INTERMEDIATE : PAPER - 5

FINANCIAL ACCOUNTING

INTERMEDIATE

STUDY NOTES

The Institute of Cost Accountants of India
CMA Bhawan, 12, Sudder Street, Kolkata - 700 016

First Edition : February 2013
Revised Edition : May 2013
Second Edition : July 2013
Third Edition : March 2014
Fourth Edition : March 2016

Published by :
Directorate of Studies
The Institute of Cost Accountants of India (ICAI)
CMA Bhawan, 12, Sudder Street, Kolkata - 700 016

Printed at :
Repro India Limited
Plot No. 02, T.T.C. MIDC Industrial Area,
Mahape, Navi Mumbai 400 709, India.
Website : www.reproindialtd.com

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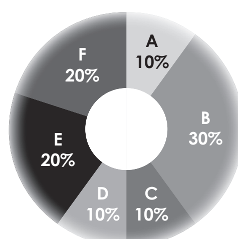
Syllabus

Paper 5: Financial Accounting (FAC)

Syllabus Structure

The syllabus comprises the following topics and study weightage

A	Generally Accepted Accounting Principles & Accounting Systems	10%
B	Preparation of Accounts	30%
C	Control of Accounting Systems	10%
D	Accounting in Service Sectors	10%
E	Accounting for Special Transactions	20%
F	Accounting for Banking, Electricity and Insurance Companies	20%



ASSESSMENT STRATEGY

There will be written examination paper of three hours

OBJECTIVES

To gain understanding and to provide working knowledge of accounting concepts, detailed procedures and documentation involved in financial accounting system.

Learning Aims

The syllabus aims to test the student's ability to:

- Understand the framework of accounting systems and the Generally Accepted Accounting Principles
- Prepare necessary financial statements related to different business entities
- Construct financial statements for understandability and relevance of stakeholders

Skill set required

Level B: Requiring the skill levels of knowledge, comprehension, application and analysis.

Section A : Generally Accepted Accounting Principles & Accounting Systems	**10%**
1. Accounting Process	
2. Accounting Standards	
3. Reconciliation Statements	
Section B : Preparation of Accounts	**30%**
4. Accounting for Depreciation, Depletion, Amortization and Impairment of Assets	
5. Preparation of Financial Statements	
6. Partnership	
7. Branch and Departmental Accounts	
8. Royalty and Hire-Purchase	
Section C : Control of Accounting Systems	**10%**
9. Self-Balancing Ledgers and Sectional Balancing Ledgers	
Section D : Accounting in Service Sectors	**10%**
10. Accounting in Service Sectors	
Section E : Accounting for Special Transactions	**20%**
11. Accounting for Special Transactions	
Section F : Accounting for Banking, Electricity and Insurance Companies	**20%**
12. Banking , Electricity and Insurance Companies	

SECTION A: GENERALLY ACCEPTED ACCOUNTING PRINCIPLES & ACCOUNTING SYSTEMS [10 MARKS]

1. Accounting Process

(a) Theoretical framework (meaning, scope and usefulness of Accounting; Accounting principles, concepts and convention)

(b) Accounting Life Cycle (ALC) – From Investment of Capital (Cash) to Realization of Revenue (Cash)

(c) Capital and Revenue transactions- capital and revenue expenditures, capital and revenue receipts

(d) Measurement, valuation and accounting estimates Double entry system, books of prime entry, subsidiary books, cash book, ledgers, trial balance

(e) Rectification of errors, opening entries, transfer entries, adjustment entries, closing entries

2. Accounting Standards

(a) AS-1: Disclosure of Accounting Policies
(b) AS-2: Valuation of Inventories
(c) AS-4: Contingencies and Events Occurring after the Balance Sheet Date
(d) AS-5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
(e) AS-10: Accounting for Fixed Assets
(f) AS-11: The Effects of Changes in Foreign Exchange Rates
(g) AS-15: Employee Benefits
(h) AS-16: Borrowing Costs

3. Reconciliation Statements

(a) Bank Reconciliation Statements
(b) Stock Reconciliation Statements
(c) Receivables / Payables Reconciliation Statement

SECTION B: PREPARATION OF ACCOUNTS [30 MARKS]

4. Accounting for Depreciation, Depletion, Amortization and Impairment of Assets

(a) Depreciation Policy, Depletion, Amortization and Impairment of Assets
(b) Depreciation Accounting (AS – 6); Impairment of Assets (AS -28)
(c) Methods, computation and accounting treatment

5. Preparation of Financial statements :

(a) Of Profit-making organizations:
   (i) Preparation of Profit & Loss Account and Balance Sheet
   (ii) Preparation of Cash Flow Statement (AS – 3)
   (iii) Accounting treatment of bad debts, reserve for bad and doubtful debts, provision for discount on debtors and provision for discount on creditors

(b) Of Not-for-Profit organizations :
   (i) Preparation of Receipts and Payments Account
   (ii) Preparation of Income and Expenditure Account
   (iii) Balance Sheet

(c) Under single entry system including conversion of single entry into double entry system :
   (i) Concept of single entry system, conversion of single entry system into double entry system of accounting
   (ii) Application of accounting ratios for preparation of accounts under single entry system

6. Partnership

(a) Past adjustments and guarantee, profit & loss appropriation account
(b) Admission, Retirement, Death, Treatment of Joint Life Policy
(c) Dissolution of partnership firms including piece meal distribution
(d) Amalgamation of partnership firms, Conversion of partnership firm into a company and sale of partnership firm to a company

7. Royalty and Hire Purchase

(a) Accounting from the point of view of various parties
(b) Possession and repossession in case of default in payments

8. Branch and Departmental Accounts

(a) Branch Accounts-Debtors system, Stock & Debtors system, Foreign Branch
(b) Departmental Accounts: Trading Account; Profit & Loss Account
(c) Calculation of net profit of various departments and allocation of expenses on the basis of suitable base, treatment of shortages, treatment of unrealized profit
(d) Preparation of General Profit & Loss Account and Balance Sheet

SECTION C : CONTROL OF ACCOUNTING SYSTEMS [10 MARKS]

9. Self-Balancing Ledger and Sectional Balancing Ledgers

(a) Self- Balancing Ledgers
(b) Sectional Balancing Ledgers

SECTION D: ACCOUNTING IN SERVICE SECTOR [10 MARKS]

10. Accounting for Service Sectors

(a) Revenue Recognition (AS-9)
(b) Construction Companies (AS 7), Project Accounting
(c) Service sectors such as Software, ITES, Telecommunication, Entertainment, Hospital, Educational Institutions

SECTION E: ACCOUNTING FOR SPECIAL TRANSACTIONS [20 MARKS]

11. Accounting for Special Transactions

(a) Bills of Exchange, Consignment, Joint venture, Sale of goods on approval or return basis, Account Current
(b) Investment Accounts (AS – 2, 13)
(c) Insurance Claim (Loss of Stock and Loss of profit)

SECTION F: ACCOUNTING FOR BANKING, INSURANCE AND ELECTRICITY COMPANIES [20 MARKS]

12. Banking, Electricity and Insurance companies

(a) Accounts of a Banking Company (as per Banking Companies Regulation Act)
(b) Accounts of an Electricity Company (as per Electricity Act)
(c) Accounts of Insurance Companies (as per Insurance Act) including Stock Valuation

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Study Note - 1

ACCOUNTING PROCESS

This Study Note includes

1.1 Introduction
1.2 Definitions
1.3 Accounting Cycle
1.4 Objectives of Accounting
1.5 Basic Accounting Terms
1.6 Generally Accepted Accounting Principles
1.7 Accounting Concepts and Conventions
1.8 Events and Transactions
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1.10 The Concepts of "Account", "Debit" and "Credit"
1.11 Types of Accounts
1.12 The Accounting Process
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1.16 Accounting Standards
1.17 Double Entry System, Books of Prime Entry, Subsidiary Books
1.18 Trial Balance
1.19 Measurement, Valuation & Accounting Estimates
1.20 Journal Proper – Opening entries, Closing entries, Transfer entries and Rectification entries

1.1 INTRODUCTION

Business is an economic activity undertaken with the motive of earning profits and to maximize the wealth for the owners. Business cannot run in isolation. Largely, the business activity is carried out by people coming together with a purpose to serve a common cause. This team is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, body corporate etc. The rules of business are based on general principles of trade, social values, and statutory framework encompassing national or international boundaries. While these variables could be different for different businesses, different countries etc., the basic purpose is to add value to a product or service to satisfy customer demand.

The business activities require resources (which are limited & have multiple uses) primarily in terms of material, labour, machineries, factories and other services. The success of business depends on how efficiently and effectively these resources are managed. Therefore, there is a need to ensure that the businessman tracks the use of these resources. The resources are not free and thus one must be careful to keep an eye on cost of acquiring them as well.

As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in course of business. Two basic questions would have to be answered:

(a) What is the result of business operations? This will be answered by finding out whether it has made profit or loss.

(b) What is the position of the resources acquired and used for business purpose? How are these resources financed? Where the funds come from?

The answers to these questions are to be found continuously and the best way to find them is to record all the business activities. Recording of business activities has to be done in a scientific manner so that they reveal correct outcome. The science of book-keeping and accounting provides an effective solution. It is a branch of social science. This study material aims at giving a platform to the students to understand

basic principles and concepts, which can be applied to accurately measure performance of business. After studying the various chapters included herein, the student should be able to apply the principles, rules, conventions and practices to different business situations like trading, manufacturing or service.

Over years, the art and science of accounting has evolved together with progress of trade and commerce at national and global levels. Professional accounting bodies have been doing intensive research to come up with accounting rules that will be applicable. Modern business is certainly more complex and continuous updating of these rules is required. Every stakeholder of the business is interested in a particular facet of information about the business. The art and science of accounting helps to put together these requirements of information as per universally accepted principles and also to interpret the results. It is interesting to note that each one of us has an accountant hidden in us. We do see our parents keep track of monthly expenses. We make a distinction between payment done for monthly grocery and that for buying a house or a car. We understand that while grocery is a monthly expense and buying a house is like creating a resource that has indefinite future use. The most common accounting record that each one of us knows is our bank passbook or a bank statement, which the bank maintains for us. It tracks each rupee that we deposit or withdraw from our account. When we go to supermarket to buy something, the cashier at the counter will record things we buy and give us a 'bill' or 'cash memo'. These are source documents prepared for the transaction between the supermarket and us. While these are simple examples, there could be more complex business activities. A good working knowledge of keeping records is therefore necessary. Professional accounting bodies all over the world have been functioning with the objective of providing this body of knowledge. These institutions are engaged in imparting training in the field of accounting. Let us start with some basic definitions, concepts, conventions and practices used in development of this art as well as science.

1.2 DEFINITIONS

In order to understand the subject matter with clarity, let us study some of the definitions which depict the scope, content and purpose of Accounting. The field of accounting is generally sub-divided into:

(a) Book-keeping

(b) Financial Accounting

(c) Cost Accounting and

(d) Management Accounting

Let us understand each of these concepts.

(a) Book-keeping

The most common definition of book-keeping as given by J. R. Batliboi is "Book-keeping is an art of recording business transactions in a set of books."

As can be seen, it is basically a record keeping function. One must understand that not all dealings are, however, recorded. Only transactions expressed in terms of money will find place in books of accounts. These are the transactions which will ultimately result in transfer of economic value from one person to the other. Book-keeping is a continuous activity, the records being maintained as transactions are entered into. This being a routine and repetitive work, in today's world, it is taken over by the computer systems. Many accounting packages are available to suit different business organizations.

It is also referred to as a set of primary records. These records form the basis for accounting. It is an art because, the record is to be kept in such a manner that it will facilitate further processing and reporting of financial information which will be useful to all stakeholders of the business.

(b) Financial Accounting

It is commonly termed as Accounting. The American Institute of Certified Public Accountants defines Accounting as "an art of recoding, 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."

The first step in the cycle of accounting is to identify transactions that will find place in books of accounts. Transactions having financial impact only are to be recorded. E.g. if a businessman negotiates with the customer regarding supply of products, this will not be recorded. The negotiation is a deal which will potentially create a transaction and will have exchange of money or money's worth. But unless this transaction is finally entered into, it will not be recorded in the books of accounts.

Secondly, the recording of the business transactions is done based on the Golden Rules of accounting (which are explained later) in a systematic manner. Transaction of similar nature are grouped together and recorded accordingly. e.g. Sales Transactions, Purchase Transactions, Cash Transactions etc. One has to interpret the transaction and then apply the relevant Golden Rule to make a correct entry thereof.

Thirdly, as the transactions increase in number, it will be difficult to understand the combined effect of the same by referring to individual records. Hence, the art of accounting also involves the step of summarizing them. With the aid of computers, this task is simplified in today's accounting world. The summarization will help users of the business information to understand and interpret business results.

Lastly, the accounting process provides the users with statements which will describe what has happened to the business. Remember the two basic questions we talked about, one to know whether business has made profit or loss and the other to know the position of resources that are used by the business.

It can be noted that although accounting is often referred to as an art, it is a science also. This is because it is based on universally applicable set of rules. However, it is not a pure science as there is a possibility of different interpretation.

(c) Cost Accounting

According to the Chartered Institute of Management Accountants (CIMA), Cost Accountancy is defined as "application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability as well as the presentation of information for the purpose of managerial decision-making."

It is a branch of accounting dealing with the classification, recording, allocation, summarization and reporting of current and prospective costs and analyzing their behaviours. Cost Accounting is frequently used to facilitate internal decision making and provides tools with which management can appraise performance and control costs of doing business. It primarily involves relating the costs to the different products produced and sold or services rendered by the business. While Financial Accounting deals with business transactions at a broader level, Cost Accounting aims at further breaking it up to the last possible level to indentify costs with products and services. It uses the same Financial Accounting documents and records. Modern computerized accounting packages like ERP systems provide for processing Financial as well as Cost Accounting records simultaneously.

This branch of accounting deals with the process of ascertainment of costs. The concept of cost is always applied with reference to a context. Knowledge of cost concepts and their application provide a very sound platform for decision making. Cost Accounting aims at equipping management with information that can be used for control on business activities.

(d) Management Accounting

Management Accounting is concerned with the use of Financial and Cost Accounting information to managers within organizations, to provide them with the basis in making informed business decisions that would allow them to be better equipped in their management and control functions. Unlike Financial Accounting information (which, for public companies, is public information), Management Accounting information is used within an organization (typically for decision-making) and is usually confidential and its access available only to a selected few.

According to the Chartered Institute of Management Accountants (CIMA), Management Accounting is "the process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of information used by management to plan, evaluate and control within an entity and to assure appropriate use of and accountability for its resources. Management Accounting also comprises the preparation of financial reports for non management groups such as shareholders, creditors, regulatory authorities and tax authorities"

Basically, Management Accounting aims to facilitate management in formulating strategies, planning and constructing business activities, making decisions, optimal use of resources, and safeguarding assets of business.

These branches of accounting have evolved over years of research and are basically synchronized with the requirements of business organizations and all entities associated with them. We will now see what are they and how accounting satisfies various needs of different stakeholders.

1.2.1 Difference between Book-keeping and Accountancy

The Significant difference between Book-keeping and Accountancy are : -

Sl No.	Points of difference	Book Keeping	Accountancy
1.	**Meaning**	Book-keeping is considered as end.	Accountancy is considered as beginning.
2.	**Functions**	The primary stage of accounting function is called Book-keeping.	The overall accounting functions are guided by accountancy.
3	**Depends**	Book-keeping can provide the base of Accounting.	Accountancy depends on Book-keeping for its complete functions.
4.	**Data**	The necessary data about financial performances and financial positions are taken from Book-keeping.	Accountancy can take its decisions, prepare reports and statements from the data taken from Book-keeping.
5.	**Recording of Transactions**	Financial transactions are recorded on the basis of accounting principles, concepts and conventions.	Accountancy does not take any principles, concepts and conventions from Book-keeping.

1.2 .2 Difference between Management Accounting and Financial Accounting

The significant difference between Management Accounting and Financial Accounting are :

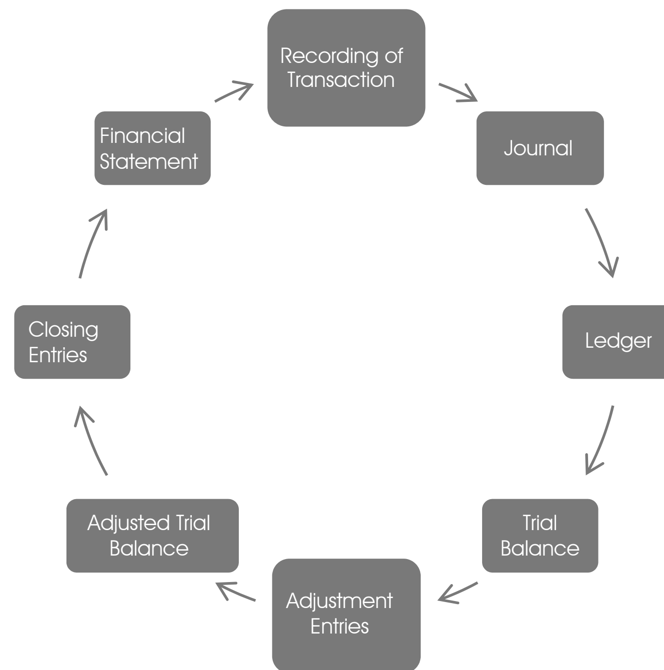
Management Accounting	Financial Accounting
1. Management Accounting is primarily based on the data available from Financial Accounting.	1. Financial Accounting is based on the monetary transactions of the enterprise.
2. It provides necessary information to the management to assist them in the process of planning, controlling, performance evaluation and decision making.	2. Its main focus is on recording and classifying monetary transactions in the books of accounts and preparation of financial statements at the end of every accounting period.
3. Reports prepared in Management Accounting are meant for management and as per management requirement.	3. Reports as per Financial Accounting are meant for the management as well as for shareholders and creditors of the concern.
4. Reports may contain both subjective and objective figures.	4. Reports should always be supported by relevant figures and it emphasizes on the objectivity of data.
5. Reports are not subject to statutory audit.	5. Reports are always subject to statutory audit.
6. It evaluates the sectional as well as the entire performance of the business.	6. It ascertains , evaluates and exhibits the financial strength of the whole business.

1.3 ACCOUNTING CYCLE

When complete sequence of accounting procedure is done which happens frequently and repeated in same directions during an accounting period, the same is called an accounting cycle.

Steps/Phases of Accounting Cycle

The steps or phases of accounting cycle can be developed as under:



ACCOUNTING CYCLE

(a) **Recording of Transaction:-** As soon as a transaction happens it is at first recorded in subsidiary book.

(b) **Journal :** The transactions are recorded in Journal chronologically.

(c) **Ledger:** All journals are posted into ledger chronologically and in a classified manner.

(d) **Trial Balance:** After taking all the ledger account's closing balances, a Trial Balance is prepared at the end of the period for the preparations of financial statements.

(e) **Adjustment Entries:** All the adjustments entries are to be recorded properly and adjusted accordingly before preparing financial statements.

(f) **Adjusted Trial Balance:** An adjusted Trail Balance may also be prepared.

(g) **Closing Entries:** All the nominal accounts are to be closed by the transferring to Trading Account and Profit and Loss Account.

(h) **Financial Statements:** Financial statement can now be easily prepared which will exhibit the true financial position and operating results.

1.4 OBJECTIVES OF ACCOUNTING

The main objective of Accounting is to provide financial information to stakeholders. This financial information is normally given via financial statements, which are prepared on the basis of Generally Accepted Accounting Principles (GAAP). There are various accounting standards developed by professional accounting bodies all over the world. In India, these are governed by The Institute of Chartered Accountants of India, (ICAI). In the US, the American Institute of Certified Public Accountants (AICPA) is responsible to lay down the standards. The Financial Accounting Standards Board (FASB) is the body that sets up the International Accounting Standards. These standards basically deal with accounting treatment of business transactions and disclosing the same in financial statements.

The following objectives of accounting will explain the width of the application of this knowledge stream:

(a) To ascertain the amount of profit or loss made by the business i.e. to compare the income earned versus the expenses incurred and the net result thereof.

(b) To know the financial position of the business i.e. to assess what the business owns and what it owes.

(c) To provide a record for compliance with statutes and laws applicable.

(d) To enable the readers to assess progress made by the business over a period of time.

(e) To disclose information needed by different stakeholders.

Let us now see which are different stakeholders of the business and what do they seek from the accounting information. This is shown in the following table.

Stakeholder	Interest in business	Accounting Information
Owners / Investors / existing and potential	Profits or losses	Financial statements, Cost Accounting records, Management Accounting reports
Lenders	Assessment of capability of the business to pay interest and principal of money lent. Basically, they monitor the solvency of business	Financial statement and analysis thereof, reports forming part of accounts, valuation of assets given as security
Customers and suppliers	Stability and growth of the business	Financial and Cash flow statements to assess ability of the business to offer better business terms and ability to supply the products and services
Government	Whether the business is complying with various legal requirements	Accounting documents such as vouchers, extracts of books, information of purchase, sales, employee obligations etc. and financial statements
Employees and trade unions	Growth and profitability	Financial statements for negotiating pay packages
Competitors	Performance and possible tie-ups in the era of mergers and acquisitions	Accounting information to find out possible synergies

1.4.1 Users of Accounting Information

Accounting provides information both to internal users and the external users. The internal users are all the organizational participants at all levels of management (i.e. top, middle and lower). Generally top level management requires information for planning, middle level management which requires information for controlling the operations. For internal use, the information is usually provided in the form of reports, for instance Cash Budget Reports, Production Reports, Idle Time Reports, Feedback Reports, whether to retain or replace an equipment decision reports, project appraisal report, and the like.

There are also the external users (e.g. Banks, Creditors). They do not have direct access to all the records of an enterprise, they have to rely on financial statements as the source of information. External users are basically, interested in the solvency and profitability of an enterprise.

1.4.2 Types of Accounting Information

Accounting information may be categorized in number of ways on the basis of purpose of accounting information, on the basis of measurement criteria and so on. The various types of accounting information are given below:

I. Accounting information relating to financial transactions and events.

(a) Financial Position- Information about financial position is primarily provided in a Balance Sheet.

The financial position of an enterprise is affected by different factors, like -

(i) Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future.

(ii) Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance.

(iii) Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

(b) Financial Performance- Information about financial performance is primarily provided in a Statement of Profit and Loss which is also known as Income Statement.

Information about the performance of an enterprise and its profitability, is required in order to assess potential changes taking place in the economic resources that it is likely to control in the future. Information about variability of performance is also important in this regard. Information about performance is necessary in predicting the capacity to generate cash flows from its available resource. It is an important input in forming judgments about the effectiveness of an enterprise to utilize resources.

(c) Cash Flows—Information about cash flows is provided in the financial statements by means of a cash flow statement.

Information concerning cash flows is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash and cash equivalent.

These information may be classified as follows:

(i) on the basis of Historical Cost, (ii)on the basis of Current Cost, (iii) on the basis of Realizable Value, (iv)on the basis of Present Value

II. Accounting information relating to cost of a product, operation or function.

III. Accounting information relating to planning and controlling the activities of an enterprise for internal reporting.

This information may further be classified as follows:

(i) Information relating to Finance Area

(ii) Information relating to Production Area

(iii) Information relating to Marketing Area

(iv) Information relating to Personnel Area

(v) Information relating to Other Areas (such as Research & Development)

IV. Accounting information relating to Social Effects of business decisions.

V. Accounting information relating to Environment and Ecology.

VI. Accounting information relating to Human Resources.

1.4.3 Qualitative Characteristics of Accounting Information

Qualitative characteristics are the attributes that make the information provided in financial statements useful to its users.

Qualitative Characteristics of Accounting Information can be segregated in the following categories

(i) Reliability

(ii) Relevance

(iii) Materiality

(iv) Understandability

(v) Comparability

(i) Reliability - To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either portrays to represent or could reasonably be expected to represent. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading and so it becomes useless. Reliability of the financial statements is dependent on the following:

- **(a) Faithful Representation-** To be reliable, information must represent faithfully the transactions and other events which either portrays to represent or could reasonably be expected to represent. Most financial information is subject to some risks of being less than faithful representation of that which it purports to portray. This is not due to bias, but rather to enhance difficulties either in identifying the transactions or other events to be measured in devising or applying measurements and presentation techniques that can convey messages that correspond with those transactions and events.

- **(b) Substance Over Form-**If information is to represent faithfully the transactions and other events that it portrays to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely by their legal forms. The substance of transactions or other events is not always consistent with that which is apart from their legal or contrived form.

- **(c) Neutrality -** To be reliable the information contained in financial statements must be neutral. Financial statements are not neutral if by selective presentation of information, they influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

- **(d) Prudence -** The preparers of financial statements have to contend with uncertainties that inevitably surround many events and circumstances. Such uncertainties are recognized by the disclosure of their nature and extent and by exercise of prudence in the financial statements. Prudence is the inclusion of a degree of caution. In the exercise of judgement needed in making the estimate required under conditions of uncertainties so that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow the creation of hidden reserves or excessive provisions, i.e. the deliberate understatement of assets or income or deliberate over statement of liabilities or expenses.

- **(e) Completeness -** To be reliable the information in the financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus, unreliable and deficient in terms of its relevance.

(ii) Relevance- To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of the users

by helping them to evaluate past, present or future events or confirming or correcting their past evaluation. The productive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset-holding has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past prediction about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

(iii) Materiality- The relevance of information is affected by its nature and materiality. Information is material if its omission or mis-statement could influence the economic decisions of users made on the basis of financial statements. Materiality depends on the size of the item or error judged in the particular circumstance of its omission or mis-statement. Thus, materiality provides a threshold or a cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

(iv) Understandability- The information provided in financial statements must be easily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities, accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the decision making needs of users and should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

(v) Comparability- The financial statements of an enterprise should be comparable. For this purpose users should be informed of the accounting policies, any changes in those policies and the effects of such changes. This qualitative characteristic requires pursuance of consistency in choosing accounting policies. Lack of consistency may disturb the comparability quality of the financial statement information. Accordingly, accounting standard on disclosure of accounting policies consider consistency as a fundamental accounting assumption along with accrual and going concern.

1.5 BASIC ACCOUNTING TERMS

In order to understand the subject matter clearly, one must grasp the following common expressions always used in business accounting. The aim here is to enable the student to understand with these often used concepts before we embark on accounting procedures and rules. You may note that these terms can be applied to any business activity with the same connotation.

(i) **Transaction:** It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.

(ii) **Goods/Services :** These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as 'goods' to one business firm may not be 'goods' to the other firm. e.g. for a machine manufacturing company, the machines are 'goods' as they are frequently made and sold. But for the buying firm, it is not 'goods' as the intention is to use it as a long term resource and not sell it. Services are intangible in nature which are rendered with or without the object of earning profits.

(iii) **Profit:** The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.

(iv) **Loss:** The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.

(v) **Asset:** Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be Tangible and Intangible. Tangible Assets are the Capital assets which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as Intangible Assets. They cannot be seen or felt although they help to generate revenue in future, e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc.

Assets can also be classified into Current Assets and Non-Current Assets.

Current Assets – An asset shall be classified as Current when it satisfies any of the following :

(a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded ,

(c) It is due to be realised within 12 months after the Reporting Date, or

(d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Non-Current Assets – All other Assets shall be classified as Non-Current Assets. e.g. Machinery held for long term etc.

(vi) **Liability:** It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created. Depending upon the period of holding, these obligations could be further classified into Long Term on non-current liabilities and Short Term or current liabilities.

Current Liabilities – A liability shall be classified as Current when it satisfies any of the following :

(a) It is expected to be settled in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded,

(c) It is due to be settled within 12 months after the Reporting Date, or

(d) The Company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Non-Current Liabilities – All other Liabilities shall be classified as Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc.

(vii) **Internal Liability :** These represent proprietor's equity, i.e. all those amount which are entitled to the proprietor, e.g., Capital, Reserves, Undistributed Profits, etc.

(viii) **Working Capital :** In order to maintain flows of revenue from operation, every firm needs certain amount of current assets. For example, cash is required either to pay for expenses or to meet obligation for service received or goods purchased, etc. by a firm. On identical reason, inventories are required to provide the link between production and sale. Similarly, Accounts Receivable generate when goods are sold on credit. Cash, Bank, Debtors, Bills Receivable, Closing Stock, Prepayments etc. represent current assets of firm. The whole of these current assets form the working capital of a firm which is termed as Gross Working Capital.

Gross Working Capital = Total Current Assets

= Long term internal liabilities plus long term debts plus the current liabilities minus the amount blocked in the fixed assets.

There is another concept of working capital. Working capital is the excess of current assets over current liabilities. That is the amount of current assets that remain in a firm if all its current liabilities are paid. This concept of working capital is known as Net Working Capital which is a more realistic concept.

Working Capital (Net) = Current Assets – Currents Liabilities.

