period.
- ii) Multiply the quantity of each type of merchandise by its unit cost.
- iii) Add the resulting costs of each type of merchandise together to obtain a total.

This total is the ending merchandise inventory.

Note that under a periodic inventory system, the cost of goods sold is a residual amount that is dependent upon a physically counted ending inventory. The foundation of the periodic inventory system is the taking of a complete *physical inventory* at the year end or *taking the inventory* only at the end of the fiscal year.

The following entries demonstrate the recording procedure followed under perpetual inventory system, contrasted with the periodic system:

Journal Entries

Transactions	Perpetual Inventory System	Periodic Inventory System
1. Purchased merchandise worth Tk.60,000 on account, terms 2/10, n/30 (recorded at invoice price)	Inventory 60,000 Accounts Payable 60,000	Purchases 60,000 Accounts Payable 60,000
2. Returned Tk.2,000 worth of merchandise to vendors	Accounts Payable 2,000 Inventory 2,000	Accounts Payable 2,000 Purchase Returns and Allowance 2,000
3. Paid Tk.5,000 as freight costs on purchases	Inventory 5,000 Cash 5,000	Freight in 5,000 Cash 5,000
4. Paid for merchandise (discount taken)	Accounts Payable 58,000 Cash 57,840 Inventory 1,160	Accounts Payable 58,000 Purchase 57,840 Discounts 1,160

Transactions	Perpetual Inventory System	Periodic Inventory System
5. Sold goods costing Tk.35,000 for Tk.56,000 on account, terms 2/10, n/60.	i) Accounts Receivable 56,000 Sales 56,000 ii) Cost of Goods sold 35,000 Inventory 35,000	i) Accounts Receivable 56,000 Sales 56,000 ii) No entry cost for goods sold
6. Customer returned goods Tk.8,000 (sales price)	i) Sales Return & Allowances 8,000 Accounts Receivable 8,000 ii) Inventory 5,000 Cost of goods sold 5,000	i) Sales Returns & Allowances 8,000 Sales 8,000 ii) No entry for cost of goods returned.
7. Cash received on account (discount allowed)	Cash 47,040 Sales Discount 960 Accounts Receivable 48,000	Cash 47,040 Sales Discount 960 Accounts Receivable 48,000

Under perpetual inventory system, the inventory account is dynamic and under the periodic inventory system, the inventory account is static.

From the above entries, it is evident that, under the perpetual inventory system, the inventory account is **dynamic** - it changes every time the inventory changes. But under the periodic inventory system, the inventory account is **static** - it does not change until the closing entries are made.

Purchases

Under periodic inventory method, all purchases of merchandise for resale are debited to the Purchase account at the gross purchase price to determine the total cost of merchandise purchased during an accounting period. *Net purchases* consist of gross purchases less *purchase discounts* and *purchase returns and allowances* plus any *freight charges* on the purchases. For example, the net purchases of an organization can be computed as follows:

Example No. 3.03

Partial Income Statement		
For the Year Ended December 31, 2023		
Gross Purchases		Tk.632,500
Less: Purchase Returns and Allowances	Tk.28,250	
Purchase Discounts	10,680	38,930
		593,570
Add: Freight-in		41,180
Net purchases		Tk.634,750

Operating Expenses

Operating expenses are expenses that arise from the normal activities of a business. These expenses make up the third major part of the income statement for a merchandising company. The operating expenses are generally grouped into two categories: (i) *Selling Expenses*, and (ii) *General and Administrative Expenses*. The selling expenses include all

expenses that are directly related to the sale and delivery of goods, such as sales salaries, displaying, advertising, freight out, store supplies expenses, insurance expenses (selling), etc. On the other hand, general and administrative expenses cover office salaries, office supplies, insurance (general), depreciation, rent, and other expenses that are necessary to the conduct of the business operations but are not directly connected with the sale and delivery of inventory.

Net Income or Net Loss

Net income or *net loss* is the famous "bottom line" on an income statement – the remainder after all expenses have been deducted from revenue. *Net income* measures the amount by which the increase in assets exceeds the revenue. On the other hand, a *net loss* means that the value of the assets used exceeds the revenues. In essence, net income is one measure of the wealth created by an organization during the accounting period.

Net income measures the amount by which the increase in assets exceeds the revenue.

Lessons-4, 5 and 6: Preparing Financial Statements

Lesson Objectives

After you have studied these lessons, you should be able to:

- explain the nature of income statement.
- discuss the single step income statement.
- narrate the multiple steps income statement.
- describe statement of retained earning.
- define the balance sheet.
- prepare financial statements.

3.4.1 Introduction

Many variations are possible in the general format of the principal parts of financial statements, in the terminology employed, and the extent to which details are presented. In this lesson, the forms or formats most frequently used are described and illustrated.

3.4.2 Income Statement

Income statement summarizes the revenues and expenses of a business entity for a specified accounting period.

The income statement is a report that measures the success of an enterprises operations for a given period of time. An income statement summarizes the revenue and expenses of a business entity for a specified accounting period. This statement is alternatively referred to as a statement of income, statement of earnings, or statement of operations. It is recognized to be the most important financial statement in the annual report. The heading of an income statement contains the name of the firm (WHO), the name of the statement, and the accounting period covered by the statement. The *revenue section* of the statement is prepared first. The *expenses section* of the income statement is prepared next. Determining the *net income* or *net loss* for the period is the last step in preparing the income statement. If the firm has more revenue than expenses, a net income is reported for the period. If the firm has more expenses than revenue, there is a loss.

Several alternative formats exist for reporting the individual revenues, expenses, gains, and losses that enter into the determination of income from continuing operations. We shall discuss the two distinct formats that dominate in practice the *single step format* and the *multiple-step format*.

3.4.3 Single Step Income Statements

In reporting revenues, gains, expenses, and losses, many accountants prefer a format known as the single-step income statement. It is the simpler type of income statement that lists all the revenues in one section and all expenses in another section. It is known as a *single-step income statement* because only one step is involved in arriving at net income. Expenses and losses are subtracted from revenues and gains to determine

net income or loss. The expression "single-step" is derived from the single subtraction necessary to arrive at net income. The main advantage of single-step income statement lies in the simplicity and flexibility of presentation and the absence of any implication that certain items of revenue or expense have priority over others.

As example 3.04 illustrates, this statement format matches total expenses against revenues to determine the net income or loss from continuing operations for the period.

In single step income statement format only one step is involved to arrive at net income.

Example No. 3.04 Exhibits the Single-Step Income Statement of Surovi Company.

SUROVI COMPANY

Income Statement

For the Year Ended December 31, 2023

Revenues and Gains		
Net Sales	Tk.3,975,000	
Interests	25,500	
Dividends	127,500	
Rent	<u>72,000</u>	
<i>Total Revenues & Gains</i>		Tk.4,200,000
Expenses and losses		
Cost of Goods Sold	2,500,000	
Selling Expenses	250,000	
Administrative Expenses	500,000	
Interest	150,000	
Income Taxes	95,000	
Loss on Sale of Securities	<u>55,000</u>	
Total Expenses and Losses		<u>3,550,000</u>
Net Income		<u><u>Tk.650,000</u></u>

3.4.4 Multiple-Step Income Statements

Some accountants contended that additional sub-classifications of revenue and expenses make the income statement more informative and advocated a multiple-step format of income statement. Example no. 3.05 and 3.06 are illustrations of *multiple-step income statement*. An advantage of this format is that it provides for a number of subtotals that are not shown in a single-step income statement. For example, cost of goods sold is deducted from net sales to obtain a gross profit on sales. A comparison of period-to-period gross profit rates is a useful measure in assessing performance and in predicting future cash flows from the sale of products. Separate identification of operating income is also useful for predictive purposes because of its recurring nature. A separation of non-operating activities of the company such as non-operating revenues,

Non-operating activities such as non-operating revenues, expenses, gains, and losses are reported on a multiple-step format.

expenses, gains, and losses are reported in a multiple-step format. A classification of expenses by functions, such as merchandising (cost of goods sold), selling, and administration permits immediate comparison with costs of previous years and with the cost of other departments during the same year. Accountants who show additional relationships in the operating data favor what is called a *multiple-step income statement*. Regardless of the particular format a company adopts, it is important to maintain consistency from year to year, because users of financial statements need comparative data.

Example No. 3.05 Exhibits the **Multiple-Step Income Statement** of Eastern Company with imaginary figures:

EASTERN COMPANY			
Income Statement			
For the Year Ended December 31, 2023			
Sales Revenue			
Sales			Tk.7,500,000
Less: Sales Return and Allowances		Tk.5,000	
Sales Discounts		45,000	50,000
Net Sales			7,450,000
Cost of Goods Sold			
Inventory, January 1 (beginning balance)		2,225,000	
Add: Purchases	Tk.3,785,000		
Less: Purchases Returns & Allowances	5,500		
Purchases Discounts	<u>9,500</u>	15,000	
		3,770,000	
Add: Transportation in		<u>85,000</u>	
Net purchases		3,855,000	
Cost of Goods Available for Sales		6,080,000	
Less: Inventory, December 31, (Ending bal.)		<u>270,000</u>	
Cost of Goods Sold			Tk.5,810,000
Gross Profit on Sales			1,640,000
Operating Expenses			
<i>Selling Expenses</i>			
Sales Salaries		135,000	
Advertising		150,000	
Delivery Expenses		25,000	
Insurance, selling		70,000	
Telephone		60,000	
Depreciation		<u>75,000</u>	

Total Selling Expenses	515,000	
<i>Administrative Expenses</i>		
Office Salaries	200,000	
Rent	50,000	
Insurance, General	65,000	
Depreciation, Building	25,000	
Depreciation, Equipment	<u>35,000</u>	
Total Administrative Expenses	<u>375,000</u>	
Total Operating Expenses		<u>Tk.890,000</u>
Net Income		<u>Tk.750,000</u>

Example No. 3.06 Multiple-Step Income Statement of Mahbub Company with imaginary figures:

MAHBUB CORPORATION			
Income Statement			
For the Year Ended December 31, 2023			
Sales Revenue			
Sales			Tk.6,250,000
Less: Sales Returns and Allowances		Tk.45,000	
Sales Discounts		<u>105,000</u>	<u>150,000</u>
Net Sales			6,100,000
Cost of Goods Sold			
Inventory, January 1		850,000	
Purchases	Tk.4,215,000		
Less: Purchases Returns & Allowances	Tk.12,500		
Purchases Discounts	<u>6,500</u>	<u>19,000</u>	
		<u>Tk.4,196,000</u>	
Add: Transportation-in		<u>84,000</u>	
Net purchases		<u>4,280,000</u>	
Merchandise available for Sales		5,130,000	
Less: Inventory, December 31		<u>950,000</u>	
			<u>4,180,000</u>
Gross Profit on Sales			Tk.1,920,000
Operating Expenses			
<i>Selling Expenses</i>			
Sales salaries	225,000		
Sales Commission	200,000		
Advertising	75,000		
Transportation-out	125,000		
Postage & Stationary	<u>45,000</u>		

School of Business

Telephone and Fax	60,000		
Insurance, Selling	40,000		
Depreciation, Selling Equipment	80,000	850,000	
<i>Administrative Expenses</i>			
Officers' Salaries	350,000		
Office Salaries	120,000		
Legal Expenses	50,000		
Insurance, General	45,000		
Utilities Expenses	65,000		
Stationary & Postage	10,000		
Depreciation, Building	35,000		
Depreciation, Office Equipment	45,000	720,000	1,570,000
Income from Operations			350,000
Other Revenues and Gains			
Dividend revenue		185,000	
Rental revenue		135,000	
Interest revenue		120,000	440,000
			790,000
Other Expenses and Losses			
Interest on debentures		115,000	
Loss on sale of equipment		125,000	240,000
Income before Income Tax			550,000
Income tax			110,000
Net income for the year			Tk.440,000
Earning per common share (200,000 shares of Tk.10.00 each)			Tk.2.20

3.5 The Statement of Retained Earnings

The statement of retained earnings is a formal summary of the debits and the credits to the retained earnings accounts from the beginning to the end of the year. It is one of the principal statements included in published financial reports that presents an analysis of the retained earnings account for the accounting period. Retained earnings is the amount of an enterprise earnings which have not been returned to shareholders as dividends. The statement summarizes the increases and decreases in retained earnings resulting from the business operations for the period. This final section links the period's income statement to the beginning of-the-period and end-of-the period balance sheets by completing two balance sheets snapshots. Sometimes this statement is called a *reconciliation of retained earnings*. The statement begins with the retained earnings balance at the beginning of the accounting period. Next, the net income for the period is added (or net loss subtracted), and any dividends declared during the period are deducted. This short computation determines the amount of retained earnings at the end of the

Retained earning is the amount of an enterprise earnings which have not been returned to shareholders as dividends.

accounting period. This statement is prepared to assist in the assessment of overall performance by providing additional information on why net assets increased or decreased during the period. An example of a retained earnings statement is as follows:

Example No. 3.07

Uttara Ltd.		
Statement of retained Earnings		
For the Year Ended December 31, 2023		
Retained Earning January 1		Tk.445,500
Add: Net income for the year		327,500
		<u>773,000</u>
Deduct dividends declared on:		
Preference stock, at Tk.6.00 per share	Tk.120,000	
Common stock at Tk.8.00 per share	<u>160,000</u>	280,000
Retained earnings December 31		<u><u>Tk.493,000</u></u>

3.6 The Balance Sheet

The *balance sheet*, also commonly known as the *statement of financial position*, is a summary of assets, liabilities, and owners' equity accounts and their related account balances at a specific date. The balance sheet presents information based on the basic accounting equation, $\text{Assets} = \text{Liabilities} + \text{Owners' equity}$. It is referred to as a balance sheet because total assets equal the total liabilities and owners' equity. The balance sheet exhibits an organization's economic resources (assets) and the sources of, or claims against those resources (liabilities and owners' equity) at the statement date. The information contained in the balance sheet can be viewed as a still photograph of a dynamic process. In short, balance sheet shows the amounts of the company's assets, liabilities, and owners' equity at a particular date. The balance sheet is a primary source of information about a *company's economic resources, obligations, and owners' equity*. In addition to providing information on liquidity and financial flexibility, the balance sheet is useful in assessing a *company's profitability and efficiency*. The presentation of balance sheet information meets one of the objectives of financial reporting to provide information about enterprise resources, claims to resources, and changes in them.

Balance Sheet, also known as the statement of financial position, is a summary of assets, liabilities, and owners' equity.

As we have noted, a balance sheet summarizes the balances of assets, liabilities, and owners' equity accounts. These accounts are grouped together in classes to assist users. Setting up sub-categories within the major categories will often make the financial statements much more useful. Investors and creditors often study and evaluate the relationship among the subcategories. When general-purpose external financial statements are divided into useful categories, they are called *classified* financial statements. The assets of a company are generally divided into four categories: (i) current assets, (ii) investments, (iii) property, plant,

In Financial Statement assets are generally divided into four categories and liabilities into two categories.

and equipment, and (iv) intangible assets. Some companies use a fifth category called other assets if there are miscellaneous assets that do not fall into any other groups. Liabilities are divided into two categories: (i) current liabilities, and (ii) long-term liabilities. Example no. 3.08 is a *classified balance sheet* that shows subdivisions that most companies have in general with imaginary figures. The subdivisions under owners' equity, of course, depend on the form of business.

Example No. 3.08 Classified Balance Sheet

Uttara Ltd.			
Balance Sheet			
As on December 31, 2023			
<u>Assets</u>			
Current Assets			
Cash		Tk.25,000	
Notes Receivable		20,000	
Accounts Receivable		75,000	
Merchandise Inventory		225,000	
Office Supplies		30,000	
Prepaid Insurance		15,000	
Prepaid Expenses		10,000	
Total Current Assets			Tk.400,000
Investments [Long Term]			
Investments in Padma Co.		250,000	
Land held for future		300,000	
Total Investment			550,000
Property, Plant, and Equipment			
Land		225,000	
Building	Tk.530,000		
Less: Accumulated Depreciation	<u>210,000</u>	320,000	
Delivery Equipment	215,000		
Less: Accumulated Depreciation	<u>85,000</u>	130,000	
Total Property, Plant, & Equipment			675,000
Intangible Assets			
Trade Mark		55,000	
Goodwill		40,000	
Total Intangible Assets			95,000
Total Assets			<u>Tk.1,720,000</u>

Liabilities and Stockholders' Equity

Current Liabilities

Note Payable	85,000
Accounts Payable	135,000
Accrued Salaries, Wages	40,000

Accrued Interest	30,000	
Income Tax Payable	<u>35,000</u>	
Total Current Liabilities		325,000
Long-Term Liabilities	<u>200,000</u>	
Total Liabilities		525,000
<u>Stockholders' Equity</u>		
Common Stock	1,000,000	
Retained Earnings	<u>195,000</u>	
Total Stockholders' Equity		<u>1,195,000</u>
Total Liabilities & Stockholders' Equity		<u><u>Tk.1,720,000</u></u>

Worked Example No. 3-1

From the following trial balance and additional information prepare: (a) multiple-step income statement, (b) a retained earning statement and (c) a classified balance sheet. The periodic inventory system is in use.

R. Sultana & Company

Trial Balance

December 31, 2023

Account Titles	Dr.	Cr.
Cash	Tk.10,000	
Accounts Receivable	50,000	
Notes Receivable	15,000	
Merchandise Inventory, January 1, 2023	125,000	
Purchase	750,000	
Sales		Tk.1,500,000
Purchase Returns & Allowances		10,000
Purchase Discounts		25,000
Sales Returns & Allowances	45,000	
Sales Discount	35,000	
Land & Building	650,000	
Fixtures	225,000	
Accumulated Depreciation-Land & Building		150,000
Accumulated Depreciation-Fixtures		100,000
Office Supplies	15,000	
Marketable Securities	45,000	
Delivery Equipment	200,000	
Notes Payable		40,000
Accounts Payable		75,000
Mortgage Payable		50,000
Transportation-in	20,000	

Officers' Salaries	110,000	
Office Salaries	60,000	
Sales Salaries	80,000	
Advertising	60,000	
Delivery Expenses	50,000	
Utilities Expenses	15,000	
Rent Expenses	30,000	
Dividend Income		30,000
Investment in Uttara Co.	100,000	
Dividends	100,000	
Common stock		600,000
Retained Earnings, January 1, 2023		215,000
Interest	5,000	
	<u>2,795,000</u>	<u>2,795,000</u>

Additional Information:

1. A physical inventory of merchandise on hand at December 31, 2023 showed goods worth Tk.120,000.
2. Office supplies unused on December 31, estimated to Tk.5,000.
3. Interest accrued on investment Tk.7,000.
4. Land and Building is to be depreciated @ 5% p.a.
5. Interest on Mortgage due Tk.5,000.
6. Depreciate Fixtures @ 10% and Delivery Equipment @ 15%.
7. Accrued expenses: Officers' salaries Tk.10,000 Office salaries Tk.5,000 and Delivery expenses Tk.15,000.

Solution to Worked Example 3-1

R. Sultana & Co.			
Income Statement			
For the Year Ended December 31, 2023			
Sales Revenue			
Sales			Tk.1,500,000
Less: Sales Returns & Allowances	Tk.45,000		
Sales Discounts	35,000		80,000
Net Sales			<u>1,420,000</u>
Cost of Goods Sold			
Merchandise Inventory, January 1, 2023	125,000		
Purchases	Tk.750,000		
Less: Purchases Returns & Allowances	Tk.10,000		
Purchase Discounts	<u>25,000</u>	<u>35,000</u>	
Cost of Goods Purchased	715,000		
Add: Transportation-in	<u>20,000</u>		
Net purchases		<u>735,000</u>	
Cost of Goods Available for Sale		860,000	
Less: Merchandise Inventory Dec. 31, 2023		<u>120,000</u>	
Cost of Goods Sold			<u>740,000</u>
Gross Profit on Sales			Tk.680,000
Operating Expenses			
<i>Selling & Distribution Expenses</i>			
Sales Salaries	Tk.80,000		
Advertising	60,000		
Delivery Expenses	50,000		
Add: Accrued	<u>15,000</u>	65,000	
Depreciation: Fixtures		22,500	
Depreciation: Delivery Equipment	<u>30,000</u>		
Total Selling Expenses		257,500	
<i>General & Administrative Expenses</i>			
Officers' Salaries	110,000		
Add: Due	<u>10,000</u>	120,000	
Office Salaries	60,000		
Add: Due	<u>5,000</u>	65,000	
Office supplies	15,000		
Less: Unused	<u>5,000</u>	10,000	
Utilities Expenses		15,000	
Rent Expense		30,000	
Depreciation: Land & Building	<u>32,500</u>		
Total General & Administration Expenses		<u>272,500</u>	
Total Operating Expenses			<u>Tk.530,000</u>
Income from Operations			Tk.150,000
Add: Non-operating Revenues			
Dividend Income	30,000		
Interest on Investment	7,000		37,000
Less: Non-operating Expenses			<u>Tk.187,000</u>
Interest on Mortgage	5,000		
Add: Due	<u>5,000</u>		10,000
Net Income			<u>Tk.177,000</u>

R. Sultana & Co. Statement of Retained Earnings For the Year Ended December 31, 2023	
Retained Earnings	Tk.215,00
Add: Net income for the year	177,000
	392,000
Less: Dividends	100,000
Retained Earnings December 31, 2023	<u>Tk.292,000</u>

R. Sultana & Co. Balance Sheet As on December 31, 2023	
--	--

<u>Assets</u>	
Current Assets	
Cash	Tk.10,000
Notes Receivable	15,000
Accounts Receivable	50,000
Marketable Securities	45,000
Merchandise Inventory	120,000
Office supplies	5,000
Interest Accrued	7,000
Total Current Assets	Tk.252,000
Investments	
Investment in Uttara Co.	100,000
Property, Plant and Equipment	
Land and Building	Tk.650,000
Less: Accumulated Depreciation (150,000+32,500)	182,500
	467,500
Fixtures	225,000
Less: Accumulated Depreciation (100,000+22,500)	<u>122,500</u>
	102,500
Delivery Equipment	200,000
Less: Accumulated Depreciation	30,000
	<u>170,000</u>
Total Property, Plant, & Equipment	<u>740,000</u>
Total Assets	<u><u>Tk.1,092,000</u></u>

Liabilities & Stockholders' Equity**Current Liabilities**

Notes Payable	Tk.40,000
Accounts Payable	75,000
Interest on Mortgage Due	5,000
Accrued Officers' Salaries	10,000
Accrued Office Salaries	5,000
Accrued Delivery Expenses	15,000

Total Current Liabilities	Tk.150,000
---------------------------	------------

Long-Term Liabilities

Mortgage Payable	50,000
------------------	--------

Stockholders' Equity

Common Stock	600,000
Retained Earnings	292,000

Total Stockholders' Equity	892,000
----------------------------	---------

Total Liability & Stockholders' Equity	Tk.1,092,000
--	--------------

Worked Example No. 3-2

The adjusted trial balance Eastern Ltd. as on December 31, 2023 contains the following information:

Cash	Tk.60,000
Accounts Receivable	210,000
Accounts Payable	256,200
Bonds Payable	420,000
Marketable Securities	300,000
Notes Receivable	30,000
Notes Payable	210,000
Mortgage Payable	120,000
Office Equipment	360,000
Accumulated Depreciation–Office Equipment	45,000
Taxes Payable	75,000
Common Stock	450,000
Office Salaries	39,000
Sales Salaries	144,000
Telephone	30,000
Sales Supplies	45,000
Utility Expenses–Selling	30,000
Postage	36,000

School of Business

Loss on disposal of Equipment	14,100
Cost of Goods Sold	960,000
Dividends	60,000
Sales	1,820,000
Sales Returns & Allowances	45,000
Sales Discounts	27,000
Advertising	63,000
Income Tax	75,000
Accrued Expenses	6,000
Prepaid Expenses	60,000
Goodwill	260,000
Retained Earnings (January 1, 2023)	105,000
Merchandise Inventory	150,000
Delivery Equipment	150,000
Accumulated Depreciation — Delivery Equipment	60,000
Interest Expenses	9,600
Gain on sale of Equipment	36,900
Depreciation—Office Equipment	45,000
Interest Revenue	28,500
Freight—out	36,000
Rent Expenses	72,000
Miscellaneous Expenses	9,000
Patents	165,000
Trade marks	90,000
Utilities Expenses —office	18,000
Casualty loss from vandalism	900
Insurance Expenses	24,000
Depreciation-Delivery Equipment	15,000

Prepare a multiple-step income statement, a retained earnings statement and a classified balance sheet.

Solution to Worked Example 3-2:

EASTERN LTD.			
Income Statement			
For the Year Ended December 31, 2023			
Sales Revenue			
Sales			Tk.1,820,000
Less: Sales Returns & Allowances	Tk.45,000		
Sales Discounts	27,000	72,000	

Net Sales		1,748,000	
Cost of Goods Sold		<u>960,000</u>	
Gross Profit			Tk.788,000
Operating Expenses			
<i>Selling and Distribution Expenses</i>			
Sales Salaries	Tk.144,000		
Sales Supplies	45,000		
Utility Expenses—Selling	30,000		
Depreciation-Delivery Equipment	15,000		
Advertising	63,000		
Freight out	<u>36,000</u>		
Total Selling Expenses		333,000	
<i>Administrative Expenses</i>			
Office Salaries	39,000		
Telephone	30,000		
Postage	36,000		
Depreciation-Office Equipment	45,000		
Rent Expenses	72,000		
Utility Expenses-Office	18,000		
Insurance	24,000		
Miscellaneous Expenses	<u>9,000</u>		
Total Administrative Expenses		<u>273,000</u>	
Total Operating Expenses			<u>Tk.606,000</u>
Income from Operations (Operating Income)			Tk.182,000
Other Revenues & Gains			
Interest Revenue	28,500		
Gain on Sales Equipment	<u>36,900</u>	65,400	
Other Expenses & Losses			
Interest Expenses	9,600		
Casualty loss from vandalism	900		
Loss on Disposal of Equipment	<u>14,100</u>	<u>24,600</u>	
Net Other Gains			<u>40,800</u>
Net Income before Tax			<u>222,800</u>
Less: Income Tax			<u>75,000</u>
Net Income after Tax			<u><u>Tk.147,800</u></u>

EASTERN LTD.
Statement of Retained Earnings

 For the Year Ended December 31, 2023

Retained Earnings, January 1, 2023	Tk.105,000
Add: Net Income	<u>147,800</u>
	252,800
Less: Dividends	<u>60,000</u>
Retained Earnings, December 31, 2023	<u><u>Tk.192,800</u></u>

EASTERN LTD.			
Balance Sheet			
As on December 31, 2023			
<u>Assets</u>			
Current Assets			
Cash		Tk.60,000	
Marketable Securities		300,000	
Accounts Receivable		210,000	
Notes Receivable		30,000	
Merchandise Inventory		150,000	
Prepaid Expenses		<u>60,000</u>	
Total Current Assets			Tk.810,000
Plant and Equipment			
Office Equipment	Tk.360,000		
Less: Accumulated Depreciation	<u>45,000</u>	315,000	
Delivery Equipment	150,000		
Less: Accumulated Depreciation	<u>60,000</u>	<u>90,000</u>	
Total Plant and Equipment			405,000
Intangible Assets:			
Goodwill		Tk.260,000	
Patents		165,000	
Trade Marks		<u>90,000</u>	
Total Intangible Assets			<u>515,000</u>
Total Assets			<u><u>Tk.1,730,000</u></u>
<u>Liabilities</u>			
Current Liabilities			
Notes Payable		Tk.210,000	
Accounts Payable		256,200	
Taxes Payable		75,000	
Accrued Expenses		<u>6,000</u>	
Total Current Liabilities			<u><u>Tk.547,200</u></u>
Long-Term Liabilities:			
Bonds Payable		420,000	
Mortgage Payable		<u>120,000</u>	
Total Long-term Liabilities			540,000
<u>Stockholders' Equity</u>			
Common Stock		450,000	
Retained Earnings		<u>192,800</u>	
			<u>642,800</u>
Total Liabilities & Stockholders' Equity			<u><u>Tk.1,730,000</u></u>

Worked Example No. 3-3

From the following information prepare, in good form, an income statement for Jamuna Ltd. for the year ended December 31, 2023. Assume that there are 250,000 shares of stock outstanding.

Gross Sales Revenue	Tk.45,000,000
Sales Returns and Allowances	250,000
Sales Discounts	350,000
Flood Loss	400,000
Income Taxes on Operations	2,500,000
Administrative Salaries	1,800,00
Sales Salaries	4,000,000
Rent (General and Administrative)	160,000
Utilities Expenses (General and Administrative)	20,000
Supplies Expenses (General and Administrative)	80,000
Delivery Expenses	131,500
Payroll Tax (Selling)	30,000
Automobile Expenses (General and Administrative)	19,000
Advertising	1,990,000
Insurance (General and Administrative)	170,000
Interest Revenue	30,000
Interest Expenses	460,000
Insurance (Selling)	35,000
Entertainment (Selling)	36,000
Dividend Revenue	100,000
Miscellaneous Selling Expenses	75,000
Miscellaneous Expenses (General and Administrative)	54,000
Tax rate applicable to flood loss	30%
Cost of Goods Sold	29,750,000

Solution to Worked Example 3-3

Jamuna Ltd.			
Income Statement			
For the Year Ended December 31, 2023			
Sales Revenue			
Gross Sales Revenue			Tk.45,000,000
Less: Sales Returns & Allowances	Tk.250,000		
Sales Discounts	350,000		600,000
Net Sales Revenue			44,400,000
Goods sold			29,750,000
Gross Profit on Sales			14,650,000
Operating Expenses			
<i>Selling Expenses</i>			
Sales Salaries	Tk.4,000,000		
Advertising	1,990,000		
Delivery Expenses	131,500		
Payroll Tax	30,000		
Insurance	35,000		
Entertainment	36,000		
Miscellaneous	75,000		
Total Selling Expenses		6,297,500	
<i>General and Administrative Expenses</i>			
Administrative Salaries	Tk.1,800,000		
Utilities Expenses	20,000		
Automobile Expenses	19,000		
Rent	160,000		
Supplies	80,000		
Insurance	170,000		
Miscellaneous Expenses	54,000		
Total General and Administrative Expenses		2,303,000	
Total Operating Expenses			Tk.8,600,500
Operating Income			6,049,500
Other Revenues & Expenses			
Interest Revenue	30,000		
Dividend Revenue	100,000	130,000	
Other Expenses			
Interest Expenses		460,000	
Net other Expenses/Non-operating Income (Loss)			<u>Tk.(330,000)</u>
Income from Operations before Taxes			5,719,500
Less: Income Tax on operations			2,500,000
Net Income before Extra Ordinary item			3,219,500
Extra Ordinary item:			
Flood loss		(400,000)	
Income Tax effect (30%)		120,000	280,000
Net Income after Tax			<u>(Tk.2,939,500)</u>
Earnings per Share:			
Before Extra-Ordinary item	Tk.12.88	(Tk.3,219,500 ÷ 250,000 shares)	
Extraordinary Loss	<u>Tk.1.12</u>	(Tk.280,000 ÷ 250,000 shares)	
Net Income	<u>Tk.11.76</u>	(Tk.2,939,500 ÷ 250,000 shares)	

Worked Example No. 3.4

Presented below are a number of balance sheet items for Shanta Ltd. for the year 2023.

Cash	Tk.849,700
Marketable Securities	565,000
Merchandise Inventory	9,794,260
Investment in Padma Co.	1,750,000
Land at Cost	2,500,000
Accounts Receivable	3,316,480
Allowances for Doubtful Accounts	37,000
Notes Receivables	460,000
Notes Payable	1,000,000
Supplies on hand	195,600
Prepaid Expenses	325,040
Building at cost	19,516,000
Accumulated Depreciation–Building	6,824,000
Accounts Payable	3,950,640
Plant at cost	3,250,000
Accumulated Depreciation–Plant	1,250,000
Investment in Jamuna Co.	1,250,000
Income Taxes Payable	1,260,400
Goodwill	3,500,000
Accrued Salaries & others	198,400
Retained Earnings	3,251,640
15% Debentures	10,000,000
Long-Term Bank Loan	1,500,000
7% Cumulative Preference Stock	8,000,000
Common Stock	10,000,000

Required:

Prepare a classified balance sheet in good form, Common Stock issued and outstanding 100,000 shares of Tk.100 each and 7% Preference Stock authorized, issued and outstanding 80,000 shares of Tk.100 each.

Solution to Worked Example 3-4

Shanta Ltd. Balance Sheet As on December 31, 2023			
<u>Assets</u>			
Current Assets			
Cash		Tk.849,700	
Marketable Securities		565,000	
Notes Receivable		460,000	
Accounts Receivable	Tk.3,316,480		
Less: Allowances for			
Doubtful Accounts	<u>37,000</u>	3,279,480	
Merchandise Inventory		9,794,260	
Supplies on hand		195,600	
Prepaid Expenses		<u>325,040</u>	
Total Current Assets			Tk.15,469,080
Long-term Investments			
Investment in Padma Ltd.		1,750,000	
Investment in Jamuna Co.		<u>1,250,000</u>	
Total Long-term Investment			Tk.3,000,000
Property Plant & Equipment			
Land at cost		2,500,000	
Building at cost	Tk.19,516,000		
Less: Accumulated Depreciation	<u>6,824,000</u>	12,692,000	
Plant at cost	<u>3,250,000</u>		
Less: Accumulated Depreciation	<u>1,250,000</u>		
		<u>2,000,000</u>	
Total Property, Plant, & Equipment			Tk.17,192,000
Intangible Assets			
Goodwill			<u>Tk.3,500,000</u>
Total Assets			<u><u>Tk.39,161,080</u></u>
<u>Liabilities & Stockholders' Equity</u>			
Current Liabilities			
Notes Payable		1,000,000	
Accounts Payable		3,950,640	
Income Taxes Payable		1,260,400	
Accrued Salaries and others		<u>198,400</u>	
Total Current Liabilities			Tk.6,409,440
Long-term Liabilities			
15% Debentures		10,000,000	
Long-Term Bank Loan		<u>1,500,000</u>	
Total Long-term Loan			<u>Tk.11,500,000</u>
Total Liabilities			<u>Tk.17,909,440</u>
Stockholders' Equity			
<i>7% Cumulative Preference Stock-</i>			
Authorized, issued & outstanding			
80,000 shares of Tk.100 each		8,000,000	
<i>Common Stock-</i>			
Issued & outstanding			
100,000 shares of Tk.100 each		<u>10,000,000</u>	
		18,000,000	
Retained Earnings		<u>3,251,640</u>	
Total Stockholders' Equity			<u>Tk.21,251,640</u>
Total Liabilities & Stockholders Equity			<u><u>Tk.39,161,080</u></u>

Questions and Exercises

Self-Test Questions

1. Two basic approaches as to accounting for inventory and the cost of goods sold are the perpetual inventory system and periodic inventory system. Indicate which of the following statement/statements are correct?
 - (a) Most large merchandising and manufacturing business use periodic inventory system.
 - (b) A grocery store or departmental store could not maintain a perpetual inventory system without the use of point of sale terminals.
 - (c) In a periodic inventory system the cost of goods sold cannot be determined until a complete physical inventory is taken.
 - (d) In a perpetual inventory system the cost of goods sold account is debited promptly for the cost of merchandise sold.
2. ABC Ltd. uses perpetual inventory system. The company sells merchandise costing Tk.30,000 at a price of Tk.43,000. In recording this transactions which of the entry/entries will be made by the company.
 - (a) Credit sales Tk.43,000 (b) Credit inventory Tk.43,000 (c) Debit cost of goods sold Tk.30,000 (d) Debit Income Statement by Tk.13,000 (e) Credit one or more accounts in the inventory subsidiary ledger for amounts totaling Tk.30,000.
3. The net income of XYZ Ltd. was 400,000 in 1998 & 160,000 in 1999. What percentage increase in net income must the company achieve in 2000 to offset the decrease in profits in 1999?
 - (a) 60% (b) 150% (c) 600% (d) 76% (e) %
4. The Income Statement is which total of all expenses are deducted from the total of all revenue is called:
 - (a) Multiple step form (b) Account form (c) Report form (d) Single step form.
5. After all the income statement accounts of a corporation have been closed to income summary, the income summary account is closed to:
 - (a) Capital Stock (b) Retained Earning (c) Sales (d) Purchase.

Discussion Questions

1. What are the three primary activities of most business?
2. Why is it important to have separate accounts for Sales Returns and Allowances and Sales Discounts? Would not it be much easier

to directly reduce the Sales Revenue account for these adjustments?

3. Distinguish between a multiple-step, and a single-step income statement. Which format results in the higher amount of net income?
4. Distinguish between operating income and net income.
5. Why might earnings per share be more significant to a stockholder in a large corporation than the total amount of net income?
6. What is meant by gross-profit on sales, and of what significance is this item to management?
7. What is importance of the income statement? What are its major limitations?
8. What are the advantages and disadvantages of the single-step income statement?
9. Define the terms 'revenues' and 'expenses'.
10. What is the difference between accumulated depreciation and depreciation expenses?
11. Why are contra accounts used in recording depreciation?
12. What is an accrued expenses? Give three examples.
13. What major types of items are reported in the retained earnings statement?
14. What is contra account? Give example.
15. Why is the income statement usually the first statement prepared from the trial balance?

Exercises

- 3.01** From the following information prepare a single-step and multiple-steps income statement for Raymond Company for the year ended 20××.

Purchases	Tk. 86,000
Sales	207,000
Transportation in	5,000
Purchase Discounts	3,000
Merchandise Inventory (January, 1)	75,000
Merchandise Inventory (December, 31)	45,000
Purchase Returns & Allowances	2,500
Sales Returns and Allowances	4,500
Transportation-out	1,500
Rent Expenses	5,000
Sales Salaries	35,000
Sales Discounts	2,000

Depreciation–office Equipment	5,000
Office Supplies Expenses	1,000
Office Salaries	7,500
Depreciation–Delivery Van	8,000
Utilities–Selling	3,500
Advertising	4,000
Insurance–Selling	1,500
Sales Salaries	6,000

3.02 Two accountants are arguing about the merits of presenting an income statement in a multiple-step versus at single-step format. The discussion involves the following 2023 information related to Far East Company:

Purchases	Tk.250,000
Purchase Returns	12,000
Office Salaries	10,000
Depreciation-Office Equipment	14,500
Sales	425,000
Rental Revenue	36,000
Transportation-out	5,000
Sales Commission	30,500
Depreciation-Sales Equipment	15,000
Merchandise Inventory - Beginning	60,000
Merchandise Inventory - Ending	35,000
Transportation-in	6,000
Income Tax	27,000
Interest Expenses	3,000

Required:

- i) Prepare an income statement for the year 2023 using the multiple-step format.
- ii) Prepare an income statement for the year 2023 using single-step format.
- iii) Which one do you prefer? Discuss.

3.03 The following balances are extracted from the books of Western Ltd. at December 31, 2023:

Net Sales	Tk.6,500,000
Cost of Goods Sold	3,800,000
Selling Expenses	350,000
Administrative Expenses	225,000
Dividend Revenue	105,000

Interest Revenue	40,000
Write off inventory due to obsolescence	300,000
Depreciation expenses omitted by accident in 2022	200,000
Flood Damage before Taxes	300,000
Dividend Declared	250,000
Retaining Earnings at December 31, 2022	
Tax Rate is 40%	8,500,000

Required:

- i) Prepare a multiple-step income statement for 2023.
- ii) Prepare a statement of retained earnings for 2023.

3.04 Presented below are certain account balances of K. Rahman & Co. at December 31, 20xx.

Sales	Tk.750,000
Sales Discount	5,000
Sales Returns & Allowances	12,000
Purchases	250,000
Purchase Returns & Allowances	4,500
Purchase Discounts	2,000
Freight in	15,000
Sales Salaries	125,000
Sales Supplies	2,500
Rent-Selling	24,000
Utility Expenses–Selling	15,000
Advertising	30,000
Depreciation on Fixtures–Selling	14,500
Office Salaries	60,000
Office Supplies	3,500
Rent–Office	6,000
Depreciation–Office Equipment	5,000
Utility–Office	4,000
Postages	1,000
Insurance	4,500
Miscellaneous	6,000
Interest Expenses	14,000
Interest Revenue	17,500
Income Taxes	40,000
Dividends	45,000
Retained Earnings	125,000

Required:

- i) Prepare a multiple-step income statement.
- ii) Prepare a retained earnings statement.

- 3.05** From the following account balances of AK Ltd., prepare a combined statement of income and retained earnings using the single-step format:

Purchases	Tk.590,000
Merchandise Inventory – Beginning	89,000
Merchandise Inventory – Ending	124,000
Purchase Discounts	10,000
Sales	1,000,000
Rent Revenue	18,000
Retained Earnings	260,000
Sales Discount	14,500
Sales Returns	17,500
Selling Expenses	232,000
Administrative Expenses	99,000
Income Taxes	45,000
Cash Dividends	75,000
Allowances for Doubtful Accounts	5,000
Supplies	14,000
Freight-in	20,000
Gain on Sale of Plant	50,000
Extra Ordinary Loss	15,000

- 3.06** From the following information, prepare a classified balance sheet of Al-Amin Hardware Company at December 31, 20xx

Cash	Tk.28,800
Short-term Investment	31,200
Notes Receivable	8,000
Accounts Receivable	276,000
Merchandise Inventory	150,400
Prepaid Rent	1,600
Unexpired Insurance	4,800
Sales Supplies	1,280
Office Supplies	440
Unexpired Advertising	3,680
Land and Building	72,000
Delivery Equipment	41,200
Accumulated Depreciation–Delivery Equipment	Tk.24,800
Franchise Fee	4,000
Accounts Payable	107,440
Salaries Payable	5,200
Interest Payable	840

Long-Term Notes Payable	80,000
Common Stock	180,000
Retained Earnings	225,120

3.07 Accounts from the December 31, 20xx, post closing trial balance of Piniuon Company appears below:

Account Name	Debit	Credit
	Tk.	Tk.
Cash	102,000	
Short-Term Investments	56,750	
Notes Receivable	202,500	
Accounts receivable	382,850	
Merchandise Inventory	783,750	
Prepaid Rent	10,000	
Prepaid Insurance	6,000	
Prepaid Expenses	2,615	
Building	57,500	
Fixtures	362,000	
Accumulated Depreciation–Fixtures		105,000
Office Equipment	120,500	
Accumulated Depreciation–Office Equipment		51,250
Trade Mark	30,000	
Accounts Payable		539,725
Salaries Payable		8,935
Interest Payable		8,000
Notes Payable (Long-Term)		180,000
Common Stock, Tk.10 Par Value		100,000
Paid-in-Capital in Excess of Par Value		650,000
Retained Earnings		473,555
	<u>2,116,465</u>	<u>2,116,465</u>

Required:

From the information provided, prepare a classified balance sheet.

3.08 From the following trial balance of Osman Ltd., prepare (i) a single-step income statement; and (ii) a classified balance sheet on December 31, 20xx.

Account Name	Debit	Credit
	Tk.	Tk.
Cash	43,000	
Purchases	220,000	
Purchase Returns & Allowances		5,600
Purchase Discounts		2,800
Sales		374,000
Sales Returns & Allowances	4,800	
Sales Discounts	4,000	
Accounts Receivables	65,200	
Merchandise Inventory	112,000	
Prepaid Insurance	1,800	
Supplies	3,400	
Furniture & Fixtures	32,000	
Accumulated Depreciation–Furniture & Fixtures		3,600
Delivery Equipment	65,000	
Accumulated Depreciation–Delivery Equipment		19,000
Accounts Payable		17,400
Common Stock		200,000
Transportation-in	11,200	
Salaries	92,000	
Rent	20,800	
Delivery Expenses	16,400	
Utilities Expenses	6,800	
Retained Earnings		76,000
	<u>698,400</u>	<u>698,400</u>

Additional Information:

- i) Prepaid insurance at December 31, Tk.360.
- ii) Supplies on hand at December 31, Tk.1,600.
- iii) Depreciate Furniture & Fixtures @10% and Delivery Equipment @ 20% on cost.
- iv) Salaries outstanding Tk.1,500.
- v) Inventory at December 31, Tk.125,000.

3.09 The trial balance of Salmon Ltd. at December 31, is as follows:

**Trial Balance
As on December 31, 20xx**

Particulars of Accounts	Debit	Credit
	Tk.	Tk.
Merchandise Inventory, January 1	225,000	
Purchase	755,000	
Purchase Returns & Allowances		12,000
Purchase Discounts		20,000
Sales		1,260,000
Sales Returns & Allowances	70,000	
Sales Discounts	17,500	
Cash	31,000	
Office Supplies	4,000	
Accounts Receivable	40,000	
Notes Receivable	100,000	
Prepaid Insurance	10,500	
Land	170,000	
Building	410,000	
Accumulated Depreciation–Building		80,000
Office Equipment	106,500	
Accumulated Depreciation–Office Equipment		26,500
Accounts Payable		95,000
Common Stock		806,000
Transportation-in	41,000	
Sales Salaries	138,000	
Advertising	30,500	
Transportation-out	39,000	
Office Salaries	111,500	
Dividends	50,000	
Taxes	75,000	
Postage & Telephone	25,000	
Retained Earnings		150,000
	<u>2,449,500</u>	<u>2,449,500</u>

The following information is available at December 31:

- i) Merchandise inventory Tk.225,000
- ii) Office Supplies on hand Tk.1,000
- iii) Prepaid insurance Tk.7,000

- iv) Depreciate building @15% per annum and Office equipment @ 17.5% per annum.
- v) Outstanding sales salaries Tk.2,500 and office salaries Tk.2,000.

Required:

- a) Prepare a classified income statement for year. Of the insurance expense, postage & telephone expenses, and depreciation expenses on building, 75% is treated as selling expense and 25% is treated as administrative expenses.
- b) Prepare a classified balance sheet at December 31.

3.10 From the following figures extracted from the books of M/S. Munem Traders, you are required to prepare a single-step income statement for the year ended 31st December 2023 and a balance sheet as on that date after making necessary entries for the adjustments.

Cash in hand	Tk.7,400
Cash at Bank	56,600
Plant and Machinery	1000,000
Capital	220,000
Sundry Creditors	48,000
Purchases	90,000
Return inwards	2,000
Freehold Property	60,000
Sales	215,000
Return outwards	1,000
Drawings	12,000
Salaries-Office	12,000
Office Expenses	2,500
Furniture	25,000
Discount Allowed	1,200
Sundry Debtors	26,600
Loan to Ibrahim @ 15% balance on 1.1.2023	40,000
Bills Payable	38,000
Opening Inventory	35,000
Wages	32,000
Postage	1,400
Insurance Expense	1,600
Bad Debts	600
Office Rent	2,600
Freight and Duty	9,000
Loose Tools	2,000
Provision for Bad and Doubtful Debts	800
Interest on loan to Ibrahim	1,000
Salaries-Sales	4,300

Adjustments:

- (a) Of the Sundry Debtors Tk.600 are bad and should be written off.
- (b) Insurance unexpired was Tk.400.
- (c) Wages Tk.1,700 and Salaries Tk.700 were due.
- (d) Depreciate Plant and Machinery by 10%, Furniture by 5%; Loose Tools by 20%, and Freehold Property by 2% per annum.
- (e) Maintain a provision for bad debts of 5% on Sundry Debtors.
- (f) Stock on 31.12.2023 was valued at Tk.75,000.

3.11 From the following balances extracted from the Ledger of M/S. Shimul, prepare an income statement for the year ended December 31, 2023 and the Balance sheet as on that date:

Opening Stock	Tk.275,000
Land and Building	Tk. 450,000
Plant and Machinery	600,000
Purchases	500,000
Sales	1,400,000
Office Salaries and Expenses	100,000
Advertisement	20,000
Carriage inwards	6,000
Wages	200,000
Bad Debts Provision	10,000
Bills payable	30,000
Carriage outwards	5,000
Sundry Creditors	475,000
Loan (Cr.)	150,000
Capital	338,000
Office Rent and Insurance	40,000
Bills Receivable	25,000
Printing and Stationery	10,000
Discount Allowed	5,000
Cash at Bank	50,000
Sundry debtors	250,000
Drawing	60,000
Investment	10,000
Dividend Received	1,000
Discount Received	2,000

The following further information are given:

- (a) Stock on 31st Dec. 2023 is valued at Tk.2,50,000; Stock includes goods valued at Tk.10,000 which are sold but not yet delivered.

- (b) Interest on Loan at 10% p.a. has accrued and has not yet been paid.
- (c) A purchase of goods worth Tk.25,000 made on December 31, 2023 but the invoice concerned being lost, it was not recorded in the Purchase Day Book although it was included in the stock.
- (d) Provision for bad debts is to be raised to 5% on Sundry Debtors.
- (e) Make provision for Discount on creditors @ 5%.
- (f) Depreciate Land and Building and Plant and Machinery by 5% & 10% p.a. respectively.

3.12 The following information is available for the Harbour Ltd. for December 31, 20xx.

Purchase	Tk.1,185,000
Purchase Returns & Allowances	4,800
Purchase Discounts	12,600
Sales	1,770,000
Sales Returns & Allowances	14,400
Sales Discounts	24,600
Cash	49,200
Accounts Receivable	79,500
Merchandise Inventory (January 1)	210,000
Insurance	10,800
Plant & Machinery	42,000
Accumulated Depreciation- Plant & Machinery	16,200
Delivery Equipment	105,000
Accumulated Depreciation- Delivery Equipment	36,600
Accounts Payable	104,100
Notes Payable (Long-term)	45,000
Common Stock	225,000
Taxes	12,000
Transportation-in	52,200
Sales Salaries	162,000
Delivery Expenses	55,200
Advertising	39,300
Rent Expenses	45,000
Office Salaries	108,000
Utilities Expenses	12,900
Office Supplies	7,200

Rent and utilities expenses are administrative expenses. The following data are available at December 31:

- a) Prepaid insurance Tk.3,600 (insurance expense is classified as a selling cost.)
- b) Office supplies on hand Tk.2,700.
- c) Depreciation expenses on Furniture and Fixtures for the year (an administrative expenses) Tk.3,000.
- d) Depreciation expense on delivery equipment for the year Tk.15,000
- e) Salaries payable Tk.2,400 (office- Tk.900 and Sales Tk.1,500)
- f) Merchandise Inventory - Tk.198,000

Required:

- i) Prepare a classified income statement for the year 20xx
- ii) Prepare a classified balance sheet at December 31.

3.13 The accountant for the Careless Company accidentally pressed the wrong computer key and erased the amount of Retained Earnings. With the exception of Retained Earnings, the following account balances are available at December 31, 20xx:

Cash	Tk.244,000
Furniture	160,000
Accounts Payable	480,000
Land	1,040,000
Building (net)	960,000
Sales Revenue	1,660,000
Salaries Expenses	200,000
Cost of Goods Sold	880,000
Accounts Receivable	196,000
Inventory	640,000
Notes Payable	1,000,000
Supplies on hand	40,000
Capital Stock	1,200,000
Dividends	800,000
Retained Earnings	?

Required:

- a) Compute the amount of total assets at December 31, 20xx.
- b) Compute the amount of net income for the year ended December 31, 20xx.

- c) After all closing entries are made, what is the amount of Retained Earnings at December 31, 20xx.
- d) What was the beginning Retained Earnings at January 1, 20xx.

3.14 The following accounts (in alphabetical order) and amounts were taken from December 31, 2023, year end adjusted trial balance of Rani Company:

Accounts Payable	Tk.67,200
Accounts Receivable	174,800
Accumulated Depreciation–Building	52,400
Accumulated Depreciation–Equipment	34,800
Building	220,000
Cash	12,500
Common Stock (Tk.10 per value)	80,000
Paid up Capital in Excess of Par value	120,000
Cost of Goods Sold	492,000
Depreciation Expenses–Building	9,000
Depreciation Expenses–Equipment	12,200
Dividend Income	8,100
Dividends	47,800
Equipment	159,200
Income Tax	2,000
Investment in Padma Co. 100 shares (Short-term)	13,000
Interest Expenses	22,400
Inventory	112,300
Land held for Future Use	40,000
Land used in Operation	58,000
Mortgage Payable	180,000
Notes Payable (Short-term)	50,000
Notes Receivable	24,000
Operating Expenses–excluding Depreciation	302,700
Retained Earnings	270,900
Sales (Net)	852,000
Trade Mark	13,500

Total assets and total stock–holders' equity at the beginning of the year were Tk.747,900 and Tk.470,900 respectively.

Required:

From the information above, prepare (i) an income statement in condensed multi-step form; (ii) a statement of retained earnings, and (iii) a classified balance sheet.

3.15 Queen Corporation has been in business for one year. During this time Queen has kept track of all her revenues and expenses. She feels that her sales have been good, but her profit is not as high as she would like. As a friend, you have agreed to look at her income statement. Queen gives you the following statement:

Queen Corporation		
Income Statement		
December 31, 20xx		
Revenues		
Sales for the Year	Tk.351,900	
Interest on Saving Account	2,520	
Rent form Building not Used in Business	9,900	
Purchase Discounts	3,000	
Total Revenues		367,320
Expenses		
Salaries—Sales	57,900	
Salaries—Office	51,210	
Rent & Fixtures: $\frac{2}{3}$ Sales; $\frac{1}{3}$ Office	14,400	
Supplies: $\frac{2}{3}$ Sales; $\frac{1}{3}$ Office	2,520	
Interest on Debt	8,820	
Insurance: $\frac{1}{2}$ Sales $\frac{1}{2}$ Office	6,360	
Property Taxes: : $\frac{2}{3}$ Sales; $\frac{1}{3}$ Office	7,290	
Miscellaneous Expenses: : $\frac{1}{2}$ Sales; $\frac{1}{2}$ Office	4,440	
Sales Discount	2,820	
Advertising	30,180	
Dividends	18,000	
Purchases	127,380	
Depreciation: : $\frac{2}{3}$ Sales; $\frac{1}{3}$ Office	13,500	
Utility Expenses: : $\frac{2}{3}$ Sales; $\frac{1}{3}$ Office	11,970	
Income Taxes	6,000	
Total Expenses		362,790
Net Income		<u><u>Tk.4,530</u></u>

Required:

- a) Prepare a condensed multi-step income statement in good form for Queen Corporation, taking into account beginning merchandise inventory of Tk.33,600, and ending merchandise inventory of Tk.50,500.
- b) What incorrect classification did Queen make?
- c) Comment on the usefulness of the multi-step form over single-step form of income statement.

3.16 During the first year of operation, Mehedi, who owns Mehedi Fashion Inc. has kept accurate records of all revenues and expenses. At the end of the year, he prepared the income statement shown below. Although the net income appears to be low in relation to sales, Mehedi finds the statement difficult to interpret. The beginning merchandise inventory was Tk.300,000 and the ending was Tk.275,000. The number of common stock shows outstanding is 10,000.

Mehedi Fashion Inc.
Income Statement
 December 31, 20xx

Revenues		
Sales	Tk.8,865,000	
Purchase Discounts	135,000	
Purchase Returns and Allowances	321,000	
Interest on Government Bonds	100,000	
Rent Income	200,000	
Total Revenues		Tk.9,621,000
Expenses		
Salaries	2,850,000	
Rent	200,000	
Supplies Expenses	75,000	
Interest Expenses	145,000	
Insurance	90,000	
Property Taxes	120,000	
Miscellaneous Expenses	45,000	
Sales Discount	60,000	
Sales Returns & Allowances	47,250	
Dividends (Tk. 40 per share)	400,000	
Purchases	4,452,550	
Depreciation	160,000	
Utility Expenses	120,000	
Income Tax	210,000	
Total Expenses		8,974,800
Net Income		Tk.646,200

Required:

- a) To aid Mehedi in evaluating his company, prepare a condensed multi-step income statement for his shop. Show the calculations of the components. Assume that salaries, supplies, and miscellaneous expenses should be divided in the ratio of $\frac{2}{3}$ sales and $\frac{1}{3}$ general and that rent, insurance, property taxes, depreciation, and utility expenses are allocated $\frac{3}{4}$ to sales and $\frac{1}{4}$ to general expenses.
- b) What incorrect classification did Mehedi make?
- c) What did you learn about Mehedi's shop by using multi-step form of income statement?

Lesson-7: Statement of Cash Flows

Lesson Objectives

After you have studied this lesson, you should be able to:

- define the statement of cash flows.
- classify in the statement of cash flows.
- understand the format of the statement of cash flows.
- explain the procedure of preparing the statement of cash flows.

3.7.1 Introduction

Although there are variations in the method of determination, cash flows is approximately equivalent to income from operation plus depreciation, depletion and any other expenses had no effect on working capital during the period. A variety of terms also is found to be used to describe this such as cash flow from operations, cash income, cash throw off etc. This lesson is devoted to evaluate, in brief different aspects of cash flow statement, which now-a-days treated by many business firm as a part of financial statement.

3.7.2 Statement of Cash Flows

The income statement, as you know, is designed to measure the success or failure of the business in achieving its objective of profitable operations. A balance sheet is a snapshot of the status of a business organization's funds at one point of time. The liabilities and owners' equity side of the balance sheet shows the sources from which the funds that the organization is currently using were obtained and the assets side shows the uses that the organization currently is making of these funds. Because a business entity is usually formed to return cash to the owners, and because creditors must be paid in cash, many decision makers want a financial statement focused on cash in addition to the income statement and balance sheet. Thus a third type of financial statement, the *statement of cash flows* is prepared by accountants to fill this need. A statement of changes in financial position on *cash basis*, commonly known as the *statement of cash flows*, summarizes the causes of changes in cash position between dates of two balance sheets. The statement of cash flow is a financial statement which reveals the methods by which the business has been financed and how it has used its funds between the opening and closing balance sheet date. This statement analyzes changes in non-current accounts as well as current accounts (other than cash) to determine the flow of cash. In short, it is a periodic basic financial statement that summarizes the information about the flow of cash into and out of a company. The statement of cash flows complements the income statement by disclosing the amount of cash generated by the company's operating activities. It also complements the balance sheet by disclosing cash flow transactions that causes changes in assets, liabilities, and stockholders' equity. The statement meets one of the objectives of

Statement of cash flows summarizes the causes of changes in cash balance between the two dates of the balance sheets.

financial reporting- to help assess the amounts, timings, and uncertainty of future cash flows.

The primary purpose of the statement of cash flows is to provide information about a company's cash receipts and cash payments during an accounting period.

The primary purpose of the statement of cash flows is to provide information about a company's cash receipts and cash payments during an accounting period. It does not include any transactions or accounts that are not reflected in the balance sheet or in the income statement. Rather, the statement of cash flows reports the period's transactions and events in terms of their impact on cash. The statement is useful internally to management and externally to investors and creditors. The management can use the statement of cash flows to assess the liquidity of the business, to determine whether or not short-term financing is necessary to pay its current liabilities, to determine whether to raise or lower its dividends, and to evaluate the effects of major policy decisions involving investments and financing.

A statement of cash flows would assist investors, creditors and others in assessing the company's

- ability to generate positive future cash flows;
- ability to meet its obligations and to pay dividends;
- need for additional financing;
- reasons for differences between the amount of net income and the related net cash flow from operating activities;
- causes of the net change in the amount of cash between the beginning and the end of the accounting period.

3.7.3 Classification in the Statement of Cash Flows

A statement of cash flows classifies cash receipts and payments into three major categories: *operating activities*, *investing activities*, and *financing activities*. Grouping cash flows into these categories identifies the effects on cash of each of the major activities of a firm. The combined effects on cash of all three categories explain the net change in cash for the period.

Operating activities, investing activities, and financing activities are the three major categories of cash receipts and payments into a statement of cash flows.

Operating activities relate to a company's primary revenue-generating activities. Cash flows from operating activities are generally the cash effects of transactions and economic events included in the determination of income.

Investing activities include lending money and collecting on those loans, buying and selling productive assets that are expected to generate revenue over long periods, and buying and selling securities.

Financing activities include borrowing money from creditors and repaying the amounts borrowed, and obtaining resources from owners and providing them with both a return on their investment (through dividends) and a return of their investment.

As a matter of convenience in discussion; the term "**non cash investing and financing activities**" are discussed here. *Non cash Investing and Financing Activities* are those activities which do not affect cash. For example, equipment may be purchased with a note payable, or land and building may be acquired by issuing stock or debentures. These non-cash transactions are not reported in the statement of cash flows. However, if a company has sufficient non-cash financing and investing activities, these should be disclosed in a separate schedule or in a narrative explanation. The separate schedule may be placed immediately below the statement of cash flows or it may be placed among the notes to the financial statements.

Non cash Investing and Financing Activities do not affect cash.

3.7.4 Format of the Statement of Cash Flows

As we have mentioned cash flows are classified into three categories; depending on that the statement of cash flows has assumed the following basic format:

Format for the Statement of Cash Flows		
Elham Company		
Statement of Cash Flows		
For the year Ended December 31, 2023		
Cash Flows from Operating Activities		
(Details of individual cash inflows and outflows)	Tk.×××	
Net Cash Provided (Used) by Operating Activities		Tk.×××
Cash Flows from Investing Activities		
(Details of individual cash inflows and cash outflows)	×××	
Net Cash Provided (Used) by Investing Activities		×××
Cash Flows from Financing Activities		
(Details of individual cash inflows and cash outflows)	×××	
Net Cash Provided (Used) by Investing Activities		×××
Net Increase (Decrease) in Cash		××××
Cash at the Beginning of Year		××××
Cash at the End of Year		Tk.××××

Examples of cash inflows and outflows relating to ***operating activities***, ***investing actives***, and ***financing activities*** are listed bellows:

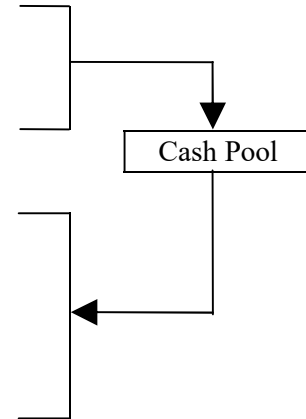
Operating Activities

Cash Inflows

- Collections from customers
- Receipts of interest and dividends
- Other operating cash receipts

Cash Outflows

- Payment to suppliers
- Payments to employees
- Interest payments
- Payments to income taxes
- Other operating cash payments



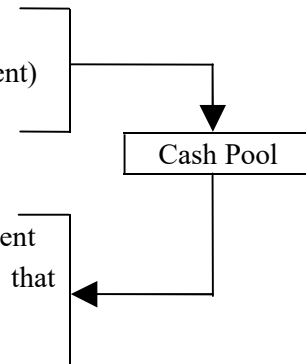
Investment Activities

Cash Inflows

- Sales of property, plant, and equipment
- Sale of debt or equity instruments(investment)
- Collection on loans

Cash Outflows

- Purchase of property, plant, and equipment
- Purchase of debt or equity instruments that are not cash equivalent
- Loans to other entities



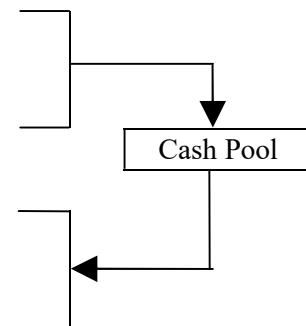
Financing Activities

Cash Inflows

- Issuance of equity securities
- Issuance of long-term debt instruments (bonds & notes)

Cash Outflows

- Payment of dividends
- Redemption of debt Debenture
- Reacquisition of Capital Stock



3.7.5 Preparation of the Statement of Cash Flows

You will find a detail discussion about the preparation and content of cash flows in the course *Management Accounting*. The presentation of this lesson is simply introductory. So, comprehensive coverage of this

topic has been deferred to that course from where you would be able to learn complex topics that make up the content of a typical statement of cash flows. However, the process of preparing the statement of cash flows draws upon data from three sources: (i) the current income statement, (ii) comparative balance sheets, and (iii) selected transaction data. Preparing the statement of cash flows from these sources involves the following steps:

- Determine the cash provided by operations.
- Determine the cash provided by or used in investing and financing activities.
- Determine the change (increase or decrease) in cash during the period.
- Reconcile the change in cash with the beginning and the ending cash balances.

An illustration of cash flows statement is presented below with imaginary figures (Indirect Method):

Ripon Company Statement of Cash Flows For the Year Ended December 31, 2023		
Cash flows from Operating Activities		
Net Income		Tk.1,283,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	Tk.418,800	
Gain on sale of Machinery	(34,800)	
Increase in accounts receivable (net)	(44,000)	
Decrease in inventory	62,000	
Decrease in accounts payable	(38,000)	364,000
Net Cash provided by operating activities		1,647,000
Cash flows from Investing Activities		
Sale of Machinery	362,000	
Purchase of building	(730,000)	
Purchase of Equipment	(280,000)	
Net cash used by investing activities		(648,000)
Cash flows from Financing Activities		
Payment of cash dividend	(79,200)	
Issuance of common stock	400,000	
Redemption of Debentures	(200,000)	
Net cash provided by financing activities		120,800
Net increase in cash during 2023		1,119,800
Cash at the beginning of the year		540,000
Total		<u>Tk.1,659,800</u>

Example-3.5

The Comparative Balance Sheets of the S.T. Company are given below:

	31st Dec. 2022 Taka ('000)	31st Dec. 2023 Taka ('000)
<i>Owners Equity and Liabilities:</i>		
Share Capital	500	500
Reserves and Surplus	600	700
Long Term Debts	950	800
Short Term Debts	700	800
Trade Creditors	500	600
Provisions	100	150
Other Liabilities	100	-
Total	<u>3,450</u>	<u>3,550</u>
<i>Assets:</i>		
Fixed Assets (Net)	1,800	1,900
Inventories	700	600
Debtors	600	700
Cash	200	150
Other Assets	150	200
Total	<u>3,450</u>	<u>3,550</u>

The Incomes Statement of S.T. Company

for the year, 2023 is given below:

Income Statement for 2023

	Taka ('000)	Taka ('000)
Net Sales		8,000
<i>Cost of Goods Sold:</i>		
Stocks	3,000	
Wages and Salaries	1,050	
Other Manufacturing Expenses	<u>1,150</u>	
		<u>5,200</u>
Gross Profit		2,800
<i>Operating Expenses:</i>		
Selling, Administrative and General	1,300	
Depreciation	<u>200</u>	
		<u>1,500</u>
Operating Profit		1,300
Non-Operating Surplus (deficit)		<u>(500)</u>
EBIT		800
Interest		<u>300</u>

Profit before Tax	500
Tax	200
Profit after Tax	300
Dividends	200
Retained Earnings	100

Required:

Prepare a Cash Flow Statement.