(ix) **Contingent Liability :** It represents a potential obligation that could be created depending on the outcome of an event. E.g. if supplier of the business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the verdict of the case is given in favour of the supplier then only the obligation is created. Till that it is treated as a contingent liability. Please note that contingent liability is not recorded in books of account, but disclosed by way of a note to the financial statements.

(x) **Capital :** It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.

(xi) **Drawings :** It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawings will result in reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.

(xii) **Net worth :** It represents excess of total assets over total liabilities of the business. Technically, this amount is available to be distributed to owners in the event of closure of the business after payment of all liabilities. That is why it is also termed as Owner's Equity. A profit making business will result in increase in the owner's equity whereas losses will reduce it.

(xiii) **Non-current Investments :** Non-current Investments are investments which are held beyond the current period as to sale or disposal. e. g. Fixed Deposit for 5 years.

(xiv) **Current Investments :** Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made. e. g. 11 months Commercial Paper.

(xv) **Debtor :** The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Receivable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit. These debtors may again be classified as under:

(i) Good debts : The debts which are sure to be realized are called good debts.

(ii) Doubtful Debts : The debts which may or may not be realized are called doubtful debts.

(iii) Bad debts : The debts which cannot be realized at all are called bad debts.

It must be remembered that while ascertaining the debtors balance at the end of the period certain adjustments may have to be made e.g. Bad Debts, Discount Allowed, Returns Inwards, etc.

(xvi) **Creditor :** A creditor is a person to whom the business owes money or money's worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.

(xvii) **Capital Expenditure :** This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from. e. g. amount paid to buy a computer for office use is a capital expenditure. At times expenditure may be incurred for enhancing the production capacity of the machine. This also will be a capital expenditure. Capital expenditure forms part of the Balance Sheet.

(xviii) **Revenue expenditure :** This represents expenditure incurred to earn revenue of the current period. The benefits of revenue expenses get exhausted in the year of the incurrence. e.g. repairs, insurance, salary & wages to employees, travel etc. The revenue expenditure results in reduction in profit or surplus. It forms part of the Income Statement.

(xix) **Balance Sheet :** It is the statement of financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income Statement.

(xx) **Profit and Loss Account or Income Statement :** This account shows the revenue earned by the business and the expenses incurred by the business to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, a half year or a year. The net result of the Profit and Loss Account will show profit earned or loss suffered by the business entity.

(xxi) **Trade Discount :** It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price. e.g. the list price of a TV set could be ₹ 15000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for ₹ 12000 and is expected to sale it to final customer at the list price. Thus the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In above example, the transaction will be recorded at ₹ 12000 only.

(xxii) **Cash Discount :** This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount. e.g. if list price is ₹ 15000 on which a trade discount of 20% and cash discount of 2% apply, then first trade discount of ₹ 3000 (20% of ₹ 15000) will be deducted and the cash discount of 2% will be calculated on ₹12000 (₹15000 – ₹ 3000). Hence the cash discount will be ₹ 240/- (2% of ₹ 12000) and net payment will be ₹ 11,760 (₹12,000 - ₹ 240)

Let us see if we can apply these in the following illustrations.

Illustration 1.

Fill in the blanks:

(a) The cash discount is allowed by _________ to the _________.

(b) Profit means excess of _________ over _________.

(c) Debtor is a person who _________ to others.

(d) In a credit transaction, the buyer is given a _________ facility.

(e) The fixed asset is generally held for _________.

(f) The current liabilities are obligations to be settled in _________ period.

(g) The withdrawal of money by the owner of business is called _________

(h) The amount invested by owners into business is called _________.

(i) Transaction means exchange of money or money's worth for _________.

(j) The net result of an income statement is _________ or _________.

(k) The _________ shows financial position of the business as on a particular date.

(l) The _________ discount is never entered in the books of accounts.

(m) Vehicles represent _________ expenditure while repairs to vehicle would mean _________ expenditure.

(n) Net worth is excess of _________ _________ over _________ _________.

Solution:

(a) creditor, debtor

(b) income, expenditure

(c) Owes

(d) Credit

(e) Longer period

(f) Short

(g) Drawings

(h) Capital

(i) Value

(j) Profit, loss

(k) Balance sheet

(l) Trade

(m) Capital, revenue

(n) Total assets, total liabilities

Illustration 2.

Give one word or a term used to describe the following:-

(a) An exchange of benefit for value

(b) A transaction without immediate cash settlement.

(c) Commodities in which a business deals.

(d) Excess of expenditure over income.

(e) Things of value owned by business to earn future profits.

(f) Amount owed by business to others.

(g) An obligation which may or may not materialise.

(h) An allowance by a creditor to debtor for prompt payment.

(i) Assets like brand value, copy rights, goodwill

Solution:

(a) Transaction, (b) Credit transaction, (c) Goods, (d) Loss, (e) Assets, (f) Liability, (g) Contingent Liability, (h) Cash Discount, (i) Intangible Assets

1.6. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board are called Generally Accepted Accounting Principles (GAAP). These are the common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

GAAP is to be followed by companies so that investors have a optimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP cover such aspects like revenue recognition, balance sheet item classification and outstanding share measurements.

1.7 ACCOUNTING CONCEPTS AND CONVENTIONS

As seen earlier, the accounting information is published in the form of financial statements. The three basic financial statements are

(i) The Profit & Loss Account that shows net business result i.e. profit or loss for a certain periods

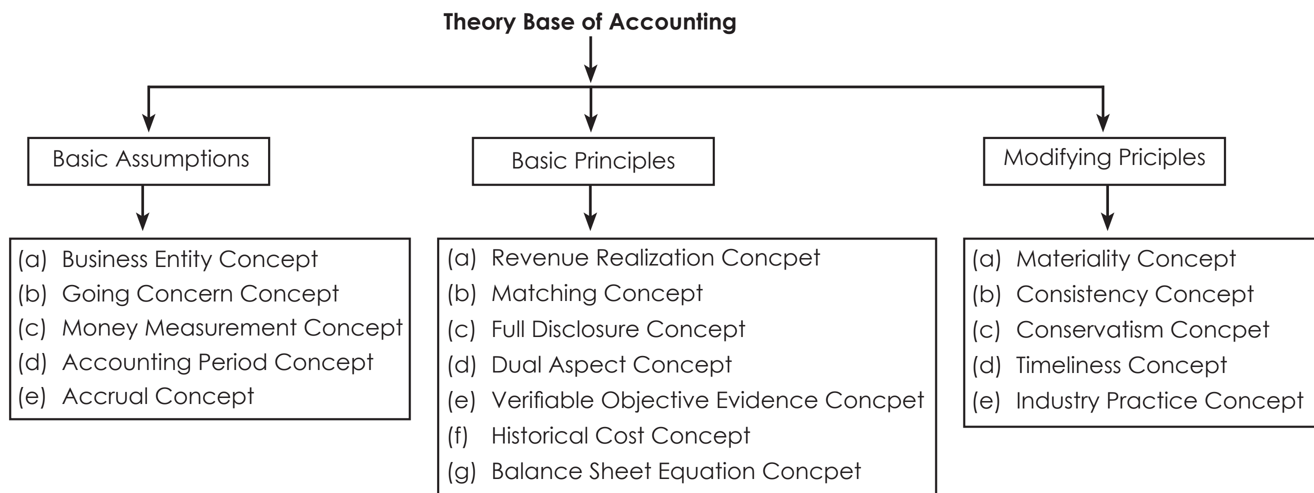
(ii) The Balance Sheet that exhibits the financial strength of the business as on a particular dates

(iii) The Cash Flow Statement that describes the movement of cash from one date to the other.

As these statements are meant to be used by different stakeholders, it is necessary that the information contained therein is based on definite principles, concrete concepts and well accepted convention.

Accounting principles are basic guidelines that provide standards for scientific accounting practices and procedures. They guide as to how the transactions are to be recorded and reported. They assure uniformity and understandability. Accounting concepts lay down the foundation for accounting principles. They are ideas essentially at mental level and are self-evident. These concepts ensure recording of financial facts on sound bases and logical considerations. Accounting conventions are methods or procedures that are widely accepted. When transactions are recorded or interpreted, they follow the conventions. Many times, however, the terms-principles, concepts and conventions are used interchangeably.

Professional Accounting Bodies have published statements of these concepts. Over years, many of these concepts are being challenged as outlived. Yet, no major deviations have been made as yet. Path breaking ideas have emerged and the accounting standards of modern days do require companies to record and report transactions which may not be necessarily based on concepts that are in vogue for long. It is essential to study accounting from the basic levels and understand these concepts in entirety.



A. BASIC ASSUMPTIONS

(a) Business Entity Concept

As per this concept, the business is treated as distinct and separate from the individuals who own or manage it. When recording business transactions, the important question is how will it affect the business entity? How they affect the persons who own it or run it or otherwise associated with it is irrelevant. Application of this concept enables recording of transactions of the business entity with its owners or managers or other stakeholders. For example, if the owner pays his personal expenses from business cash, this transaction can be recorded in the books of business entity. This transaction will take the cash out of business and also reduce the obligation of the business towards the owner.

At times it is difficult to separate owners from the business. Consider an individual, who runs a small retail outlet. In the eyes of law, there is no distinction made between financial affairs of the outlet with that of the individual. The creditors of the retail outlet can sue the individual and collect his claim from personal resources of the individual. However, in accounting, the records are kept as distinct for the retail outlet and the individual respectively. For certain forms of business entities, such as limited companies this distinction is easier. The limited companies are separate legal persons in the eyes of law as well.

The entity concept requires that all the transactions are to be viewed, interpreted and recorded from 'business entity' point of view. An accountant steps into the shoes of the business entity and decides to account for the transactions. The owner's capital is the obligation of business and it has to be paid back to the owner in the event of business closure. Also, the profit earned by the business will belong to the owner and hence is treated as owner's equity.

(b) Going Concern Concept

The basic principles of this concept is that business is assumed to exist for an indefinite period and is not established with the objective of closing it down. So unless there is good evidence to the contrary, the accountant assumes that a business entity is a 'going concern' - that it will continue to operate as usual for a longer period of time. It will keep getting money from its customers, pay its creditors, buy and sell goods, use assets to earn profits in future. If this assumption is not considered, one will have to constantly value the worth of the assets and resource. This is not practicable. This concept enables the accountant to carry forward the values of assets and liabilities from one accounting period to the other without asking the question about usefulness and worth of the assets and recoverability of the receivables.

The going concern concept forms a sound basis for preparation of a Balance Sheet.

(c) Money Measurement Concept

A business transaction will always be recoded if it can be expressed in terms of money. The advantage of this concept is that different types of transactions could be recorded as homogenous entries with money as common denominator. A business may own ₹ 3 Lacs cash, 1500 kg of raw material, 10 vehicles, 3 computers etc. Unless each of these is expressed in terms of money, we cannot find out the assets owned by the business. When expressed in the common measure of money, transactions could be added or subtracted to find out the combined effect. In the above example, we could add values of different assets to find the total assets owned.

The application of this concept has a limitation. When transactions are recorded in terms of money, we only consider the absolute value of the money. The real value of the money may fluctuate from time to time due to inflation, exchange rate changes, etc. This fact is not considered when recording the transaction.

(d) The Accounting Period Concept

We have seen that as per the going-concern concept the business entity is assumed to have an indefinite life. Now if we were to assess whether the business has made profit or loss, should we wait until this indefinite period is over? Would it mean that we will not be able to assess the business performance on an ongoing basis? Does it deprive all stakeholders the right to the accounting information? Would it mean that the business will not pay income tax as no income will be computed?

To circumvent this problem, the business entity is supposed to be paused after a certain time interval. This time interval is called an accounting period. This period is usually one year, which could be a calendar year i.e. 1st January to 31st December or it could be a fiscal year in India as 1st April to 31st March. The business organizations have the freedom to choose their own accounting year. For certain organizations, reporting of financial information in public domain are compulsory. In India, listed companies must report their quarterly unaudited financial results and yearly audited financial statements. For internal control purpose, many organizations prepare monthly financial statements. The modern computerized accounting systems enable the companies to prepare real-time online financials at the click of button.

Businesses are living, continuous organisms. The splitting of the continuous stream of business events into time periods is thus somewhat arbitrary. There is no significant change just because one accounting period ends and a new one begins. This results into the most difficult problem of accounting of how to measure the net income for an accounting period. One has to be careful in recognizing revenue and expenses for a particular accounting period. Subsequent section on accounting procedures will explain how one goes about it in practice.

(e) The Accrual Concept

The accrual concept is based on recognition of both cash and credit transactions. In case of a cash transaction, owner's equity is instantly affected as cash either is received or paid. In a credit transaction, however, a mere obligation towards or by the business is created. When credit transactions exist (which is generally the case), revenues are not the same as cash receipts and expenses are not same as cash paid during the period.

When goods are sold on credit as per normally accepted trade practices, the business gets the legal right to claim the money from the customer. Acquiring such right to claim the consideration for sale of goods or services is called accrual of revenue. The actual collection of money from customer could be at a later date.

Similarly, when the business procures goods or services with the agreement that the payment will be made at a future date, it does not mean that the expense effect should not be recognized. Because an obligation to pay for goods or services is created upon the procurement thereof, the expense effect also must be recognized.

Today's accounting systems based on accrual concept are called as Accrual System or Mercantile System of Accounting.

B. BASIC PRINCIPLES

(a) The Revenue Realisation Concept

While the conservatism concept states whether or not revenue should be recognized, the concept of realisation talks about what revenue should be recognized. It says amount should be recognized only to the tune of which it is certainly realizable. Thus, mere getting an order from the customer won't make it eligible to recognize as revenue. The reasonable certainty of realizing the money will come only when the goods ordered are actually supplied to the customer and he is billed. This concept ensures that income unearned or unrealized will not be considered as revenue and the firms will not inflate profits.

Consider that a store sales goods for ₹ 25 lacs during a month on credit. The experience and past data shows that generally 2% of the amount is not realized. The revenue to be recognized will be ₹ 24.50 lacs. Although conceptually the revenue to be recognized at this value, in practice the doubtful amount of ₹ 50 thousand (2% of ₹ 25 lacs) is often considered as expense.

(b) The Matching Concept

As we have seen the sale of goods has two effects: (i) a revenue effect, which results in increase in owner's equity by the sales value of the transaction and (ii) an expense effect, which reduces owner's equity by the cost of goods sold, as the goods go out of the business. The net effect of these two effects will reflect

either profit or loss. In order to correctly arrive at the net result, both these aspects must be recognized during the same accounting period. One cannot recognize only the revenue effect thereby inflating the profit or only the expense effect which will deflate the profit. Both the effects must be recognized in the same accounting period. This is the principle of matching concept.

To generalize, when a given event has two effects – one on revenue and the other on expense, both must be recognized in the same accounting period.

(c) Full Disclosure Concept

As per this concept, all significant information must be disclosed. Accounting data should properly be clarified, summarized, aggregated and explained for the purpose of presenting the financial statements which are useful for the users of accounting information. Practically, this principle emphasizes on the materiality, objectivity and consistency of accounting data which should disclose the true and fair view of the state of affairs of a firm. This principle is going to be popular day by day as per Companies Act, 1956 major provisions for disclosure of essential information about accounting data and as such, concealment of material information, at present, is not very easy. Thus, full disclosure must be made for such material information which are useful to the users of accounting information.

(d) Dual Aspect Concept

The assets represent economic resources of the business, whereas the claims of various parties on business are called obligations. The obligations could be towards owners (called as owner's equity) and towards parties other than the owners (called as liabilities).

When a business transaction happens, it will involve use of one or the other resource of the business to create or settle one or more obligations. e.g. consider Mr. Suresh starts a business with the investment of ₹ 25 lacs. Here, the business has got a resource of cash worth ₹ 25 lacs (which is its asset), but at the same time it has created an obligation of business towards Mr. Suresh that in the event of business closure, the money will be paid back to him. This could be shown as:

Assets = Liabilities + Capital

In other words,

Cash brought in by Mr. Suresh (₹ 25 lacs) = Liability of business towards Mr. Suresh (₹ 25 lacs)

We know that liability of the business could be towards owners and parties other than owners, this equation could be re-written as:

Assets = Liabilities + Owner's equity

Cash ₹ 25,00,000 = Liabilities ₹ nil + Mr. Suresh's equity ₹ 25,00,000

This is the fundamental accounting equation shown as formal expression of the dual aspect concept. This powerful concept recognizes that every business transaction has dual impact on the financial position. Accounting systems are set up to simultaneously record both these aspects of every transaction; that is why it is called as Double-entry system of accounting. In its present form the double entry system of accounting owes its existence to an Italian expert Mr. Luca Pacioli in the year 1495.

Continuing with our example of Mr. Suresh, now let us consider he borrows ₹ 15 lacs from bank. The dual aspect of this transaction-on one hand the business cash will increase by ₹ 15 lacs and a liability towards the bank will be created for ₹ 15 lacs.

Assets = Liabilities + Owner's equity

Cash ₹ 40,00,000 = Liabilities ₹ 15,00,000 + Mr. Suresh's equity ₹ 25,00,000

The student must note that the dual aspect concept entails recognition of the two effects of each transaction. These effects are of equal amount and reverse in nature. How to decide these two aspects?

The golden rules of accounting are used to arrive at this decision. After recording both aspects of the transaction, the basic accounting equation will always balance or be equal.

The above concepts find the application in preparation of the Balance Sheet which is the statement of assets and liabilities as on a particular date. We will now see some more concepts that are important for preparation of Profit and Loss Account or Income Statement.

(e) Verifiable Objective Evidence Concept

Under this principle, accounting data must be verified. In other words, documentary evidence of transactions must be made which are capable of verification by an independent respect. In the absence of such verification, the data which will be available will neither be reliable nor be dependable, i.e., these should be biased data. Verifiability and objectivity express dependability, reliability and trustworthiness that are very useful for the purpose of displaying the accounting data and information to the users.

(f) Historical Cost Concept

Business transactions are always recorded at the actual cost at which they are actually undertaken. The basic advantage is that it avoids an arbitrary value being attached to the transactions. Whenever an asset is bought, it is recorded at its actual cost and the same is used as the basis for all subsequent accounting purposes such as charging depreciation on the use of asset, e.g. if a production equipment is bought for ₹ 1.50 crores, the asset will be shown at the same value in all future periods when disclosing the original cost. It will obviously be reduced by the amount of depreciation, which will be calculated with reference to the actual cost. The actual value of the equipment may rise or fall subsequent to the purchase, but that is considered irrelevant for accounting purpose as per the historical cost concept.

The limitation of this concept is that the Balance Sheet does not show the market value of the assets owned by the business and accordingly the owner's equity will not reflect the real value. However, on an ongoing basis, the assets are shown at their historical costs as reduced by depreciation.

(g) Balance Sheet Equation Concept

Under this principle, all which has been received by us must be equal to that has been given by us and needless to say that receipts are clarified as debits and giving is clarified as credits. The basic equation, appears as :-

Debit = Credit

Naturally every debit must have a corresponding credit and vice-e-versa. So, we can write the above in the following form –

Expenses + Losses + Assets = Revenues + Gains + Liabilities

And if expenses and losses, and incomes and gains are set off, the equation takes the following form –

Asset = Liabilities

or, Asset = Equity + External Liabilities

i.e., the Accounting Equation.

C. MODIFYING PRINCIPLES

(a) The Concept of Materiality

This is more of a convention than a concept. It proposes that while accounting for various transactions, only those which may have material effect on profitability or financial status of the business should have special consideration for reporting. This does not mean that the accountant should exclude some transactions from recording. e.g. even ₹ 20 worth conveyance paid must be recorded as expense. What this convention claims is to attach importance to material details and insignificant details should be ignored while deciding certain accounting treatment. The concept of materiality is subjective and an accountant will have to decide on merit of each case. Generally, the effect is said to be material, if the knowledge of an event would influence the decision of an informed stakeholder.

The materiality could be related to information, amount, procedure and nature. Error in description of an asset or wrong classification between capital and revenue would lead to materiality of information. Say, If postal stamps of ₹ 500 remain unused at the end of accounting period, the same may not be considered for recognizing as inventory on account of materiality of amount. Certain accounting treatments depend upon procedures laid down by accounting standards. Some transactions are by nature material irrespective of the amount involved. e.g. audit fees, loan to directors.

(b) The Concept of Consistency

This concept advocates that once an organization decides to adopt a particular method of revenue or expense recognition in line with the other concepts, the same should be consistently applied year after year, unless there is a valid reason for change in the method. Lack of consistency would result in the financial information becoming non-comparable between the different accounting periods. The insistence of this concept would result in avoidance of window dressing the results by choosing the accounting method by convenience and thereby either inflating or understating net income.

Consider an example. An asset of ₹ 10 lacs is purchased by a business. It is estimated to have useful life of 5 years. It will follow that the asset will be depreciated over a period of 5 years at the rate of ₹ 2 lacs every year. The estimate of useful life and the rate of depreciation cannot be changed from one period to the other without a valid reason. Suppose the firm applies the same depreciation rate for the first three years and due to change in technology the asset becomes obsolete, the whole of the remaining amount could be expensed out in the fourth year.

However, it may be difficult to be consistent if the business entities have two factories in different countries which have different statutory requirement for accounting treatment.

(c) The Conservatism Concept

Accountants who prepare financial statements of the business, like other human being, would like to give a favourable report on how well the business has performed during an accounting period. However, prudent reporting based on skepticism builds confidence in the results and in the long run best serves all the divergent interests of users of financial statements. This philosophy of prudence leads to the conservatism concept.

The concept underlines the prudence of under-stating than over-stating the net income of an entity for a period and the net assets as on a particular date. This is because business is done in situations of uncertainty. For years, this concept was meant to “anticipate no profits but recognize all losses”. This can be stated as

(i) Delay in recognizing income unless one is reasonably sure

(ii) Immediately recognize expenses when reasonably sure

This, of course, does not mean to overdo and create window dressing in reporting. e.g. if the business has sold ₹ 20 Lacs worth goods on the last day of accounting period and also received a cheque for the same, one cannot argue that the revenue should not be recognized as it is not certain whether the cheque will be cleared by the bank. One cannot stretch the conservatism concept too much. But at the same time, if the business has to receive ₹ 5 lacs from a customer to whom goods were sold quite some time ago and no payments are forthcoming, then while determining the net income for the period, the accountant must judge the likelihood of the recoverability of this money and the prudence will prevail to make a provision for this amount as doubtful debtors.

Let us take another example. A business had purchased goods for ₹ 10 lacs before the end of an accounting period. If sold at the usual selling price, the goods would fetch the price of ₹ 12.50 lacs. Due to innovative product introduced by the competition, the goods are likely to be sold for ₹ 9 lacs only. At what value should the goods be shown in the balance sheet? Would it be at ₹ 10 lacs being the actual cost of buying? Or would it be at ₹ 9 lacs? Here, the conservatism principle will come in play. The stock of goods will be valued at ₹ 9 lacs, being the lower of cost or net realisable value, as per AS-2.

(d) Timeliness Concept

Under this principle, every transaction must be recorded in proper time. Normally, when the transaction is made, the same must be recorded in the proper books of accounts. In short, transaction should be recorded date-wise in the books. Delay in recording such transaction may lead to manipulation, misplacement of vouchers, misappropriation etc. of cash and goods. This principle is followed particularly while verifying day to day cash balance. Principle of timeliness is also followed by banks, i.e. every bank verifies the cash balance with their cash book and within the day, the same must be completed.

(e) Industry Practice

As there are different types of industries, each industry has its own characteristics and features. There may be seasonal industries also. Every industry follows the principles and assumption of accounting to perform their own activities. Some of them follow the principles, concepts and conventions in a modified way. The accounting practice which has always prevailed in the industry is followed by it. e.g Electric supply companies, Insurance companies maintain their accounts in a specific manner. Insurance companies prepare Revenue Account just to ascertain the profit/loss of the company and not Profit and Loss Account. Similarly, non trading organizations prepare Income and Expenditure Account to find out Surplus or Deficit.

CONCLUSION

The above paragraphs bring out essentially broad concepts and conventions that lay down principles to be followed for accounting of business transaction. While going through the different topics, students are advised to keep track of concepts applicable for various accounting treatment. One would have by now understood the importance of these concepts in preparation of basic financial statements. More clarity will emerge as one explores the ocean of different business transactions arising out of complex business situations. The legal and professional requirements also have their say in deciding the accounting treatment. Let us see if you can apply these concepts in the following illustrations.

Exercise :

Recognise the accounting concept in the following:

(1) The business will run for an indefinite period.
(2) The business is distinct and separate from its owners.
(3) The transactions are recorded at their original cost.
(4) The transactions recorded are those that can be expressed in money terms.
(5) Revenues will be recognized only if there is reasonable certainty that it will be paid for.
(6) Accounting treatment once decided should be followed period after period.
(7) Every transaction has two effects to be recorded in books of accounts.
(8) Transactions are recorded even if an obligation is created and actual cash is not involved.
(9) Stock of goods is valued at lower of its cost and realizable value.
(10) Effects of an event must be recognized in the same accounting period.

1.8 EVENTS AND TRANSACTIONS

Event is a transaction or change recognized on the financial statements of an accounting entity. Accounting events can be either external or internal. An external event would occur with an outside party, such as the purchase or sales of a good. An internal event would involve changes in the accounting entity's records, such as adjusting an account on the financial statements.

An accounting event is any financial event that would impact the account balances of a company's financial statements. Every time the company uses or receives cash, or adjusts an entry in its accounting records, an accounting event has occurred.

1.8.1 Transactions vs. Events

Transaction is exchange of an asset with consideration of money value while event is any thing in general purpose which occur at specific time and particular place. All transactions are events but all events are not transactions. This is because in order events to be called transaction an event must involve exchange of values.

1.9 VOUCHER

It is a written instrument that serves to confirm or witness (vouch) for some fact such as a transaction. Commonly, a voucher is a document that shows goods have bought or services have been rendered, authorizes payment, and indicates the ledger account(s) in which these transactions have to be recorded.

1.9.1 Types of Voucher - Normally the following types of vouchers are used. i.e.:

(i) Receipt Voucher
(ii) Payment Voucher
(iii) Non-Cash or Transfer Voucher
(iv) Supporting Voucher

(i) Receipt Voucher

Receipt voucher is used to record cash or bank receipt. Receipt vouchers are of two types. i.e.

(a) Cash receipt voucher – it denotes receipt of cash
(b) Bank receipt voucher – it indicates receipt of cheque or demand draft

(ii) Payment Voucher

Payment voucher is used to record a payment of cash or cheque. Payment vouchers are of two types. i.e.

(a) Cash Payment voucher – it denotes payment of cash
(b) Bank Payment voucher – it indicates payment by cheque or demand draft.

(iii) Non Cash Or Transfer Voucher

These vouchers are used for non-cash transactions as documentary evidence. e.g., Goods sent on credit.

(iv) Supporting Vouchers

These vouchers are the documentary evidence of transactions that have happened.

1.9.2 Source Documents

Vouchers are the documentary evidence of the transactions so happened. Source documents are the basis on which transactions are recorded in subsidiary books i.e. source documents are the evidence and proof of transactions.

Name of the Book	Source document
(a) Cash Book	Cash Memos, Cash Receipts and issue vouchers
(b) Purchase Books	Inward invoice received from the creditors of goods
(c) Sales Book	Outward Invoice issued to Debtors
(d) Return Inward Book	Credit Note issued to Debtors and Debit Notes received from Debtors
(e) Returns Outward Book	Debit Note issued to creditors and Credit Note received from creditors.

1.10 THE CONCEPTS OF 'ACCOUNT', 'DEBIT' AND 'CREDIT'

One must get conversant with these terms before embarking to learn actual record-keeping based on the rules.

An 'Account' is defined as a summarised record of transactions related to a person or a thing. e.g. when the business deals with customers and suppliers, each of the customers and supplier will be a separate account. We must know that each one of us is identified as a separate account by the bank when we open an account with them. The account is also related to things – both tangible and intangible. e.g. land, building, equipment, brand value, trademarks etc. are some of the things. When a business transaction happens, one has to identify the 'account' that will be affected by it and then apply the rules to decide the accounting treatment.

Typically, an account is expressed as a statement in form of English letter 'T'. It has two sides. The left hand side is called as "Debit' side and the right hand side is called as "Credit' side. The debit is connoted as 'Dr' and the credit by 'Cr'. The convention is to write the Dr and Cr labels on both sides as shown below. Please see the following example:

Dr.	**Cash Account**	**Cr.**
Debit side		Credit side

Each side of the account will show effects, so that one can easily take totals of both sides and find out the difference between the two. Such difference in the two sides of an account is called 'balance'. If the total of debit side is more than the credit side, the balance is called as 'debit balance' and if the total of credit side is more than the debit side, the balance is called as 'credit balance'. If the debit and credit side are equal, the account will show 'nil balance'.

The balances are to be computed at the end of an accounting period. These balances are then considered for preparation of income statement and balance sheet. Let us see the example,

Dr. **Cash Account** ***Cr.***

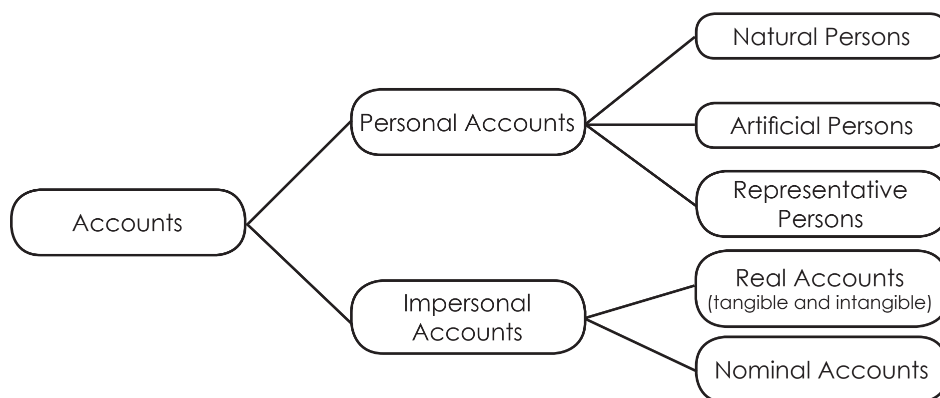
Particulars	Amount ₹	Particulars	Amount ₹
Cash brought into business	1,00,000	Paid for goods purchased	50,000
Received for goods sold	25,000	Paid for rent	15,000
		Balance at the end	60,000
	1,25,000		**1,25,000**

It can be seen from the above example that the debit side of cash account shows the receipt of cash into the business and the credit side reflects the cash that has gone out of the business. What is the meaning of the balance at the end? Well, it shows that cash balance available in the business.

1.11 TYPES OF ACCOUNTS

We have seen that an account may be related to a person or a thing – tangible or intangible. While doing business transactions (that may be large in number and complex in nature), one may come across numerous accounts that are affected. How does one decide about accounting treatment for each of them? If common rules are to be applied to similar type of accounts, there must be a way to classify the account on the basis of their common characteristics.

Please take look at the following chart.



Let us see what each type of account means.

(1) Personal Account : As the name suggests these are accounts related to persons.

(a) These persons could be natural persons like Suresh's A/c, Anil's A/c, Rani's A/c etc.

(b) The persons could also be artificial persons like companies, bodies corporate or association of persons or partnerships etc. Accordingly, we could have Videocon Industries A/c, Infosys Technologies A/c, Charitable Trust A/c, Ali and Sons trading A/c, ABC Bank A/c, etc.

(c) There could be representative personal accounts as well. Although the individual identity of persons related to these is known, the convention is to reflect them as collective accounts. e.g. when salary is payable to employees, we know how much is payable to each of them, but collectively the account is called as 'Salary Payable A/c'. Similar examples are rent payable, Insurance prepaid, commission pre-received etc. The students should be careful to have clarity on this type and the chances of error are more here.

(2) Real Accounts : These are accounts related to assets or properties or possessions. Depending on their physical existence or otherwise, they are further classified as follows:-

(a) Tangible Real Account – Assets that have physical existence and can be seen, and touched. e.g. Machinery A/c, Stock A/c, Cash A/c, Vehicle A/c, and the like.

(b) Intangible Real Account – These represent possession of properties that have no physical existence but can be measured in terms of money and have value attached to them. e.g. Goodwill A/c, Trade mark A/c, Patents & Copy Rights A/c, Intellectual Property Rights A/c and the like.

(3) Nominal Account : These accounts are related to expenses or losses and incomes or gains e.g. Salary and Wages A/c, Rent of Rates A/c, Travelling Expenses A/c, Commission received A/c, Loss by fire A/c etc.

1.12 THE ACCOUNITNG PROCESS

There are two approaches for deciding when to write on the debit side of an account and when to write on the credit side of an account:

A. American Approach/ Modern Approach

B. British Approach/ Traditional Approach/Double Entry System

A. American approach : In order to understand the rules of debit and credit according to this approach transactions are divided into the following five categories:

(i) Transactions relating to owner, e.g., Capital – These are personal accounts

(ii) Transactions relating to other liabilities, e.g., suppliers of goods – These are mostly personal accounts

(iii) Transactions relating to assets, e.g., land, building, cash, bank, stock-in-trade, bills receivable – These are basically all real accounts

(iv) Transactions relating to expenses, e.g., rent, salary, commission, wages, cartage – These are nominal accounts

(v) Transactions relating to revenues, e.g., interest received, dividend received, sale of goods – These are nominal accounts

The rules of debit and credit in relation to these accounts are stated as under:

(i) For Capital Account:
Debit means decrease
Credit means increase

(ii) For any Liability Account:
Debit means decrease
Credit means increase

(iii) For any Asset Account:
Debit means increase
Credit means decrease

(iv) For any Expense Account:
Debit means increase
Credit means decrease

(v) For any Revenue Account:
Debit means decrease
Credit means increase

A careful perusal of the above rules will reveal that meaning of debit is the same for the first three types of accounts on the one side and last two types of accounts on the other. It also reveals that in the first three cases 'debit' stands for decrease, and for increase in the last two cases. Similarly, 'credit' stands for increase in the first three cases and for decrease in the last two cases. The meaning of debit and credit has been diagrammatically illustrated as under:

ANY ASSET ACCOUNT

DEBIT	CREDIT
Record increase on this side ↑	Record decrease on this side ↓

ANY CAPITAL ACCOUNT

DEBIT	CREDIT
Record decrease on this side ↓	Record increase on this side ↑

ANY LIABILITY ACCOUNT

DEBIT	CREDIT
Record decrease on this side ↓	Record increase on this side ↑

ANY REVENUE ACCOUNT

DEBIT	CREDIT
Record decrease on this side ↓	Record increase on this side ↑

ANY EXPENSE ACCOUNT

DEBIT	CREDIT
Record increase on this side ↑	Record decrease on this side ↓

The rules can be further compressed in the following way:

ANY CAPITAL, LIABILITY OR REVENUE ACCOUNT

DEBIT	CREDIT
Record decrease on this side ↓	Record increase on this side ↑

ANY ASSET OR EXPENSE ACCOUNT

DEBIT	CREDIT
Record increase on this side ↑	Record decrease on this side ↓

TO SUM UP

For Assets	Increase in Assets Decrease in Assets	Dr. Cr.
For Liabilities	Decrease in Liabilities Increase in Liabilities	Dr. Cr.
For Capital	Decrease in Capital Increase in Capital	Dr. Cr.
For Incomes	Decrease in Income Increase in Income	Dr. Cr.
For Expense	Increase in Expense Decrease in Expense	Dr. Cr.
For Stock	Increase in Stock Decrease in Stock	Dr. Cr.

Illustration 4.

Ascertain the debit and credit from the following particulars under Modern Approach.

(a) Started business with capital.

(b) Bought goods for cash.

(c) Sold goods for cash.

(d) Paid salary.

(e) Received Interest on Investment.

(f) Bought goods on credit from Mr. Y

(g) Paid Rent out of Personal cash.

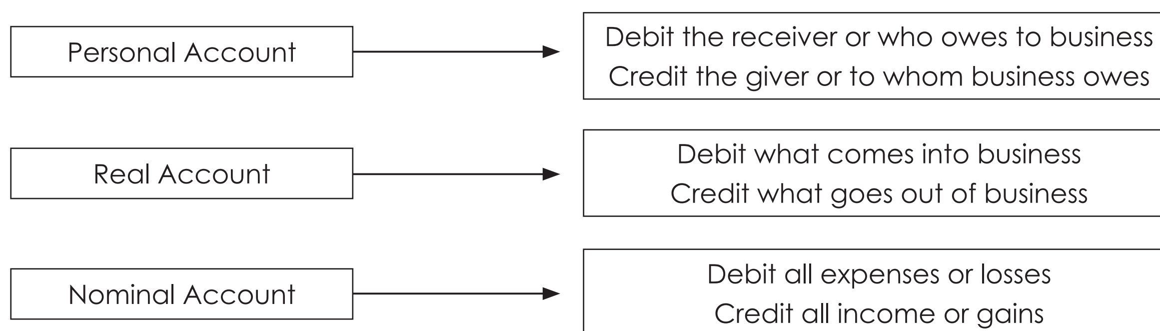
Solution:

	Effect of Transaction	Account	To be debited/Credited
(a)	Increase in Cash Increase in Capital	Cash A/c Capital A/c	Debit Credit
(b)	Increase in Stock Decrease in Cash	Purchase A/c Cash A/c	Debit Credit
(c)	Increase in Cash Decrease in Stock	Cash A/c Sale A/c	Debit Credit
(d)	Increase in Expense Decrease in Cash	Salary A/c Cash A/c	Debit Credit
(e)	Increase in Cash Increase in Income	Cash A/c Interest A/c	Debit Credit
(f)	Increase in Stock Increase in Liability	Purchase A/c Y A/c	Debit Credit
(g)	Increase in Expense Increase in Capital	Rent A/c Capital A/c	Debit Credit

B. British Approach or Double Entry System :

When one identifies the account that is getting affected by a transaction and type of that account, the next step is to apply the rules to decide whether the accounting treatment is to debit or credit that account. The Golden Rules will guide us whether the account is to be debited or credited.

There is one rule for each basic type of account i.e. personal, real and nominal. These rules are shown in the following chart.



We will see the following example to understand application of these rules. Consider the following transactions:

(i) Mr. Vikas and Mrs. Vaibhavi who are husband and wife started offering consultancy services, by investing cash of ₹ 5,00,000 and ₹ 2,50,000 respectively.

From business point of view the two effects of this transaction are: first, the cash of ₹ 7,50,000 has come into business and second, there is an obligation of the business towards Mr. Vikas and Mrs. Vaibhavi.

Now, we know that Cash is real account, so rule for real account will apply. Cash has come into the business thereby increasing the asset. Hence, Cash Account should be debited.

We also know that Vikas's A/c and Vaibhavi's A/c are personal accounts, so rule for personal account will apply. (As both Vikas and Vaibhavi are givers of cash, their respective accounts will be credited.)

The answer will be	Debit Cash	₹ 7,50,000
	Credit Vikas's Capital	₹ 5,00,000
	Credit Vaibhavi's capital	₹ 2,50,000

Please note that the total debits and total credit match. It is the reflection of the dual aspect concept

(ii) They buy office furniture of ₹ 25,000 for cash.

Here, the two effects are: First, Furniture (which is an asset) has come into the business and second cash (which is also an asset) that has gone out of business.

Since, both the accounts viz. Furniture and Cash are real accounts, rule for real account will apply. Furniture has come in (asset increase), it will be debited and cash has gone out (asset decrease), it will be credited.

The answer will be:-	Debit Furniture	₹ 25,000
	Credit Cash	₹ 25,000

(iii) They open a current account with Citi Bank by depositing ₹ 1,00,000

Here, the two effects are: First, cash in hand has gone out (asset decrease) and second, the business cash at bank has increased (asset increase). Cash is a real account and Bank is a personal account.

The answer will be	Debit Citi Bank	₹ 1,00,000
	Credit Cash	₹ 1,00,000

(iv) They pay office rent of ₹ 15,000 for the month by cheque drawn on their Citi Bank to M/s Realtors Properties.

Here, the two effects are: First, since the payment is made by cheque, bank balance will reduce (asset decrease), and second, rent being an item of expense rent expense will increase.

Citi Bank A/c being a personal A/c, rule for personal account will apply. Citi bank A/c will be credited.

Rent A/c being a nominal account, rule for nominal account will apply. Since, rent is paid, it is an expense. Hence, Rent A/c will be debited.

The answer will be	Debit Rent	₹ 15,000
	Credit Citi Bank	₹ 15,000

In case of a cash transaction, the party with whom the transaction is made, is not recorded, but the cash or bank account is recorded.

(v) They buy a motor car worth ₹ 4,50,000 from Millennium Motors by making a down payment of ₹ 50,000 by cheque drawn on Citi Bank and the balance by taking a loan from HDFC Bank.

Here the effects will be: First, Motor Car (which is an asset) has come into the business (increase in asset). Second, Bank balance (which is an asset) has reduced (decrease in asset). Thirdly, there is an obligation created towards HDFC Bank from whom loan of ₹ 400000 is taken (increase in liability).

Citi Bank is a personal account, so rule for personal account will apply. Citi Bank will be credited.

Motor Car is a real account is so rule for real account will apply. Motor Car has come in, so Motor Car A/c will be debited.

HDFC Bank is provider of loan to whom money is payable by the business in future. HDFC Bank account being a personal account, rule for personal account will apply. HDFC Bank being the giver, it will be credited. (Note: In different opinions, we can consider Citi Bank A/c as Real Account. The

reason behind that is the balance at Citi Bank A/c belongs to the business, so it is an asset. However, in any circumstances HDFC Bank, who has paid Millennium Motors on behalf of the business, cannot be considered as Real Account. It is a Personal Account as it does not hold any business cash)

The answer will be	Debit Motor Car	₹ 4,50,000
	Credit Citi Bank	₹ 50,000
	Credit Loan from HDFC Bank	₹ 4,00,000

(vi) Vikas and Vaibhavi carried out a consulting assignment for Avon Pharmaceuticals and raise a bill for ₹ 1000000 as consultancy fees. Avon Pharmaceuticals have immediately settled ₹ 250000 by way of cheque and the balance will be paid after 30 days. The cheque received is deposited into Citi Bank.

Here the effects will be: First, the work done by Vikas and Vaibhavi has resulted in the revenue for the business. What should be the amount of revenue considered? Is it ₹ 10 lac for which work is done or only ₹ 2.50 lacs which is received? The revenue of entire ₹ 10 lac will be considered as by doing the work the business has acquired legal claim against Avon Pharmaceutical. Second effect will be cash that is received by way of cheque (asset increase). The third effect will be the amount of ₹ 7.50 lacs, which Avon Pharmaceuticals owes to the business.

Consultancy fees received (revenue earned) being income, rule for nominal account will apply and this account will be credited. Cheque received and deposited into Citi bank will increase the balance at the bank. Citi Bank being a personal account will be debited. The amount receivable from Avon is an asset, but it's due from Avon at a future date. To be able to recover it from them, their personal account will have to be created in books of accounts. Avon Pharmaceuticals is a personal account and they are receiver of consultancy, it will be debited.

The answer will be	Debit Citi Bank	₹ 2,50,000
	Debit Avon Pharmaceuticals	₹ 7,50,000
	Credit Consultancy Fees	₹ 10,00,000

(vii) They have employed a receptionist on a salary of ₹ 5,000 per month and one officer at a salary ₹ 10,000 per month. The salary for the current month is payable to them.

Is this a transaction to be recorded in the books? Remember accrual concept? Accordingly the expense of salary for the current month must be recognized as the expense for the current month even if it's not paid for. In fact, the business owes the salary to its employees and this obligation (which is a liability) must be shown in the books.

The effects will be: First, salary being an item of expense, is a nominal account and rule for nominal account will be applied. So, Salary A/c will be debited. Secondly, the obligation to pay salary is towards both employees, the convention is not to create separate employee accounts, but to use a representative personal account named as Salary Payable account. Since, this is personal account, rule of personal account will apply. Employees being givers of service, it will be credited.

The answer will be:	Debit Salary	₹ 15,000
	Credit Salary payable	₹ 15,000

Please look at the way we have approached each transaction and decided about accounting treatment. If you follow these logical steps, you will certainly be able to grasp the basics thoroughly

Under double entry system, the accounting of a business transaction involves the following steps:

(a) Consider whether an event qualifies to be entered in books of accounts in money terms

(b) If the answer to the above is 'yes', then assess the two aspects of the transaction

(c) Determine what type of 'account' is affected by each of the aspects
(d) Apply the Golden Rule of 'Debit' and 'Credit'
(e) Prepare the basic document such as invoice, voucher, debit note or credit note
(f) Record the transaction in the primary books or subsidiary books
(g) Carry out the posting into the ledger
(h) Prepare the list of all ledger balances and ensure it tallies
(i) Rectify the errors, if any
(j) Pass adjustment entries
(k) Prepare adjusted Trial Balance
(l) Prepare the financial statements – the Income Statement and Balance Sheet

Although it looks to be a lengthy process on paper, in practice it does not take time. In a computerised accounting environment in fact one has to prepare basic documents and enter them into accounting program. The computer program automatically carries out the rest of the processes to give us real time online financial statements. To get a hang of this, students are advised to lay their hands on simple computerized accounting packages to gain real time exposure.

Illustration 5.

Ascertain the Debit Credit under British Approach or Double Entry System. Take Previous illustration.

Solution:

	Step-I	**Step-II**	**Step-III**	**Step-IV**
(a)	Cash A/c Capital A/c	Real Personal	Comes in Giver	Debit Credit
(b)	Purchase A/c Cash A/c	Nominal Real	Expenses Goes out	Debit Credit
(c)	Cash A/c Sales A/c	Real Nominal	Comes in Incomes	Debit Credit
(d)	Salary A/c Cash A/c	Nominal Real	Expenses Goes out	Debit Credit
(e)	Cash A/c Interest A/c	Real Nominal	Comes in Incomes	Debit Credit
(f)	Purchase A/c Y' A/c	Nominal Personal	Expenses Giver	Debit Credit
(g)	Rent A/c Capital A/c	Nominal Personal	Expenses Giver	Debit Credit

1.13 ACCOUNTING EQUATION

The whole Financial Accounting dependes on Accounting Equation which is also known as Balance Sheet Equation. The basic Accounting Equation is:

Assets = Liabilities + Owner's equity

or A = L + P
or P = A - L
or L = A - P

} Where A = Assets, L = Liabilities, P = Capital

While trying to do this correlation, please note that incomes or gains will increase owner's equity and expenses or losses will reduce it.

Students are advised to go through the following illustration to understand this equation properly.

Illustration 6.

Prepare an Accounting Equation from the following transactions in the books of Mr. X for January, 2013 :

1 Invested Capital in the firm ₹ 20,000

2 Purchased goods on credit from Das & Co. for ₹ 2,000

4 Bought plant for cash ₹ 8,000

8 Purchased goods for cash ₹ 4,000

12 Sold goods for cash (cost ₹ 4,000 + Profit ₹ 2,000) ₹ 6,000.

18 Paid to Das & Co. in cash ₹ 1,000

22 Received from B. Banerjee ₹ 300 (being a debtor)

25 Paid salary ₹ 6,000

30 Received interest ₹ 5,000

31 Paid wages ₹ 3,000

Solution:

Effect of transaction on Assets, Liabilities and Capital

Date	Transaction	Assets =	Liabilities +	Capital
January, 2013 1	Invested Capital in the firm, ₹ 20,000	20,000	-	20,000
2	Purchased goods on credit from Das & Co. ₹ 2,000	+2,000	+2,000	-
	Revised Equation	**22,000 =**	**2,000 +**	**20,000**
4	Bought Plant for cash ₹ 8,000	+8,000 -8,000	-	-
	Revised Equation	**22,000 =**	**2,000 +**	**20,000**
8	Purchased goods for cash ₹ 4,000	+4,000 -4,000	- -	- -
	Revised Equation	**22,000 =**	**2,000 +**	**20,000**
12	Sold Goods for cash (Cost ₹ 4,000 + Profit ₹ 2,000)	+6,000 -4,000		+2,000
	Revised Equation	**24,000**	**2,000 +**	**22,000**
18	Paid to Das & Co. for ₹ 1,000	-1,000	-1,000	
	Revised Equation	**23,000 =**	**1,000 +**	**22,000**
22	Received from B.Banerjee for ₹ 300	+300 -300		
	Revised Equation	**23,000 =**	**1,000 +**	**22,000**
25	Paid salary for ₹ 6,000	- 6,000		-6,000
	Revised Equation	**17,000 =**	**1,000 +**	**16,000**
30	Received Interest for ₹ 5,000	+5,000		+5,000
	Revised Equation	**22,000 =**	**1,000 +**	**21,000**
31	Paid Wages for ₹3,000	-3,000		-3,000
	Revised Equation	**19,000 =**	**1,000 +**	**18,000**

1.14 ACCRUAL BASIS AND CASH BASIS OF ACCOUNTING

(i) Accrual Basis of Accounting

Accrual Basis of Accounting is a method of recording transactions by which revenue, costs, assets and liabilities are reflected in the accounts for the period in which they accrue. This basis includes consideration relating to deferrals, allocations, depreciation and amortization. This basis is also referred to as mercantile basis of accounting. Under the Companies Act 1956, all companies are required to maintain the books of accounts according to accrual basis of accounting

(ii) Cash Basis of Accounting

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

1.14.1 Distinction between Accrual Basis of Accounting and Cash Basis of Accounting

Accrual basis of accounting differs from Cash basis of accounting in the following respects:

Basis of Distinction	Accrual Basis of Accounting	Cash Basis of Accounting
1. Prepaid/Outstanding Expenses/ accrued/unaccrued Income in Balance Sheet.	Under this, there may be prepaid/ outstanding expenses and accrued/unaccrued incomes in the Balance Sheet.	Under this, there is no prepaid/outstanding expenses or accrued/ unaccrued incomes.
2. Higher/lower Income in case of prepaid expenses and accrued income	Income Statement will show a relatively higher income	Income Statement will show lower income.
3. Higher/lower income incase of outstanding expenses and unaccrued income	Income Statement will show a relatively lower income.	Income Statement will show higher income.
4. Recognition under the Companies Act. 1956.	This basis is recognized under the Companies Act, 1956.	This basis is not recognized under the Companies Act, 1956.
5. Availability of options to an accountant to manipulate the accounts by way of choosing the most suitable method out of several alternative methods of accounting e.g. FIFO/LIFO/SLM/ WDV	Under this, an accountant has options.	Under this an accountant has no option to make a choice as such.

1.14.2 Hybrid or Mixed Basis

Is the combination of both the basis i.e. Cash as well as Accrual basis. Incomes are recorded on Cash basis but expenses are recorded on Accrual basis.

This is not a system of accounting on its own. It is a combination of the Cash Basis Accounting and Accrual Basis Accounting. This system is based on the concept of conservatism.

Under the hybrid system of accounting, incomes are recognised as in Cash Basis Accounting i.e. when they are received in cash and expenses are recognised on accrual basis i.e. during the accounting period in which they arise irrespective of when they are paid.

Illustration 7.

Mr. Anil Roy, a junior lawyer, provides the following particulars for the year ended 31st December, 2012:

	₹
Fees received in cash in 2013	60,000
Salary paid to Staff in 2013	8,000
Rent of office in 2013	14,000
Magazine and Journal for 2013	1,000
Travelling and Conveyance paid in 2013	3,000
Membership Fees paid in 2013	1,600
Office Expenses paid in 2013	10,000

Additional Information:-

Fees include ₹ 3,000 in respect of 2012 and fees not yet received is ₹ 7,000.

Office rent includes ₹ 4,000 for previous year and rent of ₹ 2,000 not yet paid.

Membership fees is paid for 2 years.

Compute his net income for the year 2013, under – (a) Cash Basis, (b) Accrual Basis and (c) Mixed or Hybrid Basis.

Solution:

(i)

Mr. Anil Roy

Statement of Income (Cash Basis)

For the year ended 31st December, 2013

Particulars	Amount (₹)	Amount (₹)
Fees received		60,000
Less :		
Salary	8,000	
Office Rent	14,000	
Magazine & Journal	1,000	
Travelling & Conveyance	3,000	
Membership Fees	1,600	
Office Expenses	10,000	37,600
Net Income		22,400

(ii)

Mr. Anil Roy

Statement of Income (Accrual Basis)

For the year ended 31st December, 2013

Particulars		Amount (₹)	Amount (₹)
Fees received		60,000	
Add: Accrued fees for 2012		7,000	
		67,000	
Less: Fees for 2011 received in 2012		3,000	64,000

Less :			
Salary		8,000	
Office Rent	14,000		
Add: Outstanding rent	2,000		
	16,000		
Less: Rent for 2011 paid in 2012	4,000	12,000	
Magazine & Journal		1,000	
Travelling & Conveyance		3,000	
Membership Fees	1,600		
Less: Advance fee paid for 2013 (½ x 1600)	800	800	
Office Expenses		10,000	34,800
Net Income			29,200

(iii)

Mr. Anil Roy

Statement of Income (Mixed or Hybrid Basis)

For the year ended 31st December, 2013

Particulars	Amount (₹)	Amount (₹)	Amount (₹)
Fees received			60,000
Less :			
Salary		8,000	
Office Rent	14,000		
Add: Outstanding rent	2,000		
	16,000		
Less: Fees for 2011	4,000	12,000	
Magazine & Journal		1,000	
Travelling & Conveyance		3,000	
Membership Fees	1,600		
Less: Advance	800	800	
Office Expenses		10,000	34,800
Net Income			25,200

1.14.3 Conversion of Cash Basis of Accounting into Accrual Basis of Accounting:

When accounting is done under Cash Basis and the final accounts are prepared, the same can be converted into Accrual Basis from the beginning of the next financial period. The following procedure should be followed for the purpose.

At first it is necessary to ascertain the amount of outstanding and prepaid expenses and at the same time, accrued incomes and income received in advance.

Thereafter following journal entries should be made:

Sl. No.	Particulars		L.F.	Dr. Amount (₹)	Cr. Amount (₹)
(a)	Accrued Income A/c	Dr.		-	
	Prepaid Expenses A/c	Dr.		-	
	To, Profit and Loss Adjustment A/c				-
	(Bringing into account the accrued income, prepaid expenses for converting the cash basis of accounting into accrual basis)				
(b)	Profit and Loss Adjustment A/c	Dr.		-	
	To, Income Received in Advance A/c				-
	To, Outstanding Expenses A/c				-
	(Bringing into account the income received in advance and outstanding expenses for converting the cash basis of accounting into accrual basis)				
(c)	If there is a profit as a result of above adjustment-				
	Profit and Loss Adjustment A/c	Dr.		-	-
	To, Capital A/c				
	(Profit transferred to capital account as a result of conversion from cash basis to accrual basis.)				
	If there is a loss as a result of above adjustment-				
	Capital A/c	Dr.		-	-
	To, Profit and Loss Adjustment A/c				
	(Loss transferred to capital account as a result of conversion from cash basis to accrual basis.)				

Illustration 8.

X and Y formed partnership sharing profits as 2 : 1. The term was to distribute mercantile profit. But cash profit has been calculated all through. Now it is desired to convert cash accounts into mercantile accounts. The details are :

	Cash Profit ₹	Closing Outstanding Income. ₹	Closing Outstanding Expenses ₹
1st Year	10,000	1,000	500
2nd Year	12,000	3,000	1,000
3rd Year	18,000	2,000	800.

Pass conversion entry.

Solution:

		₹
Cash Profit for three years (₹ 10,000 + ₹ 12,000 + ₹ 18,000)	40,000	
Add : Closing outstanding incomes	2,000	
		42,000
Less : Closing outstanding expenses		800
Mercantile Profit		41,200
Less : Cash profit which are already distributed		40,000
Profit to be distributed between X and Y in 2 : 1.		1,200

Thus, the entry being :

Journal

Date	Particulars	L.F.	Dr. Amount (₹)	Cr. Amount (₹)
?	Outstanding Income A/c Dr.		2,000	
	To Outstanding Expenses A/c			800
	,, X's Capital A/c			800
	,, Y's Capital A/c			400
	(Cash basis of accounting converted into mercantile basis of accounting).			

1.15 CAPITAL AND REVENUE TRANSACTIONS

The concepts of capital and revenue are of fundamental importance to the correct determination of accounting profit for a period and recognition of business assets at the end of that period. The distinction affects the measurement of profit in a number of accounting periods.

Capital has been defined by economists as those assets which are used in the production of goods and rendering of services for further production of assets. In accounting, on the other hand, the capital of a business is increased by that portion of the periodic income which has not been consumed by the owner.

The relationship between capital and revenue is that of between a tree and its fruits. It is the tree which produces the fruits, and it is the fruit that can be consumed. If the tree is tendered with care, it will produce more fruits, conversely, if the tree is destroyed, there will be no more fruits. Likewise, revenue comes out of capital and capital is the source of revenue. Capital is invested by a person in the business so that it may produce revenue. Moreover, as a fruit may give birth to another new tree, different revenues may also produce further new capital.

Capital can be brought in by a person into the business in different forms-cash or kind. When capital is brought in the form of cash, it is spent away on various items of assets that make the business a running concern. Capital of the firm is thus, represented by its inventory of assets.

Capital of a business can be increased in a two fold way:

1. When the owner brings in more capital to the business; and/or
2. When the owner does not consume the entire periodic income.

When the owner brings in further capital to his business, the amount is credited to the Capital Account. Likewise, the net income for a period is credited to the Capital Account, and if his drawings are less than that income, the capital is increased by the difference. Example, Capital ₹ 500, Profit ₹ 300, drawings ₹ 350. So the revised capital will be ₹ 450 (₹ 500 + ₹ 300 - ₹ 350)

The difference between the two terms 'revenue' and 'receipt' should be carefully distinguished. A receipt is the inflow of money into business, whereas revenue is the aggregate exchange value received for goods and services provided to the customers.