Solution:

S.T. Company
Cash Flow Statement

For the year ended 31st December, 2023

	Taka ('000)	Taka ('000)
<i>Inflow of Cash</i>		
Cash From Operation:		
Fund from Operation:		1,200
Add:		
Increase in Short term Debts	100	
Trade Creditors	100	
Provision	50	
Decrease in Inventories	100	
		350
		1,550
Less: Increase in Debtors		100
Cash from Operation		1,450
<i>Outflow of Cash:</i>		
Purchase of Fixed Assets	300	
Purchase of Other Assets	50	
Payment of Long Term Debts	150	
Tax Paid	200	
Payment of Dividend	200	
Non-Operating Deficit	500	
Payment of Other Liabilities	100	
		1,500
Decrease in Cash (200-150)		50

Workings:

Fixed Assets Account

Dr.

Cr.

	Tk. ('000)		Tk. ('000)
Balance B/d	1,800	Depreciation	200
Purchase (balance)	300	Balance c/d	1,900
	<u>2,100</u>		<u>2,100</u>

Fixed Assets Account

Dr.

Cr.

	Tk. ('000)		Tk. ('000)
Depreciation	200	Balance b/f	600
Non-operating deficit	500	Fund from Operation	1,200
Tax	200	(Balancing figure)	
Dividend	200		
Balance c/d	700		
	<u>2,100</u>		<u>2,100</u>

Questions and Exercises

Self-Test Questions

1. The statement of cash flow is designed to assess the following, except:
 - (a) the ability of the company to remain solvent
 - (b) The major source of cash receipts during the period
 - (c) The cash in hand position
 - (d) The portability position of company
 - (e) The reason why net cash flow from operating activities differs from net income.
2. The cash flows shown in the statement are grouped into:
 - (a) generating activities, investing activities and financing activities
 - (b) Direct cash flows and indirect cash flows
 - (c) Cash receipts, cash disbursed and non cash activities
3. Which of the following is not included in the statement of cash flows:
 - (a) Disclosure of the amount of cash invested in money market
 - (b) A reconciliation of net income to net cash flow from operating activities
 - (c) The amount of cash and cash equivalents owned by the business at the end of accounting period.

Discussion Questions

1. What is meant by cash flow statement? State its purposes.
2. In general, cash flow statement shows items that is flanged under three heads. What are the heads and which are the general items included under each head?
3. Show the format of cash flow statement and state the steps necessary to prepare the statement.

Exercises

1. The net income reported in the Income Summary Statement for the year was Tk.89,150. Depreciation recorded on equipment amounted to Tk.24,500. Balances of current assets and liabilities were as follows:

	Beginning of the period	End of the period
	Tk.	Tk.
Cash	71,500	66,250
Trade receivables	91,250	84,100
Inventories	1,04,000	91,000
Prepaid Expenses	6,500	7,100
Accounts payable	58,900	60,700
Salaries payable	8,000	5,750

Compute the cash provided by operations for the purpose of cash flow statement.

2. Following are the Balance Sheets of ABC Company

Liabilities	2022	2023	Assets	2022	2023
Share Capital	29,40,000	29,40,000	Fixed Assets	18,90,000	25,27,000
Retained earning	15,53,000	22,04,000	Inventory	10,29,000	12,18,000
Creditors	6,50,000	7,00,000	Accounts Receivable	19,02,000	20,39,000
Proposed Dividend	22,000	35,000	Cash	4,75,000	1,37,000
Salary due	83,000	64,000	Cash	4,75,000	1,37,000
Outstanding expenses	2,10,000	82,000	Prepaid exp.	1,62,000	1,04,000
	54,58,000	60,25,000		54,58,000	60,25,000

Other information:

- An old machine costing Tk.6,50,000 was sold for Tk.6,98,000.
- Depreciation for the year amounted to Tk.63,000 and the balance at the beginning of the year was Tk.3,36,000.
- Misc. expenses amounts to Tk.9,85,000 for the year, wages Tk.4,83,00 and Rent Tk.1,26,000.
- Sales process Tk.63,00,000.
- Cost of Sales Tk.39,90,000.

Required: Prepare a Cash Flow Statement for 2023.

3. From the following Balance sheet and other information supplied, you are required to prepare a cash flow statement for the year 2023

<u>Assets</u>	<u>2022</u>	<u>2023</u>
Fixed Assets	Tk.70,000	Tk.1,10,000
Addition during the year	40,000	40,000
	1,10,000	1,50,000
Less Depreciation	50,000	60,000
Investment	60,000	90,000
Inventory	1,00,000	-
Receivables	1,05,000	1,70,000
	96,000	1,55,000
Total Assets	<u>Tk.3,61,000</u>	<u>Tk.4,15,000</u>
<u>Liabilities</u>		
Capital Stock	Tk.1,00,000	Tk.1,00,000
Retained Earning	35,800	40,300
Income Statement (Income)	25,600	32,200
Provision for Taxation	36,000	45,800
Bank overdraft	53,000	1,12,500
Creditors	1,03,100	74,600
Proposed Dividend	7,500	9,600
Total Liabilities	<u>Tk.3,61,000</u>	<u>Tk.4,15,000</u>

Additional Information

- Investment of Tk.1,00,000 was sold at Tk.1,10,000.
- During the year Tk.20,7000 was provided for taxation.
- Dividend for 2022 paid in the current year.
- Profit for the year was Tk.45,400 which arrived at after charging depreciation Tk.10,000 and Directors remuneration Tk.15,000.
- Sales and purchase for the year was Tk.3,58,000 and Tk.3,62,600.

Case Study

Case 3-1: Hey, You! Put that Back!

Amin Hardware is a retail store selling hardware, small appliances, and sporting goods. The business follows a policy of selling all merchandise at exactly twice the amount of its cost to the store and uses a *periodic* inventory system.

At year-end, the following information is taken from the accounting records:

Net sales	Tk. 800,000
Inventory, January 1	80,000
Purchases	410,000

A physical count indicates merchandise costing Tk. 68,000 is on hand at December 31.

Instructions:

(a) Prepare a partial income statement showing computation of the gross profit for the year.

(b) Upon seeing your income statement, the owner of the store makes the following comment: "Inventory shrinkage losses are really costing me. If it weren't for shrinkage losses, the store's gross profit would be 50% of net sales. I'm going to hire a security guard and put an end to shoplifting once and for all."

Determine the amount of loss from inventory "shrinkage" stated (1) at cost, and (2) at retail sales value. (*Hint:* Without any shrinkage losses, the cost of goods sold and the amount of gross profit would each amount to 50% of net sales.)

(c) Assume that Amin Hardware could virtually eliminate shoplifting by hiring a security guard at a cost of Tk.3,000 per month. Would this strategy be profitable? Explain your reasoning.

Case 3-2: Statement of Cash Flows

The Uttara City and Elham's are retail stores that sell computer software. A summary of each store's net cash flows for the last three years appears below. (Taka amounts are stated in thousands.)

The Uttara City	2023	2022	2021
Net cash provided by (used in) operating activities	Tk.(10)	Tk.40	Tk.85
Net cash provided by (used in) investing activities	50	20	(10)
Net cash provided by (used in) financing activities	<u>80</u>	<u>50</u>	<u>20</u>

Increased (decrease) in cash during the year	<u>Tk.120</u>	<u>Tk.110</u>	<u>Tk.95</u>
Cash balance at year-end (per balance sheet)	<u><u>Tk.335</u></u>	<u><u>Tk.215</u></u>	<u><u>Tk.105</u></u>

Elham's

Net cash provided by operating activities	Tk.320	Tk.260	Tk.210
Net cash provided by (used in) investing activities	(200)	(100)	(50)
Net cash provided by (used in) financing activities	<u>(150)</u>	<u>(100)</u>	<u>(70)</u>
Increase (decrease) in cash during the year	<u>Tk.(30)</u>	<u>Tk.60</u>	<u>Tk.90</u>
Cash balance at year-end (per balance sheet)	<u><u>Tk.260</u></u>	<u><u>Tk.290</u></u>	<u><u>Tk.230</u></u>

Instructions:

- Explain briefly the nature of (1) *operating activities*, (2) *investing activities*, and (3) *financing activities* as these terms are used in a statement of cash flows.
- Explain the meaning of the phrase, "Net cash provided by (used in) ... activities." As part of your answer, explain the use of brackets () as indicated by this caption.
- For each of the three cash flow classifications discussed in part a, describe two types of transactions that involve (1) cash receipts, and (2) cash payments.
- Which of these stores appears "healthier" in terms of its cash flows? Explain your reasoning and include a brief discussion of any trends relevant to your conclusion.

ACCOUNTING FOR CURRENT ASSETS



From the discussions of this unit, students will be able to understand:

-  **Current Assets : Accounts Receivable**
-  **Estimating Uncollectible Accounts Expenses**
-  **Writing off an Uncollectible Accounts Receivable**
-  **Accounting for Inventories**
-  **Inventory Valuation Methods- Perpetual Inventory System**
-  **Periodic Inventory System**

এই পৃষ্ঠা খালি থাকবে

Unit-4

Lesson-1: Current Assets: Accounts Receivable

Lesson Objectives

After studying this lesson, you will be able to:

- define current assets.
- explain the concept of accounts receivable.
- describe uncollectible accounts receivable.

4.1.1 Introduction

Assets are economic resources which are owned by a business and are expected to benefit future operations. Assets may be classified into two groups according to their useable time or longevity and convertibility into cash. These are:

- (i) Current Assets, and
- (ii) Fixed Assets.

In this unit we discuss the accounting record-keeping system of current assets.

4.1.2 Current Assets

Current assets comprise those items, which in the routine course of business operations are immediately converted into cash or tend to be converted into cash within a short time, or within the normal operating cycle of the business, without undergoing a diminution in value and without disrupting the operation of the organization. These include

- Cash in Hand
- Cash at Bank
- Marketable Securities
- Receivables - Notes Receivable, Accounts Receivable and Interest Receivable
- Supplies
- Prepaid Expenses - Insurance, Rent, etc.
- Inventories - Raw Materials, Work-in-Progress, Stores - Spares & Others and Finished Goods.

Current assets except inventories are also known as liquid assets. Liquidity is an indication of an organization's ability to meet its obligation as and when they mature. The current asset, which can be converted into cash quickly is more liquid. Among all the current assets cash is the most liquid one. Accounts receivable are relatively liquid assets, usually converted into cash within a short period of time. Among the current assets, in this lesson, we discuss accounts receivable.

Current assets are immediately converted into cash or tend to be converted into cash within a short time.

Current assets except inventories are also known as liquid assets.

4.1.3 Accounts Receivable

Accounts receivable arise from sales of goods and services on credit to customers.

Credit department will decide whether to sell on credit to a particular customer or not.

Accounts receivable arise from sales of goods and services on credit to customers at either the wholesale or retail level. Now-a-days accounts receivable comprise the largest financial assets of many merchandise companies. To increase sale it has become a common practice of the companies to sell on credit. Normally companies want to sell on credit only to those customers who will pay. To control credit sales most of the companies establish credit department. The main function of the department is to assess the credit worthiness of the prospective customers who want to purchase on credit. The credit department's responsibilities include examination financial resources and debts of each person or company who applied for credit. The department collects information from personal references and establishes credit bureaus, which may have all the information about the customers. On the basis of this information, the credit department will decide whether to sell on credit to that customer.

Let us explain with example how credit sale, return of goods and collection of cash affect accounts receivable.

Example 4.01

On July 1, 2023 East-West Ltd. sells merchandise on account to Jalil & Co. amounting to Tk. 30,000, terms 2/10, n/30. On July 5, merchandise having selling price of Tk. 5,000 is returned to East-West Ltd. On July 11, payment is received from Jalil & Co. for the balance due. Give journal entries relating to receivable.

Solution

EAST-WEST LTD.

General Journal

2023			
July 1	Accounts Receivable (Jalil Co.)	Tk.30,000	
	Sales		Tk.30,000
	(To record sales on account)		
July 5	Sales Returns & Allowances	Tk.5,000	
	Accounts Receivable (Jalil Co.)		Tk.5,000
	(To record merchandise returned)		
July 11,	Cash (25,000 - 500)	Tk.24,500	
	Sales Discounts (Tk. 25,000 × 2%)	500	
	Accounts Receivable (Jalil Co.)		Tk.25,000
	(To record collection of accounts receivable, less 2% discount)		

When an organization sells on account, the volume of accounts receivable increases. On the other hand, collection of receivables decreases it.

4.1.4 Uncollectible Accounts Receivable

As discussed earlier a company which sells merchandise on account generally maintains a credit department. Although the sales department takes every steps to sell only to those customers who have the willingness to pay, still then some customers will not pay. The accounts owed by such customers are called **uncollectible accounts** or **bad debts**, and are a loss or an expense of selling on account. A limited amount of uncollectible accounts is not only expected - it is an evidence of a sound credit policy. If the credit department becomes very stringent, the organization's sales volume may decrease to large extent which is not expected. As some of the customers never pay their bills, their accounts become uncollectible. These uncollectible accounts are no longer assets of the companies. The loss of this assets represents an expense, termed as the **Uncollectible Accounts Expenses**. One of the basic principle of accounting is conservatism, i.e. all probable losses should be matched against the revenue of that particular period.

Uncollectible accounts or bad debts are a loss or an expense of selling on account.

Uncollectible accounts are no longer assets of the companies.

Example 4.02

Let us assume that at the end of 2023, East West Ltd.'s accounts receivable amounted to Tk.500,000. On that day, credit manager reviewed the accounts receivable and estimated that Tk.15,000 of these accounts will prove to be uncollectible. The following adjusting entry would be made on December 31, 2023:

2023

Dec. 31	Uncollectible Accounts Expenses	Tk.15,000
	Allowance for Doubtful Accounts	Tk.15,000
	(To record the estimated uncollectible accounts expenses for the year 2023)	

Uncollectible Accounts Expenses is also known as **Bad Debt Expense**. The estimated amount of uncollectible account expense is shown in the income statement as an operating expense and as a deduction from accounts receivable in the balance sheet. This process automatically reduces accounts receivable to their net realizable value as follows:

Balance Sheet Assets

Current Assets

Cash and Bank Balances		Tk.875,000
Short-term Investment		125,000
Accounts Receivable	500,000	
Less: Allowance for Doubtful Accounts	15,000	

		485,000
Inventory		315,000

Total Current Assets		Tk.1,800,000
		=====

Lesson 2: Estimating Uncollectible Accounts Expenses

Lesson Objective

After studying this lesson, you would be able to:

- estimate uncollectible accounts expenses.
- explain the percentage of sales approach.
- describe the accounts receivable aging approach.

4.2.1 Introduction

A limited amount of uncollectible account is not only expected but is also found to be a part of credit policy. If the sales and/credit department becomes overly cautious, the business may lose many sales opportunities by rejecting customers who should have been considered under the orbit of acceptable credit risks. In such a case, in the context of accounting for receivables, the uncollectible part of accounts receivable is not considered as an asset and the loss thus occurred is treated as an expense formed as uncollectible accounts expenses. This lesson is devoted to discuss this aspect of accounts receivable.

4.2.2 Estimating Uncollectible Accounts Expenses

Accounts receivable are to be valued and reported in the balance sheet at net realizable value.

Accounts receivable are to be valued and reported in the balance sheet at net realizable value - the net amount expected to be received in cash. Determining net realizable value requires an estimation of both collectible receivable and allowances to be granted. The accountant of the organization makes an estimate based on past experience, modified by current economic conditions. The final decision as to how much is enough is taken by the finance manager. As this estimation affects the income statement and balance sheet of the company, it should be realistic.

There are two common approaches available for estimating uncollectible accounts expense for an accounting period:

- (i) The Percentage of Sales Approach, and [Income Statement Approach]
- (ii) The Accounts Receivable Aging Approach. [Balance Sheet Approach]

4.2.3 Percentage-of-Sales (Income Statement) Approach

The most common approach in estimating uncollectible accounts expense is the percentage of sales approach. Here sales mean credit sales only. In case of cash sales the question of uncollectible does not arise. The percentage used depends in part on past experience and in part on management's judgment as to whether past experience reflects the current situation. The percentage of sales approach matches costs with

revenues because it relates the charge to the period in which sales are recorded.

Example 4.03

Assume that East-West Ltd.'s net credit sales for the year 2023 was Tk.900,000. Management believes that uncollectible accounts will on the average be about 2 per cent of net sales, the entry to record uncollectible accounts expense using the percentage of sales approach be as follows:

2023

Dec. 31 Uncollectible Accounts Expense Tk.18,000
 Allowance for Doubtful Accounts Tk.18,000
 (To record uncollectible accounts expense
 at 2 per cent of Tk.900,000 net sales)

Because of the concept of conservatism, the allowances for doubtful accounts should be sufficient to absorb the accounts that will prove to be uncollectible. The allowance for doubtful accounts is a valuation account (i.e. a contra asset) and is deducted from the accounts receivable in the balance sheet. This approach is also known as the **income statement approach** because uncollectible accounts expense is estimated on the basis of nominal account (sales), and any balance in the allowance for doubtful accounts is ignored.

The percentage of sales approach matches costs with revenues.

The allowance for doubtful accounts is a valuation account and is deducted from the accounts receivable in the balance sheet.

4.2.4 The Accounts Receivable Aging Approach

This requires the preparation of an aging schedule of accounts receivable. The aging of accounts receivable is the process of listing each customer in accounts receivable according to the due date of the account. **An aging schedule** is frequently used in practice. The following schedule of East-West Ltd. is an example:

The aging of accounts receivable is the process of listing each customer in accounts receivable according to the due date of the account.

Example 4.04

EAST-WEST LTD. AGING SCHEDULE December 31, 2023

Name of Customers	Total	Not Yet Due	1-60 Days Past Due	61-90 Days Past Due.	91-120 Days Past Due.	Over 120 Days Past Due
	Tk.	Tk.	Tk.	Tk.	Tk.	Tk.
F. Rahman	50,000	50,000				
B. Karim	120,000	90,000	30,000			
A. Hasan	55,000			25,000	30,000	
S. Kamal	45,000	20,000	25,000			
Other Customers	230,000	100,000	35,000	45,000	20,000	30,000
Total	500,000	260,000	90,000	70,000	50,000	30,000

SUMMARY

Status as of December 31, 2023	Amount Outstanding	Percentages Estimated to be Uncollectible	Allowance for Doubtful Accounts
	Tk.		Tk.
Not yet due	260,000	2%	5,200
1-60 days old	90,000	5%	4,500
61-90 days old	70,000	15%	10,500
91-120 days old	50,000	25%	12,500
Over 120 days	<u>30,000</u>	40%	<u>12,000</u>
Total	<u>500,000</u>		<u>44,700</u>

Allowance for doubtful accounts to be reported for the year if there is no balance in the allowance account.

The amount Tk.44,700 would be of **allowance for doubtful accounts** to be reported for this year if there is no balance existed in the allowance account. But unlike the percentage of sales approach this approach takes into account the balance in the allowance for doubtful accounts. Suppose that the allowance account had a credit balance of Tk.2,700 before adjustment. Thus, the uncollectible accounts expense for the year 2023 is estimated to be:

	Tk.
Estimated uncollectible accounts	44,700
<i>Less:</i> Credit balance-allowance for doubtful accounts	<u>2,700</u>
Uncollectible accounts expense	<u>42,000</u>

The entry will be:

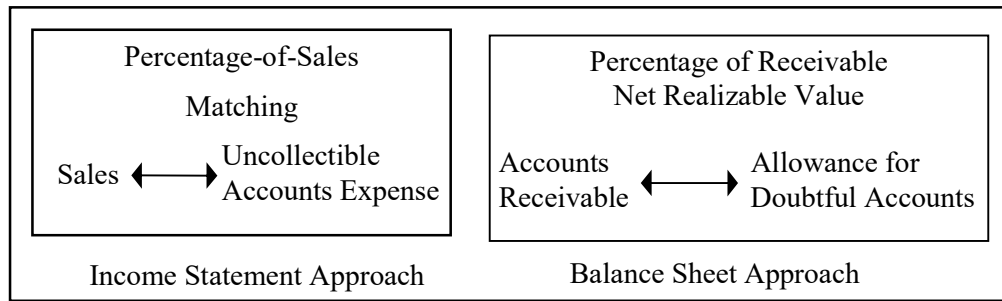
2023

Dec. 31,	Uncollectible Accounts Expense	Tk.42,000
	Allowance for Doubtful Accounts	Tk.42,000
	(To increase the allowance for doubtful accounts to the level of expected losses.)	

This approach does not fit the concept of **matching costs and revenues**. But it provides a reasonably accurate estimated amount of receivable to be realized. The objective of this approach is to report receivable in the balance sheet at its net realizable value. That is why, this approach is also known as **percentage of receivable** or **balance sheet approach**.

From the view point of matching concept, the percentage of sales approach provides a better result.

If we compare the two approaches for estimating uncollectible accounts expense, we find that from the view point of matching concept, the percentage of sales approach provides a better result. But **the accounts receivable aging** or **percentage of receivable approach** represents a more accurate valuation of receivable in the balance sheet. The following diagram relates these approaches basic theory:



Comparison of Approaches for Estimating Uncollectible Accounts Expense.

Lesson 3: Writing off an Uncollectible Accounts Receivable

Lesson Objectives

After studying this lesson, you will be able to:

- identify the reasons of writing off an uncollectible accounts receivable.
- record the recovery of an accounts receivable previously written off.
- evaluate the quality of accounts receivable.

4.3.1 Introduction

Whenever an account receivable from a specific customer or a part of total account receivable is ascertained to be uncollectible, it should be written off to reduce the balance by this uncollectible amount. For this necessary entry must be made in the books of accounts with resultant presentation in financial statements. Further, if an account that has been written off is collected later, the account should be reinstated.

4.3.2 Writing off an Uncollectible Accounts Receivable

When a company fails after taking all the routine steps to collect the amount due from a customer, then it becomes clear that the specific customer is never going to pay the amount owed, i.e. the account becomes uncollectible. The uncollectible account is no longer qualified to be considered as an asset and should be written off to the ***Allowances for Uncollectible Accounts***. The entry that will have to be made is shown with an example.

The uncollectible account is no longer qualified to be considered as an asset.

Example 4.05

Assume that K. Rahman, who owes East-West Ltd. Tk.2,500, is declared bankrupt by the court and nothing would be realized from his estate. The entry to write off this account is as follows:

2023

Dec. 31	Allowance for Doubtful Accounts	Tk.2,500
	Accounts Receivable - K. Rahman	Tk.2,500
	(To write off receivable from K. Rahman as uncollectible)	

Note that in this entry debit is made to the ***Allowance for Doubtful Accounts*** and not to the ***Uncollectible Accounts Expense***. This entry does not affect the estimated net amount of accounts receivable because there is no expense involved and the related allowance for doubtful accounts has already been created. The write-off simply reduces K. Rahman's account to zero and reduces allowance for doubtful accounts by a similar amount. The following illustration shows the net realizable value of East West Ltd.'s accounts receivable before and after write-off of the account receivable from K. Rahman:

	Balances Before Write-off	Balances After Write-off
Accounts Receivable	Tk. 500,000	Tk. 497,500
Less: Allowance for Doubtful Accounts	<u>15,000</u>	<u>12,500</u>
Estimated Net value of Accounts Receivable	<u>Tk. 485,000</u>	<u>Tk. 485,000</u>

4.3.3 Recovery of an Account Receivable Previously Written-off

When an account is determined to be uncollectible, the balance is removed from the books by debiting **Allowance for Doubtful Accounts** and crediting **Accounts Receivable**. But occasionally a customer whose account has been written-off as worthless will later be able to pay the amount in full or part. Such collection is referred to as recoveries of bad debts. The receivable should be re-established by debiting Account Receivable and crediting Allowance for Doubtful Accounts.

For example, assume that K. Rahman after his bankruptcy notified the company that he is in a position to pay Tk.1,500 and sent a cheque for that amount. The entries to record this transaction are as follows:

2023

March 15	Accounts Receivable, K. Rahman	Tk.1,500
	Allowance for Doubtful Accounts	Tk.1,500
	(To reinstate the portion of the account of K. Rahman as an asset account previously written-off.)	

2023

March 15	Cash	Tk.1,500
	Accounts Receivable, K. Rahman	Tk.1,500
	(To record collection from K. Rahman)	

In the above entries Accounts Receivable which was earlier debited has now been credited. As a result the balance of this account remained intact. Cash account has increased and the balance of Allowance for Doubtful Accounts has also increased which would be deducted from Accounts Receivable in the balance sheet. It means that the total of balance sheet will remain unaffected as a result of these entries.

Direct Write-off Method

Some companies instead of using the Allowance for Doubtful Accounts have the practice to write-off directly a specific receivable which is proved to be worthless. Under this method no entry is made for expense in the period in which sales were made rather it is recorded in the period when any particular account receivable is proved to be worthless. From the accounting point of view the direct write-off method is not sound because it makes no attempt to match revenues with related expenses.

Uncollectible account is removed from books by debiting Allowance for doubtful accounts and crediting Accounts receivable account.

Direct method violates the matching concept and conservatism convention of accounting.

The direct write-off method is not sound because it makes no attempt to match revenues with related expenses.

When a particular customer's account is determined to be uncollectible, it is written off directly to **Uncollectible Accounts Expenses**. For example, assume that the finance director of East-West Ltd. has authorized to write off. Tk.3,000 owed by S. Jamil on April 15, 2023. The entry will be:

2023
 April 15 Uncollectible Accounts Expense 3,000
 Accounts Receivable, S. Jamil 3,000
 (To write-off the receivables from S. Jamil
 as uncollectible)

In the balance sheet the accounts receivable are shown at gross value, not at realizable value, because there is no **Allowance for Doubtful Account**. though not sound from the stand point of accounting theory. In some situations, the use of **direct write off method** is appropriate. For example, if a company makes most of its sales for cash or sells almost all of its output to a few companies which are financially strong, the expense from uncollectible accounts would be small. Above all, the allowance method is better as this method enables to match revenues and expenses and thus makes a logical measurement of net income.

The allowance method is better as this method enables to match revenues and expenses.

4.3.4 Evaluating the Quality of Accounts Receivable

The success of a company's collection and credit policies depend to a large extent upon the collection of accounts receivable in time. If accounts receivable are not collected in time the possibility of bad debts expense increases. With the help of the ratio of net sales to average accounts receivable we can assess whether a company is performing its job properly or not in granting credit and collecting its receivable. This **accounts receivable turnover ratio** tells us how many times the company's average investment in receivable was converted into cash during the year. The formula is:

$$\text{Accounts Receivable Turn over Ratio} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

If accounts receivable are not collected in time the possibility of bad debts expense increases.

Example 4.06

Assume that East-West Ltd.'s financial statements show net sales of Tk.1,800,000 for the year 2023. The beginning receivables were Tk.280,000 and the ending receivables were Tk.320,000. Find out the accounts receivable turnover ratio.

Solution:

$$\text{Accounts Receivable Turn over Ratio} = \frac{1,800,000}{300,000} = 6 \text{ times}$$

The higher the Accounts Receivable turnover ratio, the more liquid the company's receivable.

Another technique to assess the liquidity of a company's accounts receivable is to convert the accounts receivable turnover ratio to the number of days (on average) required by the company to collect its accounts receivable. The formula for days' receivables is:

$$\text{Average Number of Days to Collect Receivables} = \frac{\text{Days in a Year}}{\text{Accounts Receivable Turnover ratio}}$$

With the help of data of example 4.06 we can compute the average number of days to collect accounts receivable as follow:

$$\text{Days Receivable} = \frac{365}{6} = 61 \text{ days}$$

Generally the collection period is related to the credit terms offered by the company. A rule of thumb is that the collection period should not exceed $1\frac{1}{3}$ times the regular payment period. Changes in the **accounts receivable turn-over ratio** or **days' receivables** indicate either changes in the company's credit policy or changes in its ability to collect receivables. A company's receivables collection efficiency can very well be assessed with the help of comparison of the collection period of other companies in the same industry and also with the company's own ratio for previous years.

The higher the Accounts Receivable turnover ratio, the more liquid the company's receivable.

A rule of thumb is that the collection period should not exceed $1\frac{1}{3}$ times the regular payment period.

Lesson 4: Inventories

Lesson Objectives

After studying this lesson, you will be able to:

- define inventories.
- describe the accounting for inventory.
- explain the importance of accurate inventory valuation.

4.4.1 Introduction

Uncorrected errors in ending inventories affect income determination for two periods.

The term inventories is used to designate (i) merchandise held for sale in the normal course of business, (ii) Work-in-process, and (iii) materials in the process of production or held for such use. This lesson of this unit and the following lessons focus on inventory accounting for merchandising firms that buy finished products to sell to their customers.

4.4.2 Inventories

Inventories are particularly significant because they may materially affect both the income statement and the balance sheet.

Inventories constitute the lifeblood of merchandising and manufacturing companies. Conventionally, inventories are the most essential items for the smooth functioning of a business, and the sale of inventories provides the major source of revenue. Inventories consist of all raw materials owned and held for sale in the regular course of business or goods that will be used or consumed in the production of goods to be sold. The measurement and valuation of inventory require careful attention because investment in inventories is the largest current asset in manufacturing and retailing businesses. Inventories are current assets because they are typically sold within one year or in the ordinary course of business. Inventories are particularly significant because they may materially affect both the income statement and the balance sheet.

4.4.3 Accounting for Inventory

The matching principle states that the revenue for the period must be offset by all the expenses incurred in producing that revenue.

The objective of accounting for inventories is to determine the appropriate income through the process of matching costs against revenues. The matching principle states that the revenue for the period must be offset by all the expenses incurred in producing that revenue. In most of the companies, the cost of goods sold is the largest single deduction from revenue.

To find out the cost of goods sold, first of all, we have to determine the costs of inventory. Inventory costs are all costs necessary to acquire goods and bring them to the site of sale and include the purchase price, plus any transportation or freight in, less purchase returns and allowances, and purchase discounts. In measuring the gross profit on sales for an accounting period, we deduct the cost of goods sold from the total sales of that period. The cost of goods sold is the net acquisition cost of goods sold to customers in generating the sales revenue of an accounting period. The cost of goods sold can be computed by applying the following equation:

$$\left(\begin{array}{c} \text{Cost of Goods} \\ \text{Available for sale} \end{array} - \begin{array}{c} \text{Ending} \\ \text{Inventory} \end{array} \right) = \begin{array}{c} \text{Cost of Goods} \\ \text{Sold} \end{array}$$

The following is a typical example of the computation of the cost of goods sold :

Example 4.07

	<u>Tk.</u>	<u>Tk.</u>
Beginning Inventory		70,000
Add: Net Cost of Purchases :		
Purchases	317,000	
Less: Purchases Returns		
and Allowances	15,500	
Purchase Discount	<u>4,500</u>	
	20,000	
	<u>297,000</u>	
Add: Transportation in	<u>13,000</u>	
		<u>310,000</u>
Cost of Goods Available for Sale		<u>380,000</u>
Less: Ending Inventory		<u>65,000</u>
Cost of Goods Sold		<u><u>315,000</u></u>

The cost of goods sold is the net acquisition cost of goods sold to customers in generating the sales revenue of an accounting period.

4.4.4 Importance of an Accurate Valuation of Inventory

Proper income determination depends on the appropriate measurement of all assets. As inventories are relatively large and their sizes fluctuate, the correct valuation of inventories is important in measuring the proper income. An error in inventory valuation can cause a material misstatement of financial position and net income. The following example will share the impact of inventory valuation on the measurement of income.

Example 4.08**Relationship of Inventory Measurements to Reported Income**

Assumed Data	With Correct Ending Inventory	With Incorrect Ending Inventory	
	<u>Tk.</u>	<u>Tk.</u>	<u>Tk.</u>
Sales	<u>415,000</u>	<u>415,000</u>	<u>415,000</u>
Beginning Inventory	70,000	70,000	70,000
Net Cost of Purchases	<u>310,00</u>	<u>310,00</u>	<u>310,00</u>
Cost of Goods Available for Sale	380,000	380,000	380,000
Less: Ending Inventory	<u>65,000</u>	<u>50,000</u>	<u>80,000</u>
Cost of Goods Sold	<u>315,000</u>	<u>330,000</u>	<u>300,000</u>
Gross Profit on Sales	100,000	85,000	115,000
Operating Expenses	<u>35,000</u>	<u>35,000</u>	<u>35,000</u>
Reported Net Income	<u>65,000</u>	<u>50,000</u>	<u>80,000</u>

Example 4.08 exhibits that incorrect valuation of ending inventory affects key figures in the income statement, such as the cost of goods

Proper income determination depends on the appropriate valuation of assets.

sold, the gross profit on sales and the reported net income for the period. Overstating or understating ending inventories overstates or understates income, respectively. The financial statement will also be affected by the amount of overstatement or understatement of ending inventories. In this connection, it is to be mentioned here that uncorrected errors in ending inventories affect income determination for two periods. Regardless of the direction of errors, it will cause an offsetting error of the same amount in the second period if it is not corrected. This is because of the fact that the ending inventory of one year is also the beginning inventory of the following year. Sometimes it is argued that an error in reported income due to the incorrect valuation of inventory for one year is exactly offset by the error in reported income for the next year. So, ultimately, the error has no serious consequences. But this is totally a wrong concept. Management may take many actions on the basis of reported income. Moreover, the bankers, creditors, investors, and other interested groups may be influenced by the reported income and by the trends of the reported income. So, an accurate valuation of ending inventory is essential to determine the actual income of an organization.

Questions and Exercises

Self-Text Questions

1. At the end of the accounting period of Rahman Ltd., the Accounts Receivable has a balance of Tk.100,000. Rahman Ltd. provision for Doubtful accounts has a balance of Tk.7,000. The expected realizable value of Accounts receivable will be:
(a) Tk.7,000 (b) Tk.93,000 (c) Tk.1,00,000 (d) Tk.1,07,000.
2. Which of the following constitute current assets:
(a) Preliminary expenses (b) Notes Receivable (c) Inventories (d) Furniture.
3. Following methods are employed for estimating uncollectible accounts.
(a) accounts receivable aging (b) percentage receivable approach
(c) perpetual accounts receivable approach (d) None of these approach.
4. At the end of the year before accounts are adjusted, accounts receivable balance stood at Tk.200,000 and allowance for doubtful accounts had a credit balance of Tk.2,500. If the estimate of uncollectible accounts determined by aging the receivable is Tk.8,500, the current provision to be made for uncollectible accounts expenses would be:
(a) Tk.2,500 (b) Tk.6,000 (c) Tk.8,500 (d) Tk.2,00,000

Discussion Questions

1. Define current assets. What are the segments of current assets?
2. What are the basic problems that occur in the valuation of accounts receivable?
3. Explain the relationship between the matching principle and the need to estimate uncollectible accounts receivable.
4. Why is it important to have separate accounts for Sales Returns and Allowances & Sales Discounts? Wouldn't it be much easier to reduce the Sales Revenue account directly for these adjustments?
5. What do you mean by uncollectible accounts receivable?
6. In what ways are the Allowance for Uncollectible Accounts similar to Accumulated Depreciation? In what ways are these different?
7. Why does the accounting profession require use of the allowance method of accounting for losses due to uncollectible accounts rather than the direct write-off method?

8. Describe the two most commonly used methods of estimating uncollectible accounts expense when the allowance method is employed.
9. What procedure for estimating uncollectible accounts also gives management a view of the status of collections and the overall quality of accounts receivable?
10. Indicate how well the percentage-of-sales method and the aging method accomplish the objective of the allowance method of accounting for bad debts.
11. Are the following terms different in any way?
Allowance for bad debts, Allowance for doubtful accounts, Allowance for uncollectible accounts.
12. What is the effect on the net income of an optimistic versus a pessimistic view by management of estimated uncollectible accounts?
13. What is the underlying reasoning behind the percentage of net sales and the accounts receivable aging methods of estimating uncollectible accounts?
14. Gazi Ltd. estimates its uncollectible by aging its accounts and applying percentages to various strata of the aged accounts. This year, it has calculated a total of Tk.63,000 possible losses. On December 31, the Accounts Receivable balance is Tk.304,000 and the Allowance for Uncollectible Accounts has a credit balance of Tk.15,000 before adjustment. Give the adjusting entry to provide for credit losses. Determine the net amount of Accounts Receivable added into current assets.
15. Why is the "aging" method of determining uncollectible accounts receivable usually more accurate than basing the estimate on total receivables?
16. Why should the entry for an account that has been written off as uncollectible be reinstated if the amount owed is subsequently collected?
17. How is the accounts receivable turnover rate computed? Why is this rate significant to short-term creditors?
18. What is the normal procedure for handling the collection of accounts receivable previously written off using the direct write-off method? The allowance method?
19. Why is it important to monitor operating ratios such as accounts receivable turn over ratio?
20. How do you evaluate the quality of accounts receivable?
21. Is the cost of merchandise acquired during the period classified as an asset or an expense? Explain.

Exercises

- On January 25, 2023, Hasam Ltd. sold merchandise to Hiltop Company for Tk.2,400,000 with terms 2/10, n/30. On January 30, Hiltop paid Tk.1,176,000 on her account. On February 15, Hiltop paid Tk.720,000 on her account and returned Tk.480,000 of merchandise, claiming that it did not meet contract terms.

Record the necessary journal entries on January 25, January 30 and February 15. The cost of merchandise to Hasam Ltd. is 70 percent of its selling price.

- Purobi Company shows a balance of Tk.3,622,800 in the Accounts Receivable account on December 31, 2022. The balance consists of the following:

Installment accounts due in 2023	Tk. 460,000
Installment accounts due after 2023	480,000
Overpayments to creditors	52,800
Due from regular customers, of which	800,00
Represents accounts pledged as security for a bank loan	1,580,000
Advance to employees	30,000
Advance to subsidiary company (made in 2017)	1,020,000

Illustrate how the information above should be shown on the balance sheet of Purlobi Company on December, 2022.

- The trial balance before adjustment of Surovi Ltd. shows the following balances:

	Dr. (Taka)	Cr. (Taka)
Accounts receivable	450,000	
Allowance for doubtful Accounts	8,750	
Sales (all on credit)		3,400,000
Sales return and allowances	150,000	

- The preliminary trial balance of Rohan Company shows the following balances:

	Dr. (Taka)	Cr. (Taka)
Accounts receivable	400,000	
Allowance for doubtful Accounts		10,000
Sales for uncollectible Accounts		3,400,000
Sales return and allowances		1,500,000
Sales returns and allowances	15,000	

Using this data, prepare journal entries to record uncollectible accounts expense assuming the company wants to maintain Allowances for Uncollectible Accounts balances at 4 percent of account receivable.

5. The credit manager of Olympic Ltd. has gathered the following information about the company's accounts receivable and credit losses during the current year:

Net credit sales for the year		Tk.24,000,000
Accounts receivable at year en		2,880,000
Uncollectible accounts receivable:		
Actually written off during the year	Tk.349,200	
Estimated portion of year end receivable expected to prove uncollectible		
(per aging schedule)	144,000	493,200

Prepare one journal entry summarizing the recognition of uncollectible accounts expense for the entire year under each of the following independent assumptions:

- Uncollectible accounts expense is estimated at an amount equal to 2 percent of net credit sales.
 - Uncollectible accounts expense is recognized by adjusting the balance in the Allowances for Doubtful Accounts to the amount indicated in the year-end aging schedule. The balance in the allowance account at the beginning of the current year was Tk.120,000. (Consider the effect of the write-offs during the year upon the balance in the Allowance for Doubtful Accounts.)
 - The company uses the direct write-off method of accounting for uncollectible accounts.
 - Which of the three methods gives investors and creditors the most accurate assessment at a company's liquidity? Defend your answer?
6. Jahan Company uses the balance sheet approach to estimate uncollectible accounts expense. At year end an aging of the accounts receivable produced the following classification:

Not yet due	Tk.11,665,000
1-30 days past due	675,000
31-60 days past due	292,500
61-90 days past due	67,500
Over 90 days past due	112,500
Total	<u>2,812,500</u>

On the basis of past experience, the company estimated the percentages probably uncollectible for the above five age groups to be as follows: Group-1, 1 percent Group-2, 3 percent Group-3, 10 percent Group-4, 20 percent and Group-5, 50 percent.

The Allowance for Doubtful Accounts before adjustment at December 31, showed a credit balance of Tk.40,500.

Required

- (a) Compute the estimated amount of uncollectible accounts based on the above classification by age groups.
 - (b) Prepare the adjusting entry need to bring the Allowance for Doubtful Accounts to the proper amount.
 - (c) Assume that on January 10 of the following year, Jahan learned that an account receivable which had originated on September 1, in the amount of Tk.42,750 was worthless because of the bankruptcy of the customer Belal Ltd. Prepare the journal entry required on January 10, to write-off this account.
 - (d) The company is considering the adoption of a policy whereby customers whose outstanding accounts become more than 60 days past due will be required to sign interest-bearing note for the full amount of their outstanding balance. What advantages would such a policy offer?
7. The following data were taken from the accounts receivable records of Pioneer Company as of December 31, 2023:

Receivable Aging Classification	Receivable Balances Outstanding	Probability of Non collection
0-30 days past due	Tk.2,800,000	0.5%
31-60 days past due	350,000	1.0%

A credit balance of Tk.7,000 exists in the Allowance for Uncollectible Accounts.

Determine the amount of uncollectible accounts expenses to be recorded at the year end 2023 by Pioneer Company.

8. The Moon Beam Ltd., is a manufacturer that makes all sales on 30-day credit terms. The annual sales of it is approximately Tk.50 million. At the end of 2022, accounts receivable were presented in the company's balance sheet as shown below:

Accounts receivable from customers	Tk.4,700,000
Less: Allowance for doubtful accounts	140,000

During 2023 Tk.1,430,000 in accounts receivable were written off as uncollectible. Of these accounts written off, receivable totaling Tk.48,000 were unexpectedly collected. At the end of 2023, an aging of accounts receivable indicated a need for Tk.160,000 allowance to cover possible failure to collect the accounts currently outstanding.

Moon Beam makes adjusting entries in its accounting records only at year-end. Monthly and quarterly financial statements are prepared from work sheet, without any adjusting or closing entries actually being entered in the accounting records. (In short, you may assume the company adjusts its accounts only at year-end.)-

- (a) Give entries to the following in the form of general journal:
 - (i) One entry to summarize all accounts written off against the allowance for doubtful accounts during 1999.
 - (ii) Entries to record the Tk.48,000 in accounts receivable, which were unexpectedly collected.
 - (iii) The adjusting entry required at December 31, 1999 to increase the allowance for doubtful accounts to Tk.160,000.
- (b) Notice that the allowance for doubtful accounts was only Tk.140,000 at the end of 2022, but uncollectible accounts during 2023 totaled Tk.1,432,000 (Tk.1,480,000 less the Tk.48,000 reinstated). Do these relationships appear reasonable, or was the allowance for doubtful accounts greatly under - stated at the end of 2022? Explain.

Lesson 5: Inventory Valuation Methods- Perpetual Inventory System

Lesson Objectives

After studying this lesson, you will be able to:

- describe inventory valuation methods.
- discuss specific identification method, average cost method, last-in, first out method and first-in, first-out method.
- make a comparison and find out the effects of alternative methods of inventory valuation.

4.5.1 Introduction

In valuing the inventory in its dual position as (i) the value that is reported in the operating statement in determining the cost that is to be applicable to current revenue and (ii) a value reported in the Balance sheet, it is the cost that is treated as the primary basis for valuation. However, when there is a marked change in the value of inventory at purchase time and at the valuation date, the question arises as to whether some recognition should be given to replacement cost or market price. This cost or market price whichever is lower and other related aspects along with different modes of valuation will be discussed in this lesson.

4.5.2 Inventory Valuation Methods (Perpetual Inventory System)

In general, inventory valuation is made at historical cost. If all merchandises are purchased at the same unit cost, the determination of ending inventory and cost of goods sold for a period would not pose any problem once the quantity of goods in hand is determined. But the prices of most kinds of merchandise vary during any fiscal year, and identical lots of merchandise may have been purchased at different prices. If inventories are to be priced at cost and numerous purchases have been made at different unit costs, which of the various prices should be used? For this reason, the accountant must turn to one of several systematic inventory cost flow assumptions. In practice, the actual physical flow of goods and the cost flow assumptions are quite different, the assumption is really an assumption about the flow of costs rather than the flow of physical inventory. Flow of goods describes the actual physical movement of goods in the company's operations. Cost flow is the real or assumed association of unit costs with goods either sold or in hand. The assumed cost flow may not reflect the actual flow of goods. In the following sections, we will discuss four generally accepted methods of pricing inventories: (i). specific identification method, (ii). average-cost method, (iii). first-in, first-out (FIFO) method, and (iv) Last-in, last-out (LIFO) method. Each of the four methods of inventory pricing mentioned above is acceptable for use in published financial statements. The factors that should be considered in choosing an inventory pricing method are the effects of each method on the balance sheet, the income statement, income taxes, and management decisions.

The prices of most kinds of merchandise vary during any fiscal year.

Flow of goods describes the actual physical movement of goods in the company's operations.

4.5.3 Specific Identification Method

If the units in ending inventory can be identified as coming from specific purchases, the specific identification method may be used to price the inventories. The method involves (i) keeping track of the purchased price of each specific unit, (ii) knowing which specific units are sold, and (iii) pricing the ending inventory at the actual prices of the specific units not sold. This method is best suited to inventories of high-priced, low-volume articles such as automobiles, heavy equipment, jewelry, estate homes, and other types of real estate. Conceptually, this method appears ideal because actual costs are matched against actual revenue, and ending inventory is reported at actual cost. However, though this method appears to be logical, it is not used much because it has two definite disadvantages. First, it is very difficult and impractical in most cases to keep track of the purchases and sales of inventory items. Second, when a substantial number of physically identical items are sold, this method can be unsatisfactory because the cost of goods sold depends on what specific items happen to be sold. In addition, a company can deliberately manipulate the cost of goods sold by choosing items that have low or high costs. To illustrate the specific identification inventory costing method, we will consider the records of East-West Co. for the month of July, 2023, which sells identical items.

It is very difficult and impractical in most cases to keep track of the purchases and sales of inventory items.

Example 4.09

July 01	Beginning inventory 200 units	@ Tk. 400 each
05	Purchased 160 units	@ " 500 "
08	Sold 240 units	@ " 800 "
17	Purchased 320 units	@ " 600 "
25	Purchased 200 units	@ " 640 "
30	Sold 400 units	@ " 800 "

Assume that of the 240 units sold on July 08, 160 units come from the beginning inventory and 80 from the July 05 purchase, and that of the 400 units sold on July 30, 300 come from the July 17 purchase and 100 from the July 25 purchase.

Solution :

The cost of ending inventory is the total of the individual costs of inventories still in hand at the end of the month, or :

Remaining 40 units from beginning inventory	@	Tk.400 =	Tk.16,000
" 80 units purchased on July 05	@	" 500=	40,000
" 20 units purchased on July 17	@	" 600=	12,000
" 100 units purchased on July 25	@	" 640=	64,000
Total ending inventory (240 units)			= <u>Tk.132,000</u>

Similarly, the cost of goods sold is the total cost of the specific units sold, or :

160 units from beginning inventory	@	Tk. 400=	Tk.64,000
80 units from the purchase of July 08	@	" 500=	" 40,000
300 units from the purchase of July 17	@	" 600=	" 180,000
100 units from the purchase of July 25	@	" 640=	" 64,000
Total cost of goods sold			<u>Tk. 348,000</u>

With the above data, the cost of goods sold and ending inventory can be computed in the following way:

	<u>Units</u>	<u>Cost</u>
Beginning inventory	200	Tk.80,000
Add: Net purchases	<u>680</u>	<u>400,000</u>
Goods available for sale	880	480,000
Less: Ending inventory	<u>240</u>	<u>132,000</u>
Cost of goods sold	<u>640</u>	<u>Tk.348,000</u>

4.5.4 Average Cost Method

As the name implies, the average cost method prices items in the inventory on the basis of the average cost of similar goods available during the period. Under this method, it is assumed that the cost of inventory is the average cost of goods on hand at the beginning of the period plus all goods purchased during the period. Average cost is computed at the end of the period by dividing the total cost of goods available for sale by the number of units available for sale. This computation gives weighted average unit cost, which is then applied both to the units in the ending inventory and the cost of goods sold. To illustrate, when the periodic weighted average method is used, the East-West Co.'s ending inventory would be as follows:

The average cost method prices items in the inventory on the basis of the average cost of similar goods available during the period.

Date	Purchases			Cost of Goods Sold			Balance of inventory		
	No. of Units	Units Cost	Total Cost	No. of Units	Unit Cost	Total Cost	No. of Units	Units Cost	Total Cost
		Tk.	Tk.		Tk.	Tk.		Tk.	Tk.
Beginning inventory	--	--	--	--	--	--	200	400	80,000
July 05	160	500	80,000	--	--	--	360		
08	--	--	--	240	545.454	130,909	120		
17	320	600	192,000	--	--	--	440		
25	200	640	128,000	--	--	--	640		
30	<u>680</u>		<u>400,000</u>	<u>400</u>	<u>545.454</u>	<u>218.182</u>	<u>240</u>	<u>545.454</u>	<u>130.909</u>
Total	<u>680</u>		<u>400,000</u>	<u>640</u>	<u>545.454</u>	<u>349,091</u>	<u>240</u>	<u>545.454</u>	<u>130,909</u>

Another average cost method is the moving average method, which is used with perpetual inventory records.

Another average cost method is the moving average method, which is used with perpetual inventory records. Under this method, a new average unit cost is computed each time a purchase is made. To illustrate, assume that East-West Co. used the moving average method:

Date	Purchases			Cost of Goods Sold			Balance of inventory		
	No. of Units	Units Cost	Total Cost	No. of Units	Unit Cost	Total Cost	No. of Units	Units Cost	Total Cost
		Tk.	Tk.		Tk.	Tk.		Tk.	Tk.
Beginning inventory	---	---	---	---	---	---	200	400.00	80,000
July 05	160	500	80,000				360	444.44	160,000
08	---	---	---	240	444.44	106,667	120	444.44	53,333
17	320	600	192,000	---	---	---	440	557.58	245,333
20	200	640	128,000	---	---	---	640	583.33	373,333
30				400	583.33	233,333	240	583.33	140,000
Total	680		400,000	640		340,000	240	583.33	140,000

4.5.5 First-in, First-out (FIFO) Method

The first-in, first-out method assumes that the cost of the first items acquired should be assigned to the first items sold.

The first-in, first-out method is based on the assumption that the oldest goods are sold first and that the most recently purchased goods are in the ending inventory. In other words, it assumes that the cost of the first items acquired should be assigned to the first items sold. The costs of the goods on hand at the end of the period are assumed to be from the most recent purchases, and the costs assigned to goods that have been sold are assumed to be from the earliest purchases. Assume that East-West Co. uses the FIFO method, the ending inventory and the cost of goods sold would be as follows:

Date	Purchases			Cost of Goods Sold			Balance of inventory		
	No. of Units	Units Cost	Total Cost	No. of Units	Unit Cost	Total Cost	No. of Units	Units Cost	Total Cost
		Tk.	Tk.		Tk.	Tk.		Tk.	Tk.
Beginning inventory	--	--	--	--	--	--	200	400	80,000
July 05	160	500	80,000	--	--	--	200 160	400 500	160,000
08	--	--	--	200 40	400 500	100,000	120	500	60,000
17	320	600	192,000	--	--	--	120 320	500 600	252,000
25	200	640	128,000	--	--	--	120 320 200	500 600 640	380,000
30	--	--	--	120 280	500 600	228,000	40 200	600 640	152,000
Total	680		400,000	640		328,000	240		152,000

The distinguishing characteristic of the FIFO method is that the oldest purchase costs are transferred to the cost of goods sold, while the most recent purchase costs remain in inventory.

4.5.6 Last-in, First-out (LIFO) Method

The last-in, first-out method, commonly known as LIFO, is one of the most interesting methods of pricing inventories. This method of costing inventories is based on the assumption that the cost of the most recently acquired goods should be assigned to the first to be used or sold and that the cost of the ending inventory consists of the cost of merchandise purchased earliest. This assumption, of course, does not agree with the actual physical movement of goods in most businesses. Under this method, the cost of goods sold and the ending inventory of East-West Co. would be computed as follows:

The last-in, first-out method is based on the assumption that the cost of the most recently acquired goods should be assigned at first towards uses or sales.

Date	Purchases			Cost of Goods Sold			Balance of inventory		
	No. of Units	Units Cost	Total Cost	No. of Units	Unit Cost	Total Cost	No. of Units	Units Cost	Total Cost
		Tk.	Tk.		Tk.	Tk.		Tk.	Tk.
Beginning inventory	--	--	--	--	--	--	200	400	80,000
July 05	160	500	80,000	--	--	--	200	400	160,000
							160	500	
08	--	--	--	160	500	112,000	120	400	48,000
				80	400				
17	320	600	192,000	--	--	--	120	400	240,000
							320	600	
25	200	640	128,000	--	--	--	120	400	
							320	600	368,000
							200	640	
30	--	--	--	200	640		120	400	
				200	600	248,000	120	600	120,000
Total	680		400,000	640		360,000	240		120,000

The LIFO method assures the fairest determination of income as the current costs of merchandise are matched against current sales revenue, regardless of which physical units of merchandise were sold.

Comparison and Effects of Alternative Methods of Valuation of Inventory

The specific identification, average cost, FIFO, and LIFO methods of pricing inventory have been discussed so far. The specific identification method is based on actual costs, whereas the other methods are based on assumptions regarding the flow of costs. Let us now compare the effects of the four methods on net income, using the same data as before: (see on next page)

The specific identification method is based on actual costs, whereas the other methods are based on assumptions regarding the flow of costs.

	Specific Identification Method	Average cost method		First-in, First-out Method	Last-in, First out Method
		Periodic Average	Moving Average		
	Tk.	Tk.	Tk.	Tk.	Tk.
Net sales	<u>512,000</u>	<u>512,000</u>	<u>512,000</u>	<u>512,000</u>	<u>512,000</u>
Cost of Goods sold:					
Beginning Inventory	80,000	80,000	80,000	80,000	80,000
Net Purchase	<u>400,000</u>	<u>400,000</u>	<u>400,000</u>	<u>400,000</u>	<u>400,000</u>
Cost of Goods Available for Sale	480,000	480,000	480,000	480,000	480,000
Less: Ending Inventory	<u>132,000</u>	<u>130,909</u>	<u>140,000</u>	<u>152,000</u>	<u>120,000</u>
Cost of Goods sold	<u>348,000</u>	<u>349,091</u>	<u>340,000</u>	<u>328,000</u>	<u>360,000</u>
Gross Margin from Sales	<u>164,000</u>	<u>162,909</u>	<u>172,000</u>	<u>184,000</u>	<u>152,000</u>

Effect of Inventory Valuation Method on Net Income in Inflationary and Deflationary Conditions

The effect of the methods of valuation upon the net profit in Inflationary and Deflationary time is of great significance. The use of FIFO method in a rising price matches rising sales prices with the oldest low cost inventory, thus expanding the gross margin on sales. In a period of falling prices, declining sales prices are matched against the oldest high-cost inventory, thus narrowing the margin on sales. On the other hand use of LIFO method leads to relate the current high cost of acquiring merchandise with rising sales prices in a period of rising prices and the low cost of acquiring merchandise with decreasing sale, prices in a period of falling prices. The average method, however, recognizes both past and present costs in the inventory. In this case, generally, results will closely parallel to FIFO costs since ordinarily purchases during the period are usually several times the inventory balance carried into the period and the average cost forming the classing inventory valuation will thus approach current costs.

Lesson-6: Periodic Inventory System

Lesson Objectives

After studying this lesson, you will be able to:

- discuss the periodic inventory system.
- explain First-in, First-out (FIFO) Method, Last-in, Last-out (LIFO) Method and Average Cost Method.
- identify the need for consistency in the valuation of inventory.
- assess how well an organization manages its inventory.

4.6.1 Introduction

There are two principal systems of inventory periodic and perpetual. The periodic system is often used in small and medium sized enterprises that sell a variety of low unit cost merchandise and where expenses of maintaining perpetual inventory, that continuously discloses the amount of inventory, is considered not rational and prohibited thereby. In this lesson, a detailed discussion as to the valuation of inventory under the periodic inventory system is aimed at.

4.6.2 Periodic Inventory Systems

Although the perpetual inventory method provides excellent control over merchandise and allows for a quick determination of the amount of inventory at all times, some businesses do not use the perpetual system because it is too time-consuming and complex. A periodic inventory system is an alternative to a perpetual inventory system. Under the periodic inventory system, no effort is made to keep up-to-date records of either the quantum of inventory or the cost of goods sold, instead, the quantity and cost of inventory are determined, as its name implies, only periodically - usually at the end of each financial year. It allows a firm to determine inventory and cost of goods sold at the end of the period without recording the effect on inventory of every sale and purchase transaction. Under this method, all the acquisitions of merchandise of the period are debited to the purchase account. The total of the purchase account is added to the cost of beginning inventory at the end of the period to determine the cost of goods available for sale. To compute the cost of goods sold, ending inventory is deducted from the *cost of goods available for sale*. Note that under this system, the *cost of goods sold* is a residual amount that is dependent upon the physical count of inventory at the end of the period. Since inventory available for sale has to be either included in the ending inventory or sold during the period, ending inventory and cost of goods sold are complementary amounts, and their sum must always equal to the total cost of goods available for sale. The physical count of inventory should be taken at the end of the financial year of the company so that correct inventory quantities are available, for use in preparing annual accounting reports and statements.

A periodic inventory system is an alternative to a perpetual inventory system.

The total of purchase account is added with the cost of beginning inventory at the end of the period to determine the cost of goods available for sale.

Inventory available for sale has to be either included in the ending inventory or sold during the period.

4.6.3 Periodic Inventory Cost Flow Assumptions

The quantity of inventory is determined by taking a complete physical count of the inventory on hand at the end of the financial year.

As discussed above, the company that maintains the periodic inventory system, does not keep track of the cost of goods sold during the period. The quantity of inventory is determined by taking a complete physical count of the inventory on hand at the end of the financial year. The cost of ending inventory is computed at the time of physical count and subtracted from *cost of goods available for sale* to determine *cost of goods sold*. The accountant must choose one of several systematic inventory cost flow assumptions - FIFO, LIFO, or Average costing.

First-in, First-out (FIFO)

The periodic inventory system makes all calculations at the end of the period, normally after physical counting of ending inventory.

The FIFO method one of the cost-assigning method, assumes that the earliest acquired items are first used or sold. The ending inventory therefore represents the most recent purchases. Unlike the perpetual method, which makes calculations throughout the period, the periodic inventory system makes all calculations at the end of the period, normally after physical counting of ending inventory. To illustrate, under the periodic FIFO method, East-West Co. (see Example 4.09) would determine its ending inventory and cost of goods sold as follows:

	<u>Units</u>	<u>Costs</u>
Beginning inventory	200	Tk.80,000
Add: Net Purchases	<u>680</u>	<u>400,000</u>
Goods available for sale	880	Tk.480,000
Less: Ending inventory *	<u>240</u>	<u>152,000</u>
Cost of goods sold	<u>640</u>	<u>Tk.328,000</u>
40 units @ Tk. 600 (Purchased on July-17)		Tk. 24,000
*200 units @ Tk. 640 (Purchased on July- 25)		<u>128,000</u>
		= Tk. <u>152,000</u>

Note that the same results may be obtained under the perpetual FIFO method also. Whatever method, perpetual or periodic system, is used under FIFO the amount of cost of goods sold, net income, and ending inventory will be same. Only the recording process is different.

Last in, First-out (LIFO)

Under LIFO method the cost of the last items purchased are first matched against revenue.

The LIFO method is opposite to FIFO i.e. under the LIFO method the cost of the last items purchased are first matched against revenue. With the periodic LIFO system, the cost of goods sold and the ending inventory of East-West Co. (see Example 4.09) are calculated as follows:

	<u>Units</u>	<u>Costs</u>
Beginning inventory	200	Tk.80,000
Add: Net purchases	<u>680</u>	<u>400,000</u>
Goods available for sale	880	Tk.480,000
Less: Ending inventory *	<u>240</u>	<u>100,000</u>
Cost of goods sold	<u>640</u>	<u>Tk.380,000</u>

* 200 units beginning inventory @ Tk.400 =	Tk.80,000
40 units (Purchased on July 17) @ Tk.500 =	<u>20,000</u>
Total	Tk. <u>100,000</u>

The cost of ending inventory under the periodic LIFO method is Tk.100,000 and under the perpetual LIFO method is Tk.120,000. This difference of Tk.20,000 arises due to the fact that under periodic LIFO method no calculation is made until the end of the period.

Average Costs

The average cost approach is a cost flow alternative whereby the cost of goods sold and the cost of ending inventory are determined by using a weighted average cost of all inventories available for sale during the period. To illustrate, assuming that East-West Co. (see Example 4.09) used the periodic inventory method, the ending inventory, and cost of goods sold would be computed as follows using a weighted average method:

	<u>Units</u>	<u>Costs</u>
Beginning inventory	200	Tk.80,000
Add: Net Purchases	<u>680</u>	<u>400,000</u>
Goods available for sale	880	Tk.480,000
Less: Ending inventory *	<u>240</u>	<u>130,909</u>
Cost of goods sold	<u>640</u>	Tk. <u>349,091</u>

* Under the periodic weighted average method the average cost is computed by the cost of goods available for sale by the number of units available for sale during that periodic, or;

$$\frac{\text{Cost of goods available for sale}}{\text{Total no. of units available for sale}} = \frac{480,000}{880} = 545.454$$

As discussed earlier, in periodic weighted average method the rate is calculated only once at the end of the period. By contrast, in the perpetual moving average method, a new average rate is computed after each purchase.

4.6.4 The Consistency is the valuation of Inventory

The reliability of the financial statement of a company depends to a large extent on whether the company follows the principle of consistency. The principle of consistency means that once a company has adopted a particular method of accounting, the company should follow the method consistently in the following years without shifting to another method frequently. Therefore before selecting a particular method, the pros and cons of the method should be considered carefully. A company can increase or decrease its net income simply by changing its method of inventory valuation. As discussed earlier, the reported income of a company differs due to the adoption of different methods of inventory

In periodic weighted average method the rate is calculated only once at the end of the period.

Before selecting a particular method, the pros and cons of the method should be considered carefully.

valuation. Frequent methods of switching would make income statements undependable. In order to ensure the reliability of financial statements an organization should follow a particular method for a reasonable period of time.

The principle of consistency does not mean that company can never change its inventory valuation method.

The principle of consistency does not mean that a company can never change its inventory valuation method. If circumstances demand, a company can switch to another method. However, when a company changes its methods of inventory valuation, the effect of the change on the reported income should be disclosed fully in the footnotes accompanying financial statements. However, it may be mentioned that when a company follows a particular method consistently for adequate disclosure of all information, the even then inventory valuation method in use should be disclosed in the Balance sheet.

4.6.5 Assessing How Well Organizations Manage Their Inventories

Traditionally, companies have maintained large amounts of inventories to act as buffers so that operations can proceed smoothly. But now-a-days companies try their best to minimize investment in inventories. In fact, in recent years a method of inventory management called just-in-time (JIT) inventory has become popular. Under ideal conditions, a company operating a just-in-time system would purchase only enough materials each day to meet that day's needs. Although it is tough to reach this ideal, JIT has made it possible for many companies to reduce inventories to only a fraction of their previous levels. The result has been a substantial reduction in ordering and warehousing costs and much more effective operations. Its purpose is to minimize the amount of money needed for purchasing and holding inventory.

A company operating under a just-in-time system would purchase only enough materials each day to meet that day's needs.

Two widely used measurements of how effectively a company is managing its inventory are the inventory turnover ratio and a number of days of inventory on hand. The inventory turnover ratio indicates the velocity with which merchandise moves through a business. It is the ideal method of assessing the soundness of inventory management. It is calculated by dividing the cost of goods sold by the average inventory (beginning and ending inventory balances divided by 2) as follows:

Inventory turnover ratio indicates the velocity with which merchandise moves through a business.

$$\text{Inventory Turnover ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

The ratio indicates whether investment in inventory is efficiently used or not. The same relationship can be expressed as the number of days' investment on hand. This ratio is computed by dividing 365, or the number of days in a year, by the inventory turnover, as follows:

$$\frac{\text{Number of days of}}{\text{Inventory on hand}} = \frac{365}{\text{Inventory Turnover}}$$

To assess whether a company is managing its inventory properly or not, it can compare the above mentioned ratios over time with other firms in the same industry.

Questions and Exercises

Self-Test Questions

1. The inventory system employing accounting records continuously discloses the amount and quantity is called:
(a) periodic (b) perpetual (c) physical.
2. The inventory pricing for costing that is based on the assumption that costs should be charged against revenue in the order in which they were incurred is:
(a) FIFO (b) LIFO (c) Average (d) Perpetual Inventory.
3. A company maintains a large inventory. It has been using LIFO method of inventory for a long time, during which purchase costs of its products have risen dramatically. In such a context what happen?
(a) It would have reported a higher net income in past years if it had been using the average cost method.
(b) Its financial statements imply a higher inventory turnover rate share than they would if the company would have used the FIFO method.
(c) Its current ratio is lower than it would be if the company would have used FIFO
4. If inventory is being valued at cost and the price level is being stolidly rising, the method of costing that will yield the largest net income is:
(a) LIFO (b) FIFO (c) Periodic (d) Average.