1.15.1 Capital and Revenue Expenditures

Capital expenditure is the outflow of funds to acquire an asset that will benefit the business for more than one accounting period. A capital expenditure takes place when an asset or service is acquired or improvement of a fixed asset is effected. These assets are expected to provide benefits to the business in more than one accounting period and are not intended for resale in the ordinary course of business. In short, it is an expenditure on assets which is not written off completely against income in the accounting period in which it is acquired.

Revenue expenditure is the outflow of funds to meet the running expenses of a business and it will be of benefit for the current period only. A revenue expenditure is incurred to carry on the normal course of business or maintain the capital assets in a good condition.

It may be pointed out here that an expenditure need not necessarily be a payment made to somebody in cash - it may be made by the exchange of another asset, or by assuming a liability. Expenditure incurrence and expenditure recognition are distinct phenomena. Expenditure incurrence refers to the receipt of goods and services, whereas expenditure recognition is a matter to be decided whether the expenditure is of capital or revenue nature. For example, the buying of an asset is a capital expenditure but charging depreciation against profit is a revenue expenditure, over the entire life of that asset. On the application of periodicity, accrual and matching concepts, accountants identify all revenue expenditures for a given period for ascertaining profit. An expenditure which cannot be identified to a particular accounting period is considered of capital nature.

1.15.2 The accounting treatment of capital and revenue expenditure are as under:

Revenue expenditures are charged as an expense against profit in the year they are incurred or recognised. Capital Expenditures are capitalised-added to an Asset Account.

The following are the points of distinction between Capital Expenditure and Revenue Expenditure :

Sl. No.	Capital Expenditure	Sl. No.	Revenue Expenditure
1.	The economic benefits of Capital Expenditures are enjoyed for more than one accounting period.	1.	The economic benefits of Revenue Expenditures are enjoyed within a particular accounting period.
2.	Capital Expenditures are of non-recurring in nature.	2.	Revenue Expenditures are of recurring in nature.
3.	All Capital Expenditures eventually become Revenue Expenditures like depreciation	3.	Revenue Expenditures are not generally capital expenditures.
4.	Capital Expenditures are not matched with Capital Receipts.	4.	All Revenue Expenditures are matched with Revenue Receipts.

1.15.3 Rules for Determining Capital Expenditure

An expenditure can be recognised as capital if it is incurred for the following purposes :

An expenditure incurred for the purpose of acquiring long term assets (useful life is at least more than one accounting period) for use in business to earn profits and not meant for resale, will be treated as a capital expenditure. For example, if a second hand motor car dealer buys a piece of furniture with a view to use it in business; it will be a capital expenditure. But if he buys second hand motor cars, for re-sale, then it will be a revenue expenditure because he deals in second hand motor cars.

When an expenditure is incurred to improve the present condition of a machine or putting an old asset into working condition, it is recognised as a capital expenditure. The expenditure is capitalised and added to the cost of the asset. Likewise, any expenditure incurred to put an asset into working condition is also a capital expenditure.

For example, if one buys a machine for ₹ 5,00,000 and pays ₹ 20,000 as transportation charges and ₹ 40,000 as installation charges, the total cost of the machine comes upto ₹ 5,60,000. Similarly, if a building is purchased for ₹ 1,00,000 and ₹ 5,000 is spent on registration and stamp duty, the capital expenditure on the building stands at ₹ 1,05,000.

If an expenditure is incurred, to increase earning capacity of a business that will be considered as of capital nature. For example, expenditure incurred for shifting the factory for easy supply of raw materials. Here, the cost of such shifting will be a capital expenditure.

Preliminary expenses incurred before the commencement of business is considered capital expenditure. For example, legal charges paid for drafting the memorandum and articles of association of a company or brokerage paid to brokers, or commission paid to underwriters for raising capital.

Thus, one useful way of recognising an expenditure as capital is to see that the business will own something which qualifies as an asset at the end of the accounting period.

Some examples of capital expenditure:

(i) Purchase of land, building, machinery or furniture; (ii) Cost of leasehold land and building; (iii) Cost of purchased goodwill; (iv) Preliminary expenditures; (v) Cost of additions or extensions to existing assets; (vi) Cost of overhauling second-hand machines; (vii) Expenditure on putting an asset into working condition; and (viii) Cost incurred for increasing the earning capacity of a business.

1.15.4 Rules for Determining Revenue Expenditure

Any expenditure which cannot be recognised as capital expenditure can be termed as revenue expenditure. A revenue expenditure temporarily influences only the profit earning capacity of the business. An expenditure is recognised as revenue when it is incurred for the following purposes :

Expenditure for day-to-day conduct of the business, the benefits of which last less than one year. Examples are wages of workmen, interest on borrowed capital, rent, selling expenses, and so on.

Expenditure on consumable items, on goods and services for resale either in their original or improved form. Examples are purchases of raw materials, office stationery, and the like. At the end of the year, there may be some revenue items (stock, stationery, etc.) still in hand. These are generally passed over to the next year though they were acquired in the previous year.

Expenditures incurred for maintaining fixed assets in working order. For example, repairs, renewals and depreciation.

Some examples of Revenue Expenditure

(i) Salaries and wages paid to the employees; (ii) Rent and rates for the factory or office premises; (iii) Depreciation on plant and machinery; (iv) Consumable stores; (v) Inventory of raw materials, work-in-progress and finished goods; (vi) Insurance premium; (vii) Taxes and legal expenses; and (viii) Miscellaneous expenses.

1.15.5 Replacement of Fixed Assets

The above rules of capital and revenue expenditure do not hold good when an existing asset is replaced for another. If an asset is replaced with a similar kind of asset, the expenditure incurred is treated as Revenue Expenditure. For example, if a set of weighing machines in a shop becomes defective and is replaced with a similar set, the cost of replacement should be treated as revenue expenditure and it should be charged to the Profit and Loss Account. However, if an asset is replaced with an asset which is superior than the previous one, the expense is partly capital and partly revenue. For example, if a manual typewriter costing ₹ 5,000 is replaced with an electronic typewriter costing ₹ 15,000, then ₹ 5,000 will be revenue expenditure and the excess value of the new typewriter over the old one, ₹ 10,000 will be capital expenditure.

1.15.6 Deferred Revenue Expenditures

Deferred revenue expenditures represent certain types of assets whose usefulness does not expire in the year of their occurrence but generally expires in the near future. These type of expenditures are carried forward and are written off in future accounting periods. Sometimes, we make some revenue expenditure but it eventually becomes a capital asset (generally of an intangible nature). If one undertake substantial repairs to the existing building, the deterioration of the premises may be avoided. We may engage our own employees to do that work and pay them at prevailing wage-rate, which is of a revenue nature. If this expenditure is treated as a revenue expenditure and the current year's-profit is charged with these expenses, we are making the current year to absorb the entire expenses, though the benefit of which

will be enjoyed for a number of accounting years. To overcome this difficulty, the entire expenditure is capitalised and is added to the asset account. Another example is an insurance policy. A business can pay insurance premium in advance, say, for a 3 year period. The right does not expire in the accounting period in which it is paid but will expire within a fairly short period of time (3 years). Only a portion of the total premium paid should be treated as a revenue expenditure (portion pertaining to the current period) and the balance should be carried forward as an asset to be written off in subsequent years.

AS 26 - Intangible Asset does not accept this view. As per AS-26, "Expenditure incurred to provide future economic benefit to an enterprise that can be recognized as an expense when it is incurred. e.g. expenditure incurred on Scientific Research is recognized as an expense when it is incurred". In short, the whole amount of expenditure is treated as expense for the current year only and will not proportionately be transferred as deferred charge.

1.15.7 Capital and Revenue Receipts

A receipt of money may be of a capital or revenue nature. A clear distinction, therefore, should be made between capital receipts and revenue receipts.

A receipt of money is considered as capital receipt when a contribution is made by the proprietor towards the capital of the business or a contribution of capital to the business by someone outside the business. Capital receipts do not have any effect on the profits earned or losses incurred during the course of a year.

Additional capital introduced by the proprietor; by partners, in case of partnership firm, by issuing fresh shares, in case of a company; and, by selling assets, previously not intended for resale.

A receipt of money is considered as revenue receipt when it is received from customers for goods supplied or fees received for services rendered in the ordinary course of business, which is a result of the firm's activity in the current period. Receipts of money in the revenue nature increase the profits or decrease the losses of a business and must be set against the revenue expenses in order to ascertain the profit for the period.

The following are the points of difference between capital receipts and revenue receipts :

Sl. No.	Revenue Receipt	Sl. No.	Capital Receipt
1.	It has short-term effect. The benefit is enjoyed within one accounting period.	1.	It has long-term effect. The benefit is enjoyed for many years in future.
2.	It occurs repeatedly. It is recurring and regular.	2.	It does not occur again and again. It is nonrecurring and irregular.
3.	It is shown in profit and loss account on the credit side, as an income for the year	3.	It is shown in the Balance Sheet on the liability side.
4.	It does not produce capital receipt.	4.	Capital receipt, when invested, produces revenue receipt e.g. when capital is invested by the owner, business gets revenue receipt (i.e. sale proceeds of goods etc.).
5.	This does not increase or decrease the value of asset or liability.	5.	The capital receipt decreases the value of asset or increases the value of liability e.g. sale of a fixed asset, loan from bank etc.
6.	Sometimes, expenses of capital nature are to be incurred for revenue receipt, e.g. purchase of shares of a company is capital expenditure but dividend received on shares is a revenue receipt.	6.	Sometimes expenses of revenue nature are to be incurred for such receipt e.g. on obtaining loan (a capital receipt) interest is paid until its repayment.

1.15.8 Capital and Revenue Profits

While ascertaining the trading profit of a business for a particular period, a proper distinction is to be made between capital and revenue profits. If profit arises out of an ordinary nature, being the outcome

of the ordinary function and object of the business, it is termed as 'Revenue Profit'. But, when a profit arises out of a casual and non-recurring transaction, it is termed as Capital Profit. Revenue profit arises out of the sale of the merchandise that the business deals in.

Capital Profit arises from :-

(a) Profit prior to incorporation;

(b) Premium received on issue of shares;

(c) Profit made on re-issue of forfeited shares;

(d) Redemption of Debenture at a discount;

(e) Profit made on sale or revaluation of a Fixed Asset.

Generally, capital profits arise out of the sale of assets other than inventory at a price more than its book value or in connection with the raising of capital or at the time of purchasing an existing business. For example, if an asset, whose book value is ₹ 5,000 on the date of sale, is sold for ₹ 6,000 then ₹ 1,000 will be considered as capital profit. Likewise, issue of shares at a premium is also a capital profit. Revenue profits are distributed to the owners of the business or transferred to General Reserve Account, being shown in the balance sheet as a retained earning. Capital profits are generally capitalised-transferred to a capital reserve account which can only be utilised for setting off capital losses in future. Capital profits of a small amount (arising out of selling of one asset) is taken to the Profit and Loss Account and added with the revenue profit-applying the concept of materiality.

1.15.9 Capital and Revenue Losses

While ascertaining losses, revenue losses are differentiated from capital losses, just as revenue profits are distinguished from capital profits. Revenue losses arise from the normal course of business by selling the merchantable at a price less than its purchase price or cost of goods sold or where there is a declining in the current value of inventories. Capital losses may result from the sale of assets, other than inventory for less than written down value or the diminution or elimination of assets other than as the result of use or sale (flood, fire, etc.) or in connection with raising capital of the business (issue of shares at a discount) or on the settlement of liabilities for a consideration more than its book value (debenture issued at par but redeemed at a premium). Treatment of capital losses are same as that of capital profits. Capital losses arising out of sale of fixed assets generally appear in the Profit and Loss Account (being deducted from the net profit). But other capital losses are adjusted against the capital profits. Where the capital losses are substantial, the treatment is different. These losses are generally shown on the balance sheet as fictitious assets and the common practice is to spread that over a number of accounting years as a charge against revenue profits till the amount is fully exhausted.

Illustration 9.

State whether the following are capital, revenue or deferred revenue expenditure.

(i) Carriage of ₹ 7,500 spent on machinery purchased and installed.

(ii) Heavy advertising costs of ₹ 20,000 spent on the launching of a company's new product.

(iii) ₹ 200 paid for servicing the company vehicle, including ₹ 50 paid for changing the oil.

(iv) Construction of basement costing ₹ 1,95,000 at the factory premises.

Solution :

(i) Carriage of ₹ 7,500 paid for machinery purchased and installed should be treated as a Capital Expenditure.

(ii) Advertising expenses for launching a new product of the company should be treated as a Revenue Expenditure. (As per AS-26)

(iii) ₹ 200 paid for servicing and oil change should be treated as a Revenue Expenditure.

(iv) Construction cost of basement should be treated as a Capital Expenditure.

Illustration 10.

State whether the following are capital or revenue expenditure.

(i) Paid a bill of ₹ 10,000 of Mr. Kumar, who was engaged as the erection engineer to set up a new automatic machine costing ₹ 20,000 at the new factory site.

(ii) Incurred ₹ 26,000 expenditure on varied advertisement campaigns under taken yearly, on a regular basis, during the peak festival season.

(iii) In accordance with the long-term plan of providing a well- equipped Labour Welfare Centre, spent ₹ 90,000 being the budgeted allocation for the year.

Solution :

(i) Expenses incurred for erecting a new machine should be treated as a Capital Expenditure.

(ii) Advertisement expenses during peak festival season should be treated as a Revenue Expenditure.

(iii) Expenses incurred for Labour Welfare Centre should be treated as a Capital Expenditure.

Illustration 11.

Classify the following items as capital or revenue expenditure :

(i) An extension of railway tracks in the factory area;

(ii) Wages paid to machine operators;

(iii) Installation costs of new production machine;

(iv) Materials for extension to foremen's offices in the factory;

(v) Rent paid for the factory;

(vi) Payment for computer time to operate a new stores control system,

(vii) Wages paid to own employees for building the foremen's offices.

Give reasons for your classification.

Solution :

(i) Expenses incurred for extension of railway tracks in the factory area should be treated as a Capital Expenditure because it will yield benefit for more than one accounting period.

(ii) Wages paid to machine operators should be treated as a Revenue Expenditure as it will yield benefit for the current period only.

(iii) Installation costs of new production machine should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

(iv) Materials for extension to foremen's offices in the factory should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

(v) Rent paid for the factory should be treated as a Revenue Expenditure because it will benefit only the current period.

(vi) Payment for computer time to operate a new stores control system should be treated as Revenue Expenditure because it has been incurred to carry on the normal business.

(vii) Wages paid for building foremen's offices should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

Illustration 12.

For each of the cases numbered below, indicate whether the income/expenditure is capital or revenue.

(i) Payment of wages to one's own employees for building a new office extension.

(ii) Regular hiring of computer time for the preparation of the firm's accounts.

(iii) The purchase of a new computer for use in the business.

(iv) The use of motor vehicle, hired for five 'years, but paid at every six months.

Solution :

(i) Payment of wages for building a new office extension should be treated as a Capital Expenditure.

(ii) Computer hire charges should be treated as a Revenue Expenditure.

(iii) Purchase of computer for use in the business should be treated as a Capital Expenditure.

(iv) Hire charges of motor vehicle should be treated as a Revenue Expenditure.

Illustration 13.

State with reasons whether the following are capital or revenue expenditure :

(i) Freight and cartage on the new machine ₹ 150, and erection charges ₹ 500.

(ii) Fixtures of the book value of ₹ 2,500 sold off at ₹ 1,600 and new fixtures of the value of ₹ 4,000 were acquired. Cartage on purchase ₹ 100.

(iii) A sum of ₹ 400 was spent on painting the factory.

(iv) ₹ 8,200 spent on repairs before using a second hand car purchased recently, to put it in usable condition.

Solution :

(i) Freight and cartage totaling ₹ 650 should be treated as a Capital Expenditure because it will benefit the business for more than one accounting year.

(ii) Loss on sale of fixtures ₹ (2,500 – 1,600) = ₹ 900 should be treated as a Capital Loss. The cost of new fixtures and carriage thereon should be treated as a Capital Expenditure because the fixture will be used for a long period. So ₹ (4,000+100) the cost of new fixture will be ₹ 4,100.

(iii) Painting of the factory should be treated as a Revenue Expenditure because it has been incurred to maintain the factory building.

(iv) Repairing cost of second hand car should be treated as a Capital Expenditure because it will benefit the business for more than one accounting year.

Illustration 14.

State the nature (capital or revenue) of the following expenditure which were incurred by Vedanta & Co. during the year ended 30th June, 2013 :

(i) ₹ 350 was spent on repairing a second hand machine which was purchased on 8th May, 2013 and ₹ 200 was paid on carriage and freight in connection with its acquisition.

(ii) A sum of ₹ 30,000 was paid as compensation to two employees who were retrenched.

(iii) ₹ 150 was paid in connection with carriage on goods purchased.

(iv) ₹ 20,000 customs duty is paid on import of a machinery for modernisation of the factory production during the current year and ₹ 6,000 is paid on import duty for purchase of raw materials.

(v) ₹ 18,000 interest had accrued during the year on term loan obtained and utilised for the construction of factory building and purchase of machineries; however, the production has not commenced till the last date of the accounting year.

Solution :

(i) Repairing and carriage totaling ₹ 550 for second hand machine should be treated as a Capital Expenditure.

(ii) Compensation paid to employees shall be treated as a Revenue Expenditure.

(iii) Carriage paid for goods purchased should be treated as a Revenue Expenditure.

(iv) Customs duty paid on import of machinery to be treated as a Capital Expenditure. However, import duty paid for raw materials should be treated as a Revenue Expenditure.

(v) Interest paid during pre-construction period to be treated as a Capital Expenditure.

Illustration 15.

State with reasons whether the following items relating to Parvati Sugar Mill Ltd. are capital or revenue :

(i) ₹ 50,000 received from issue of shares including ₹ 10,000 by way of premium.

(ii) Purchased agricultural land for the mill for ₹ 60,000 and ₹ 500 was paid for land revenue.

(iii) ₹ 5,000 paid as contribution to PWD for improving roads of sugar producing area.

(iv) ₹ 40,000 paid for excise duty on sugar manufactured.

(v) ₹ 70,000 spent for constructing railway siding.

Solution :

(i) ₹ 40,000 (50,000 – ₹ 10,000) received from issue of shares will be treated as a Capital Receipt. The premium of ₹ 10,000 should be treated as a Capital Profit.

(ii) Cost of land ₹ 60,000 to be treated as Capital Expenditure and land revenue of ₹ 500 to be treated as Revenue Expenditure.

(iii) Contribution paid to PWD should be treated as a Revenue Expenditure.

(iv) Excise duty of ₹ 40,000 should be treated as a Revenue Expenditure.

(v) ₹ 70,000 spent for constructing railway siding to be treated as a Capital Expenditure.

Illustration 16.

State with reasons whether the following are Capital Expenditure or Revenue Expenditure :

(i) Expenses incurred in connection with obtaining a licence for starting the factory were ₹ 10,000.

(ii) ₹ 1,000 paid for removal of stock to a new site.

(iii) Rings and Pistons of an engine were changed at a cost of ₹ 5,000 to get full efficiency.

(iv) ₹ 2,000 spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the Plaintiff. The suit was not successful.

(v) ₹ 10,000 were spent on advertising the introduction of a new product in the market, the benefit of which will be effective during four years.

(vi) A factory shed was constructed at a cost of ₹ 1,00,000. A sum of ₹ 5,000 had been incurred for the construction of the temporary huts for storing building materials.

Solution :

(i) ₹ 10,000 incurred in connection with obtaining a license for starting the factory is a Capital Expenditure. It is incurred for acquiring a right to carry on business for a long period.

(ii) ₹ 1,000 incurred for removal of stock to a new site is treated as a Revenue Expenditure because it is not enhancing the value of the asset and it is also required for starting the business on the new site.

(iii) ₹ 5,000 incurred for changing Rings and Pistons of an engine is a Revenue Expenditure because, the change of rings and piston will restore the efficiency of the engine only and it will not add anything to the capacity of the engine.

(iv) ₹ 2,000 incurred for defending the title to the firm's assets is a Revenue Expenditure.

(v) ₹ 10,000 incurred on advertising is to be treated as a Revenue Expenditure. [As per As-26]

(vi) Cost of construction of Factory shed of ₹ 1,00,000 is a Capital Expenditure, similarly cost of construction of small huts for storing building materials is also a Capital Expenditure.

Illustration 17.

State clearly how you would deal with the following in the books of a Company :

(i) The redecoration expenses ₹ 6,000.

(ii) The installation of a new Coffee-making Machine for ₹ 10,000.

(iii) The building of an extension of the club dressing room for ₹ 15,000.

(iv) The purchase of snacks & food stuff ₹ 2,000.

(v) The purchase of V.C.R. and T.V. for the use in the club lounge for ₹ 15,000.

Solution :

(i) The redecoration expenses of ₹ 6,000 shall be treated as a Revenue Expenditure.

(ii) The installation of a new Coffee - Making Machine is a Capital Expenditure because it is the acquisition of an asset.

(iii) ₹ 15,000 spent for the extension of club dressing room is a Capital Expenditure because it creates an asset of a permanent nature.

(iv) The purchase of snacks & food stuff of ₹ 2,000 is a Revenue Expenditure.

(v) The purchase of V.C.R. and T.V. for ₹ 15,000 is a Capital Expenditure, because it is the acquisition of assets.

1.16 ACCOUNTING STANDARDS

Comparative Statement of AS & IND AS (Subject- Wise)

SL.No.	Accounting Standards (AS)	IND AS No.	Name of IND AS
			I. **Standards on Presentation**
1	AS 1	Ind AS 1	Presentation of Financial Statements
2	AS 3	Ind AS 7	Statement of Cash Flows
3	AS 5	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
4	AS 4	Ind AS 10	Events after the Reporting Period
5	AS 25	Ind AS 34	Interim Financial Reporting
6	**No Corresponding Standard**	Ind AS 29	Financial Reporting in Hyperinflationary Economies
			II. **Standards on Consolidation**
7	AS 21	Ind AS 27	Consolidated and Separate Financial Statements
8	AS 23	Ind AS 28	Investments in Associates
9	AS 27	Ind AS 31	Interests in Joint Ventures
10	AS 14	Ind AS 103	Business Combinations
			III. **Standards on Revenue**
11	AS 2	Ind AS 2	Inventories

12	AS 7	Ind AS 11	Construction Contracts
13	AS 9	Ind AS 18	Revenue
14	AS 12	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
15	AS 11	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
			IV. **Standards on Liabilities and Provisions**
16	AS 15	Ind AS 19	Employee Benefits
17	AS 29	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
18	**Guidance Note**	Ind AS 102	Share-based Payment
19	**No Corresponding Standard**	Ind AS 104	Insurance Contracts
			V. **Standards on Disclosures**
20	AS 18	Ind AS 24	Related Party Disclosures
21	AS 20	Ind AS 33	Earnings Per Shares
22	AS 17	Ind AS 108	Operating Segments
			VI. **Standards on Assets**
23	AS 16	Ind AS 23	Borrowing Costs
24	AS 28	Ind AS 36	Impairments of Assets
25	AS 26	Ind AS 38	Intangible Assets
26	**No Corresponding Standard**	Ind AS 40	Investment Property
27	AS 10 & AS 6	Ind AS 16	Property, Plant and Equipment
28	AS 19	Ind AS 17	Leases
29	AS 24	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
30	**Guidance Note**	Ind AS 106	Exploration for and Evaluation of Mineral Resources
			VII. **Standards on Taxes**
31	AS 22	Ind AS 12	Income Taxes
			VIII. **Standards on Financial Instruments**
32	AS 31	Ind AS 32	Financial Instruments: Presentation
33	AS 30	Ind AS 39	Financial Instruments: Recognition and Measurement
34	AS 32	Ind AS 107	Financial Instruments: Disclosures
			IX. **Standards on First Time Adoption**
35	**No Corresponding Standard**	Ind AS 101	First Time Adoption of Ind AS

Comparative Statement of AS & IND AS (Ind AS – wise)

SL.No.	Accounting Standards (AS)	IND AS No.	Name of IND AS
1	AS 1	Ind AS 1	Presentation of Financial Statements
2	AS 2	Ind AS 2	Inventories
3	AS 3	Ind AS 7	Statement of Cash Flows
4	AS 5	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
5	AS 4	Ind AS 10	Events after the Reporting Period
6	AS 7	Ind AS 11	Construction Contracts

7	AS 22	Ind AS 12	Income Taxes
8	AS 10 & AS 6	Ind AS 16	Property, Plant and Equipment
9	AS 19	Ind AS 17	Leases
10	AS 9	Ind AS 18	Revenue
11	AS 15	Ind AS 19	Employee Benefits
12	AS 12	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
13	AS 11	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
14	AS 16	Ind AS 23	Borrowing Costs
15	AS 18	Ind AS 24	Related Party Disclosures
16	AS 21	Ind AS 27	Consolidated and Separate Financial Statements
17	AS 23	Ind AS 28	Investments in Associates
18	**No Corresponding Standard**	Ind AS 29	Financial Reporting in Hyperinflationary Economies
19	AS 27	Ind AS 31	Interests in Joint Ventures
20	AS 31	Ind AS 32	Financial Instruments: Presentation
21	AS 20	Ind AS 33	Earnings Per Shares
22	AS 25	Ind AS 34	Interim Financial Reporting
23	AS 28	Ind AS 36	Impairments of Assets
24	AS 29	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
25	AS 26	Ind AS 38	Intangible Assets
26	AS 30	Ind AS 39	Financial Instruments: Recognition and Measurement
27	**No Corresponding Standard**	Ind AS 40	Investment Property
28	**No Corresponding Standard**	Ind AS 101	First Time Adoption of Ind AS
29	**Guidance Note**	Ind AS 102	Share-based Payment
30	AS 14	Ind AS 103	Business Combinations
31	**No Corresponding Standard**	Ind AS 104	Insurance Contracts
32	AS 24	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
33	**Guidance Note**	Ind AS 106	Exploration for and Evaluation of Mineral Resources
34	AS 32	Ind AS 107	Financial Instruments: Disclosures
35	AS 17	Ind AS 108	Operating Segments

Comparative Statement of AS & IND AS (AS- Wise)

SL.No.	**Accounting Standards (AS)**	**IND AS No.**	**Name of IND AS**
1	AS 1	Ind AS 1	Presentation of Financial Statements
2	AS 2	Ind AS 2	Inventories
3	AS 3	Ind AS 7	Statement of Cash Flows
4	AS 4	Ind AS 10	Events after the Reporting Period
5	AS 5	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors

6	AS 7	Ind AS 11	Construction Contracts
7	AS 9	Ind AS 18	Revenue
8	AS 10 & AS 6	Ind AS 16	Property, Plant and Equipment
9	AS 11	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
10	AS 12	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
11	AS 14	Ind AS 103	Business Combinations
12	AS 15	Ind AS 19	Employee Benefits
13	AS 16	Ind AS 23	Borrowing Costs
14	AS 17	Ind AS 108	Operating Segments
15	AS 18	Ind AS 24	Related Party Disclosures
16	AS 19	Ind AS 17	Leases
17	AS 20	Ind AS 33	Earnings Per Shares
18	AS 21	Ind AS 27	Consolidated and Separate Financial Statements
19	AS 22	Ind AS 12	Income Taxes
20	AS 23	Ind AS 28	Investments in Associates
21	AS 24	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
22	AS 25	Ind AS 34	Interim Financial Reporting
23	AS 26	Ind AS 38	Intangible Assets
24	AS 27	Ind AS 31	Interests in Joint Ventures
25	AS 28	Ind AS 36	Impairments of Assets
26	AS 29	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
27	AS 30	Ind AS 39	Financial Instruments: Recognition and Measurement
28	AS 31	Ind AS 32	Financial Instruments: Presentation
29	AS 32	Ind AS 107	Financial Instruments: Disclosures
30	**Guidance Note**	Ind AS 102	Share-based Payment
31	**Guidance Note**	Ind AS 106	Exploration for and Evaluation of mineral Resources
32	**No Corresponding Standard**	Ind AS 29	Financial Reporting in Hyperinflationary Economies
33	**No Corresponding Standard**	Ind AS 40	Investment Property
34	**No Corresponding Standard**	Ind AS 101	First Time Adoption of Ind AS
35	**No Corresponding Standard**	Ind AS 104	Insurance Contracts

Need for Accounting Standards

1. It helps in dissemination of timely and useful financial information to all Stakeholders and users.
2. It helps to provide a set of standard accounting policies, valuation norms and disclosure requirement.
3. It ensures disclosures of accounting principles and treatments, where important information is not otherwise statutorily required to be disclosed.
4. It helps to reduce or totally eliminate, accounting alternatives, thereby it leads to better inter-firm and intra-firm comparison of Financial Statements.
5. It reduces scope of creative accounting, i.e. twisting of accounting policies to produce Financial Statement favourable to a particular interest group.

1.17 DOUBLE ENTRY SYSTEM, BOOKS OF PRIME ENTRY, SUBSIDIARY BOOKS

1.17.1 Double Entry System - This part we have already explained in 1.12B

1.17.2 Books of Prime Entry

A journal is often referred to as Book of Prime Entry or the book of original entry. In this book transactions are recorded in their chronological order. The process of recording transaction in a journal is called as 'Journalisation'. The entry made in this book is called a 'journal entry'.

1.17.2.1 Functions of Journal

(i) *Analytical Function :* Each transaction is analysed into the debit aspect and the credit aspect. This helps to find out how each transaction will financially affect the business.

(ii) *Recording Function :* Accountancy is a business language which helps to record the transactions based on the principles. Each such recording entry is supported by a narration, which explain, the transaction in simple language. Narration means to narrate – i.e. to explain. It starts with the word – Being …

(iii) *Historical Function :* It contains a chronological record of the transactions for future references.

1.17.2.2 Advantages of Journal

The following are the advantages of a journal :

(i) *Chronological Record :* It records transactions as and when it happens. So it is possible to get a detailed day-to-day information.

(ii) *Minimising the possibility of errors :* The nature of transaction and its effect on the financial position of the business is determined by recording and analyzing into debit and credit aspect.

(iii) *Narration :* It means explanation of the recorded transactions.

(iv) *Helps to finalise the accounts :* Journal is the basis of ledger posting and the ultimate Trial Balance. The Trial balance helps to prepare the final accounts.

The specimen of a journal book is shown below.

Date	Particulars	Voucher number	Ledger folio	Debit amount (₹)	Credit amount (₹)
dd-mm-yy	Name of A/c to be debited Name of A/c to be credited (narration describing the transaction)	-----------	Reference of page number of the A/c in ledger	-----------	-----------

Explanation of Journal

(i) *Date Column :* This column contains the date of the transaction.

(ii) *Particulars :* This column contains which account is to be debited and which account is to be credited. It is also supported by an explanation called narration.

(iii) *Voucher Number :* This Column contains the number written on the voucher of the respective transaction.

(iv) *Ledger Folio (L.F.) :* This column contains the folio (i.e. page no.) of the ledger, where the transaction is posted.

(v) *Dr. Amount and Cr. Amount :* This column shows the financial value of each transaction. The amount is recorded in both the columns, since for every debit there is a corresponding and equal credit.

All the columns are filled in at the time of entering the transaction except for the column of ledger folio. This is filled at the time of posting of the transaction to 'ledger'. This process is explained later in this chapter.

Example:

As per voucher no. 31 of Roy Brothers, on 10.05.2013 goods of ₹ 50000 were purchased. Cash was paid immediately. Ledger Folios of the Purchase A/c and Cash A/c are 5 and 17 respectively. Journal entry of the above transaction is given bellow:

In the books of Roy Brothers

Journal Entries

Date	Particulars		Voucher No.	Ledger Folio	Dr. Amount (₹)	Cr. Amount (₹)
10.05.2013	Purchase A/c	Dr.	31	5	50,000	
	To, Cash A/c			17		50,000
	(Being goods purchased for Cash)					

Illustration 18.

Let us illustrate the journal entries for the following transactions:

2012

April

1 Mr. Vikas and Mrs. Vaibhavi who are husband and wife start consulting business by bringing in their personal cash of ₹ 5,00,000 and ₹ 2,50,000 respectively.

10 Bought office furniture of ₹ 25,000 for cash. Bill No. - 2013/F/3

11 Opened a current account with Punjab National Bank by depositing ₹ 1,00,000

15 Paid office rent of ₹ 15,000 for the month by cheque to M/s Realtors Properties. Voucher No. 3

20 Bought a motor car worth ₹ 4,50,000 from Millennium Motors by making a down payment of ₹ 50,000 by cheque and the balance by taking a loan from HDFC Bank. Voucher No. M/13/7

25 Vikas and Vaibhavi carried out a consulting assignment for Avon Pharmaceuticals and raised a bill for ₹ 10,00,000 as consultancy fees. Bill No. B13/4/1 raised. Avon Pharmaceuticals have immediately settled ₹ 2,50,000 by way of cheque and the balance will be paid after 30 days. The cheque received is deposited into Bank.

30 Salary of one receptionist @ ₹ 5,000 per month and one officer @ ₹ 10,000 per month. The salary for the current month is payable to them.

Solution:

The entries for these transactions in a journal will look like:

In the Books of Vikash & Vaibhavi

Journal Entries **Journal Folio-1**

Date	Particulars		Voucher number	L.F	Dr. Amount (₹)	Cr. Amount (₹)
01-04-2013	Cash A/c To Vikas's Capital A/c To Vaibhavi's Capital A/c (Being capital brought in by the partners)	Dr.		1 2 3	7,50,000	 5,00,000 2,50,000
10-04-2013	Furniture A/c To Cash A/c (Being furniture purchased in cash)	Dr.	2013/F/3	4 1	25,000	 25,000
11-04-2013	Punjab National Bank A/c To Cash A/c (Being current account opened with Punjab National Bank by depositing cash)	Dr.		5 1	1,00,000	 1,00,000
15-04-2013	Rent A/c To Punjab National Bank A/c (being rent paid to Realtors Properties for the month)	Dr.	3	6 5	15,000	 15,000
20-04-2013	Motor Car A/c To Punjab National Bank A/c To Loan from HDFC Bank A/c (Being car purchased from Millennium Motors by paying down payment and loan arrangement)	Dr.	M/13/7	7 5 8	4,50,000	 50,000 4,00,000
25-04-2013	Punjab National Bank A/c Avon Pharmaceuticals A/c To Consultancy Fees A/c (Being amount received and revenue recognized for fees charged)	Dr. Dr.	B13/4/1	5 9 10	2,50,000 7,50,000	 10,00,000
30-04-2013	Salary A/c To Salary payable A/c (Being the entry to record salary obligation for the month)	Dr.		11 12	15,000	 15,000

Illustration 19.

Journalise the following transactions in the books of Mr. Roy

2013

April

1 He started business with a capital of – Plant ₹ 10,000, Bank ₹ 8,000, Stock ₹ 12,000

2 Bought furniture for resale ₹ 5,000

Bought furniture for Office decoration ₹ 3,000

3 Paid rent out of personal cash for ₹ 2,000

8 Sold furniture out of those for resale ₹ 6,000

12 Paid Salary to Mr. X for ₹ 1,200

15 Purchased goods from Mr. Mukherjee for cash ₹ 3,000

18 Sold goods to Mr. Sen on credit for ₹ 8,000

20 Mr. Sen returned goods valued ₹ 1,000

22 Received cash from Mr. Sen of ₹ 6,500 in full settlement

28 Bought goods from Mr. Bose on credit for ₹ 5,000

30 Returned goods to Mr. Bose of ₹ 500 and paid to Mr. Bose ₹ 4,000 in full settlement.

Solution :

In the Books of Mr. Roy
Journal Entries

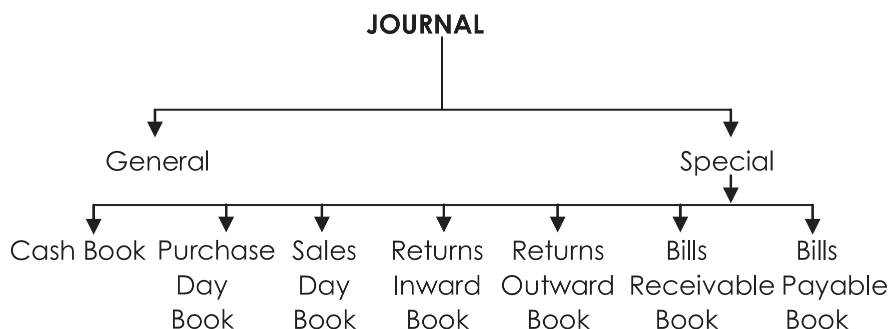
Date	Particulars		L. F.	Debit (₹)	Credit (₹)
April, 2013					
1	Plant A/c	Dr.		10,000	
	Bank A/c	Dr.		8,000	
	Stock A/c	Dr.		12,000	
	To, Capital A/c				30,000
	[Being Plant, Bank, Stock introduced to the business]				
2	Purchase A/c	Dr.		5,000	
	To, Bank A/c				5,000
	[Being furniture purchased for resale]				
	Furniture A/c	Dr.		3,000	
	To, Bank A/c				3,000
	[Being furniture purchased for office decoration]				
3	Rent A/c	Dr.		2,000	
	To, Capital A/c				2,000
	[Being rent paid out of personal cash]				
8	Cash A/c	Dr.		6,000	
	To, Sales A/c				6,000
	[Being furniture out of those meant for resale are sold]				
12	Salary A/c	Dr.		1,200	
	To, Bank A/c				1,200
	[Being salary paid to Mr. X]				
15	Purchase A/c	Dr.		3,000	
	To, Cash A/c				3,000
	[Being goods purchased]				
18	Mr. Sen A/c	Dr.		8,000	
	To, Sales A/c				8,000
	[Being goods sold on credit to Mr. Sen]				
20	Returns Inward A/c	Dr.		1,000	
	To, Mr. Sen A/c				1,000
	[Being goods returned from Mr. Sen]				
22	Cash A/c	Dr.		6,500	
	Discount Allowed A/c	Dr.		500	
	To, Mr. Sen A/c				7,000
	[Being cash received from Mr. Sen in full settlement]				

Date	Particulars		L. F.	Debit (₹)	Credit (₹)
April, 2013					
28	Purchase A/c	Dr.		5,000	
	To, Mr. Bose A/c				5,000
	[Being goods purchased from Mr. Bose on credit]				
30	Mr. Bose A/c	Dr.		5,000	
	To, Cash A/c				4,000
	To, Returns Outward A/c				500
	To, Discount Received A/c				500
	[Being goods returned to Mr. Bose and paid cash in full settlement]				

Please observe the convention of entry. Accounts to be debited are written first with 'Dr' as a suffix, and accounts to be credited are written subsequently with a prefix 'To'.

1.17.2.3 Sub-division of Journals

Journal is divided into two types -(i) General Journal and (ii) Special Journal.



(i) General Journal

- This is a book of chronological record of transactions.
- This book records those transactions which occur so infrequently that they do not warrant the setting up of special journals.

Examples of such entries : (i) opening entries (ii) closing entries (iii) rectification of errors.

The form of this general journal, is as under :

JOURNAL

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

L.F. : Ledger Folio

Dr : Debit

Cr : Credit

Recording of transactions in this book is called journalising and the record of transactions is known as journal entry.

(ii) Special Journal

It is subdivided into Cash Book, Purchase Day Book, Sales Day Book, Returns Inward Book, Returns Outward Book, Bills Receivable Book and Bills Payable Book. These books are called subsidiary books.

Importance of Sub-division of journals

When the number of transactions is large, it is practically not possible to record all the transactions through one journal because of the following limitations of Journal:

(i) The system of recording all transactions in a journal requires (a) writing down the name of the account involved as many times as the transaction occurs; and (b) an individual posting of each account debited and credited and hence, involves the repetitive journalizing and posting labour.

(ii) Such a system can not provide the information on a prompt basis.

(iii) Such a system does not facilitate the installation of an internal check system because the journal can be handled by only one person.

(iv) The journal becomes huge and voluminous.

To overcome the shortcomings of the use of the journal only as a book of original entry, the journal is sub-divided into special journal.

The journal is sub-divided in such a way that a separate book is used for each category of transactions which are repetitive in nature and are sufficiently large in number.

1.17.2.4 Compound Journal

If for a single transaction, only one account is debited and one account is credited, it is known as simple journal.

If the transaction requires more than one account which is to be debited or more than one account is to be credited, it is known as Compound Journal.

The following illustration will make it clear :

Illustration 20.

(i) Started business with Cash ₹50,000; Plant ₹24,000; Stock ₹4,000

(ii) Sold Goods for Cash ₹8,000 and to Ms. Agarwal for ₹10,000

(iii) Ms. Agarwal settled her account less discount ₹ 600

Solution :

In the Books of ....

Journal

Date	Particulars		L.F.	Debit ₹	Credit ₹
(i)	Cash A/c	Dr.		50,000	
	Plant A/c	Dr.		24,000	
	Stock A/c	Dr.		4,000	
	To Capital A/c				78,000
	(Being business started with cash, plant and stock as capital)				
(ii)	Cash A/c	Dr.		8,000	
	Ms. Agarwal's A/c	Dr.		10,000	
	To Sales A/c				18,000
	(Being goods sold for cash ₹ 8,000 and on credit ₹ 10,000)				
(iii)	Cash A/c	Dr.		9,400	
	Discount Allowed A/c	Dr.		600	
	To Ms. Agarwal's A/c				10,000
	(Being cash received as final settlement and discount allowaed)				

1.17.3 Subsidiary Books

Although once understood, the entries are easy to be written, but if transactions are too many, it may become difficult to manage them and retrieve. Imagine there are 25 purchase transactions in a day. Because the journal will record all transaction chronologically, it may be possible that the purchase transactions could be scattered i.e. they may not all come together one after the other. Now, at the end of the day if the owner wants to know the total purchases made during the day, the accountant will spend time first to retrieve all purchase transactions from journal and then take total. This invalve time.

This being the greatest limitation of journal, it is generally sub-divided into more than one journal. On what logic is such a sub-division made? It is done on the basis of similar transactions which are clubbed in a single book e.g. purchase transactions, sales transaction etc. The sub-division of journal is done as follows:

Transaction	Subsidiary Book
All cash and bank transactions	Cash Book - has columns for cash, bank and cash discount
All credit purchase of goods – only those Goods that are purchased for resale are covered here.	Purchase Day Book or Purchase register
All credit sale of goods	Sales Day Book or sales register
All purchase returns – i.e. return of goods back to suppliers due to defects	Purchase Return Book or Return Outward Book
All sales returns – i.e. return of goods back from customers	Sales Return Book or Return Inward Book
All bill receivables – these are bills accepted by customers to be honoured at an agreed date. This is dealt with in depth later in the study note	Bills Receivable Book
All bills payable - these are bills accepted by the business to be honoured by paying to suppliers at an agreed date.	Bills Payable Book
For all other transactions not covered in any of the above categories – i.e. purchase or sale of assets, expense accruals, rectification entries, adjusting entries, opening entries and closing entries.	Journal Proper

Let us see the formats for each of these and examples as illustration.

1.17.3.1 Recording of Cash and Bank Transactions

1.17.3.1.1 Cash Book

A Cash Book is a special journal which is used for recording all cash receipts and all cash payments. Cash Book is a book of original entry since transactions are recorded for the first time from the source documents. The Cash Book is larger in the sense that it is designed in the form of a Cash Account and records cash receipts on the debit side and cash payments on the credit side. Thus, the Cash Book is both a journal and a ledger.

Cash Book as the only Book of Original Entry

1.17.3.1.2 This Cash Book records all types of transactions even if there are some credit transactions i.e. all transactions are recorded and not like the ordinary Cash Book where only cash transactions are recorded. For non cash transactions, that will be two entries in the cash Book, ultimately that will be no effect in Cash Balance. For example, if goods are sold to Mr. X on credit for ₹ 5,000, the entries will be

			Dr.	Cr.
(1)	Cash A/c To Sales A/c	Dr	5,000	 5,000
(2)	X A/c To Cash A/c	Dr	5,000	 5,000

Although the original entry is

X A/c To Sales A/c	Dr	*5,000*	 *5,000*

1.17.3.1.3 Types of Cash Book

There are different types of Cash Book as follows:

(i) Single Column Cash Book- Single Column Cash Book has one amount column on each side. All cash receipts are recorded on the debit side and all cash payments on the payment side, this book is nothing but a Cash Account and there is no need to open separate cash account in the ledger.

(ii) Double Column Cash Book- Cash Book with Discount Column has two amount columns, one for cash and other for Discount on each side. All cash receipts and cash discount allowed are recorded on the debit side and all cash payments and discount received are recorded on the credit side.

(iii) Triple Coulmn Cash Book- Triple Column Cash Book has three amount columns ,one for cash, one for Bank and one for discount , on each side. All cash receipts, deposits into book and discount allowed are recorded on debit side and all cash payments, withdrawals from bank and discount received are recorded on the credit side. In fact, a triple-column cash book serves the purpose of Cash Account and Bank Account both . Thus, there is no need to create these two accounts in the ledger.

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

Receipts				Payments			
Date	**Particulars**	**L.F.**	**Cash**	**Date**	**Particulars**	**L.F.**	**Cash**

Dr. **Specimen of Double Column Cash Book** **Cr.**

Receipts					Payments				
Date	**Particulars**	**L.F.**	**Cash**	**Disc. Allowed**	**Date**	**Particulars**	**L.F.**	**Cash**	**Disc. Received**

Dr. **Specimen of Triple Column Cash Book** **Cr.**

Receipts						Payments					
Date	Particulars	L.F.	Cash	Bank	Discount Allowed	Date	Particulars	L.F.	Cash	Bank	Discount Received

Double Column Cash Book containing contra transaction and cheque transaction

The double column Cash book has columns on both the sides of the Cash book. This cash book can have two columns on both the sides as under :

(a) Cash and Discount Columns,

(b) Cash and Bank columns,

(c) Bank and Discount columns.

(I) Contra Transactions

Transactions which relates to allowing discount or receiving discount in cash after the settlement of the dues are known as Contra Transactions.

Example:

1. Received ₹ 500 as discount from Mr. Ghosh whose account was previously settle in full.

   Cash A/c Dr. 500

   To Discount Received A/c 500

   (Being cash received as discount from Mr. Ghosh whose account was previous settled in full)

2. Paid ₹ 400 as discount to Mr. Ghosh Dastidar who settled his account in full previously.

   Discount Allowed A/c Dr. 400

   To Cash A/c 400

   (Being discount allowed in cash to Mr. Ghosh Dastidar who settled his account in full)

(II) Cheque Transactions

When a cheque is received and no any other information at a later date about the same is given, it will be assumed that the said cheque has already been deposited into bank on the same day when it was received. Then the entry should be as under:

Bank A/c Dr.

To Debtors/Party A/c

But if it is found that the said cheque has been deposited into the bank at a later date, then the entry will be:

(i) When the cheque is received

Cash A/c Dr.

To Debtors/Party A/c

(ii) When the same was deposited into bank at a later date

Bank A/c Dr.

To Cash A/c

(iii) When the said cheque is dishonoured by the bank

Debtors/Party A/c Dr.

To Bank A/c

Let us see an illustration for the following cash and bank transactions in the books of Mr. Abhishek

January 1 Opening cash balance was ₹ 3,800 and bank balance was ₹ 27,500

January 4 Wages paid in cash ₹ 1,500

January 5 received cheque of ₹ 19,800 from KBK enterprises after allowing discount of ₹ 200

January 7 Paid consultancy charges by cheque for ₹ 7,500

January 10 Cash of ₹ 2,500 withdrawn from bank

January 12 Received a cheque for ₹ 4,500 in full settlement of the account of Mr. X at a discount of 10% and deposited the same into the Bank.

January 15 X's cheque returned dishonoured by the Bank

In the Books of Mr. Abhishek

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

Receipts						Payments					
Date	**Particulars**	**L.F.**	**Cash (₹)**	**Bank (₹)**	**Discount Allowed (₹)**	**Date**	**Particulars**	**L.F.**	**Cash (₹)**	**Bank (₹)**	**Discount received (₹)**
1-Jan	Opening Balance		3,800	27,500		4-Jan	Wages paid		1,500		
5-Jan	Recd from KBK			19,800	200	7-Jan	Consultancy fees			7,500	
10-Jan	Cash withdrawn		2,500			10-Jan	Cash withdrawn			2,500	
12-Jan	Mr. X			4,500	500	15-Jan	Mr. X			4,500	500
							Closing balance		4,800	37,300	
			6,300	51,800	700				6,300	51,800	500

Please note that the balance of discount columns is not taken and these are posted directly to the respective ledger account separately. The balance of cash and bank columns are posted into cash and bank accounts periodically. The posting into ledger is explained later in this chapter.

1.17.3.2 Purchase Day Book

The purchase day book records the transactions related to credit purchase of goods only. It follows that any cash purchase or purchase of things other than goods is not recorded in the purchase day book. Periodically, the totals of Purchase Day Book are posted to Purchase Account in the ledger. The specimen Purchase Day Book is given below:

In the Books of ....

Purchase Day Book

Date	Name of the Suppliers and details of Goods purchased	Invoice reference	L. F.	Amount (₹)	Remarks

The format for Purchase Return is exactly the same; hence separate illustration is not given.

Let us see an illustration for following transactions for a furniture shop:

1. Bought 20 tables @ ₹ 500 per table from Majestic Appliances on credit @ 12% trade discount as per invoice number 22334 on 2nd March.
2. Purchased three dozen chairs @ ₹ 250 each from Metro chairs as per invoice number 1112 on 4th March.
3. Second hand furniture bought from Modern Furnitures on credit as per invoice number 375 for ₹ 1200 on 7th March.
4. Purchased seven book racks from Mayur Furnitures for ₹ 4900 paid for in cash on 6th March.
5. Purchased Machinery for ₹ 30000 from Kirloskar Ltd on 9th March as per invoice number 37.

In the Books of Furniture Shop

Purchase Day Book

Date	Name of the Suppliers and Details of goods purchased	Invoice reference	L. F.	Amount (₹)
2nd March	Majestic Appliances 20 tables @ ₹ 500 and 12% trade discount [(20 × ₹ 500) = ₹ 10000 less 12% discount i.e., ₹ 1,200]	22334		8,800
4th March	Metro Chairs 3 dozen chairs @ 250 per chair	1112		9,000
7th March	Modern Furnitures	375		1,200
	Total			19,000

Please note that the transaction for purchase of book rack will not be entered in the purchase book as it is not purchased on credit. (Where will it go then? It will go to the cash book!). Similarly purchase of machinery will not form part of purchase book. It will be entered in Journal Proper.

1.17.3.3 Sales Day Book

The sales day book records transaction of credit sale of goods to customers. Sale of other things, even on credit, will not be entered in the sales day book but will be entered in Journal Proper. If goods are sold for cash, it will be entered in cash book. Total of sales day book is periodically posted to sales account in the ledger. The specimen of a sales day book is given below.

In the books of ....

Sales Day Book

Date	Particulars	Invoice reference	L. F.	Amount	Remarks

The format of sales return book is exactly the same as in the case of Purchase Day Book.

Let us see how will be the following transaction recorded in the books of a Cloth Merchant.

1st July — Sold Tip Top clothing 50 suits of ₹ 2,200 each on two months credit on invoice number -2

11th July — Sold to New India Woolen 100 sweaters @ ₹ 250 each on invoice number 55

13th July — Received an order from Modern clothing for 100 trousers @ ₹ 500 at trade discount of 10%

17th July — Sold 50 sarees to Lunkad brothers @ ₹ 750 each

25th July — Sold T-shirts at exhibition hall for cash for ₹ 7,500

In the books of Cloth Marchant

Sales Day Book

Date	Particulars	Invoice reference	L. F.	Amount
1st July	Tip Top Clothing 50 suits @ ₹ 2,200	2		1,10,000
11th July	New India Woolen 100 sweaters @ ₹ 250	55		25,000
17th July	Lunkad brother 50 sarees @ ₹ 750			37,500
	Total			1,72,500

Here again, cash sales at exhibition hall are not recorded. Also, merely getting an order for goods is not a transaction to be entered in sales book.

1.17.3.4 Other Subsidiary Books – Returns Inward, Return Outward, Biils Receivable, Bills Payable.

(i) Return Inward Book- The transactions relating to goods which are returned by the customers for various reasons, such as not according to sample, or not up to the mark etc contain in this book. It is also known as Sales Return Book.

Generally when a customer returns good to suppliers he issues a Debit Note for the value of the goods returned by him. Similarly the supplier who receives those goods issues a Credit Note.

Returns Inward Day Book

Date	Particulars	Outward Invoice	L.F.	Details	Totals	Remarks

(ii) Return Outward Book- This book contains the transactions relating to goods that are returned by us to our creditors e.g. goods broken in transit, not according to the sample etc.It's also known as Purchase Return Book.

Return Outward Day Book

Date	Particulars	Debit Note	L.F.	Details	Totals	Remarks

(iii) Bills Receivable Book- It is such a book where all bills received are recorded and therefrom posted directly to the credit of the respective customer's account. The total amounts of the bills so received during the period (either at the end of the week or month) is to be posted in one sum to the debit of Bills Receivable A/c.

Bills Receivable Day Book

No. of Bills	Date of Receipt of Bill	From whom	Name of the Receiver	Name of Drawer	Name of Acceptor	Date of Bill	Due Date	L.F.	Amount of Bill	How disposed off

(iv) Bills Payable Book- Here all the particulars relating to bills accepted are recorded and therefrom posted directly to the debit of the respective creditor's account. The total amounts of the bills so accepted during the period (either at the end of the week or month) is to be posted in one sum to the credit of Bills Payable A/c.

Bills Payable Day Book

No. of Bills	Date of Acceptance	To whom given	Name of Drawer	Name of the Payee	Where Payable	Date of Bill	Term	Due Date	L.F.	Amount of Bill	How disposed off

1.17.3.5 Journal Proper

We know that usual transactions are recorded in primary books of accounts. If any transaction is not recorded in the primary books the same is recorded in Journal Proper. It includes Credit Purchase and Credit Sales of Assets; Transfer Entries; Opening Entries; Closing Entries; Adjusting Entries and Rectification of Errors.

However, these are explained in subsequent Para.

1.17.3.6 Ledger Accounts

Ledger is the main book or principal book of account. The entries into ledger accounts travel through the route of journal and subsidiary books. The ledger book contain all accounts viz. assets, liabilities, incomes or gains, expenses or losses, owner's capital and owner's equity. The ledger is the book of final entry and hence is a permanent record. There is a systematic way in which transactions are posted into a ledger account. Once the transactions are posted for an accounting period, the ledger accounts are balanced (i.e. the difference between debit side and credit side is calculated). These balances are used to ultimately prepare the financial statement like Profit and Loss A/c and Balance Sheet. The ledger may also be divided as General ledger and Sub-ledgers. While the General Ledger will have all ledger accounts, the sub-ledgers will have individual accounts of customers and suppliers. If there are 10 customers, the general ledger will not have 10 individual accounts for each customer. Instead, these 10 customer account will exist in what is called as 'Receivables or Debtors Ledger' and the general ledger will have only one account that represents the customers. This is named as Debtors Control Account. Similar is the case of supplier accounts. Such sub-ledgers are necessary for better control over individual accounts. Also, this will avoid the general ledger from becoming too big, especially when number of customers and suppliers is large.

The specimen of a typical ledger account is given below.

Dr. Ledger-Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)

1.17.3.6.1 Ledger Posting

As and when the transaction takes place, it is recorded in the journal in the form of journal entry. This entry is posted again in the respective ledger accounts under double entry principle from the journal. This is called ledger posting.

The rules for writing up accounts of various types are as follows :

Assets	:	Increases on the left hand side or the debit side and decreases on the credit side or the right hand side.
Liabilities	:	Increases on the credit side and decreases on the debit side.
Capitals	:	The same as liabilities.
Expenses	:	Increases on the debit side and decreases on the credit side.
Incomes or gain	:	Increases on the credit side and decrease on the debit side.

To summarise

Dr.	*Assets*	Cr.
Increase		Decrease

Dr.	*Liabilities & Capital*	Cr.
Decrease		Increase

Dr.	*Expenses or Loses*	Cr.
Increase		Decrease

Dr.	*Income or Gains*	Cr.
Decrease		Increase

The student should clearly understand the nature of debit and credit.

A debit denotes :

(a) In the case of a person that he has received some benefit against which he has already rendered some service or will render service in future. When a person becomes liable to do something in favour of the firm, the fact is recorded by debiting that person's account : (relating to Personal Account)

(b) In case of goods or properties, that the value and the stock of such goods or properties has increased, (relating to Real Accounts)

(c) In case of other accounts like losses or expenses, that the firm has incurred certain expenses or has lost money. (relating to Nominal Account)

A credit denotes :

(a) In case of a person, that some benefit has been received from him, entitling him to claim from the firm a return benefit in the form of cash or goods or service. When a person becomes entitled to money or money's worth for any reason. The fact is recorded by crediting him (relating to Personal Account)

(b) In the case of goods or properties, that the stock and value of such goods or properties has decreased. (relating to Real Accounts)

(c) In case of other accounts like interest or dividend or commission received, or discount received, that the firm has made a gain (relating to Nominal Account)

At a glance :

Dr. (Debit side)	***Cr. (Credit side)***
DESTINATION Where the economic benefit reaches / is received.	SOURCE of each economic benefits
Receiver	Giver
What comes in	What goes out
All expense and losses	All income and gains

Let us now understand the mechanism of posting transaction into the ledger account. Consider the transaction: Rent paid in cash for ₹ 10,000. The journal entry for this transaction would be:

Jan 15	Rent A/c	Dr.	10,000	
	To, Cash A/c			10,000

We will open two ledger accounts namely Rent A/c and Cash A/c. Let us see how the posting is made

Rent Account

Dr. **Cr.**

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
Jan15	To, Cash A/c		10,000				

Cash Account

Dr.							Cr.
Date	**Particulars**	**J. F.**	**Amount (₹)**	**Date**	**Particulars**	**J. F.**	**Amount (₹)**
				Jan 15	By Rent A/c		10,000

Please observe the following conventions while posting a transaction into ledger accounts. Note that both the effects of an entry must be recorded in the ledger accounts simultaneously.