Discussion Questions

1. What is merchandise inventory, and what is the primary objective of inventory measurement?
2. Why should inventories be included in (a) a statement of financial position and (b) the computation of net income?
3. Is net income under or overstated if inventory is sold and slapped but not recorded as a sale?
4. Why is accurate valuation of inventory important?
5. What is the effect on net income when goods held on consignment are included in the ending inventory balance?
6. Define inventory and identify the costs that should be included as inventory costs.
7. What is meant by goods flow and cost flow?
8. Specific identification is sometimes said to be the ideal method of assigning cost to inventory and to cost of goods sold. Briefly indicate the arguments for and against this method of inventory valuation.

9. First-in, first-out; weighted average; and Fast-in First-out methods are often used inside of specific identification for inventory valuation purposes. Compare these methods with the specific identification method, discussing the theoretical properties of each method in the determination of income and asset valuation.
10. Why do relatively stable purchase prices reduce the significance of the choice of an inventory pricing method?
11. Why is it necessary to know the alternative followed for inventory cost flow compared before the financial performances of different firms?
12. If prices have been rising, which inventory pricing method - weighted average; first-in, first-out; or last-in, first-out yields (a) the lowest inventory amount? (b) the lowest net income? (c) the largest inventory amount? (d) the largest net income?
13. As compared with the FIFO method of costing inventories, does the LIFO method result in a larger or smaller net income in a period of rising prices? What is the comparative effect on net income in a period of falling prices?
14. Under which method of cost flow are (a) the earliest costs assigned to inventory, (b) the latest costs assigned to inventory, (c) the average costs assigned to inventory?
15. Assume that a periodic inventory system is in use. Explain which per unit acquisition costs are assigned to the year-end inventory under each of the following inventory costing procedures:
 - (a) The average cost method
 - (b) FIFO
 - (c) LIFO
16. Which inventory pricing methods give the same results (ending inventory and total cost of goods sold) if applied under a perpetual inventory system and a periodic inventory system?
17. Why do companies using LIFO in the perpetual inventory system often restate their ending inventory at per unit cost that result from applying periodic LIFO costing procedures?
18. What does the term 'taking a physical inventory' mean?
19. May a company change its inventory costing method from year to year? Explain. Why such change may be necessary and what steps should be followed to report such change.

Exercises

1. The accounts of Star Company have the following balances for 2023:

Purchases	Tk.1,300,000
Inventory, January 1, 2023	200,000
Purchase returns and allowances	38,200
Purchase discount	4,400
Freight in	62,000
Freight-out (selling expense)	12,000
Cash	20,000

The inventory balance on December 31, 2023 is Tk.240,000.
Using the information given, compute the cost of goods sold for Star Company for 2023.

2. The Model Company has provided the following information for the calendar year 2023:

Inventory balance, January 1	Tk.800,000
Total cost of goods available for sale	2,400,000
Sales returns and allowances	104,000
Purchase returns and allowances	40,000
Freight-in	16,000
Sales (net of returns and allowances)	3,256,000
Operating expenses	216,000

The gross sales of Model Company are 160 percent of cost of goods sold. Using the available information, compute the following:

- (a) Gross sales for 2023.
 - (b) Net Purchases and gross purchases for 2023.
 - (c) Cost of goods sold for 2023.
 - (d) Inventory balance at December 31, 2023.
 - (e) Gross margin for 2023.
 - (f) Net income for 2023.
3. The beginning inventory, purchase and sales of product F 75 for April are presented below:

April 1	Beginning inventory	400 units @ Tk.50
5	Purchases	350 units @ Tk.55
8	Sales	500 units
12	Purchases	800 units @ Tk.66
15	Purchases	300 units @ Tk.58
20	Sales	1,000 units
25	Purchases	750 units @ Tk.62
30	Sales	800 units

Required:

Ascertain the quantity of ending inventory as on April 30, and state what will be its value (in each case) if issues are made under the following methods:

- a) First-in, First-out (FIFO)
 - b) Last-in, First-out (LIFO)
 - c) Average cost
4. The July 2023 inventory records of Sun-Moon Ltd. showed the following:
- | | | |
|---------|---------------------|-----------------------|
| July 1, | Beginning inventory | 56,000 units @ Tk. 40 |
| 5 | Sales | 15,000 units |
| 14 | Purchases | 6,000 units @ Tk. 50 |
| 18 | Sales | 18,000 units |
| 25 | Purchases | 32,000 units @ Tk. 48 |
| 30 | Sales | 25,000 units |
- a) Using the perpetual inventory method, compute the ending inventory and cost of goods sold balances with (i) FIFO, (ii) LIFO and (iii) moving average
 - b) Which of the above three alternatives is best? Why?
5. The following data relate to the records of M/S Apex Traders.

		Purchases			Sales
April 1	(balance on hand)	300 units @ Tk. 25	April 3		250 units @ Tk. 25
4	.....	800 units @ Tk. 14	9		700 units @ Tk. 25
8	.....	500 units @ Tk. 16	11		400 units @ Tk. 26
13	.....	600 units @ Tk. 17	23		600 units @ Tk. 26
21	.....	400 units @ Tk. 17	27		500 units @ Tk. 27
29	.....	300 units @ Tk. 18			
		<u>2,900 units</u>			<u>2,450 units</u>

Required:

- a) Assume that the periodic system is used, compute the inventory April 30, using (i) LIFO, and (ii) Average cost methods.
- b) Compute cost of goods sold assuming periodic inventory procedures and inventory priced at FIFO.
- c) In an inflationary period, which of the methods (FIFO, LIFO, average cost) will show the highest net income? Which will show the lowest rate of return on assets?

6. Examine the April data below for Singer Ltd., which prices inventory on the last in, first out basis and uses periodic inventory system.

Beginning inventory: 6,000 units @ Tk.30 each

	Purchases		Sales
April 5	5,000 units @ Tk.40	April 8	4,000 units @ Tk.50
10	8,000 units @ Tk.45	15	10,000 units @ Tk.60
22	14,000 units @ Tk.50	25	12,000 units @ Tk.65
30	7,000 units @ Tk.55	27	5,000 units @ Tk.75

Required:

- How much gross profit on sales would Singer Ltd. report for April?
 - By what amount would Singer Ltd.'s reported gross profit for April change if the final merchandise purchase had been postponed for several days.
 - How would Singer's reported gross profit differ if the final purchase had been for 20,000 units instead of for 7,000 units?
 - Assuming Singer used first-in, first-out method, calculate the answers to requirements (a), (b) & (c).
7. The Longman Company sells one product. Presented below is information for June for the Longman Company.

June 1	Inventory	500 units @ Tk.25 each
4	Sales	400 units @ Tk.40 each
15	Purchases	750 units @ Tk.30 each
18	Sales	600 units @ Tk.45 each
25	Purchases	750 units @ Tk.35 each
30	Sales	500 units @ Tk.48 each

The Longman uses the FIFO cost flow assumptions. All purchases and sales are on account.

Required:

- Assume the Longman uses a periodic system. Prepare all necessary journal entries, including one ending of month closing entry to record cost of goods sold. A physical count indicates that ending inventory for June is 500 units.
- Compute gross profit using the periodic system.
- Assume the Longman uses a perpetual system. Prepare all necessary journal entries.
- Compute gross profit using the perpetual system.

References

1. Financial Accounting, Robert F. Meigs, Mary A. Meigs, Mark Better and Rany Whittington, 9th ed. Irvin/McGraw Hill, (1998)
2. Intermediate Accounting, douald E. Kieso and Jerry J. Weygandt 8th ed. (1993) John Wiky and Sons. Inc.
3. Financial Accounting, K. Fred Skousen, W. Steve Albrecht and James D. Stice 6th ed. South-Western College Publishing (1996).
4. Accounting Principles, Robert N. Anthony and James E. Reece, 7th ed. Irwin, (1995).
5. Financial Accounting: An Introduction, Paul H. Walgenbach and Earnest I. Hanson, 6th ed. (1990), Harccourt Brace Jovanovich College Publishers.
6. Financial Accounting, Robert F. Meigs & Walter B. Miry, 6th ed. (1989), McGraw Hill Publishing Company.
7. Financial Accounting, Belverd E. Needces Jr. 3rd (1989), Honghton, Mifflin Company.

Case Study

Case 4-1: Group Assignment with Business Community Involvement

Identify one local business that uses a perpetual inventory system, and another that uses a periodic system. Interview an individual in each organization who is familiar with the inventory system and the recording of sales transactions.

Instructions:

Separately for each business organization:

- (a) Describe the procedures used in accounting for sales transactions, keeping track of inventory levels, and determining the cost of goods sold.
- (b) Explain the reasons offered by the person interviewed as to *why* the business uses this type of system.
- (c) Indicate whether your group considers the system in use appropriate under the circumstances. If not, recommend specific changes. *Explain your reasoning.*

Case 4-2: Call Up the (LIFO) Reserves!

Steel Specialties has been in business for 52 years. The company maintains a perpetual inventory system, uses a LIFO flow assumption, and ends its fiscal year at December 31. At year-end, the cost of goods sold and inventory are adjusted to reflect periodic LIFO costing procedures.

A railroad strike has delayed the arrival of purchases ordered during the last several months of 2022, and Steel Specialties has not been able to replenish its inventories as merchandise is sold. At December 22, one product appears in the company's perpetual inventory records at the following unit costs:

Purchase Date	Quantity	Unit Cost	Total Cost
November 14, 2019	6,000	Tk. 6	Tk.36,000
April 12, 2020	4,000	8	32,000
Available for sale at December 22, 2022	<u>Tk.10,000</u>		<u>Tk.68,000</u>

Steel Specialties has another 8,000 units of this product on order at the current whole-sale cost of Tk.30 per unit. Because of the railroad strike, however, these units have not yet arrived (the terms of purchase are F.O.B destination). Steel Specialties also has an order from a customer who wants to purchase 4,000 units of this product at the retail sales price

of Tk.45 per unit. Steel Specialties intends to make this sale on December 30, regardless of whether or not the 8,000 units on order arrive by this date. (The 4,000 unit sale will be shipped by truck, F.O.B. shipping point.)

Instructions:

- a. Are the units in inventory really almost 40 years old? Explain.
- b. Prepare a schedule showing the sales revenue, cost of goods sold, and gross profit that will result from this sale on December 30, assuming that the 8,000 units currently on order (1) arrive before year-end, and (2) do not arrive until sometime in the following year. (In each computation, show the number of units comprising the cost of goods sold and their related per-unit costs).
- c. Comment upon these results.
- d. Might management be wise to delay this sale by a few days? Explain.

ACCOUNTING FOR FIXED AND LONG LIVED ASSETS



From the discussions of this unit, students will be able understand:

-  **Property, Plant, and Equipment: Definition, Classification and Determination of Cost**
-  **Depreciation**
-  **Methods of Computing Depreciation**
-  **Disposal of Plant Assets**
-  **Accounting for Natural Resources and Intangible Assets**

এই পৃষ্ঠা খালি থাকবে

Unit- 5

Lesson-1: Property, Plant, and Equipment: Definition, Classification, and Determination of Cost

Lesson objectives

After studying this lesson, you will be able to:

- identify the three major balance sheet categories of fixed and long-lived assets.
- understand the accounting issues related to acquiring and valuing plant assets.
- distinguish between capital expenditure and revenue expenditure.

5.1.1 Introduction: Fixed and Long-Lived Assets

'Long-lived' is a general term applied to assets of a relatively fixed nature owned by a concern used in the operation of the business and not held for sale in the ordinary course of business. In the Balance Sheet, it is termed as fixed assets or property, plant, and equipment. This lesson will attempt to discuss important aspects of this asset as to its classification, assets, and the like.

Fixed and long-lived assets are those assets that (i) have a useful life of more than one year, (ii) are acquired for use in the operation of the business, and (iii) are not intended for resale to customers. The valuation of these assets is normally made on the basis of historical costs. As with the other business assets, the costs relating to the use of long-term assets must be properly calculated and matched against revenue to determine the correct periodic net income. These long-term assets fall in three major balance sheet categories. **Plant assets; natural resources; and intangible assets.** The procedures applied in accounting for these three categories vary somewhat because of the nature of the assets in each category.

Plant Assets are long-lived assets. This category includes land, buildings, machinery, equipment, and furniture. The accounting process of converting the original cost of a plant asset to expense is called **depreciation**. **Depreciation** refers to the periodic allocation of the cost of a tangible long-lived asset over its useful life. The concept of depreciation applies to all these assets except land, which usually has an unlimited life.

Natural Resources such as petroleum and natural gas in the ground, mineral deposits, gravel deposits, and timber tracts are assets that are physically consumed or are used up. The accounting process of converting the cost of these natural resource assets to expense is called **depletion**.

Natural Resources are assets that are physically consumed or are used up.

The terms 'depreciation' 'depletion' and 'amortization' have the same meaning in accounting.

Intangible Assets are long-lived assets that do not have physical substance and in most cases, they provide their owners with competitive advantages over other firms. Typical intangible assets are patents, copyrights, trademarks, franchises, and goodwill. The allocation of costs of intangible assets over their estimated useful lives is called **amortization**. All the above mentioned terms 'depreciation' 'depletion' and 'amortization' have the same meaning in accounting - that is, periodic charging to expense.

Property, Plant, and Equipment (PPE):

Plant and equipment represent long-lived assets acquired for use in the operations of the business and not intended for resale to customers.

The term **plant and equipment** is used to describe long-lived assets acquired for use in the operations of the business and not intended for resale to customers. Another alternative title used on many corporation balance sheets is **property, plant and equipment**. They represent a place to operate (land and building) and equipment to produce, sell, deliver, and service its goods. For this reason, they are often called **operating assets**, or sometimes **fixed-assets, tangible assets or long-lived assets**. The major characteristics of plant and equipment are:

- **They are acquired for use in operations and not for resale**
Long-lived tangible assets are usually listed on the balance sheet under the heading 'property, plant and equipment'. These are acquired for use in business operations and are not intended to resale to customers.
- **They are long-term in nature and usually subject to depreciation**
Plant assets render services over a number of years. All plant assets except land and are subject to depreciation, which is done through the process of allocating the costs of these assets over their estimated useful lives.
- **They possess physical substance**
Plant assets are characterized by physical existence or substance and thus differ from intangible assets, such as goodwill or patents.

5.1.2 Acquisition of Property, Plant, and Equipment

Historical cost is the usual basis for valuing property, plant, and equipment.

Historical cost is the usual basis for valuing property, plant, and equipment. The cost of an asset includes not only the purchase price but also any other costs incurred in acquiring the asset and placing it in a position and condition for use in the operations of the business. The purchase price, freight costs, sales tax, installation cost of a productive asset, trail runs, and any other costs necessary to make the asset ready for operation are considered part of the asset's cost. The concept of including in the cost of a plant asset all of the incidental charges necessary to put the asset in use is illustrated by the following example:

Example 5.01

Mehdi Ltd., a manufacturing firm in Dhaka, purchased a machinery from Germany at a list price of Tk.1,000,000, with terms of 2/10, n/30. Other related taxes and expenditures for the machine were as follows:

Sales tax	Tk.65,000
Freight charges	80,000
Transportation cost to factory	55,000
Installation cost	50,000
Testing of installed machine	20,000

The machine was damaged while being installed. The cost of repairing the damage was Tk.15,000. Determine the cost of the machine to be entered in the machinery account.

Solution :

The cost of the machine to be entered in the machinery account would be computed as follows:

List price of the machine	Tk.1,000,000
Less: Cash discount (2% of Tk.1,000,000)	20,000
Net cash price	Tk.980,000
Sales tax	65,000
Freight charge	80,000
Transportation cost to factory	55,000
Installation cost	50,000
Testing of installed machine	20,000
Cost of the machine	Tk.1,250,000

The cost of the plant asset includes all expenditures that are reasonable and necessary for getting the asset to the desired location and ready for use. Note that the cost of repairing the machine was not included in the cost of the machine. The cost of repairing damage should be recognized as the expense of the current period.

Allocation of Lump-Sum Purchase

Sometimes land and other assets are purchased for a lump sum. It may be mentioned that land is a non-depreciable asset and has an unlimited life. However, separate controlling accounts must be maintained for each type of plant asset, such as land, building, equipment, etc. Further, when plant assets comprising more than one element are purchased for lump sum, the purchase price needs to be allocated among the types of assets acquired.

When plant assets comprise more than one element are purchased for lump-sum, the purchase price need to be allocated among the types of assets acquired.

For example, assume that Mehedi Ltd. purchased a piece of land and a building with equipment for a bargain price of Tk.1,600,000. The allocation of this cost, based on an appraisal, is illustrated below:

	Value per Appraisal	Percentage of Appraisal Value	Allocation of Tk.1,600,000 cost
Land	Tk.1,000,000	50%	Tk.800,000
Building	700,000	35%	560,000
Equipment	<u>300,000</u>	<u>15%</u>	<u>240,000</u>
Total	<u>Tk.2,000,000</u>	<u>100%</u>	<u>Tk.1,600,000</u>

Assuming that Mehedi Ltd. purchased this facility for cash, the journal entry to record this acquisition would be:

Land	Tk.800,000	
Building	560,000	
Equipment	240,000	
Cash		Tk.1,600,00

(To record the purchase of land and a building with equipment for cash.)

5.1.3 Capital Expenditures and Revenue Expenditures

The term *expenditure* refers to a payment or incurrance of an obligation to make a future payment for asset.

The term **expenditure** refers to payment or incurrance of an obligation to make a future payment for an asset. Expenditures for the purchase or expansion of plant assets are called **capital expenditures** and are recorded in asset account. Typical capital expenditures related to plant assets are:

- ⇒ Initial acquisition and additions
- ⇒ Betterments
- ⇒ Extra-ordinary repairs.

In the above example, the total is taken to be the asset acquisition cost which implies that the total cost equals to cash price plus the costs necessary to make the asset ready for use. These amounts are capital expenditures and are debited to the asset account.

Expenditures for ordinary repairs, maintenance, fuel, and other items necessary to maintain and operate plant and equipment are called **revenue expenditures**. These items are recorded by debits to expense accounts. Revenue expenditures are charged to expense because the benefits from the expenditures will be used up in the current period. A business may purchase many small items that provide years of service at a relatively small cost, such as paperweights, ashtrays, and wastebaskets. Such items are theoretically capital expenditures, but because of the small amount involved, establishing these items as assets and depreciating them over their expected useful lives really serves no useful purpose. These items have no significant effect on the financial statement. For this reason, these items are treated as revenue

expenditures. Costs of waste and inefficiency related to the acquisition of plant assets are treated as expenses when incurred. As discussed earlier, only reasonable and necessary expenditures should be included in the asset account, any unnecessary or unreasonable outlays are expensed.

In summary, any material expenditure that will benefit several accounting periods is considered a ***Capital expenditure***. Any expenditure that will benefit only the current accounting period or that is not material in amount is treated as ***revenue expenditure***.

Any material expenditure that benefit several accounting periods is considered as capital expenditure.

Any expenditure that benefit only the current accounting period is treated as revenue expenditure.

Questions and Exercises

Self-Test Questions

1. Which of the following are the examples of intangible assets:
(a) patent (b) goodwill (c) copyright (d) preliminary expenses.
2. Which of the following expenditure incurred in connection with the acquisition of machinery is a proper charge to the asset account?
(a) Transportation expenditure (b) Installation cost (c) both a and b
(d) Neither a nor b.
3. A machine acquired for Tk.1,00,000 by trading is a similar asset that has a book value of Tk.20,000. Assume that trade-in allowance is Tk.30,000 and Tk.70,000 is paid in cash. What is the cost basis for the new asset;
(a) Tk.1,00,000 (b) Tk.70,000 (c) Tk.90,000 (d) None

Discussion Questions

1. Define a fixed asset. How can it be classified? Illustrate with example.
2. State the basis of recording fixed asset acquisition cost with an imaginary example.
3. What are the characteristics of long-term assets?
4. Which of the following characteristics would prevent an item from being included in the classification of plant and equipment?
(a) Intangible, (b) limited life, (c) unlimited life, (d) held for sale in the regular course of business, (e) not capable of rendering benefits to the business in the future. Explain.
5. List three major types of long-term assets, present examples of each, and indicate for each type the term that denotes the periodic write-off to expense.
6. In what way is land different from other long-term assets?
7. In general, what amounts constitute the initial cost of plant assets?
8. Which of the following expenditures incurred in connection with the purchase of a computer system would be charged to the assets account:
(a) purchase price of the equipment, (b) interest on debt incurred to purchase the equipment, (c) freight charges, (d) installation charges, (e) cost of special communications outlets at the computer site, (f) cost of repairing a door that was damaged during Installation, (g) cost of adjustments to the system during the first month of operation.
9. Why are fair market values used to determine the cost of operating assets acquired in a basket purchase?

10. Sagor Ltd. bought land with a vacant building for Tk.1,700,000. Sagor will use the building in its operations. Must Sagor allocate the purchase price between the land and the building? Why or why not? Would your answer be different if Sagor intended to raze the building and build a new one? Why or why not?
11. What is the distinction between revenue expenditures and capital expenditures, and why is this distinction important?
12. If it is uncertain whether an expenditure will benefit one or more than one accounting period, or whether it will increase the capacity or useful life of an operational asset, most firms will expense rather than capitalize the expenditure. Why?
13. If a capital expenditure is erroneously treated as a revenue expenditure, will the net income of the current year be overstated or understated? Will this error have any effect on the net income reported in future years? Explain.

Exercises

1. The following data relate to a firm's purchases of a machine used in the manufacture of its product:

Invoice price	Tk.500,000
Sales tax	24,000
Cash discount taken for prompt payment . . .	6,000
Freight	26,300
Insurance	17,500
Installation costs	20,000
Testing & adjusting costs	12,500
Repair of damages to the machine caused by firm's employees	8,000
Prepaid maintenance contract for the first year of machine's use	4,500

Compute the initial amount at which the machine should be carried in the firm's account.

2. To expand its business, Padma Ltd. Paid Tk.9,500,000 for most of the property, plant, and equipment of a small trucking company that was going out of business. Before agreeing to the price, Padma hired a consultant for Tk.100,000 to appraise the assets. The appraised values were as follows:

Land	Tk.1,200,000
Building	4,800,000
Trucks	3,000,000
Equipment	1,000,000
	<u>Tk.10,000,000</u>

Compute the amounts allocated to the various types of plant assets acquired in July, 2023.

Lesson-2: Depreciation

Lesson Objectives

After studying this lesson, you will be able to:

- explain the concept of depreciation.
- narrate how to record depreciation.
- discuss the causes of providing depreciation.
- describe the objectives of providing depreciation.
- identify the factors involved in the depreciation process.

5.2.1 Introduction

With the passage of time fixed assets, with the exception of land, lose their capacity to yield services. In such a context the cost of such assets needs to be transferred to related expense accounts in a systematic way during the useful life of the relevant asset. This allocation of cost is the depreciation. This lesson will examine the definite nature, cause, and factors of depreciation.

5.2.2 Plant and Equipment: Depreciation

Plant assets, with the exception of land, have a limited life; that is, they will provide service to the organization over a limited number of future accounting periods. A fraction of the cost of assets, therefore, is properly chargeable as an expense in each of the accounting periods in which the assets provide services. Accountants use the term **depreciation** to describe this gradual conversion of the cost of a plant asset into expense. The concept of depreciation is closely linked to the concept of business income. In the process of generating income, the use of long-term assets tend to consume their economic potential. The economic potential so consumed represents the expired cost of these assets and must be matched against revenue in order to determine the fair reported income.

The concept of depreciation is closely linked to the concept of business income.

Depreciation Accounting is mainly concerned with a rational and systematic distribution of cost over the estimated useful life of the assets.

Depreciation Accounting is mainly concerned with a rational and systematic distribution of cost over the estimated useful life of the assets. The American Institute of Certified Public Accountants (AICPA) defined **depreciation accounting** as a system of accounting, which aims to distribute the cost or other basic values of tangible capital assets less salvage (if any) over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is the process of allocation and not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measure of the effect of all such occurrences." Accounting for depreciation is often confusing because

students tend to think that depreciation expense reflects the decline in an **asset's value**. The concept of depreciation is nothing more than a systematic write-off of the original cost of an asset.

Depreciation differs from other expenses in that it does not require a cash payment at or near the time it is recorded. The basic entry to record each period's depreciation expense is

Depreciation Expense - Plant	xxx
Accumulated Depreciation : Plant	xxx

The above entry has no effect on current assets and current liabilities. A separate **depreciation expense** account and a separate **accumulated depreciation** account are generally maintained for each group of depreciable assets. Like other expense account, **depreciation expense** is deducted from revenue in determining net income. **Accumulated depreciation** is a contra-asset account that is off-set against the cost of the asset on the balance sheet. **Book value** is equal to the asset account balance, which retains the original cost of the asset a debit balance, minus the credit balance in the **accumulated depreciation** account.

Accumulated depreciation is a contra asset account that is off-set against the cost of the asset on the balance sheet.

5.2.3 Causes of Depreciation

The main causes of depreciation are:

- **Physical Deterioration**

Physical deterioration of tangible fixed assets results from use, and also from exposure to the elements, such as wind, sun, and other climatic factors. The physical factors set the outside limit for the service life of an asset. Physical factors are the wear and tear, decay, and casualties that make it different for the asset to perform indefinitely. Periodic repairs and a sound maintenance policy may keep plant assets in good running order and extract the maximum useful life from them, but every machine or building at some point must be discarded. In brief, the making of repairs does not lessen the need for recognition of depreciation.

The physical factors set the outside limit for the service life of an asset.

- **Obsolescence**

Obsolescence refers to loss of usefulness because of the development of improved equipment or process, changes in style, or other causes not related to the physical condition of the asset. With fast-changing technology as well as fast-changing demands, machinery, and even buildings often become obsolete before they wear out. A machine, for example, may become obsolete even though it is in excellent physical condition; it becomes obsolete because more efficient and economical machines have become available. Such a loss on account of new inventions or changes in fashions is termed as **loss on account of obsolescence**.

A machine, may become obsolete even though it is in excellent physical condition.

5.2.4 Objectives of Providing Depreciation

The following are the objectives of providing depreciation:

- ***Allocation of Asset Cost***

Assets are consumed over the potential life of the assets. This consumption represents the expired cost of the assets which must be distributed over the estimated life of the asset based on relevant principles and method. This allocation of cost is the main objective of providing for depreciation.

The purchase of an asset is nothing more than a payment in advance for an expense.

- ***Determination of True Profits***

The purchase of an asset is nothing more than a payment in advance for an expense. For example, an asset is purchased for Tk.500,000, used for several years, and then sold for Tk.50,000. The Tk.450,000 decline in value is, in every sum of the word, an expense of generating the revenue realized during the periods that the asset was used. Therefore, if the income figure is to be meaningful, Tk.450,000 of expense must be allocated to these periods and matched against the respective revenue. Failure to do so would overstate income for the periods.

The assets should be shown in the balance sheet at their proper values.

- ***Presentation of True Financial Position***

An important objective of providing depreciation is that unless shrinkage in the value of the assets is provided for, the value of assets will be overstated in the balance sheet. In order to present a true state of affairs of the business, the assets should be shown on the balance sheet at their proper values.

- ***Replacement of Assets***

The object of replacement of assets is also important in the question of providing for depreciation. If profits are fully distributed without providing for depreciation, a time will come when the company will find themselves in great difficulty in replacing assets for want of necessary funds. This objective, if to be achieved needs the creation of such fund and investment of the same to be realized at the required time. So, a depreciation provision is necessary to guard against impairment of capital and for the replacement of fixed assets when the need for such replacement may arise. It is possible if the organization enjoys enough profit.

5.2.5 Factors Involved in the Depreciation Process

The exact measure of depreciation undergone by an asset in any particular accounting period is difficult to determine, yet a fair and reasonable estimate can be made. The following are the important factors that would be considered for determining the amount of depreciation in respect of a particular asset:

- ***Cost of the Asset***

As explained in ***Lesson-1***, cost is the net purchase price plus all reasonable and necessary expenditures to get the asset in a position and

condition for use in the operations of the business. In this connection, it is to be mentioned here that financial charges, such as interest on money borrowed for the purchase of an asset, should not be included in the cost of the asset.

Financial charges should not be included in the cost of the asset.

- ***Residual Value***

Salvage value is the estimated amount that will be received at the time the asset is sold or removed from service. When an asset is purchased, its actual life and salvage or residual value are obviously unknown; they must be estimated as realistically as is feasible. In determining the salvage value, the cost to be incurred in the disposal or removing the asset should be deducted from the total salvage value. If the salvage value is not significant, it is usually ignored in computing depreciation.

Salvage value is the estimated amount that will be received at the time the asset is sold or removed from service.

- ***Estimated Useful Life***

This is also termed as ***economic life*** of the asset. The estimated useful life of an asset is the number of accounting periods over which the asset will be useful to the specific entity that owns it. In computing the estimated useful life of an asset, the factors to be considered are: (i) past experience with similar assets, (ii) the asset's present condition (iii) the company's repair and maintenance policy, (iv) current technological and industry trends, and (v) local condition such as weather.

Lesson-3: Methods of Computing Depreciation

Lesson Objectives

After studying this lesson, you will be able to:

- discuss the methods of computing depreciation.
- compute depreciation by the straight-line; units-of-production, declining-balance, and sum-of-the-years digits methods.

5.3.1 Introduction

Depreciation can be charged based on different methods which are found suitable in different circumstances relevant to the nature of assets and business. Further, it is not necessary that an enterprise employ single method for all classes of its depreciable assets. This lesson will deal with different methods of depreciation with examples of their computation.

5.3.2 Methods of Computing Depreciation

There are several methods that can be used for depreciating the cost of assets for financial reporting. The most common methods are: (i) Straight-line method, (ii) Units-of-output method, and (iii) two accelerated methods known as the declining-balance method and sum-of-the-years' digits methods. Each of them is proper for certain circumstances. For example, a company may use straight-line depreciation on some assets and sum-of-the-years' digits method for other assets.

Straight-line Method

Straight-line depreciation is probably the simplest and most widely used method of computing depreciation. It assumes that an asset's cost should be assigned equally to all periods benefited. The formula for calculating annual straight-line depreciation is:

The straight-line depreciation is probably the simplest and most widely used method of computing depreciation.

$$\frac{\text{Cost} - \text{Salvage value}}{\text{Estimated useful life}} = \text{Annual depreciation charge}$$

Example-5.02

To illustrate straight-line, units-of-production, and accelerated depreciation methods, we assume that Mehedi Ltd. purchased a truck at a cost of Tk.450,000. The following facts apply:

Estimated salvage value	Tk.50,000
Estimated life:	
In years	4 years
In kilo-meters driven	160,000 kilo meters

Solution:

The annual depreciation expense for the truck will be calculated as:

$$\frac{\text{Tk.450,000} - \text{Tk.50,000}}{4\text{years}} = \text{Tk.100,000}$$

This depreciation computation is shown below in tabular form.

Cost of the depreciable asset	Tk.450,000
<i>Less:</i> Estimated salvage or residual value	<u>50,000</u>
Total amount to be depreciated (depreciable cost)	<u>Tk.400,000</u>
Estimated useful life	4 years
Depreciation expense each year (Tk.400,000 ÷ 4)	<u>Tk.100,000</u>

The entry to record straight-line depreciation each year is:

Depreciation Expense	100,000	
Accumulated Depreciation – Truck		100,000

(To record annual depreciation for the truck.)

The depreciation expense for four years would be as follows:

Depreciation Schedule: Straight-line Method:

	Annual Depreciation	Accumulated Depreciation	Book Value
Acquisition date	---	---	Tk.450,000
End of first year	Tk.100,000	Tk.100,000	350,000
End of second year	100,000	200,000	250,000
End of second years	100,000	300,000	150,000
End of fourth year	<u>100,000</u>	400,000	50,000
	<u>Tk.400,000</u>		

Units-of-Output or Activity Method

The unit-of-output method of depreciation on assets is based on the assumption that depreciation is solely the result of use and that the passage of time plays no role in the depreciation process. This method is used primarily when a company expects that asset usage will vary significantly from year to year. Of course, if use is uniformly spread over the asset's life, the units-of-production method will produce the same depreciation result as the straight-line method. The formula for calculation of the units-of-output depreciation rate may be stated as:

The unit-of-output method of depreciation on assets is based on the assumption that depreciation is solely the result of use.

$$\frac{\text{Cost} - \text{Salvage Value}}{\text{Estimated Units of total Output}} = \text{Depreciation per Unit of Output}$$

To illustrate, we again consider Mehedi Ltd's truck, which has an expected life of 160,000 kilometers. If the truck is driven 60,000 kilometers during the first year, the depreciation expense for the year would be:

$$\frac{450,000 - 50,000}{160,000 \text{ kilometers}} \times 60,000 \text{ kilometres} = \text{Tk.150,000}$$

The entry to record units-of-output depreciation at the end of the first year of the truck's life is:

Depreciation Expense Tk.150,000
 Accumulated Depreciation – Truck Tk.150,000

(To record depreciation for the first year of the truck.)

The depreciation expense for four years would be as follows if it is assumed that 40,000 kilometers were driven in the second year, 35,000 kilometers in the third year, and 25,000 kilometers in the fourth year.

Depreciation Schedule: Units-of -Output Method

	Kilo-metros Driven	Depreciation Expense	Accumulated Depreciation	Book Value
Acquisition date	---	---	---	Tk.450,000
End of first year	60,000	Tk.150,000	Tk.150,000	300,000
End of second year	40,000	100,500	250,000	200,000
End of third year	35,000	87,500	337,500	112,500
End of fourth year	<u>25,000</u>	<u>62,500</u>	400,000	50,000
	160,000	<u>Tk.400,000</u>		

Accelerated Depreciation Methods

So far we have discussed straight-line and units-of-output methods. With straight line depreciation, each time period during the asset's useful life is assigned an equal amount of depreciation. With units-of-output depreciation, each kilometers driven, hour used, or other measurement of useful life is assigned an equal amount of depreciation. A second concept recognizes that the stream of benefits provided by a fixed asset may not be level. Rather, benefits provided may be greatest in the first year of the asset's service life and least in the last year. The **accelerated method** recognizes this fact. Accelerated methods result in relatively large amounts of depreciation in the early years and smaller amounts in later years. This is consistent with the basic accounting concept of matching costs with related revenue.

Accelerated depreciation methods result in relatively large amounts of depreciation in the early years and smaller amounts in later years.

Declining-Balance Method

The declining-balance depreciation method provides for higher depreciation charges in the earlier years of an asset's life than does the straight-line method. Though any fixed rate might be used under the method, the most common rate is a percentage equal to twice the straight-line percentage. When twice the straight-line rate is used the method is usually called the **double-declining-balance method**.

When twice the straight-line rate is used the method is usually called the double-declining-balance method.

To determine the annual double-declining-balance depreciation expense, we simply multiply the asset's book value at the beginning of the period by the constant rate (or percentage). This method is different in two respects from the other depreciation methods: (i) the initial computation ignores the asset's salvage value, and (ii) a constant depreciation rate is multiplied by the book value of the assets. Remember that an asset's book value at any time is its original cost less its accumulated depreciation to date.

The double-declining-balance rate is twice the straight-line rate, computed as follows:

$$\frac{1}{\text{Estimated Life (Year)}} \times 2 = \text{Double - Declining - Balance (DDB) Rate.}$$

To illustrate, consider our earlier example of the Tk.450,000 truck. The estimated useful life of the truck is four years. The depreciation calculation for the truck using the 200% declining balance method is:

Straight-line rate	4 years = $1 \div 4 = 25$ per cent
Double the straight-line rate	25 per cent $\times 2 = 50$ per cent
Annual depreciation	50 per cent $\times$ undepreciated cost (book value).

The following table shows the computation of each year's depreciation expense by declining-balance method:

Depreciation Schedule: Double-Declining-Balance Method:

Year	Computation	Depreciation Expense	Accumulated Depreciation	Book Value
Acquisition Date	---	---	---	Tk.450,000
End of first year	$(50\% \times 450,000)$	Tk.225,000	Tk.225,000	225,000
End of second year	$(50\% \times 225,000)$	112,500	337,500	112,500
End of third year	$(50\% \times 112,500)$	56,250	393,750	56,250
End of fourth year	*	6,250	400,000	50,000

* At the end of the fourth year, depreciation expense cannot exceed Tk.6,250 since the book value cannot be reduced below salvage value (Tk.50,000). It is to be noted here that although salvage value is ignored in the initial computations, the asset is not depreciated below its salvage value.

Sum-of-the-years'-digits method, provides for a proportionately high depreciation expense in the early years of an asset's life.

Sum-of-the -Years'-Digits Method

Another accelerated depreciation method is the ***sum-of-the-years'- digits (SOYD) method***, which provides for a proportionately high depreciation expense in the early years of an asset's life. Under this method, the years in the service life of an asset are added. Their sum becomes the denominator of a service of fractions that are applied against the depreciable cost of the asset in allocating the total depreciation over the estimated useful life. The numerators of the fractions are the individual years in the estimated useful life of the asset in reverse order. For n years,

$$\text{SOYD} = 1 + 2 + 3 + \dots + n = \frac{n(n+1)}{2}$$

In our example, the SYD for a four-year asset life is

$$1 + 2 + 3 + 4 = 10$$

Determining the SOYD factor by simple addition may require tedious calculations for long-lived assets. For these assets, the formula is $n(n+1)/2$. Where n = the number of years in the asset's useful life, can be applied to find out SOYD. In our example,

$$\frac{4(4+1)}{2} = \frac{20}{2} = 10$$

The formula for yearly depreciation is:

$$\frac{\text{Remaining useful life (Years)}}{\text{SOYD}} \times (\text{Cost} - \text{Salvage value}) = \text{Depreciation expense}$$

In our example, for the first year, the depreciation on the truck will be

$$\frac{4}{10} \times (\text{Tk.}450,000 - 50,000) \text{ or Tk.}160,000.$$

The depreciation schedule for the 4 years will be as follows:

Depreciation schedule, Sum-of-the-Years' Digits Method

Year	Computation	Depreciation Expense	Accumulated Depreciation	Book Value
Acquisition Date	--	--	--	Tk.450,000
End of first year	$(\frac{4}{10} \times 400,000)$	Tk.160,000	Tk.160,000	290,000
End of second year	$(\frac{3}{10} \times 400,000)$	120,000	280,000	170,000
End of third year	$(\frac{2}{10} \times 400,000)$	80,000	360,000	90,000
End of fourth year	$(\frac{1}{10} \times 400,000)$	40,000	400,000	50,000

The schedule portrays that the depreciation is the highest in the first year and declines each year after that. The book value of the asset decreases each year by the amount of depreciation until it reaches the salvage value.

Questions and Exercises

Self-Test Questions

1. For which of the following types of asset straight-line method of depreciation is suitable:
(a) Mine (b) plant (c) Leasehold property (d) None
2. An example of an accelerated depreciation method is:
(a) Straight line (b) Sum of the years digits (c) Units of production (d) None of these three.
3. Which of the following statements is (are) correct:
(a) Accumulated depreciation represents a fund being accumulated for the replacement of assets.
(b) Company can use different depreciation method
(c) the use of an accelerated depreciation method causes an asset to wear out more quickly than does the use of straight-line method.
4. Alpha Ltd. sold a machine that had originally cost Tk.50,000 for Tk.22,000. If the company reports a gain of Tk.5,000 on this sale, the accumulated depreciation may have been:
(a) 33,000 (b) 28,000 (c) 23,000 (d) Some other amount

Discussion Questions

1. Explain why the recognition of depreciation expense is necessary to match revenue and expense properly.
2. Do you think that the purpose of depreciation is to determine the value of equipment? Explain
3. Evaluate the statement, "A parking lot should not be depreciated, because adequate repairs will make it last forever."
4. Should depreciation continue to be recorded on a building when ample evidence exists that the current market value is greater than the original cost and that the rising trend of market values is continuing? Explain.
5. What basic questions must be answered before the amount of depreciation charge can be computed?
6. Explain the objectives of providing depreciation.
7. Identify the factors that are relevant in determining the annual depreciation charge and explain whether these factors are determined objectively or whether they are based on judgment.
8. What are the major factors considered in determining what depreciation method to use?

9. Explain what is meant by an 'accelerated' depreciation method. Are accelerated methods more widely used in financial statements or in income tax returns? Explain.
10. What does the balance of the Accumulated Depreciation Account represent? Does it represent funds available to purchase new plant assets?
11. It is said that no matter which depreciation method is being used to allocate costs over a period of years, a straight-line method of apportionment is always made when an asset is acquired or disposed of during a year, what does this statement mean?
12. Describe the sum-of-the-years'-digits method of providing depreciation.
13. List three types of assets that are commonly depreciated using the sum-of-the-years' digits method of depreciation.
14. How does the declining balance method of depreciation differ from other methods of depreciation?
15. Why does the computation to determine the DDB rate ignore salvage value?
16. If a plant asset is sold during the year, why should depreciation be computed for the partial year prior to the date of the sale?

Exercises

1. A delivery truck costing Tk.1,600,000 is expected to have a Tk.192,000 salvage at the end of its useful life of four years or 110,000 miles,
 - (a) Assume the truck was purchased on January 2, 2023. Compute the depreciation expense for 2023 using each of the following depreciation methods: (i) straight line, (ii) sum-of-the-years'-digits, (iii) double declining balance, and (iv) units of production (assume that the truck was driven 30,000 miles in 2023).
 - (b) Assume the truck was purchased in April 2023. Compute expenses for 2024 using each of the following depreciation methods: (i) straight-line, (ii) sum-of-the-year's-digits, (iii) double declining balance, and (iv) units of production (assume the truck was driven 33,000 miles in 2024.)
2. On January 2, 2022, a machine was purchased for Tk.2,500,000. The installation cost was Tk.100,000. It was estimated that the salvage value of the machine would be Tk.200,000. The machine has a useful life of 5 years. Compute the depreciation expense for 2022 and 2023 using the straight line and double declining balance depreciation methods.

3. Robin Hardware Company has a giant paint mixer that costs Tk.12,600,000 plus Tk.16,000 to install. The estimated salvage value of the paint mixer at the end of its useful life of 15 years is estimated to be Tk.76,000. Robin estimates that the machine can mix 850,000 cans of paint during its lifetime. Compute the second year's depreciation expense, using the following methods:
- (a) Straight-line.
 - (b) Sum-of-the-years' digits.
 - (c) Units of production, assuming that the machine mixes 51,000 cans of paint during the second year.

Lesson-4: Disposal of Plant Assets

After studying this lesson, you will be able to:

- explain and illustrate the accounting for the disposal of plant assets.

5.4.1 Introduction

Assets that are no longer useful may be sold, discarded, or applied toward the purchase of other assets. The detail of the record may vary but in all cases, it is necessary to write off the book value of that asset from accounts. This use deals with the procedure of disposal and recording process there of.

5.4.2 Disposal of Plant Assets

Plant assets eventually become worthless and obsolete. When items of plant assets are no longer useful in business because they are worn out or obsolete, they may be sold, retired, exchanged for a similar asset, or traded in as partial payment for a new similar asset. The asset's usefulness to the firm may also be ended by an unfavorable and unanticipated event - the asset may be stolen or destroyed by a natural disaster. Regardless of the method of disposal, depreciation must be taken into consideration up to the date of disposition, and then all accounts related to the retired asset should be removed. This step is accomplished by debiting the **accumulated depreciation** account for the total depreciation to the date of disposal and crediting the **asset** account for the cost of the asset. Ideally, the book value of the specific plant asset would be equal to its disposal value. But this is generally not the case. As a result, a gain or loss develops depending on the facts of the situation. Gain or loss on the retirement of plant assets should be shown in the income statement along with other items that may arise from normal business activities. If an asset lasts longer than its estimated life, as often occurs, and as a result, is fully depreciated, it should not continue to be depreciated. In addition, the asset should not be written off until it is actually disposed of.

Regardless of the method of disposal, depreciation must be taken into consideration up to the date of disposition, and then all accounts related to the retired asset should be removed.

5.4.3 Retirement of Plant Assets

When an asset wears out or becomes obsolete, it must be scrapped. Upon discard or retirement of depreciable asset, the cost of the property should be removed from the 'asset account' and the accumulated depreciation should also be removed from the related contra-asset account. If the asset's total cost has been depreciated, there is no loss on the disposal. If, on the other hand, the cost is not completely depreciated, the undepreciated cost represents a loss on disposal.

If the disposal date does not coincide with the end of an accounting period, a journal entry must record depreciation for a partial period (the period from the date when depreciation was last recorded to the disposal

If an asset's cost is not completely depreciated, the undepreciated cost represents a loss on disposal.

date). To illustrate, we assume that a computer purchased 5 years ago at a cost of Tk.75,000 has been fully depreciated on a straight-line basis and is no longer, useful. The entry to record the disposal is as follows:

Accumulated Depreciation– Computer Tk.75,000
Computer Tk.75,000

(To record the disposal of a fully depreciated computer.)

If the computer is scrapped after only 3 years of service (only Tk.45,000 has been depreciated), there would be a loss of Tk.30,000 on disposal of the computer. The entry would be:

Accumulated Depreciation– Computer Tk.45,000
Loss on Disposal of Computer 30,000
Computer Tk.75,000

(To record disposal of partly depreciated computer at a loss.)

When a fully depreciation asset is continued in use beyond the original estimated useful life, the **asset account** and the **accumulated depreciation account** should remain in the accounting records without further entries until the asset is disposed or scrapped.

5.4.4 Sale of Plant Assets

A second way of disposing of property, plant, or equipment is to sell it. Since the residual value and the useful life of plant assets are only estimates, it is very common for plant assets to be sold at a price that differs from their book value at the date of disposal. If the sales price of the asset exceeds its book value (the original cost less accumulated depreciation), there is a gain on the sale. Conversely, if the sales price is less than the book value, there is a loss. The sale transaction exchanges used plant assets for cash. Because the plant asset sold is no longer on hand, a journal entry must be given to remove all the accounts related to the asset sold. If the asset is sold in the mid-term of the accounting period, then first of all, a journal entry must be given to provide depreciation from the beginning of the accounting period to the date of the asset sold. For example, assume that the computer (earlier example) is sold for Tk.25,000 mid-way through its third year. The related entries are:

Depreciation Expense Tk.7,500
Accumulated Depreciation– Computer Tk.7,500

(To record depreciation expense for six months.)

Cash Tk.25,000
Accumulated Depreciation– Computer. 52,500
Computer Tk.75,000
Gain on Sale of Computer. 2,500

(To record the sale of computer at a gain.)

If the sales price of the asset exceeds its book value there is a gain on the sale.

Assume that the computer is sold for Tk.10,000 at the end of the fourth year. The entry would be:

Cash	Tk.10,000
Loss on Sale of Computer	5,000
Accumulated Depreciation– Computer	60,000
Computer	Tk.75,000

(To record the sale of computer at a loss)

If a plant asset is sold exactly at its book value, there arise no loss or gain.

If a plant asset is sold exactly at its book value, there arises no loss or gain. However, if an asset is abandoned, stolen, or destroyed (with no insurance coverage) before the end of its expected useful life, a loss equal to its book value should be recorded.

5.4.5 Exchange of Plant Assets

Exchange may involve similar assets or dissimilar assets.

Some items of plant assets are disposed of by trading them in or exchanging them for new assets. The exchange may involve similar assets or dissimilar assets. In either case, the purchase price is reduced by the amount of the trade-in allowance given for the asset traded in. The amount used in this calculation depends on whether or not the asset traded is similar to the new asset. If the trade - in is similar - of the same type or performing the same function value is assumed to be its net book value. If the asset traded in is dissimilar, its value is its estimated fair market value.

• Exchange of Similar Plant Assets

When a plant asset is traded in to a similar new asset, if there is any loss it will be reflected in the accounting entry, but a gain will not.

When a plant asset is traded into a similar new asset, the accounting analysis depends on whether a loss or gain is implicit in the transaction. If the trade-in allowance received is greater than the book value of the asset surrendered, there has been a **gain**. If the allowance is less, there has been a **loss**. A loss will be reflected in the accounting entry, but a gain will not.

To illustrate the **recognition of loss**, let us assume that the computer (in our earlier example) is traded in after four years (accumulated depreciation Tk.60,000) for a newer, modern computer on the following terms:

Price of the new computer	Tk.90,000
Trade-in allowance for old computer	10,000
Cash payment required	<u>Tk.80,000</u>

In this case, the trade-in allowance (Tk.10,000) is less than the book value (Tk.15,000) of the old computer. There is a loss of Tk.5,000 (15,000 – 10,000). The entry to record the exchange would be:

Computer (new)	Tk.90,000	
Accumulated Depreciation– Computer	60,000	
Loss on exchange of Computer	5,000	
Computer (old)		Tk.75,000
Cash		80,000
(To record trade of computer)		

According to financial accounting principles, the loss on exchange transaction should be recognized in the financial statement. However, if a trade-in transaction involves only a small loss, most companies do not recognize the loss. But the generally accepted accounting principles require that no gain would be recognized when a depreciable asset is traded in on another similar asset. If in the proceeding exchange the trade-in allowance was Tk.18,000 (rather than 10,000), there the company would require to pay cash Tk.72,000. There is a gain of Tk.3,000. But this gain would not be recognized. The cost of the new asset would be the sum of the book value of the old asset traded in plus the additional amount paid or to be paid in acquiring the new asset.

The cost of the new asset would be the sum of the book value of the old asset traded in plus the additional amount paid or to be paid in acquiring the new asset.

The journal entry for this exchange transaction is as follows:

Computer (new)	Tk.87,000	
Accumulated Depreciation	60,000	
Computer (old)		Tk.75,000
Cash		72,000
(To record the trade of computer.)		

Note that in both cases the cost and accumulated depreciation of old assets are removed from the accounts. In case of gain, the new asset is recorded at an amount equal to the sum of the book value the assets traded in plus cash paid.

• Exchange of Dissimilar Plant Assets

Both gains and losses are recognized when a company exchanges **dissimilar assets**. Assets are dissimilar when they perform different functions. When dissimilar assets are exchanged, the new assets should be recorded at the fair value of the asset. The used asset's book value, of course, is removed from the accounts. **Loss or gain** on the exchange transaction is determined by comparing the fair value assigned to the new asset with the total of the used asset's book value plus cash payment. If the used asset's book value plus cash paid exceeds the new asset's fair value, there is a **loss**. On the other hand, if the new asset's fair value is larger, a **gain** is recorded. To illustrate the recognition of a gain, we will continue the just earlier example, assuming that the computer is exchanged for a machine. Here the trade-in allowance (Tk.18,000)

Both gains and losses are recognized when a company exchanges dissimilar assets.

exceeds the book value (Tk.15,000) of the computer by Tk.3,000. Thus, there is a gain, if it is assumed that the price of the new machine is not a figure that has been inflated for the purpose of allowing an excessive trade-in value. Assuming this condition is true, the entry to record this transaction is as follows:

Machinery (new)	Tk.90,000
Accumulated Depreciation– Computer	60,000
Gain on exchange of computer	Tk.3,000
Computer (Old)	75,000
Cash	72,000

(To record the exchange transaction.)

In some exchanges, the suggested selling price may be higher than the asset's cash selling price; therefore the trade-in allowance is inflated and does not indicate the used asset's fair value. Situation like this, the gain should not be recognized.

Lesson-5: Accounting for Natural Resources and Intangible Assets

After studying this lesson, you will be able to:

- identify natural resource accounting issues and compute **depletion**.
- describe the nature of and the accounting for intangible assets and compute **amortization**.

5.5.1 Introduction

Natural resources and intangible are the other two types of fixed assets over the tangible fixed assets. The nature of these two types of assets differs from tangible asset and these the loss due to consumption of these assets in their useful life also requires different treatment. This lesson will deal with depletion and amortization of natural resources and intangible assets as to their accounting statement.

5.5.2 Accounting for Natural Resources

Natural resources are assets of the company that owns the right to extract them. These include such assets as oil and gas fields, coal mines, standing timber, and mineral deposits. These resources are also known as **wasting assets**. The distinguishing characteristics of these assets are that they are physically consumed and converted into inventory by pumping, mining or cutting. As with plant assets, natural resources are initially accounted for at their cost. When known deposit are purchased, the cost is the purchase price and related acquisition costs. When the natural resource is discovered after extensive exploration, determining its initial cost is difficult. There are two schools of opinion as to how exploration cost should be accounted for. Some people argue that all the exploration costs of a year should be capitalized as the asset value of the reserves that are discovered during the year; this is **full cost method**. Others argue that only the costs necessary to discover the successful resource should be capitalized and the remaining amounts are expensed. This is the **successful efforts method**. Generally the last method is accepted. The cost of developing the site so the natural resource may be extracted is another component of initial cost. Expenditures to remove land overburdens, build access roads, and construct mine entrance are the examples of development costs. Natural resources are shown on the balance sheet as long-term assets with descriptive titles such as Oil and Gas Reserves, Timber Land, and Mineral Deposits.

The process of amortizing the cost of natural resources in accounting periods benefited is called **depletion**. The term **depletion** is used not only the exhaustion of natural resource but also the proportional allocation of the cost of natural resources to the units extracted from the ground or, in the case of timberland, the board feet of timber cut. The objective is the same as that for depreciation; to allocate the cost in some systematic

When the natural resource is discovered after extensive exploration, determining its initial cost is difficult.

*The process of amortizing the cost of natural resources in accounting periods benefited is called **depletion**.*

manners, to the years of the asset's useful life. The average depletion cost per unit of natural resource is computed as follows:

$$\frac{\text{Cost of Natural Resource} - \text{Residual Value}}{\text{Estimated Total Units of Resource}} = \text{Depletion per unit.}$$

The amount of depletion cost for each accounting period is then computed by multiplying the depletion cost per unit by the number of units pumped, mined, or cut. *To illustrate*, assume that the Mehedi Ltd. purchased a coal mine for Tk.275,000,000 having an estimated Tk.1,000,000 tons of coal, and an estimated residual value of Tk.25,000,000, the depletion charge per ton of coal is Tk.200. If 150,000 tons of coal are mined and sold in the current year, the depletion entry is:

Depletion Expense	Tk.37,500,000
Accumulated Depreciation– Coal Mine	Tk.37,500,000

(To record depletion of coal mine; 150,000 tons mined at Tk.250 per ton.)

After the first year's depletion expense has been recorded, the coal mine would be presented as follows:

Coal Mine.	Tk.275,000,000
Less: Accumulated Depreciation	<u>37,500,000</u>
	Tk.237,500,000

The disposition of the periodic depletion charge depends on whether the extracted units are sold or on hand at the end of the period. The depletion amount of units sold is deducted in the income statement as part of the cost of the resources sold. Units on hand at the end of the year, however, constitute inventory items, which is a current asset. Since most natural resource cannot be counted, the amount of the resource owned is an estimate, which may be changed if new information becomes available. When an estimate changed, a new depletion rate per unit is calculated and used to compute depletion during the remaining life of the natural resource or unit another new estimate is made.

The disposition of the periodic depletion charge depends on whether the extracted units are sold or on hand at the end of the period.

5.5.3 Accounting for Intangible Assets

As the word ***intangible*** implies, assets in this classification have no physical substance. Intangible assets are exclusive rights and privileges that are long-term, are not held for resale, and usually provide their owners with comparative advantages over other firms. Familiar examples are patents, copyrights, leaseholds, trademarks and brand names, franchises, licenses, formula, and goodwill. An account receivable, for example or certain prepaid expenses have no physical existence, but they are not called intangible assets because they are short-term. Intangible assets are both long-term and nonphysical. In short, ***intangible assets*** are assets which are used in the operation of the business but which have no physical substance and are long-term.

Intangible assets are exclusive rights and privileges that are long-term, are not held for resale, and usually provide their owner with comparative advantages over other firms.

The basis of valuation for intangible assets is cost. A firm should record intangible assets acquired from outside entities at acquisition cost, that is, the amount paid for them. Certain intangible assets such as goodwill or trade marks may have great value and are needed for profitable operations but may have been acquired at a little or no cost. An intangible asset should not appear on the balance sheet of the company unless a cost of acquisition or development has been incurred.

An intangible asset should not appear on the balance sheet of the company unless a cost of acquisition or development has been incurred.

The accounting process connected with intangible assets is essentially the same process as the depreciation of tangible asset. The systematic allocation of the costs of intangible asset over the term of its expected useful life is called **amortization**. Because salvage values are ordinarily not involved, amortization typically entails (i) determining the asset's cost, (ii) estimating the period over which it provides benefits the firm, and (iii) allocating the cost in equal amount to each accounting period involved. Although it is difficult to estimate the useful life of an intangible asset, yet some intangible assets have a determinable life, such as patents, copyrights and leasehold, should be written off through periodic amortization over their useful lives. Even though some intangible assets, such as goodwill and trade marks, have no measurable limit on their useful lives, they should also be amortized over a reasonable length of time (but no more than forty years), because few things last forever. The straight-line method of amortization is generally used for intangible assets.

The systematic allocation of the costs of intangible asset over the term of its expected useful life is called amortization.

The usual accounting entry for amortization consists of debit the appropriate **amortization expense account** and a credit to the **intangible asset account**. There is no theoretical objection to credit an accumulated amortization account rather than intangible asset account, but generally there is no particular benefit to financial statement users from accumulating amortization in a separate contra asset account. To illustrate the accounting for patents, assume that Mehedi Ltd. purchased a patent for Tk. 125,000. The entry to record the patent would be:

The usual accounting entry for amortization consists of debit the appropriate amortization expense account and a credit to the intangible asset account.

Patents Tk.125,000
 Cash Tk.125,000
 (To record legal costs of acquiring patents.)

It is expected that the patent would provide benefits for 10 years. The following entry records the first year's straight-line amortization :

Amortization Expense Tk.12,500
 Patents Tk.12,500
 (To record annual amortization of patents.)

Because an accumulated amortization account is not used, the asset account balance reflects the asset's book value. The balance sheet presentation at year-end would be:

Patents (cost less amortization to date) Tk.112,500.

Questions and Exercises

Self-Test Questions

1. Which of the following statement(s) is (are) wrong:
 - (a) Depreciation and depletion signify similar meaning
 - (b) Straight-line method of depreciation is suitable for wasting asset.
 - (c) The process of amortization of natural resources is called depletion
 - (d) Intangible implies asset having no physical substance.
2. Which one is correct:
 - (a) For amortization, debit amortization expense and credit cash
 - (b) The basis of valuation of intangible is cost
 - (c) If on retirement or sale of asset the cost is not completely depreciated, the balance is a loss on disposal.

Discussion Questions

1. What factors determine the gain or loss on the sale of a plant asset?
2. If a plant asset is discarded before the end of its useful life, how is the amount of loss measured?
3. Why is it common to have a gain or loss on the disposal of a long-term operating asset? Is it true that if the useful life and the salvage value of an asset are known with certainty and are realized, there will never be such a gain or loss?
4. Assume a company exchanged an used microcomputer with a Tk.36,000 book value and Tk.24,000 cash for a new microcomputer having a cash selling price of Tk.68,000. At what amount should the company record the new microcomputer? What is the gain (or loss) on the exchange of assets?
5. When recording the disposal of a long-term operating asset, why it is necessary to debit the accumulated depreciation of the old asset?
6. Why is a gain not recognized when similar operating assets are exchanged?
7. Are gains and losses recognized on exchange of dissimilar assets?
8. Why are intangible assets considered assets if they have no physical substance?
9. It has been argued, on the ground of conservatism, that all intangible assets should be written off immediately after acquisition. Give the accounting arguments against this treatment.

10. Define depletion. The total depletion charged for a period may not all be expensed in the same period. Explain.
11. What is the maximum amortization period for an intangible asset? Why?
12. Define intangible assts. Would an account receivable arising from a sale of merchandise under terms of 2/10, n/30 qualify as an intangible asset under your definition?
13. What do accountants mean by the term 'depreciation' and what is its relationship to depletion and amortization?
14. Why is it often necessary to recalculate the depreciation rate for natural resources?

Exercises

1. Azim Corporation purchased land, a building, and equipment for a total cost of Tk.9,000,000. After the purchase, the property was appraised. Fair market values were determined to be Tk.2,400,000 for the land, Tk.5,600,000 for the building, and Tk.1,600,000 for the equipment. Given these appraisals, record the purchase of the property by Azim Corporation.
2. Nirman Construction traded in a used crane on a similar new one. The original cost of the old crane was Tk.3,000,000 and Nirman's accountant records the accumulated depreciation amounted to Tk.2,400,000. The new crane cost Tk.3,750,000, but Nirman was given a trade-in-allowance of Tk.750,000.

Required:

- (a) What amount of cash must Nirman pay?
- (b) Compute the gain or loss that would be reported **on** the disposal of old crane and give entry to record the transaction.
3. A piece of equipment that cost Tk.972,000 and on which Tk.540,000 of accumulated depreciation had been recorded was disposed of on January, 2, the first day of business of the current year.

Give journal entries to record the disposal under each of the following assumptions:

- (i) It was discarded having no value.
- (ii) It was sold for Tk.180,000 cash.
- (iii) It was sold for Tk.540,000 cash
- (iv) The equipment was trade-in on other equipment having a list price of Tk.1,440,000. A Tk.468,000 trade-in was allowed, and the balance was paid in cash. Gains and losses are to be recognized

- (v) The equipment was trade-in on another equipment having on list price of Tk.1, 440,000. A Tk.216,000 trade-in was allowed, and the balance was paid in cash. Gains and losses are to be recognized.
- 4. On July1, 2023, Moon Printing exchanged its printing press for a new press that cost Tk.4,550,000. The Old Press, which had a 20-years estimated life, was originally purchased for Tk.3,500,000 on Januarys, 2018, and had no salvage value. In making the exchange, the company received trade-in allowance of Tk.1,400,000. Moon uses 150 per cent declining-balance method of depreciation. Assuming Moon is a calendar-year company, compute the following:
 - (i) Calculate the depreciation taken on the old press to the date of the trade.
 - (ii) Prepare Journal entry to record the exchange.
- 5. On April 30, 2021, Shale Oil Company purchased an oil well, which reserves an estimated 100,000 barrels of oil, for Tk.6,000,000 cash.

Required: Prepare journal entries for the following

- a) Record the purchase of the oil well.
- b) During 2021, 10,000 barrels of oil were extracted from the well. Record the depletion expenses for 2021.
- c) During 2022, 18,000 barrels of oil were extracted from the well. Record the depletion expense for 2022.
- d) At the beginning of 2023, it was determined that only 60,000 barrels of oil remained in the well. During that year 15,000 barrels of oil were extracted from the well. Record depletion expense for 2023.
- 6. Crescent Mining Corporation purchased land containing an estimated 12,000,000 tons of ore for a cost of Tk.264,000,000. The land without the ore is estimated to be worth Tk.48,000,000. The company expects that all the useable ore can be mined in 10 years. Building costing Tk.32,000,000 with an estimated useful life of 30 years were erected on the site. Equipment costing Tk.28,800,000 with an estimated useful life of 10 years was installed. Because of the remote location, neither the building nor the equipment has an estimated residual value. During its first year of operation, the company mined and sold 1,000,000 tons of ore.

Required:

- (a) Compute the depletion charge per ton.
- (b) Compute the depletion that should be recorded for the year.
- (c) Determine the annual depreciation expense for the building, making it proportional to the depletion.

- (d) Determine the annual depreciation expense for the equipment, using (i) the straight line method, and (ii) making the expense proportional to the depletion.

7. King Company purchased the Crystal Mine for Tk.900,000,000. The mine was estimated to contain 2 million tons of ore and to have a residual value of Tk.180,000,000.

During the first year of mining operations at the Crystal Mine, 400,000 tons of ore were mined, of which 300,000 tons were sold.

Required:

- (a) Prepare the journal entry to record depletion of the crystal Mine during the year.
 - (b) Show how the mine and the accumulated depletion would appear in king Mining Company's balance sheet after the first year of operations.
 - (c) Will the entire amount of depletion computed in part (a) be deducted from revenue in determining the income for the year? Explain.
8. Mukti Publishing Company purchased the copyright to a basic computer textbook for Tk.700,000. The usual life of a textbook is about four years. However, the copy right will remain in effect for another 75 years.

Calculate the annual amortization of the copyright.

9. Tariq Ltd. purchased a trademark from a well-known supermarket for Tk.480,000. The management of the company argued that the trade mark value would last forever and might even increase and so no amortization should be charged.

Calculate the minimum amount of annual amortization that should be charged, according to guidelines of the appropriate Accounting Principles Board opinion.

Case Study

Daniels Gravel Company

Billy Bob Daniels is in the gravel business in Oklahoma and has engaged you to assist in evaluating his company. Your first step is to collect the facts about the company's operations. On January 3, 2024; Billy Bob purchased a piece of property with gravel deposits for Tk.6,310,000. He estimated that the gravel deposits contained 4,700,000 cubic yards of gravel. The gravel is used for making roads. After the gravel is gone, the land, which is in the desert, will be worth only about Tk.200,000.

The equipment required to extract the gravel cost Tk.1,452,000. In addition, Billy Bob had to build a small frame building to house the mine office and a small dining hall for the workers. The building cost Tk.152,000 and would have no residual value after its estimated useful life of ten years. It cannot be moved from the mine site. the equipment has an estimated useful life of six years (with no residual value) and also cannot be moved from the mine site.

Trucks for the project cost Tk.308,000 (estimated life, six years; residual value, Tk.20,000). The trucks, of course, can be used at a different site.

Billy Bob estimated that in five years all the gravel would be mined and the mine would be shut down. During 2024 Tk.1,175,000 cubic yards of gravel were mined. The average selling price during the year was Tk.2.66 per cubic yard, and at the end of the year 125,000 cubic yards remained unsold. Operating expenses were Tk.852,000 for labor and Tk.232,000 for other expenses.

Required:

1. Prepare general journal entries to record the purchase of the property and all the buildings and equipment associated with the mine.
2. Prepare adjusting entries to record depletion and depreciation for the first year of operation 2024. Assume that the depreciation rate is equal to the percentage of the total gravel mine during the year unless the asset is movable. For movable assets, use the straight-line method.
3. Prepare an income statement for 2024 for the Daniels Gravel Company.
4. What is your evaluation of the company's operations? What are the reasons for your evaluation?

PARTNERSHIP ACCOUNTS



From the discussion made in this unit, students will be able to know:

- **The principles of partnership business**
- **Provisions governing accounts of partnership**
- **Methods of valuation of Goodwill**
- **Procedure of preparing accounts of partnership**
- **Overall idea as to Admission, Retirement, Death, & Dissolution of partnership**

এই পৃষ্ঠা খালি থাকবে

Unit-6

Lesson-1 : Principles of Partnership Business

Lesson Objectives

After studying this lesson, you will be able to:

- describe the meaning of partnership business.
- explain the feature of partnership.
- define the partnership deed.
- specify the contents of partnership deed.
- mention the types of partners.
- describe the rights and duties of partners.

6.1.1 Introduction

At the outset it is essential to know as to what is meant by partnership, what are its features, how is it constituted and governed etc. This will help the learners to have an insight into the nature of partnership business and its relation with accounting practice. Let us continue the following discussion.

6.1.2 Definition of Partnership

Partnership is defined as "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". (Section 4 of the partnership Act, 1932). Each member individually is called partner, they are collectively called a firm, the name under which their business is carried out is called a firm name.

Partnership is the relation which subsists between persons, carrying on business in common with a view to earn profit.

6.1.3 Essentials of Partnership

The essentials or ingredients of partnership are the following:

- i) An association of two or more persons (maximum 10 for banking business and 20 for other types of business).
- ii) An agreement entered into by all partners (it may be oral or written).
- iii) To carry on a business (for example mere ownership of a business by some persons will be treated as Co-ownership, not a partnership).
- iv) Sharing profits (including losses, if any) of the business.
- v) Business to be managed by all or any one of them acting for all.

6.1.4 Partnership Deed

A partnership is to be formed through a mutual agreement. The relationship among partners and the management of the firm will be governed through the agreement, which is called partnership deed. The agreement, however, may be oral, written or may be in duly stamped deed. To avoid future dispute and misunderstanding, it is better to have the written agreement. The deed in general incorporates the following provisions :

Written Partnership deed is not compulsory but it is advisable to do so in order to avoid future troubles and disputes.

- i) The name of the firm.
- ii) Nature and location of the business.
- iii) Recital clause giving the antecedent of partners.
- iv) Date of agreement and commencement of business.
- v) The amount of capital contribution of partners.
- vi) Ratio of sharing profits and losses.
- vii) The rate of interest to be charged on capital and loan, if any, provided by any partner.
- viii) Salary to any partner, if to be provided.
- ix) Drawing and interest, if any, to be charged on drawing.
- x) Methods of calculation of Goodwill.
- xi) Bank account.
- xii) Accounts and audit.
- xiii) Procedure for admission and retirement of a partner.
- xiv) Methods of settlement of accounts in case of death or retirement of a partner.
- xv) Treatment of loss arising out of insolvency.
- xvi) Dissolution of firm.
- xvii) Arbitration in case of dispute.
- xviii) Any special condition relevant to management of the firm.

In practice different types of partners are seen in partnership businesses. Next section is devoted to examine this aspect in brief.

6.1.5 Kinds of Partners

Besides the general partners, who contribute to the capital of the firm and can take part in its business management, the following special types of partners are seen in the practical field:

Sleeping or Dormant partner, Nominal partner, Partner by Holding out and Quasi partner are the special types of partners.

- **Sleeping or Dormant Partner:** One who retains his capital in the business but does not take any active part in the management of the business. He has no duty to perform but has the right of access in the books of accounts and of examine and copying them.
- **Nominal Partner:** One who neither contributes any capital in the business nor take any part in the management of the firm but merely lends his name to be used by the firm. He is liable to those third parties who give credit to the firm on the strength of his being a partner.
- **Partner by Holding out:** A holding partner is one who without really being a partner conducts himself outside as to lead others to believe him to be a partner. Such partners are liable to those third parties who extend credit to the firm on the belief that such person is a partner of the firm.

- **Quasi Partner:** One who has retired from the business but has left his capital to the business as loan receiving interest varying with the amount of profit. Such a partner, in fact, is a deferred creditor as his money is repayable after all the outside creditors are paid in full.

Partners have different rights and obligations. Their rights and obligations have a bearing on accounts. Let us know the rights and duties of partners from the following discussion.

6.1.6 Rights of Partners

- Every partner has a right to take part in the conduct and management of the business of the firm.
- Every partner has a right to be consulted and heard in all matters affecting the business.
- Every partner has right of free access to all records and accounts of business and also to examine and copy them.
- Every partner is entitled to share in the profit equally (unless there is an agreement contrary to this).
- Partner who contributes to the capital more than the agreed amount or provides loan is entitled to get interest on the excess amount or loan @ 6% per annum.
- Every partner as a rule is a joint owner of the partnership property and is entitled to have the partnership property used exclusively for the purpose of the firm.
- Every partner is entitled to be indemnified by the firm for all acts performed by him in the course of business; for all payments made by him relevant to partnership debt and liability.
- A partner has the right to act in an emergency for protecting the firm from loss but in such a case he must act reasonably.
- Every partner has a right to prevent the admission of a new partner without his consent, has the right to continue in the partnership, and is entitled to retire according to the deed or consent of other partners.
- Any retiring partner or the heir of the deceased partner is entitled to share in the profit earned with assets to which the retiring or deceased partner has the share until the accounts are finally settled.

Partners come to an agreement at the time of forming a partnership and their rights and duties are determined with reference to that agreement.

6.1.7 Duties of Partners

- Every partner must be just and faithful to other partners.
- Every partner is bound to diligently carry on the business of the firm to the greatest common advantage.

- A partner is bound to indemnify the firm for any loss caused by his willful neglect or fraud in the conduct of the business of the firm.
- A partner is bound to keep and render true, proper and correct accounts of the partnership and must permit other partners to inspect and copy such documents and accounts.
- Every partner is bound to share loss equally with other partners unless there is any provision contrary to this in the agreement.
- Every partner is bound to act within the scope of his authority.

In this connection it may be mentioned that a partner must not carry on competing business, nor use the property of the firm for his private purpose. In both the cases he must handover to the firm any profit or gains made by him, however, he must suffer himself any loss that might have incurred.

6.1.8 Implied Authority of a Partner

Rights and duties so far discussed are related to the relations among partners themselves. When it comes to deal with outsiders, the partners are supposed to have power to act in certain matters and not to have power in others. In case of trading firm, the implied powers of partners are as follows:

- Buying and selling of goods.
- Receiving payments on behalf of the firm and giving receipts.
- Borrowing money on behalf of the firm with or without pledging the inventory.
- Drawing or endorsing cheque, bill of exchange and promissory notes on behalf of the firm.
- Engaging servants for the firm.

In the following cases the partners have no implied authority and the third party, unless the partners have agreed otherwise, cannot bind the firm:

- Placing a dispute to arbitration.
- Withdrawal of suit file by the firm.
- Relinquishment of any claim of the firm.
- Admission of any liability in a suit or proceedings against the firm.
- Entering into partnership on behalf of the firm by an agreement between themselves the partner in a firm may extend or restrict the implied authority of any partner.

In some circumstances minor is found associated with partnership. Against this backdrop the rights and duties of minor need to be examined. Following para deals with the same.

6.1.9 Minor as a Partner

Partnership business is formed through an agreement i.e. contract. Here minor due to age limitation can not enter into partnership and thus cannot be a partner. However, a minor can be admitted to the benefit of an existing partnership with the consent of all the partners. The minor is not personally liable for the debts of the firm but his share in the partnership property and profits of the firm will be liable for the firm's debts and obligations. Within six months of his attaining majority or when he comes to know that he enjoys benefits of partnership (whichever date is latter), he has to elect whether or not he wants to continue as partner of the firm. In this context if he does not like to continue in the partnership then he must give public notice of his decision not to continue in partnership. If such notice is not given, he will be deemed to have elected to continue as full-fledged member from attending has majority. Further, on his retention as a partner, he will become liable for the debt of the firm since he was admitted to the benefits of the partnership.

A minor can be admitted as a partner for the benefit of an existing partnership with the consent of all the partners.

Questions

Self-Test Questions

1. Which of the following statements are characteristics of partnership business:
 - (a) Owners are personally liable for debts if the business fails to meet the same.
 - (b) Owners have limited lives, but the business entity assumed to be a going concern.
 - (c) If the business fails, the owner's potential losses are limited to the amounts of their equity.
 - (d) Each partner has the right to bind the business to contracts and to make managerial decision.
 - (e) The property invested in business becomes property of all the owners jointly.
2. Which of the following is not related to partnership:
 - (a) The share in the ownership can be transferred to another without disrupting the continuity of business.
 - (b) Owners do not have to pay income tax on dividend or share of profits received because the firm is subject to income tax.
 - (c) Owners are liable for the debt of the business only in proportion to the percentage ownership in capital.
 - (d) An agreement to form the business is the essential element in the formation of the business.
3. Which of the following fall in the category of right and obligation of the partners:
 - (a) Every partner has the right to be consulted.
 - (b) Every partner has the right to prevent admission of a new partner.
 - (c) Every partner must be just and faithful to other partners.
 - (d) Every partner has equal right to profit and loss.
 - (e) Every partner must take part in the management of the business.
 - (f) Every partner can borrow money for business by pledging inventory.

Lesson-2: Accounts of Partnership Firm: General Principles

Lesson Objectives

After studying this lesson, you will be able to:

- describe the principles governing the distribution of profits of partnership.
- apply the techniques of computation of interest on capital and drawings.
- the procedure of drawing capital and loan accounts of partners.

6.2.1 Introduction

Partnership Act -1932, which guides partnership, does not incorporate any special or new principle for this type of business as to keeping books of accounts or maintaining and preparing accounts. As a result, the accounts to be kept and methods to be followed in preparing accounts will be the same as is followed for any other business. But in doing so, some points to be remembered and policies to be followed, which are relevant to distribution of profits, calculation of interest and preparing individual accounts of partners with reference to mutual interest of the partners and the relationship thereof.

6.2.2 Appropriation/Distribution of Profit

So far as apportionment or distribution of profit is concerned, the partnership agreement- whether oral or written- is the final. However, ***in the absence of any agreement*** or provision relevant to the following points, the principles detailed below will be followed as per section-13 of the Partnership Act, 1932:

- ***Interest on capital:*** No interest on capital will be allowed.
- ***Interest on partner's loan:*** Interest will be allowed @ 6% per annum.
- ***Interest on drawings:*** No interest on drawings will be charged.
- ***Salary and commission:*** A partner is not entitled to salary, commission etc. for taking any part in the conduct of business of the firm.
- ***Profit or loss:*** Profits or losses are to be shared equally.

For apportionment or distribution of profit the partnership agreement, whether oral or written, is the final.

Illustration 6.01

A and B are partners with a capital of Tk.60,000 and Tk.80,000. Profit at the end of the year amounts to Tk.40,000. It is agreed that 5% interest on capital will be allowed. There is no agreement as to salary and sharing of profits. A acts as whole time partner and B does not attend the business regularly. As such A claims salary @ Tk.2,000 per month and 60% of

the balance profit. B advanced a loan of Tk.20,000 in the middle of the year. Show the distribution of profit with your comments, if any.

Solution:

Distribution of Profit:

	<u>A</u>	<u>B</u>	<u>Total</u>
	<u>Tk.</u>	<u>Tk.</u>	<u>Tk.</u>
Interest on Capital @ 5% p.a.	3,000	4,000	7,000
Interest on loan @ 6% for 6 month	—	600	600
Share in the balance of profit	16,200	16,200	32,400
	19,2,000	20,800	40,000

Comments:

In absence of any agreement as to salary of partners and interest on capital, sec.13 of the Partnership Act, 1932 will be applicable to those points and disputes. As per the provision:

- i) Although A is a whole time partner, he is not entitled to salary as he claims.
- ii) A is not entitled to 60% of the profit as profits or losses are to be shared equally in the absence of agreement.
- iii) Interest on loan is to be charged @ 6% per annum.

6.2.3 Sharing Profit and Losses

Sharing profits and losses may take any of the following forms:

- **Statutory basis:** In the absence of agreement as to share of profits and losses, it will be shared equally as per Section-13 of Partnership Act, 1932.
- **Contractual basis:** The partners of a firm are free to decide among themselves as to the ratio of sharing profit and losses. In practice any of the following methods may be agreed upon and followed:
 - a) **Arbitrary Fixed Ratio:** If the profit and loss sharing ratio is not in line with respective capital contribution of the partners, then it is called arbitrary ratio. In such a case, partners may agree on ratio, say 2:1 (among partners x & y) and so on. In some cases partners may also agree to share profits in one ratio and losses in another ratio.
 - b) **Arbitrary Ratio with Graduate Proportions:** Partners may agree to share profits and losses up to a certain limit in one ratio and remaining balance, if any, in other ratio.
 - c) **Capital Ratio:** The partners of a firm may agree to share profits and losses in proportion to their capital. If the capital is fixed, the debit or credit balance in the Current Accounts of the respective partners need not be considered. Profits and losses will be shared in proportion to the amounts of capital standing to the credit of

the individual partner. If the capital is fluctuating, current account balances need to be adjusted and here the partners must decide the stage at which the capital balances are to be struck for the purposes of ratio.

- d) Average Capital Ratio:** The partners of a firm may agree to share the profits and losses of their business relating to a period in proportion to their respective average capitals employed in the related period.

Illustration-6.02:

A and B are partners of a firm. The profit for the year ended on 31st December, 2023 was Tk.50,000. As per agreement, they will share profits and losses as to 3:2 up to Tk.40,000 and the rest, if any, equally. Show the distribution of profits.

Solution:

Profit up to Tk.40,000 in 3:2 ratio and balance in 1:1 ratio.

$$\therefore A = \frac{3}{5} \text{ of } 40,000 + \frac{1}{2} \text{ of } 10,000 = (24,000 + 5,000) = \text{Tk.}29,000$$

$$B = \frac{2}{5} \text{ of } 40,000 + \frac{1}{2} \text{ of } 10,000 = (16,000 + 5,000) = \text{Tk.}21,000$$

6.2.4 Interest on Capital and Drawings

Partnership agreement may provide for allowing interest on capital. In that case interest is to be calculated on time basis. Introduction of new capital and withdrawal of capital will also be subject to consideration for calculation of interest. If the agreement provides for charging interest on drawing then it is to be charged on the amounts drawn from the date of drawing up to the date of closing the accounts unless there is no agreement to the contrary.

Partnership agreement may provide for allowing interest on capital.

Illustration-6.03:

A and B are partners of a firm. The capital of partners on 1.1.2023 stood at Tk.40,000 and Tk.60,000 respectively. A introduced a further capital of Tk.10,000 on 1st October 2023. A was drawing Tk.1,200 at the end of each month. B in anticipation of profit withdrew the following:

Tk.1000 on 01.07.2023; Tk.500 on 10.08.2023; Tk.1000 on 12.09.2023;

Tk.800 on 16.10.2023 and Tk.700 on 20.12.2023.

10% interest on both capitals and drawings is to be charged. Show the calculation of interest.

Solution:**A. Interest on capital:**

A = on Tk.40,000 @ 10%	= Tk.4,000
on Tk.10,000 @ 10% for 3 months	= 250
Total	= Tk.4,250

Alternatively:

Tk.40,000 stand for 12 month or 4,80,000 for one month

Tk.10,000 stand for 3 month or 30,000 for one month

Total product = 5,10,000 for one month

∴ Interest = on Tk.5,10,000 @ 10% for one month = Tk.4,250

Again, interest on capital of

$$B = \text{on Tk.60,000 @ 10\%} = \underline{\text{Tk.6,000}}$$

B. Interest on drawings:

A = 1,200 drawn on 31-1-2023 stands for 11 months, product is	13,200
1,200 drawn on 28-2-2023 stands for 10 months, product is	12,000
1,200 drawn on 31-3-2023 stands for 9 months, product is	10,800
1,200 drawn on 30-4-2023 stands for 8 months, product is	9,600
1,200 drawn on 31-5-2023 stands for 7 months, product is	8,400
1,200 drawn on 30-6-2023 stands for 6 months, product is	7,200
1,200 drawn on 31-7-2023 stands for 5 months, product is	6,000
1,200 drawn on 31-8-2023 stands for 4 months, product is	4,800
1,200 drawn on 30-9-2023 stands for 3 months, product is	3,600
1,200 drawn on 31-10-2023 stands for 2 months, product is	2,400
1,200 drawn on 30-11-2023 stands for 1 months, product is	1,200
1,200 drawn on 31-12-2023 stands for 0 months, product is	0

Total product = 79,200

∴ Interest = Tk.79,200@ 10% for one month = Tk.660

B = In this case, there is no regularity as to the date of drawings and not the amount is fixed. In such a case product is to be computed with reference to date. In such a case average due date better be computed.

<u>Amount</u>	<u>No. of days</u>	<u>Product</u>
1,000	0	0
500	40	20,000
1,000	73	73,000
800	107	85,600
700	170	1,19,000
<u>4,000</u>		<u>2,97,600</u>

$$\text{Average due date} = \frac{2,97,000}{4,000} = 74.40 \text{ from } 01.07.2023$$

Now, after 74 days sin 01.07.2023, we get

July =	30
August =	31
September =	13
	<u>74 i.e. 14th September</u>

∴ The remaining days after 14 September. to 31 December is

In September	= 17
In October	= 31
In November	= 30
In December	= 31
Total =	<u>109 days</u>

∴ Int. @ 10% on 4,000 for 109 days = Tk.119.45

6.2.5 Partners' Capital Accounts

Partners' Capital account may be of two types, viz., fixed capital and fluctuating capital. In case the capital accounts is kept under fixed capital system, the amount will remain fixed year after year but may change by the introduction of new capital. In case it is kept under fluctuating capital system, the balance of capital will change year to year. The system can be explained as follows:

Fixed capital and fluctuating capital are the two types of Partners Capital Account.

i) **Fixed Capital:** Under this system partner's capital accounts are sub-divided into the under noted parts:

- a) **Capital Account:** The amount contributed by partner is credited to it, the amount is kept intact from year to year unless the partners introduce any additional capital.
- b) **Current Account:** The amount and balance will fluctuate year to year because a number of items will be debited or credited in this account.

The under noted items are recorded to the credit of this account:

Interest on partners' capital, salaries and commission allowed to the partners, and share of profit.

Following items are debited to this account;

Partners' drawings, interest on drawings, share of losses, if any, during the year.

Current account may show debit balance under the following circumstance:

- a) When amount of drawing exceeds his share of profit.
- b) When the business has suffered loss and the amount due to partners as salary, commission etc. are less than the share of loss.
- c) **Drawings Account:** Partners may keep separate drawing account. Drawings, in such a case, will be debited to this account and at the end of the period it will be transferred to the debit of current account of respective partner and thus the account will be closed. When drawings are frequent, this account is kept so that current account does not become too heavy.

Under fixed capital system partners, capital accounts are sub-divided into capital account, current account and drawings account.

Under fluctuating capital system all transactions relevant to partner's capital, drawing, and share of profit or loss are recorded.

ii) Fluctuating Capital: Under this system all transactions relevant to partners' capital, drawing, and share of profit or loss are recorded in this account. Thus the balance of capital account naturally fluctuate year to year. No such accounts as current account and drawings account for partners are opened. Transactions noted below are recorded to the credit in this account:

Amount contributed as capital, Interest on capital, Salaries and commission due to partners, share of profit, etc.

Following items are recorded to the debit of this account:

Partners' drawing, interest on drawing, share of loss (if any).

Amount advanced by a partner over and above contribution of capital should be kept by crediting to partner's loan account.

iii) Partners' Loan Accounts: Any amount advanced by a partner over and above his contribution of capital should be kept credited to partners loan account. It should be maintained as separate account and not to be mixed up with capital. Interest on such loan may either be credited to this account or to the partners' current account.

Illustration-6.04:

X and Y share profits and losses in the ratio of 3:2. Their capital balances were Tk.60,000 and Tk.70,000 respectively. Salary payable and drawn by X & Y for the year amounted to Tk.10,000 and 8,000 respectively. 8% interest is payable on capital. Total profit for the year was Tk.80,000. In addition to salary X drew Tk.5,000 and Y drew Tk.10,000 during the year. Show the profit and loss adjustment account and capital account under both fixed and fluctuating capital method.

Solution:

X & Y

Profit and Loss Appropriation Account

Dr. For the year ended..... Cr.

Account Titles	Tk.	Account Titles	Tk.
Int. on Capital: X = 4,800 Y = <u>5,600</u>	10,400	Net profit for the year b/d from P/L A/c	80,000
Partners' Salary: X = 10,000 Y = <u>8,000</u>	18,000		
Share of the balance of profit: X = 30,960 Y = <u>20,640</u>	51,600		
	<u>80,000</u>		<u>80,000</u>

Capital Accounts:**A) Fixed Capital System**

Dr. **Partners' Capital** Cr.

Explanation	X	Y	Explanation	X	Y
Balance c/d	Tk. 60,000	Tk. 70,000	Balance b/f	Tk. 60,000	Tk. 70,000
	<u>60,000</u>	<u>70,000</u>		<u>60,000</u>	<u>70,000</u>

Dr. **Partners' Current Accounts** Cr.

Explanation	X	Y	Explanation	X	Y
Drawings	Tk. 15,000	Tk. 18,000	Int. on capital	Tk. 4,800	Tk. 5,600
Balance c/d	30,760	16,240	Salary	10,000	8,000
	<u>45,760</u>	<u>34,240</u>	Share of profit	30,960	20,640
				<u>45,760</u>	<u>34,240</u>

B) Fluctuating Capital System

Dr. **Partners' Capital** Cr.

Explanation	X	Y	Explanation	X	Y
Drawings	15,000	18,000	Balance b/f	60,000	70,000
Balance c/d	90,760	86,240	Int. on capital	4,800	5,600
			Salary	10,000	8,000
			Share of profit	30,960	20,640
	<u>1,05,760</u>	<u>1,04,240</u>		<u>1,05,760</u>	<u>1,04,240</u>

Questions

Self-Test Questions

1. In the absence of agreement, which of the following provisions will be applicable for partnership account:
 - (a) Interest on capital @ 6% will be charged.
 - (b) Interest on loan @ 6% will be allowed.
 - (c) Profit & loss will be shared equally.
 - (d) Partners will not be allowed salary.
 - (e) Commission will not be allowed.
2. X and Y are in partnership. X contributed Tk.50,000 and contributed Tk.20,000 as capital. How will X and Y share in the division of net income or loss?
 - (a) 5 : 2; (b) 2 : 1; (c) 1 : 1; (d) None of the a, b, & c.
3. A and B invested Tk.1,00,000 and Tk.50,000 respectively in a business and agreed to a division of net income that provides for an allowance of interest @ 10% on original investment, salary of Tk.12,000 and Tk.24,000 to A and B respectively with the remainder divided equally. What would be A's share of a periodic net income of Tk.45,000?
 - (a) Tk.22,500; (b) Tk.22,000; (c) Tk.19,000; (d) Tk.10,000; (e) None

Lessons-3 and 4: Practical Problems on Partnership

Lesson objectives

After studying this lesson, you will be able to:

- draw profit and loss appropriation account.
- draw capital account and current account of partners.
- explain the matters relevant to preparation of final accounts of partnership.

Introduction

Different aspects of partnership and matters related with accounts have been outlined in earlier sections. Based on that discussion, the techniques of finalization of partnership accounts, after preparation of Income Statement (or Profit & Loss Accounts in normal way) have been presented here. In fact, the accounts to be prepared at this stage are:

- Profit & Loss Appropriation Account.
- Capital Accounts of partners.
- Current Accounts of partners (where capital account is fixed.)
- Drawing Accounts of partners.
- Loan Account, if any.

Profit & Loss Appropriation Account will start with net profit shown in Profit & Loss Account. It will be shown in the credit side as first item. (If there is net loss, it will naturally be shown in the debit of the account). In credit side interest on drawing (if any) will be shown. On the other hand, all claims or dues to partners such as interest on capital, salary, commission etc. will be shown in the debit side. The resultant balance will be distributed to partners as per the profit & loss sharing ratio.

Contrary, all dues to partners such as interest on capital, salary, commission, share of profit, etc. will be credited to respective capital accounts in case where capital is fluctuating, and to respective current account where capital is fixed. Interest on drawing and share of loss if any will be debited to capital / current accounts. Capital or current accounts may be prepared individually for each partner or may be prepared in columnar form.

The following illustrations will make the point clear to the learners.

Illustration: 6.05

A, B and C are partners of a firm sharing profits & losses as 3:2:1 up to 60% of profit, the balance 40% is to be shared equally. The profit of the firm disclosed at Tk.90,000 for the year ended on 30th June 2023, before charging interest on capital and partnership salaries.

On 1-7-2022 A, B and C had capitals amounting to Tk.100,000, Tk.80,000 and Tk.60,000 respectively, but B withdrew Tk.20,000 on 1-2-2023 and C introduced Tk.30,000 on 1-3-2023. A had no drawing except salaries of Tk.10,000 a year but B's drawings were Tk.5,000 on 31-12-2022, and Tk.10,000 on 1-4-2023. C regularly drew @ Tk.1,000 at the end of each

Capital or current accounts may be prepared individually for each partner or may be prepared in columnar form.

month. B is entitled to a commission @ 5% on net profit before appropriation, allowances and charges paid to partners. Interest on capitals and drawings is to be charged @ 10% and 6% respectively. Prepare Profit and Loss Appropriation Account and Capital Accounts of partners.

Solution:

i) Computation of interest on capitals:

A = On Tk.1,00,000 for 1 year @ 10% = Tk.10,000

B = On Tk.80,000 for 7 months @ 10% = Tk.4.667

On Tk.60,000 for 5 months @ 10% = Tk.2,500

Tk.7,167

C = On Tk.60,000 for 8 months @ 10% = Tk.4,000

On Tk.90,000 for 4 months @ 10% = Tk.3,000

Tk.7,000

ii) Interest on drawings:

B = 5,000 for 6 months @ 6% = Tk.150

10,000 for 3 months @ 6% = Tk.150

Tk.300

C = On Tk.1,000 for 11 months = 1,000 x 11 for one month.

1,000 for 10 months (28.2 to 31.12)

1,000 for 1 month (30.11.to 31.12)

1,000 for 0 month (31.12 to 31.12)

i.e. 1,000 x 66 for one month

$$= 66,000 \text{ for one month} = 66,000 \times 6\% \times \frac{1}{12} = \text{Tk. 330.}$$

A, B, and C

Profit and Loss Appropriation Account

Dr. For the Year Ended on 30 June, 2023

Cr.

Explanation	Tk.	Explanation	Tk.
Partners' Capital Account:		Profit and loss A/c:	
Commission-B	4,500	Net profit b/d	90,000
Partners' Capital Account :		Partners' capital Account:	
Salary-A	10,000	Interest on drawings:	
Partners' Capital Accounts :		B = 300	
Interest on Capital:		<u>C = 330</u>	630
A- Tk.10,000			
B- 7,197			
<u>C- 7,000</u>	24,167		
Partners' Capital Account:			
Share of profit :			
A = (15,589+6928) = Tk.22,517			
B =(10,393+6928) = 17,321			
C = (5196+6929) = <u>12,125</u>	51,963		
	90,630		90,630

Dr. Partners' Capital				Cr.			
Explanation	A	B	C	Explanation	A	B	C
Cash		20,000		Balance b/d	1,00,000	80,000	60,000
P/L APP. A/c:				Cash			30,000
Int. on Drawing		300	330	P/L APP. A/c:			
				Commission		4,500	
Balance c/d	1,42,517	88,688	1,08,825	P/L APP. A/c:			
				-Salary	10,000		
				P/L App. A/c:			
				-Int. on Capital	10,000	7,167	7,000
				P/L App. A/c:			
				-Share of Profit	22,517	17,321	12,125
	1,42,517	1,08,988	1,09,125		1,42,517	1,08,988	1,09,125

Illustration 6.06

X and Y were in partnership sharing profits equally after crediting interest at 5 per cent per annum on their capitals. No interest was to be charged or allowed on Current Account balances.

On 31st December, 2019 their capitals were Tk.60,000 and Tk.30,000 respectively. On the same date Y owed X Tk.3,000 being the balance of an amount which Y had agreed to pay X for an interest in the goodwill to the business. The debt carried no interest, and was to be discharged out of any surplus arising on B's current account at the end of each year but kept in the business as additional capital of X.

Balance sheets had been prepared regularly, and the partners' Capital Account had not been credited with interest of their share of profits, but investigation disclosed that X had drawn Tk.5,000 per annum on account of profits and Y had drawn Tk.4,000 per annum, and that the surplus of assets over liabilities had drawn, as shown by the books, was as follows:

		Tk.
On 31st	December, 2020	92,500
On 31st	December, 2021	94,500
On 31st	December, 2022	97,000
On 31st	December, 2023	1,01,000

Show the relative positions of the partners on 31st December, 2023.

Solution:

Profit before adjustment of interest:

Year	Capital at the end	Drawings	Total	Capital at the beginning	Adjusted Profit (4-5)
1	2	3	4	5	6 = (4-5)
	Tk.	Tk.	Tk.	Tk.	Tk.
2020	92,500	9,000	1,01,500	90,000	11,500
2021	94,500	9,000	1,03,500	92,500	11,000
2022	97,000	9,000	1,06,000	94,500	11,500
2023	1,01,000	9,000	1,10,000	97,000	13,000

Dr. Partners' Current Accounts				Cr.			
Date	Explanation	X	Y	Date	Explanation	X	Y
		Tk.	Tk.			Tk.	Tk.
2020	Drawings	5,000	4,000	2020	Balanced b/d	3,000	1,500
	Transfers to X's Capital	-----	1,000		Interest on Capital	3,500	3,500
	Balance c/d	1,500	-----		Share of profit	-----	-----
		<u>6,500</u>	<u>5,000</u>			<u>6,500</u>	<u>5,000</u>
2021	Drawings	5,000	4,000	2021	Balance b/d	1,500	
	Transfer to X's Capital	-	725		Interest on capital	3,050	3,225
	Balance c/d	2,775	-		Share of profit	3,225	1,500
		<u>7,775</u>	<u>4,725</u>			<u>7,775</u>	<u>4,725</u>
2022	Drawings	5,000	4,000	2022	Balance b/d	2,775	--
	Transfer to X's Capital	--	957		Interest on capital	3,086	1,500
	Balance c/d	4,318			Share of profit	3,457	3,457
		<u>9,318</u>	<u>4,957</u>			<u>9,318</u>	<u>4,957</u>
2023	Drawings	5,000	4,000	2023	Balance b/d	4,318	--
	Transfer to X's Capital	--	318		Interest on capital	3,134	1,500
	Balance c/d	6,635	1,365		Share of profit	4,183	4,183
		<u>11,635</u>	<u>5,683</u>			<u>11,635</u>	<u>5,683</u>
				2024	Balance b/d	6,635	1,365

Dr. Partners' Capital				Cr.			
Years	Explanation	X	Y	Years	Explanation	X	Y
		Tk.	Tk.			Tk.	Tk.
2020				2020			
Dec. 31	Balance c/d	61,000	30,000	Jan. 1	Balance b/d	60,000	30,000
		<u>61,000</u>	<u>30,000</u>	Dec. 31	Y's Current A/c	1,000	--
						<u>61,000</u>	<u>30,000</u>
2021				2021			
Dec. 31	Balance c/d	61,725	30,000	Jan. 1	Balance b/d	61,000	30,000
		<u>61,725</u>	<u>30,000</u>	Dec. 31	Y's Current A/c	725	-
						<u>61,725</u>	<u>30,000</u>
2022				2022			
Dec. 31	Balance c/d	62,682	30,000	Jan. 1	Balance b/d	61,725	30,000
		<u>62,682</u>	<u>30,000</u>	Dec. 31	Y's Current A/c	957	--
						<u>62,682</u>	<u>30,000</u>
2023				2023			
Dec. 31	Balance c/d	63,000	30,000	Jan. 1	Balance b/d	62,682	30,000
		<u>63,000</u>	<u>30,000</u>	Dec. 31	Y's Current A/c	318	--
						<u>63,000</u>	<u>30,000</u>
				2024			
				Jan. 1	Balance b/d	63,000	30,000

Profit & Loss Appropriation Account

Dr.	Years	Explanation	Tk.	Tk.	Cr.	Years	Explanation	Tk.
	2020	Interest on Capitals: X : 5% on 60,000 Y : 5% on 30,000 Profit transferred to: X : Y :	3,000 1,500 3,500 3,500	4,500 7,000 11,500		2020	Net Profit	11,500
	2021	Interest on Capitals: X: 5% on 61,000 Y: 5% on 30,000 Profit transferred to: X: Y:	3,050 1,500 3,225 1,225	4,550 6,450 11,000		2021	Net Profit	11,500 11,000
	2022	Interest on Capitals: X: 5% on 61,725 Y: 5% on 30,000 Profit transferred to: X: Y:	3,086 1,500 3,457 3,457	4,586 6,914 11,500		2022	Net Profit	11,000 11,500
	2023	Interest on Capitals: X: 5% on 62,682 Y: 5% on 30,000 Profit transferred to: X: Y:	3,134 1,500 4,183 4,183	4,634 8,366 13,000		2023	Net Profit	11,500 13,000

Illustration-6.07 (Minimum guarantee to a partner) :

A, B & C are in partnership sharing profits and losses in the ratio of

$\frac{1}{2} : \frac{1}{3} : \frac{1}{6}$ respectively. Balances of their Capital Accounts and Current

Accounts on 1st Jan. 2023 & Drawings for the year were as follows:

Partner Capital A/c Balance		Current A/c Balance	Drawings
A-	Tk.20,000	Tk.5,000	Tk.2,000
B-	15,000	4,000	1,200
C-	10,000	3,000	1,000

Interest is to be charged @ 5% on Capitals and Drawings. According to agreement C is to manage the firm on behalf of A & B who is guaranteed a minimum of Tk.3,000 in all for each year. Profit of the firm before

adjusting the above for the year ended on 31st Dec. 2023 amounted to Tk.12,000. Prepare Profit and Loss Appropriation Account & Partners' Capital Accounts.

Solution:

Profit & Loss Appropriation Account For the Year Ended at 31st December 2023			
Dr.		Cr.	
Explanation	Tk.	Explanation	Tk.
Interest On Capitals:		Profit	12,000
A- 1,000		Interest on Drawings.	
B- 750		A- 50	
C- 500	2,250	B- 30	
		C- 25	105
Share of profit:			
A = Tk.4927.50			
Less transferred to C's A/C to meet the			
guaranteed $\frac{3}{5}$ of			
882.50 = <u>529.50</u>	4,398		
B = Tk.3285			
Less transferred to C's A/c to meet the			
guaranteed amount			
$\frac{2}{5}$ of 882.50 = <u>353</u>	2,932		
C = Tk.1642.50			
Add transferred from			
A = 529.50			
B = <u>353.00</u> <u>882.50</u>	2,525		
	<u>12,105</u>		<u>12,105</u>

Note: As per guarantee C will not get less than Tk.3,000. But it is seen that he gets Tk.1642.50 from divisible profit and Tk.500 from interest on capital. Further he is to pay to the firm Tk.25 as interest on drawing. So his net receipt stands at Tk.2117.50 (1642.50+500–25). Thus deficiency of Tk.882.50 (3000–2117.50) is to be provided by A and B in their P/L ratio

of $\frac{1}{2} : \frac{1}{3}$ or 3:2.

Dr. Partners' Capital				Cr.			
Explanation	A	B	C	Explanation	A	B	C
	Tk.	Tk.	Tk.		Tk.	Tk.	Tk.
Balance c/d	20,000	15,000	10,000	Balance b/f	20,000	15,000	10,000
	<u>20,000</u>	<u>15,000</u>	<u>10,000</u>		<u>20,000</u>	<u>15,000</u>	<u>10,000</u>

Dr. Partners' Current Accounts				Cr.			
Explanation	A Tk.	B Tk.	C Tk.	Explanation	A Tk.	B Tk.	C Tk.
Interest on Drawings	50	30	25	Balance b/f	5,000	4,000	3,000
Balance c/d	10,348	7,652	6,000	Interest on capital	1,000	750	500
				Share of profit	4,398	2,932	2,525
	<u>10,398</u>	<u>7,682</u>	<u>6,025</u>		<u>10,398</u>	<u>7,682</u>	<u>6,025</u>

Note: As the dates of drawings have not been mentioned, half yearly interest has been charged. As there is balance of current account, capital accounts have been treated as fixed.

Illustration-6.08

Chowdhury, Syed and Khan are partners in a firm sharing profit in the ratio of 60%, 30% & 10% respectively. According to partnership agreement:

- 1) Interest on capital is to be charged @ 6% p.a.
- 2) Interest on current account is to be charged @ 5% on the opening balance every year.
- 3) Interest on drawings (excluding salary) is to be charged @ 5% on excess or short drawings over share of profits after charging all the expenses except interest on drawings.
- 4) Syed and Khan are to get salary of Tk.9,000 and Tk.12,000 respectively per annum.
- 5) Their manager, Mr. Gupta, is to get bonus of Tk.15,000
- 6) Following are the information for the year ended on 31st Dec. 2023:

Partners	Capital Account balance on 1-1-2023	Current Account balance on 1-1-2023	Drawings including Salary
Chowdhury	Tk.1,35,000	Tk.30,000	Tk.61,000
Syed	Tk.90,000	Tk.15,000 (Dr)	Tk.49,500
Khan	Tk.45,000	Tk.18,000	Tk.34,500

Profit for the year before providing for the above adjustment were Tk.1,88,850. You are required to prepare Profit & Loss Appropriation A/c for the year ended on 31-12-2023.

Solution:

Chowdhury, Syed & Khan Profit & Loss Appropriation Account For the Year Ended on 31-12-2023			
Dr.			Cr.
	Tk.		Tk.
Bonus (Gupta)	15,000	Net profit	1,88,850
Int. on capital :		Interest on current A/c	750
Chowdhury- 8,100		Syed-	
Syed- 5,400			
Khan- 2,700	16,200		
Interest on current A/Cs:			
Chowdhury 1,500			
Khan 900	2,400		
Partner's salary:			
Syed- 9,000			
Khan- 12,000	21,000		
Balance c/d	1,35,000		
	<u>1,89,600</u>		<u>1,89,600</u>
Interest on drawings:		Balance b/d	1,35,000
(Chowdhury)	1,000	Interest on drawings:	
Share of profit :		(Khan)	450
Chowdhury- 80,670			
Syed- 40,335			
Khan- 13,445	1,34,450		
	<u>1,35,450</u>		<u>1,35,450</u>

Workings: Determination of short or excess drawings:

	Choudhury	Syed	Khan
	Tk.	Tk.	Tk.
Drawings excluding salary	61,000	40,500	22,500
Share of profit due (Before adjusting interest on drawings i. e. on 60 : 30 : 10 Tk.1,35,000)	81,000	40,500	13,500
Short or excess drawings	(-) 20,000	0	(+) 9,000
Interest due to Choudhury	1,000		
Interest payable by Khan			450

Illustration-6.09 (Final Accounts of Partnership Firm)

A, B and C are in partnership as confectioners, sharing profits and losses as follows: A-3/6ths, B-2/6ths and C-1/6ths.

The following were the balances extracted from Ledger accounts of the partnership as on December 31, 2023.

Explanation	Tk.	Explanation	Tk.
1. Fixed Capital Accounts :		13. Lighting & Heating	500
A- 20,000		14. Loan given by A on 1-7-2023	10,000
B- 18,000		15. Rent, Rates & Insurance	1,300
C- 15,000	23,000	16. Motor Van at cost	54,000
2. Current Accounts (Cr.):		17. Shop-Fittings at cost	11,000
A- 1,000		18. Trade Creditors	6,000
C- 800	1,800	19. Ena Bank Ltd. (Cr.)	5,000

Explanation	Tk.	Explanation	Tk.
3. Current Account (Dr.): B-	100	20. General Expenses	7,000
4. Provision for Doubtful Debts as on 1st Jan. 2023	1000	21. Motor Van-Expenses for delivery	500
5. Provision for depreciation on Motor Van as on 1st Jan, 2023	1,800	22. Sales	1,79,850
6. Provision for Depreciation on Shop-Fittings as on 1st Jan, 2023	1,900	23. Bills Receivable	500
7. Inventories- 1st January, 1999	18,000	24. Balance at National Bank Ltd.	41,000
8. Cash in hand	150	25. Bad Debts	500
9. Purchases	1,00,000		
10. Wages	5,600		
11. Salaries (Administrative)	15,000		
12. Trade Debtors	5,200		

You are also given the following information:

- B and C were entitled to a salary of Tk.500 and Tk.400 per month respectively.
- Inventories on 31st December, 2023 was valued at Tk.40,000.
- Goods were supplied during the year to the partners for personal consumption, the agreed values being A-Tk.500, B-Tk.300 and C-Tk.200. Such supplies remained unrecorded.
- Included in salaries (administrative) were Partners' drawings, which were as follows: A-Tk.2,000, B-Tk.1,200 and C-Tk.900.
- Bad debts to be written off amounted to Tk.800, Provision for Doubtful Debts to be made at 10% on Debtors.
- Depreciation on Motor Vans was to be charged @ 20% and on Shop Fittings @ 10%.

You are required to prepare:

- The Trading and Profit & Loss Account for the year ended 31st December, 2023 and the Profit & Loss Appropriation Account and Partners' Capital & Current Accounts.
- The Balance Sheet of the firm as on that date.

Solution:**Trading and Profit & Loss Account**

Dr. For the Year Ended on 31st December, 2023 Cr.

Explanation	Tk.	Tk.	Explanation	Tk.	Tk.
Inventories (Opening)		18,000	Sales		1,79,850
Purchases	1,00,000		Inventories (Closing)		40,000
Less Goods Supplied to partners:					
A Tk. 500					
B 300					
C <u>200</u>	1,000	99,000			
Wages		5,600			
Gross Profit c/d		97,250			
		<u>2,19,850</u>			<u>2,19,850</u>
Salaries	15,000		Gross Profit b/d		97,250
Less partners' Drawings:			Reserve for Doubtful debts.	1000	
A 2,000			Less provision for current year	<u>440</u>	560
B 1,200					
C <u>900</u>	4,100	10,900			
Lighting & Heating		500			
Rent Rates & Insurance		1,300			
General Expenses		7,000			
Motor van Expenses for delivery		500			
Bad debts	500				
Add Amount written off	<u>800</u>				
Depreciation:		1,300			
Motor Van					
Shop Fittings	10,800				
P & L Appr. A/c	<u>1,100</u>	11,900			
Net Profit transferred		64,410			
		<u>97,810</u>			<u>97,810</u>

Profit & Loss Appropriation Account

Dr. For the Year Ended 31st December, 2023 Cr.

Particulars	Tk.	Tk.	Particulars	Tk.	Tk.
Partners' Salaries			Profit an Loss A/c - Net Profit		64,410
B 6,000					
C <u>4,800</u>		10,800			
Interest on loan : A		300			
Current Accounts : (Share of Profits)					
A 26,655					
B 17,770					
C <u>8,885</u>		53,310			
		<u>64,410</u>			<u>64,410</u>

Dr.**Partners' Capital****Cr.**

Date	Particulars	A	B	C	Date	Particulars	A	B	C
		Tk.	Tk.	Tk.			Tk.	Tk.	Tk.
31.12.2023	Balance c/d	20,000	18,000	15,000	01.01.2023	Balance b/d	20,000	18,000	5,000
		<u>20,000</u>	<u>18,000</u>	<u>15,000</u>			<u>20,000</u>	<u>18,000</u>	<u>15,000</u>

Dr. Partners' Current Accounts					Cr.				
Date	Explanation	A	B	C	Date	Explanation	A	B	C
01.01.2023	Balance b/d	Tk.	Tk.	Tk.	01.01. 2023	Balance b/d	Tk.	Tk.	Tk.
31.12. 2023	Drawings:								
	Cash	200	1,200	900	31.12. 2023	Salaries		6,000	4,800
	Goods	500	300	200	31.12. 2023	Share of profit	26,665	17,770	8,885
31.12. 2023	Balance c/d	25,165	22,170	13,385					
		<u>27,665</u>	<u>23,770</u>	<u>14,485</u>			<u>27,665</u>	<u>23,770</u>	<u>14,485</u>

A's Loan

Date	Explanation	Amount	Date	Explanation	Amount
		Tk.			Tk.
31.12.2023	Balance c/d	10,000	01.07.2023	Cash	10,000
		<u>10,000</u>			<u>10,000</u>

[Note: Interest @ 6% p.a. on loan has been allowed and shown in P/L Appropriation Account as an expenses and in Balance sheet as amount due]

M/s A, B, & C**Balance Sheet****As at 31st December, 2023**

Liabilities	Tk.	Tk.	Assets	Tk.	Tk.
Capital Accounts:			Fixed Assets :		
A-	<u>10,000</u>		Motor Van	54,000	
B-	<u>8,000</u>		Less Depreciation		
C-	<u>5,000</u>	23,000	Up to 31.12.22 Tk.1,800		
Current Accounts :			Depreciation for		
A-		25,165	the year Tk.10,800	<u>12,600</u>	
B-		22,170	Shop- Fitting	11,000	41,400
C-		13,385	Less Depreciation		
Interest on loan (Due to A)		300	up to 31.12.22 Tk.1,900		
Trade Creditors		6,000	Depreciation for		
Bank Overdraft (Ena Bank Ltd.)		5,000	the year Tk.1,100	<u>3,000</u>	8,000
			Current Assets :		
			Trade Debts	5,200	
			Less Bad debts	<u>800</u>	
			written off	4,400	
			Less Reserve for		
			Doubtful Debts	<u>440</u>	3,960
			Inventories		40,000
			Bills Receivable		500
			Cash at Bank		
			(National Bank Ltd.)		41,000
			Cash in hand		150
		<u>1,35,010</u>			<u>1,35,010</u>

Questions

Self-Test Questions

1. X is a partner of a firm. He withdraw Tk.45,000 in cash from the business for 2023-2024 and took for his personal use inventory costing Tk.3,200. His share in the partnership net income for the year amounted to Tk.39,000. What amount he showed report on his personal income tax as return from the partnership business?
2. X and Y are partners sharing profit and loss 2 : 1. The capital balance of the partners stands of Tk.65,000 and Tk.35,000 respectively. If Z, their manager is admitted as partner who acquires half of X's share for Tk.40,000, for what amount Z's capital account be credited?
(a) Tk.32,000, (b) Tk.40,000 (c) Tk.50,000 (d) None of a, b and C.

Lesson-5: Valuation and Treatment of Goodwill

Lesson Objectives

After studying this lesson, you will be able to:

- state the concept of goodwill.
- apply different procedures of valuing goodwill.
- explain the procedure relevant to the treatment of goodwill in case of admission and retirement of a partner.

6.5.1 Introduction

The question of valuation and treatment of goodwill arises mainly in the case of admission, retirement, and death of a partner. But in some other cases like a change of profit and loss sharing ratio, sale of business, etc. this question may also arise. In such a context this lesson is devoted to explaining the concept of goodwill, its valuation, and other related aspects.

6.5.2 The Concept of Goodwill and Its Relevance

Goodwill is an intangible asset. It is the value of the reputation of firm arising out of its capacity to bring in, unaided profit. Such a situation may arise due to:

- Personal reputation of the owner/management
- Reputation or quality of goods dealt in
- Special advantage of the site
- Advantage of brand, patent, copyrights, etc.

Goodwill is the value of the connection and reputation of an established business.

Goodwill is realizable only if the business is disposed of. But in certain circumstances, there may arise a necessity to value goodwill. In case of partnership, such necessity may arise in the following cases:

- When there is a change in profit sharing ratio between partners;
- When a new partner is admitted;
- When a partner retires or dies; and
- When the firm sells its business to a company or amalgamates with another.

6.5.3 Valuation of Goodwill

Valuation of goodwill is difficult. However, a number of methods have been evolved for this purpose which are described below:

a) Average Profit Basis:

In this case, profits of the last few years are averaged. Adjustments may be made for any expected change. Then the average is multiplied by a certain number. Thus the method is also called a number of years' purchase of average profit. The objection against

this method is that it does not make any allowance for the capital employed and for remuneration to the partners in respect of their contribution. This method can be explained with the following example:

Goodwill is to be valued at 3 years' purchase of 5 years' average profit. Profit for last 5 years were: Tk.50,000, Tk.60,000, Tk.45,000, Tk.55,000 and Tk.65,000 respectively.

Here, average works out at = Tk.55,000

Three years' purchases = $(3 \times 55,000) = \text{Tk.}1,65,000$

Thus, Goodwill = Tk.1,65,000

Average profit basis, super profit basis and capitalization basis are various methods of valuation of goodwill.

- b) Super Profit Basis:** In this case, interest on capital employed at the rate prevailing in the market and the reasonable salary of the proprietor/ partners are deducted from average profit. What then remains is called super profit. This method can be explained with the above example along with the following additional information:

The capital of the firm is Tk.3,00,00 and 15% is a reasonable return in the firm. The reasonable normal profit of the firm revealed to be Tk.45,000.

The average profit is Tk.55,000, the super profit = $\text{Tk.}(55,000 - 45,000) = \text{Tk.}10,000$. This super profit is generally multiplied by some years. Taking the above example, 3 years' purchase leads to the work out of goodwill at $(10,000 \times 3) = \text{Tk.}30,000$.

- c) Capitalization Basis** = In this case, first the value of the whole business is found out by the following formula:

$$\frac{\text{Profit}}{\text{Reasonable or Normal Profit}} \times 100$$

Then from this figure, the value of net assets (except goodwill) is deducted and the remainder is goodwill. Taking the previous

example; the value of the firm is $\frac{55,000}{15} \times 100 = \text{Tk.}3,66,667$. Net

asset or capital = Tk.3,00,000. Hence goodwill = $\text{Tk.}(3,66,667 - 3,00,000) = \text{Tk.}66,667$.

6.5.4 Treatment of Goodwill in Accounts

Treatment of goodwill will be different in different cases. Following is an attempt to explain the situation with examples.

1) In Case of Changes in the Profit-sharing Ratio:

If partners decide to change the profit and loss sharing ratio in the future different from the one hitherto followed, the gaining partner should compensate the losing partner, unless otherwise agreed. The compensation is the value of goodwill represented by gain.

Illustration-6.10

X and Y are partners sharing profits in the ratio of 3:1. The capitals were X Tk.90,000 and Y Tk.30,000. It is decided that with effect from 1st January. The profit-sharing ratio will be: X-5 and Y-3. The Deed states that goodwill is to be valued at two years' purchase of three years' profits and that the capital of the two partners should be proportionate to the profit-sharing ratio. The profits for the years 1, 2 and 3 were Tk.52,000, Tk.49,000 and Tk.55,000 respectively. Make necessary journal entries.

Solution:

	Tk.
Value of Goodwill: Total profit for 3 years	Year : 1 = 52,000
	Year : 2 = 49,000
	Year : 3 = 55,000
Total.....	<u>156,000</u>
Average Profit (156,000 ÷ 3)	<u>52,000</u>
Goodwill at 2 years' purchase (52,000 × 2)	<u>104,000</u>
Y's gains in the profit-sharing ratio is	
$\frac{3}{8} \times \frac{1}{4} = \frac{1}{8}$	

Therefore, Y must give to X an amount equal to Tk.104,000 × $\frac{1}{8}$ or Tk.13,000

Required Capital after the change in profit ratio :

- Y:** For $\frac{1}{4}$ share, required capital is Tk.30,000
 For $\frac{3}{8}$ share, required capital is Tk.30,000 × $\frac{4}{1} \times \frac{3}{8} = 45,000$
- X :** For $\frac{3}{4}$ share, required capital is Tk.90,000
 For $\frac{3}{8}$ share, required capital is Tk.90,000 × $\frac{4}{3} \times \frac{5}{8} = 75,000$

Journal Entries

Account Titles & Explanation	Dr.	Cr.
Y's Capital X's Capital (The value of $\frac{1}{8}$ share of goodwill (total value Tk.104,000) which Y acquires from X)	Tk.13,000	Tk.13,000
Bank Y's Capital (The Sum required to make up Y's capital up to Tk.45,000 after the debit of Tk.13,000, i.e. 45,000-(30,000-13,000))	28,000	28,000
X's Capital Bank (The sum to be returned to X to bring his capital down to Tk.75,000, i.e., 90,000+ 13,000-75,000.)	28,000	28,000

[Note: In the above illustration, the sum payable by Y to X can also be arrived at by first crediting the total value of the goodwill to the partners in the old profit-sharing ratio and then writing it off in the new ratio]

ii) In Case of Admission of a Partner:

In the case of admission of a partner, one important question is the valuation and treatment of goodwill. Depending on the situation the method of treatment becomes different. The situations vis-a-vis methods of treatment are described below :

(A) Premium Method

a) The new partner brings goodwill in cash which is left in business:

- | | | |
|------------------------------|---|---|
| (i). Debit Cash or Bank | } | With the actual amount which is brought in as goodwill. |
| Credit Goodwill Account | | |
| (ii). Debit Goodwill Account | } | In the ratio in which the old partners sacrifice on the admission of the new partner. |
| Credit Old Partners' | | |
| Capital Accounts | | |

Illustration-6.11

X and Y share profit in the ratio: X, 5 and Y, 3. Z is admitted as a partner. He brings in Tk.1,00,000 as his capital and Tk.80,000 as goodwill. The new profit-sharing ratio will be 7:5:4. Make journal entries.

Solution:

X previously received $\frac{5}{8}$ and now will receive $\frac{7}{16}$; his loss is $\frac{5}{8} - \frac{7}{16} = \frac{3}{16}$. Y's loss similarly is $\frac{3}{8} = \frac{5}{16} = \frac{1}{16}$. Entries are:

Account Titles & Explanation		Dr.	Cr.
i)	Bank Z's Capital Goodwill Account (Being the sum brought in by As capital and goodwill)	Tk.180,000	Tk.100,000 80,000
ii)	Goodwill X's Capital Y's Capital (Being the amount of goodwill credited to X and Y in the ratio of 3: 1 i.e., the ratio of loss suffered on Z's Admission.	80,000	60,000 20,000

b) Goodwill is brought in cash and is withdrawn by the old partners. The entries in this case are similar to those made in case (a) except that an additional entry is required when cash is withdrawn. The additional entry is:

- | | | |
|-------------------------------------|---|----------------------------------|
| Debit Old Partners' Capital Account | } | With the cash withdrawn by them. |
| Credit Cash or Bank | | |

(B) Revaluation Method

When goodwill is not brought in cash by a new partner but is raised in the books of the firm:

The required journal entry is:

Debit Goodwill	}	With the full value of the goodwill and old partners' Capital Accounts credited in the old ratio.
Credit Old Partners' Capital		

Goodwill will then appear in the Balance Sheet of the Firm.

Illustration-6.12

X and Y are partners sharing profits and losses in the ratio of 3:2. They admit Z as a partner who is unable to bring goodwill in cash but pays Tk.100,000 as his capital. The goodwill of the firm is to be valued at Tk.80,000. The new profit loss sharing ratio will be 4:3:3. Make journal entries.

	Account Titles & Explanation	Dr.	Cr.
i)	Bank Z's Capital (Being the sum brought in by As his capital)	Tk.1,00,000	Tk.100,000
ii	Goodwill X's Capital Y's Capital (Being the amount of goodwill credited to X and Y in the ratio of 3:2.)	80,000	48,000 32,000

(C) Memorandum Revaluation Method

In this case, goodwill is raised in the books of the firm (the new partner being unable to bring goodwill in cash) and is immediately written off. All partners (including the incoming partner) will be debited in the new profit-sharing ratio. The entries to be made in the above illustration would be:

	Account Titles & Explanation	Dr.	Cr.
i)	Goodwill Account X's Capital Y's Capital (Being the value of goodwill to be raised on Z's admission as a partner)	Tk.80,000	Tk.48,000 32,000
ii)	X's Capital Y's Capital Z's Capital Goodwill (Being the amount of goodwill written off to all the partners in the new ratio)	32,000 24,000 24,000	80,000

Goodwill in this case will not appear in the Balance Sheet.

[Attention: The above treatment of goodwill related to the additional value of goodwill so that if goodwill already appears in the books of the firm and is revealed at a higher figure on the admission of a new partner, entries will be made only for the difference. If, on revaluation, the value of goodwill is found to be lower than that of what appears in the books, the difference is a loss and has to be written off to the old partners in the old profit-sharing ratio.]

iii) In Case of Retirement of a Partner

- a) Goodwill is raised in the books of the firm; the entry will be:
 Debit Goodwill
 Credit all (including the retiring) partners in the old profit-sharing ratio.
- b) Goodwill is raised in the books but is then written off. Entries will be:
 - i) Debit Goodwill
 Credit all partners (including the retiring one) in the old profit-sharing ratio.
 - ii) Debit remaining partners (excluding the retiring one) in the new profit-sharing ratio Credit Goodwill.
- c) Only the share of the retiring partner is brought into books. The entry is to credit the retiring partner with his share and debit goodwill. The Goodwill Account is written off to remaining partners in the ratio in which they gain on the retirement.

(The students will see for themselves that if goodwill has already appeared in the books, entries for raising goodwill should be made only for the difference. If the new value of goodwill is less than what appears already, it is a loss to be written off to all partners in the old ratio.)

Illustration-6.13

X, Y, and Z are three partners sharing profits in the ratio of 3:3:2 respectively. Y retires and the goodwill is valued at Tk.80,000. No goodwill appears as yet in the books of the firm. Assuming that X and Z will share profits in the future in the ratio of 5:3, pass entries for goodwill in all the relevant cases.

Journal

	Account Titles & Explanation	L.F.	Dr.	Cr.
	Case (a) : Goodwill Account raised in the Books			
	Goodwill		Tk.80,000	
	X' s Capital			Tk.30,000
	Y' s Capital			30,000
	Z' s Capital			20,000
	(The value of goodwill raised on y's retirement).			

	Account Titles & Explanation	L.F.	Dr.	Cr.
	Case (b) : Goodwill raised but written off immediately:			
	(i) Goodwill		80,000	
	X' s Capital			30,000
	Y' s Capital			30,000
	Z's Capital			20,000
	(The value of goodwill raised on Y' s retirement)			
	(ii) X's Capital		50,000	
	Z's Capital		30,000	
	Goodwill			80,000
	(Goodwill raised on Y's retirement, now written off to remaining partners in the new profit-sharing ratio.)			
	Case (c) : Only Y's share of goodwill raised in the book			
	(i) Goodwill		30,000	
	Y's Capital			
	(Y's share of goodwill raised)			30,000
	(ii) X's Capital		20,000	
	Z's Capital		10,000	
	Goodwill			30,000
	(Goodwill raised on Y's retirement is written off to the remaining partner in the gaining ratio.)			

[Note: Calculation of gain:

X's gain on Y's retirement = $5/8 - 3/8 = 2/8$

Z's gain on Y's retirement = $3/8 - 2/8 = 1/8$]

Lesson-6: Admission and Retirement of a Partner

Lesson Objectives

After studying this lesson, you will be able to:

- know the changes that arise due to the admission or retirement of a partner.
- solve the accounting problems arising out of admission and retirement.
- draw out revaluation account and changed capital and relevant account & statements arising out of admission and retirement.

1. Admission of a Partner

New partner may be admitted only with the consent of all the partners unless there is an agreement to the contrary.

When an existing partnership or a sole trader is in need of assistance in management or in capital, a person may be admitted in to the business. In partnership, new partner may be admitted only with the consent of all the partners unless there is an agreement to the contrary. When such a person joins a firm, the terms on which he joins must be fair both to him and existing proprietor/ proprietors. In admission, two basic problems need to be solved.

- i) Treatment of Goodwill
- ii) Revaluation of assets and liabilities

In lesson 5 (five) the methods of valuation of goodwill and its treatment in case of admission of a partner, along with other cases, have been discussed. Thus this section is devoted to bringing to light the treatment as to revaluation of assets and liabilities.

When a new partner is admitted, it is logical that neither he should benefit from any appreciation of an existing asset, nor he should suffer from any fall in the price of the asset. Similar is the case with liabilities. Thus a revaluation of assets or liabilities of the business may be necessary and the resultant profit or loss thereof be transferred to old partners in the old profit & loss sharing ratio. In this regard, the adjustment in the books of account will be as follows:

Event / Transaction	Journal Entry
1) For increase in the value of assets	Individual asset .....Dr. Revaluation .....Cr.
2) For decrease in the value of asset	Revaluation .....Dr. Individual asset .....Cr.
3) For increase in the value of liability	Revaluation .....Dr. Individual liability .....Cr.
4) For decrease in the value of liability	Individual liability .....Dr. Revaluation .....Cr.

5) For transfer of the balance of Revaluation A/c to partner:	
a) In case of profit (credit balance)	Revaluation .....Dr. Old partners capital Cr.
b) In case of loss (debit balance)	Old partners' capital.....Dr. Revaluation .....Cr.

In this connection it is to be remembered that entries will lead to change in the value of concerned assets/ liabilities. But if the decision is taken that values will not be altered in the books then an increase or decrease in the value will be entered in the Memorandum Revaluation Account & the balance will be transferred to the accounts of old partners as usual. But in addition, a reverse entry will be followed for the balance of the Memorandum Account and the balance in reverse order will be transferred to the accounts of all partners in the new profit & loss sharing ratio.

Illustration-6.14:

Milton and Farhad are partners of a firm sharing profit & losses 3:1.

Their Balance sheet on 30th June 2023 was as follows:

Liabilities	Tk.	Assets	Tk.
S/Creditors	22,500	Cash	2,500
General Reserve	6,000	Book Debts	18,000
Capitals:		Stock	15,000
Milton.....28,000		Machinery	30,000
Farhad..... <u>12,000</u>	40,000	Goodwill	3,000
	68,500		68,500

Rafique was admitted as a partner on 1st July 2023 on the following conditions:-

- 1) He should bring in Tk. 12,500 as capital for a fifth share in the profits.
- 2) Goodwill should be revalued at Tk. 7,000.
- 3) An item of Tk. 2,500 included in creditors is not likely to be paid & this should be written back. A reserve of $2\frac{1}{2}\%$ on creditors is to be created.
- 4) Stock & Machinery revealed at Tk. 13,000 & Tk. 28,000 respectively.

- 5) The capital Accounts of the partners be re-adjusted on the basis of profit sharing ratio & additional amount so required to be debited or credited to their current accounts.

Set out Journal Entries, Revaluation Account, & Opening Balance sheet of the firm.

Solution:

Milton, Farhad, and Rafique

Journal Entries

Date	Account Titles & Explanation	L.F.	Dr.	Cr.
2023 July-1	Cash Rafiq's Capital (Being cash brought in as capital)		Tk. 12,500	Tk. 12,500
2023 July-1	Goodwill Milton's Capital Farhad's Capital (Being goodwill distributed to partners according to old P/L ratio)		4,000	3,000 1,000
2023 July-1	S/Creditors Reserve on Creditors Revaluation (Being Tk. 2,500 included in Creditors not likely to be paid and thus written back & reserve on the balance @ $2\frac{1}{1}\%$ created).		2,500 500	3,000
2023 July-1	Revaluation Stock Machinery (Being value of assets decreased)		4,000	2,000 2,000
2023 July-1	Milton's Capital Farhad's Capital Revaluation (Being revaluation loss distributed to old partners in old ratio.)		750 250	1,000
2023 July-1	Milton's Current Milton's Capital (Being current account debited to adjust his capital according to P/L ratio i.e. deficiency in Capital A/c. adjusted in current A/c.)		2,750	2,750
2023 July-1	Farhad's Capital Farhad's Current (Being excess of balance in Farhad's Capital A/c. transferred to his current A/c to adjust his capital according to P/L ratio).		1,750	1,750

Revaluation Account

Dr.		Cr.	
Explanation	Tk.	Explanation	Tk.
Stock	2,000	S/Creditors	2,500
Machinery	2,000	Reserve on Creditors	500
		Loss Tr., to:	
		Milton's Capital	750
		Farhad's Capital	250
	4,000		4,000

Partners' Capital

Dr.				Cr.			
Explanation	Milton	Farhad	Rafique	Explanation	Milton	Farhad	Rafique
Revaluation	750	250	---	Bal. b/d.	28,000	12,000	---
Current A/c	---	1,750	---	Goodwill	3,000	1,000	---
Balance c/d	37,500	12,500	12,500	Reserve	4,500	1,500	---
				Cash	---	---	12,500
				Current A/c	2,750	---	---
	38,250	14,500	12,500		38,250	14,500	12,500

Notes :

- i) Calculation of the P/L ratio of Milton and Farhad :

Rafique will get 1/5 of profit. So remainder is 4/5.

$$\text{Milton's share} : \frac{3}{4} \text{ of } \frac{4}{5} = \frac{3}{5}$$

$$\text{Farhads' share} = \frac{1}{4} \text{ of } \frac{4}{5} = \frac{1}{5}$$

So new Ratio = Milton: Farhad: Rafique=3:1:1

- ii) Calculation of new capital as per new P/L ratio:

Rafique will bring Tk. 12,500 for 1/5 share of profit.

$$\therefore \text{Total capital} = \frac{12,500}{1} \times 5 = 62,500$$

Milton's share = 3/5 of 62,500 = Tk.37,500

Farhad's share = 1/5 of 62,500 = Tk.12,500

Rafique's share = 1/5 of 62,500 = Tk.12,500

**Milton, Farhad & Rafique
Balance Sheet**

As at 1st July, 2023

Liabilities		Tk.	Assets		Tk.
S/Creditors	22,500	19,500	Cash		15,000
Less not to be paid	<u>2,500</u>		Book Debts		18,000
	20,000		Stock	15,000	
Less Reserve	<u>-500</u>		Less decrease	<u>2,000</u>	13,000
Capitals:		62,500	Machinery	30,000	
Milton	37,500		Less decrease	<u>2,000</u>	28,000
Farhad	12,500		Goodwill		7,000
Rafique	<u>12,500</u>		Milton's Current A/c		2,750
Rahad's Current A/c		1,750			
		<u>83,750</u>			<u>83,750</u>

[**Note:** For adjusting capital in the ratio of profit & loss sharing ratio, partners may bring in cash or withdraw cash. In that case instead of treatment through current account treatment will go through cash /Bank entry.]