(1) The posting in the account which is debited, is done on the debit side by writing the name of the account or accounts that are credited with the prefix 'To'.

(2) The posting in the account which is credited, is done on the credit side by writing the name of the account or accounts that are debited with the prefix 'By'.

Let us now see how we can create ledger account for the seven journal entries that we passed for Illustration 18.

Folio No. 1

Dr. Cash Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
1.4.2013	To Vikas's capital A/c	1	500,000	10.4.2013	By Furniture A/c	1	25,000
1.4.2013	To Vaibhavi's capital A/c	1	250,000	11.4.2013	By Punjab National Bank A/c	1	1,00,000
				30.4.2013	By Balance c/d		6,25,000
			750,000				7,50,000
1.5.2013	To Balance b/d		625,000				

Folio No. 2

Dr. Mr. Vikas's Capital Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
30.4.2013	To Balance c/d		5,00,000	1.4.2013	By Cash A/c	1	5,00,000
			5,00,000				5,00,000
				1.5.2013	By Balance b/d		5,00,000

Folio No. 3

Dr. Mrs. Vaibhavi's Capital Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
				1.4.2013	By Cash A/c	1	2,50,000

Folio No. 4

Dr. Furniture Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
10.04.2013	To Cash		25,000				

Folio No. 5

Dr. Punjab National Bank Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
11.4.2013	To Cash A/c	1	1,00,000	15.4.2013	By Rent A/c	1	15,000
25.4.2013	To Consultancy Fees A/c	1	2,50,000	20.4.2013	By Motor Car A/c	1	50,000

Folio No. 6

Dr. Rent Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
15.4.2013	To Punjab National Bank A/c	1	15,000				

Folio No. 7

Dr. **Motor Car Account** Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
20.4.2013	To Punjab National Bank A/c	1	50,000				
"	To Loan from HDFC Bank A/c	1	4,00,000				

Folio No. 8

Dr. **Loan from HDFC Bank Account** Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
				20.4.2013	By Motor Car A/c	1	4,00,000

Folio No. 9

Dr. **Avon Pharmaceuticals Account** Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
25.4.2013	To Consultancy Fees A/c	1	7,50,000				

Folio No. 10

Dr. **Consultancy Fees Account** Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
				25.4.2013	By Punjab National Bank A/c	1	2,50,000
				25.4.2013	By Avon Pharmaceuticals A/c	1	7,50,000

Folio No. 11

Dr. **Salary Account** Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
30.4.2013	To Salary payable A/c	1	15,000				

Folio No. 12

Dr. **Salary Payable Account** Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
				30.4.2013	By Salary A/c	1	15,000

Please carefully observe the posting of journal entries into various ledger accounts. Do you see some further calculation in the cash A/c and Mr. Vikas's Capital A/c? What is done is that after posting all transactions to these accounts, the difference between the debit and credit sides is calculated. This difference is put on the side with smaller amount in order to tally grand totals of both sides. The convention is to write "To Balance c/d" or "By Balance c /d" as the case may be. This procedure is normally done at the end of an accounting period. This process is called as "balancing of ledger accounts'.

Once the ledgers are balanced for one accounting period, the balance needs to be carried forward to the next accounting period as a running balance. This is done by writing "To Balance b/d" or "By balance b/d" as the case may be after the grand totals. This is also shown in the Cash A/c and Mr. Vikas's Capital Account.

Could you now attempt to balance the other ledger accounts and carry the balances to the next accounting period?

Important note: *Please remember that the balances of personal and real accounts only are carried down to the next accounting period as they represent resources and obligations of the business which will continue to be used and settled respectively in future. Balances of nominal accounts (which represent incomes or gains and expenses or losses) are not carried down to the next period. These balances are taken to the Profit and Loss Account (or Income statement) prepared for the period. The net result of the P & L Account will show either net income or net loss which will increase or decrease the owner's equity.*

In the above example, please note that the balances of Rent A/c, Consultancy Fees Account and Salary Account will not be carried down to the next period, but to the P & L Account of that period.

1.17.3.6.2 Posting to Ledger Accounts from Subsidiary books

In the above section, we explained posting to ledger accounts directly on the basis of journal entries. In practice, however, we know that use of subsidiary books is in vogue. Let us see how the posting to ledger accounts is done based on these records.

For each of the subsidiary books, there is a ledger account e.g. for purchase book, there is Purchase Account, for sales book there's Sales A/c, for cash book there will be Cash A/c as well as Bank A/c and so on.

Let us continue with illustration seen in the section 1.17.3.1.3 above and post the totals into respective ledger accounts. It considered that there was a Purchase of ₹ 19,000 and Sales of ₹ 1,72,500.

Dr. Cash Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
1st Jan	To Balance b/d To Bank A/c		3,800 2,500		By Wages A/c By Balance c/d		1,500 4,800
			6,300				6,300

Dr. Purchases Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
	To Sundries as per purchase book		19,000		By Transfer to P & L A/c		19,000

Dr. Sales Account Cr.

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
	To Transfer to P & L A/c		1,72,500		By Sundries as per sales book		1,72,500

1.17.3.6.3 Typical Ledger Account Balances

We have seen how to balance various ledger accounts. It can be seen that while some accounts will show debit balance, while the other will show credit balance. Is there any relationship between the type of account (whether it is the account of asset, liability, capital, owner's equity, incomes or gain, expenses or losses) and the kind of balance (debit or credit) it should show?

The answer is generally 'Yes'. You may test to find the following are typical relationships.

Type of Account	Type of balance
All asset accounts	Debit balance
All liability accounts	Credit balance
Capital & Owner's equity account	Credit balance
Expenses or loss accounts	Debit balance
Incomes or gain accounts	Credit balance

Let us test these possibilities for confirmation. How does one go about testing this? Consider 'Cash A/c'. Whenever business receives cash we debit it, and whenever it is paid we credit it. Is it possible to see a situation that credits to cash are more than debits? In other words could we have negative cash in hand? No. Cash account will therefore always show a debit balance. So is true for all real asset accounts. After solving problems, if the contrary is observed, there is every chance that an error has been made while passing the accounting entries.

1.17.3.6.4 The Structure of Ledger

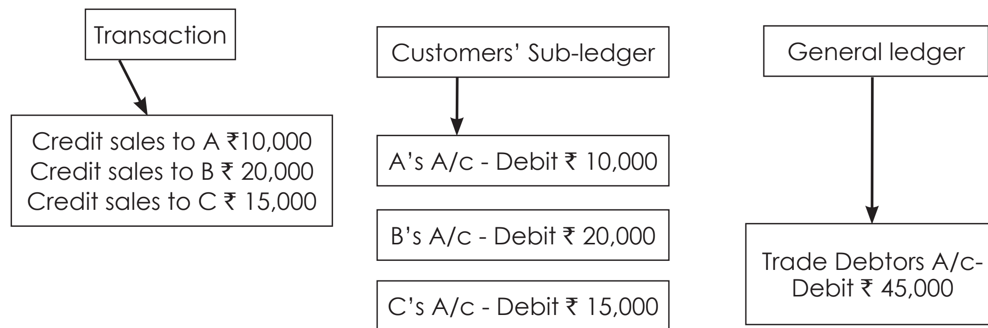
In practice, for the sake of convenience and ease of operations, the ledger is subdivided as follows:

a) General Ledger: This contains all main ledger accounts excepting individual accounts of customers, vendors and employees. For these categories there will be only one representative account in the general ledger e.g. for customers – Trade Debtors A/c (or Trade Receivables Control A/c), for suppliers – Trade Creditors A/c (or Trade Payables A/c) etc.

b) Sub-Ledgers: These are primarily, Customers' Ledger, Suppliers Ledger, Employees ledger etc. The customer ledger will have all individual accounts of all customers. Suppliers' ledger will have all individual accounts of all suppliers. Employee ledger will have individual accounts of all employees.

The balances of all individual accounts must tally with the balance reflected in the representative A/c in the general ledger. For this a periodical reconciliation is a must.

For example, if business has 3 customers A, B, and C; then an A/c for each of them is opened in the sub-ledger called Customers Ledger and General Ledger will have only one A/c by the name of Trade Debtors A/c. All transactions with each of them will be recorded in the individual accounts as well as the control ledger. See the following:



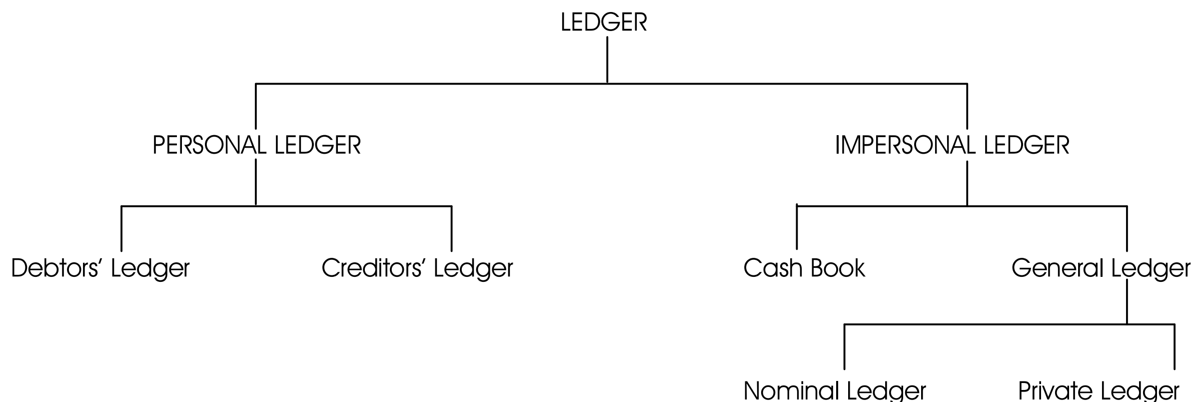
Such separation is made for better control. A person in charge of customer accounting is given responsibility of all individual customer accounting in the Customers sub-ledger, whereas another person be given responsibility for Suppliers' sub-ledger. In bigger organizations this division of labour is an absolute necessity. The person looking after General ledger is different.

Simultaneous posting of transactions into sub-ledgers A/cs and representative A/cs in general ledger may be quite tedious in manual accounting. But computerised accounting automates this process as well.

1.17.3.6.5 Subdivisions of Ledger

Practically, the Ledger may be divided into two groups -

(a) Personal Ledger & (b) Impersonal Ledger. They are again sub-divided as :



Personal Ledger: The ledger where the details of all transactions about the persons who are related to the accounting unit, are recorded, is called the Personal Ledger.

Impersonal Ledger: The Ledger where details of all transactions about assets, incomes & expenses etc. are recorded, is called Impersonal Ledger.

Again, Personal Ledger may be divided into two groups:

Viz. (a) Debtors' Ledger, & (b) Creditors' Ledger.

(a) **Debtors' Ledger:** The ledger where the details of transactions about the persons to whom goods are sold, cash is received, etc. are recorded, is called Debtors' Ledger.

(b) **Creditors' Ledger:** The ledger where the details of transactions about the persons from whom goods are purchased on credit, pay to them etc. are recorded, is called Creditors' Ledger.

Impersonal Ledger may, again be divided into two group, viz, (a) Cash Book; and (b) General Ledger.

(a) **Cash Book:** The Book where all cash & bank transactions are recorded, is called Cash Book.

(b) **General Ledger:** The ledger where all transactions relating to real accounts, nominal accounts, details of Debtors' Ledger and Creditors' Ledger are recorded, is called General Ledger.

General Ledger may, again, be divided into two groups. Viz, Nominal Ledger; & Private Ledger.

(a) **Nominal Ledger:** The ledger where all transactions relating to incomes and expenses are recorded, is called Nominal Ledger.

(b) **Private Ledger:** The Ledger where all transactions relating to assets and liabilities are recorded, is called Private Ledger.

1.17.3.6.6 Advantages of sub-division of Ledger.

The advantages of sub-division of ledger are:

(a) **Easy to Divide work :** As a result of sub-division, the division of work is possible and records can be maintained efficiently by the concerned employee.

(b) **Easy to handle :** As a result of sub-division, the size and volume of ledger is reduced.

(c) **Easy to collect information:** From the different classes of Ledger a particular type of transactions can easily be found out.

(d) **Minimizations of mistakes :** As a result of sub-division, chances of mistakes are minimized.

(e) **Easy to compute :** As a result of sub-division, the accounting work may be computed quickly which is very helpful to the management.

(f) **Fixation of responsibility:** Due to sub-division, allotment of different types of work to different employees is done for which concerned employee will be responsible.

1.18 TRIAL BALANCE

After the transactions are posted to various ledger accounts (either from journal or from subsidiary books) and they are balanced, the next stage is to draw up the list of all balances. We know that some ledger accounts will show 'debit balance' (debit side greater than the credit side), while the other will reflect a 'credit balance' (credit side being higher than debit side). All account balances are listed to ensure that the total of all debit balances equals the total of all credit balances. Why does this happen? Remember the dual aspect concept studied earlier in this study note?. According to this concept, every debit has equal corresponding credit. This list of balances is called Trial Balance.

According to the Dictionary for Accountants by Eric. L. Kohler, Trial Balance is defined as "a list or abstract of the balances or of total debits and total credits of the accounts in a ledger, the purpose being to determine the equality of posted debits and credits and to establish a basic summary for financial statements". According to Rolland, "The final list of balances, totaled and combined, is called Trial Balance".

As this is merely a listing of balances, this will always be as on a particular date. Further it must be understood that Trial Balance does not form part of books of account, but it is a report prepared by extracting balances of accounts maintained in the books of accounts.

When this list with tallied debit and credit balances is drawn up, the arithmetical accuracy of basic entries, ledger posting and balancing is ensured. However, it does not guarantee that the entries are correct in all respect. This will be explained later in this chapter.

Although it is supposed to be prepared at the end of accounting period, computerized accounting packages are capable of providing instant Trial Balance reports even on daily basis, as the transactions are recorded almost on line.

Let us prepare the trial balance for the ledger accounts from the illustration 18.

Trial Balance as on...

Account name	**Debit** (₹)	**Credit** (₹)
Cash A/c	6,25,000	
Vikas's capital A/c		5,00,000
Vaibhavi's capital A/c		2,50,000
Furniture A/c	25,000	
Punjab National Bank A/c	2,85,000	
Rent A/c	15,000	
Motor Car	4,50,000	
Loan from HDFC A/c		4,00,000
Avon Pharmaceuticals	7,50,000	
Consultancy fees A/c		10,00,000
Salary A/c	15,000	
Salary payable A/c		15,000
Total	21,65,000	21,65,000

It can be seen that the totals of debit and credit balances is exactly matching. This is the result of double entry book-keeping wherein every debit has equal corresponding credit. Here you can check for yourself, the relationship between type of account and type of balance explained in section 1.17.3.6.3 above.

1.18.1Feature's of a Trial Balance

1. It is a list of debit and credit balances which are extracted from various ledger accounts.
2. It is a statement of debit and credit balances.
3. The purpose is to establish arithmetical accuracy of the transactions recorded in the Books of Accounts.
4. It does not prove arithmetical accuracy which can be determined by audit.
5. It is not an account. It is only a statement of account.
6. It is not a part of the final statements.
7. It is usually prepared at the end of the accounting year but it can also be prepared anytime as and when required like weekly, monthly, quarterly or half-yearly.
8. It is a link between books of accounts and the Profit and Loss Account and Balance Sheet.

1.18.2 Preparation of Trial Balance:

1. It may be prepared on a loose sheet of paper.
2. The ledger accounts are balanced at first. They will have either "debit-balance" or "credit balance" or "nil-balance".

3. The accounts having debit-balance is written on the debit column and those having credit-balance are written on the credit column.

The sum total of both the balances must be equal, for "Every debit has its corresponding and equal credit".

1.18.3 Purpose of a Trial Balance

It serves the following purposes :

1. To check the arithmetical accuracy of the recorded transactions.
2. To ascertain the balance of any Ledger Account.
3. To serve as an evidence of fact that the double entry has been completed in respect of every transaction.
4. To facilitate the preparation of final accounts promptly.

1.18.4 Is Trial Balance indispensable?

It is a mere statement prepared by the accountants for his own convenience and if it agrees, it is assumed that at least arithmetical accuracy has been done although there may be a lot of errors.

Trial Balance is not a process of accounts, but its preparation helps us to finalise the accounts. Since it is prepared on a particular date, as at .... / as on .... is stated.

1.18.5 Forms of a Trial Balance

A trial balance may be prepared in two forms, they are –

1. Journal Form
2. Ledger Form

The trial balance must tally irrespective of the form of a trial balance.

1. Journal Form : This form of a Trial Balance will have a format of Journal Folio. It will have a column for serial number, name of the account, ledger folio, debit amount and credit amount columns in this journal form.

The ledger folio will show the page number on which such account appears in the ledger.

Specimen of Journal Form of Trial Balance :

Trial Balance as on …………

Sl. No.	Name of the Account	L.F.	Debit Balance ₹	Credit Balance ₹

2. Ledger Form : This form of a trial balance have two sides i.e. debit side and credit side. In fact, the ledger form of a trial balance is prepared in the form of an account. Each side of the trial balance will have particulars (name of the account) column, folio column and the amount column.

Specimen of ledger form of Trial Balance

Dr. **Trial Balance as on ……** **Cr.**

Name of the Account	L.F.	Amount ₹	Name of the Account	L.F.	Amount ₹

1.18.6 Methods of Preparation

1. Total Method or Gross Trial Balance.
2. Balance Method or Net Trial Balance.
3. Compound Method.

These are explained as under :-

1. **Total Method or Gross Trial Balance :** Under this method, two sides of the accounts are totaled. The total of the debit side is called the "debit total" and the total of the credit side is called the "credit total". Debit totals are entered on the debit side of the Trial Balance while the credit total is entered on the credit side of the Trial Balance.

   If a particular account has total in one side, it will be entered either in the debit column or the credit column as the case may be.

   Advantages : (a) It facilitates arithmetical accuracy of the accounts.

   (b) Extraction of ledger balances is not required at the time of preparation of Trial Balance.

   Disadvantages : Preparation of final accounts is not possible.

2. **Balance Method or Net Trial Balance :** Under this method, all the ledger accounts are balanced. The balances may be either "debit-balance" or "credit balance".

   Advantages : (a) It helps in the easy preparation of final accounts.

   (b) It saves time and labour in constructing a Trial Balance.

   Disadvantages : Errors may remain undisclosed irrespective of the agreement of Trial Balance.

3. **Compound Method :** Under this method, totals of both the sides of the accounts are written in the separate columns. Along with this, the balances are also written in the separate columns. Debit balances are written in the debit column and credit balances are written in the credit column of the Trial Balance.

   Advantages : It offers the advantage of both the methods.

   Disadvantages : Lengthy process and more time consumed in the preparation of a Trial Balance.

Summary of Rules

Debit Balance — All Assets, Drawings, Debtors, Expenses and losses.

Credit Balance — All liabilities, Capital, Creditors, Gains and Incomes.

1.18.7 Trial Balance – Utility and Interpretation

The utility of Trial balance could be found in the following:

(1) It forms the basis for preparation of Financial Statements i.e. Profit and Loss Account and Balance Sheet.

(2) A tallied trial balance ensures the arithmetical accuracy of the entries made. If the trial balance does not tally, the errors can be found out, rectified and then financial statements can be prepared.

(3) It acts as a quick reference. One can easily find out the balance in any ledger account without actually referring to the ledger.

(4) If the listing of ledger accounts is systematically done in the trial balance, one can do quick time analysis. Hence, listing is usually done in the sequence of Asset accounts, Liability accounts, Capital accounts, Owner's equity accounts, Income or gain accounts and Expenses or losses accounts in that order.

One can draw some quick inferences from trial balance by interpreting the same. If one plots monthly trial balances side by side, one can analyse the movement of balances in various accounts e.g. one can see how expenses are increasing or decreasing or showing a trend of movements. By comparing the owner's equity balances as on two dates, one can interpret the business result e.g. if the equity has gone up, one can interpret that business has earned net profit and vice versa.

1.18.8 Trial Balance and Errors

We have seen that a tallied Trial Balance (T. B.) ensures arithmetical accuracy. What does it mean? It means entries have been passed as per double entry, that every debit has equal corresponding credit. If the T.B. does not tally, there could be errors in transaction entry. Such errors are called 'Errors affecting trial balance'. These can be:

(a) Only one effect of a transaction is posted to ledger e.g. for rent paid in cash, if entry is posted to cash but not to rent account, then obviously the T.B. will not match.

(b) Posting of wrong amount in one of the ledger accounts e.g. rent of ₹ 1,000 is paid in cash. The posting to Rent A/c is done for ₹ 1,000, Cash A/c is recorded at ₹ 10,000. The T.B. will not tally.

(c) If one of the posting is entered twice, T.B. will not match.

(d) If the balance in a ledger is not correctly taken to the T.B. e.g. the Rent A/c has a balance of ₹1,000, but while taking it to the T.B. it is taken as ₹ 100, the T.B. will through up difference.

(e) Taking balance to the wrong side in the T.B. e.g. a debit balance of ₹ 5,00,000 in Debtors A/c is taken as credit balance in the TB, then there will be a mismatch.

(f) Wrong carry forwards also will result in the T.B. mismatch.

No financial statements can be prepared if the T.B. does not tally. Hence, the errors will have to be rectified before proceeding further. The accountants therefore endeavour to minimize errors by being more careful and by doing periodical scrutiny of the entries.

1.18.8.1 Errors which are not disclosed by a Trial Balance

The following errors cannot be detected by a Trial Balance :

(a) **Errors of Omission :** When the transaction is not at all recorded in the books of accounts, i.e. neither in the debit sider nor in the credit side of the account – trial balance will agree.

(b) **Errors of Commission :** Where there is any variation in figure/amount, e.g. instead of ₹ 800 either ₹80 or ₹8,000 is recorded, in both sides of ledger accounts – trial balance will agree.

(c) **Errors of Principal :** When accounts are prepared not according to double entry principle e.g. Purchase of a Plant wrongly debited to Purchase Account – Trial balance will agree.

(d) **Errors of Misposting :** When wrong posting is made to a wrong account instead of a correct one although amount is correctly recorded, e.g., sold goods to B but wrongly debited to D's Account – trial balance will agree.

(e) **Compensating Errors :** When one error is compensated by another error e.g. Discount Allowed ₹100 not debited to Discount Allowed Account, whereas interest received ₹100, but not credit to Interest Account – trial balance will agree.

1.18.8.2 Procedure to locate Errors:

If the Trial Balance does not agree, the following procedure should carefully be followed :

(i) At first, check all ledger account balance one by one.

(ii) Addition of both the columns (Debit and Credit) should be checked.

(iii) If any difference comes divide the same by 2 and see whether the said figure appear on the correct side or not.

(iv) Additions of the subsidiary books, and ledger accounts to be checked up.

(vi) Posting from subsidiary books to the ledger to be checked up.

(vii) Opening balance of all account whether brought forward correctly or not to be checked up.

(viii) Even if the trial balance does not agree upto this level checking should be started again from the journal and book of original entry using tick mark (✓).

AT A GLANCE

Trial Balance
as at / as on .....

Heads of Accounts	Side of Trial Balance	Reasons
Cash in hand	Debit	Assets
Cash at Bank	Debit	Assets
Cash at Bank (overdrawn)	Credit	Liability
Bank Overdraft	Credit	Liability
Capital	Credit	Liability
Opening stock	Debit	Assets
Wages	Debit	Expenses
Purchase	Debit	Expense/Increase in stock
Carriage Inwards	Debit	Expenses
Freight	Debit	Expenses
Royalty on production	Debit	Expenses
Gas, Water, Fuel	Debit	Expenses
Motive Power	Debit	Expenses
Import Duty	Debit	Expenses
Sales	Credit	Income/Decrease in stock
Discount Allowed	Debit	Losses
Discount Received	Credit	Gains
Bad Debts	Debit	Losses
Reserve /Provision for Bad & Doubtful Debt (Opening)	Credit	Gains (Part of Retained Earnings)
Commission Received	Credit	Incomes
Salaries	Debit	Expenses
Commission paid	Debit	Expenses
Rent, rates, and taxes	Debit	Expenses
Repairs and maintenance	Debit	Expenses
Insurance	Debit	Expenses
Carriage outward	Debit	Expenses
Trade charges	Debit	Expenses

Royalty on sales	Debit	Expenses
Interest paid	Debit	Expenses
Interest received	Credit	Income
Advertisement	Debit	Expenses
Sundry expenses	Debit	Expenses
Miscellaneous expenses	Debit	Expenses
Miscellaneous receipts	Credit	Incomes
Income tax	Debit	Drawings/Assets
L.I.C. Premium	Debit	Drawings/Assets
Office expenses	Debit	Expenses
Export duty	Debit	Expenses
Allowances	Debit	Losses
Rebates	Debit	Losses
Sales tax	Debit	Expenses
Horses and Carts	Debit	Assets
Watch Dag Squad	Debit	Assets
Loan Secured	Credit	Liability
Loans Advanced	Debit	Assets
Reserve Funds	Credit	Liability
Sinking Fund	Credit	Liability
Sinking Fund Investments	Debit	Assets
Ecology Fund	Credit	Liability
Ecology Fund Investments	Debit	Assets
Building Fund	Credit	Liability
Building	Debit	Assets
Land	Debit	Assets
Plant	Debit	Assets
Machinery	Debit	Assets
Furniture & fittings	Debit	Assets
Motor vehicles	Debit	Assets
Computer	Debit	Assets
Office equipments	Debit	Assets
Goodwill	Debit	Assets
Patent rights	Debit	Assets
Copyrights	Debit	Assets
Trade marks	Debit	Assets
Investments	Debit	Assets

Shares & Securities	Debit	Assets
G. P. Notes	Debit	Assets
Sundry debtors	Debit	Assets
Sundry creditors	Credit	Liability
General Reserve	Credit	Liability
Bill Receivable	Debit	Assets
Bills Payable	Credit	Liability
Provision for Discount on Debtors	Credit	Liability
Provision for Discount on Creditors	Debit	Assets
Lighting and Heating	Debit	Expense
Drawings	Debit	Assets
Contribution to Provident Fund	Debit	Assets
Prize Fund	Credit	Liability
Depreciation	Debit	Losses
Provision for Depreciation	Credit	Liability
Returns Inwards	Debit	Losses
Returns Outwards	Credit	Gains
Freehold Property	Debit	Assets
Premises	Debit	Assets
Leasehold Property	Debit	Assets
Loose Tools	Debit	Assets
Petty Cash	Debit	Assets
Provident Fund	Credit	Liability
Debentures Purchased	Debit	Assets
Debentures (from Public)	Credit	Liability
Loan on Mortgage	Credit	Liability
Prepaid Expenses	Debit	Assets
Outstanding Expenses	Credit	Liability
Bad Debts Recovered	Credit	Gains
Accrued Incomes	Debit	Assets
Apprenticeship Premium received	Credit	Income
Books	Debit	Assets
Newspaper and Magazine	Debit	Expenses
Profit and Loss A/c (Dr.)	Debit	Losses
Profit and Loss A/c (Cr.)	Credit	Gains
Accumulated Depreciation	Credit	Liability
Postage and Telegram	Debit	Expense
Travelling & Conveyance	Debit	Expenses

Illustration 21.

From the following ledger account balances, prepare a Trial Balance of Mr. Sen for the year ended 31st March,2013.

Capital ₹ 80,000 ; Sales ₹10,00,000; Adjusted Purchase ₹ 8,00,000; Current A/c(cr) ₹ 10,000; Petty Cash ₹ 10,000; Sales Ledger Balance ₹ 1,20,000; Purchase Ledger Balance ₹ 60,000; Salaries ₹24,000; Carriage Inwards ₹ 4,000; Carriage Outward ₹ 6,000; Discount Allowed ₹ 10,000; Building ₹ 80,000; Outstanding Expenses ₹ 10,000; Prepaid Insurance ₹ 2,000 ; Depreciation ₹ 4,000 ; Cash at Bank ₹ 80,000 ; Loan A/c (cr) ₹ 66,000; Profit & Loss A/c(cr) ₹ 20,000; Bad Debts Recovered ₹ 2,000 ; Stock at 31.03.2013

₹ 1,20,000; Interest Received ₹ 10,000; Accrued Interest ₹ 4,000; Investment ₹ 20,000; Provision for Bad Debts (01.04.2012) ₹ 6,000 ; General Reserve ₹ 20,000.

Solution.