2. Retirement or Death of a Partner

On the retirement or death of a partner, the firm is dissolved & thus the accounts are settled unless the remaining partners immediately agree that they will continue in the business through the formation of a new partnership. However, a retiring partner or the inherent of the deceased partner is entitled to the net asset of the firm along with a share of profit till the retirement/ death of the partner from the last periodic account. Computation of such share will involve the following steps:

Retiring partner or the deceased partner is entitled to the net asset of the firm along with share of profit till the retirement/death of the partner from the last periodic account.

(i) **Share of Goodwill:** The goodwill belonging to the retiring partner/deceased partner be determined and be given treatment as per the following rule based on the situation:

a) Goodwill is raised in the books of the firm. Then the entry will be-

Goodwill	Dr.	}	In the Old profit sharing ratio
Partners' Capital	Cr.		
(Including the retiring partner)			

b) Goodwill is raised in the books but is then written off. Entries are-

(i) Goodwill	Dr.	}	In the Old profit sharing ratio.
Partners' Capital	Cr.		
(including the retiring partner)			

(ii) Partners' Capital	Dr.	}	In the New profit sharing ratio.
(excluding the retiring partner)			
Goodwill	Cr.		

(c) Sometimes, goodwill at all is not raised in the books, rather the retiring partner is credited with the share of goodwill, and the remaining partners' capital accounts are debited with the corresponding amount in accordance with their profit-sharing ratio. Entry will be as follows:

Remaining Partners' Capital	Dr.	}	With the share of Goodwill.
Retiring Partners' Capital	Cr.		

d) Only the share of the Retiring partner is brought into books. The entry will be-

Goodwill	Dr.	}	With the share of Retiring Partners only.
Retiring Partner's Capital	Cr.		

(ii) Revaluation of Assets and Liabilities

The treatment will be the same as is the case with the admission of a partner. Please see the discussions in that section.

(iii) Distribution of General Reserve and P/L Balance

General Reserve as shown in the Balance Sheet prepared preceding the date of retirement, should be credited to All Partners' Capital Accounts including the Retiring partner. Alternatively, only the Retiring partner may be credited with his share, the remaining reserve continuing to appear in the books. The same will be the case with the P/L credit balance. In case of a debit balance, the partners' capital account be debited with the same in the old P/L ratio.

(iv) Calculation of Amount Due:

Share of goodwill, reserve, & P/L credit balance is transferred to capital account. Adjustments will have to be made as to revaluations account balance. In such a context following points need consideration:

- The balance of the capital account of the retiring partner is either taken to be the balance as it stood at the commencement of the year in which retirement takes place or else the final account of the firm is prepared for this purpose on the date of retirement.
- The capital account of a retiring partner is credited with such relevant items as, interest on capital, salary, etc. as may be due in accordance with the partnership agreement.

(V) Payment of Amount to a Retiring Partner

The amount due to a retiring partner having been ascertained in the manner described above, will have to be paid out in accordance with the partnership agreement. It may be paid in one lump sum i.e. at a time immediately after retirement, or it may be paid in installments to the Retiring partner' or may be paid by means of an annuity. The accounting records in such cases will be as follows:

- (a) If the amount due to a retiring partner is paid off in one lump sum, the entry will be:-

Retiring Partner's Capital	Dr.
Cash/Bank	Cr.

- (b) If the payment of the amount due to an outgoing partner is to be made by means of periodical installment, the balance of his Capital Accounts will be transferred to a Loan Account in his name. This account thereafter will be credited periodically with interest at an agreed rate and debited with payments made on account, from time to time, until the balance is completely paid off.

Illustration -6.15

Akbar, Humayun & Shahjahan are partners of a firm sharing profits & losses 40%, 30% & 30% respectively. Their Balance sheet as at 30th June, 2023 was as follows:

Liabilities		Tk.	Assets		Tk.
Capital					
Akber	50,000		Land & Building		60,000
Humayun	40,000		Plant & Machinery		40,000
Shahjahan	<u>30,000</u>	1,20,000	Stock		30,000
Loan A/C		30,000	Debtors		25,000
Creditors		20,000	Bill Receivable		15,000
Bills Payable		<u>5,000</u>	Cash & Bank		<u>5,000</u>
		<u>1,75,000</u>			<u>1,75,000</u>

On 30th September Humayun retires on the following conditions:

- Goodwill of the firm will be valued at Tk.35,000 & Humayun's share of it be adjusted with the capital of Akber & Shahjahan.
- Humayun is to get his proportionate share of the current year's profit up to his retirement based on the last two years, average profit which was Tk.35,000 & 27,000 respectively.
- That the value of Land & Building should be shown at a figure of Tk.70,000 & Stock be depreciated by 10%.
- Bills payable were to be paid immediately earning a discount of Tk.200.
- Liability for workmen's compensation to the amount of Tk.500 is to be brought in the book.
- That the capital of the new firm be fixed at Tk.77,000 which the remaining partners will maintain at their P/L sharing ratio by bringing in or withdrawing cash as the case may be.

Show necessary journal entries & the opening B/S of the new firm.

Solution:**Journal Entries**

Date	Account Titles & Explanation	L .F.	Dr.	Cr.
2023 Sept. 30	Akbar's capital Shahjahan's capital Humayun's capital (Being Humayun's share of goodwill adjusted with Akbar's and Shahjahan's capital in their new P/L ratio)		Tk. 6,000 4,500	Tk. 10,500
2023 Sept. 30	Profit & loss suspense Humayun's capital (Being proportionate share of current year's profit credited to his capital A/c)		2,325	2,325
2023 Sept. 30	Land & Building Revaluation (Being value of land & building increased)		10,000	10,000
2023 Sept. 30	Revaluation Stock (Being value of stock decreased)		3,000	3,000
2023 Sept. 30	Bills payable Bank Revaluation (Being B/P paid at a discount of Tk. 200)		5,000	4,800 200
2023 Sept. 30	Revaluation Workmen's compensation (Being liability for workmen's compensation brought into book)		500	500
2023 Sept. 30	Revaluation Akbar's capital Humayun's capital Shahjahan's capital (Being Revaluation profit distributed)		6,700	2,680 2,010 2,010
2023 Sept. 30	Humayun's capital Humayun's loan (Being Humayun's capital transferred to his loan A/c)		54,835	54,835
2023 Sept. 30	Akbar's capital Bank (Being cash withdrawn by him to maintain the capital in P/L ratio).		2,680	2,680
2023 Sept. 30	Bank Shahjahan's capital (Being cash brought in to maintain the capital in P/L ration)		5,490	5,490

Revaluation

Dr.		Cr.	
Explanation	Tk.	Explanation	Tk.
2023 Sep. 30:		2023 Sep. 30:	
Stock	3,000	Land & Building	10,000
Workmen's compensation	500	Bill Payable	200
Profit transferred to:			
Akbar's capital	2,680		
Humayun's capital	2,010		
Shahjahan's capital	2,010		
	<u>10,200</u>		<u>10,200</u>

Partners' Capital

Dr.

Cr.

Explanation	Akbar	Humayun	Shahjahan	Explanation	Akbar	Humayun	Shahjahan
	Tk.	Tk.	Tk.		Tk.	Tk.	Tk.
Humayun's capital	6,000	--	4,500	balance b/d	50,000	40,000	30,000
" Cash	2,680			Akbar & Humayun's capital		10,500	
balance C/d	44,000	--	33,000	P/L suspense		2,325	
Humayun's Loan		54,835		Revaluation	2,680	2,010	2,010
				Bank			5,490
	52,680	54,835	37,500		52,680	54,835	37,500

Balance Sheet of Akbar & Shahjahan As at 30th September, 2023

Liabilities	Tk..	Assets	Tk.
Capitals:		Land & Building	70,000
Akbar	44,00	Plant & Machinery	40,000
Shahjahan	0	Stock	27,000
Loan A/c:	<u>33,00</u>	Debtors	25,000
Humayun's loan A/c	<u>0</u>	Bill Receivable	15,000
Creditors	20,000	Cash & Bank	3,000
Workmen's compensation A/c	500	P/L suspense A/c	2,325
	<u>1,82,33</u>		<u>1,82,33</u>
	<u>5</u>		<u>5</u>

Notes:

- i) Humayun's share of goodwill = $35,000 \times 30/100 = 10,500$
- ii) Share of Humayun's profit =
Two years profit = $35,000 + 27,000 = 62,000$. Average profit = 31,000
 $\therefore$ 3 month profit = 7,750. Thus Humayun's share = 30% of 7,750 = 2,325
- iii) As new P/L ratio of Akbar & Shahjahan not mentioned, it will remain as before i.e.4:3 and thus of the capital Tk.77,000, Akbar & Shahjahan will provide the same in their P/L ratio.

Lesson-7: Dissolution of Partnership

Lesson Objectives

After studying this lesson, you will be able to:

- know the circumstances leading to the dissolution of a firm.
- procedure of settlement of accounts on dissolution & preparing accounts thereof.
- know the procedure of treating gradual realization & payment thereof.

6.7.1 Circumstances of Dissolution

When a partnership ceases to exist, it is said to be dissolved which may happen due to retirement of a partner, death of a partner, expiry of the period for which it was formed for that purpose. In addition the firm may be dissolved under the following circumstances:

When a partnership ceases to exist, it is said to be dissolved which may happen due to retirement of a partner, death of a partner, expiry of the period for which it was formed for any purpose.

- i) Where the partners agree that the firm be dissolved.
- ii) Where all partners except one are insolvent.
- iii) Where any partner gives notice of dissolution, in case of partnership at will.
- v) Where the court orders for dissolution.

6.7.2 Settlement of Accounts

Section 48 of the partnership Act. 1932 provides that

" In settling the account of a firm after dissolution, the following rules shall, subject to agreement by the partners, be observed:-

- (a) Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportions in which they are entitled to share profits;
- (b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order:
 - (i) in paying the debts of the firm to third parties;
 - (ii) in paying to each partner ratably what is due to him from the firm for advance as distinguished from capital;
 - (iii) in paying to each partner ratably what is due to him on account of capital; and
 - (iv) the residue, if any, shall be divided among the partners in the proportions in which they are entitled to share profits."

In case of dissolution of partnership the books will be closed. For this purpose a Realization Account will be opened. All assets except cash will be transferred to the debit of this account and all accounts of liabilities to third parties (i.e. excluding partners' capital and loan) will be transferred to the credit of this account. If there is any reserve fund or P/L account balance, these will be transferred to partners' capital accounts.

Following table shows the journal entries necessary to give effect to the transactions relevant to dissolution

Transactions	Journal Entries
1. On transfer of all assets at book values:	Realization Account Dr. Sundry assets Account Cr.
2. On transfer of external liabilities at book values:	Sundry Liabilities Account Dr. Realization Account Cr.
3. For Bad Debts Reserve and Depreciation Fund Account	Reserve for Bad Debts Account Dr. Depreciation Fund Account Dr. Realization Account Cr.
4. If there is any Reserve Fund or undistributed profits:	Reserve Fund Account Dr. Profit & Loss Account Dr. Partners' Capital Account Cr.
5. When assets are sold for cash:	Cash Account Dr. Realization Account Cr.
6. If any asset is taken over by a partner:	Partner's Capital Account Dr. Realization Account Cr.
7. For expenses on dissolution paid:	Realization Account Dr. Cash or Bank Account Cr.
8. When liabilities to the third parties are paid off:	Realization Account Dr. Cash or Bank Account Cr.
9. If a partner agrees to discharge a liability :	Realization Account Dr. Relevant Partner's Capital Account Cr.
10. For accumulated loss of the firm:	Partner's Capital Accounts Dr. Profit & Loss Account Cr.
11. For Profit or Loss on Realization:	a) For profit: Realization A/c Dr. Partner's capital Account Cr. b). For Loss: Partners' capital Account Dr. Realization Account Cr.
12. For payment to partner:	Partners' capital a/c Dr. Cash or Bank Cr.

Alternatively the following steps can be taken:

- On realization of an asset, debit Cash or Bank and credit the asset. The balance remaining in the Asset Account, being profit or loss, is then transferred to the Realization Account. In case a partner takes an asset, his Capital Account should be debited instead of Cash.
- When payment of expenses is made, debit Realization Account and credit Cash or Bank.
- At the time of payment of liabilities, debit the Liability Account and credit Cash or Bank. Any balance remaining in the Liability Account is then transferred to Realization Account.
- Worthless assets, that is to say assets without having any salable value, are transferred to Realization Account.

- (e) The Surplus left or deficiency shown in the Realization Account, being profit or loss, is transferred to Capital Accounts of partners in the profit sharing ratio.
- (f) While paying the partners' loans and capitals, debit such accounts and credit Cash or Bank.

Illustration-6.16:

Following is the summarized Balance Sheet as at 30th June, 2023 of Baker and Seraj who were partners sharing profit and losses in the ratio 3:2

Liabilities		Tk.	Assets		Tk.
S/creditors		79,500	Land and Building		30,000
Capital A/c:			Motor Vehicle		18,300
Baker =	85,000		Inventories		72,800
Seraj =	<u>63,000</u>	1,48,000	Debtors		1,10,750
			Less Provision	1,13,200	
			Cash	<u>2,450</u>	13,650
		<u>2,45,500</u>			<u>2,45,500</u>

The partners decided to dissolve the firm from the date of the Balance Sheet. Motor Vehicles & inventories were sold for cash at Tk.16,950 and Tk.77,600 respectively and all debtors account were realized in full. Baker took over Land and Building at an agreed valuation of Tk.43,500; Creditors were paid off subject to discount amounting to Tk.1,700. Expenses of realization were Tk.1,250.

Prepare and close the realization A/c; the Cash book and Capital Accounts of partners assuming that amount if any due to and from the partners were settled in cash.

Solution**Realization Account**

Dr.			Cr.		
Explanation	Tk.		Explanation	Tk.	
To Land & Building	30,000		By S/creditors	97,500	
Motor Vehicle	18,300		Provision for bad debts	2,450	
Inventories	72,800		Cash :		
Debtors	1,13,200		i) Motor	16,950	
Cash A/c:			ii) Inventories	77,600	
i) S/creditors	95,800		iii) Debtors	<u>1,13,200</u>	2,07,750
ii) Expenses	<u>1,250</u>	97,050	Baker's Capital A/c	43,500	
			(Land & Building)		
Profit transferred to					
Capital A/Cs:					
Baker	11,910				
Seraj	<u>7,940</u>	19,850			
		<u>3,51,200</u>			<u>3,51,200</u>

Partners' Capital Accounts

Dr.			Cr.		
Explanation	Tk.		Explanation	Tk.	
	<u>Baker</u>	<u>Seraj</u>		<u>Baker</u>	<u>Seraj</u>
By Realization			By Balance b/f	85,000	63,000
A/c (L & B)	43,500	-	Realization A/c		
Cash	53,410	70,940	(Profit)	11,910	7,940
	<u>96,910</u>	<u>70,940</u>		<u>96,910</u>	<u>70,940</u>

Cash Account

Dr.			Cr.	
Explanation	Tk.		Explanation	Tk.
BY Balance b/f	13,650		By Realization A/c:-	
Realization A/c:			i) S/creditors	95,800
i) Motor	16,950		ii) Expenses	<u>1,250</u>
ii) Inventories	77,600		Baker's Capital	53,410
iii) Debtors	<u>1,13,200</u>		Seraj's Capital	<u>70,940</u>
	<u>2,07,750</u>			<u>2,21,400</u>
	<u>2,21,400</u>			

6.7.3 Gradual Realization of Assets and Piecemeal Distribution of Cash

In practice it may not happen that all assets are realized (sold) at a time and liabilities paid off simultaneously. In this context with gradual realization the payment will be made piecemeal. In such a case following procedure be followed:

- i) Realization expenses shall have to be paid first.
- ii) The remaining amount will be used to pay off third parties in proportion to their dues.
- iii) After paying off third parties, the remainder will be used to pay off partner's loan, if any.
- iv) If any thing remain thereafter the capital of the partner be paid off.
- v) If any thing remaining, that will be distributed to the partners in profit sharing ratio.

In paying off the partners' capital a problem may arise when profit & loss sharing ratio is not in proportion to capital. The rule in this case is that partners whose capital is more than proportionate to capitals should first be re-funded so much as to bring his/their capitals to proportionate levels. After this, the cash available should be distributed among partners in profit sharing ratio.

Illustration-6.17:

A, B and C are partners in a firm, sharing profits and losses in the ratio of 5:3:2. The firm is dissolved and on the date of dissolution the Balance Sheet was as below:

Liabilities	Tk.	Assets	Tk.
Capital Accounts :		Goodwill	10,000
A	30,000	Machinery	50,000
B	39,000	Stock	40,000
C	46,000	Debtors	55,000
Reserve	10,000	Cash at Bank	5,000
Creditors	35,000		
	<u>1,60,000</u>		<u>1,60,000</u>
	0		0

It is decided to distribute cash in installments based on realization to partners after meeting the creditors and after retaining Tk.4,000 for meeting liquidation expenses. The realizations were as follows:

		Tk.
1st installment:	Machinery	41,000
2nd installment:	Stock	10,000
	Debtors	5,000
3rd installment	Stock	25,000
	Debtors	10,000
Last installment	Debtors	9,000

Expenses of liquidation amounted to Tk.2,000.

Prepare a statement showing distribution of cash.

Solution:**a) Preliminary Computation**

Statement showing Capitals on the basis of profits-sharing ratio of 5:3:2

Explanation	A Tk.	B Tk.	C Tk.
Capital as per Balance Sheet	30,000	39,000	46,000
Add Share of Reserve	5,000	3,000	2,000
	35,000	42,000	48,000
Capital as per profit- sharing Ratio (taking A's Capital as the basis which gives Tk.7,000 per unit)	35,000	21,000	14,000
Excess/Surplus Capitals	Nil	21,000	34,000
Surplus Capitals in Profit Sharing ratio (taking B's Capital as the basis which gives Tk.7,000 per unit)		21,000	14,000
Absolute Surplus Capital		Nil	20,000

Priority of payment to be followed:

First Tk.35,000 to Sundry Creditors.

Next Tk.20,000 to C only to pay off absolute surplus capital.

Next Tk.35,000 to B and C only in their P/L ratio to pay off surplus capital.

Balance to all partners in their profit sharing ratio.

b) Main Solution:**Statement Showing Piecemeal Distribution of Cash**

Explanation	Total Tk.	Sundry creditors Tk.	Capitals		
			A Tk.	B Tk.	C Tk.
Balance as per Balance Sheet		35,000	30,000	39,000	46,000
Add share of Reserve		-	5,000	3,000	2,000
Out of 1st installment of realization	1,60,000	35,000	35,000	42,000	48,000
-(Tk. 41,000+Tk. 5,000 Cash in hand Tk. 4,000 kept for expenses)	42,000	35,000			7,000
Balance after Repayment	1,18,000	Nil	35,000	42,000	41,000
Out of 2nd installment of realization	15,000			1,200	8,00
Balance after Repayment	1,03,000		35,000	40,800	27,200
Out of 3rd installment of realization	35,000		1,000	600	400
	68,000		34,000	20,400	13,600
Out of final installment (Tk. 9,000+Tk. 2,000 left out of amount kept for expenses)	11,000		5,500	3,300	2,200
Balance after Repayment	57,000		28,500	17,100	11,400
Less Loss on realization	57,000		28,500	17,100	11,400
	Nil		Nil	Nil	Nil

Notes:

- * Tk. 7,000+13,000 = 20,00 first paid to C for excess capital
- ** Tk. 1200+800+19,800+13,200 paid to B & C for excess capital
- *** Rest of the money distributed to A, B & C in P/L ratio
- **** As balance of capital due to partners is not available out of realized money, this will be treated as loss.

Questions

1. What is meant by partnership? What are its features?
2. State the provisions that govern partnership accounts in the absence of agreement.
3. Discuss the rights and duties of partners.
4. Distinguish between:
 - a) Fixed capital and Fluctuating capital
 - b) Profit and loss Account and Profit and loss Appropriation Account.
5. What is meant by Goodwill? State different methods of its valuation.
6. State the methods of treatment of goodwill in case of admission of a partner.
7. What is meant by dissolution of a firm? State the methods of closing the books in dissolution of a firm.

Exercises (Try yourself)

Ex-1:

On 1st January, 2024 X, Y and Z were in partnership, and their respective capitals were Tk.40,000, Tk.20,780 and Tk.10,590. Y is entitled to a salary of Tk.2000 and Z also entitled to a commission of Tk.2000 per annum, payable before division of profits. Interest is allowed on capital at 5% per annum and is not charged on drawing. Of the net divisible profits, X is entitled to 40 per cent of the first Tk.10,000, Y to 35 percent; over that amount profits are shared equally. The profit for the year ended December, 2024 after debiting partners salaries & commission but before charging interest on capital, was Tk.40,317 and the partners had drawn 3000 each on account of salaries & interest on profits etc. Show the closing entries of the profit and Loss Account and prepare the capital accounts of the partner's for the year.

Ex-2:

Three Chartered Accountants X, Y and Z formed a partnership, Profits beginning divisible in the ratio of 3:2:1, subject to the following:

- i) Z's share of profit is guaranteed to be not less than Tk.15,000 per annum;
- ii) Y gives guarantee to the firm to the effect that gross fees earned by him for the firm shall be equal to his average gross fees of the preceding five years when he was carrying on profession alone (which average works out at Tk.25,000).

You are required to show the Profit & Loss Appropriation Account (after giving effect to the above) and the Current Accounts of the partners.

Ex-3:

A and B have been carrying on business since 1st January, 2020 and the results of their business have been as follows after allowing 5% interest on capitals;

2020 Loss Tk.8,000; 2022 Profit Tk.41,000;

2021 Profit Tk.36,000; 2023 Profit Tk.53,600.

Capital of the two partners have remained unchanged at Tk.1,50,000 and Tk. 1,00,000 respectively for A and B who shared profit and losses in the same ratio. On 1st January, 2020 C, the Manager, gave a loan of Tk.25,000 at 8% interest. The interest has been regularly paid but the loan has not yet been paid. C was paid a salary of Tk.10,000 per annum.

It was decided on 1st January, 2024 that C should be treated as a partner with effect from 1st January, 2020 giving him one-fifth share of profit. His interest was to be treated as capital bearing interest at the rate of 5%; C's salary was to be Tk.4,000 with effect from 1st January 2020.

What would be the entries necessary to adjust the matters?

Ex -4

X and Y are partners of a firm sharing profits and losses in the ratio 3:2. On 1st January, 2023 their capitals were Tk.34,000 and Tk.20,000 respectively. They are allowed interest on capital at the rate of 5 per cent. Interest at the rate of 4% per annum is charged on partners' drawings. Y is to receive an annual salary of Tk.5,000 which is not yet withdrawn. X withdrew Tk.2,000 on 1st January, and Tk.2,500 on 1st July while Y withdrew Tk.2,000 on 1st July and Tk.2,000 on 1st October. The profit for the year ending 31st December, 2023 before charging up interest on capital, salary and interest on drawings amount to Tk.28,000. Show the division of profits amongst the partners and their Capital Accounts and Drawing Accounts assuming that the partners' capitals are fixed.

Ex-5

Black and White are partners, and on 31st December 2023, the capital of the partnership was Tk.2,10,000 of which Tk.1,40,000 stood to the credit of Black and Tk.70,000 to the credit of White, Profits and losses were to be divided as to 2:1 between Black & white Drawings on account of profits being made in the same proportion.

On 31st December 2024, the following information were given to you as to the position of affairs:

- (a) The total combined capital was Tk.2,91,000.
- (b) White had drawn Tk.3,000 in excess of the arranged proportion of drawings.
- (c) White had to be credited with Tk.15,000 as special salary earned during 2024 as agreed by the partners.

- (d) The partners were to be credited with 10 per cent interest on capital.

You are required prepare a statement showing how the capital of Tk.2,91,000 is divided between Black and White along with further adjustments that may be necessary.

Ex-6

A and B are partners in a firm. Their Capital Accounts on 1st January, 2024, stood as A-Tk.25,000 and B-Tk.20,000. On 1st April C entered the firm as a partner with Tk.15,000 as his Capital. On the same date, A and B introduced further Capital of Tk.5,000 each. On 1st October D-joined the firm with a Capital of Tk.20,000 and on the same date C introduced further Capital of Tk.10,000. On 31st December, the net trading profit of the firm amounts to Tk.1,00,000. The partners agree to shares the profit in the ratio of their capital contributions. Partners are allowed salaries per annum as A-Tk.5,000, B-Tk.,4000. C-Tk.3,000 and D-Tk.2,000.

You are asked to prepare the profit and Loss Appropriation Account of the firm for the year ended 31st December, 2024.

Ex-7

A, B & C are partners of a firm. The partnership agreement provides that.

- i) Partners are entitled to interest on their capitals @ 5% p.a.
- ii) Each partner is to be credited with salary per year @ Tk.1,000 A, Tk.500 B & Tk.300 C.
- iii) Profits & losses are to be shared by partners in the ratio of 50%, 30%, & 20% respectively.

There Trial Balance as at 31st December, 2023 was as follows:

	Particulars	Dr. Tk.	Cr. Tk.
1.	Partners' capital A/Cs:		
	A-Balance on 1/1/2023		16,000
	B-Do		10,000
	C-Do		6,000
2.	Partners' Current A/Cs:		
	A-Balance on 1/1/2023		3,200
	B-Do		2,400
	C-Do		1,600
3	. Sales		93,000
4.	Creditors		7,400
5.	Furniture & Fittings at cost	7,200	
6.	Provision for depreciation		2,800
7.	Land & Building	21,000	
8.	Purchase during the year (Land & Building)	5,000	
9.	Purchases	56,000	
10.	Inventories (1/1/2023)	8,400	
11.	Salaries & wages	12,800	

	Particulars	Dr. Tk.	Cr. Tk.
12.	Office Expenses	9,040	
13.	Rent & Insurance	2,100	
14.	General Expenses	4,120	
15.	Debtors	700	
16.	Provision for bad debts (1/1/2023)		100
17.	Balance at Bank	8,740	
18.	Drawings other than monthly payments:		
	A-	3,400	
	B-	2,200	
	C-	1,800	
		142,500	1,42,500

Following are other information:

- i) Inventories on 31/12/2023 was valued at Tk.7,200
- ii) A debt of Tk. 120 is to be written off & a provision of 5% is to be created on debtor.
- iii) Salaries & wages include the following monthly drawings by partners:
A Tk.40, B Tk.30 & Tk.C-20.
- iv) Partners had during the year been supplied with goods from inventory amounting to Tk.120-A & Tk.80-B.
- v) On 31st Dec. 2023 rent paid in advance & office expenses owing were Tk.400 & Tk.200 respectively.
- vi) Depreciation on Furniture is to be charged @ 7.5%.
- vii) General expenses include Tk. 600 paid in respect of acquisition of land which is to be capitalized.

You are required to prepare:

- 1) Trading, Profit & loss and Profit & loss Appropriation Accounts.
- 2) Balance Sheet.
- 3) Partners' Current Accounts in columnar form.

Treatment of Goodwill**Ex-8:**

Set out Journal entries in the following cases:

- (a) X & Y are partners of a firm. They share profits & losses in the ratio of 3:2. They decided to admit Z for a fifth share in the profit. He is to pay Tk. 5,000 as premium for goodwill. The profit sharing ratio between X & Y remains unaltered. No goodwill account will be opened in the book.
- (b) X & Y are partners of a firm. They share profits & losses in the ratio of 4:3. They decided to admit Z for a fifth share in the profits. He is to pay Tk. 7,000 as premium for goodwill. X & Y as between themselves will share profits equally.

- (c) X & Y are partners of a firm. They share profits & losses 3:2. Goodwill appears in their book at Tk. 20,000. They admit Z for a fifth share paying Tk. 5,000 as premium for goodwill. Profit sharing ratio between X & Y remains unaltered.
- (d) X & Y are partners of a firm. They share profits & losses 3:2. Goodwill appears in their book at a figure of Tk. 20,000. They admit Z for a fifth share in the profit who pays Tk. 6,000 for goodwill. X & Y would share profits & Losses equally in future.
- (e) X & Y are partners of a firm. They share profits & losses 3:2. Goodwill appears at their book at Tk. 20,000. They admit Z for a fifth share in the profits who pays Tk. 5,000 as goodwill. Partners decided to maintain goodwill in their books at Tk., 20,000.
- (f) X & Y are partners of a firm. They share profits & losses 3:2. They admit Z into partnership for fifth share in the profits. Goodwill on this date valued at Tk. 20,000. Partners decided not to show goodwill in the Balance sheet.
- (g) X,Y & Z are partners of a firm. They share profits & losses in the ratio of 2:2:1. They decided to share profits & losses equally from this date & goodwill on this date valued at Tk. 30,000

Admission of a Partner

EX-9

The following was the balance sheet of A. B and C sharing profits and losses in the proportion of 6/14,5/14,3/14 respectively:

Liabilities		Tk.	Assets		Tk.
Creditors		90,000	Land & Building		240,000
Bill Payable		30,000	Furniture		35,000
Capital:			Inventories		140,000
A	1,90,000		Debtors		120,000
B	160,000		Cash		15,000
C	80,000	430,000			
		<u>5,50,000</u>			<u>5,50,000</u>

They agreed to take D into partnership and give him one-eighth share on the following terms.

- a) That D should bring in Tk. 42,000 as goodwill and Tk. 70,000 as his capital.
- b) That Furniture be depreciated by 12%.
- c) That Inventories be depreciated by 10%.
- d) That a Reserve of 5% be created for doubtful debts.
- e) That the value of Land and buildings having appreciated be brought up to Tk. 3,10,000.

- f) That after making the above adjustments the capital of the partners (who continued to share in the same proportion as before) be adjusted on the basis of the proportion of D's capital to his business (i.e. actual cash to be paid off to or to be brought in by old partners as the case may be.)

Pass the journal entries necessary to give effect to the arrangement and prepare the opening Balance Sheet of the firm as newly constituted.

EX-10

A.K. Sen & Mukonda Lal are partners of a firm. They share profit & loss equally. Following is their Balance Sheet as at 31st December 2023.

Liabilities	Tk.	Assets	Tk.
Creditors	50,000	Freehold Premises	20,000
Capitals:		Fixture & Fittings	5,000
A.K. Sen	30,000	Stock	35,000
M. Lal	20,000	Debtors	27,000
		Bank & Cash Balance	13,000
	<u>1,00,000</u>		<u>100,000</u>

They agree to admit Lata into equal partnership on payment of Tk. 20,000 for goodwill & credit her with the following assets brought in; Goodwill Tk., 5000. Furniture Tk. 1000, Stock Tk.15,000; and debtors Tk. 4,000. It is further agreed that freehold premises shall be revolved at Tk. 33,000 & that Sen and Lal will withdrew cash so as to leave all their capital equal.

Show Journal entries for the necessary adjustments & draw up Balance sheet of the new firm as at 1st January 2023 assuming that all transactions have been completed.

Retirement of a Partner

EX-11

Motiur Rahman, Mostafa Kamal & Ruhul Amin are partners of a firm sharing profit & loss in the ratio of 3:2:1. Mostafa retired on 30th June 2023. In this context goodwill was valued at Tk. 30,000. What will be the journal entries under the following:

- Goodwill will be shown in full value in the books.
- Only Mostafa Kamal's share will be shown in the books.
- Mostafa's share of Goodwill will be adjusted with capitals of Motiur Rahman & Ruhul Amin.

EX-12

A, B and C carry on business in partnership. C wishes to retire from the firm. A and B agree to carry on the business, taking over the assets at a valuation agreed by the three partners and discharging the liabilities of the firm. The following is the position of the firm as on 30th September 2023.

Liabilities	Tk.	Assets	Tk.
Sundry Creditors	18,900	Plant and Machinery	4,000
Loan	7,000	Fixtures	500
Capital Accounts:		Furniture	250
A.....3,000		Stock in- trade	10,000
B.....4,000		Sundry Debtors	18,000
C..... <u>1,000</u>	8,000	Notes Receivable	4,000
Profit and Loss Account	3,000	Cash in hand	50
		Cash at Bank	100
	<u>36,900</u>		<u>36,900</u>

The agreed values of the assets are as follows:

Plant and Machinery 3,050; Fixtures Tk. 350; Furniture Tk. 150; Stock in trade less 20%; Sundry Debtors (Less Discount and Bad debts) Tk.15,000. Provision for Doubtful Debts Tk. 1,000 to be maintained for Notes Receivable.

- Prepare the Balance sheet showing the position of the new firm of A and B on taking over the Business;
- Also the Capital Accounts and Balance sheet of A, B & C after the above valuation and adjustments have been made. The profit and losses are divisible on the basis of capital originally contributed.

EX-13:

In a firm A, B and C are three partners sharing profits and losses in the ratio of 3:2:1 respectively, The balance sheet of the said firm as on 31st December, was as follows:

Liabilities	Tk.	Assets	Tk.
Capital:		Buildings	90,000
A.....80,000		Plant and Machinery	86,000
B.....60,000		Inventory	50,000
C..... <u>50,000</u>	1,190,000	Receivables.....32,000	
Reserve	24,000	Less provision <u>1,000</u>	31,000
Creditors	48,000	Bank	5,000
	<u>2,62,000</u>		<u>2,62,000</u>

B retires on that date subject to the following conditions:

- The goodwill of the firm is to be valued at Tk. 36,000
- Plant Machinery is to be depreciated by 10%.
- Inventory is to be appreciated by 20% and Building by 10%.
- The Provision for doubtful debts is to be increased to Tk. 3,900.
- A liability of Tk. 3,300

for workmen's compensation is to be brought into Account. (vi) Amount due to B is to be transferred to his loan Account. As between A and C they agreed to share Profits and losses in the ratio of 3:2.

Dissolution of Partnership

Exercices-14:

Habib & Nakib are partners sharing profits & losses 3:2. They decided to dissolve the partnership on 30th June on which date their Balance Sheet was as follows:

Liabilities	Tk.	Assets	Tk.
Capital:			
Habib	10,000	Fixtures & fittings	8,000
Nakib	<u>7,000</u>	Stock	7,000
Habib's loan A/c	3,000	Debtors	7,000
Creditors	5,000	Cash	3,000
	<u>25,000</u>		<u>25,000</u>

Debtors realized 90% & other assets sold at Tk.14,9000. Creditors were paid at Tk. 5,500 there having been an error in the Balance Sheet. During the realization events actualize a contingent liability of Tk.200 which had to be paid. Expenses of realization amounted to Tk.500.

Show Journal Entries, Realization Account and Capital Accounts of partners & also Cash account.

Exercices-15:

A, B and C are partners sharing profits and losses in the ratio of 3:3:2. They dissolved the partnership on 1st July, 2024 and agreed that the sale of the assets should not be forced but should be made gradually and cash should be distributed amongst the partners as and when available.

The following was the Balance Sheet of the firm at the date of dissolution:

Liabilities	Tk.	Assets	Tk.
Creditors	10,000	Sundry Assets	36,000
Loan Account	2,000		
Capital Accounts			
A	12,000		
B	8,000		
C	4,000		
	<u>36,000</u>		<u>36,000</u>

The realizations were as follows:

1st Instalment	Tk.	6,000
2nd Instalment	Tk.	10,000
3rd Instalment	Tk.	5,600
4th Instalment	Tk.	6,000
Final Instalment	Tk.	5,700

Draw up a detailed statement show in the distribution of each instalment received and the final settlement.

Case Study

1. Friends Enterprise

Rahim and Robin are two friends running Electric goods shop in a super market at Rajshahi town. To avoid competition and organize the business in large scale they decided so form partnership. Following is the Balance sheet of the two shops.

**Rahim Enterprise
Balance Sheet
As at 31-12-2024**

Assets	Amount Tk.	Liabilities	Amount Tk.
Cash	28,000	Notes payable (due	32,800
Accounts receivable	56,000	in 60 days	
Office equipment	7,200	Accounts payable	37,600
Inventory	68,000	Total liabilities	70,400
Furniture	1,200		
		Capital	90,000
Total	160,400	Total	160,400

**Robin Electrics
Balance Sheet
As at 31-12-2024**

Assets	Amount Tk.	Liabilities	Amount Tk.
Cash	4,800		
Accounts receivable	9,600	Notes payable (due	22,400
Office equipment	96,000	in 60 days	
Inventory	60,000	Accounts payable	50,000
Furniture	12,000	Total liabilities	72,400
		Capital	72,000
		Retained earnings	38,000
Total	182,400	Total	182,400

They have appointed you as a consultant to draw a partnership agreement taking in to consideration of the following:

- i) Profit and Loss will be shared as per capital contribution, (ii) Robin will be full time manager for which he will be allowed a salary (iii)

Drawing against profit will be made quarterly (iv) No interest will be charged on capital and drawing (v) a Balance sheet will be prepared at opening.

2. Khan & Chowdhury

Z. A Khan started a Bicycle Trading shop, a sole proprietorship business with Tk.2 lakh from his personal and family sayings on March, 2022. He deposited this initially in a bank account & to draw the necessary amount for business purpose as and when necessary. The name of the shop was given as Ureka and the bank account also titled so. On September 10th he took a loan from his uncle Tk.2,50,000 by issuing a three years note payable. To help the business run smoothly his uncle Mr. A.B. Chowdhury decided so join the business as a partner from 1st November, 2023, and turn his loan as capital and agreed that no interest will be charged on loan which has been turned into capital but interest on loan be paid for the period it remained as loan. Following transactions were carried out as the business from start of business till February 2023, 1st year and February 2024 for 2nd year on which date accounts are to be closed, profit decided and Balance sheet to be drawn will necessary accounts that need to be prepared :

a) Bought bicycles at total cost of 8.50 lakhs paid 5 lakhs in cash and to pay the balance within June, 2024.

b) Bought supplied for cash Tk. 4,000.

The only record that the business maintained was a cheque book with memorandum notes written on the cheque stubs and sales cash memo. From notes it was see that Mr. Khan invested an additional amount of Tk.75,000 from his savings in the business on September, 2022. It is also revealed that all cash received by the business had been paid by cheque immediately upon receipt. It was also reported that sales are made on cost plus profit basis in which 20% is the profit margin on cost. Bicycles at stock found 10 in number with purchase cost of Tk.40,000. The bank statement showed a balance of Tk. 1,12,000. No drawing is reportedly made till February 2024 except expenses exclusively required for business.

Khan and Chowdhury have sought your professional guidance to help his newly appointed accounts assistant regarding the following:

(a) How to share profit and loss.

- (b) How to decide the position of loan of his uncle till its conversion into capital.
- (c) How to proceed to draw up accounts for business prior to and after admission of his uncle as partner.
- (d) Other legal and account matter that may be relevant.

Give report for the above mentioned points to Mr. Khan and Chowdhury.

3. Eureka Enterprise

Background

A and B are two friends. They passed M.Com examination in 2020. Instead of looking for job they decided to form a partnership. A will procure spare parts of Textile mills from both home and abroad and B will take care of sale and distribution. They took an office at Dewanhat, Chittagong.

Management: The policy and decisions are to be take by both the partners jointly and unanimously. As per agreement A will get monthly salary of Tk. 5,000 per month for overall management responsibility and B will get a commission of 2% on sale. For office management and keeping accounts C was appointed as manager from July 2020 on which date they officially commenced the business.

Capital and Profit Sharing

A and B introduced Tk. 5 lakhs and 4 lakhs respectively as their capital and decided to share profit and loss equally. However, as the capital was unequal they decided to charge interest @ 8% per annum on capital. They also decided that drawing against profit can be made half yearly with mutual discussion and that no interest will be charged on drawing.

Expansion

The partnership is going on smoothly and the business was expanded subsequently. A & B further introduced Tk. 1 lakh and 80 thousand respectively in July 2022 and took a loan of Tk. 2 lakh from their manager 'C' with an interest @ 9% per annum.

As a Manager C had to deposit on 1-7-2020 Tk. 1,40,000 as security carrying interest at 9% per annum. In July 2022 it was settled that C should be treated as a partner from 1st July, 2020. It was agreed that he

would be entitled to share profit in capital ratio and his security deposit would be treated as his capital along with his loan carrying interest at 8% instead of the 9% he had received. It was further agreed that this new arrangement should not result in C's share for any of these year being less than he had already received under the original agreement and terms of his appointment. The profit before giving effect to the new arrangement were:

- a) For the year ended 30th June, 2021 Tk. 60,000
- b) For the year ended 30th June, 2022, Tk. 88,000
- c) For the year ended 30th June, 2023 Tk. 93,000
- d) For the year ended on 30th June, 2024 Tk. 1,20,000

Mr. C who is also in charge of accounts is unable to revise accounts which according to him complex and advised A and B to take help of an expert. They all sought your cooperation.

- i) You are required to draw an scheme for revised accounts.
- ii) Finalize accounts at the end of June 2024.

ACCOUNTING FOR ISSUE OF SHARES AND DEBENTURES



From this unit, students will be able to learn:



Definition and Features of a Company



Classification of Shares



Procedures of Recording Shares Issue



Redemption of Preference Shares



Issue of Bonus Shares



Issues of Debenture

এই পৃষ্ঠা খালি থাকবে

Unit-7

Lesson-1: Definition and Features of a Company

Lesson Objectives

After you have studied this lesson, you will be able to:

- understand the meaning and features of a company.
- know the types of company and formation thereof.
- identify the basic documents relating to formation.
- know the types of shares a company can issue.
- have an idea as to the books of accounts to be kept by a company.
- explain the share issuing procedure in Bangladesh.

7.1.1 Introduction

A corporation/company is a form of organization recognized under the law as a legal entity with rights and responsibilities separate from those of its owners. As a separate entity the assets of the corporation belong to it, it is responsible for its debts and must pay income tax on its earnings. It may be classified as profit oriented and not for profit. This lesson is devoted to discuss matters relevant to formation, operation and record keeping etc. as to the profit oriented corporation/company.

7.1.2 Meaning of Company

A company denotes an association of persons with a legal entity for the purpose of some business with a view to earn profits. Company Act, 1994, as existing now in Bangladesh, defines company under section 2(1) as 'the companies formed and registered under this Act and the existing companies'. Existing companies mean the companies formed and registered under relevant previous Acts. This definition is not clear but an indicative one. However, a company is defined by Lord Justice Lindley as 'an artificial person created by law with perpetual succession and a common seal'. He further elaborates the definition and states that a company is meant an association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is the capital of the company. The persons who contribute it or to whom it belongs are members. The proportion of capital to which a member is entitled is his share.

A company is an association of persons with a legal entity for the purpose of some business with a view to earn profits.

7.1.3 Features of a Company

An analysis of the definition of the company leads to identification of the following important features of the Company:

- i) **Corporate Body:** It is a voluntary association of person created under law. It has a separate entity in the eye of law over the members of entity. Thus it is said to be an artificial person and it can sue or be sued in the court.

- ii) **Perpetual Succession:** The company if properly managed can continue for indefinite period. Its continuity does not depend on the continuity of its members. If it is not dissolved under the provision of the Act, it can have a perpetual succession.
- iii) **Common Seal:** As it is an artificial person, it shall act through its representatives and shall use its common seal. Its common seal is its identification. Its documents must bear this common seal to be a valid document. Using it is now optional.
- iv) **Limited Liability:** As an artificial person having separate legal entity it is the owner of its assets and liable for its liabilities. But the liability of its members are limited to the value of their shares and the extent covers the unpaid amount of their share values.
- v) **Number of Members:** The number of share holders for private limited company is minimum two and maximum fifty. For public limited company the minimum number is seven and maximum number is limited to the maximum number of shares as stated in prospectus.
- vi) **Compulsory Registration:** Company must be registered under existing law. No company can be formed without registration.
- vii) **Separation of Ownership and Management:** The share holders (i.e. members) of the company shall elect directors who will run the management of the company and thus shareholders do not directly manage the company. As such ownership and management are separate.

7.1.3 Kinds of Company

Company can be divided into various kinds from different angles. Depending on the way they are formed, it can be divided into two:

- i) **Registered Companies:** These are the companies which are formed or registered under companies Act.
- ii) **Statutory Companies:** These are the companies which are created by special acts of legislature.

On the basis of liability of the shareholders or members, companies can be divided into three categories:-

- a) **Companies limited by shares-** In case of a company in which the liability of the members does not exceed the unpaid amount, if any, on the shares held by them, such a company is called company limited by shares. Thus a shareholder cannot be called upon to pay anything if he has already paid the full face value of the share to the company. This is so even if the creditors of the company cannot be paid in full. Most of the trading companies in our country fall within this class.

- b) *Companies limited by guarantee*- In this case the liability of the members is limited to the amount which shareholders undertake to contribute in the event of liquidation of the company.
- c) *Unlimited Companies*- In this case the liability of the members is not restricted at all. They have to contribute the necessary amounts in order to pay off the creditors of the company fully.

It is the Memorandum of Association which lays down whether the liability of the members will be limited, or limited up to the amount guaranteed or be unlimited.

From status of ownership point of view the companies may be divided into two:

- i) **Private Company:** The Companies Act defines a *Private Company* as a company which by its article-
 - a) restricts the right to transfer its shares;
 - b) limits the number of its members (excluding employees who are members and ex-employees who continue to be members) to fifty; and
 - c) prohibits any invitation to the public to subscribe to any of its shares and debentures.

When two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this definition, be treated as a single member.

- ii) **Public Company:** A *Public Company* may be defined as one which offers its shares and debentures to the public for subscription and is not subject to above restrictions as applicable in the case of private limited company.

Memorandum of Association lays down whether the liability of the members will be limited, or limited up to the amount guaranteed or be unlimited.

From ownership point of view the companies may be divided into private company and public company.

7.1.4 Formation of Company

It is usually the "Promoters" who think up the idea of a business and take initiative to form a company. The promoters then make detailed investigations to find out whether the idea is practical and formation of the company is feasible. They then get the following documents prepared and send them to the Registrar of Joint Stock Companies:-

- i) The Memorandum of Association and the Articles of Association.
- ii) Statement of the Nominal Capital addressed to the Controller of Capital Issues for permitting the issue of capital.
- iii) A list of persons who have consented to act as Directors.
- iv) A written consent by the Directors to act in that capacity.
- v) An undertaking by the Directors to take up and pay for their qualification shares.

- vi) A Statutory Declaration by the Solicitor or the Secretary that all the requirements of the Act have been complied with.

The Memorandum and Articles of Association after being signed by at least seven persons, in case of public Ltd. Company, must be stamped and lodged with Registrar, who, if satisfied that everything is in order, will issue a Certificate of Incorporation.

Now, in the following paras a brief description of some important documents is given:

a) Memorandum of Association

Memorandum of Association defines the power of the company and clearly sets the areas of its operation.

This is a document of prime importance. It defines the power of the company and clearly sets the arena of its operation. The company can exist and run the operation of the business as per set guidelines of the memorandum and anything done beyond that is ultra vires.

The memorandum shall contain the following:

- i) the name of the company, with Limited as the last word in its name;
- ii) the place in which the registered office of the company is to be situated;
- iii) the objectives of the company, and in some cases the area of operations of objects;
- iv) the statement that the liability of the members is limited;
- v) the amount of share capital with which the company proposes to be registered, and the division thereof into shares of a fixed amount.

Each subscriber to the Memorandum must subscribe at least one share and shall write opposite to his name the number of shares he takes.

b) Articles of Association

Articles of Association is the regulation framed for internal management of the company.

It is the regulation framed for internal management of the company. It is subordinate to Memorandum of association. Generally it contains the following items:

- i) The description of share capital and its division into various classes.
- ii) List of rights attaching to the different classes of shares.
- iii) Calls on shares.
- iv) Shares warrants.
- v) Transfer and Transmission of shares.
- vi) Lien on shares.
- vii) Forfeiture of shares.
- viii) Conversion of shares into stock.

- ix) Underwriting commission.
- x) Alteration of capital
- xi) Directors-their number, powers, duties, qualification, remuneration, disqualification and rotation.
- xii) Election of Directors.
- xiii) Managing Agents and their rights and duties.
- xiv) Voting rights of members.
- xv) General and Extraordinary meetings.
- xvi) Proceedings of meetings.
- xvii) The common seal, etc.

c) Certificate of Incorporation

On payment of necessary fees, the Registrar will issue certificate of incorporation if he is satisfied that the requirements of the company Act have been complied with. He will enter the name of the company in the Register.

d) Prospectus

A private limited company can commence business immediately after incorporation. But a public limited company has to wait till the Registrar grants to it the certificate of commencement. For this purpose the company is to issue a prospectus and advertise the same.

Prospectus is a notice/circular/advertisement or other invitation, offering to the public for subscription any shares or debentures of a company.

The copies of such prospectus signed by every person who is named therein as a director or proposed director of the company or by his agent authorized in writing, must be filed for registration with the Registrar on or before the date of its publication, and no such prospectus must be issued until a copy thereof has been so filed with the Registrar. Every prospectus must show on the face of it a copy that has been led for registration.

The prospectus among others include the contents of Memorandum of Association with names, description and address of the signatories, the number of the share to be subscribed by them, classification of shares and mode of payment of shares, right and duties of share holders, distribution of dividend, Bankers to the company, address of auditors and solicitors, minimum subscription, etc.

Prospectus is a notice/circular/advertisement or other invitation, offering to the public any shares or debentures of a company for subscription.

e) Minimum Subscription

It is the minimum amount, which in the opinion of the directors or signatories of the Memorandum, must be raised by issue of shares. It is the director who will decide the amount. In this regard provision is made for the following:

- i) The purchase price of any property acquired or to be acquired out of the proceeds of the shares;

- ii) Preliminary expenses payable by the company.
- iii) Commission payable for procuring subscription of shares;
- iv) Repayment of any money borrowed by the company in respect of any of the foregoing matters; and
- v) Working Capital.

f) Certificate of Commencement of Business

A public company shall not commence any business or exercise any borrowing powers unless-

- (a) Shares held, subject to the payment of the whole amount thereof in cash, have been allotted to an amount not less in the whole than the minimum subscription;
- (b) Every director of the company has paid to the company on each of the shares taken or contracted to be taken by him, and for which he is liable to pay in cash, a proportion equal to the proportion payable on application and allotment on the shares offered for public subscription;
- (c) There has been filed with the registrar a duly verified declaration by the secretary or one of the directors, in the prescribed form, that the aforesaid conditions have been complied with; and
- (d) In the case of company which does not issue prospectus inviting the public to subscribe for its shares, there has been filed with the registrar a statement in lieu of prospectus.

The registrar shall, on the filing of duly verified declaration, certify that the company is entitled to commence business, and that certificate shall be conclusive evidence that the company is so entitled. This restriction will not apply to a private company.

7.1.5 Share Capital and its Division

Share capital of a company means the capital raised by a company by the issue of shares. Based on the amount of capital with which a company is registered, the quantum of issue of that amount, the quantum of call up and paid up, it can be divided as follows:

Share capital of a company means the capital raised by a company by issue of shares.

(i) *Nominal Capital or Registered Capital or Authorized Capital* indicates the full amount of share capital which is shown in a company's Memorandum rather with which the company is registered.

(ii) *Issued Capital* represents that part of the Authorized Capital which is offered for subscription and includes shares allotted to vendors for consideration other than cash.

(iii) *Subscribed Capital* relates to the total amount of the shares taken up by the public including the shares issued to vendors as fully or partly paid up.

(iv) *Called -up Capital* shows the total amount that the shareholders have been called upon by the company to pay on the shares subscribed by them, and also includes the amount of fully or partly paid shares issued to the vendors.

(v) *Paid-up Capital* means the actual amount received by the company on account of the called up amount, including, of course, the amount of shares issued for consideration other than cash.

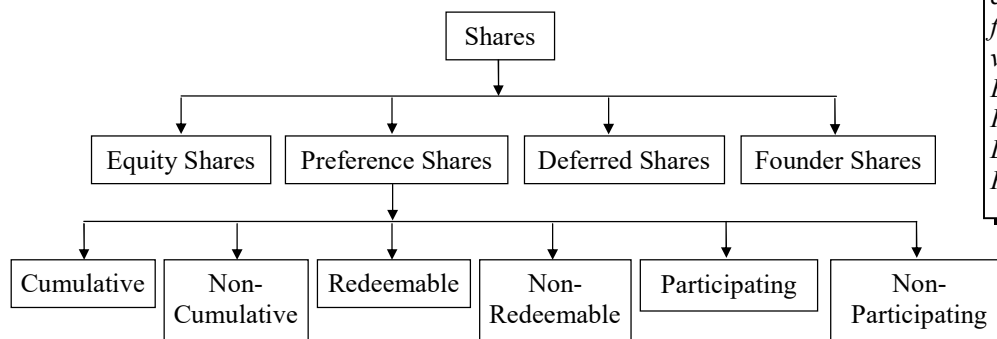
(vi) *Uncalled Capital* would represent the difference between the subscribed capital and the called up amount.

(vii) *Reserve Capital* indicates that portion of the subscribed capital which has not been called up and which the Company, by special resolution, has declared not to be called up, except in the event of the purpose of winding up.

7.1.6 Shares and their Classification

Share capital of a company is divided into certain indivisible units of a fixed amount. These units are called shares. The persons owing the share or shares of company are called share holders.

A public limited company can issue four types of shares viz., Ordinary/equity share, Preference share, Deferred shares and Founders shares. Further, preference shares can be of different types. Following chart shows the picture in this regard:



A public limited company can issue four types of shares viz., Ordinary/ Equity shares, Preference shares, Deferred shares and Founders shares.

i) **Equity or Ordinary Shares** are those the holders of which do not enjoy any special privilege but are entitled to surplus profit or a portion to the same that may be available after all the preferential rights as to dividend have been met.

ii) **Preference Shares** are those that enjoy a fixed dividend out of the profits in priority to any other class of shareholders. These shares may be preferential as to dividend or capital or as to dividend and capital both. A

preference in respect of capital gives the right to a return of capital in priority to other classes of shares in the event of winding up.

Preference shares can be of various types, with various types of rights, such as,

(a) Cumulative Vs. Non-cumulative Preference Shares

The holders of cumulative preference shares are entitled to recover the arrears of preference dividend before any dividend is paid to equity share holders. On the other hand in case of non-cumulative preference shares, arrears of dividend do not accumulate and hence if dividend is to be paid to equity shares in any year, first preference dividend is to be paid before such payment to equity share holders is made and here the question of payment of arrear to preference shares does not arise.

(b) Redeemable Vs. Non-redeemable Preference Shares

Redeemable preference shares are those whose amount can be returned by the company subject to the terms of issue and fulfillment of certain legal conditions. On the other hand non-redeemable preference shares are those which by terms of issue are not redeemable.

(c) Participating Vs. Non-Participating Preference Shares

Participating preference shares are entitled not only to a fixed rate of dividend but also to a share in the surplus profits which remain after dividend at certain declared rate has been paid to equity shareholders. Here the surplus profits are distributed between equity share holders and participating preference share holders at an agreed rate. On the other hand non-participating preference share holders are those which do not carry this right of participation.

iii) Deferred Shares are those in respect of which the right to dividend is postponed till the rights of preference and ordinary shareholders are satisfied. Where deferred shares exist, the ordinary shares frequently take a prior fixed dividend, with a right of participation in any surplus left after the satisfaction of fixed deferred interest.

iv) Founders' Shares are generally issued to founders or promoters of the company and sometimes to the vendors. The right to dividend on these shares is usually deferred to that of all other classes of shares.

In this connection it may be pointed out that shares fully paid up can be converted into stock, and such conversion carries some advantages.

7.1.7 Books of Account

Broadly a Company is to keep three types of Books viz.

- i) **Statutory Books:*** The Books that are to be kept compulsorily as per company Act are called statutory books. These are: Register of share holders, Index of shareholders, Annual register of shareholders and description of share capital, Minutes of meetings, Register of Directors, Register of contract, Register of mortgage, Register of debenture holders etc.

Statutory books, Statistical books and Account books are broad three types of books maintained by a company.

- ii) **Statistical Books:** For smooth running of the business and future reference companies keep some books called statistical books. These books include share application book, share allotment book, share call book, share transfer book, share warrant book, document register etc.
- iii) **Account Books:** As per section 181(1) of the company Act, 1994, a company needs to keep proper books of accounts relevant to the following so that a true and fair view as to its accounts can be revealed:
 - a) all sums of money received and expended and the matters in respect of which receipt of expenditure took place.
 - b) all sales and purchase of goods by the company.
 - c) all assets and liabilities of the company.

7.1.8 Share Issuing Procedure in Bangladesh

Issuing shares in Bangladesh involves several steps and follows guidelines set by the Bangladesh Securities and Exchange Commission (BSEC). Here's an overview of the procedure:

1. Preparation and Planning

- **Board Approval:** The Company's board of directors must approve the decision to issue shares.
- **Appointment of Advisers:** Engage financial advisers, underwriters, legal advisers, and auditors.

2. Regulatory Filings

- **Prospectus Preparation:** Prepare a detailed prospectus that includes financial statements, business descriptions, risk factors, and other relevant information.
- **Submission to BSEC:** Submit the prospectus to the BSEC for approval. The BSEC may ask for additional information or modifications.

3. Approval from BSEC

- **Review by BSEC:** The BSEC reviews the prospectus and may conduct a hearing with the company's representatives.
- **Approval:** Once satisfied, the BSEC approves the prospectus and allows the company to proceed with the share issuance.

4. Initial Public Offering (IPO) Process

- **Announcement:** Announce the IPO and publish the prospectus in at least two national newspapers.
- **Application Collection:** Collect applications from potential investors through designated banks and financial institutions.
- **Subscription Period:** The subscription period usually lasts for a specific period as approved by the BSEC.

5. Allotment of Shares

- **Application Processing:** Process the applications received during the subscription period.

- **Allotment:** Allot shares based on the applications and in accordance with the rules set by the BSEC.
- **Refund of Excess Money:** Refund any excess money to the applicants who did not receive shares.

6. Listing with Stock Exchange

- **Submission to Stock Exchange:** Submit required documents to the stock exchange (Dhaka Stock Exchange and/or Chittagong Stock Exchange) for listing.
- **Approval and Listing:** The stock exchange reviews the submission and, upon approval, lists the shares for trading.

7. Post-Issue Compliance

- **Regular Reporting:** Adhere to ongoing reporting requirements set by the BSEC and the stock exchange.
- **Disclosure:** Regularly disclose financial and other material information to the public.

Key Regulatory Bodies

- **Bangladesh Securities and Exchange Commission (BSEC):** The primary regulatory authority overseeing the issuance of shares and other securities.
- **Registrar of Joint Stock Companies and Firms (RJSC):** Responsible for the incorporation and registration of companies.
- **Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE):** The two main stock exchanges where shares are listed and traded.

Considerations

- **Compliance:** Ensure compliance with the Companies Act, 1994, Securities and Exchange Ordinance, 1969, and other relevant laws.
- **Transparency:** Maintain transparency and provide accurate information to investors and regulatory bodies.

The process of issuing shares in Bangladesh is regulated and requires adherence to specific legal and procedural requirements to protect the interests of investors and maintain market integrity.

Questions

Self-Test Questions

1. Which of the following statement/statements is/are correct:
 - (a) Stockholders are liable for the debts of the business only in proportion to their percentage of ownership of capital
 - (b) Stockholders do not have to pay personal income tax on dividend as the corporation is subject to tax.
 - (c) Each stock holder has the right to bind the corporation to contracts.
 - (d) Fluctuation in the market value of share does not affect the amount of stock holders' equity shown in the Balance Sheet.
2. Which of the following is not a characteristic of a public company:
 - (a) The share may be transferred.
 - (b) Voting rights is the election of directors.
 - (c) Maximum number of members is limited to 50.
 - (d) A cumulative right to receive dividends.

Discussion Questions

1. Define a company. Show with brief description its classification
2. Discuss the procedure of formation of a company
3. Discuss the features of:
 - (a) Equity Shares (b) Preferred Shares (c) Founders' Shares
4. How capital stock is generally classified for phrasing in the Balance sheet? Discuss each element.
5. Discuss in brief the contents of Memorandum of Association and Articles of Association.
6. Write notices on:
 - (a) Minimum Subscription (b) Certificate of Commencement
 - (c) Prospectus.

Blank Page

Lesson-2: Share Issue [Old Procedure]

Lesson Objectives

After you have studied this lesson, you will be able to:

- understand the legal and accounting procedure relevant to the recording of issue of share.
- know the entries required to be given for issue of shares.
- understand recording procedure of share issue in practice.

7.2.1 Introduction

The articles of the company specify the types and number of shares that a corporation has been authorized to issue. Companies normally obtain authorization for more shares than they initially plan to issue. If more capital is needed later, the corporation then issues additional shares over the initial ones up to authorized capital. This lesson discusses the issues as to the recording of transactions relevant to issue of shares.

7.2.2 Recording of Share Issue Transactions

Company can collect the price of share in a single installment. In such a case, recording of transaction becomes easy. Money received is debited to Bank account and credit is given to share capital account. But in many cases, price value of share is collected in different installments viz., at application, at allotment and at call/calls. This is done for convenience of the shareholders and also for full utilization of the share capital. Generally company realizes the value of the shares from the shareholders in several installments. The procedure followed and transactions recorded take the following form.

Generally company realizes the value of the shares from the shareholders in several installments.

(i) Share Application: Applicants deposit share application form in the proforma given in the prospectus to the bankers of the company along with the prescribed share application money. Bankers keep proper record of the money received and send the applications along with statement of account to the company. Company on receipt of the same records the application in a register and gives entry for money received in cash book along with necessary particulars.

Legal provisions as to share application are as follows:

- a) 5% of the face value of share is to be paid with application.
- b) If minimum subscription cannot be raised within 180 days of issue of prospectus then within next 10 days such money must be returned after which period money is to be returned with 5% interest.
- c) Money received on application shall have to be deposited with scheduled bank till the certificate of commencement is received.

(ii) Share Allotment: On fulfillment of the condition of allotment as set out in companies Act, the Directors take decision as to allotment of shares through a meeting and the proceedings are recorded in Minute Book. Based on this decision the secretary of the company issues allotment letters to the concerned applicants with a request to pay allotment money within set time. At the time of issue of allotment letter, the name of shareholder, number of share allotted, amount due etc. are recorded and on receipt of the allotment money entry is given to this end in cash Book.

Legal provisions as to allotment are as follows:

- (a) Minimum subscription must be raised before allotment is made.
- (b) At least 5% of the face value of the shares must be paid on allotment.
- (c) A return as to share allotment must be submitted to the Register within 60 days of allotment.
- (d) Prospectus or Statement in lieu of prospectus must be submitted to the Registrar.

In this connection it may be mentioned that application for shares may be excess or less with reference to number of shares issued for subscription, purchase. In such a case following points may arise for giving relevant treatment.

(a) Refund of Excess Application Money

If the application money received exceed allotment, then the Directors can take decision to refund excess application money. The return of money is recorded in allotment register and cash book.

(b) Adjustment of Excess Application Money

If an applicant or a number of applicants are allowed allotment to a lesser number of share than he/they applied for, then instead of refunding the excess application money the Directors can take decision to adjust the excess application money with money due on allotment. This adjustment is recorded in application and allotment register.

iii) Share Call: Company as per condition of prospectus can make one or more calls after allotment of share to receive share price from the shareholders. Directors' decision as to call along with date, amount, etc. are recorded in the proceedings of the meeting of the Directors. Based on this decision, share call is notified and particulars of the call viz., name of shareholders, amount due, payment date etc. are recorded in share call register. On receipt of the call money entry is given in share call register and cash Book. After receipt of call money the amount is transferred to the credit of call account in the ledger. If call money is received in full, there will be no balance. If there is arrear in the call account then the account will show debit balance. This debit balance will be treated as calls in arrears and the adjusting amount will be shown in the Balance Sheet.

Legal provisions as to call are as follows:

- (a) Call be made as per Article of the company.
- (b) A 21 days notice be required for call.
- (c) If call money is not paid within time limit then interest as per provision of Article can be charged.
- (d) Call money cannot be more than 25% of face value and that one month interval be given between two calls.

7.2.3 Issue of Share at Different Value

Share may be issued at par, at premium or at discount. A brief description in this regard is now in order.

i) Share Issued at par: When shares are offered for sale at price equal to the amount of their face value, it is called share issued at par. For instance, share of Tk.100 issued at Tk.100.

Shares may be issued at par, at premium or at discount.

ii) Share Issued at Premium: When shares of a company are issued at a higher price than the face value, it is called shares issued at a premium. For instance, share of Tk.100 issued at Tk.110, Tk.10 being premium. When there is a demand for such share in the capital market or among public, such shares can be issued at a higher price, the higher price being the premium of share. The premium so received must not be mixed up with share capital rather be credited to a separate account titled "Premium on Issue of Share" and be shown in the liabilities side of the Balance sheet.

When shares of a company are issued at a higher price than the face value, it is called shares issued at a premium.

iii) Shares Issued at Discount: When a company issues share at a price less than the face value, it is said to have issued share at a discount. For example, a company issued shares the face value of Tk.100 at Tk.95. In such a case, shares are issued at 5% discount. Following restrictions have been provided in section 152 of the Company Act, 1994:

- (a) The decision for shares to be issued at discount must be taken in general meeting and be approved by the court.
- (b) It must be issued within 6 months of the order of the court or within such extended time as approved by the court.
- (c) In no way the rate of discount shall exceed 10%.
- (d) The shares to be issued at a discount must be of a class already issued.
- (e) At the time of issue, the company must have been working at least a year from the date it was entitled to commence the business.

When a company issues share at a price less than the face value, it is said to have issued shares at a discount.

iv) Different Types of Shares: When there is more than one type of share such as Ordinary share, Preference share, Deferred share etc. then separate share capital account for each type of share be opened. Account

for application, allotment, and call money of these shares be kept separately.

7.2.4 Specimen Entries for Issue of Share

The entries as to the issue of share capital, for giving journal entries, including entries connecting with receipts of cash, will appear as follows:

(a) In case of issue of shares payable in full with application :

Transactions	Account Titles	Explanation
(1) On receipt of money along with applications:	Bank Account .....Dr. To Sundry Shareholders' Account	Being cash received in full on shares along with applications
(2) On allotment of Shares by Board of Directors :	Sundry Shareholders' Account ...Dr. To Shares Capital Account	Being the allotment of share as per Boards resolution dated transferred to capital account.

(b) In case of Issue of shares payable by installment:

Transactions	Account Titles	Explanation
1) On receipt of money along with applications:	(i) Bank Share Application	Being the application money received on share @ Tk.....
	(ii) Share Application Share Capital	Being the transfer of application money for shares allotted, @ Tk.... per share to Share Capital Account.
2) On allotment of Shares by Board of Directors :	(i) Share Allotment Share Capital	Being the allotment shares as per Board's resolution dated.....@ Tk..... per share.
Note: Premium and Discount on issue of shares are generally adjusted at the point of allotment. Therefore on adjustment of :-		
i) Premium at the point of allotment:	a) Share allotment Share Capital Share Premium	Being the allotment of shares @ Tk.....per share adjustment of premium @ Tk..... per share as per Board's resolution dated.....
ii) Discount at the point of allotment:	b) Share allotment Discount on Shares Share Capital	Being the allotment of shares @ Tk.. per share and adjustment of discount @ Tk..... per share as per Board's resolution dated.....
iii) On part-allotment :- If excess application money is refunded:	c) Share Application Bank	Being the refund of excess application money owing to non-allotment of shares.
iv) If excess application money is adjusted against amount due on allotment:	d) Share Application Share Allotment	Being the adjustment of application money for.....shares @ Tk....per share towards part-payment off allotment money
3) On receipt of allotment money:	ii) Bank Share Allotment	Being the allotment money received on shares @ Tk.....per share.

Transactions	Account Titles	Explanation
4) On making calls on the shares:	Share Call Share Capital	Being the call made on shares @ Tk.....per share as per Board's resolution dated....
5) On receipt of call money:	Bank Share Call	Being call money received on shares @ Tk .....Per share
6) On transferring the debit balance standing in the Call Account at the end of the year (i.e., for money due on calls):	Calls-in-Arrear Share call	Being the transfer of debit balance standing in the Calls Account at the end of the year.
7) On receipt of call money in advance :	Bank Calls-in-Advance	Being the call money received on share @ Tk..... per share in Advance
8) On making calls in respect of which money has already been received in advance:	Calls-in-Advance (Related) Calls	Being the call money received on share @ Tk.....per share in advance.
9) On allotment of shares for consideration otherwise than in cash.	Vendor's Share Capital	Being the value of shares @ Tk.... each allotted to the vendors.

Attention: Theoretically, all entries may be journalized as shown above. However in practice the cash entries will be recorded through the Cash Book and only the other stated entries will be passed through the Journal proper.

7.2.5 Calls in Arrear and Calls in Advance

a) Calls is Arrear

Sometimes, some share holders may not pay allotment or call money in time. This is called calls in arrear. Any of the following two methods may be used for recording calls in arrear:

- At the end of the period a separate Call in Arrear Account may be opened to which account debit will be made for the amount of calls in arrear and credit will be made for relevant Allotment or call account.
- No entry shall be given for call in arrear and the debit balance of allotment and calls account will remain as they appear in the books.

Legal Provisions as to Calls in Arrear

- Decision shall have to be taken in the Board meeting to collect call in arrear money.
- A 21 days notice shall have to be given for payment of call in arrear money.
- If calls in arrear money is not paid within the time limit then interest @ 5% shall have to be paid till the date of payment of arrear dues.
- Directors can reduce full or part of the interest money.

b) Calls in Advance

A company, if its Articles of Association permits, may receive from its shareholders the amount remaining unpaid at allotment/call even though such call have not been made. The amount so received is called calls in advance. When such calls are to be made in future, the actual amount is transferred from calls in advance account.

Legal Provision as to Calls in Advance

- a) Interest @ 6% per annum can be paid on calls in advance. But if rate of interest is given in Article of Association, then that rate will be applicable.
- b) Interest is to be paid from the date of receipt of the advance to the date of apportionment (i.e. date of making call)
- c) Share holders cannot compel the company to refund calls in advance money.

7.2.6 Practical Problems

Illustration-:7.01

Dhaka Ltd. was registered with an authorized capital of Tk.50,00,000 divided into 2,50,000 share of Tk.20 each. The company issued 1,00,000 shares on 1st July, 2023 payable as follows:

On application	Tk. 5
On allotment	Tk. 8 (including Tk. 1 as per premium)
On 1st call	Tk. 4
On final call	Tk. 4

Applications were received for 1,20,000 shares till 5.8.2023 of which 1,00,000 shares were allotted. Excess application money for 15,000 shares was refunded on 25.8.2023 to the applicants to whom shares were not allotted and the remaining balance of application money for 5,000 shares was adjusted to the Share Allotment account. All the calls were made and money was received. Show journal entries and relevant matters in the Balance sheet.

Solution:

Workings: Allotted shares: 1,00,000 shares of Tk.20 each plus Tk.1 Premium per share.

Name of Installments	Amount per Installment	Amount due / receivable	Amount received	Excess application Money	Excess money refunded and adjusted
Application	Tk. 5	-----	Tk. 6,00,000	Tk. 1,00,000	(i) Tk. 75,000 cash refunded (ii) Tk. 25,000 adjustment with allotment
Allotment	Tk. 8 (7+1)	Tk. 8,00,000	Tk. (8,00,000-25,000) = 7,75,000	-----	-----
1st call	Tk. 4	Tk. 4,00,000	Tk. 4,00,000	-----	-----
Final call	Tk. 4	Tk. 4,00,000	Tk. 4,00,000	-----	-----

In the Books of Dhaka Ltd.**Journal Entries**

Date	Account Titles & Explanation	L.F.	Dr.	Cr.
5.8.2023	Bank Share application (Application money received on 120,000 shares)		Tk.600,000	Tk.600,000
5.8.2023	Share Application Share Capital (Transfer of application money to Share Capital Account on allotment of 1,00,000 Shares as per Board's Resolution)		5,00,000	5,00,000
25.8.2023	Share Application Share allotment (Adjustment of excess application money with Share Allotment on 5,000 share)		25,000	25,000
25.8.2023	Share Application Bank (Share application money refunded)		75,000	75,000
25.8.2023	Share Allotment Share Capital Share Premium (Allotment money @ Tk. 7 per share and @ Tk.1 as premium due on 1,00,000 shares as per Board's Resolution dated.....)		8,00,000	7,00,000 1,00,000
25.8.2023	Bank Share Allotment (Allotment money received)		7,75,000	7,75,000
25.8.2023	Share First Call Share Capital (First call money of Tk. 4 per share due on 1,00,000 shares as per Board's Resolution dated.....)		4,00,000	4,00,000

Date	Account Titles & Explanation	L.F.	Dr.	Cr.
25.8.2023	Bank Share First Call (First call money received on 1,00,000 shares @ Tk.4 per share)		4,00,000	4,00,000
25.8.2023	Share Final Call Share Capital (Final call money of Tk. 4 per share due on 1,00,000 share as per Board's Resolution dated.....)		4,00,000	4,00,000
25.8.2023	Bank Share Final Call (Final call money received)		4,00,000	4,00,000

Bank

Date	Explanation	Dr.	Cr.	Balance
5.8.2023	Share Application	6,00,000	75,000	5,25,000
25.8.2023	Share Allotment	7,75,000		13,00,000
25.8.2023	Share 1st Call	4,00,000		17,00,000
25.8.2023	Share Final Call	4,00,000		21,00,000

**Dhaka Ltd.
Balance Sheet
As at 31-12-2023**

Liabilities	Tk.	Assets	Tk.
Authorized Capital 2,50,000 shs. of Tk. 20 each	50,00,000	Cash at Bank	21,00,000
Issued and Subscribed Capital : 1,00,000 shares of Tk. 20	20,00,000		
Called and Paid up Capital 1,00,000 shares of Tk. 20 each fully paid	20,00,000		
Share Premium	1,00,000		
	21,00,000		21,00,000

Illustration-:7.02

"X" Company Ltd. with a registered capital of Tk.5,00,000 in shares of Tk. 10 in ordinary shares and Tk.5,00,000 in shares of Tk.10 in preference share issued 30,000 ordinary and 25,000 preference share.

Money payable as follows:

	<u>Ordinary Share</u>	<u>Preference Share</u>
On application	Tk. 2/-	Tk. 1/-
On allotment	Tk. 2/-	Tk. 2/-
On First call	Tk. 3/-	Tk. 3/-
On Final call	-----	Tk. 4/-

Money received with the exception of Tk. 1,800 in respect of First call on Ordinary Share's, and Tk. 3,000 on account of First Call and Tk. 10,000 on account of Final call on Preference Shares. Make the necessary Journal, Cash Book and Ledger entries and show how the Share Capital will appear in the Balance Sheet.

Solution:**X Company Ltd.****CASH BOOK (Bank Column Only)**

Date	Explanation	Bank Tk.	Date	Explanation	Bank Tk.
	To, <i>Application Account</i> (<i>Ordinary Shares</i>) ... (Being Cash received on application of 30,000 Ordinary Shares)	60,000		By Balance c/d	4,45,200
	To, <i>Application Account</i> (<i>Preference Shares</i>) ... (Being Cash received on Application of 25,000 Preference Shares)	25,000			
	To, <i>Allotment Account</i> (<i>Ordinary Shares</i>) ... (Being Allotment money received on 30,000 Ordinary Shares)	60,000			
	To, <i>Allotment Account</i> (<i>Preference Shares</i>) ... (Being Allotment money received on 25,000 Preference Shares)	50,000			
	To, <i>First Call Account</i> (<i>Ordinary Shares</i>) ... (Being First Call money received on 29,400 Ordinary Shares)	88,200			
	To, <i>First Call Account</i> (<i>Preference Shares</i>) ... (Being First Call money received on 24,000 Preference Shares)	72,000			
	To, <i>Final Call Account</i> (<i>Preference Shares</i>) ... (Being Final Call money received on 22,500 Preference Shares)	90,000			
		<u>4,45,200</u>			<u>4,45,200</u>

Journal Entries

Date	Account Titles & Explanation	L.F	Dr.	Cr.
	Application (Ordinary Shares) Ordinary Share Capital (Being the transfer of application money received on 30,000 Ordinary Shares to Ordinary Share Capital Account)		Tk. 60,000	Tk. 60,000

Date	Account Titles & Explanation	L.F	Dr.	Cr.
	Application (Preference Shares) Preference Share Capital (Being the transfer of application money received on 25,000 Preference Share to Preference share Capital Account)		25,000	25,000
	Allotment (Ordinary Shares) Ordinary Share Capital (Being the total amount due on allotment of 30,000 Ordinary Shares at Tk. 2 per share as per Board's Resolution dated-----.)		60,000	60,000
	Allotment (Preference Shares) Preference Share Capital (Being the total amount due on allotment of 25,000 Preference Shares at Tk. 2 per share per Board's Resolution dated-----)		50,000	50,000
	First call (Ordinary Shares) Ordinary Share Capital (Being the total amount due on First Call on Tk. 3 per share on 30,000 Ordinary Shares as per Board's Resolution dated.....)		90,000	90,000
	First Call (Preference Shares) Preference Share Capital (Being the total due on First Call of Tk. 3 per share on 25,000 Preference Share as per Board's Resolution dated.....)		75,000	75,000
	Final Call (Preference Shares) Preference Share Capital (Being the total amount due on Final Call of Tk.4 per share on 25,000 Preference Shares as per Board's Resolution dated.....)		1,00,000	1,00,000

Ledger Accounts**Ordinary Share Capital Account**

Dr.	Explanation		Explanation	Cr.
	To Balance <i>c/d</i>	Tk. 2,10,000	By Application Account- (Ordinary Shares).....	Tk. 60,000
			By Allotment Account- (Ordinary Shares).....	60,000
			By First Call Account (Ordinary Shares)	90,000
		2,10,000		2,10,000
			By Balance <i>b/d</i>	2,10,000

Preference Share Capital Account

	To Balance <i>c/d</i>	Tk. 2,50,000	By Application Account- (Preference Shares).....	Tk. 25,000
			By Allotment Account- (Preference Shares).....	50,000
			By First Call Account (Preference Shares)	75,000
			By Final Call Account- (Preference Shares).....	1,00,000
		2,10,000		2,50,000
			By Balance <i>b/d</i>	2,50,000

Application Account (Ordinary Shares)

	To Ordinary Share Capital Account	Tk. 60,000		By Bank Account	Tk. 60,000
--	-----------------------------------	---------------	--	-----------------	---------------

Allotment Account (Ordinary Shares)

	To Ordinary Share Capital Account	Tk. 60,000		By Bank Account	Tk. 60,000
--	-----------------------------------	---------------	--	-----------------	---------------

First Call Account (Ordinary Shares)

	To Ordinary Share Capital Account	Tk. 90,000		By Bank Account	Tk. 88,200
		90,000		By Balance c/d	1,800
	To Balance b/d	1,800			90,000

Application Account (Preference Share)

	To Preference Share Capital Account	Tk. 25,000		By Bank Account	Tk. 25,000
--	-------------------------------------	---------------	--	-----------------	---------------

Allotment Account (Preference Shares)

	To Preference Share Capital Account	Tk. 50,000		By Bank Account	Tk. 50,000
--	-------------------------------------	---------------	--	-----------------	---------------

First Call Account (Preference Share)

	To Preference Share Capital Account	Tk. 75,000		By Bank Account	Tk. 75,000
		75,000		By Balance c/d	3,000
	To Balance b/d	3,000			75,000

Final Call Account (Preference Share)

	To Preference Share Capital Account	Tk. 10,00,000		By Bank Account	Tk. 90,000
		10,00,000		By Balance c/d	10,000
	To Balance b/d	10,000			10,00,000

X Company Limited
Balance Sheet

As at.....

	Tk.	Tk.	Tk.
Capital and Liabilities side only			
<i>Authorized Capital:-</i>			
50,000 Ordinary Shares of Tk. 10 each	5,00,000		
50,000 Preference Shares of Tk. 10 each	5,00,000		
		10,00,000	
<i>Issued and Subscribed Capital:-</i>			
30,000 Ordinary Shares of Tk. 10 each	3,00,000		
25,000 Preference shares of Tk. 10 each	2,50,000		
		5,50,000	
<i>Called and Paid up Capital:-</i>			
25,000 Preference shares of Tk. 10 each fully called up	2,50,000	2,08,200	
Less Calls in arrears	13,000		
30,000 Ordinary Shares of Tk. 10 each, Tk. 7 per share called	2,10,000		
Less Calls in arrears	1,800		
		2,37,000	
			4,45,200
Amount paid up			4,45,200

Lesson-3: Forfeiture of Share [Old Procedure]

Lesson Objectives

After you have studied this lesson, you will be able to:

- know about the grounds and procedure of forfeiture of shares.
- know the procedure of re-issue of forfeited shares.
- have an idea as to the journal entries and accounting procedure to deal with forfeited shares.

7.3.1 Introduction

Share price may be paid in one instalment or through a number of instalments. The latter is the most widely used practice. In such a case a share holder may fail to pay instalment which after due notice and reasonable time may be required to be forfeited and sometimes may be issued too. This lesson will deal with the relevant aspects of forfeiture of shares.

7.3.2 Forfeiture of Shares

If a shareholder fails to pay allotment money or call money by the last date fixed for such payment, the Board of Director, if the Articles of Association permits, may proceed to forfeit the shares on which allotment or call money has become in arrear. Here the right to forfeit the shares must be exercised after due notice and with utmost exactness. The effect of forfeiture is that the concern shareholder whose shares are forfeited ceases to be a member of the company but his liability for the amount due at the time of forfeiture still remains though not for any future call to be made on such shares. On the other hand, from the view point of the company, the amount resulting from forfeiture of share will constitute a fund for the company-it is a capital gain and is credited to forfeited share account. In this connection it may be pointed out that the directors are often empowered by Articles of Association of the company to cancel forfeiture order if the defaulting shareholder pays the amount due along with remission fee. In such a case remission entry shall have to be passed to reverse the effect of forfeiture.

If a shareholder fails to pay allotment money or call money by the last date fixed for such payment, the Board of Director, if the Articles of Association permits, may forfeit those shares.

7.3.3 Re-issue of Forfeited Share

The Directors of a company are usually empowered to re-issue the forfeited shares. Such shares may be re-issued at par, at premium or at discount. It may be re-issued at discount provided the amount of discount does not exceed the amount already received thereon from original shareholder. The discount or deficit on re-issue be adjusted against of surpluses on forfeiture. The balance of surplus, if any shall be transferred to capital Reserve Account.

Journal Entries Relating to Forfeiture of Shares

Transactions	Journal Entries	Explanation
(1) When Shares are forfeited:	Share Capital t (With total amount called up)	
(i) On account of non - payment of allotment:	Share Allotment (With amount due) Forfeited Share (With amount already received)	Being Shares forfeited for non-payment of allotment @ Tk..... per share as per Board's resolution dated.....
(ii) On account of non-payment of a call:	Share Capital (With total amount called up) Share Call (With amount due) Forfeited Shares Account (With amount already received)	Being shares forfeited for non-payment of call @ Tk..... per share as per Board's resolution dated
(iii) On account of non-payment of both allotment and call	Share Capital Share allotment Share Call Forfeited Shares Account	Being shares forfeited for non-payment of allotment @ Tk..... per share and call @ Tk..... per share as per Board's resolution date
(2) On reissue of forfeited shares at par:	Allottee's or Party's (With amount to be received) Share Capital (With full called up value of shares)	Being forfeited shares issued at par as per Board's resolution date.....
(3) On reissue of forfeited shares at discount:	Allottee's (With amount to be received) Forfeited Shares (With amount of discount) Share Capital (With full called up value of shares)	Being forfeited shares reissued at a discount of Tk..... per share as per Board's resolution date.....
(4) On receipt of cash after reissued:	Bank Allottee's	Being Cash received @ Tk..... per share on reissue of forfeited shares.
(5) On transfer of Credit balance standing in forfeited shares Account.	Forfeited Shares Capital Reserve	Being the transfer of capital profit on reissue of forfeited shares to Capital Reserve

Points to Remember

(i) The share capital account will thus be written back to the extent of the amount called on the forfeited shares, and the credit balance of Forfeited Shares Account will represent the amount received by the company in respect of the forfeited shares. The debit balance on the Allotment Account or the Call Account will be wiped off by the credit given to such account with the amount outstanding, as a result of the above entry.

(ii) The nominal amount of forfeited shares would be shown as a deduction from the total Subscribed Capital, and the called up amount on the forfeited shares as a deduction from the total Called Up Capital. The credit balance of forfeited shares account must appear as a separate item on the liabilities side of the Balance sheet immediately underneath the Share Capital item.

(iii) Reissue of Forfeited Shares Previously Issued at a Premium:

If shares originally issued at a premium are subsequently forfeited, the premium received should remain in share premium account. If the premium is not received but the share premium account is credited, then the share premium account should be debited with the amount on

forfeiture of the related shares. When these shares are reissued after forfeiture, shares premium account would also remain undisturbed.

(iv) Reissue of Forfeited Shares Previously Issued at a Discount:

If shares originally issued at a discount are subsequently forfeited, it is necessary to write back the discount allowed on those shares to keep the proportion between the discount and shares issued. On reissue of these forfeited shares a reverse entry is required to be made.

Illustration:- 7.03

Purbachal Limited has an authorized capital of Tk.10,00,000 divided into 1,00,000 shares of Tk.10 each.

The shares of the company were payable as follows:

On application	Tk. 2
On allotment (including premium)	Tk. 5
On 1st call	Tk. 2
On final call	Tk. 3

All shares were applied for and allotment made in due time. "A" who held 500 shares failed to pay his allotment and 1st call and his shares were forfeited after the first call. "B" who held 600 shares failed to pay his first and final call dues and his shares were forfeited after the final call. Of the forfeited shares 700 shares were sold to "C" as fully paid for Tk. 9 per share. The whole of A's shares being included. Show the Journal and Cash Book entries in the Books of the Company and also draw up the Balance Sheet.

Solution

In the Books of Purbachal Limited

CASH BOOK

Dr.			Cr.
Explanation	Tk.	Explanation	Tk.
Share Application A/c (Appl. money received for 1,00,000 shares @ 2/=per share)	2,00,000	Cash at Bank	11,98,300
Share Allotment A/c (Allotment money received for 99,500 shares @ Tk. 2/=per share)	4,97,500		
Share 1st Call A/c/ (Share 1st Call money received for 98,900 Shares @ Tk. 2/=per share)	1,97,800		
Share Final Call A/c (Share final call money received for 98,900 shares @ Tk. 3 per share)	2,96,700		
Share Capital A/c (700 forfeited shares re-issued at Tk. 9 per share)	6,300		
	11,98,300		11,98,300

Journal

Date	Account Titles & Explanation	L.F	Dr. Tk.	Cr. Tk.
	Share Application Share Capital (Share application money for 10,000 shares @ Tk. 2 per share transferred to share capital A/c		2,00,000	2,00,000
	Share Allotment Share Capital Share Premium (Allotment money including Premium due for 1,00,000 shares)		5,00,000	3,00,000 2,00,000
	Share Allotment Arrear Share Allotment (Share allotment money for 500 shares remained in arrear including premium)		2,500	2,500
	Share 1st Call Share Capital (Share 1st Call money due for 1,00,000 share @ Tk. 2 per share)		2,00,000	2,00,000
	Share 1st Call Arrear Share 1st Call (Share 1st Call money arrear for 1,100 shares)		2,200	2,200
	Share Capital Share Premium Share Allotment Arrear Share 1st Call Arrear Share Forfeited (500 Shares Forfeited after 1st Call)		3,500 1,000	2,500 1,000 1,000
	Share Final Call Share Capital (Share Final call money due for 99,500 shares @ Tk. 3 per share)		2,98,500	2,98,500
	Share Final Call Arrear Share Final Call (Share Final Call money arrear for 600 shares)		1,800	1,800
	Share Capital Share 1st call Arrear Share Final call Arrear Share forfeited (600 share forfeited)		6,000	1200 1,800 3,000
	Share Forfeited Share capital (For amount of discount)		700	700
	Share Forfeited Capital Reserve (credit balance of forfeited A/c transferred)		1,300	1,300

Purbachal Ltd.
Balance Sheet as at

	Tk.		Tk.
<i>Authorized capital :</i>		Cash at Bank	11,98,300
1,00,000 shares of Tk. 10 etc.	<u>10,00,000</u>		
Subscribed, called & paid up Capital			
99,600 share @ Tk.10	9,96,000		
Share premium	1,99,000		
Share Forfeited A/c	2,000		
Capital Reserve	1,300		
	<u>11,98,300</u>		<u>11,98,300</u>

Working: Computation of Capital Reserve & Forfeited Account Balance:

A = Money forfeiture 500 shares $(500 \times 2) = 1,000$

B = Money forfeiture 600 shares $(600 \times 5) = 3,000$
 Tk. 4,000

500 shares forfeited at Tk.1 discount. 80 Tk.500 (1000-500) is the profit which will be transferred to capital Reserve A/c.

Likewise capital reserve for B's 600 shares $(1000-200) = \text{Tk. } 800$. Thus, total capital reserve = $(500+800) = 1300$. There 400 shares not net re-issued will require to be credit is forfeited share account extant of Tk.2000

Lesson-4: Pro-rata Allotment of Share

Lesson Objectives

After you have studied this lesson, you will be able to:

- understand the meaning and significance of pro-rata allotment.
- compute pro-rata issue of share and other relevant matters.
- have an idea as to the recording procedure of pro-rata share issue.

7.4.1 Introduction

It is not unusual that the number of applicant for share purchase may exceed the quantity irritable for sale. In such a context the excess application can be rejected out right or that they may be allotted share on prorata basis taking some variables into consideration or that both rejection and pro-rata basis allotment can be adopted. This lesson deals with these aspects of share issue.

7.4.2 Pro- Rata Allotment

Pro rata means proportionately.

Pro rata means proportionately. Allotment on pro-rata basis means that allotment on every application is made in the ratio which the total number of shares to be allotted on this basis bears to the total number of shares applied for in all such applications. For Example, if, 20,000 shares are allotted on pro-rata basis on applications for 25,000 shares, it means that four shares are allotted for every five shares applied for. Usually applications are invited in multiples of a certain number and it becomes possible to allot shares on pro rata basis without involving fractions of shares to be allotted.

Illustration-:7.04

A company issued for public subscription 40,000 equity shares of Tk.10 each at a premium of Tk. 2 per share as under:

- On application Tk. 2 per share
- On allotment Tk. 5 per share (including premium),
- On 1st call Tk. 2.50 per share
- On final call Tk. 2.50 per share

Applications were receive for 60,000 shares. Allotment was made pro-rata to the applicants for 48,000 shares, the remaining applications were refused and application money was paid back. Money over paid on application was utilized towards sums due on allotment. A, to whom 1600 shares were allotted, failed to pay the allotment, first and final call money and B, to whom 2,000 shares were allotted, failed to pay the two calls. These shares were subsequently forfeited after the final call was made. All the forfeited shares were sold to C as fully paid up at Tk.8 per share.

Show Journal Entries required to record the above transactions and the opening Balance Sheet of the Company.

Solution

Working: Calculation of Share Allotment-in-Arrear:

Pro-rata allotment was made to the applicants for 48,000 shares.

Excess share applications which were refused = $(60,000 - 48,000) = 12,000$ shares.

Adjustment of excess share applications $(48,000 - 40,000) =$ For 8000 share applications.

40,000 shares were allotted when number of share application 48,000

1	"	"	"	"	"	"	"	<u>48000</u>
								40000
1,600	"	"	"	"	"	"	"	<u>4800×1600</u>
								40000
								= 1,920 Shares

Excess share applications of Mr. A = $(1920 - 1600) = 320$ shares

So, excess application money paid by Mr. A $(320 \times \text{Tk. } 2) =$	<u>Tk. 640</u>
Allotment money relevant to Mr. A $= 1,600 \times \text{Tk. } 5 =$	<u>Tk. 8,000</u>
Less : Excess application money adjusted with allotment	<u>Tk. 640</u>
$\therefore$ Share Allotment-in-Arrear =	<u><u>Tk. 7,360</u></u>

Journal Entries

Date	Account Titles & Explanation	L.F	Dr. Tk.	Cr. Tk.
	Bank Share Application (Application money received for 60,000 shares @ Tk. 2 per share.)		1,20,000	1,20,000
	Share Application Share Capital Share Allotment Bank (Transfer of share application money to Share Capital A/c for 40,000 shares @ Tk. 2 each on allotment of shares as per Board's Resolution dated..... and excess application money for 8,000 shares adjusted with allotment and for 12,000 shares refunded on refusal)		1,20,000	80,000 16,000 24,000
	Share Allotment Share Capital Share Premium (Share allotment money of Tk. 5 each (including premium of Tk. 2) due on 40,00 shares as per Board's Resolution dated.....)		2,00,000	1,20,000 80,000

Date	Account Titles & Explanation	L.F	Dr. Tk.	Cr. Tk.
	Bank Share Allotment-in-Arrear Share Allotment (Share allotment money received expect for 1,600 shares.)		1,76,640 7,360	1,84,000
	Share 1st call Share Capital (Share 1st call money of Tk. 2.50 each due on 40,000 shares as per Board's Resolution dated.....)		1,00,000	1,00,000
	Bank Share 1st Call-in-Arrear Share 1st call (Share 1st Call money received expect for 3,600 shares.)		91,000 9,000	1,00,000
	Share Final Call Share Capital (Final Call money of Tk. 2.50. each due on 40,000 shares as per Board's Resolution dated.....due on 40,000 shares as Board' Resolution dated.....)		1,00,000	1,00,000
	Bank Share Final Call-in-Arrear Share Final Call (Final call money received except for 3,600 shares)		91,000 9,000	1,00,000
	Share Capital Share Premium Share Allotment -in Arrear Share 1st Call -n-Arrear Share Final Call-in Arrear Forfeited Share (3,600 forfeited shares reissued at Tk. 8 per share)		36,000 3,200	7,360 9,000 9,000 13,840
	Bank Forfeited Share Share Capital (3,600 forfeited shares reissued at Tk. 8 per share)		28,800 7,200	36,000
	Forfeited Share Capital Reserve (Balance of forfeited share account transferred to capital reserve account)		6,640	6,640

Bank Account

Dr.		Cr.	
Explanation	Tk.	Explanation	Tk.
Sh. Application	1,20,000	Sh. application	24,000
Sh. Allotment	1,76,640	Balance C/d	4,83,440
Sh. 1st Call	91,000		
Sh. Final Call	91,000		
Sh. Capital	28,800		
	5,07,440		5,07,440

Balance Sheet

Capt. & Liabilities	Tk.	Assets	Tk.
Authorized Capital	?		
Issued Capital :		Cash Bank	4,83,440
4,000 Sh. @ Tk. 10 each	4,00,000		
Subscribed & paid up Cap.			
40,000 Sh. @ Tk. 10 each	4,00,000		
Share Premium	76,800		
Capital Reserve	6,640		
	4,83,440		4,83,440

Notes : (i) Share Premium for 40,000 shares were due @ 2	= 80,000
Less not paid for 1,600 shares @ Tk. 2	= 3,200
	<u>= 76,800</u>
(ii) Calculation of Capital Reserve :	13,840
Forfeited Amount	
Less utilized for re-issue	<u>7,200</u>
	<u>6,640</u>

As there is no shares left for re-issue against forfeited shares this money is fully transferred to Capital reserve.

Illustration-:7.05 (Pro-rata Allotment of Shares, Premium Received with Application)

Asha Ltd. with authorized Capital of 30,000 shares of Tk. 20/- each issued 20,000 shares of Tk.20 each payable as follows:

- On application Tk.12 (including Tk.4 as premium)
- On allotment Tk.8
- On call Tk.4

Applications were received for 37,000 shares, of which the application money on 7,000 shares were refunded and allotment was made to the rest of the applicants on pro-rata basis.

All the money due on the shares was received in full with the exception of allotment money on 300 shares and call money on 500 shares (including those on which allotment money was due). These 500 shares were forfeited by the company. Subsequently, 400 of these shares, of which 300 were those shares on which allotment money was not paid, were re-issued at Tk.15 per share as fully paid up.

Show Journal Entries (including the cash transactions) and the Balance Sheet of the Company.

Solution

Workings:

Computation of Allotment-in-Arrear:

Allotment was made in the proportion of: $\left(\frac{30,000 \text{ Shares}}{20,000 \text{ Shares}} \right) = 3:2$

For 300 allotted shares, share applications were

$$\frac{3 \times 300}{2} = 450 \text{ Shares}$$

Excess share applications: $(450-300) = 150$ shares.

Excess application money adjusted with allotment :
 $(150 \times \text{Tk.}12) = \text{Tk.}1,800$

Allotment money due on 300 shares were: $300 \times \text{Tk.} 8 = \text{Tk.} 2,400$

Allotment-in-Arrear: $\text{Tk.} 2,400-1,800=\text{Tk.} 600$

Journal Entries

Sl. No.	Account Titles & Explanation	Dr.	Cr.
		Tk.	Tk.
1	Bank Shares Application (Application money received for 37,000 share @ Tk. 12 each including premium of Tk. 4)	4,44,000	4,44,000
2	Share Application Share Capital Share Premium Share Allotment Bank (Transfer of application money to Capital A/C and Premium A/c on allotment of 20,000 shares as per Board's Resolution... Excess application money for 7,000 shares refunded and for 10,000 shares adjusted with allotment A/c)	4,44,000	1,60,000 80,000 1,20,000 84,000
3.	Share Allotment Share Capital (Allotment money of Tk. 8 per share due on 20,000 shares as per Board's Resolution dated.....)	1,60,000	1,60,000
4.	Bank Allotment-in-Arrear Share Allotment (Allotment money received on 19,700 shares after adjusting retained application money)	39,400 600	40,000
5.	Share Final Call Share Capital (Call money of Tk. 4 per share due on 20,000 share as per Board's Resolution dated)	80,000	80,000
6.	Bank Final Calls-in-Arrear Share Final Call (Final call money received with the exception of 500 shares)	78,000 2,000	80,000
7.	Share Capital Share Allotment-in-Arrear Share Final Call-in-Arrear Forfeited Share (500 shares forfeited after final call as per Board's Resolution dated.....)	10,000	600 2,000 7,400
8.	Bank Forfeited Share Share Capital (400 forfeited shares re-issued at Tk. per share as full paid up)	6,000 2,000	8,000
9.	Forfeited Share Share Capital (Profit for 40 re-issued shares transferred to Capital reserve A/c)	3,800	3,800

Bank Account

Dr.		Cr.	
Explanation	Tk.	Explanation	Tk.
Share Application	4,44,000	Share Application	84,000
Share Allotment	39,400	Balance c/d	4,83,400
Share Final Call	78,000		
Share Capital	6,000		
	<u>5,67,400</u>		<u>5,67,400</u>

Asha Ltd.
Balance Sheet as at

Capital and Liabilities	Tk	Properties & Assets	Tk.
Authorized Capital :	<u>6,00,000</u>		
30,000 shares of Tk. 20		Cash at Bank	4,83,400
Issued Capital :			
20,000 shares @ Tk. 20	<u>4,00,000</u>		
Subscribed & Paid up Capital			
19,900,000 Shares @			
Tk. 20, each	3,98,000		
Forfeited Share, A/c	1,600		
Share Premium	80,000		
Capital Reserve	3,800		
	<u>4,83,400</u>		<u>4,83,400</u>

Note: (1) Calculation of Capital Reserve

Profit on forfeiture of 500 Shares =	Tk. 7,400
(See Journal No. 7)	
Less money for 100 shares not reissued	<u>1,600</u>
[100 x (20-4)]	5,800
Less: loss on 400 shares re-issued	<u>2,000</u>
(See Journal No. 8)	
Bal. transferred to Capt. Reserve	<u>3,800</u>

Note: (2) Balance of forfeiture Account =
 7,400 - (2,000+3,800) = 1,600

Lesson-5: Redemption of Preference Share

Lesson Objectives

After you have studied this lesson, you will be able to:

- know the sources of redemption of preference share.
- know the journal entries necessary for redemption.
- have an idea to the practice of redemption of preference share.

7.5.1 Introduction

Preference shares can be classified into redeemable and non-Redeemable. In case of redeemable shares a number of methods and procedure can be followed. This lesson will deal with matters relevant to redemption of preference share.

7.5.2 Redemption of Preference Share

Generally company cannot purchase its share. It can, on the permission of the court, refund the share money to its shareholder. In this regard provisions incorporated in the Companies Act must be followed. A company can issue preference share and can redeem the same when possible and desirable. For this following conditions are to be satisfied:

- (i) Share cannot be redeemed unless it is fully paid
- (ii) It can be redeemed from:
 - a) Profit available for distribution
 - b) Sale of new share
 - c) Sale of property of the company.

a) Redeemed from Profit

If redemption of preference share is made from divisible profit then amount corresponding to face value of redeemable preference share be transferred to Capital Redemption Reserve Account. As Capital Redemption Reserve Account replace paid up capital there is restriction on its use. Thus, procedure relevant to capital reduction need to be followed. It is to be noted that if shares are redeemed at premium, the same amount must also be provided before redemption is made.

b) Redeemed from Sale of New Shares or Sale of Property

There is no restriction as to redemption of preference share from sale of new shares or sale of property of the company. But if the shares are to be redeemed at premium then unless the premium amount is made available from profit or premium account of the company, the redemption can not be made.

Provisions incorporated in the Companies Act must be followed on redemption of preference shares.

7.5.3 Relevant Journal Entries

- i) When preference share is redeemed from divisible profit, General Reserve or Sinking Fund for Redemption of Preference Share:

Profit &..... Dr.
 General Reserve Dr.
 Sinking Fund for Redemption of Pref. share..... Dr.
 Capital Redemption Reserve Account..... Cr.

- ii) When Preference share will be redeemed at premium:

Profit & loss Dr.
 General Reserve Dr.
 Share Premium Dr.
 Sinking Fund for Redemption of Pref. share..... Dr.
 Premium for Redemption of Preference share Cr.

- iii) For transferring preference share and premium to preference shareholders account:

Redeemable Pref. share capital Dr.
 Premium for Redemption of Pref. share..... Dr.
 Redeemable pref. share holder Cr.

- iv) When new shares are issued for redemption of preference share:

Bank Account Dr.
 Share Capital Cr.

- v) When shares are redeemed:

Redeemable Preference shareholders Account ... Dr.
 Bank Account Cr.

Illustration-7.06:

Show journal entries in the books of a company for redemption of preference share in the following circumstances:

- Company redeems 10%, 10,000 preference share of Tk.10/- at par.
- Company redeems 10%, 10,000 preference share of Tk.10/- at a premium of 10% from divisible profit.
- Company redeems 10%, 10,000 preference share of Tk.10/- at a premium of 10% by issue of 10,000 equity shares Tk.10/ each.
- Company redeems 10%, 10,000 preference share of Tk.10/- at a premium of 10% by issue of 10,000 equity such of TK 10 each at a premium of 10%
- Company redeems 10%, 10,000 preference share to Tk.10/- at a premium of 10% by issue of 5,000 equity of Tk.10 each at a premium of 10%. There is a credit balance of Tk.2,50,00/- in the profit and loss account of the company.

Solution**Journal Entries**

Date	Account Titles & Explanation	L.F.	Debit Tk.	Credit Tk.
(a)	(i) Profit and Loss Capital Redemption Reserve (For transfer of the amount to Capital Redemption to pay of pref. share holders)		1,00,000	1,00,000
	(ii) Redeemable Pref. share capital Redeemable pref. shares holder (For transfer of capital to shareholders account)		1,00,000	1,00,000
	(iii) Redeemable Pref. shareholder Bank (For payment of the money)		1,00,000	1,00,000
(b)	(i) Profit and Loss Capital Redemption Reserve (For transfer of the amount to capital redemption A/c)		1,00,000	1,00,000
	(ii) Profit and Loss Premium on Redemption of pref. share (For transfer of premium from P/L Account)		10,000	10,000
	(iii) Redeemable pref. share capital Premium on Redemption of pref. share Redeemable Pref. shareholder (For tr. of capital and premium)		1,00,000 10,000	1,10,000
	iv) Redeemable pref. shareholders Bank		1,10,000	1,10,000
(c)	(i) Bank Equity share capital (For sale of equity share)		1,00,000	1,00,000
	(ii) Profit and Loss Premium on Redemption of Preference share (For transfer of Premium from P/L Account)		10,000	10,000
	iii) Pref. share capital Premium on Redemption of pref. share Redeemable pref. shareholder (For transfer of capital of premium)		1,00,000 10,000	1,10,000
	iv) Redeemable pref. shareholder Bank (For payment of pref. shareholder)		1,10,000	1,10,000
(d)	i) Bank Equity share capital Share Premium (For sale of share at a premium of 10%)		1,10,000	1,00,000 10,000
	ii) Share Premium Premium on Redemption of preference share (For transfer of premium)		10,000	10,000
	iii) Pref. share capital Premium on Redemption of pref. share Redeemable pref. shareholder (For transfer of capital of premium)		1,00,000 10,000	1,10,000

Date	Account Titles & Explanation	L.F.	Debit Tk.	Credit Tk.
	iv) Redeemable pref. shareholder Bank (For payment of pref. shareholder)		1,10,000	1,10,000
(e)	i) Bank Equity share capital Share premium (For sale of 5,000 share at a premium of 10%)		55,000	50,000 5,000
	ii) Share premium Premium on Redemption of pref. share (For transfer of premium)		5,000	5,000
	iii) Profit and Loss Capital Redemption Reserve A/c (For transfer of balance amount from P/L A/c for redemption of pref. share)		55,000	55,000
	iv) Pref. share capital Premium on Redemption of Pref. capital Redeemable pref. share holder (For transfer of capital and premium)		1,00,000 10,000	1,10,000
	v) Redeemable pref. shareholder Bank (For payment of shareholders)		1,10,000	1,10,000

Lesson-6: Bonus Shares

Lesson Objectives

After you have studied this lesson, you will be able to:

- state what is meant by Bonus share.
- know the accounting entries necessary to record the issue of Bonus share.
- understand the meaning and significance of right issue.

7.6.1 Introduction

When company accumulates large reserve out of profits and is in excess of present need or when cash resources of a company are inadequate or when company wants to build up funds for expansion and these does not want to distribute dividend in cash, in such situations company can resort to issue Bonus shares. These shares are issued without cash consideration. This lesson will deal with the concept of bonus shares, circumstances when such shares can be issued along with recording procedures thereof.

7.6.2 Meaning of Bonus Share

Bonus shares are the shares that are allotted to equity shareholders without any consideration being received from them.

Bonus shares are the shares that are allotted to equity shareholders without any consideration being received from them. Bonus signifies on extra dividend paid not in cash but in kind, i.e. some bonus shares are issued to the shareholders through the process of capitalization of accumulated reserve or profits otherwise available for cash dividend. So, such shares are issued to capitalize profits of the company and that it can be issued only if Articles of Association of the company permits issue of such shares. In fact (i) When reserve or accumulated profit is considered excess than required or (ii) When liquidity of the company is not satisfactory, than it can issue bonus shares from its profit. It can be issued in two ways, viz.,

- (i) Issue of shares to the existing shareholders without any consideration.
- (ii) Making partly paid up shares into fully paid up shares.

7.6.3 Accounting Entries for Bonus Shares

On issue of bonus shares, Reserves of any sort which are used for this purpose, Share premium, if any, Profit loss appropriation Account balance etc. are debited and Bonus to Equity shareholder Account is credited with amount for which bonus shares are issued. In the next stage, Bonus to Equity shareholder Account is debited and Equity share capital is credited with that amount.

Specimen of Journal Entries

(A) When Bonus shares are issued without consideration

Transactions	Account Titles	Remarks
i) When Bonus is declared	Share Premium Capital redemption Reserve Capital Reserve General Reserve Any other Free Reserve A/c Profit & Loss Appropriation Bonus Dividend (Being the Bonus dividend declared out of .. A/c as per share holders' Resolution no.... dated)	With amount used from each of the fund. (Here only relevant fund will be debited)
ii) When Bonus share is issued at par	Bonus Dividend Share Capital (Being the issue of bonus shares of Tk..... per share)	For credit to share Capital
iii) When Bonus share is issued at premium	Bonus Dividend Share Capital Share Premium (Being the issue of Bonus share of Tk..... each at a premium of Tk..... per share)	Share capital = Face value Premium = Premium as decided

B) When partly paid up share are made fully paid up:

Transactions	Account Titles	Remarks
i) When call is made	Share Final call Share Capital (Being the call made on.... share of Tk....each @ Tk. per share as per board's Resolution No.... dated....)	For call money
ii) When Bonus is declared	General Reserve Profit & Loss Appropriation Any other Free Reserve Bonus dividend (Being the Bonus dividend declared out of... A/c as per share holders' Resolution on... dated.....)	With amount used for each fund
iii) When call is made up with Bonus share	Bonus Dividend Share Final call (Being the utilization of Bonus dividend towards payment of the call of Tk. per share.)	For meeting the call

Illustration-7.07

The Balance sheet of X Ltd. on 31st March, 2023 was as follows:

Capital And Liabilities	Taka	Property and Assets	Taka
Share Capital :			
2,400 shares of Tk. 100 each	2,40,000	Sundry Assets	5,75,000
Share Premium	50,000		
Reserve Fund	1,80,000		
Profit and Loss Account	60,000		
Sundry Creditors	45,000		
	5,75,000		5,75,000

The company decided to issue Bonus shares at the rate of 3 shares for every 4 shares held at a premium of 10% and decide for this purposed, to utilize the Reserve and the balance out of Profit and Loss Account. Shares are quoted at Tk. 133 on the date of allotment of Bonus Shares.

Required:

- Give the Journal to give effect to the above transactions.
- Prepare amended Balance Sheet.

Solution:**In the Book of "X" Ltd.****Journal Entries**

Date	Account Titles & Explanation	L.F	Debit Tk.	Credit Tk.
	Reserve		1,80,000	
	Profit & Loss		18,000	
	Bonus Divided			1,98,000
	$\left(\frac{2,400 \times 3 \times 110}{4} \right)$			
	(As per resolution No. the amount of resource account & balance Tk.18,000 is used to declare bonus dividend)			
?	Bonus dividend		1,98,000	
	Share capital			1,80,000
	Share premium			18,000
	(For issue of Bonus share of Tk.100 each at Tk.110)			

Balance Sheet (After Issue of Bonus Share)

Capital and Liabilities	Taka	Property & Assets	Taka
Share Capital:		Sundry Assets	5,75,000
4,200 shares of Tk.100 each	4,20,000		
Share premium	68,000		
Profit & Loss Account	42,000		
Sundry Creditors	45,000		
	<u>5,75,000</u>		<u>5,75,000</u>

Illustration-7.08:

Arco Ltd. has resolved to utilize Tk.65,000 out of its Reserve fund in declaration of a bonus to the shareholder. The bonus, however, is to be applied to the extent of Tk.15,000 in payment of final call of Tk.3 per share on 5,000 shares of Tk.10 each; and to the extent of Tk.50,000 in the issue of 5,000 fully paid shares of Tk.10 each to the existing shareholder. Pass Journal entries to give effect to the resolution.

Solution:

A. For making partly shares into fully paid		
Account Titles & Explanation	Dr. Tk.	Cr. Tk.
1. Share final Call Share Capital (Final call due @ Tk. 3 per share on 5,000 shares)	15,000	15,000
2. Reserve fund Bonus dividend (Amount of bonus payable out of reserve fund)	15,000	15,000
3. Bonus dividend Share final call (Issue of bonus of Tk. 3 per share in making partly paid shares of fully paid)	15,000	15,000
B. For bonus share distribution		
4. Reserve fund Bonus Dividend (Bonus declares and approved under holders resolution dated.....)	50,000	50,000
5. Bonus dividend Share capital (Issue of 5,000 fully paid bonus share of Tk. 10 each to the present shareholders)	50,000	50,000

7.6.4 Right Issue

A company which has already issued shares wants to make further issue of shares, it is under a legal obligation to first offer the fresh issue to the existing shareholders unless the company has resolved otherwise by a

Right issue is an issue of shares in which the existing shareholders have a pre-emptive right to subscribe in new issue of shares.

special resolution. It is an issue of shares in which the existing shareholders have a pre-emptive right to subscribe in new issue of shares. Here two things must be remembered:

- i) The right of the existing share holders to purchase share from their company is transferable,
- ii) If the market price of the shares is higher than the amount at which the company offer right issue, the right to purchase from the company will carry a price.

Following illustration will make the point clear.

Illustration-7.09:

A company offers to its equity shareholders the right to buy one equity share of Tk.100 each at Tk.120 for every four equity shares of Tk.100 each held. Suppose the market value of one equity is Tk.150. Then the value of the right will be calculated as follows:-

	<u>Taka</u>
Market value of 4 equity shares Tk.150 × 4	= 600
Add Issue Price of 1 new equity share	= 120
Total price of 5 shares	= <u>720</u>
Value of one share = Tk. 720/5	= 144
The value of right = Tk. (150-144)	= 6

Alternatively, the whole process can be expressed in the form of the following formula also:

$$\begin{aligned} \text{Value of right} &= \frac{\text{New Shares}}{\text{Total Shares}} \times (\text{Cum right price} - \text{New issue price}) \\ &= \frac{1}{5}(150 - 120) = \frac{1}{5} \text{ of } 30 = \text{Taka } 6.00 \end{aligned}$$

Questions and Exercises

Self-Test Questions

1. The owners' in a corporation is commonly called:
(a) Capital (b) Stockholders' equity (c) Stockholders' investment
(d) All the above
2. The stockholders equity section in Balance Sheet may include:
(a) Discount on stock (b) Stock subscribed (c) premium on stock
(d) All the above.
3. Which of the following statements are correct:
(a) 5% of the face value of share is to be paid with application for share
(b) A 15 days notice is required for call
(c) Rate of discount for share may vary from 5 to 15 percent
(d) A 21 days notice be issued for payment of calls in area money.
4. Identify the statements that correctly state the situation.
(a) Directors of a company are empowered to re-issue forfeited share.
(b) Directors can reduce part of interest money on calls in area.
(c) Resorted capital indicates un-called capital.
(d) Shares cannot be redeemed unless it is fully paid.

Discussion Questions

1. What are the various types of share capital of a company?
2. Describe the different classes of shares into which Share Capital is usually divided.
3. Can shares be issued at a discount? If so, what are the provisions of the Companies Act, 1994 in this regard?
4. What is meant by issuing shares and debentures at a premium and at a discount? How should premiums and discounts be treated in books of a company?
5. How would calls in advance and calls in arrear be treated in books of accounts of a company?
6. What are the differences between a Shareholder and a Debenture holder?
7. When and why are shares forfeited? How should such forfeiture be dealt with in accounts?

8. What entries are made on re-issue of forfeited shares? How to deal with credit balance of forfeited shares account left after the re-issue of such shares?
9. What do you mean by Bonus share? Under what circumstance and for what purpose the bonus shares are issued?
12. What is a Preference share? What are its different Kinds? State the sources from which preference share can be redeemed.

Exercises

1. Pioneer Machinery Co. Ltd. had an authorized capital of Tk. 1,00,000 divided into 10,000 equity shares of Tk. 10 each. The company issued all the shares and the installments of payment for the shares were as follows: Tk. 2 on Application; Tk. 2 on Allotment; Tk. 3 on First call; and Tk. 3 on Final Call.

All the shares were subscribed by the public. Assuming all the moneys were duly received, show the Journal entries and the Ledger Accounts in the books of the company relating to the above issue of shares. Also draw up the opening Balance Sheet of the Company.

2. A limited company invited applications for 20,000 shares of Tk. 100 each at discount of 6 percent payable as follows: On application, Tk. 20; on allotment, Tk. 39. On first and final call, Tk. 35.

The applications received were for 18,000 shares and all of these were accepted. All moneys due were received except the first and final call on 200 shares which were forfeited. 100 shares were re-issued at the rate of Tk. 90 per share as fully paid.

Pass the necessary entries in the Cash Book and Journal of the Company. Also show the Company's Balance Sheet.

3. Toyota Ltd. issued 50,000 shares of Tk. 10 each at a premium of Tk. 2 per share payable as follows:

On Application Tk. 3 (on January 1, 2023)

On Allotment Tk. 6 (on February 1, 2023)

On First Call Tk. 2 (on May 1, 2023)

On Final Call Tk. 1 (on August 1, 2023)

The Company's Articles provided 6% p.a. interest on Calls-in-Arrear and 5% p.a. interest on Calls-in-Advance. Company received application for 40,000 shares for which all money were received on the due dates except that (i) holders of 2,000 shares paid the entire amount due along with Allotment, (ii) a holder of 100 shares paid the amount due on Final Call with the amount due on First Call. Cash in respect of interest on Calls-in-Arrear or Calls-in-Advance was neither received nor paid.

Set up Journal entries in Journal proper and cash book to record the above transaction and also prepare the Balance Sheet.

4. Alpha Company Ltd. registered with Tk. 60,000 capital of Tk. 10 per share. The Company issued 4,000 shares of Tk. 10 each at a discount of Tk. 1 per share, payable as follows: Tk. 20 on application; Tk. 3 on allotment and Tk. 4 on call. Company received applications for 5,000 shares of which application for 4,000 share duly allotted. Application for 400 shares were rejected and money on these shares were returned to the respective applicants.

Excess application money for the rest shares was retained to be credited and adjusted to allotment account. Allotment money of all the shares was duly received. On call Company received money on 3,600 shares and money on 400 shares remained unpaid.

Prepare necessary journal and ledger account to record the above transactions and show how these will be shown in the Balance Sheet of the Company.

5. Era Co. has an authorized capital of Tk. 1,20,000 in shares of Tk. 10 each. Of these 9,000 shares were subscribed by the public, payable Tk. 4 on application, Tk. 2 on allotment, Tk. 2 on 1st call and Tk. 2 on final call. The amounts received in respect of these share were as follows:

On 7,000 shares Tk. 10 per share.

On 1,250 shares Tk. 8 per share

On 500 shares Tk. 6 per share

On 250 shares Tk. 4 per share

The directors forfeited 750 shares on which less than Tk. 8 per share has been paid. These shares were subsequently re-issued as fully paid @ Tk. 8 per share.

Enter these transactions in the books of the company and prepare the Balance Sheet.

6. Chand Traders Limited was floated on March 1. At September 1 after a first call of Tk. 2, its Balance Sheet was as follows:

	Taka		Taka
Share capital		Cash at Bank	4,800
1,000 shares of 6,000		Discount on shares at	
Tk. 10 (Tk. 6 called)		Tk. 1 per share	1,000
Less : Arrears on 200			
first call, 100 shares	5,800		
at Tk. 2			

On October 1, the owner of 30 shares with arrears paid Tk. 60.

On October 1, the remaining 70 shares with arrears were forfeited.

On November 1, the forfeited shares were reissued to Mr. Alam at Tk. 5 per Share.

On November 2, Mr. Alam pays the money due.

On December 1, the company made a final call of Tk. 4 per share and receive money in full on December, 15.

Show the transaction in the company's Journal and draft a Balance Sheet after they are recorded.

7. "X" Ltd. Co. has an authorized capital of Tk. 10,00,000 in Tk. 100 shares. Of these, 2,000 shares were issued as fully paid in payment of a Machinery purchased, 500 shares were issued as fully paid to promoters (without payment) and the rest of the shares were offered for public subscription. Public reception was not very encouraging and the directors after fulfilling legal requirements, offered these shares to be issued at a discount of 5% payable as follows:

	<u>Tk.</u>
On Application	20
On Allotment	25
On First and final call	50

Applications received were for 5,000 shares. All moneys due were received except the first and final calls on shares. These shares were forfeited, 100 of these shares were later on re-issued @ Tk. 90 as fully paid.

Assuming that all requirements of the law were complied with, pass entries in the Cash book and Journal of the Company. Also show how these transactions will be shown in the Company's Balance Sheet.

8. Rupali Limited invited applications for 2,00,000 of its ordinary shares of Tk. 10 each on the following terms:
- On application Tk. 4 per share;
 - On allotment Tk. 4 per share (including Tk. 2 premium);
 - On first call Tk. 2 per share;
 - On second and final call Tk. 2 per share.

Application for 2,50,000 shares were received. It was decided;

- (a) to refuse allotment to the applicants for 10,000
- (b) to allot in full to applicants for 40,000 shares;
- (c) to allot the balance of the available shares pro-rata among other applicants; and
- (d) to utilize excess application money in part payment of allotment money.

One applicant to whom shares had been allotted pro-rata basis did not pay the amount due on allotment and on call and his 200 shares were forfeited. The shares were reissued at Tk. 8 per share as fully paid.

Show Journal and Cash Book necessary to record the issue and also show the Balance Sheet.

9. A limited company was registered with a nominal capital of Tk. 2,00,000 in Tk. 10 shares. The company issued 5,000 shares payable on application Tk. 3, on allotment Tk. 4, on 1st call Tk. 2 and on final call Tk. 1 per share. Applications were received for all the shares and allotment was made for all the shares.

A, who held 50 shares, had paid only application money.

B, who held 40 shares, had paid application and allotment money.

C, who held 30 shares, had paid application, allotment and 1st call money.

All the calls were made and all the shareholders except A, B, and C had paid the full amount called. The directors took resolution to forfeit the shares of the above shareholders in default. The directors executed the decision after giving proper notice. Half the number of above forfeited shares were subsequently re-issued at a discount of Tk. 1 per share and they were fully paid for. Show the Journal and Cash Book entries and draw the Balance Sheet.

Bonus Shares

10. A limited company in one of its profitable years faced shortage of working capital. It proposes, in lieu of cash dividend, to issue Bonus shares at a premium of Tk. 0.25 per Tk. 1 share. The value of bonus shares was equal to the dividend that would have been paid if cash had been available.

Give your opinion from legal & professional view point on the proposal and show how you would deal with such transactions in the books of the company.

11. A Limited Company has resolved to utilize Tk. 45,000 out of its reserve fund in declaration of bonus to the shareholders. The bonus, however, is to be applied to the extent of Tk. 15,000 in payment of final call of Tk. 5 per share on 3,000 shares of Tk. 10 each; and to the extent of Tk. 30,000 in the issue of 3,000 fully paid shares of Tk. 10 each to the existing shareholders.

Show necessary entries in the books of the company.

12. The share capital of "X" company Ltd. is divided into 20,000 shares of Tk. 10 each. These shares were called up and paid to the extent of Tk. 8 per share. The balance of Reserve fund of the above company stood at Tk. 1,00,000. The company proposed to capitalize its Reserve fund in its general meeting and make the partly paid shares as fully paid up by issuing shares in proportion to their holding at a premium of Tk. 5.

Show Journal Entries for the above transactions and calculate at which proportion the shares were allotted to the present shareholders.

13. The Balance Sheet of Gama Ltd. on 31st December, 2023 was as follows:

	Taka		Taka
<i>Share Capital :</i>		Sundry Assets	4,35,000
2,000 shares of Tk. 100 each, Tk. 80 called up.	1,60,000		
Share Premium	60,000		
Reserve Fund	90,000		
Profit and Loss Account	80,000		
Creditors	45,000		
	4,35,000		4,35,000

The company decided to utilize the Share Premium, Tk. 50,000 out of Reserve Fund and the balance out of the Profit and Loss Account for making the existing shares fully paid up and to issue bonus shares at the rate of two bonus shares for every four shares held.

Give journal entries to give effect to the above and draw up the amended Balance Sheet.

Redemption of Preference Shares

14. The Balance Sheet of Best Ltd. as on 31st March, 2024 disclosed the following information:

Authorized Share capital:

5% Redeemable Preference Shares of Tk. 10 each.	1,50,000
Ordinary Shares of Tk. 10 each.	5,00,000

Paid up capital :

5% Redeemable Preference Shares of Tk. 10 each fully paid	1,10,000
Ordinary Shares of Tk. 10 each fully paid	3,00,000
Profit and Loss A/c	2,00,000

On 6th April 2024 the preference shares were redeemed at a premium of Tk. 4 per shares. The company could not yet trace holders of 1,200 preference shares. On 8th April, 2024 a bonus issue of one fully paid ordinary share for three shares held was made.

Show the Journal entries to record transactions (Including cash) and show these accounts as they would appear in the Balance Sheet as on 8th April, 2024.

15. The Issued and Paid-up Capital of XY Ltd. included 2000 8% Redeemable Preference shares of Tk. 100 each. The company decided to redeem the Preference shares at par. You are required to give journal entries separately in the following cases:
- (a) When the shares are redeemed out of profits.
 - (b) When the shares are redeemed out of the proceeds of new issue of Equity shares of Tk. 10 each at par.
16. A company has 8,000 redeemable preference shares of Tk. 100 each fully paid. The company decides to redeem the shares on 30th September, 2000 at a premium of 7%. The company has sufficient profits but in order to augment liquid funds the following issues are made:
- (a) 3,000 6% Debentures of Tk. 106.
 - (b) 2,000 Ordinary shares of Tk. 100 each at Tk. 111.

The issues were fully subscribed and all the amounts were received. The redemption was duly carried out. Give Journal entries, also explain what you understand by sufficient profits in this regard.

Lesson-7: Debenture Issue

Lesson Objectives

After you have studied this lesson, you will be able to:

- state the meaning of Debenture.
- distinguish between debenture and share.
- know the classification of debenture.
- have an idea as to entries necessary to record issue and redemption of debenture.

7.7.1 Introduction

In addition to issue of shares for permanent fund a company can borrow money on long term basis through the issue of debenture/Bond. Debenture may be issued to relatively few lending agencies or to a single investor or to the public depending on the circumstances and policy of the company. This lesson will deal with matters relevant to issue of debenture and its recording aspects.

7.7.2 Meaning of Debenture

Debenture represents the loan of a company on which the company is to pay interest at a fixed rate.

A debenture may be defined as an acknowledgment (mostly under seal of the company) of a debt or loan raised by a company containing a contract for the repayment of the principal amount at a specified date, and for the payment of interest at a fixed rate. A share capital of a company which is divided in a large number of parts, each part being called a share; almost in a similar way, when a loan is raised, a company may divide it in a large number of parts, each part being called a debenture. Debentures enable the company to raise a loan easily by enabling investors to buy as many debentures as they want. It is usual to prefix Debenture with annual rate of interest which is agreed to be given on it in percentage.

7.7.3 Distinctions between Debentures and Shares

The following are the points of distinctions between debentures and shares:

- (i) **Creditorship Security vs Ownership Security:** Whereas a debenture is a creditorship security, a share is an ownership security. It means that a debenture holder is a creditor of the company, while a shareholder is a part-owner of the company.
- (ii) **Certainty of Return:** A debenture holder is certain of return on his investment in the way of interest. The company has to pay interest on debenture at the fixed rate agreed upon at the time of issue even if it suffers heavy losses. A shareholder receives dividend; but a shareholder cannot get dividend if the company does not earn profit. As a matter of fact, even when a company earns a profit, its Directors may decide to plough back full or part of the profit and

not to declare dividend. Thus there is no certainty for equity share holder as to his return on investment in shares. But return is certain for debenture holder on his investment.

- (iii) **Order of Repayment on Winding up:** In case of winding up of company, a debenture holder, even if unsecured, will always rank for repayment in full before the shareholder of any class.
- (iv) **In the books of accounts:** Interests on debentures are the charge against profits shown under 'secured loan' in the Company Balance Sheet. On the other hand, dividends on shares are appropriation of profits and are not deductible in determining taxable profit of the company; and shown under 'Share Capital' in the Company Balance Sheet.
- (v) **Control of the Company:** Shareholders can extend a controlling hand in the management of the company by selecting directors through voting at the general meeting but debenture holders do not enjoy such right.

7.7.4 Classification of Debentures

Debenture may be classified into different types. From the view point of security it can be divided into two:

- i) **Simple/Ordinary, Unsecured or naked Debenture:** When debenture is issued without giving mortgage of any property, it is called simple or ordinary debenture. In this types company merely promises to pay interest on due dates and to repay the amount due on maturity date.
- ii) **Mortgage or Secured Debenture:** When debenture is issued by keeping any asset as mortgage against it, it is called mortgage or secured debenture. This can be of two types, viz. Mortgage debenture of fixed charge- when a definite asset is given mortgage; Mortgage debenture of floating charge- when assets are not fixed against the mortgage rather a floating charge is given.

Further, on the basis of payment/redemption, debenture may be classified into two, viz.:

- i) **Redeemable Debenture:** When debenture will be repaid i.e. redeemed on the happening of certain event or after a definite time, it is called redeemable debenture.
- ii) **Irredeemable Debenture:** When company is not bound to redeem debenture except on the eve of dissolution or failure to pay interest regularly, this is called irredeemable debenture. As this type of debentures are not generally repayable during the life time of the company, this is also called perpetual debentures.

Debenture can further be divided into Registered or Unregistered; Convertible or non-Convertible into shares, etc.

7.7.5 Journal Entries for Issue of Debenture

Debenture are issued in the same manner as shares. They may be issued through invitation in a prospectus. It may be payable in full at a time or through instalment. Further, it may be issued at par or at discount. The usual journal entries as to issue of debenture may be as follows:

(a) In case of issue of Debentures payable in full at a time :

Transactions	Account Titles	Explanation
(1) When Debentures are issued at par and are redeemable at par :	Cash or Bank Debentures <i>(With face value)</i>	Being cash received in full on debentures issued at par.
(2) When Debentures are issued at a premium but are redeemable at par :	Cash or Bank <i>(With amount received)</i> Debentures <i>(With face value)</i> Premium on Issue of Debentures <i>(With Premium)</i>	Being Cash received in full on debentures issued at a premium of Tk..... per Debenture.
(3) When Debentures are issued at a discount but are redeemable at par:	Cash or Bank <i>(With Amount received)</i> Discount on Issue of Debentures <i>(With discount)</i> Debenture <i>(With face value)</i>	Being cash received on Debentures issued at a discount of Tk.....per Debenture.
(4) When Debentures are issued at par but are redeemable at a premium :	Cash or Bank <i>(With amount received)</i> Loss on Issue of Debentures <i>(With difference between the amount to be paid redemption and the amount received)</i> Debentures <i>(With face value)</i> Premium on Redemption of Debentures	Being cash receive on debenture issued at par of Tk.... and redeemable at a premium of Tk..... Per debenture.
(5) When Debentures are issued at a discount but redeemable at a premium :	Cash of Bank <i>(With amount received)</i> Loss on issue of Debentures <i>(With difference between the amount to be paid on redemption and the amount received)</i> Debentures <i>(With face value)</i> Premium on Redemption of Debentures <i>(With premium)</i>	Being cash receive on debenture issued at a discount of Tk.... per Debenture and redeemable at a premium Tk..... per Debenture.