Trial Balance of Mr. Sen

Dr. **as on 31st March, 2013** **Cr.**

Heads of Accounts	Amount (₹)	Heads of Accounts	Amount (₹)
Adjusted Purchase	8,00,000	Capital	80,000
Petty Cash	10,000	Sales	10,00,000
Sales Ledger Balance	1,20,000	Current A/c	10,000
Salaries	24,000	Purchase Ledger Balance	60,000
Carriage Inward	4,000	Outstanding Expenses	10,000
Discount Allowed	10,000	Loan A/c	66,000
Building	80,000	Profit & Loss A/c(cr)	20,000
Prepaid Insurance	2,000	Bad Debts Recovered	2,000
Depreciation	4,000	Interest Received	10,000
Cash at Bank	80,000	Provision for Bad debts	6,000
Stock (31.03.2013)	1,20,000	General Reserve	20,000
Accrued Interest	4,000		
Investment	20,000		
Carriage outward	6,000		
	12,84,000		**12,84,000**

***Note**: Closing Stock will appear in Trial Balance since there is adjusted purchase.*

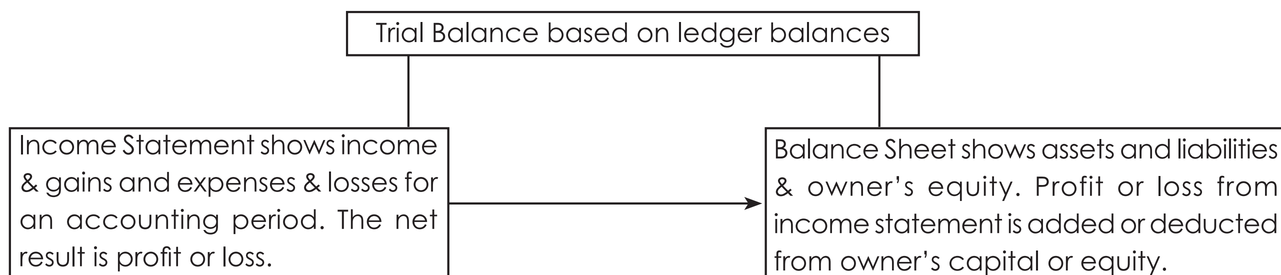
Adjusted purchase = Opening Stock + Purchase - Closing Stock.

It may be noted that if only adjusted purchase is considered then the matching concept is affected. Hence, to satisfy the matching concept, closing stock is also considered in Trial Balance.

1.19 MEASUREMENT, VALUATION AND ACCOUNTING ESTIMATES

At the end of the last section, it was stated that Trial Balance forms the basis for preparing financial statements. However, there are certain other tasks that have to be completed before these final accounts are prepared. You know that accounting entries are made on the basis of actual transactions carried out during an accounting period. These are all included in the trial balance. However, there could be certain other business realities which are to be recognized as either asset, liability, income, gain, expense, loss or a combination thereof. As we know the matching concept necessitates the consideration of all aspects which may affect the financial result of the business. Technically these are called as adjustments for which entries need to be passed, without which the financial statements will not give a true and fair view of business activity. We discuss some of these entries and adjustments in the following sections.

Before discussing these, let us understand the meaning of Income Statement and Balance Sheet.



Depending on the nature of business, the income statement is prepared in different forms like:

(a) In case of manufacturing concern, a Manufacturing, Trading and P & L A/c is prepared

(b) In case of a trading or service organization, a Trading and P & L A/c is prepared

The Manufacturing or Trading Accounts show Gross margins (or gross losses) and the P & L A/c shows Net Profit or Net Loss.

The Balance Sheet exhibits the list of assets (which indicate resources owned) and the liabilities & owners' capital and equity (which shows how the resources are funded).

For company type of organizations, standard formats for P & L and Balance Sheet are given in the Companies Act that is to be adhered to. The accounting should be as per the prescribed Accounting Standards.

1.19.1 Closing Stock

We know when goods are purchased for resale we include them in Purchases A/c, while goods sold are shown in Sales A/c. At the end of accounting period, some of these goods may remain unsold. If we show the entire cost of purchases in income statement, it will not be as per the matching concept. We should only show the cost of those goods that are sold during the period. The balance cost should be carried forward to the next accounting period through the balance sheet. How should the closing stock be valued? According to the conservative principle, the stock is valued at lower of cost or market price. If cost of stock is ₹ 125000 and its realizable market price is only ₹ 115000, then the value considered is ₹ 115000 only. What it means is the difference of ₹ 10000 is charged off to the current periods profits.

Students are advised to refer to Accounting Standard 2 - 'Valuation of Inventories' to get thorough knowledge.

Please remember the closing stock figure does not appear in the trial balance, but is valued and directly taken to the P & L A/c. The entry passed for this is:

Closing Stock A/c Dr.

To Trading and P & L A/c

In solving the examination problem, this entry is not actually passed, but the effect of its outcome is given. Here, one effect is "show closing stock as asset in Balance Sheet" and second effect is "show it on the credit side of Trading A/c".

Note : But, if the closing stock appears in the debit side of Trial Balance, it means it has already been adjusted against purchases. In that case, the closing stock will appear only in the asset side of the Balance Sheet.

1.19.2 Depreciation

When the business uses its assets to earn income, there is wear and tear of the asset life. Assets will have limited life and as we go on using it, the value diminishes. Again the question to be asked is – at what value should the asset be shown in the balance sheet? Consider a machine was bought on 1st April 2012 for ₹ 2,00,000. It's used for production activity throughout the year. When the final accounts are being prepared, at what value should it be shown in Balance Sheet as on 31st March 2013?

Well, according to cost principle initial entry for purchase of machine is shown at cost paid for it e.g. ₹2,00,000 in this case. But the fact that the machine is used must be recognized in financials. Hence the value in the Balance sheet must be brought down to the extent of its use. This is called as Depreciation. How is it calculated? While there are different methods of calculating depreciation (explained in subsequently), the simple idea is to spread it over the useful life of the asset, so that at the end of its life the value is zero. In our example, if useful life of the machine is taken as 10 years, the depreciation will be simply ₹ 2,00,000 ÷ 10 i.e. ₹ 20,000 every year. So a depreciation of ₹ 20,000 will be charged to the profit of every year and value of asset will be brought down by the same value.

Students are advised to refer to Accounting Standard 6 issued by ICAI to get thorough knowledge on Depreciation accounting.

The entry passed for this is:

Depreciation A/c Dr.

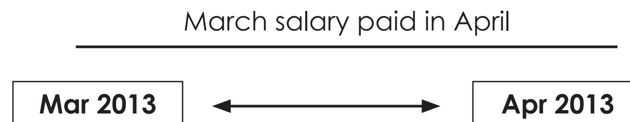
To Fixed Asset A/c

The effect given is one – include in the P & L A/c as expense for the period and two – reduce from asset value in the Balance Sheet.

Please refer study Note 3 for further explanation.

1.19.3 Accrued Expenses or Outstanding Expenses

There may be expenses incurred for the current accounting period, but not actually paid for. The matching concept, however, necessitates that this expense must be recognized as expense for the current year and should not be deferred till its actual payment. Typically, we know salary for the month is normally paid in the 1st week of the next month. Imagine the accounting period close on 31st March. The salary for the month of March is not paid till 31st March. But is it is related to this month, it must be booked as expense for the current month and also as a liability payable in the next month (which is in next accounting period). This can be shown as follows:



The entry for this is:

Expense A/c Dr

To Outstanding Expense A/c or Expense payable A/c

The two effects when preparing the final accounts are:

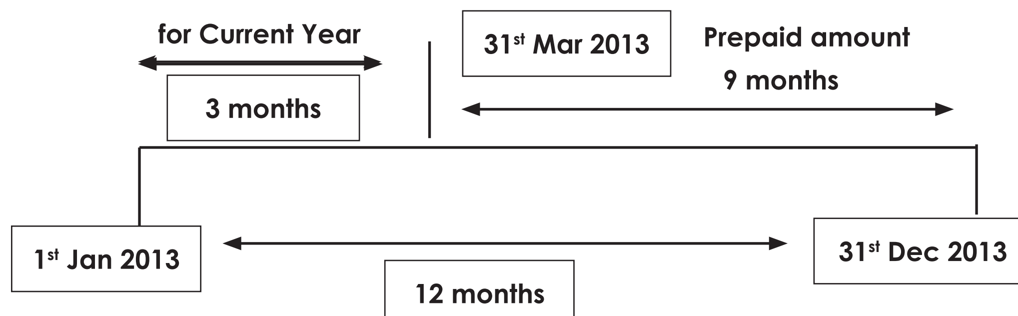
One – add in respective expense in P & L A/c and two – show as a liability in the Balance Sheet.

1.19.4 Prepaid Expenses

At times we may pay for certain expenses which are period related. For example, the business has taken an insurance policy against fire on which the annual premium payable is ₹ 75,000. The policy is taken on 1st January 2013 valid till 31st December 2013. But the company's accounting period ends on 31st March 2013. When considering the insurance expense for the accounting year, what amount should be considered? See the following.

As can be seen, out of the total premium period of 12 months, only 3 months are related to the current accounting period and the remaining 9 months' premium is related to the next accounting period. Hence only 3 months' premium is to be considered as expense for the current year i.e. ₹ 18750 (75000 ÷ 4).

The entry for this is:



Prepaid Insurance A/c Dr

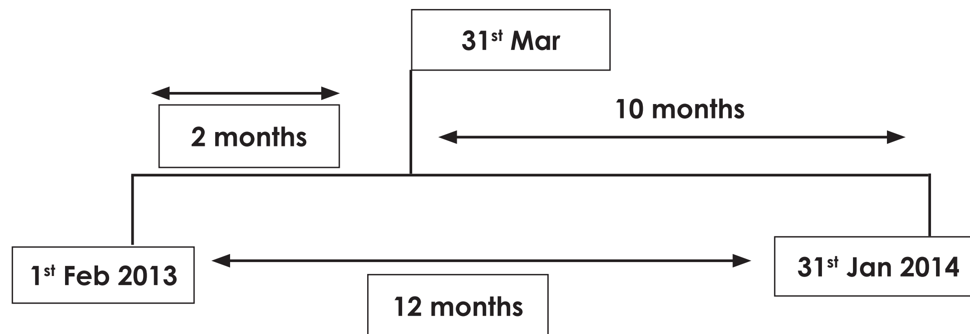
To Insurance A/c

The two effects while preparing final accounts are:

One – Reduce from respective expense in P & L A/c and two – show as an asset in the Balance Sheet

1.19.5 Accrued Incomes

Just as expenses accrue, there are instances of income getting accrued at the end of accounting period. The extent to which it accrues, it must be booked as income for the current accounting period. Consider, the business has put a One year fixed deposit of ₹ 1,00,000 with Citi Bank at a fixed interest of 9 % p.a. on 1st February 2013 and the interest is credited by the bank on a semi-annual basis. Also, consider that the accounting period ends on 31st March 2013. The Citi bank will credit the 1st semi-annual interest on 31st July 2013 and the next on 31st January 2014. Now, consider the following :



It can be noticed that interest for the 2 months will be considered as accrued as on 31st of March 2013 and must be taken as income for the current accounting year.

The entry for this is:

Accrued Interest A/c Dr.

To Interest A/c

The two effects while preparing final accounts are:

One – Show as income in the P & L A/c and two – show as an asset in the Balance Sheet

1.19.6 Income Received in Advance

If an income is received which is not related to the current accounting period, it cannot be included in the current year's P & L A/c. So, if it's already included as income it must be reduced. The entry for this is:

Respective Income A/c Dr.
To Income received in advance A/c

The effects while preparing final account are:
One – Reduce from respective income and two – show it as liability in Balance Sheet

1.19.7 Accounting In Practice

These are days of computerised accounting. Even smaller firms like sole proprietors use accounting packages like Tally 9.0 which are very strong. At this stage it is necessary to understand the practical aspects of how accounting is actually done by these packages. Based on years of experience, they come with a standard chart of account. The chart of account is nothing but master ledger accounts and they are numerically coded for quick and easy identification and reporting. There are customized screens made to enter different transactions. Hence, the user can not by mistake put a purchase

transaction into sales book. The customers and vendors are also alpha-numerically coded for ease of identification. Once the basic documents are entered, the job of posting, balancing and trial balance is all automated. So actually, most of the potential errors can be avoided.

There is an increased feeling among students that when there are automated systems available, why should one go through the study of manual processes. This is absolutely essential for grasping basic concepts. Once, you thoroughly understand them, it will be easy to operate any computerised accounting package in practice.

Comprehensive Illustrations

To enable the students to get complete grasp of this process, comprehensive examples are given below.

Illustration 22.

Journalize the following transactions in the books of Gaurav, post them into ledger and prepare trial balance for June 2013 :

June 1: Gaurav started business with ₹ 10,00,000 of which 25% amount was borrowed from wife.

June 4: Purchased goods from Aniket worth ₹ 40,000 at 20% TD and 1/5th amount paid in cash.

June 7: Cash purchases ₹ 25,000.

June 10: Sold goods to Vishakha ₹ 30,000 at 30% TD and received 30% amount in cash.

June 12: Deposited cash into bank ₹ 20,000.

June 15: Uninsured goods destroyed by fire ₹ 5,500.

June 19: Received commission ₹ 3,500.

June 22: Paid to Aniket ₹ 25,500 in full settlement of A/c.

June 25: Cash stolen from cash box ₹ 1,000.

June 27: Received from Vishakha ₹ 14,500 and discount allowed ₹ 200.

June 30: Interest received ₹ 2,400 directly added in our bank account.

Solution

In the books of Gaurav
Journal

Date	Particulars		L.F.	Dr. Amount (₹)	Cr. Amount (₹)
2013 1-Jun	Cash A/c	Dr.		10,00,000	
	To Capital A/c				7,50,000
	To Loan from Wife A/c				2,50,000
	(Being capital brought into business)				
4-Jun	Purchases A/c	Dr.		32,000	
	To Cash A/c				6,400
	To Aniket's A/c				25,600
	(Being goods purchased at 20% TD & 1/5th amount paid in cash)				
7-Jun	Purchases A/c	Dr.		25,000	
	To Cash A/c				25,000
	(Being cash purchases)				

10-Jun	Cash A/c Dr. Vishakha's A/c Dr. To Sales A/c (Being goods sold at 30% TD & 30% amount received in cash)		6,300 14,700	 21,000
12-Jun	Bank A/c Dr. To Cash A/c (Being cash deposited in bank)		20,000	 20,000
15-Jun	Loss by Fire A/c Dr. To Purchases A/c (Being uninsured goods lost by fire)		5,500	 5,500
19-Jun	Cash A/c Dr. To Commission A/c (Being commission received)		3,500	 3,500
22-Jun	Aniket's A/c Dr. To Cash A/c To Discount A/c (Being paid to Aniket in full settlement & discount received)		25,600	 25,500 100
25-Jun	Loss by Theft A/c Dr. To Cash A/c (Being cash stolen)		1,000	 1,000
27-Jun	Cash A/c Dr. Discount A/c To Vishakha's A/c (Being amount received from Vishakha & discount allowed)		14,500 200	 14,700
30-Jun	Bank A/c To Interest A/c (Being interest received directly added into bank account)		2,400	 2,400
			1,150,700	1,150,700

Dr. **Cash Account** **Cr.**

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amont (₹)
1/6/13	To Capital A/c		7,50,000	4/6/13	By PurchasesA/c		6,400
1/6/13	To Loan from Wife A/c		2,50,000	7/6/13	By Purchases A/c		25,000
10/6/13	To Sales A/c		6,300	12/6/13	By Bank A/c		20,000
19/6/13	To Commission A/c		3,500	22/6/13	By Aniket's A/c		25,500
27/6/13	To Vishakha's A/c		14,500	25/6/13	By Loss by Theft A/c		1,000
				30/6/13	By Balance c/d		9,46,400
			10,24,300				10,24,300
1/7/13	To Balance b/d		9,46,400				

Dr.			Capital Account				Cr.
Date	Particulars	J.F.	Amt. (₹)	Date	Particulars	J.F.	Amt. (₹)
30/6/13	To Balance c/d		7,50,000	1/6/13	By Cash A/c		7,50,000
			7,50,000				7,50,000
				1/7/13	By Balance b/d		7,50,000

Dr.			Loan from Wife Account				Cr.
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amt. (₹)
30/6/13	To Balance c/d		2,50,000	1/6/13	By Cash A/c		2,50,000
			2,50,000				2,50,000
				1/7/13	By Balance b/d		2,50,000

Dr.			Purchases Account				Cr.
Date	Particulars	J.F.	Amt. (₹)	Date	Particulars	J.F.	Amt. (₹)
4/6/13	To Cash A/c		6,400	15/6/13	By Loss by fire		5,500
4/6/13	To Aniket's A/c		25,600	30/6/13	By Balance c/d		51,500
7/6/13	To Cash A/c		25,000				
			57,000				57,000
1/7/13	To Balance b/d		51,500				

Dr.			Aniket's Account				Cr.
Date	Particulars	J.F.	Amt. (₹)	Date	Particulars	J.F.	Amt. (₹)
22/6/13	To Cash A/c		25,500	4/6/13	By Purchases A/c		25,600
22/6/13	To Discount A/c		100				
			25,600				25,600

Dr.			Vishakha's Account				Cr.
Date	Particulars	J.F.	Amt. (₹)	Date	Particulars	J.F.	Amt. (₹)
10/6/13	To Sales A/c		14,700	27/6/13	By Cash A/c		14,500
				27/6/13	By Discount A/c		200
			14,700				14,700

Dr.			Sales Account				Cr.
Date	Particulars	J.F.	Amt. (₹)	Date	Particulars	J.F.	Amt. (₹)
30/6/13	To Balance c/d		21,000	10/6/13	By Cash A/c		6,300
				10/6/13	By Vishakha's A/c		14,700
			21,000				21,000
				1/7/13	By Balance b/d		21,000

Dr.			Bank Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F.**	**Amt. (₹)**
12/6/13	To Cash A/c		20,000	30/6/13	By Balance c/d		22,400
30/6/13	To Interest A/c		2,400				
			22,400				22,400
1/7/13	To Balance b/d		22,400				

Dr.			Loss by Fire Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F.**	**Amt. (₹)**
15/6/13	To Purchases A/c		5,500	30/6/13	By Balance c/d		5,500
			5,500				5,500
1/7/13	To Balance b/d		5,500				

Dr.			Commission Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F.**	**Amt. (₹)**
30/6/13	To Balance c/d		3,500	19/6/13	By Cash A/c		3,500
			3,500				3,500
				1/7/13	By Balance b/d		3,500

Dr.			Discount Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F.**	**Amt. (₹)**
27/6/13	To Vishakha's A/c		200	22/6/13	By Aniket's A/c		100
				30/6/13	By Balance c/d		100
			200				200
1/7/13	To Balance b/d		100				

Dr.			Loss by Theft Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F.**	**Amt. (₹)**
25/6/13	To Cash A/c		1,000	30/6/13	By Balance c/d		1,000
			1,000				1,000
1/7/13	To Balance b/d		1,000				

Dr.			Interest Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F.**	**Amt. (₹)**
30/6/13	To Balance c/d		2,400	30/6/13	By Bank A/c		2,400
			2,400				2,400
				1/7/13	By Balance b/d		2,400

Trial Balance as on 30.6.13

Name of Account	Dr. (₹)	Cr. (₹)
Cash A/c	9,46,400	-----
Capital A/c	-----	7,50,000
Loan from Wife A/c	-----	2,50,000
Purchases A/c	51,500	-----
Aniket's A/c	-----	-----
Vishakha's A/c	-----	-----
Sales A/c	-----	21000
Bank A/c	22,400	-----
Loss by Fire A/c	5,500	-----
Commission A/c	-----	3500
Discount A/c	100	-----
Loss by Theft A/c	1,000	-----
Interest A/c	-----	2,400
Total	10,26,900	10,26,900

Illustration 23.

Journalize the following transactions in the books of M/s Kothari & Sons, post them into ledger and prepare trial balance for April 2013:

Apr. 1: Commenced business with ₹ 40,000.

Apr. 4: Bought goods for cash ₹ 4,000

Apr. 7: Sold goods ₹ 700 (for Cash)

Apr. 10: Bought goods from M/s Bhandari Bros. ₹ 3,000 at 10% trade discount.

Apr. 14: Purchased machinery of ₹ 5,000 from M/s Kirloskar Bros.

Apr. 16: Paid for transportation of machinery ₹ 500 & installation charges ₹ 300 on it.

Apr. 20: Paid quarterly interest on borrowed amount of ₹ 5,000 at 12% p.a.

Apr. 24: Supplied goods to M/s Kunal & Sons ₹ 3,500.

Apr. 27: Paid to M/s Bhandari Bros. ₹ 2600 in full settlement of account.

Apr. 28: M/s Kunal & Sons returned goods worth ₹ 300 & paid for ₹ 1,200 on account.

Apr. 29: Received commission ₹ 250.

Apr. 30: Paid conveyance to manager ₹ 450.

Solution:

In the books of M/s Kothari and Sons

Journal

Date	Particulars		L.F.	*Dr.* Amount ₹	*Cr.* Amount ₹
2013 1-Apr	Cash A/c	Dr.		40,000	
	To Capital A/c				40,000
	(Being cash introduced as capital)				
4-Apr	Purchases A/c	Dr.		4,000	
	To Cash A/c				4,000
	(Being bought goods for cash)				
7-Apr	Cash A/c	Dr.		700	
	To Sales A/c				700
	(Being sold goods for cash)				
10-Apr	Purchases A/c	Dr.		2,700	
	To M/s Bhandari Bros. A/c				2,700
	(Being purchased goods at 10% TD)				
14-Apr	Machinery A/c	Dr.		5,000	
	To M/s Kirloskar Bros. A/c				5,000
	(Being purchased machinery on credit)				
16-Apr	Machinery A/c	Dr.		800	
	To Cash A/c				800
	(Being transportation & installation charges on machinery paid)				
20-Apr	Interest A/c	Dr.		150	
	To Cash A/c				150
	(Being paid quarterly interest on borrowed amt. of ₹ 5000 at 12% p.a.)				
24-Apr	M/s Kunal & Sons A/c	Dr.		3,500	
	To Sales A/c				3,500
	(Being goods sold on credit)				
27-Apr	M/s Bhandari Bros. A/c	Dr.		2,700	
	To Cash A/c				2,600
	To Discount A/c				100
	(Being paid in full settlement & discount received)				
28-Apr	Return Inwards A/c	Dr.		300	
	Cash A/c	Dr.		1,200	
	To M/s Kunal & Sons A/c				1,500
	(Being goods returned & received on account)				
29-Apr	Cash A/c	Dr.		250	
	To Commission A/c				250
	(Being commission received)				
30-Apr	Conveyance A/c	Dr.		450	
	To Cash A/c				450
	(Being conveyance paid to manager)				
	Total			61,750	61,750

Ledger

Dr. — Cash Account — Cr.

Date	Particulars	J.F	Amt. (₹)	Date	Particulars	J.F	Amt. (₹)
1/4/13	To Capital A/c		40,000	4/4/13	By Purchases A/c		4,000
7/4/13	To Sales A/c		700	16/4/13	By Machinery A/c		800
28/4/13	To M/s Kunal & Sons A/c		1200	20/4/13	By Interest A/c		150
29/4/13	To Commission A/c		250	27/4/13	By M/s Bhandari Bros. A/c		2,600
				30/4/13	By Conveyance A/c		450
				30/4/13	By Balance c/d		34,150
			42,150				42,150
1/5/13	To Balance b/d		34,150				

Dr. — Capital Account — Cr.

Date	Particulars	J.F	Amt. (₹)	Date	Particulars	J.F	Amt. (₹)
30/4/13	To Balance c/d		40,000	1/4/13	By Cash A/c		40,000
			40,000				40,000
				1/5/13	By Balance b/d		40,000

Dr. — Purchases Account — Cr.

Date	Particulars	J.F	Amt. (₹)	Date	Particulars	J.F	Amt. (₹)
4/4/13	To Cash A/c		4,000	30/4/13	By Balance c/d		6,700
10/4/13	To M/s Bhandari Bros. A/c		2,700				
			6,700				6,700
1/5/13	To Balance b/d		6,700				

Dr. — Sales Account — Cr.

Date	Particulars	J.F.	Amt. (₹)	Date	Particulars	J.F	Amt. (₹)
30/4/13	To Balance c/d		4,200	7/4/13	By Cash A/c		700
				24/4/13	By M/s Kunal & Sons A/c		3,500
			4,200				4,200
				1/5/13	By Balance b/d		4,200

Dr. — M/s Bhandari Bros. Account — Cr.

Date	Particulars	J.F.	Amt. (₹)	Date	Particulars	J.F	Amt. (₹)
27/4/13	To Cash A/c		2,600	10/4/13	By Purchases A/c		2,700
27/4/13	To Discount A/c		100				
			2,700				2,700

Dr. — Machinery Account — Cr.

Date	Particulars	J.F.	Amt. (₹)	Date	Particulars	J.F	Amt. (₹)
14/4/13	To M/s Kirloskar Bros. A/c		5,000	30/4/13	By Balance c/d		5,800
16/4/13	To Cash A/c		800				
			5,800				5,800
1/5/13	To Balance b/d		5,800				

Dr.			M/s Kirloskar Bros. Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F**	**Amt. (₹)**
30/4/13	To Balance c/d		5,000	14/4/13	By Machinery A/C		5,000
			5,000				5,000
				1/5/13	By Balance b/d		5,000

Dr.			Interest Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F**	**Amt. (₹)**
20/4/13	To Cash A/c		150	30/4/13	By Balance c/d		150
			150				150
1/5/13	To Balance b/d		150				

Dr.			M/S Kunal & Sons Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F**	**Amt. (₹)**
24/4/13	To Sales A/c		3,500	28/4/13	By Return Inwards A/c		300
				28/4/13	By Cash A/c		1,200
				30/4/13	By Balance c/d		2,000
			3,500				3,500
1/5/13	To Balance b/d		2,000				

Dr.			Discount Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F**	**Amt. (₹)**
30/4/13	To Balance c/d		100	27/4/13	By M/s Bhandari Bros. A/c		100
			100				100
				1/5/13	By Balance b/d		100

Dr.			Return Inwards Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F**	**Amt. (₹)**
28/4/13	To M/s Kunal & Sons A/c		300	30/4/13	By Balance c/d		300
			300				300
1/5/13	To Balance b/d		300				

Dr.			Commission Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F**	**Amt. (₹)**
30/4/13	To Balance c/d		250	29/4/13	By Cash A/c		250
			250				250
				1/5/13	By Balance b/d		250

Dr.			Conveyance Account				Cr.
Date	**Particulars**	**J.F.**	**Amt. (₹)**	**Date**	**Particulars**	**J.F**	**Amt. (₹)**
30/4/13	To Cash A/c		450	30/4/13	By Balance c/d		450
			450				450
1/5/13	To Balance b/d		450				

Trial Balance as on 30.4.13

Name of Account	*Dr.* (₹)	*Cr.* (₹)
Cash A/c	34,150	-----
Capital A/c	-----	40,000
Purchases A/c	6,700	-----
Sales A/c	-----	4,200
M/s Bhandari Bros. A/c	-----	-----
Machinery A/c	5,800	-----
M/s Kirloskar Bros. A/c	-----	5,000
Interest A/c	150	-----
M/s Kunal & Sons A/c	2,000	-----
Discount A/c	-----	100
Return Inwards A/c	300	-----
Commission A/c	-----	250
Conveyance A/c	450	-----
Total	49,550	49,550

Illustration 24.

Enter the following transactions in the proper subsidiary books and post them to ledger accounts. Also prepare Trial Balance:

2013

Jan. 1: Purchased goods worth ₹ 6,000 from M/s Akshaykumar & Sons.
Jan. 5: Sold goods to M/s Vinaykumar ₹ 2,000.
Jan. 7: Purchased goods from M/s Vinod Bros. ₹ 4,000 at 5% TD.
Jan. 9: Sold goods to Pravinkumar on cash ₹ 500.
Jan. 12: Bought goods from Jayant Kumar ₹ 3,500 at 10% TD.
Jan. 17: Supplied goods to M/s Rajnikant ₹ 2,500 at 5% TD.
Jan. 20: Sold furniture to M/s Narendrakumar worth ₹ 1,200.
Jan. 22: Returned goods to M/s Vinod Bros. ₹ 500 gross.
Jan. 25: M/s Vinaykumar returned goods worth ₹ 500.
Jan. 27: Sent debit note to M/s Akshaykumar for ₹ 200.
Jan. 30: Sold goods to Narendrakumar worth ₹ 9,000 and received half amount on the spot.