(b) In Case of issues Debenture payable in installment

Transactions	Account Titles	Explanation
(i) When application are received	Cash or Bank Debenture Application	(Being money received on application @ Tk..... Per application.)
(ii) On allotment	Debenture Application Debenture	(Being application money transferred)
(iii) On return of surplus application money	Debenture Application Cash/Bank	(Being Surplus application rejected and money refunded.)
(iv) On transfer of surplus application money to allotment money	Debenture Application Debenture Allotment	(Being surplus money on application transferred to allotment A/c)
(v) For money due on allotment	Debenture Allotment Debenture	(Being money due on allotment)
(vi) On accept of allotment money	Cash or Bank Debenture Allotment	Being money received for allotment)

Like way entry for call money will appear and on receipt of call money entry will be passed. Students can recall the procedure applied for share issue.

Illustration-7.10:

Alpha Ltd. issued 2,000 7% Debenture of Tk. 100 each. Money is payable as follows:

On application Tk. 50

On allotment Tk. 50

Application was received for 3,000 debenture out of which 1600 application were given allotment in full, application for 1000 were allotted 400 debenture and remaining application were rejected and money refunded. All sums due were received in time. Show Journal (entries) and Balance sheet.

Solution:**In the Book of Alpha Ltd.****Journal Entries**

Date	Account Titles & Explanation	L.F.	Debit Tk.	Credit Tk.
	Bank 7% Debenture Application (Being application money on 3,600 received)		1,80,000	1,80,000
	7% Debenture Application 7% Debenture 7% Debenture Allotment Bank (Being allotment of 2,000 debenture-application money of 600 debenture transferred to allotment application money of 1000 application refunded)		1,80,000	1,00,000 30,000 50,000

Date	Account Titles & Explanation	L.F.	Debit Tk.	Credit Tk.
?	7% Debenture Allotment 7% Debenture (Being allotment money due)		1,00,000	1,00,000
	Bank 7% Debenture Allotment (Being allotment money on 1,400 received)		70,000	70,000

Lesson-8: Redemption of Debenture

Lesson Objectives

After you have studied this lesson, you will be able to:

- understand the sources from which debenture can be redeemed.
- know the accounting treatment of redemption of debenture.

7.8.1 Introduction

Debenture/Bond can be redeemed as per agreement and required procedure. The fund required for such redemption can be procured from various sources. This lesson deals with these aspects of Debenture redemption.

7.8.2 Redemption of Debenture

Debenture may be redeemed. In this case a number of conditions may be attached, such as, debenture issued at par and redeemable at par, debenture issued at discount or premium and redeemable at par, etc. Following section shows entries in such case with a specimen example.

7.8.3 Different Sources of Redemption of Debenture

There are a number of ways through which money can be procured for redemption of debenture. Such as:

- i) From capital raising:
 - (a) Through issue of new shares or sale of new debenture
 - (b) By converting new debenture into new shares/debenture
 - (c) By sale of asset of a company
- (ii) From profit of the company:
 - (a) From profit through lottery i.e. by selecting a specified portion of Debentures through lottery (using profit of the relevant year)
 - (b) By taking insurance policy for fixed period.
 - (c) From accumulated reserve of profit and by creating sinking fund.

In this connection it may be mentioned that debenture may be redeemed at a loss and this loss can be recouped from profit on next some period.

An example to this end is now followed.

7.8.4 Journal Entries for Redemption of Debenture

- (1) When Debentures are issued at par and are also redeemable at par :-

Bank	Dr.	} With the nominal value of debentures.
Debentures	Cr.	

- (2) When debentures are issued at a discount, but are redeemable at par :-

(a) Bank	Dr.	} (a) Actual amount received
(b) Discount on Debentures	Dr.	
Debentures	Cr.	
		(b) Discount allowed.
		Nominal value of debentures.

- (3) When debentures are issued at a premium, but are redeemable at par :-

Bank	Dr.	}	Actual amount received.
Debentures (a)	Cr.		Nominal value of Debentures (a)
Premium on Debentures (b)	Cr.		Premium (i.e. extra amount) (b)

- (4) When debentures are issued at par (or at a discount), but are redeemable at a premium (that is to say, when at the time of repayment something extra will have to be paid):

(a) Bank	Dr.	}	(a) Actual amount received.
(b) Loss on Issue of Debentures	Dr.		(b) Difference between the total amount repayable and the amount received.
Debentures Account (c)	Cr.		Nominal value of debentures.
Premium on Redemption of Debentures (d)	Cr.		(c) The extra amount payable on redemption. (d)

It is to be noted that the "Premium on Redemption of Debentures Account" should be credited only when it is certain that the premium will be repayable. (This account represents a liability).

Illustration-7.11

Beta Limited issues 10,000 eight percent Debentures of Tk. 100 each. Give journal entries if the debentures are (1) issued at par, (2) issued at a discount of ten per cent and (3) issued at a premium of ten per cent (redemption being in all these cases at par.)

Also show the entries which will be made if the Debentures are repayable at a premium of five percent but are issued (a) at par, and (b) at a discount of ten per cent.

In each case show how the figures will appear in the Balance Sheet.

Solution:

In the Book of Beta

(A) Debenture Redeemable at par:

	Account Titles & Explanation	L.F.	Dr.	Cr.
(1)	Issued at par : Bank To 8% Debentures (Being the issue of 10,000 8% Debentures at Tk. 100 each.)		Tk. 10,00,000	Tk. 10,00,000
(2)	Issued at discount : Bank Discount on Debentures 8% Debentures (Being the issue of 10,000 8% Debentures at Tk. 90 per Debentures.)		9,00,000 1,00,000	10,00,000
(3)	Issued at a premium : Bank 8% Debentures Premium on Debentures (Being the issue of 10,000 8% Debentures of Tk. 100 each at Tk. 110 per Debentures.)		11,00,000	10,00,000 1,00,000

(B) Debenture Redeemable at a premium of 5%

(a)	Issued at par : Bank Loss on Issue of Debentures 8% Debentures Premium on Redemption of Debentures [Being the issue of 10,000 8% Debentures at Tk. 100 each (redeemable at Tk. 105) issued at par.]		<u>Tk.</u> 10,00,000 50,000	<u>Tk.</u> 10,00,000 50,000
	Issued at discount of 10%: Bank Loss on Issue of Debentures 8% Debentures Premium on Redemption of Debentures (Being the issue of 10,000 8% Debentures of Tk. 100 @ Tk. 90 each.)		9,00,000 1,50,000	10,00,000 50,000

BALANCE SHEET OF BETA LTD.

Debentures redeemable at Par:

Liabilities	Tk.	Assets	Tk.
(1) Issued at par : 8% Debentures	10,00,000	Cash at Bank	10,00,000
(2) Issued at a discount of 10% : 8% Debentures	10,00,000	Cash at Bank	9,00,000
	10,00,000	Discount on Debentures	1,00,000
			10,00,000
(3) Issued at a premium of 10% : 8% Debentures Premium on Redemption	10,00,000 1,00,000	Cash at Bank	11,00,000
	11,00,000		11,00,000

BALANCE SHEET

Debentures redeemable at premium of 5%:

Liabilities	Tk.	Assets	Tk.
(1) Issued at par : 8% Debentures Premium on Redemption of Debentures	10,00,000 50,00,000	Cash at Bank Loss on Issue of Debentures	10,00,000 50,000
	10,50,000		10,50,000
(2) Issued at a discount of 10% : 8% Debentures Premium on Redemption of Debentures	10,00,000 50,000	Cash at Bank Loss on Issue of Debentures	9,00,000 1,50,000
	10,50,000		10,50,000

Illustration-7.12

Issue at discount and redeemed at premium Gama Ltd. issued 600 Debenture bonds of Tk.1,000 each at a discount of 5% repayable after 5 years at a premium of 5%.

Journalize the transactions relating to issue of Debentures and give the Loss on Issue of Debentures Account in the books of the Company over the period.

Solution:

Gama Co. Ltd.
Journal Entries

Date	Account Titles & Explanation	L.F	Dr.	Cr.
			<u>Tk.</u>	<u>Tk.</u>
	Bank		5,70,000	
	Loss on Issue of Debentures		60,000	
	6% Debentures			6,00,000
	Premium on Redemption of Debentures			30,000
	(Being the issue of 600 6% Debenture Bonds of Tk. 1,000 each issued at a Discount of 5% repayable after 5 year's at a Premium of 5% according to Board's Resolution No.....dated....)			

LOSS ON ISSUE OF DEBENTURES ACCOUNT

Dr.				Cr.			
Years		Tk.	Years		Tk.		
I	Sundries	60,000	I	Profit & Loss A/c	12,000		
				Balance c/d	48,000		
		60,000			60,000		
II	Balance b/d	48,000	II	Profit & Loss A/c	12,000		
				Balance c/d	36,000		
		48,000			48,000		
III	Balance b/d	36,000	III	Profit & Loss A/c	12,000		
				Balance c/d	24,000		
		36,000			36,000		
IV	Balance b/d	24,000	IV	Profit & Loss A/c	12,000		
				Balance c/d	12,000		
		24,000			24,000		
V	Balance b/d	12,000	V	Profit & Loss A/c	12,000		
					12,000		
		12,000					

Illustration-7.13: Redemption of debenture through-drawing by lot

Q Ltd. made an issue of 1,000 6% Debentures of Tk. 500 each on 1st January, 2020 at the issue price of Tk. 480. The terms of issue provided that beginning with 2022 Tk. 20,00 Debentures should be redeemed either by purchase in the market or by drawings by lot at par. The

expenses of issue amounted to Tk. 4,000 which were written off in 2020. In 2021 and 2022 Tk. 5,000 was written off the Discount on Debentures.

In 2022, the company purchased Tk. 6,000 Debentures @ Tk. 470 on 30th September cum-dividend and Tk. 10,000 Debentures @ Tk. 475 ex-dividend on 30th November, the expenses being Tk.400. On 31st December the Debentures necessarily to be redeemed were paid off at par through drawings by lot. Assuming the interest is payable on 30th June and 31st December, give Journal Entries to record the above transactions including interest on debenture.

Solution:

**Q Ltd.
Journal Entries**

Date	Account Titles & Explanation	L.F.	Dr.	Cr.
			Tk.	Tk.
2020 Jan. 1	Bank Discount on Debentures 6% Debentures (Issue of 1,000 6% Debentures of Tk. 500 each at a discount of Tk. 20 each.)		4,80,000 20,000	5,00,000
"	Expenses on Issue of Debenture Bank (Payment of expenses of issue of debentures)		4,000	4,000
June 30	Debenture Interest Bank (Payment of interest on debentures @ 6% P.a. for 6 months.)		15,000	15,000
Dec. 31	Debenture Interest Bank (Payment of debenture interest for the half year ending 31st December, 1996.)		15,000	15,000
"	Profit & Loss Account Debenture Interest Expenses on Issue of Debenture (Transfer of debenture interest and expenses on issue of debentures to profit & Loss account.)		34,000	30,000 4,000
2021 June 30	Debenture Interest Bank (Payment of debenture interest for the half year ended 30th June, 1997.)		15,000	15,000
Dec. 31	Debenture Interest Bank (Payment of debenture interest for half year ended 31st December, 1997.)		15,000	15,000
"	Profit and Loss Account Debenture Interest Discount on Debentures (Transfer of debenture interest to profit & Loss Account; and the Discount on Debentures written off to the extent of 5,000)		35,000	30,000 5,000

Date	Account Titles & Explanation	L.F.	Dr.	Cr.
			Tk.	Tk.
2022	Debenture Interest		15,000	
June	Bank (Debenture Interest for half year due today paid in Cash.)			15,000
Sept. 30	6% Debentures		6,000	
	Debentures Interest		90	
	Bank			5,640
	Profit on Redemption of Debentures			450
	(Redemption of 12 debentures of Tk. 500 each at Tk. 470 each, cum-interest meaning a " saving" of interest for 5 month on the 12 debentures.)			
Nov. 30	6% Debentures		10,000	
	Debentures Interest		250	
	Bank			9,750
	Profit on Redemption of Debentures			500
	(Redemption of 20 debentures @ Tk. 475 per debenture ex-interest, i.e. interest paid for 5 months in addition to purchase price.)			
Nov. 30	Expenses on Redemption of Debentures			
	Bank		400	
	(Expenses on redemption of debentures paid in cash.)			400
Dec. 31	6% Debentures		4,000	
	Debentures Interest		120	
	Bank			4,120
	(Redemption of 8 debentures at par and payment of interest thereon.)			
"	Debenture Interest		14,400	
	Bank			14,400
	(Payment of half yearly interest on debentures of the face value of Tk. 4,80,000 remaining after redemption on debentures of the face value of Tk. 20,000).			
"	Profit & Loss Account		35,260	
	Debenture Interest			29,860
	Discount on Debentures			5,000
	Expenses on Redemption of Debentures			400
	(Transfer of debenture interest and expenses on redemption of debentures to Profit & Loss Account and the Discount on Debentures Account written off to the extent of Tk. 5,000.)			

Note: Profit on Redemption of Debentures can, alternatively, be used to write off the on redemption of debentures.

7.8.5 Use of Sinking Fund for Redemption of Debenture

A sinking fund may be created to collect fund for redemption of debentures after their specified life. It enables the company to redeem the debenture without upsetting its working capital. With the help of Sinking Fund Tables, an amount set aside every year out of the profits of the company ascertained. The annual installment so managed is then invested in some safe securities. The interest received on investments is also invested. When debentures are to be redeemed, the investments are sold out to provide cash for redemption.

A sinking fund may be created to collect fund for redemption of debentures after their specified life.

Entries in the case of a sinking fund for redemption of debentures are as follows:

<i>At the end of the first year :</i>	
(i) Profit and Loss Appropriation Debenture Redemption fund	With annual installment ascertained with the help of Sinking Fund Tables
(ii) Debenture Redemption Fund Investment Bank	With the amount of investments made
<i>In each of the subsequent Year (except the last year):</i>	
(i) Bank Interest on Debenture Redemption Fund Investment	with the amount of interest received on investments
(ii) Interest on Debenture Redemption Fund Investment Debenture Redemption Fund	Transfer of interest received to Sinking Fund
(iii) Profit & Loss Appropriation Fund Debenture Redemption Fund	with annual installment
(iv) Debenture Redemption Fund Investments Bank	with the amount invested
<i>In the last year :</i>	
(i) Bank Interest on Debenture Redemption Fund Investments	with interest received
(ii) Interest on Debenture Redemption Fund Investments Debenture Redemption Fund	Transfer of interest received
(iii) Profit & Loss Appropriation Debenture Redemption Fund	with annual installment
(iv) Bank Debenture Redemption Fund Investments	with sale process of all the investments
(v) For profit Debenture Redemption Fund Investments	Transfer of profit on sale of investments
Debenture Redemption Fund	Transfer of loss on sale of investments

For Loss	
Debenture Redemption Fund	
Debenture Redemption Fund Investment	Transfer of balance in Debenture
(vi) Debenture Redemption Fund	Redemption after redemption of debentures
General Reserve	

Note: In the above mentioned scheme of entries, Debenture Redemption Fund Account, Debenture Redemption Fund Investments Account and Interest on Debenture Redemption Fund Investments account may be named Sinking Fund Account, Sinking Fund Investment Account & Interest on Sinking Fund Investments Account respectively. The scheme may also be used to collect funds to repay any liability. The scheme is similar to the Depreciation Fund which is a sinking fund to replace a wasting asset.

Illustration-7.14:

On 1st April, 2019 X, Y and Z Limited issued 12% Debentures for Tk.50,00,000 at par redeemable at a premium of 2% after four years on 31st March 2023. To collect funds for redemption, the company decided to establish a Sinking Fund; investments which were to be made to the nearest taka were to earn interest @ 10% per annum. Sinking Fund Tables show that Tk.0.2155 invested every year for four years @ 10% per annum will accumulate Tk. 1.

On 31st March, 2023 the investments were sold at a loss of 1% and the debentures were duly redeemed for the four accounting years ended 31st March 2023. Entries relating to interest on debentures and for writing off Loss on Issue of Debentures Account need not be presented. All calculations may be made to the nearest taka.

Solution:

Amount to be collected for redemption:	<u>Taka</u>
Par Value of Debentures	5,00,000
Add: Premium @ 2% payable on redemption	<u>10,000</u>
Total	<u>5,10,000</u>
Annual installment = Tk. 5,10,000 x 0.2155 = Tk. 1,09,905	

Journal Entries

Date	Account Titles & Explanation	L.F	Dr.	Cr.
2019 April, 1	Bank Loss on issue of Debentures 12% Debentures Premium on Redemption of Debentures Account Issue of 12% Debentures of the face value of Tk.5,00,00 at par redeemable at a premium of 2%.		Tk. 5,00,00 10,000	Tk. 5,00,000 10,000
2020 Mar. 31	Profit & Loss Appropriation Debenture Redemption Fund Annual installment needed to build up a sinking fund of Tk.5,10,000 in four years.		1,09,905	1,09,905
"	Debenture Redemption Fund Investments Bank Investment of the Debenture Redemption Fund.		1,09,905	1,09,905
2021 Mar. 31	Bank Interest on Debenture Redemption Fund Investment Receipt of interest @ 10% per annum on Tk. 1,09,905.		10,991	10,991
"	Interest on Debenture Redemption fund Investments Debenture Redemption Fund Transfer of interest received to Debenture Redemption Fund.		10,991	10,991
"	Profit & Loss Appropriation Debenture Redemption Fund Annual installment credited to Debenture Redemption Fund.		1,09,905	1,09,905
"	Debenture Redemption Fund Investments Bank Investment of the annual installment and the interest received during the year.		1,20,896	1,20,896
2022 Mar. 31	Bank Interest on Debenture Redemption Fund Investments Interest received on total investment of Tk.2,30,801.		23,080	23,080
"	Interest on Debenture Redemption Fund Investments Debenture Redemption Fund Transfer of interest to Debenture Redemption Fund		23,080	23,080

Date	Account Titles & Explanation	L.F	Dr.	Cr.
2022 Mar. 31	Profit and Loss Appropriation Debenture Redemption Fund Annual installment credited to Debenture Redemption Fund		1,09,905	1,09,905
"	Debenture Redemption Fund Investment Bank Investment of annual investment and the interest received during the year		1,32,985	1,32,985
2023 Mar. 31	Bank Interest on Debenture Redemption Fund Investments Account Receipt of interest on total investments of Tk.3,63,786 @ 10%.		36,379	36,379
"	Interest on Debenture Redemption Fund Investments Debenture Redemption Fund Interest received transferred to Debenture Redemption Fund.		36,379	36,379
"	Profit and Loss Appropriation Debenture Redemption Fund Annual installment credited to Debenture Redemption Fund.		1,09,905	1,09,905
2023 Mar. 31	Bank Debenture Redemption Fund Investments Sale proceeds of investment		3,60,148	3,60,148
"	Debenture Redemption Fund Debenture Redemption Fund Investments Transfer of loss on sale of investments to Debenture Redemption Fund		3,638	3,638
"	12% Debentures Premium on Redemption of Debentures Account Sundry Debenture holders Payment to be made to Sundry Debentures holders to redeem 12% Debentures of the face value of Tk.5,00,000 at a premium of 2%		5,00,000 10,000	5,10,000
"	Sundry Debenture holder Bank Payment made to sundry debenture holders		5,10,000	5,10,000
"	Debenture Redemption Fund General Reserve Transfer of balance of Debenture Redemption Fund to General Reserve after redemption of debentures.		5,06,432	5,06,432

Questions and Exercises

Self-Test Questions

1. Which of the statement represent actual situation:
 - (a) Interest on debenture is a charge against profit
 - (b) Interest on debenture fluctuate with the level of profit
 - (c) Only secured debenture will rank for payment in full at winding up of a company.
 - (d) Debenture holder can take part in the decision making life shareholders in the general meeting of the company.
2. Which of the following statement is incorrect:
 - (a) Debenture can be redeemed through issue of new debenture or share or sale of an asset
 - (b) Sinking fund can be created for redemption of debenture
 - (c) Debenture is always redeemable
 - (d) Company will pay interest on debenture as per recommendation of the directors.
3. If a corporation plans to issue Tk.2,00,000, 9% Debenture at a time when market rate for similar instruments is 8%, the debenture can be expected to sell:
 - (a) at the face value
 - (b) at a premium
 - (c) at a discount
4. If a concern purchase Tk.1,00,000 debenture of a company at 101 plus accrued interest of Tk.3,000 at pays broker's commission of Tk.100, the amount desisted to investment on the company in debenture would be:
 - (a) Tk.1,00,000
 - (b) Tk.1,01,100
 - (c) Tk.104,000
 - (d) None of the above.
5. Which of the following source/sources can be used for redemption of debenture:
 - (a) New issue of shares
 - (b) Converting old debenture into new debenture
 - (c) Share premium
 - (d) From accumulated profit
 - (e) For capital reserve

Discussion Questions

1. What is meant by Debenture? What are its different kinds? What are the different sources of redemption of debenture?
2. Distinguish between:
 - (a) Secured and unsecured debenture
 - (b) Redeemable and non-redeemable debenture
 - (c) Registered and unregistered debenture.
3. State two methods of redemption of debenture.
4. Distinguish between shares and debenture and shareholder and debenture holder.
5. What is sinking fund for redemption of debenture? Show entries necessary for redemption of debenture under sinking fund method.

Exercises

1. Arang Company Ltd. issued 2,000, 6% Debentures of Tk.100 each at a discount of 5% payable as 40% on application and the balance on allotment. Applications for 2,500 debentures were received out of which debentures were allotted at the rate of 4 debentures for every 5 debentures applied for, and Tk.100,000 was refunded to applicants for 250 debentures. All sums due were received on due date. Journalize and also show the Balance Sheet.
2. Show what Journal Entries will be made and how the relevant items will be disclosed in the Balance Sheet in the following cases:-
 - (a) Mathews Ltd. issued at par 6,000, 12% Debentures of Tk.100 each to be redeemable at par.
 - (b) Hagi Ltd. issued Tk.2,00,000 Debentures (14%) at per, but redeemable at the end of 8 years at 110%.
 - (c) Basten Ltd. issued Tk.10,000, 8% Debentures of Tk.10 each at a discount of 6% to be redeemed at the end of 10 years.
 - (d) Pele Ltd. issued Tk.6,00,000 Debentures (13%) at a discount of 10% to be repaid at a premium of 5% at the end of 7 years.
 - (e) Mitchel Ltd. issued 14% Debentures of the face of Tk.5,00,000 at a premium of 10% to be redeemed at par.
3. Simuitra Ltd. issued 4,000, 8% Debentures of Tk.50 each at a premium of 10%. The issued was fully subscribed. Money was payable as follows:

Application	Tk.5
Allotment	Tk.20 (including premium)
First call	Tk.30
Balance on final call.	

According to the terms of issue payment could be made in full on allotment. Interest at a flat rate on any amounts prepaid being allowable at 3%. Such interest was payable by the company on 31st December, the allotted of one half of the debentures took advantage of the pre-payment terms. The others paid on due dates. Journalize the transactions.

4. Nabin Ltd. issued 5% Debentures on 1st January 2024 as follows:

	<u>Taka</u>
(i) To Sundry persons for cash at 90 percent	5,00,000 Nominal
(ii) To a creditor for Tk.45,000 in satisfaction of his claims.	50,000 Nominal
(iii) To Bank as collateral security against a loan of Tk.1,00,000	50,000 Nominal

The issue (i) and (ii) are redeemable at the end of 5th year at a premium of 10%. Show necessary Journal entries at the first year.

5. Sumitra Ltd. issued 4,000, 8% Debentures of Tk.50 each at a premium of 10%. The issue was fully subscribed. Money was payable as follows:

Application	Tk.5
Allotment	Tk.20 (including premium)
First Call.	Tk.30

All dues were received in time. Show journal entries to give effect to the above actions.

Redemption of Debentures

7. 100, 10% Debentures of Tk.1,000 each have been issued by Pioneer Ltd. at Tk.990 each to be redeemed at Tk.1,010 each after 5 years. Calculate the amount to be debited to Profit and Loss Account at the end of first year in respect of these debentures.
8. A company issued 1,000, 8% Debentures of Tk.100 each repayable after 5 years with a premium of 5%. They were issued at a discount of 4%.

You are required to show the related ledger accounts assuming that a Sinking Fund had been raised to earn interest @ 5% per annum. It is given that Tk.1 per annum would accumulate to Tk.5,5256.

9. In order to facilitate the redemption the preference shares the company took the following decision:
- (i) To sell the investments for Tk.15,000
- (ii) To finance part of the redemption from the company's fund, subject to leaving a balance of Tk.10,000 in the Profit & Loss Account

(iii) To issue sufficient equity shares at a premium of Tk.2.50 per share to raise the balance of funds necessary.)

The preference shares were redeemed on the due date and the issue of equity shares was fully subscribed.

Give necessary Journal Entries including Cash and the Balance Sheet on payment of Redeemable Preference Share money.)

10. Q Ltd. made an issue of 1,000, 6% Debentures of Tk.2,500 each on 1st January, 2020 at the issue price of Tk.480. The terms of issue provided that beginning with 2022 Tk.20,000 Debentures should be redeemed either by purchase in the market or by drawings by lot at par. The expenses of issue amounted to Tk.4,000 which were written off in 2020. In 2021 and 2022 Tk.5,000 was written off the Discount on Debentures.

In 2022 the company purchased Tk.6,0000 Debentures @ Tk.470 on 30th September cum-dividend and Tk.10,000 Debentures @ 475 ex-dividend on 30th November, the expenses being Tk.400. On 31st December the Debentures necessarily to be redeemed were paid off at par by drawings by lot. Assuming the interest is payable on 30th June and 31st December, give Journal Entries to record the above transactions including interest on debentures.

Case Study

1. North-South Company Ltd.

North-South Company Ltd. is a public limited Company with an authorized capital of Tk.2,50,00,000 of shares of Tk.50/- each. The paid up capital is Tk.1,50,00,000. The company is engaged in producing power tiller and its registered office is at Khulna.

Management

The management of the company is vested to the Board of Directors composed of seven members. The day-to-day administration is looked after by Managing Director assisted by divisional managers and other supporting staff.

Operation & Financial result

The company in last 5 years produced 66,000 power tillers and earned profits as follows:

	Production	Sales	Profit
2019	10,000 unit	9,000	Tk.7,50,000
2020	12,000	10,000	12,00,000
2021	13,000	11,000	11,50,000
2022	15,000	13,000	12,20,000
2023	16,000	14,500	11,00,000

Public Offering of Shares

The directors of the company have expressed pleasure in a meeting of the board by the way things are going on at the company and resolved to lower the debt-equity ratio by making a large public offer to obtain funds to finance the expansion program to be given effect to in the following year and thus ensure larger involvement of people through implementation of Govt. policy of Holding concept. The decision was taken in view of the changing and congenial investment atmosphere and the Govt.'s effort in this regard. In March, 2024 the company offered 140,000 shares of Tk.50 each for public subscription. The response from the public was not encouraging and that only 80% shares were subscribed. As a result, the rest 20% shares remain a problem to the company. The unsatisfactory response made the top management a bit worried and consequent upon which management decided to appoint a committee to investigate and find the reason for the poor response.

The committee met in executive session, pursuant to call, at 2.00 p.m., in room 305, Mr. Kamal (Chairman of the Committee) presiding.

Present members: Mr. M Chief Accounts, Mr. N Banker, Mr. P underwriter, and Mr. Q an industrialist and Managing Director of the company [Extract from conversation].

: Hon. members, as per terms of reference, we are to explore and find the major factor responsible for the low response from the public. The company has been making progress steadily and it was the company's expectation that the offer would have been fully accepted by the public. I invite you to express your views on the issue.

Banker: Enough time was given to the public for subscription. I do not think timing is a limiting factor. May be, the customer service of banks is allegedly deteriorated but in your case we tried utmost to do the best.

Underwriter: You know, we have years of experience in underwriting. The problem we faced in pushing the sale of shares of the company appear to us is that people lack information about the financial standing of your business. What is your opinion in this regard, Mr. Accountant?

Accountant: Mr. Underwriter, let me inform you that we have been trying to make accounts more clear and informative as is evident from our accounts. I believe, the accounts will be more informative in the following year when the accounts will be prepared in compliance with the provisions of the Securities and Exchange Rules, 1987.

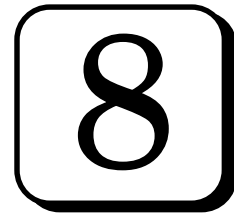
Industrialist: That's right. My observation is that Securities and Exchange Rules, 1987 also do not ensure full disclosure of information in financial statements.

Managing Director: Well, Disclosure of information may be regarded as a major problem. I feel something must be done to improve the reporting system of the company. As to the remaining shares, I think we may issue them at discount. We need sale of shares as the money is required for construction purpose.

Required:

- (i) Management requires a draft incorporation provision of company's Act and Security and Exchange Rule relevant to Disclosure.
- (ii) Management further require a draft relevant to issue of shares at discount.

FINAL ACCOUNTS OF JOINT STOCK COMPANIES



From the discussions of this unit, students will be able to learn:

-  **The meaning and features of final accounts and the parts comprising final accounts**
-  **Techniques of preparing Trading Account, Profit and Loss Account, Profit and Loss Appropriation account and Balance Sheet**
-  **Legal and accounting provisions governing final accounts**
-  **Procedure relevant to the solution of practical problems**

এই পৃষ্ঠা খালি থাকবে

Unit- 8

Lesson-1: Final Accounts and their Components

Lesson Objectives

After studying this lesson, you will be able to:

- understand as to what is meant by final accounts.
- know the parts, formats & contents of each part of final account.

8.1.1 Meaning of Final Accounts/Financial Statements

Commercial organizations are required to prepare different accounting statements at the end of an accounting period to find out the results of operation concerning the period. In fact the statements and accounts prepared at the culmination period based on the records maintained under the double entry system are the trading and profit and loss account and balance sheet. These are often jointly called final accounts or financial statements. These accounts and statements are to be made out as per accounting principles but for joint stock companies, these accounts and statements must also conform to the legal requirements as required by relevant provisions of the Companies Act, 1994 as applicable for Bangladesh and other relevant Acts and rules such as Security Exchange Rules etc. For example, section 181(1) of the Companies Act states that, every company shall have to keep proper books of accounts for recording and presenting the following:

- a) Sums of money received and spent by the company and the matters in respect of which the receipt and expenditures take place.
- b) All sales and purchases of goods made by the company.
- c) The assets and liabilities of the company.
- d) Cost accounts (where applicable).

These books shall have to be kept at the registered office of the company or at such offices or places as the directors may think fit.

8.1.2 Parts of Final Accounts/Financial Statements

The final periodic financial statements, generally called final accounts of a joint stock company, in traditional form, comprise five parts, viz.

- i) Manufacturing Account
- ii) Trading Account
- iii) Profit and Loss Account
- iv) Profit and Loss Appropriation Account
- v) Balance Sheet

But nowadays modern business enterprises are found to prepare final accounts in three parts, viz.,

- i) Income Statement
- ii) Balance Sheet / Position Statement
- iii) Retained Earnings Statement

In such a context, Income Statement shows the turnover (i.e. sales) from which the cost of manufacture and other direct expenses are deducted to show gross earnings and thus serve the purpose of Manufacturing & Trading accounts. The details in this regard are shown in notes which form integral parts of accounts. The proforma of such a statement has been shown in the Profit & Loss Account section in (c) that follows.

Let us have a look at the format and contents of different parts of the final accounts viewed from all angles:

• Manufacturing Account

The account through which the cost of products produced in a manufacturing concern is computed is called a manufacturing account. In general the costs of raw material, direct labor, direct cost, and factory overhead constitute the elements of this account focusing on the cost of manufacture. A specimen of this account is now in order

The account through which cost of products produced in a manufacturing concern is computed is called a manufacturing account.

..... Company Manufacturing Account For the Year Ended

i. Opening stock of raw materials (if any)	Tk.×××××	
Add: Purchases	×××××	
Less Closing stock	×××××	
ii. Direct labour	×××××	
iii. Direct Expenses like Freight, carriage, etc	×××××	
iv. Factory overhead like coal & gas, factory depreciation etc.	×××××	
Total manufacturing cost		Tk.×××××

Sometimes small manufacturing companies combine this Manufacturing Account to Trading Account and term it as a Combined Manufacturing and Trading Account. A specimen of this account is shown below:

..... Company
Combined Manufacturing and Trading Account
 For the Year Ended on

(a) Sales	Tk.×××××	
<i>Less</i> Returns Inward	<u>×××××</u>	Tk.×××××
(b) Stock at close :		
Raw Materials	×××××	
Work-in-Progress	×××××	
Finished Goods	<u>×××××</u>	<u>×××××</u>
		×××××
<i>Less:</i> Stock at commencement :		
Raw materials	×××××	
Work-in-Progress	×××××	
Finished Goods	<u>×××××</u>	
(c) Stock Adjustment (+)/(-)		×××××
Purchase of Raw Materials	×××××	
<i>Less</i> Return Outward	<u>×××××</u>	×××××
(e) Other Expenses:		
Freight and Duty		×××××
Carriage Inwards		×××××
Wages		×××××
Factory Lighting and Heating		×××××
Motive Power		×××××
Coal, Coke and Water		×××××
Sundry Manufacturing Expenses		×××××
Repairs to Factory Building		×××××
Repairs to Plant		×××××
Factory Rent, Taxes and Insurance		×××××
Depreciation on Factory Building		×××××
Depreciation on Plant, etc.		×××××
Total		×××××
Gross Profit including Profit on Manufacture, transferred to the Profit and Loss Account		<u>×××××</u> Tk.×××××

Illustration- 8.01:

From the following particulars of East-West Manufacturing Co., prepare Manufacturing A/c for the year ended June 30, 2023.

Factory Building Tk.44,000, Machinery Tk.26,000, Furniture Tk.2,000 (office Tk.1,000; Factory Tk.1,000). Repairs to Plant Tk.500, Rent Tk.1,600, Excise Duty- Tk.1,700, Insurance: Factory Building Tk.300 & Raw Materials Tk.400; Purchase of Raw Materials Tk.1,50,000, Purchase of Stores Tk.5,000.

Further information available: Opening & closing stock of raw materials Tk.20,000 & Tk.30,000, Opening & closing stock of semi-finished products Tk.20,000 & Tk.10,000, Opening & closing stock of finished products Tk.20,000 & Tk.25,000, Closing stock of stores Tk.2,000, Outstanding wages Tk.500, Depreciation is to be charged @ 10% & 5% on Building & Machinery respectively.

Solution:

East-West Company
Manufacturing Account
For the Year Ended June 30, 2023

Raw materials:		
Opening Stock	Tk.20,000	
Add purchase	<u>1,50,000</u>	
	1,70,000	
Less Closing Stock	<u>30,000</u>	Tk.1,40,000
Stores	5,000	
Less Closing Stock	<u>2,000</u>	<u>3,000</u>
Cost of materials used :		1,43,000
Semi-finished materials:		
Opening stock-	20,000	
Less Closing Stock	<u>30,000</u>	(-10,000)
Direct wages	30,000	
Add Outstanding	<u>500</u>	30,500
Other Direct Expenses:		
Freight & Carriage		5,000
Excise duty		1,700
Insurance on raw materials		400
Factory Overhead:		
Repairs to plant		500
Rent		1,600
Ins. on Factory Building		300
Electricity (³ / ₄)		2,250
Salary		5,000
Depreciation :		
Building	4,400	
Machinery	<u>1,300</u>	<u>5,700</u>
		<u>1,85,950</u>
By cost of production transferred to Trading A/c or Income Statement		Tk.1,85,950

• Trading Account

The account through which the operational result of the purchase and sale of a concern for an accounting period is computed is called a trading account. The items that constitute the elements of this account are shown in the specimen of the account presented below:

The account through which the operational result of purchase and sale of a concern for an accounting period is computed is called a trading account.

..... Company

Trading A/c

For the Year Ended

(a) Sales Less Returns		Tk.×××××
(b) Purchases:		×××××
Raw Materials less returns		×××××
Finished goods less returns		×××××
(c) Stock Adjustment:		
Closing stock of Raw materials	Tk.×××××	
Opening stock of Raw materials + / -	×××××	×××××
(d) Other expenses:		
Stores		×××××
Wages		×××××
Freight, Railway, & Cartage		×××××
Cooly		×××××
Import Duty & Dock Charges		×××××
Warehouse Charges		×××××
Clearing charges		×××××
Repairs to Machinery		×××××
Depreciation on Machinery		×××××
Depreciation on Loose Tools		×××××
Repairs to Factory Building		×××××
Depreciation on Factory Building		×××××
Factory Rent, Rates, Taxes and Insurance		×××××
Gas, Lighting & Heating		×××××
Factory & Machinery Cleaning		×××××
Coal & Fuel, Electric Power		×××××
Special Packing Charges		×××××
Excise Duty, Royalty		×××××
Factory Supervisor's Salary and Commission		×××××
Factory Manager's Salary		×××××
Total 1c		×××××
Gross Profit (Tr. to P/L A/c or Income Statement)		×××××
Total Taka		Tk.×××××

(If credit exceeds debit it will represent gross profit, if debit exceeds credit it will represent gross loss)

Illustration- 8.02:

The following particulars are available in the books of Southern Company for the year ended June 30, 2024.

Particulars	Tk.	Particulars	Tk.
Purchases	40,000	Sales	1,90,000
Manufacturing Expenses	20,000	Sales returns	10,000
Wages	10,000	Return outwards	6,000
Carriage	5,000	Freight & Cartage	15,000
Opening stock	20,000	Cash in hand	6,000
Dock charges	3,000	Stores	4,000
Power	5,000	Salaries	10,000
Office expenses	7,000		

The entire closing stock was destroyed by fire. Records revealed that the average gross profit for the last 5 years was 25% on Net sales. You are required to prepare Trading A/c and to ascertain stock lost by fire.

Solution:**Southern Company****Trading A/c**

For the Year Ended June 30, 2023

(a) Sales	Tk.1,90,000	
<i>Less</i> Returns	<u>10,000</u>	Tk.1,80,000
(b) Stock Adjustment:		
Closing stock destroyed by fire (balancing figure)	21,000	
<i>Less</i> Opening stock	<u>20,000</u>	<u>1,000</u>
	Total A	<u>1,81,000</u>
(c) Purchases	80,000	
<i>Less</i> Returns	<u>6,000</u>	74,000
(d) Other Expenses:		
Wages		10,000
Carriage		5,000
Manufacturing Expenses		20,000
Freight & Cartage		15,000
Dock charges		3,000
Power		5,000
Stores		<u>4,000</u>
Total = (c+d)		1,36,000
Gross profit (a+b) - (c+d) @ 25% on Net sales		<u>45,000</u>
		Tk.1,81,000

(Note: Salaries & office expenses are not items of Trading A/c rather Profit & Loss Account. Cash in hand is not an expense rather an asset.)

• Profit & Loss Account or Income Statement

The account which is prepared to compute the net operational result of the workings of a concern by matching costs and revenues relevant to management and sales functions of a concern for an accounting period is called profit and loss account. The items included in this account are shown in the proforma of this account that is depicted below as found to be in practice in modern business houses.

..... Company Limited
Profit & Loss Account
(or Income Statement)

For the Year Ended on

The account which is prepared to compute net operational result of a concern by matching costs and revenues for an accounting period is called profit and loss account.

Particulars	Notes	Last Year Tk.	Current Year Tk.
Turnover (Sales Less return and relevant tax adjustment)	1		
Less Cost of Goods Sold	2		
Gross Profit (Loss)			
Less Administrative Overhead	3		
Operating Profit (Loss)			
Financial Expenses	4		
Net Profit (Loss) Before WPP&W Fund Contribution to Workers' Profit Participation and Welfare (WPP&W) Fund			
Net Profit(Loss) for the Year before tax			
Tax for the year (provision)	6		
Surplus(Deficit) for the Year			
Accumulated Surplus or Deficit Brought Forward	7		
Accumulated Surplus or Deficit Carried Forward			

Note: The annexed notes form part of these accounts

..... Company
Notes to the Accounts

(Forming an integral part of the accounts)

Note: 1. Turnover : Tk. ...

Turnover comprises sales of Tk.

---- of (a) + (b) less

return

Sub-Note (a) Raw Materials Issued: Tk.

This is arrived at as follows:

Opening Stock:

Add: Purchases:

Less: Closing Stock:

Note: 2. Cost of Goods Sold: Tk.

This is arrived at as follows:

Tk.

Opening WIP

+ Raw Materials Issued (Note a)

- Closing WIP

Raw Materials Consumed

Packing Materials Consumed
(Note b)

Manufacturing Overhead (Note c)

Depreciation

Cost of Production

+ Opening Finished Goods

– Closing Finished Goods

Sub-Note: (b) Packing Materials
Comment:

This is arrived at as follows

Tk.

Opening Stock

+ Purchase

– Closing Stock

Sub-Note: C

Manufacturing Overhead: Tk.

This consists of :

Salaries & Wages

Bonus

Insurance-Car

Note: 3. Administrative Overhead Tk.

This consists of :

Salaries & Allowances

Travelling & Conveyance

Repairs & Maintenance

Insurance-say Vehicls		Telephone, Telex, Fax and Postage	
Lab Material Expenses		Books and Periodicals	
Testing Expenses		Entertainment	
Canteen		Petrol & Fuel	
Gas		Registration & License Fees	
Indirect Material (Stores and Spares)		Subscription	
Lub Oil		Board Meeting Fee	
F/Rent Equipment		Audit Fee	
Maintenance		Legal Fees	
	Tk.	Office Rent	
		Printing & Stationery	
Note: 4 List of Financial expenses		Insurance Premium	
Note: 5 Selling overhead:		Utilities-Electricity, Gas & Water	
i) Advertisement		W/Off Preliminary Expenses	
ii) Commission		AGM Expenses	
iii) Salesmen's Salary etc.		Other Administrative Overhead	
Note: 6 Tax adjustment : computation		Depreciation	
Note: 7 Retained Earnings Position		Total	

Illustration-8.03:

From the following particulars of Northern Company, prepare Profit & Loss Account for six months ended June 30, 2024.

Salaries & Wages Tk.25,000, Rent & Rates Tk.6,000, Printing & Stationery Tk.2,000, Postage & Telegram Tk.6,000, Trade Expenses Tk.1,000, Insurance Tk.700, Discount received Tk.800, Interest paid Tk.3,600, Rent from sub-let Tk.1,600, Carriage Outward Tk.3,000.

Additional information:

Salaries outstanding Tk.300; Insurance prepaid Tk.200; Write off Tk.600 as bad debts & provision of bad debts @ 5% on debtors is required.

Debtors at the end of the period stand at Tk.40,000. A 2% Discount on debtors is also to be provided.

A fire occurred on 25th June 2024 at the godown which destroyed goods worth Tk.2,000, half of which was insured and the insurance company admitted the claim. His gross profit from purchase and sales was Tk.80,500.

Solution:

**Northern Company
Profit & Loss Account
For the Half Year Ended June 30, 2024**

Gross profit		Tk.80,500
Discount		800
Rent from sublet		<u>1,600</u>
Total = A		<u>82,900</u>
Salaries & Wages	Tk.25,000	
Add: Outstanding	<u>300</u>	25,300
Rent & Rates		6,000
Printing & Stationery		2,000
Postage & Telegram		600
Trade Expenses		1,000
Insurance	700	
Less: Prepaid	<u>200</u>	500
Interest		3,600
Carriage Outward		3,000
Loss of Stock on Fire		1,000
Bad Debt	600	
Add: New Reserve	<u>2,000</u>	2,600
Discount on Debtors		<u>748</u>
Total = B		<u>45,348</u>
Net Profit (= A–B) transferred to Retained Earning Statement or P/L Appropriation Account		<u>Tk.37,552</u>

[Note: The amount of goods destroyed for which insurance company has not taken responsibility will be a loss to the company & will be debited to P/L A/c]

The account in which deposition, division and appropriation of profit of a concern are shown is called Profit & Loss Appropriation Account or Retained Earning Statement.

• **Profit & Loss Appropriation Account or Retained Earning Statement**

The account in which deposition, division and appropriation of profit of a concern are shown is called Profit & Loss Appropriation Account or Retained Earning Statement.

A specimen of this account is shown below:

..... Company
Profit & Loss Appropriation Account
(or Retained Earnings Statement)

For the year ended on

i) Last year's balance	
ii) Current year's profit	
iii) Balance of reserve of any account, not now required	
Total = A	
i) Current year's loss (if any)	
ii) Compulsory appropriation (with Specific title)	
iii) Transfer to reserve fund (with specific title)	
iv) Proposed dividend & dividend paid	
Total = B	
v) A - B : Balance transferred to B/S	

Illustration-8.04:

XYZ Ltd. had a balance of Tk.11,500 in its Profit and Loss Account on 1st January, 1999. During the year its profits amounted to Tk.1,47,500. The income-tax for the year amounted to Tk.48,000. The company decided to transfer Tk.20,000 to the General Reserve, Tk.15,000 to Sinking Fund for Redemption of Debentures and to pay a dividend for 1999 at the rate of 10%. The company's share capital consisted of 50,000 shares of Tk.10 each. Draw up the Profit and Loss Appropriation Account. Ignore tax on dividends.

Solution:

XYZ Ltd.
Profit and Loss Appropriation Account
For the Year Ended on

Particulars	Tk.
Balance <i>b/d</i>	11,500
Profits for the year	1,47,500
Total - A =	1,59,000
Provision for Income Tax	48,000
Transfer to General Reserve	20,000
Transfer to Sinking Fund	15,000
Dividend (Proposed) 10% on Tk. 5,00,000	50,000
Total - B =	1,33,000
A - B = Balance transferred to B/S	26,000

● Balance Sheet

A Balance Sheet can be defined as a statement prepared at the end of each trading or financial period, setting forth the various assets and liabilities of the concern as at a particular date.

A Balance Sheet can be defined as a statement prepared at the end of each trading or financial period, setting forth the various assets and liabilities of the concern as at a particular date. It is prepared to measure the financial position of a business on a particular date. In fact a Balance Sheet is a formal statement of accounting equation (Assets = Liabilities + Proprietorship) at a certain date. As a result of business transactions, the assets and liabilities change from day to day and the trader must necessarily feel anxious to find out the financial position at the end of each trading period and whether the net profit and loss disclosed by the Profit and Loss Account is correctly arrived at. The concern may see as to how the capital is made up, and what the components of Assets and Liabilities of the business are. So to obtain the information at the end of the trading period, a presentation of various assets and liabilities as at that date in the form of a statement can be made and this statement is called the Balance Sheet.

In this connection it can be pointed out that as the Balance Sheet summarizes the balances remaining after the preparation of Trading and Profit and Loss Account, its agreement is a proof of the arithmetical accuracy of the adjustment made for the purpose of the final accounts. A specimen of Balance Sheet is shown below:

..... Company Limited

Balance Sheet

As at

	Note	prices year	current year
Net Assets:			
Tangible Fixed Assets	1		
Long Term Security/Deposit (if any)			
Preliminary Expenses (if any)			
Current Assets:			
Stocks and Stores			
Trade Debtors-Considered good			
Advances and Deposits			
Cash and Bank balances			
Current Liabilities:			
Long term Loan-Current Portion	2		
Short Term Loan from Banks	3		
Other Current Liabilities			
Net Current Assets			

Financed By:			
Shareholders' Equity:			
Share Capital	4		
Tax Holiday Reserve (if any)			
Surplus/Deficit-As per Profit and Loss Account			
Long Term Loan:			
..... Debenture			
Long Term Loan			

Note: The annexed notes form part of these accounts

Notes Forming part of the Balance Sheet

Note: 1

Tangible Fixed Assets

Types of any	As at last date of previous year	Addition - --	As of last day of current year	Dep. of the year	Accumulated	WDV
Land						
Building						
Machinery:						
X						
Y						
Z						
Furniture						
Vehicles etc.						

Note: 2 & 3

List of long term and short term loan:

Note: 4

Share capital: Tk.

Authorized:

Issued & subscribed:

Paid up:

Illustration: 8.05

From the following particulars prepare Balance Sheet of East-West Company at the close of the accounting period as at 31-12-2023.

- Cumulative 8% preference stock Tk.100 par, callable at Tk.104, 10,000 shares authorized & issued
- Common stock, Tk.1 par Authorized 10,00,000 shares, issued 6,00,000; 20,000 shares paid-in capital in excess
- Reserve 2,10,000

iv) Retained earnings	15,42,000
v) Plant and Equipment :	
Land	9,00,000
Building	52,83,000
Accumulated depreciation on Building:	
Previous balance	12,00,000
Current year's transfer	50,000
vi) Organizational cost (deferred)	14,000
vii) Accounts payable	8,97,100
viii) Income tax payable	3,24,200
xi) Dividend payable	1,29,700
x) Bonds payable 12%, due Oct. 1999	10,00,000
xi) Cash and Bank	3,05,000
xii) Accounts Receivable (net)	11,05,200
xiii) Stock subscription receivable	1,10,000
xiv) Inventories: FIFO cost	13,00,800
Market value	13,50,700
xv) Prepaid rent	25,000

Solution:

**East-West Company
Balance Sheet
As at December 31, 2023**

Particulars	Amount		
	Tk.	Tk.	Tk.
A) Fixed Assets			
Land		9,00,000	
Buildings	52,83,000		
<i>Less: Accumulated depreciation</i>	<u>12,50,000</u>	<u>40,33,000</u>	49,33,000
B) Current Assets			
Cash and Bank			305,000
Accounts receivable (net of allowance for doubtful accounts)			11,05,200
Stock subscriptions receivable:			
Common			1,10,000
Inventories (lower of FIFO cost or market)			13,00,800
Short-term prepayments of Rent			<u>25,000</u>
Total current assets			28,46,000
Other assets: Organization costs			<u>14,000</u>
Total assets (A + B)			<u><u>77,93,000</u></u>

Particulars	Amount		
	Tk.	Tk.	Tk.
Assets Represented by Liabilities & Stockholders' Equity			
C) Current Liabilities:			
Accounts payable			
Income taxes payable			8,97,100
Dividends payable			3,24,200
Total current liabilities			<u>1,29,700</u>
D) Long-term Liabilities:			13,51,000
Bonds payable, 12%, due Oct.1, 1999			10,00,000
C + D = Total external liabilities			23,51,000
E) Stockholders' Equity:			
Cumulative 8% preferred stock, Tk. 100 par, callable at Tk. 104, authorized and issued 10,000 shares		10,00,000	
Common stock, Tk. 1 par, authorized 1,000,000 shares, issued 600,000 shares		600,000	
Common stock subscribed, 20,000 shares		20,000	
Paid-in capital in excess of par: common		20,70,000	
Reserve		<u>2,10,000</u>	
Total paid-in capital		39,00,000	
Retained earnings		<u>15,42,000</u>	
Total stockholders' equity			<u>54,42,000</u>
C + D + E = Total liabilities & stockholders' equity			<u><u>77,93,000</u></u>

Lessons-2 & 3: Legal and Professional Guidelines Relevant to Financial Statement

Lesson Objectives

After studying this lesson, you will be able to:

- state the provisions governing preparation of financial statements as per Companies Act and Security Exchange Rule (SER) of Bangladesh.
- explain the guidelines of International Accounting Standard relevant to disclosure in financial statement.

8.2.1 Introduction

Against the backdrop of introduction to the final account and its components, students at higher stage need to have an idea as to legal provisions governing corporation accounts along with professional guidelines. This lesson is devoted to this end.

8.2.2 Provisions of Companies Act, 1994 Governing Annual Accounts

Section 181: Books to be kept by company

- (1) Every company shall keep proper books of account with respect to-
 - (a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place;
 - (b) all sales and purchases of goods by the company;
 - (c) the assets and liabilities of the company; and
 - (d) in the case of a company engaged in production, distribution, marketing, transportation, processing, manufacturing, milling, extraction and mining activities, such particulars relating to utilization of material, labor and other items of overhead cost.

It is to be noted that the books of account shall be kept at the registered office of the company and shall at all times be open to inspection by directors during business hours.

Section 183. Annual Balance Sheet:

- (1) The Board of Directors of every company shall, at every annual general meeting held in pursuance of section 81, lay before the company a balance sheet together with the profit and loss account or in the case of a company not trading for profit, an income and expenditure account for the period specified in sub-section (2) of this section.

- (2) The said profit and loss account or the income and expenditure account shall be prepared for the following period, namely:-
- (a) in the case of the first annual general meeting for the period beginning with the date of incorporation of the company and ending on a date which is within nine months preceding the date of the meeting; and
 - (b) in the case of any subsequent annual general meeting, for the period beginning with the date immediately after last account and ending on a date which is -
 - (i) a date within nine months preceding such meeting; or
 - (ii) in the case of a company carrying on business or having interest outside Bangladesh, a date within twelve months preceding the date of such meeting; or
 - (iii) in a case where an extension of time has been granted for holding the meeting under section 81, a date within the said nine or twelve months, as the case may be, preceding the date of holding such meeting under that section.

Provided that the Registrar may, on an application being made to date before the expiry of the said nine or twelve months, extend the time by a period not exceeding three months.

- (3) The balance sheet and the profit and loss account or income and expenditure account shall be caused to be audited by the auditor of the company as in this Act provided, and the auditors' report shall be attached thereto or there shall be inserted at the foot thereof a reference to the report and the report shall be read before the company in general meeting and shall be subject to inspection by any member of the company.

Section 184: Board's Report:

- (1) There shall be attached to every balance sheet laid before a company in general meeting a report by its Board of Directors, with respect to -
- (a) the state of the company's affairs;
 - (b) the amount, if any, which the Board proposes to carry to any reserve in such balance sheet;
 - (c) the amount, if any, which the Board recommends should be paid by way of dividend;
 - (d) material changes and commitments, if any, affecting the financial position of the company which have occurred

between the end of the financial year of the company to which the balance sheet related and the date of the report.

- (2) The Board's report shall, so far as is material for the appreciation of the state of company's affairs by its members, deal with any changes which have occurred during the financial year:
 - (a) in the nature of the company's business;
 - (b) in the company's subsidiaries or in the nature of the business carried on by them; and
 - (c) generally in the classes of business in which the company has an interest.
- (3) The Board shall also be bound to give the full set information and explanations in its report aforesaid on every reservation; qualification or adverse remark contained in the auditor's report.
- (4) The Boards report and any addendum thereto shall be signed by its Chairman if he is authorized in that behalf by the Board, and where he is not so authorized &, shall be signed by such number of director as are required to sign the balance sheet and the profit and loss account or the income and expenditure account, of the company by virtue of sub-section (1) and (2) of section 189.

Section 185: Form and contents of balance sheet and profit and loss account:-

- (1) The balance sheet of a company shall contain a summary of the property and assets and of the capital and liabilities of the company giving a true and fair view of affairs as at the end of the financial year, and it shall, subject to the provisions of this section be in the form set out in Part-I of Schedule I or as near thereto as circumstance admit or in such other form as may be approved by the Government either generally or in any particular case; and in preparing the balance sheet due regard shall be had, as far as may be, to the general instructions for preparation of balance sheet under the heading "Notes" at the end of the Part:

Provided that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity or to any other class of company for which a form of balance sheet has been specified in or under the law governing such class of company.

- (2) Every profit and loss account of a company shall gave a true and fair view of the profit and or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part II of Schedule XI so far as applicable thereto:

Provided that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the

generation or supply of electricity or to any other class of company for which a form of profit and loss account has been specified in or under the law governing such class of company.

- (3) The Government may, by notification in the official Gazette, exempt any class of companies from the requirements of Schedule XI if, in its opinion, it is necessary to grant the exemption in the public interest; and any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.
- (4) The Government may, on the application or with the consent of the Board of Directors of the company, by order, modify in relation to that company of the requirement of this Act as to the matters to be stated in the balance-sheet or profit and loss account for the purpose of adopting them to the circumstances of the company;
- (5) The balance sheet and the profit and loss account of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company merely by reason of the fact that they do not disclose-
 - (i) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938 (IV of 1938);
 - (ii) in the case of a banking company, any matters which are not required to be disclosed by the Banking Company Act, 1991
 - (iii) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 1910 (IX of 1910).

8.2.3 Form of Balance Sheet As per Companies Act

Brief version of the form as prescribed by Companies Act. 1994 under Sec. 185 in Schedule, 11: Horizontal Form

Balance Sheet of Co. Ltd.

As on 20

Capital & Liabilities	Tk.	Property & Assets	Tk.
1. Share Capital		1. Fixed Assets	
Authorised Share Capital Shs. of		Distinguish as far as possible	
Tk. each Subscribed Share		between expenditure upon:	
Capital Shs. of Tk. each		a) Goodwill	.....
Called and paid up Capital Shs.		b) Building	.....
of Tk. called Deduction:		c) Land	.....
Amount called but not paid up		d) Lease holds	.....
.....	=====	e) Railway Sidings	.....
Add: Amount paid on Shares		f) Plant and Machinery	.....
forfeited		g) Furniture and fittings	.....
		h) Development of property	.....
2. Reserves and Surpluses:		j) Live Stocks	.....
a) Reserve Fund/Capital		k) Vehicles etc.	.....
b) Capital Redemption			
Reserve Fund		2. Investment:	

Capital & Liabilities	Tk.	Property & Assets	Tk.
c) Share Premium Account		a) Investment in Govt. or trust Securities:	
d) Other Reserves		b) Investment in Shares, Debenture or Bond	
e) Surplus of profit and Loss A/c after making Provision for appropriations Such as dividend, arrangement for reserves etc.		c) Investment or Fixed Assets	
f) Proposed addition to Reserve (Addition to and deduction from each head must be shown separately under each head)		d) Capital Investment in partnership	
g) Sinking Fund		3. Current Assets, Loans and Advances	
3. Long Term Loan:		a) Interest accrued on Investment	
A) Secured Loan:		b) Spare Parts	
a) Debenture		c) Stock and Stores	
b) Loan from Bank		d) Sundry Debtors:	
c) Loan from subsidiary company		Outstanding for more than six months, other receivable including provision	
d) Other Loans and Advances		e) Cash in hand	
B) Unsecured Loan:		In hand -	
a) Fixed Term Deposit		At banks-	
b) Loans and advances received from subsidiary companies		f) Loans and Advances given:	
c) Loans and Advances received from banks and other sources		Loans and Advances to Subsidiary	
4. Current Liabilities and Provision there for:		Loans and Advances to such firms where the company or its subsidiary is a party.	
A) Current Liabilities		g) Bills of Exchange	
1. Short term Loans and Advances		h) Bills in deposit with agent	
2. Current portion of long term loans-		i) Prepayment of rates, taxes insurance etc.	
3. Creditors for goods, for services like B/P etc.		j) Deposit with customers	
4. From subsidiary Cos.		4. Expenses not written off or adjusted:	
5. Advances and Pre-payments		1. Preliminary Expenses	
6. Unclaimed Dividends		2. Commission or Brokerage for subscription or under written of shares or debentures	
7. Interest on Loans accrued and due, accrued but not due		3. Approved discount on shares and debentures	
B) Provisions made:		4. Interest paid out of capital during construction period	
9. Provision for Taxation		5. Unadjusted development expenditure	
10. Proposed Dividend		6. Expenditure on other heads with nature and amount	
11. Provision for expenses			
12. Provident Fund			
13. Insurance, pension, and other schemes for employee benefits			
14. Other provisions:			

Note: Provisions

- (i) Provisions for Liabilities are to be shown in the liability side under the Heading "Current Liabilities and Provision there of"
- (ii) Provisions against Investments, Debtors and Bills receivable and also Depreciation Provision to be shown by way of deduction form the respective asset.
- (iii) A Statement of Contingent Liabilities is to be shown either inside the Balance Sheet or as foot note outside the B/S. In former case it will not be added with liabilities.

8.2.4 Form of Balance Sheet under SEC Rule

For companies registered under stock exchanges the Secreting Exchange Commission (SEC) under its Rule of SER, 1987 perceive proforma for Balance Sheet for the concerned companies. The form is shown below, which is a vertical one:

(Form A to the second Schedule to the Rules)

FORM A

[See Rule 12(2)]

Name of the company

Balance Sheet as at

Corres- pounding figures as at the end of the last year 1	Figures as at date of Balance Sheet 2	Corres - pounding figures as at the end of the last year 4	Figures as at date of Balance Sheet 5
Tk.	Tk.	Tk.	Tk.
Capital and Reserves : Share Capital: Authorised..... Shares of Tk. each Issued capital Subscribed Capital: Less: Calls unpaid Due from directors (including Managing Director) Due from Managing Agents Due from Officers Due from Managers Due from others Add: Amount paid- up on forfeited shares not reissued Calls paid in advance (Distinguishing between the various classes of issued. Subscribed, called up, and paid up capital and stating the number and value of each class, and distinguishing in respect of each class of paid up shares between shares allotted for consideration in cash, shares allotted for consideration other than cash, and bonus shares). (Where the company is a subsidiary of another company, the number of shares		Fixed Assets : (Distinguishing between intangible and tangible assets and classifying under appropriate sub-heads, such as, in the case of intangible assets: Goodwill and patents, Copy-right, trade marks and designs; and in the case of tangible assets, freehold land, leasehold land, buildings on freehold land, buildings on leasehold land, plant and machinery, furniture and fittings, vehicles, capital work in progress; and stating in each case (other than for capital work in progress) the original cost and the additions there to and deletions therefrom since the date of previous balance sheet and the accumulated depreciation written off under Paid up capital: each head) LONG-TERM REPAYMENTS AND DEFERRED COSTS. (Stating separately all material items.)	

of each class held by the holding company the ultimate holding company and its subsidiaries shall be stated). Capital Reserves Revenue Reserves and Un appropriated profit: (Showing separately each item of reserve and revenue reserve and the addition thereto and deductions there form unless the additions and deductions are disclosed in the profit and loss account or a statement or report annexed thereto.) Provision for Bad and Doubtful Debt	INVESTMENTS, LOANS AND ADVANCES (Stating mode of valuation and Showing provisions for diminution in value of investments and advance and in respect of loss of subsidiaries as deduction from the gross amounts of the respective sub-heads.)
LONG TERM LOANS AND DEFERRED LIABILITIES (Stating separately all material item Debenture (stating rate of interest; terms of redemption etc., particulars of redeemed debentures which the company has power to reissue and also the amount of debentures held by a nominee of or trustee for the company) Loans from banking companies and other financial institutions Loans from subsidiary companies and controlled firms Loans from directors (including the managing director), managing agents and managers. Other loans Deferred liabilities (Showing every material item separately)	Investment in and loan and advances to subsidiary companies, controlled firms and any other associated undertakings (stating names of subsidiary companies, controlled firms and other associated undertakings and the nature and amount of investment made and loans and advances given in each case). Investment in listed companies other than investments in subsidiary companies and other associated undertakings. Investments in unlisted companies other than investments in subsidiary companies, controlled firms and other associated undertakings (stating names of the bodies corporate or firms or undertaking and the nature and extent of investment made in each case). Investments in debentures and bonds issued by Government, Municipalities and other local authorities.
CURRENT LIABILITIES AND PROVISIONS Short-term loans: Financial institutions from subsidiary companies, controlled firms and associated undertakings from directors (including managing directors) managing agents and managers. From others	Investment in immovable property Other loans and advances (stating by way of a note the particulars prescribed by Sub-Paragraph(G) of paragraph 4).
Deposits	CURRENT ASSETS <i>Stores, spares parts and losse tools</i> (stating mode of valuation). <i>Stock in trade</i> (distinguishing between stock of raw materials and components, work in progress, stock of finished products and other stocks, and stating mode of valuation). Sundry Debtors

Creditors	(distinguishing between debts considered good and debts considered doubtful or bad. Provision made against the latter should be shown under the liabilities side. The particular prescribed in Sub-paragraph (C) of paragraph 5 should be given by way of a note).
Accrued expenses	
Bills payable	
Advance payments and unexpired discounts.	
Interest accrued on secured loans	
Interest accrued on unsecured loans ...	Short-term loan and advances (distinguishing between loans and advances considered good and loans and advances considered doubtful.
Other liabilities (to be specified)	
Provision for taxation	
Proposed dividend	
Other provisions (to be specified)	Provision made against loans considered bad and doubtful should be shown in liabilities side under appropriate sub-heads. Particulars prescribed in sub-paragraph (C) of Paragraph 5 should be given by way of a note).
(Stating whether any current liabilities are secured, the fact that they are so secured and stating the assets upon which they are secured.	Short-term prepayment Sand deferred charges. Bills receivable Interest accrued or interest outstanding.

8.2.5 Profit and Loss Account: Guidelines:

1. The profit and loss account shall be so made out as to disclose clearly the result of the working of the company during the period covered by the account and shall be so arranged under most convenient heads, to show the gross income and the gross expenditure of the company during the period, disclosing every material feature and in particular the following-
 - (A) (i) The turnover, that is, aggregate amount for which sales are effected by the company and the gross income derived from rendering, giving or supplying services or benefits, and showing as deduction therefrom:-
 - (a) Commission paid to sole selling agents;
 - (b) Commission paid to other selling agents;
 - (c) Brokerage and discount on sales other than the usual trade discount; (ii) Income from investments, (iii) Income by way of interest on loans and advances and other interest; (iv) Income from sale of bonus vouchers; (v) Profit on sale of investment; (vi) Profit on sale of items of fixed assets; (vii) profit in respect of transaction of an exceptional or non-recurring nature, not usually undertaken by the company or not envisaged in the normal course of business; and (viii) Other income showing separately every material item and the nature of such item.

- (B) (i) The value of stock in trade (inventory), including raw materials and components, work in progress and finished products, as at the commencement and the value as at the end of the period; (ii) Purchase of raw materials and components and finished products.
- (C) Expenditure on-
 - (i) stores and spare parts consumed;
 - (ii) fuel and power;
 - (iii) salaries and wages (including bonus, contributions to provident and other funds recognized under the Income-tax Ordinance, 1984 (Ordinance No XXXVI of 1984) and expenses on staff welfare).
 - (iv) rent, municipalities and provincial and local taxes (excluding taxes on income. Capital gains and wealth);
 - (v) insurance;
 - (vi) repairs and maintenance (being repairs to and maintenance of the company's fixed assets); and
 - (vii) patents, copyrights, trade marks, designs, royalties, and technical assistance.
- (D) The aggregate amount of auditor's remuneration.
- (E) Other expenses, showing separately every item of an exceptional or non-recurring nature and every material item.
- (F) The amount provided for depreciations, renewals or diminution in value of the assets. The value of the assets by various groups, the additions or deletions thereto, the rate at which depreciation is charged. The rate(s) at which depreciation, accelerated or for extra-shifts, is charged shall be shown in the form of an annexure.
- (G) (i) The amount of interest on borrowings, showing separately the amount of interest on the company's debentures, or other long-term loans and on short-term loans, and showing by way of a note the amount of interest on, borrowing from the directors (including managing director), the managing agents and the managers;
 - (ii) loss on sale of investments;
 - (iii) loss on sale of items of fixed assets;
 - (iv) debts written off as irrecoverable;
 - (v) provision for doubtful or bad debts;
 - (vi) provision for diminution in value of investments;

- (vii) provision for loss of subsidiary companies, controlled firms and associated undertakings; where loss is actually incurred; the extent of loss in the case of each subsidiary company, controlled firm and associated undertaking shall be disclosed;
 - (viii) remuneration of managing agents;
 - (ix) provision for taxation on income, capital gains and other tax or taxes, and the provision for liability deferred due to the difference between the rates of depreciation allowed for purposes of taxation on income and those adopted by the company for the charge profit and loss account and distinguishing, where applicable, between the provision of Bangladesh taxation and the provision for taxation elsewhere.
 - (x) other provisions for meeting specific liabilities, contingencies commitments.
- (H) (i) The amount set aside or proposed to be set aside as reserves, showing separately the respective amounts in respect of each item of reserve; and
- (ii) the amount of the dividend proposed.
2. The profit and the loss arising from "hedge", and "forward" contracts, trading in "future", and "badla (contango and backwardation)" and other transactions of a similar nature.
3. There shall be stated by way of a note the respective amounts included in items (G) (iv) and (v) of paragraph 1 of this part for (a) debts due by the directors, managing agents, managers and other officers of the company and any of them severally or jointly with any other person, (b) debts due by associated undertakings,.

The following shall be stated by way of a note:

- (i) the aggregate amounts paid during the period to or in respect of, or provided during the period as:
- (a) fees;
 - (b) managerial remuneration;
 - (c) remuneration or commission based on net profit or turnover;
 - (d) reimbursable expenses;
 - (e) pensions; gratuities; company's contribution to provident, superannuation and other staff funds,
 - (f) buying commission,
 - (g) selling agency commission,
 - (h) other allowances and commission, including commission for guarantee,

- (i) other perquisites and benefits in cash or in kind stating their nature,
 - (j) the amount of commission to the managing agents, to any associated person of the managing agent or to an associated person or partner or officer of the managing agent or of the company as selling or buying agents of their concerns in respect of contracts entered into by such concerns with the company.
 - (k) the aggregate amounts of the company's purchases from and sales of goods, materials and services to the managing agents, to an associated undertaking of the managing agent,
 - (l) the calculation of the commissions payable by way of a percentage of net profits to the directors (including managing director). The managing agents of managers and showing the computation of net profits with relevant particulars; and
 - (m) the amounts, if material, by which any items shown therein are affected by any charge in the basis of accounting.
4. In the case of sale of an item of fixed assets otherwise than through a regular auction showing particulars of the original cost, accumulated depreciation charged thereon, the written down value, the sale price, the mode of disposal (e.g. by tender or negotiation) and the particulars of the purchasers indicating whether such purchaser was a director or officer, managing agent or a shareholder owning 20 percent of voting share of the company.
 5. A company need not show the amount set aside as provisions other than those relating to depreciation, renewal or diminution in value of assets if, it has been allowed by the Government to do so on being satisfied that the disclosure of such information would be prejudicial to the interest of the company but shall so frame or mark the heading covering the amount of such provision as to indicate that it has been so allowed by the Government.
 6. The profit and loss account shall be so drawn up as to disclose separately the manufacturing, trading and operational results. In the case of manufacturing concern, the cost of goods manufactured shall also be shown. Where an undertaking has more than one unit of operation or line of business the working results of each such unit or line of business should be separately given.

International Accounting Standards

(As adapted in Bangladesh as As-2)

(A) General Disclosure

1. All material information should be disclosed that is necessary to make the financial statements fair, clear and understandable.
2. The name of the enterprise, the country of incorporation, the balance sheet date, and the period covered by the financial statements should be stated. A brief description of the nature of the activities of the enterprise, the legal form of the enterprise, and the currency in terms of which the financial statements are expressed should be given if they are not otherwise apparent.
3. The amounts and classifications of items should be supplemented, if necessary, by additional information to make their meanings clear. Significant items should not be included with, or offset against, other items, without separate identification.
4. Financial statements should show corresponding figures for the preceding period.

(B) Specific Disclosure-Balance Sheet

5. The following disclosures should be made:
 - (a) Restrictions on the title to assets
 - (b) Security given in respect of liabilities
 - (c) The methods of providing for pension and retirement plans
 - (d) Contingent assets and contingent liabilities, quantified if possible.

Long-Term Assets

6. Property, plant and equipment-The following items should be disclosed separately:
 - (a) Land and buildings
 - (b) Plant and equipment
 - (c) Other categories of assets, suitably identified
 - (d) Accumulated depreciation

Separate disclosure should be made of leaseholds and of assets being acquired on instalment purchase plans.

7. Other long term assets

The following items need to be disclosed separately, including, if applicable, the method & period of depreciation and any unusual written off during the period.

- (a) Long-term investments
 - Investment in subsidiaries
 - Investments in associated companies

Other investments, stating the market value of listed investments, if different from the carrying amount in the financial statements

- (b) Long-term receivable
 - Accounts and Notes receivable-trade
 - Receivable from directors
 - Inter-company receivable
 - Associated company receivable
 - Others
- (c) Goodwill
- (d) Patents, Trademarks, and similar assets
- (e) Expenditures carried forward, for example, preliminary expenses, reorganization expenses, and deferred taxes.

(C) Specific Disclosure-Income Statement

8. The following information need to be disclosed:

- (a) Sales or other operating revenues
- (b) Depreciation
- (c) Interest income
- (d) Income from investments
- (e) Interest expense
- (f) Taxes on income
- (g) Unusual charges
- (h) Unusual credits
- (i) Significant inter-company transactions
- (j) Net income

Effective Date

9. This International Accounts Standard becomes operative for financial statements covering periods beginning on or after 1 January 1977.

(D) Presentation of Current Assets & Current Liabilities

Introduction

1. This part of the statement deals with the meaning and presentation of current assets and current liabilities in financial statements. This Statement does not deal with the basis of valuation of these assets and liabilities.

Explanation

2. The identification of current assets and current liabilities has traditionally been considered useful information to assist users of financial statements in analyzing an enterprise's financial position.
3. An excess of current assets over current liabilities is often referred to either as "net current assets" or as "working capital."

Items Included in Current Assets and Current Liabilities

4. Cash and bank balances are included in current assets unless restriction on their use make them unavailable for current operations.
5. Trade and other receivables are included in current assets to the extent that they are expected to be realised within one year. Sometimes all trade receivables are included in current assets, in which case the amount not expected to be realised within one year may be disclosed.
6. Inventories are usually included in current assets entirely, notwithstanding that they may include items not expected to be realised within one year or within the normal operating cycle.
7. A loan stated to be payable at the demand of the creditor is usually included in current liabilities. However, if the creditor has agreed to a schedule of repayment, the loan is sometimes classified on the basis of scheduled repayment, notwithstanding the creditor's right to demand payment at any time.
8. The portion of a long-term liability payable within one year is usually classified as a current liability. This item is sometimes excluded from current liabilities if the enterprise intends to refinance the obligation on a long-term basis and there is reasonable assurance that the enterprise will be able to do so. Similarly, the portion of a long-term liability payable within one year is sometimes classified as non-current if assets existing at the balance sheet date, out of which settlement is to be made, have been excluded from current assets.
9. When an undertaking excludes a liability from the current classification in accordance with paragraph 11, the amount and the circumstances are often disclosed.

Presentation in the Financial Statements

10. The usefulness of the current and non-current distinction is improved by grouping and totalling current assets and current liabilities.
11. To permit adequate identification of the separate assets and liabilities of the enterprise, the amount at which a current asset or current liability is stated is generally not reduced by deducting another current liability or current asset. However, such off-setting might be appropriate when a legal right of set-off exists and the offsetting represents the expectation as to the realisation or settlement of the asset or liability.

Limitations of the Current: Non-current Distinction

12. The current and non-current distinction is generally believed to provide an identification of a relatively liquid portion of an enterprise's total capital that constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of an enterprise. However, as long as a business is a going concern, it must, for example, continuously replace the inventory that it realises with new inventory in order to carry on its operations. Further, current assets may include inventories that are not expected to be realised in the near future. On the other hand, many enterprises finance their operations with bank loans that are stated to be payable on demand and are hence classified as current liabilities. Yet, the demand feature may be primarily a form of protection for the lender and the expectation of both borrower and lender is that the loan will remain outstanding for some considerable period of time.
13. Some regard an excess of current assets over current liabilities as providing indication of the financial well-being of an enterprise, while an excess of current liabilities over current assets is regarded as an indication of financial problems. It is not appropriate to draw such conclusions without considering the nature of the operations of the enterprise and the individual components of its current assets and current liabilities.
14. The segregation of assets and liabilities between current and non-current asset is usually not considered appropriate in the financial statements of enterprises with indeterminate or very long operating cycles.
15. Thus, while it is generally believed that the identification of current assets and liabilities is a useful tool in financial analysis, some others believe that the limitations of the distinction make it of little use or even misleading in many circumstances. Imposition of a general requirement to identify current assets and liabilities in financial statements might impede further consideration of these questions. Accordingly, this Statement is intended only to

harmonise practices followed by enterprises that choose to identify current assets and liabilities in their financial statements.

Presentation of Current Assets and Current Liabilities

16. Each enterprise should determine whether or not to present current assets and current liabilities as separate classifications in its financial statements. Paragraphs 21-27 of this Standard apply when the current and non-current distinction is made.
17. When the current and non-current distinction is not made in the financial statements of an enterprise, no sub-totals of the amounts of assets and of liabilities need to be given that would imply that such distinction is made.

Current Assets

18. Among the items included in current assets should be:
 - (a) Cash and bank balances available for current operations. Cash and bank balances whose use for current operations are subject to restrictions should be included as a current asset only if the duration of the restrictions is limited to the term of an obligation that has been classified as a current liability or if the restrict lapse within one year.
 - (b) Securities not intended to be retained and capable of being readily realised.
 - (c) Trade and other receivables expected to be realised within one year of the balance sheet date. Trade receivables may be included entirely in current assets, provided that the amount not expected to be realised within one year is disclosed.
 - (d) Inventories.
 - (e) Advance payments on the purchase of current assets.
 - (f) Expense pre-payments expected to be used up within one year of the balance sheet date.

Current Liabilities

19. Among the items included in current liabilities should be obligations payable at the demand of the creditor and those parts of the following obligations whose liquidation is expected within one year of the balance sheet date:
 - (a) Bank and other loans, if a loan is repayable in accordance with a schedule of repayment agreed with the creditor, such loan may be classified in accordance therewith, notwithstanding a right of the creditor to demand current payment.

- (b) The current portion of long-term liabilities, unless excluded under the provisions of paragraph 23.
 - (c) Trade liabilities and accrued expenses
 - (d) Provision for taxes payable
 - (e) Dividends payable
 - (f) Deferred revenues and advances from customers
 - (g) Accruals for contingencies.
20. The current portion of a long-term liability may be excluded from current liabilities if the enterprise concerned intends to refinance the obligation on a long-term basis and there is reasonable assurance that the enterprise will be able to do so. Demonstration of this ability would require either:
- (a) the issue of share capital or a long-term obligation after the date of the balance sheet; or
 - (b) a non-cancellable financing agreement that does not expire within one year of the balance sheet date and that the lender or investor is financially capable of honouring.
21. When an undertaking excludes a liability from the current classification in accordance with paragraph 23, the amount of the liability and the terms of the refinancing should be disclosed.

Presentation in the Financial Statements

22. The amount at which a current asset and current liability are stated in the financial statements should not be reduced by the deduction of another current liability or current asset unless a legal right of set-off exists and the offsetting represents the expectation as to the realisation of the asset or settlement of the liability.
23. Progress payments and advances may be deducted from the amount of related construction work in progress, provided disclosure is made in accordance with Intentional Accounting Standard 11 relevant to the Accounting for Construction Contracts.
24. The total amount of current assets and the total amount of current liabilities should be disclosed in the financial statements.

Effective Date

25. This International Accounting Standard becomes operative for financial Statements covering periods beginning on or after 1 January 1981.

Questions

Self-Test Questions

1. Identify the items that will fall under fixed asset, current asset and long term liabilities section of Balance sheet as per format of Balance sheet as prescribed under Companies Act

(a) Commission for sale of shares (b) Inventory (c) Share premium
(d) Goodwill (e) Machinery (f) Fixed term deposit (g) Debenture
(h) Notes Receivable (i) Surplus of Income and Expenditure (j) Vehicles.
2. Which of the following items need to be disclosed in Balance Sheet as per International Accounting Standard:

(a) Retractions on the title of asset (b) Securities given in respect of liabilities (c) Commission paid to the bookers (d) unusual charge
(e) Loans Directors.

Discussion Questions

1. What is meant by Financial Statement?
2. State the relevant provisions of Company Act 1994 as to Balance Sheet and Profit & Loss Account.
3. Point out the salient features of Securities Exchange Rule 1987 as to preparation of Balance Sheet Profit & Loss Account.
4. State the features of Accounting Standards as to disclosure in Balance Sheet.

Lessons-4 & 5: Practical Problems

Lesson Objectives

After studying this lesson, you will be able to:

- explain the treatment of some typical items.
- prepare different parts of financial statements.
- deal with adjustments relevant to periodic accounts.

Some Typical Items of Corporate Final Account

Introduction

Corporation form of business has some special features and there are some expenditure which are typical to this form of business. Thus items which have typical treatment along with typical type of expenditure related with this form of business are dealt in this section of this chapter. Discussion on the typical items is now in order.

Income Tax

There are two views in this regard. One group holds that it is an appropriation of profit on the ground that it is determined only on the determination of profit. But other group holds opposite view and terms it as charge on the ground that appropriation implies some part of discretion on the part of management and that there is no such scope of discretion. However, the current view is a balanced approach under which above the line and below the line approach is followed. That is profit before charging tax is shown above the line, under which income tax is shown as separate items and by deducting this profit after tax is shown below the line.

Managerial Remuneration

It is a charge against profit for all legal and practical purposes, although sometime some of such remuneration may appear to be an appropriation of divisible profit. Any unpaid amount will be shown in Balance Sheet as liability.

Bonus to Employees

The amount of compulsory bonus i.e. festival bonus and the like, payable to the employee is regarded as charge. If, however it appears that the bonus is depended on profit, as to the compulsory bonus, the management does not have discretion on it and thus it should be treated as charge.

Prior Period Items

Since the purpose of the profit & loss account is to reveal the profit or loss for the period under review, it is necessary to distinguish prior or

subsequent period income or expenses and that adjustment shall have to be made if such items appear in the information sheet.

Commission Payable on Profits Available for Dividend

Profits available for dividend means profit remaining after appropriation and taxation which are to be compulsory provided for. However, in the absence of any provision to the contrary appropriation of profit, such as, transfer to reserve fund which is at the desecration of directors should not be deducted. It is to be remembered that taxes must be computed after charging all remuneration, including commission to the employee, if any. These commission to employee and tax would be interrelated. Hence, if profits are 'x', 't' is the tax and 'c' is the commission, then 'e' would be based on $(x-t)$ and t would be based on $(x-c)$. Simply it means that one has to be deducted from the profits before the other can be calculated.

Dividends

Dividend to shareholders represents appropriation of profit and shall have to be shown in appropriation account/section. If, however, one consolidated account is prepared, dividend paid and proposed dividend can be shown as deduction from available profit.

Profit Prior to Incorporation

Such profit shall be treated as capital profit and cannot be used as divisible profit. It can be used to write off intangible and fictitious asset or can be transferred to balance sheet as capital reserve.

Extraneous Profit

Profits arising from the following items need to be shown separately in profit and loss account:

- Extraordinary, unusual and non-recurring receipts;
- Profit arising from change in the basis of accounting;
- Capital gains and deferred expenses.

Preliminary Expenses

Expenses incurred in the formation of a company are called preliminary expenses. Such expenditures are incurred from initial formation stage to the commencement of business. It may include the following:

- Costs relevant to preparation and printing of Prospectus, Memorandum of Association, Article of Association etc.
- Advertisement expenses
- Printing of books
- Expenses for legal advises, counselling
- Cost of registration and the like.

Such expenditures are incurred once for the company and need to be distributed over some years. Thus a part of it is charged in one year and the rest is carried forward as deferred revenue expenditure.

Contingent Liability

It indicates the liability which may arise on the happening of some events. Examples of such liabilities are:

- Liability under bills discounted
- Liability under guarantees given
- Liability under pending suits
- Liability under unfinished contract
- Liability under partly paid shares.

Such liability is not taken into account until the event occurs and be shown as an item under inner column of Balance Sheet as note, and not to be shown in outer column i.e. as a part of total liability.

Practical Examples

Illustration-8.06

Lunar Ltd. was registered with equity share capital of Tk.40,000 of Tk.10 per share, issued 3,200 shares which were fully called up. But 1000 shareholders failed to pay the final call for Tk.3 per share.

The following is the unadjusted trial balance of the company as on 30th June, 2023.

Account Titles	Debit Tk.	Credit Tk.
Capital		29,000
Sales		1,83,000
Purchases	1,65,000	
Sales Return	600	
Purchase Return		2,500
Accounts Payable		18,000
Notes Payable		6,000
Accounts Receivable	40,000	
Office Equipment	4,600	
Cash in hand	15,000	
Merchandise Inventory (1.7.2022)	7,000	
Furniture	3,000	
Insurance	1,800	
Office Supplies	1,400	
Rental Expenses	600	
Office Salaries	3,200	

Account Titles	Debit Tk.	Credit Tk.
Last years' P/L A/c balance	900	
Advertisement Expenses	1,200	
Delivery Expenses	3,500	
Freight-in	2,200	
Bond		11,500
	<u>2,50,000</u>	<u>2,50,000</u>

The following adjusting data are available for action:

- 1) Expenses outstanding on 30-6-2023

Office salaries	Tk.800
Advertising	300
Freight-in	400
Rent	40
- 2) Office supplies expense Tk.1000
- 3) Unexpired Insurance 200
- 4) Depreciation of Office Equipment 600
- 5) Merchandise Inventory (30-6-2023) 28,500

Solution:

Income Statement of Lunar Ltd.

For the Year Ended on 30th June, 2023

Sales		Tk.1,83,000	
<i>Less: Return</i>		<u>600</u>	
Net Sales			Tk.1,82,400
Cost of goods sold:			
Opening Inventory		7,000	
Purchases	Tk.1,65,000		
<i>Less: Return</i>	<u>2,500</u>	1,62,500	
Freight-in	<u>2,200</u>		
<i>Add: Outstanding</i>	<u>400</u>	<u>2,600</u>	
		1,72,100	
<i>Less: Closing Inventory</i>		<u>28,500</u>	1,43,600
Gross Profit (Profit on purchase & sale)			<u>38,800</u>
Operating Expenses			
(a) Administration Expenses:			
i) Insurance	1,800		
<i>Less: Unexpired</i>	<u>200</u>	1,600	
ii) Office Supplies expense		1,000	
iii) Rental Expenses	600		
<i>Add: outstanding</i>	<u>40</u>	<u>640</u>	

iv) Office Salaries	3,200		
<i>Add: Outstanding</i>	800	4,000	
v) Depreciation on Office Equipment		600	
		7,840	
(b) Selling & Distribution Expenses:			
i) Advertisement Expenses	1,200		
<i>Add: outstanding</i>	300	1,500	
ii) Delivery Expenses		3,500	12,840
Net Income (Income form operation)			Tk.25,960

Balance Sheet of Lunar Ltd.

As at 30th June, 2023

<u>Assets</u>			
(A) Current Assets:			
Cash in hand		Tk.15,000	
Accounts Receivable		40,000	
Merchandise Inventory		28,500	
Office Supplies		400	
Unexpired Insurance		200	Tk.84,100
(B) Fixed Assets:			
Office Equipment	4,600		
<i>Less Depreciation</i>	600	4,000	
Furniture		3,000	7,000
Total Assets (A + B)			91,100
Represented by:			
(C) Short Term Liabilities:			
Accounts Payable	18,000		
Notes Payable	6,000		
Outstanding Expenses:			
i) Office Salaries	800		
ii) Advertising	300		
iii) Freight-in	400		
iv) Rent	40		
		25,540	25,540
(D) Long Term Liabilities			
Bond		11500	11,500
(E) Capital and Retained Earnings:			
Authorized	40,000		
Called up Capital	32,000		
<i>Less: Calls in arrear</i>	3,000	29,000	
Profit	25,960		
<i>Less: Last years' Loss</i>	900	25,060	
			54,060
Total Liabilities (C + D + E)			91,100

Illustration-8.07

The Progressive Company Ltd., a company with an authorised capital of Tk.50,000 in shares of Tk.20 each showed the following balances at December 31, 2023

Account Titles	Debit	Credit
Share Capital Account (20,000 Shares fully paid)		Tk.4,00,000
Freehold Premises at Cost	Tk.1,70,000	
Rates and Taxes	4,800	
Purchases	14,53,080	
Sales		18,93,100
Sales Ledger balances	1,74,180	
Purchases Returns		5,120
Purchases Ledger Balances		1,22,400
Director's Salaries	1,00,000	
Bad Debts written off	7,300	
Provision for Bad Debts		9,300
Interim Dividend paid	20,000	
Insurance	2,920	
Office Expenses	75,340	
Office Furniture and Fittings (Cost Tk.14,000)	7,000	
General Reserve		70,000
Inventory at January 1, 2023	2,01,980	
Bank	1,00,240	
Wages	1,17,840	
Motor Vehicles (Cost Tk.1,50,000)	1,00,000	
Discount	5,320	
Profit and Loss Account (Balance at January 1, 2023)		40,080
	<u>25,40,000</u>	<u>25,40,000</u>

Prepare the Trading and Profit and Loss Account for the year ending 31st December 2023 and a Balance Sheet as at that date, in accordance with Securities Exchange Rule 1987, as applicable in Bangladesh taking into consideration the followings, in the 'T' form

- The Rates and Taxes cover 15 months to March 31, 2024.
- The Insurance Account includes Tk.320 paid in advance.
- Depreciation is to be charged on Office Furniture and Fittings at 5 per cent on cost and on Motor Vehicles at 20 per cent on cost.
- The provision for Bad Debts is to be reduced to Tk.8,700.

- (e) Inventory in hand on 31st December, 2000 was valued at Tk.2,40,000.
 - (f) The General Reserve is to be raised to Tk.1,20,000.
 - (g) Provision is to be made for a final dividend of Tk.4 per Share issued.
 - (h) Contingent Liabilities Tk.40,000 for claims not admitted.
- Ignore income tax.

Solution:

Progressive Co. Ltd.
Trading and Profit and Loss Account

Dr.		For the Year Ended December 31, 2023		Cr.	
Opening Inventory		Tk.2,01,980	Sales		Tk.18,93,100
Purchases	Tk.14,53,080		Closing Inventory		2,40,000
Less Returns	5,120	14,47,960			
Wages		1,17,840			
Gross Profit c/d		3,65,320			
		21,33,100			21,33,100
Office Expenses		75,340	Gross Profit b/d		3,65,320
Directors' Salaries		1,00,000	Provision for Bad Debts:		
Rates and Taxes	4,800		Old	Tk.9,300	
Less Prepaid	960	3,840	Less New provision	8,700	600
Insurance	2,920				
Less Prepaid	320	2,600			
Discount		5,320			
Bad Debts		7,300			
Depreciation:					
Office Furniture @ 5%	700				
Motor Vehicles @ 20%	30,000	30,700			
Net Profit c/d		1,40,820			
		3,65,920			3,65,920

Profit and Loss Appropriation Account

Dr.		For the Year Ended December 31, 2023		Cr.	
Explanation		Tk.	Explanation		Tk.
Interim Dividend		20,000	Balance b/f from previous year		40,080
Proposed Final Dividend		80,000	Profit and Loss A/c		
General Reserve		50,000	(Net Profit of the current year)		1,40,820
Balance carried to Balance Sheet		30,900			
		<u>1,80,900</u>			<u>1,80,900</u>

Progressive Company Ltd.
Balance Sheet as at 31st December, 2023
 (According to the Form A of Securities Exchange Rule)

31.12.22 Tk.	Capital & Liabilities	31.12.23 Tk.	31.12.22 Tk.	Property & Assets	31.12.23 Tk.
	1. Capital & Reserve:			1. Fixed Assets:	
	Share Capital :		1,70,000	Freehold Premises (at cost)	1,70,000
	Authorized :			Office Furniture : cost 14,000	
5,00,000	25,000 ordinary shares of Tk.20 each.	5,00,000	7,000	Less : Dep. up to date <u>7,700</u>	6,300
	Issued & Subscribed Capital :			Motor Vehicles: cost 1,50,000	
4,00,000	20,000 ordinary shares of Tk.20 each fully paid	4,00,000	1,00,000	Less : Dep. up to date <u>80,000</u>	70,000
	Called up & Paid up Capital		—	2. Investments & Loans	-
4,00,000	20,000 ordinary shares of Tk.20 each fully paid	4,00,000		3. Current Assets:	
	2. Reserve & Un-appropriated Profit:		2,01,980	Inventory	2,40,000
	Reserves:		?	(at lower of cost & market price)	
70,000	Balance 70,000			Trade Debtors	1,74,180
	Current year's transfer <u>50,000</u>	1,20,000		Advance payments:	
			?	Prepaid Rates	960
40,080	Profit & Loss App. A/c balance	30,900	?	Prepaid Insurance	320
9,300	Bad debt provision	8,700	?		
	3. Long term Loans & Liabilities	—		Cash Bank	1,00,240
	4. Current Liabilities & Provisions:				
?	Trade Creditors	1,22,400			
?	Proposed Dividends	80,000			
	<i>Note: contingent liabilities for claims not admitted as debt Tk.40,000</i>				
		<u>7,62,000</u>			<u>7,62,000</u>

Note: As per Securities Exchange Rule figure of last year is to be given but as the figure for all items of last year is not ascertainable from given information, some of the columns remained blank.

[Students may themselves try to prepare the account in statement form i.e. in vertical form.]

Illustration-8:08

The following is the Trial balance of Sonargao Manufacturing Co., Ltd. as at 31-12-2023

Account Titles	Debit Tk.	Credit Tk.
Authorized Share Capital: 6000 Shares of Tk.10 each; Issued share capital: 4000 shares of Tk.10; Tk.7.50 called up		30,000
Call account (200 shares)	500	
Stock on 1st January	2,720	
Purchases and Sales	29,110	36,300
Debtors and Creditors	14,200	2,030
Sundry Expenses	1,820	
Wages and Salaries	4,100	
Investment (Market Price Tk.8,600)	9,000	
General Reserve		5,000
Dividend Equalisation Fund		5,000
Plant	8,000	
Goods out on Consignment	720	
Cash at Bank	10,000	
Cash in Hand	730	
Bills Receivable	10,000	
Taxation Provision		10,000
Investment Income		620
Repairs to Plant	400	
Rent paid	3,000	
Preliminary Expenses	1,000	
Investment Fluctuation Fund		300
Profit and Loss A/c Balance		6,050
	<u>95,300</u>	<u>95,300</u>

You are required to prepare Trading and Profit and Loss Account and Profit and Loss Appropriation Account for the year ended 31st December 2023 and a Balance Sheet as at that date having regard to the following as per provision of Company Act, 1994:

- (i) Closing Stock (Cost) Tk.17,000 (Market price Tk.15,000); (ii) All goods on consignment have been sold for Tk.1,000 subject to agent commission of 6% (iii) It was resolved to forfeit shares in default; (iv) Create a provision of 10% on debtors for bad and doubtful debt; (v) Taxation provision is to be increased to Tk.13,000; (vi) Transfer

Tk.1,000 to General Reserve and Tk.1,500 to Dividend Equalisation Fund; (vii) Depreciate plant @ 10% per annum; (viii) Dividend was proposed at 10% (ix) 20% of Preliminary Expenses were to be written off; (x) Increase the Investment Fluctuation Fund to cover the fall in the market price.

Solution:

Working Notes:

(a) Calculation of Profit on Consignment:	Tk.
Sales price of consigned goods	1,000
Less : Commission at 6%	60
Receivable form consignee	940
Less : Cost price	720
Profit	220
(b) Calculation of proposed dividend :	
Capital as per Trial Balance	30,000
Less: Capital for forfeited shares (200 × Tk. 7.50)	1,500
Subscribed and Paid up Capital	28,500
Proposed Dividends - 10% of Tk. 28,500	2,850

Sonargao Limited

Trading and Profit and Loss Account

Dr.		For the Year Ended on 31st Dec. 2023		Cr.	
Opening Stock	Tk.2,720	Sales		Tk.36,300	
Purchases	29,110	Closing Stock		15,000	
Wages and Salaries	4,100				
Repairs to Plant	400				
Depreciation on Plant	800				
Rent	3,000				
Gross Profit c/d	11,170				
	<u>51,300</u>			<u>51,300</u>	
Sundry expenses	1,820	Gross Profit b/d		11,170	
Provision for Bad and Doubtful Debts	1,420	Investment Income		620	
Transfer to Investment Fluctuation Fund	100	Profit out of Consignment		220	
Preliminary Expenses written off	200				
Net profit Tr. to P/L App. A/c	8,470				
	<u>Tk.12,010</u>			<u>Tk.12,010</u>	

Sonargao Limited
Profit and Loss Appropriation Account

Dr. For the Year Ended on 31st Dec. 2023 Cr.

Explanation	Tk.	Explanation	Tk.
Proposed Dividend	2,850	Balance b/d	6,050
Provision for Income tax	3,000	Profit and Loss A/c	8,470
Creation of General Reserve	1,000	(Current Year's Profit)	
Transfer to Dividend Equalisation Fund	1,500		
Balance Tr. to B/S	6,170		
	<u>14,520</u>		<u>14,520</u>

Sonargao Limited

Dr. Balance Sheet as at 31st Dec. 2023 Cr.

Liabilities	Tk.	Assets	Tk.
Share Capital:		Fixed Assets:	
Authorised Capital		Plant	8,000
6,000 shares of Tk.10 each	<u>60,000</u>	Less: Depreciation	<u>800</u>
Issued Share Capital		Investments	9,000
4,000 shares of Tk.10 each	<u>40,000</u>	Less: Fluctuation Fund	<u>400</u>
Subscribed Share Capital		Current Assets, Loans and Adv.:	
3,800 shares of Tk.10 each	<u>38,000</u>	Closing Stocks	15,000
Called up and Paid up Share Capital		Due to consignee	940
3,800 shares of Tk.10 each,		Sundry Debtors	14,200
Tk.7.50 called	28,000	Less: Provision for B/D	<u>1,420</u>
Add: Forfeited share A/c	<u>1,000</u>	Bills Receivable	10,000
	29,500	Cash in hand	730
Reserves and Surpluses:		Cash at Bank	10,000
General Reserve	5,000	Expenses not yet off:	
Add: New Reserve	<u>1,000</u>	Preliminary Exp.	1,000
Dividend Equalization fund	6,500	Less: Written off	<u>200</u>
Profit & Loss Appropriation A/c balance	6,170		800
Long-term Liability:			
Loan	-----		
Current Liabilities & Provision:			
Creditors	2,030		
Provision for Income tax			
(10,000 + 3,000)	13,000		
Proposed Dividend	2,850		
	<u>66,050</u>		<u>66,050</u>

Note: As the Company is a manufacturing one, depreciation on machinery & repair thereto has been charged to Trading A/C. As there is no indication of house to have been used for Office or Factory, the house rent has been charged to Trading Account.

Illustration-8.09

Cosmopolitan Company Limited presents you with the following Trial Balance as at 30th June, 2024:

Account/Titles	Dr. Tk.	Cr. Tk.
Preliminary Expenses	25,000	
Land and Building (Cost Tk.4,00,000)	3,10,000	
Machinery (Cost (Tk.4,50,000)	3,40,000	
Inventory (1st July, 2023)	65,000	
Purchases	3,30,000	
Salaries	50,000	
General Expenses	15,000	
Directors' Fees	13,000	
Auditors' Fees	12,000	
Wages	60,000	
Factory Overhead	20,000	
Carriage Inward	25,000	
Advertising	20,000	
Sundry Assets	60,000	
Goodwill	90,000	
Bank Balance	25,000	
Share Capital (Fully paid 4,000 shares of Tk.100 each)		4,00,000
Share Premium		60,000
General Reserve		80,000
Profit and Loss Account		45,000
Bank Loan (Taken on 1st July 2023 at 6%)		2,00,000
Accounts Payable		35,000
Sales		6,40,000
	<u>14,60,000</u>	<u>14,60,000</u>

Other Information:

The closing inventory on 30th June, 2024 was Tk.60,000. The Managing Director is entitled to a commission of 5% on net profit after charging his commission. Sundry Assets include Accounts Receivable of Tk.10,000 on which a provision of 5% is to be made for Bad Debts. The Directors recommended a dividend of 5%. Depreciation is to be charged for Machinery @ 10% and Land and Buildings @ 2% on the original cost. 50% of the advertisement is to be capitalised. Income tax provision @ 40% is to be provided for. Prepare Income Statement, Retained Earnings Statement for the year ended 30th June 2024 and a Balance Sheet as at that date.

Solution:**Cosmopolitan Trading Company Ltd.****Income Statement**

For the Year Ended 30th June, 2024

A) Sales		Tk.6,40,000.00
Return		-----
Net Sales		<u>6,40,000.00</u>
B) Cost of Good Sold:		
Inventory, July 1, 2023	Tk.65,000.00	
Purchases	<u>3,30,000.00</u>	
	3,95,000.00	
Less: Inventory, June 30, 2024	<u>60,000.00</u>	3,35,000.00
Wages		60,000.00
Carriage inward		25,000.00
Factory overhead		20,000.00
Depreciation : Machinery	45,000.00	
Land & Building	<u>8,000.00</u>	53,000.00
Cost of goods sold =		<u>4,93,000.00</u>
C) Gross profit = (A - B)		1,47,000.00
D) Selling & Administrative Expenses:		
Salaries	50,000.00	
General expenses	15,000.00	
Directors fees	13,000.00	
Auditors fees	12,000.00	
Interest on Bank loan	12,000.00	
Provision for Bad debts	500.00	
Advertising	10,000.00	
Managing Directors Commission	<u>1,642.86</u>	
		1,14,142.86
E) C - D = Profit before tax		32,857.14
F) Income tax @ 40% (Provision)		<u>13,142.86</u>
G) Net Profit after tax (E - F)		<u>Tk.19,714.28</u>

Retained Earning StatementFor the Year Ended 30th June 2024

Last Years' Profit		Tk.45,000.00
Current Year's Profit		<u>19,714.28</u>
		64,714.28
Dividend (5% on paid up capital)		<u>20,000.00</u>
Balance carried forward to Balance Sheet		<u>44,714.28</u>

Cosmopolitan Company**Balance Sheet**

As at 30th June, 2024

A) Fixed Assets:		
Goodwill		Tk.90,000.00
Land & Building	Tk.3,10,000.00	
Less Depreciation	8,000.00	3,02,000.00
Machinery	3,40,000.00	
Less Depreciation	45,000.00	2,95,000.00
Sundry assets	60,000.00	
Less Accounts Receivable	10,000.00	50,000.00
Total Fixed Assets		7,37,000.00
B) Current Assets:		
Inventories		60,000.00
Debtors		10,000.00
Cash at Bank		25,000.00
Total Current Assets		95,000.00
C) Fictitious Assets & Deferred Expenses		
Preliminary Expenses		25,000.00
Advertisement		10,000.00
		35,000.00
Total Assets (A + B + C)		8,67,000.00
Represented by:		
D) Capital & Retained Earnings:		
Authorized Capital:		
Issued and Subscribed and Paid up: 4000		
Shares of Tk.100 each	4,00,000	
Share Premium	60,000	
General Reserve	80,000	
Retained Earnings Balance	44,714.28	5,84,714.28
E) Long Term Liabilities:	-----	-----
F) Short Term Liabilities:		
Creditors	35,000.00	
Bank Loan	2,00,000.00	
Interest on Bank Loan	12,000.00	
Income tax Provision	13,142.86	
Provision for Bad debt	500.00	
Unclaimed dividend	20,000.00	
Managing Director's Commission	1,642.86	
		2,82,285.72
Total Liabilities (D + E + F)		Tk.8,67,000.00

Illustration-8.10

The following is the summary of the Balance Sheet of Five Stars Ltd. as at 31-12-2023

Capital & Liabilities	Tk.	Assets	Tk.
2,000, 9% Redeemable pref. share	2,00,000	Fixed Asset Less Dep.	3,00,000
100 Equity shares of Tk.1,000 each		Shares in Subsidiary Ltd.	
Tk.700 paid 70,000		(1,000 shares)	4,00,000
Less: Calls in arrear 4,000	66,000	Floating Assets	5,20,000
(20 shares @ Tk.200)		Cash & Bank Balance	1,80,000
calls in Advance	24,000		
(on 80 shares @ Tk.300)			
Reserves	5,00,000		
Profit and Loss App. A/c	2,50,000		
Provision for Taxation	3,60,000		
	<u>14,00,000</u>		<u>14,00,000</u>

Calls in arrear outstanding as from 1st January 2023 and the calls in advance were all received on that date. It is proposed that:

- (1) Dividend for the year ending on 31-12-2023 be declared @ 9% and 100% on preference and equity shares respectively.
- (2) Money for calls in advance be refunded.
- (3) Dividend payable to the shareholders with calls in arrear be applied to adjust amount due.
- (4) Preference shares, which are redeemable at a premium of 10% at any time upon two month's notice, to be redeemed by issue of Tk.2,00,000, 6% Debenture of Tk.100 each at par.

On the assumption that all formalities have been completed, you are asked to draft journal entries taking in the account income tax wherever applied. Assume the rate of tax to be deducted at source @ 30%. Redraft the Balance Sheet too.

Solution:

Five Stars Ltd.
Journal Entries

Date	Account Titles & Explanations	L.F.	Dr. Tk.	Cr. Tk.
31-12-2023	Profit and Loss Appropriation Account		76,000	
	Preference Dividend			12,600
	Equity Dividend			40,600
	Income-Tax			22,800
	(Dividend payable @ 9% on pref. shares Tk.18,000 less tax @ 30%, @ 100% on Equity shares; on Tk.50,000 for one year, on Tk.16,000 for 6 months less tax @ 30%)			

Date	Account Titles & Explanations	L.F.	Dr. Tk.	Cr. Tk.
	Calls in Advance		24,000	
	Interest		720	
	Shareholders			24,720
	(Calls in Adv. to be repaid with interest @ 6%)			
	Sunday Shareholders		100	
	Interest			100
	(Amount recoverable as interest on calls in arrear)			
	Equity Dividend payable		4,100	
	Calls in arrear			4,100
	(Amount recovered as calls in arrear and interest through adjustment)			
	Preference Dividend Payable Account		12,000	
	Equity Div. payable		36,600	
	Share holders (Calls in Adv.)		24,720	
	Cash			73,320
	General Reserve		20,000	
	Premium on Redemption of pref. shares			20,000
	(Premium payable on preference shares)			
	Cash		2,00,000	
	6% Debenture			2,00,000
	(Issue of 2000 Debentures of Tk.100 each at par)			
	General Reserve		2,00,000	
	Capital Redemption			2,00,000
	(Amount Tr. Redem. shares)			
	Pref. share capt. Redemption		2,00,000	
	Premium on Redemption		20,000	
	Cash			2,20,000
	(Pref. Share Redeemed)			

Five Star Ltd.

Balance Sheet

As at 31-12-2023

Capital & Liabilities	Tk.	Property & Assets	Tk.
Equity share capital		Fixed Asset	
100 shares of Tk.1,000 each		Less Depreciation	3,00,000
Tk.700 paid up	70,000	Shares in subsidiary company	4,00,000
Capital Redemption Fund	2,00,000	Floating Asset	5,20,000
General Reserve	2,80,000	Cash & Bank Balance	86,180
P/L App. A/c balance 2,50,000			
Less Dividend:			
(i) Pref. share 18,000			
(ii) Equity share 58,000			
(iii) Calls in Adv. <u>720</u>			
<u>76,720</u>			
1,73,280			
Add Interest on calls in advance <u>100</u>	1,73,380		
6% Debenture	2,00,000		
Provision for tax	3,60,000		
Income tax on dividend	<u>22,800</u>		
	<u>13,06,180</u>		<u>13,06,180</u>

Questions and Exercises

Self-Test Questions

1. Indicate where the following should be reported on the financial statement:
 - (a) gain on disposal of equipment considered obsolete
 - (b) uninsured loss on Building due to earth ----
 - (c) claims not recoverable from insurance company on goods destroyed by fire.
2. The following information is taken from Alpha-Beta Company
Total paid in Capital Tk.54,00,000

Common Stock, Tk.5 per share 1,00,000 share. 6% preference stock Tk.100 par value, callable of Tk.108 per share 10,000 shares preference dividend in arrears - 2 years

Total stockholders equity Tk.47,00,000.

Which of the following statement statements are correct:
 - (a) The preference dividends in arrears amount to Tk.1,20,000 and appear as a liability in Balance Sheet
 - (b) The stockholders equity section of the Balance Sheet should indicate a deficit of Tk.7,00,000.
 - (c) The company has paid no dividend on its common stock for past two year.

Discussion Questions

1. State the classification (asset, liability, equity, revenue expenses) of the following:
 - (a) sales receipts receivable (b) Organization cost (c) Retained earnings (d) Income tax (e) Paid in capital.
2. What is meant by Financial Statement?
3. State the relevant provisions of Company Act 1994 as to Balance Sheet and Profit & Loss Account.
4. Point out the salient features of Securities Exchange Rule 1987 as to preparation of Balance Sheet and Profit & Loss Account.
5. State the features of Accounting Standards as to disclosure in Balance Sheet.
6. What is meant by contingent liability? Give some examples of contingent liabilities.

7. What is preliminary expenses? What are its components? How is it to be treated in final account of a company?
8. How the following items will be treated in final account of a corporation :
 - (a) Income Tax; (b) Manager's Remuneration; (c) Pre-incorporation Profit; (d) Dividends; (e) Extraneous Profit.

Exercises

Ex.1

Following is the Trial Balance of Joy Trading Co. as at 30-06-2024.

Account Titles	Dr. Tk.	Cr. Tk.
Share Capital: 3,000 shares of Tk.15 each. Tk.10 called up		30,000
Calls in arrear	500	
Inventory	2,700	
Purchases & Sales	22,000	36,000
Stationery	1,300	
Loose tools	1,000	
10% Investments	9,000	
Machinery (Cost price)	21,700	
Bad Debts	1,030	
Receivable & Payable	26,000	2,000
Goods out on consignment	720	
Interest on Investment		300
Income Tax provision		5,000
Interest on Debentures	250	
Tax paid	4,100	
6% Debentures		5,000
Depreciation Reserve		6,000
Profit and Loss Account (01-07-2023)		6,000
	<u>90,300</u>	<u>90,300</u>

Adjustments:

- 1) On 30th June, 2024 closing inventories were valued at Tk.10,900, market value of the same was Tk.15,000.
- 2) Sales included Tk.3,200 goods sold on Sale or Return basis, which were not yet confirmed. Cost price of the goods was Tk.2,500.
- 3) Closing inventories includes unused stationer stock worth Tk.300.
- 4) Depreciate Machinery by 10% and create a reserve for Doubtful debts at 5% on Debtors.
- 5) Provision for income tax to be kept to Tk.6,000.
- 6) Make a provision for dividend @ 15%.

Required:

Prepare financial year-end Financial Statements of the Company.

Ex.2

From the following information, extracted from the records of Rajshahi Trading Co. Ltd., prepare Income Statement, Retained Earnings Statement for the year ended 30th June, 2023 and a Balance Sheet as at that date.

Dr.		Trial Balance		Cr.	
Account Titles	Tk.	Account Titles	Tk.		
Receivables	16,000	Creditors	12,200		
Cash	800	Provision for Doubtful Debts	650		
Inventories	17,500	Accumulated Depreciation-Vehicle	1,400		
Vehicles	3,500	Sales	67,040		
Cost of Goods Sold	46,000	Capital	20,000		
Sales returns	2,200	Accumulated Depreciation : Plant	2,000		
Salesmen's Salaries	3,000	8% Debentures	6,000		
Office Expenses	750	Profit and Loss Appropriation A/c	3,600		
Bank	1,400	Bills Payable	1,200		
Bad Debts	700	Purchase Discount	800		
Cartage on Purchases	1,600				
Goodwill	800				
Plant	8,000				
Land	5,000				
Fixtures and Fittings	2,400				
Sales Discount	650				
Rent	4,200				
Insurance	390				
	<u>1,14,890</u>		<u>1,14,890</u>		

Adjustments:

- (i) Result of physical inventories taking at 30-06-2023 Tk.17,200.
- (ii) Accrued office expenses Tk.80.
- (iii) Rent is paid firstly in advance on 1st October (at the rate of Tk.350 per month.)
- (iv) Insurance was taken out for the first time on 31st December, 2022 when one year's premium was paid.
- (v) Increase doubtful debt provision to 5% of outstanding debtors.
- (vi) Provide depreciation on plant at 10% on reducing balance.
- (vii) Provide depreciation on vehicles at 20% per annum on cost.
- (viii) Debentures were issued on 31-3-2022, interest is payable half-yearly.
- (ix) Declared dividend at 10% on paid up capital.
- (x) Transfer Tk.1,000 to general reserve.
- (xi) Provision for tax to be Tk.3,600
- (xiii) Write off balance of goodwill.

Ex.3

The following Trial Balance was extracted from the books of Ring Metals Limited, a Manufacturing Company, at 31st October, 2023.

Account Titles	Dr. Tk.	Cr. Tk.
Shares Capital (Authorised and Issued) Ordinary shares of Tk. 10 each		60,000
Profit and Loss Account, 1 November, 2022	18,550	
Share Premium Account		5,000
6% Debentures		20,000
Debtors and Creditors	64,947	20,260
Opening Stocks: Raw materials	18,260	
Work-in-Progress	12,480	
Finished goods	18,060	
Bank Balance	38,400	
Factory Buildings	42,000	
Fixtures and Fittings	28,420	
Provision for depreciation:		
Factory Building		4,200
Plant and Machinery		17,052
Fixtures and Fitting		3,840
Productive wages	71,940	
Raw materials purchased	49,770	
Bad debts written off	460	
Carriage inwards	190	
Carriage outwards	2,840	
Non-productive factory labour	21,450	
Light, heat and power	2,200	
Rent, rates and insurance	3,650	
Directors' salaries	41,205	
Audit fee	1,600	
Sales		3,00,000
Bank charges	1,400	
Advertising	1,200	
Debenture interest paid	600	
Administrative expenses	18,230	
	<u>4,48,902</u>	<u>4,48,902</u>

Notes:

(i) Closing stocks are valued as follows:

Raw materials	19,460
Work-in-Progress	14,444
Finished Goods	24,215

- (ii) Factory Buildings are depreciated at 2% per annum. All other fixed assets are depreciated at 20% of cost.
- (iii) There were accruals at 31 October, 2023 as follows:

Advertising	Tk.150
Work-in-Progress	Tk.90
- (iv) Tk.150 of the rent, rates and insurance was paid in advance at 31 October, 2023
- (v) The rent, rates and insurance is to be split in the proportion 3/5 factory, 2/5 administration and the light, heat and power is apportioned ½ factory, ¼ administration and ¼ selling expenses.
- (vi) A tax provision of Tk.30,000 is to be made and the directors propose a dividend of 20%.

You are required to:

- (a) Prepare the Manufacturing, Trading and Profit & Loss Accounts of Ring Metal Limited for the year ended 31st October, 2023 (including an Appropriation Account).
- (b) Prepare the Balance Sheet of the company as at 31st October, 2023.

Ex.4

Following are the Revenue Balances in the Books of Fair Traders Ltd. as on 31-12-23. Trading A/c: Gross profit for the year to date Tk.9,00,000, Salaries Tk.7,500 (including fees to director 5,000) Rates & Rents Tk.60,000; Repairs Tk.1,50,000, Sundry expenses Tk.1,00,000 Bank Charges & Interest 10,000; Debenture interest (Gross) Tk.25,000 and Depreciation Tk.50,000.

The part-time Director is entitled to remuneration for the year Tk.49,000 & provision is to be made for this.

The Managing Director is entitled to 5% of Profit of the year after charging such commission but a condition of the agreement is that for the purpose of calculating his commission, the charge for repairs shall not exceed 30% of total debits mentioned above excluding those for repairs & managing director's percentage.

The capital of the Company is Tk.20,00,000 & a dividend of 7% (Less tax) is proposed. Provision for tax is to be made @ 50%.

Prepare Income Statement

Ex.5

The following balances appeared on 31st December, 2023 in the books of True and Fair Ltd. Prepare the Profit and Loss account for the year ended 31st Dec. 2023 and Balance Sheet as on the date in the Standard form:

Account Titles	Dr. Tk.	Cr. Tk.
Share Capital: Authorised and issued shares of Tk.10 each		30,00,000
General reserve		3,00,000
Provision for taxation on 1st January, 2023		4,41,000
Profit and loss account		5,73,850
Taxation payment	3,65,400	
6% Mortgage debentures, redeemable in 2029		10,00,000
Balance from trading account		10,52,000
Interim dividend for the year	1,72,500	
Debenture redemption reserve		2,00,000
Share premium account		50,000
Directors' fees	20,000	
Unexpired payment	30,000	
Debentures interest (less tax at 20%)	48,000	
Creditors and accrued charges		20,34,800
Balance at bank	2,50,000	
Cash in hand	5,000	
Tax deducted at source on dividends on investments	15,750	
Dividends on investments		50,000
Investments at cost (market value Tk. 4,73,750)	5,00,000	
Debtors (including Tk. 12,800 due for more than six months)	24,55,000	
Inventory and work-in-progress	16,60,000	
Vehicles (cost Tk. 1,50,000)	1,00,000	
Furniture and equipment (cost Tk. 2,00,000)	1,60,000	
Plant and machinery (cost Tk. 30,00,000)	21,20,000	
Land and buildings (cost Tk. 10,00,000)	8,00,000	
	<u>87,01,650</u>	<u>87,01,650</u>

- Notes:**
1. Depreciation provision for the year charged against trading: Leasehold land and building Tk.50,000; Plant and machinery Tk.3,00,000; Furniture and equipment Tk.16,000; and Vehicles Tk.25,000, W.D.V. on 1-1-23: Land & Building Tk.10,00,000, Plant Tk.30,00,000 Furniture, Tk.2,00,000 & Vehicle Tk.1,50,000.
 2. Directors remuneration charged against trading: Salaries Tk.1,00,000 and Pension to retired managing director Tk.15,000.
 3. Provision for taxation required Tk.5,03,270
 4. Directors recommend: (a) transfer of Tk.2,00,000 to debentures redemption reserve. (b) transfer of Tk.3,50,000 to general reserve: and (c) Payment of final dividend of 12% subject to deduction of tax at appropriate rates.

Ex.6

The following is the Trial Balance of **Ideal Manufacturing Ltd.**

As on 30th September 2024

Debit balances	Tk.	Credit balances	Tk.
Opening inventory	1,32,000	Sales	7,76,000
Purchases	1,84,000	Departmental order and items used	
Stores and spares consumed	10,000	in works	90,400
Manufacturing and Misc. expenses	1,65,000	Dividends	1,000
Salaries, wages, etc., to employees	1,90,000	Profit on block sold	30,000
Freight and insurance	57,000	Sundry receipts	3,000
Transfer to repairs reserve	52,000	Profit and loss account	20,000
Interest on loan	22,500	Provision for depreciation on	
Depreciation	51,500	fixed assets	5,60,000
Interim dividend	28,000	Share Capital	2,80,000
		Share Premium	20,000
Fixed assets at cost:		General reserve	80,000
Opening balance	12,60,000	Development rebate reserve	1,20,000
Addition	67,000	Repairs reserve	40,000
Investments	26,000	Secured loan	2,30,000
Debtors	1,02,400	Unsecured loan	50,000
Interest on capital during construction		Creditors	1,70,000
(from last year)	15,000	Provision for taxation	75,000
Deposits	40,000	Outstanding expenses	5,000
Cash at bank	1,40,000		
Cash in hand	2,000		
Managing director's remuneration			
(minimum)	6,000		
	<u>25,50,400</u>		<u>25,50,400</u>

The following further information are available: (1) Closing inventory was valued at Tk.1,47,000. (2) Managing director is entitled to 5 per cent remuneration on the net profits of the company, (3) Profit on block sold at Tk.20,000. (4) Depreciation allowable under Income-Tax Laws Tk.65,000. (5) Profit and Loss Account: Balance Tk.20,000 has been arrived at after debating for: Provisions for taxation Tk.75,000 and Tk.15,000 for development rebate reserve. (6) Repairs reserve balance of Tk.40,000 has been arrived at as follows: Opening balance, Tk.38,000 Plus transfer during the year Tk.52,000 minus actual expenses Tk.50,000. (7) Final dividend making a total of 20 per cent on the paid-up capital of the company less interim dividend already declared has been proposed by the board of directors. (8) Amount of share capital is composed of shares of Tk.10 each fully paid.

You are required to prepare the Profit and Loss Account for the year ended 30th September 2024.

Ex. 7

A-Z Ltd., a public Ltd. Co. with an authorized capital of Tk.15,00,000 in shares of Tk.10 each, has issued 80,000 shares of which 60,000 are fully paid & 20,000 are Tk.8 each paid. On 31st December 2023, the Trial Balance of the company was as follows:

Account Titles	Dr. Tk.	Cr. Tk.
Share Capital		7,60,000
General Reserve		30,000
Share Premium Account		10,000
Freehold Land and Building, cost	2,45,000	5,73,850
Plant and Machinery, cost	5,78,000	
Calls in advance		4,000
Preliminary Expenses	20,000	
Provision for Income Tax		1,10,000
5% Debentures		40,000
Trade Investments, cost	2,10,000	
Inventory at cost	2,94,800	
Trade Creditors and accrued expenses		36,770
Debtors	65,210	
Provision for Depreciation, December 31, 2022:		
Buildings	7,500	
Plant and Machinery	<u>1,28,000</u>	
		1,35,500
Quoted Investments, cost	20,000	
Advance payment of Tax	70,000	
Interest on Debentures, net	1,400	
Profit on Trading		3,48,030
Interest on Quoted Investments, after deducting tax @ 30%		630
Interest on Trade Investments, after deducting tax @ 30%		7,350
Bank Account	51,570	
Petty cash	900	
Profit and Loss Account, January 2023		64,600
Debenture Redemption Reserve		10,000
	<u>15,56,880</u>	<u>15,56,880</u>

Adjustments:

- (1) Provision is to be made for director's fees Tk.10,000; auditors remuneration Tk.3,150; depreciation on buildings Tk.2,300 and on Plant and Machinery Tk.46,000; obsolete inventory of no value included in inventory at Tk.15,000; doubtful debts Tk.3,000 and damages payable under a judgment against the company Tk.30,000.
- (2) Profit on Trading is after charging the salary of Tk.36,000 paid to the Managing Director.
- (3) The Trade Investments are not quoted; the quoted investments had a market value of Tk.28,000 on 31st December, 2023.
- (4) Provision required for taxation Tk.2,26,780.

- (5) The Directors decide to write off the preliminary expenses; to set aside Tk.5,000 to Debenture Redemption Reserve; Tk.25,000 to meet future fluctuations in raw material prices; to transfer Tk.80,000 to General Reserve in view of unfulfilled orders for capital commitments amounting to Tk.1,00,000, to distribute a dividend of 7% free of income tax and to carry forward the balance on Profit and Loss Account.

You are required to prepare final accounts of the company for the concerned period.

Ex.8

At the close of the current year, the stockholders' equity section of the Skylab Company balance sheet appeared as follows:

Stockholders' Equity:		
Tk. 1.50 preferred stock, Tk.25 par value authorized 1,500,000:		
Issued	Tk.10,800,000	
Subscribed	5,400,000	Tk.16,200,000
Common stock, no par, Tk. 5 stated value, authorized 600,000 shares		12,300,000
Paid-in capital in excess of par or stated value:		
On preferred stock	810,000	
On common stock	7,626,000	8,436,000
Retained earnings (deficit)		(600,000)
Total stockholders' equity		Tk.36,336,000

Among the assets of the company appears the following item.
Subscriptions Receivable: Preferred, Tk.1,123,200

On the basis of this information, write a brief answer to the following questions, showing any necessary supporting computations.

- How many shares of preferred and common stock have been issued?
- How many shares of preferred stock have been subscribed?
- What was the average price per share received (including stock subscribed) by the company on its preferred stock?
- What is the total paid in capital including stock subscribed?
- What is the stated value of capital stock?

Ex.9

The Articles of Association of ABC Ltd. provide for the following:

- (1) That 10 per cent of the profits of each year shall be transferred to Reserve Fund;
- (2) That an amount equal to 10 percent of Equity Dividend shall be set aside for Bonus to staff;
- (3) That the balance available for distribution shall be applied:
 - (a) in paying 8 per cent of Cumulative Preference shares;
 - (b) in paying 12 per cent on Equity Shares;
 - (c) One-third of the balance available to additional dividend on Preference Shares and 2/3rd to additional equity Dividend.

A further condition was also imposed by the Articles, viz., that the balance carried forward shall not be reduced by the provisions under either (2) or (3) (b) or (c) below a sum equal to 6% on the Preference Share Capital.

The Company has issued 26,000, 8% Cumulative Participating Preference Shares of Tk.100 each fully paid up and 1,30,000 Equity Shares of Tk.10 each fully paid.

The profit for the year 2023 was Tk.10,00,000 and the balance brought forward from the previous year Tk.1,60,000. Provide Tk.66,000 for Depreciation and Tk.4,00,000 for Taxation before making other appropriations.

Prepare the Profit and Loss (Appropriation) Account.

Ex.10

XYZ Ltd. presents the following balance sheet to you for the year ended on 31-12-2023.

Capital & Liabilities	Tk.	Property and Assets	Tk.
Share Capital:		Fixed Assets:	
Authrised	20,00,000	Plant & Machinery	8,60,000
Issued & subscribed:		Furniture, Fittings & Fixtures	1,00,00
3,000, 10% Preference shares Tk. 100 each, fully paid up	3,00,000	Patents & Trade Mark	20,000
60,000 Equity Shares of Tk. 10 each fully paid up	6,00,000	Current Assets, Loans and Advances:	
Reserves and surplus:		(a) Current Assets	
Capital Reserve	1,10,000	Stock	7,85,000
Share Premium	90,000	Debtors	1,00,000
General Reserve	6,00,000		

Capital & Liabilities	Tk.	Property and Assets	Tk.
Profit & Loss Account	1,05,000	Cash in Hand	5,500
Current Liabilities and provisions:		Cash in Bank	1,90,000
(a) Current Liabilities		(b) Loans and Advances	
Sundry Creditors	1,15,000	Bills of Exchange	40,000
(b) Provisions			
Provision for Taxation	1,80,000		
	<u>21,00,000</u>		<u>21,00,000</u>

The company purchases fresh machinery for Tk.1,25,000 for which it pays Tk.25,000 in cash and allots 1,000, 14% Preference shares of Tk.100 each as fully paid up to vendors. The company then issues one fully paid bonus equity share of Tk.100 each for every three equity shares held to its equity shareholders. For this purpose the balances in Profit & Loss Account and General Reserve are used to the necessary extent.

You are required to pass journal entries for the above mentioned transactions and redraft the company's balance sheet.

Case Study

1. Alpha-Beta Company

Alpha-Beta Limited is in financial difficulties. They need bank loan and have contacted with several Banks. The banks have asked them to submit Balance Sheet and Income Statement. The Balance Sheet must be audited and be dated December, 31st. In November the Draft Balance Sheet stood as follows:

In '000 Tk.			
Capital and Liabilities	Amount	Property and Assets	Amount
Equity shares	200	Goodwill	180
Retained Earnings	30	Land & Building	320
Depreciation Fund	40	Inventor	250
6% Debenture	220	Stores	40
Accounts payable	280	Vehicle	80
Notes payable	150	Accounts Receivable	80
Income (Debit)	100	Notes Receivable	50
		Cash in hand	5
		Bank	15
Total	1020	Total	1020

Managing Director called a meeting of the senior officers of Accounts Division and discussed the matter with them. Managing Director desired that the Balance sheet should be so drawn at year end so that financial strength is shown better. The chief accounts officer pointed out the following three aspects which will help showing better picture.

(i) "At year-end, we'll owe accounts payable of about Tk.3,00,000. If we were to show this liability in our balance sheet at half that amount no one would know the difference. We could report the rest as stockholders' equity and our financial position would appear much stronger."

(ii) "We owe Gama Tk.2,00,000 due in 90 days. I know some people at Gama. If we were to sign a note and pay them 12% interest, they'd let us postpone payment of this debt for a year or more."

(iii) "We own land that cost Tk.2,00,000 but today is worth at least 4 times. Let's show it at Tk.8,00,000 in our balance sheet, and that will increase our total assets and our stockholders' equity."

Instructions:

(a) Separately evaluate each of these three proposals. Your evaluations should consider ethical and legal issues as well as accounting issues.

(b) Draft the Balance Sheet in statement form.

2. Fahim and Imran

Fahim and Imran were unusual friends. Fahim came from a background of poverty while Imran had an extremely affluent family. Indeed, the two would have never known each other except for an unusual set of events. Imran's parents bought him a new car on his 16th birthday. Not being used to the new vehicle, Imran misjudged a curve and wrecked the car. Fahim happened to see the accident and helped Imran get out of the vehicle. Imran was unhurt but extremely distraught. He told Fahim that his own parents would never trust him again. When the police arrived, Fahim told them that he had seen a child run in front of Imran's car and that Imran had swerved off the road to save the child's life. Upon learning the story, Imran's parents considered him a hero, the insurance company paid the claim and Imran made a friend for life.

Imran became a CA and started practicing in his father's accounting firm. Fahim worked for several restaurants and finally managed to start one of his own. The restaurant became successful, and Fahim turned the accounting work over to Imran. Having no formal education, Fahim had little knowledge of technical business practices.

At the beginning of 2023, Fahim's Balance Sheet contained a cash account with a Tk.10,000 balance, other assets with balances amounting to Tk.3,80,000, liabilities of Tk.80,000 and contributed capital of Tk.25,000. Imran provided Fahim with accounting services for several years and was reasonably certain as to the accuracy of these figures. Since Imran always advised Fahim on financial matters, Imran was aware that during 2023 Fahim repaid Tk.15,000 cash on a note payable that evidenced the restaurant's liability to a bank, he also paid cash to purchase Tk.50,000 of restaurant equipment. Finally, Fahim had received a 20,000 cash dividend from the restaurant. The records also indicated that the restaurant earned Tk.200,000 in cash revenues and incurred Tk.175,000 in cash expenses. The ending balance in the cash account was Tk.12,000.

After analyzing the data, Imran became convinced that Fahim was not reporting accurate information to him for the determination of net income.

Questions:

- (a) Based on the information provided in the case, determine the amount of Fahim's unreported income.
- (b) If you were Imran, would you sign Fahim's tax return as it was presented to you by Fahim? Why or why not?

References (Unit- 3, 4, 5)

1. Accounting Principles, Robert N. Anthony and James S. Reece, Seventh Edition (1995) Richard D. Irwin Inc.
2. Financial Accounting : An Introduction, Paul H. Walgenbach and Ernest I. Hamsou. Sixth Edition (1990), Harcourt Brace Jovanovich College Publishers.
3. Financial Accounting, Belverd E. Needles, Jr., Third Edition (1989), Houghton Mifflin Company, Boston.
4. Financial Accounting, Robert F. Meigs and Mary A. Meigs, 6th Edition (1989), McGraw Hill Publishing Company.
5. Financial Accounting, Robert F. Meigs, Mary A. Meigs, Mark Bather, and Ray Whittington, 9th Edition (1998), Irwin/McGraw-Hill.
6. Intermediate Accounting, Donald E. Kieso and Jerry J. Weygandt, 8th Edition (1995), John Wiley & Sons Inc.
7. Intermediate Accounting, Donald E. Kieso, Jerry J. Weygandt, V. Bruce Irvine, W. Harold Solvest, and Nicola M. Young, 5th Canadian Edition (1998), John Wiley & Sons Canada Ltd.
8. Financial Accounting, K. Fred Skousen, W. Steve Albrecht, and James D. Stice, 6th edition (1998), South-Western College Publishing.
9. Introduction to Financial Accounting, Charles T. Horngren, Gary S. Sundem, and John A. Elliott, 5th edition (1993), Prentice Hall Englewood Cliffs. New Jersey.
10. Intermediate Accounting, Lanny C. Chasteen, Richard E. Flatter, and Melvin C. O' Connor, 4th Edition (1992), McGraw-Hill, Inc.