Solution:

Purchases Book

Date	Name of Supplier	Inward Invoice No.	L.F	Amount (₹)
1/1/13	M/s Akshaykumar			6,000
7/1/13	M/s Vinod Bros. (4000 - 5% TD)			3,800
12/1/13	Jayant Kumar (3500 - 10% TD)			3,150
				12,950

Sales Book

Date	Name of Customer	Outward Invoice No.	L.F	Amount (₹)
5/1/13	M/s Vinaykumar			2,000
17/1/13	M/s Rajnikant (2500 - 5% TD)			2,375
30/1/13	M/s Narendrakumar			4,500
				8,875

Return Inwards Book

Date	Name of Customer	Credit Note No.	L.F	Amt (₹)
25/1/13	M/s Vinaykumar			500
				500

Return Outwards Book

Date	Name of Supplier	Debit Note No.	L.F	Amt (₹)
22/1/13	M/s Vinod Bros. (500 - 5% TD)			475
27/1/13	M/s Akshaykumar			200
				675

Dr. Cash Book Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
9/1/13	To Sales A/c (Being cash sales)		500	31/1/13	By Balance c/d		5,000
30/1/13	To Sales A/c (Being cash sales)		4,500				
			5,000				5,000
1/2/13	To Balance b/d		5,000				

Dr. Purchases Account Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
31/1/13	To Sundries as per purchases book		12,950	31/1/13	By Balance c/d		12,950
1/2/13	To Balance b/d		12,950				12,950

Dr. Sales Account Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
31/1/13	To Balance c/d		13,875	9/1/13	By Cash A/c		500
				30/1/13	By Cash A/c		4,500
				31/1/13	By Sundries as per Sales Book		8,875
			13,875				13,875
				1/2/13	By Balance b/d		13,875

Dr. Return Inwards Account Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
31/1/13	To Sundries as per return inwards book		500	31/1/13	By Balance c/d		500
1/2/13	To Balance b/d		500				500

Dr. Return Outwards Account Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
31/1/13	To Balance c/d		675	31/1/13	By Sundries as per return outwards book		675
			675	1/2/13	By Balance b/d		675

Dr. **M/s Akshaykumar Account** Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
27/1/13	To Return Outwards A/c		200	1/1/13	By Purchases A/c		6000
31/1/13	To Balance c/d		5,800				
			6,000				6,000
				1/2/13	By Balance b/d		5,800

Dr. **M/s Vinod Bros Account** Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
22/1/13	To Return Outwards A/c		475	7/1/13	By Purchases A/c		3800
31/1/13	To Balance c/d		3,325				
			3,800				3800
				1/2/13	By Balance b/d		3325

Dr. **Jayant Kumar Account** Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
31/1/13	To Balance c/d		3,150	12/1/13	By Purchases A/c		3,150
				1/2/13	By Balance b/d		3,150

Dr. **M/s Vinaykumar Account** Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
5/1/13	To Sales A/c		2,000	25/1/13	By Return Inwards A/c		500
				31/1/13	By Balance c/d		1,500
			2,000				2,000
1/2/13	To Balance b/d		1,500				

Dr. **M/s Rajnikant Account** Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
17/1/13	To Sales A/c		2,375	31/1/13	By Balance c/d		2,375
1/2/13	To Balance b/d		2,375				

Dr. **M/s Narendrakumar Account** Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
20/1/13	To Furniture A/c		1,200	31/1/13	By Balance c/d		5,700
30/1/13	To Sales A/c		4,500				
			5,700				5,700
1/2/13	To Balance b/d		5,700				

Dr. **Furniture Account** Cr.

Date	Particulars	J.F.	Amt (₹)	Date	Particulars	J.F.	Amt (₹)
31/1/13	To Balance c/d		1,200	20/1/13	By M/s Narendra kumar A/c		1,200
				1/2/13	By Balance b/d		1,200

Trial Balance as on 31.1.13

Name of Account	*Dr.* (₹)	*Cr.* (₹)
Cash A/c	5,000	-----
Purchases A/c	12,950	-----
Sales A/c	-----	13,875
Return Inwards A/c	500	-----
Return Outwards A/c	-----	675
M/s Akshaykumar A/c	-----	5,800
M/s Vinod Bros. A/c	-----	3,325
Jayant Kumar A/c	-----	3,150
M/s Vinaykumar A/c	1,500	-----
M/s Rajnikant A/c	2,375	-----
M/s Narendrakumar A/c	5,700	-----
Furniture A/c	-----	1,200
Total	28,025	28,025

Illustration 25.

The total of debit side of Trial Balance of a larger boot and shoe repairing firm as on 31.12.2013 is ₹ 1,66,590 and that of the credit side is ₹ 42,470. After several checking and re-checking the mistakes are discovered :

Items of Account	Correct Figure (as it would be)	Figures as it appear in the Trial Balance
Opening Stock	₹ 14,900	₹ 14,800
Repairs	₹ 61,780	₹ 61,780 (appear in the Debit side)
Rent & Taxes	₹ 2,160	₹ 2,400
Sundry Creditors	₹ 6,070	₹ 5,900
Sundry Debtors	₹ 8,060	₹ 8,310

Ascertain the correct total of the Trial Balance.

Solution:

Particulars	Debit (₹)	Credit (₹)
Total as per Trail Balance	1,66,590	42,470
Opening Stock understated (14,900-14,800)	+100	-
Repairs being credit balance, but shown as debit balance	-61,780	+61,780
Rent & Taxes overstated (2,400-2,160)	-240	-
Sundry Creditors understated (6,070-5,900)	-	+170
Sundry Debtors overstated (8,310-8,060)	-250	-
Total	1,04,420	1,04,420

1.20 JOURNAL PROPER – OPENING ENTRIES, CLOSING ENTRIES, TRANSFER ENTRIES AND RECTIFICATION ENTRIES

(i) Opening Entries: The opening entry is an item which is passed in the Journal Proper or General Ledger. The purpose of passing this entry is to record the opening balances of the accounts transferred from the previous year to the new year. The accounts which are appearing on the assets side of Balance Sheet are debited in the opening entry while which accounts are appearing in the liabilities side are credited.

At the end of each accounting period, the books of accounts need to be closed for preparation of final accounts. Also, in the beginning of the new accounting period, new books of accounts are to be opened. For this purpose, opening and closing entries need to be passed. These entries are passed in journal proper.

The opening entries are passed only for those ledger A/c balances which are carried forward from earlier period to the current accounting period. In other words, the balances of assets, liabilities and owners' capital and equity accounts are only considered for such opening entries. The opening entry is passed with the closing balances of assets and liabilities & capital accounts in the last year's balance sheet.

The entry can be given as:

All Asset A/cs	Dr.
To All Liabilities A/c	
To Owners' Capital A/cs	

Illustration 26.

Consider the following balances in the Balance Sheet as on 31st March 2013. Pass the opening entry on 1st April 2013.

Subodh's Capital A/c	2,75,000
Loan from HDFC Bank	4,25,000
Plant and machinery	3,30,000
Cash in hand	20,000
Balance at Citi Bank	1,75,000
Trade Debtors	3,55,000
Closing Stock	1,35,000
Trade Payables	2,95,000
Outstanding Expenses	40,000
Prepaid Insurance	20,000

Solution:

The opening entry will be as follows:

Plant and machinery A/c	Dr.	3,30,000	
Cash in hand A/c	Dr.	20,000	
Balance at Citi Bank A/c	Dr.	1,75,000	
Trade Debtors A/c	Dr.	3,55,000	
Closing Stock A/c	Dr.	1,35,000	
Prepaid Insurance	Dr.	20,000	
To Subodh's Capital A/c			2,75,000
To Loan from HDFC Bank A/c			4,25,000
To Trade Payables A/c			2,95,000
To Outstanding Expenses A/c			40,000

(ii) Closing Entries: All the expenses and gains or income related nominal accounts must be closed at the end of the year. In order to close them, they are transferred to either Trading A/c or Profit and Loss A/c. Journal entries required for transferring them to such account is called a 'closing entry'.

The Closing Entries are passed on the basis of trial balance for transferring the balances to Trading and Profit and Loss A/c. These entries are mainly for:

(a) Transferring purchases and direct expenses (goods related) to Trading A/c

Trading A/c	Dr.
To Opening stock A/c	
To Purchases A/c	
To Factory expenses A/c	
To Freight & carriage inward A/c	

(b) Transferring sales and closing stocks

Sales A/c	Dr.
Closing Stock A/c	Dr.
To Trading A/c	

(c) Transferring gross profit or gross loss to P & L A/c

Gross Profit

Trading A/c	Dr.
To P & L A/c	

Gross Loss

P & L A/c	Dr.
To Trading A/c	

(d) Transferring expenses

P & L A/c	Dr.
To Respective expense A/c	

(e) Transferring Incomes

Respective income A/cs	Dr.
To P & L A/c	

(f) Transferring Net profit or Net loss

Net Profit

P & L A/c	Dr.
To Capital A/c	

Net Loss

Capital A/c	Dr.
To P & L A/c	

Illustration 27.

Pass closing entries for the following particulars as on 31st March 2013 presented by X Ltd.

Particulars	Amount (₹)
Opening stock	10,000
Purchases	50,000
Wages	5,000
Returns outward	5,000
Sales	1,00,000
Returns inward	10,000
Salaries	8,000
Insurance	1,000
Bad debts	3,000
Interest received	3,000
Discount allowed	4,000
Discount received	3,000
Closing stock	15,000

Solution:

In the Books of X Ltd.
Journal

Date	Particulars		LF	Dr. Amount (₹)	Cr. Amount (₹)
2013 March 31st	Trading A/c	Dr.		75,000	
	To, Opening Stock A/c				10,000
	To, Purchases A/c				50,000
	To, Wages A/c				5,000
	To, Returns inward A/c				10,000
	(Transfer to balances for closing the latter accounts)				
	Sales A/c	Dr.		1,00,000	
	Returns outward A/c	Dr.		5,000	
	Closing Stock A/c	Dr.		15,000	
	To, Trading A/c				1,20,000
	(Transfer of balances for closing the former accounts)				
	Trading A/c	Dr.		45,000	
	To, Profit and Loss A/c				45,000
	(Gross profit transferred)				
	Profit and Loss A/c	Dr.		16,000	
	To, Salaries A/c				8,000
	To, Insurance A/c				1,000
	To, Bad Debts A/c				3,000
	To, Discount allowed A/c				4,000
	(Transfer of balances for closing the latter accounts)				
	Interest received A/c	Dr.		3,000	
	Discount received A/c	Dr.		3,000	
	To, Profit and Loss A/c				6,000
	(Transfer of balances for closing the former accounts)				
	Profit and Loss A/c	Dr.		35,000	
	To, Capital A/c				35,000
	(Net profit transferred to Capital A/c)				

(iii) Transfer Entries: When it is necessary for an amount or balance of one account to be transferred to some other account, it is done by means of a transfer journal entry in the Journal Proper.

i.e. Transfer of Total Drawings A/c. to Capital A/c

Capital A/c   Dr.

To, Drawings A/c

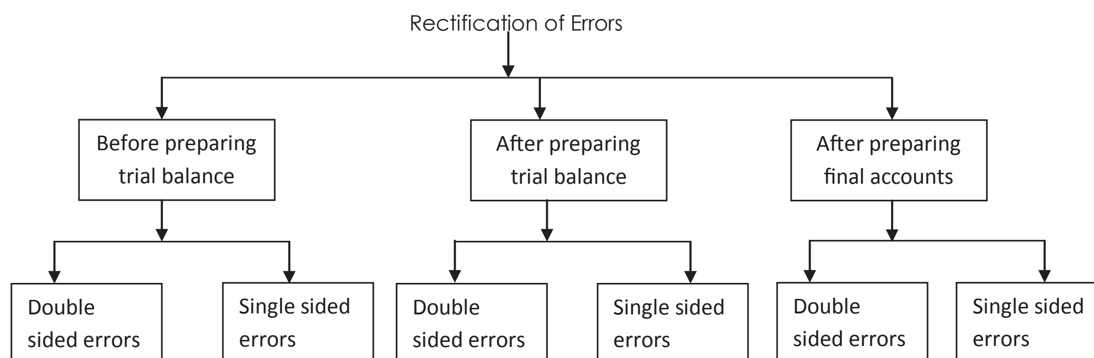
(iv) Rectification Entries (Rectification of errors): These entries are passed when errors or mistakes are discovered in accounting records. These entries are also known as Correction Entries. These entries are also passed in Journal Proper.

In this study note, you were introduced to the reasons why errors could occur and to the fact that while some errors affect trial balance and some errors do not affect it. In this section, we will see in depth how the corrections are made to the wrong entries.

When the errors affecting the T.B. are made, the normal practice is to put the difference to an A/c called as 'Suspense A/c' till the time errors are located. On identification of errors, the one effect goes to the correct A/c and the other effect to the Suspense A/c. This is done for one sided errors e.g. if sales book total is wrongly taken, but individual customers are correctly debited. Such error will cause difference in trial balance as only Sales A/c is wrongly credited. In such cases the rectification entry will be passed through Suspense A/c. In all other cases the rectification is done by debiting or crediting the correct A/c head and by crediting or debiting the wrong A/c head.

Let us recapitulate the types of errors and the ways to rectify them in the following table.

Type of error	Rectification
(a) Error of principle – entering revenue expense as capital expense or vice versa or entering revenue receipt as capital receipt or vice versa.	A journal entry is passed to give correct effect.
(b) Error of Omission – transaction forgotten to be entered in books of accounts.	Simply, the correct entry is passed.
(c) Errors of commission – entering to wrong head of account.	Debit or credit wrong A/c head and post it to correct head.
(d) Compensating errors – more than one error that could compensate effect of each other.	Pass correcting entry
(e) Wrong totaling of subsidiary books	As it affects T.B., pass through Suspense A/c
(f) Posting on wrong side of an A/c	Pass an entry with double effect – one to cancel wrong side and other to give effect on correct side
(g) Posting of wrong amount	Pass entry with differential amount



A. **Before Preparation of Trail Balance**

If errors are detected before the preparation of Trail Balance, the effect of each error should be known.

The errors are of two types: viz

(a) Double Sided Error; (b) Single Sided Error

(a) Double Sided Error:

The following principles should be followed for the purpose.

(i) What was the correct entry?

(ii) What entry had been done?

(iii) Rectifying entry.

Example: Purchased a Building for ₹ 3,00,000 wrongly passed through purchase account.

Solutions:

(i)	Building A/c	Dr.	3,00,000	
	To Cash A/c			3,00,000
(ii)	Purchase A/c	Dr.	3,00,000	
	To Cash A/c			3,00,000
(iii)	Building A/c	Dr.	3,00,000	
	To Purchase A/c			3,00,000

(b) Single Sided Error

Under the circumstances, no separate entry is required but the affected account should be rectified by appropriate posting.

Example: Purchase account was overcast by ₹ 10,000.

Solution:

The correction to be made in Purchase Account in the following manner.

Dr. **Purchase Account** ***Cr.***

Particulars	₹	Particulars	₹
		By Error - Wrong posting	10,000

So, purchase account should be credited by ₹ 10,000.

B. **After Preparation of Trial Balance**

If the errors are detected after the preparations of trial balance, the following procedure should be followed:

(a) Double Sided Errors; and (b) Single Sided Errors.

(a) **Double Sided Errors:**

- Same as method (A) above i.e., before preparation of Trial Balance.

(b) **Single Sided Errors:**

- In case of Single side errors, relevant account to be rectified by applying Suspense Account.

Suspense Account

If the Trial Balance does not agree we cannot prepare final accounts. In order to prepare final account, the difference so appeared in trail balance is to be passed through Suspense Account. When the errors will be located and rectified suspense account will automatically be Nil or closed. The suspense account will appear in the Balance Sheet. When it appears in the debit side of trial balance, the same will appear in the assets side of the Balance Sheet and vice-versa.

Example: Sales Day Book was overcast by ₹ 1,000.

		₹	₹
Sales A/c		Dr. 1,000	
To Suspense A/c			1,000

C. **After Preparation of Final Accounts**

If the errors are detected after the preparation of final accounts the following steps should carefully be followed.

(a) For Double Sided Errors

(i) Same as (A) before preparation of Trial Balance or (B) after preparation of Trail Balance. But all the nominal accounts are to be replaced by Profit and Loss Adjustment Account. And the rest one will be same as (A) or (B) stated earlier.

(ii) Suspense Account will be carried forward to the next year; and

(iii) Real and Personal Accounts are to be carried forward to the next year.

Example: Purchase a Plant wrongly debited to Purchase Account for ₹ 10,000

Solution:

(i) **If after Trial Balance**

Plant A/c Dr.

To Purchase A/c

(ii) **If after Final Account**

Plant A/c Dr.

To Profit and Loss Adjustment A/c

(b) for Single Sided Errors:

Same principle is to be followed like (B) after preparation of Trial Balance and all the nominal account are to be preplaced by Profit and Loss Adjustment Account.

Example – Discount allowed was not posted to discount Account for ₹ 500.

Solution:

(i) **If after Trial Balance**

Discount Allowed A/c Dr.

To Suspense A/c

(ii) **If after Final Account**

Profit and Loss Adjustment A/c Dr.

To Suspense A/c

Illustration 28.

Rectify the following errors assuming that the errors were detected (a) Before the Preparation of Trial Balance; (b) After the preparation of Trial Balance and (c) After the preparation of Final Accounts.

(i) Purchase Plant for ₹ 10,000 wrongly passed through Purchase Account.

(ii) Sales Day Book was cast short by ₹ 1,000.

(iii) Cash paid to Mr. X for ₹ 1,000 was posted to his account as ₹ 100.

(iv) Purchase goods from Mr. T for ₹ 3,500 was entered in the Purchase Day Book as ₹ 500.

(v) Paid salary for ₹ 3,000 wrongly passed through wages account.

Solution:

In the Books of ....

Journal (without narration)

Date	Before preparation of Trial Balance	After preparation of Trial Balance	After preparation of Final Accounts
(i)	Plant A/c Dr. 10,000 To Purchase A/c 10,000	Plant A/c Dr. 10,000 To Purchase A/c. 10,000	Plant A/c Dr. 10,000 To P&L Adjustment A/c 10,000
(ii)	Sales account will be credited with ₹ 1,000	Suspense A/c Dr. 1,000 To Sales A/c 1,000	Suspense A/c Dr. 1,000 To P&L Adjustment A/c 1,000
(iii)	X Account will be debited when ₹ 900	X A/c Dr. 900 To Suspense A/c 900	X A/c Dr. 900 To Suspense A/c 900
(iv)	Purchase A/c Dr. 3,000 To T A/c 3,000	Purchase A/c Dr. 3,000 To T A/c 3,000	P&L Adjustment A/c Dr. 3,000 To T's A/c. 3,000
(v)	Salary A/c Dr. 3,000 To Wages A/c 3,000	Salary A/c Dr. 3,000 To wages A/c 3,000	P&L Adjustment A/c. Dr. 3,000 To P&L Adjustment A/c 3,000

Ilustration 29.

A merchant, while balancing his books of accounts notices that the T.B. did not tally. It showed excess credit of ₹ 1,700. He placed the difference to Suspense A/c. Subsequently he noticed the following errors:

(a) Goods brought from Narayan for ₹ 5,000 were posted to the credit of Narayan's A/c as ₹ 5,500

(b) An item of ₹ 750 entered in Purchase Returns Book was posted to the credit of Pandey to whom the goods had been returned.

(c) Sundry items of furniture sold for ₹ 26,000 were entered in the sales book.

(d) Discount of ₹ 300 from creditors had been duly entered in creditor's A/c but was not posted to discount A/c.

Pass necessary journal entries to rectify these errors. Also show the Suspense A/c.

Solution:

(a) Goods bought from Narayan are posted to credit of his A/c as ₹ 5,500 instead of ₹ 5,000. Here, it is correct to credit Narayan's A/c. But the mistake is extra credit of ₹ 500. This is one sided error, as posting to purchases A/c is correctly made. So the rectification entry will affect the suspense A/c. This needs to be reversed by the rectification entry:

Narayan's A/c	Dr.	500	
To Suspense A/c			500

(b) Goods bought from Pandey were returned back to him. It should have appeared on the debit side of his A/c. For rectifying we will need to debit his A/c with double the amount i.e. ₹ 1500 (₹ 750 to cancel the wrong credit and another ₹ 750 to give effect for correct debit) and the effect will go to Suspense A/c. The correction entry is:

Pandey A/c	Dr.	1,500	
To Suspense A/c			1,500

(c) Sale of furniture was recorded in sales book. What's wrong here? Remember that sales book records sale of goods only and nothing else. Sale of furniture will appear in either cash book (if sold for cash) or journal proper (if sold on credit). Hence, wrong credit to Sales A/c must be removed and credit should be given to Furniture A/c. It's important to note that this rectification entry will not affect the Suspense A/c. The correction entry is:

Sales A/c	Dr	26,000	
To Furniture A/c			26,000

(d) The discount received from creditor is not entered in discount A/c but was correctly recorded in creditors' A/c. This is one sided error and will therefore be routed through suspense for correction. A discount is received; it must be credited being an income.

Suspense A/c	Dr	300	
To Discount received A/c			300

Let us now see how suspense A/c will Look like. Excess credit of ₹ 1,700 in Trial Balance will be shown on the debit side of suspense A/c. This will bring in total debit equal to total credit.

Dr **Suspense Account** **Cr**

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
	To Balance b/d		1,700		By Narayan		500
	To Discount received		300		By Pandey		1,500
			2,000				2,000

Please observe that after correcting passing all rectification entries, the Suspense A/c tallies automatically.

Illustration 30.

Pass necessary journal entries to rectify the following errors:

(a) An amount of ₹ 200 withdrawn by owner for personal use was debited to trade expenses.

(b) Purchase of goods of ₹ 300 from Nathan was wrongly entered in sales book.

(c) A credit sale of ₹ 100 to Santhanam was wrongly passed through purchase book.

(d) ₹ 150 received from Malhotra was credited to Mehrotra.

(e) ₹ 375 paid as salary to cashier Dhawan was debited to his personal A/c.

(f) A bill of ₹ 2,750 for extension of building was debited to building repairs A/c

(g) Goods of ₹ 500 returned by Akashdeep were taken into stock, but returns were not posted.

(h) Old furniture sold for ₹ 200 to Sethi was recorded in sales book.

(i) The period end total of sales book was under cast by ₹ 100

(j) Amount of ₹ 80 received as interest was credited to commission.

Solution:

Sl No.		Particulars		Debit (₹)	Credit (₹)
(a)	**Wrong Entry**	Trade Expenses	Dr	200	
		To Cash			200
	Correct entry	Drawings	Dr	200	
		To cash			200
	Rectification entry	Drawings	Dr	200	
		To Trade Expenses			200
(b)	**Wrong Entry**	Nathan	Dr	300	
		To Sales			300
	Correct entry	Purchases	Dr	300	
		To Nathan			300
	Rectification entry	Purchases	Dr	300	
		Sales	Dr	300	
		To Nathan			600
(c)	**Wrong Entry**	Purchases	Dr	100	
		To Santhanam			100
	Correct entry	Santhanam	Dr	100	
		To Sales			100
	Rectification entry	Santhanam	Dr	200	
		To Sales			100
		To Purchases			100
(d)	**Wrong Entry**	Cash	Dr	150	
		To Mehrotra			150
	Correct entry	Cash	Dr	150	
		To Malhotra			150
	Rectification entry	Mehrotra	Dr	150	
		To Malhotra			150
(e)	**Wrong Entry**	Dhawan	Dr	375	
		To cash			375
	Correct entry	Salary	Dr	375	
		To cash			375
	Rectification entry	Salary	Dr	375	
		To Dhawan			375
(f)	**Wrong Entry**	Building Repairs	Dr	2,750	
		To Cash			2,750
	Correct entry	Buildings	Dr	2,750	
		To Cash			2,750
	Rectification entry	Buildings	Dr	2,750	
		To Building Repairs			2,750
(g)	**Wrong Entry**	No entry passed			
	Correct entry	Sales Returns	Dr	500	
		To Akashdeep			500
	Rectification entry	Sales Returns	Dr	500	
		To Asashdeep			500
(h)	**Wrong Entry**	Sethi	Dr	200	
		To Sales			200

Sl No.		Particulars		Debit (₹)	Credit (₹)
	Correct entry	Sethi	Dr	200	
		To Furniture			200
	Rectification entry	Sales	Dr	200	
		To Furniture			200
(i)	**Wrong Entry**	No entry passed			
	Correct entry	Suspense	Dr	100	
		To Sales			100
	Rectification entry	Suspense	Dr	100	
		To Sales			100
(j)	**Wrong Entry**	Cash	Dr	80	
		To Commission			80
	Correct entry	Cash	Dr	80	
		To Interest			80
	Rectification entry	Commission	Dr	80	
		To Interest			80

EFFECT OF ERRORS ON PROFIT OR LOSS

Some errors may affect the profit or loss for the period while other won't. How to find it out? Remember, the P & L A/c reflects items of incomes, gains, expenses and losses. All these accounts are nominal accounts. When an error occurs which affects a nominal account, it will affect profit or loss otherwise not. So, errors that affect real and personal accounts will not affect profit or loss.

Illustration 31.

Rectifying the following errors by way of journal entries and work out their effect on profit or loss of the concern:

a. Return inward book was cast short by ₹ 500.

b. ₹ 300 received from Ram has been debited to Mr. Shyam.

c. Wages paid for the installation of a machine debited to wages account for ₹ 1,000.

d. A purchase made for ₹ 1,000 was posted to purchase account as ₹ 100.

e. Purchase of furniture amounting to ₹ 3,000 debited to purchase account.

f. Goods purchased for proprietor's use for ₹ 1,000 debited to purchase account.

Solution:

In the Books of …………

Journal

Date	Particulars		L.F	Dr. Amount (₹)	Cr. Amount (₹)
(a)	Return Inward A/c	Dr.		500	
	To, Suspense A/c				500
	(Return Inward Book was cast short, now rectified.)				
(b)	Suspense A/c	Dr.		600	
	To, Ram A/c				300
	To Shyam A/c				300
	(Received from Mr. Ram has been debited to Mr. Shyam A/c, now rectified.)				

(c)	Machinery A/c Dr. To, Wages/c (Wages paid for maintenance of machinery debited to Wages A/c, now rectified.)		1,000	1,000
(d)	Purchase A/c Dr. To, Suspense A/c (Purchase account was short by ₹ 900, now rectified.)		900	900
(e)	Furniture A/c Dr. To, Purchase A/c (Furniture purchased wrongly debited to purchase account, now rectified)		3,000	3,000
(f)	Drawings A/c Dr. To, Purchase A/c (Goods purchased for proprietor's use, debited to purchase account, now rectified.)		1,000	1,000

Effect on Profit

Items	Particulars	Increase (₹)	Decrease (₹)
(a)	Decrease in Profit		500
(b)	No Effect in Profit	-	-
(c)	Increase in Profit	1,000	-
(d)	Decrease in Profit		900
(e)	Increase in Profit	3,000	-
(f)	Increase in Profit	1,000	-
	Total	5,000	1,400
	Increase in Profit	-	**3,600**
		5,000	**5,000**

Illustration 32.

The books of M/s Shakti trading for the year ended 31st March 2013 were closed with a difference that was posted to Suspense A/c. The following errors were found subsequently:

(a) Goods of ₹ 12,500 returned to Thick & Fast Corporation were recorded in Return Inward book as ₹ 21,500 and from there it was posted to the debit of Thick & Fast Corporation.

(b) A credit sale of ₹ 7,600 was wrongly posted as ₹ 6,700 to customer's A/c in sales ledger.

(c) Closing stock was overstated by ₹ 5,000 being totaling error in the schedule of inventory.

(d) ₹ 8900 paid to Bala was posted to the debit of Sethu as ₹ 9,800

(e) Goods purchased from Evan Traders for ₹ 3,250 was entered in sales book as ₹ 3,520

(f) ₹ 1,500, being the total of discount column on the payment side of the cash book was not posted.

Rectify the errors and pass necessary entries giving effects to Suspense A/c and P & L Adjustment A/c.

Solution:

(a) There are 2 errors: one – return outward is wrongly recorded as return inward and two – amount is also recorded wrongly. First, we need to remove extra debit to Thick & Fast corporation i.e. ₹ 9,000 (21,500-12,500) by crediting it. Also we need to remove wrong credit of ₹ 21,500 in sales return by debiting it and credit ₹ 12,500 to Purchase returns A/c.

The rectification entry will be:

Suspense A/c	Dr.	21,500	
To Thick & Fast Corp			9,000
To P & L Adjustment A/c			12,500

(b) In this case, error has occurred only in customer's A/c. hence, profit or loss won't be affected and the P & L Adjustment A/c will not be in picture. As customer's A/c is debited for ₹ 6,700 instead of ₹ 7,600, it needs to be corrected.

The rectification entry will be:

Sundry Debtors A/c	Dr.	900	
To Suspense A/c			900

(c) Over casting of closing stock had affected profit which must be reduced through P & L Adjustment A/c.

The rectification entry is:

P & L Adjustment A/c	Dr.	5,000	
To Suspense A/c			5,000

(d) As only personal accounts are affected, there won't be an effect on Profits. So rectification will be done through Suspense A/c only. The rectification entry is:

Bala A/c	Dr.	8,900	
Suspense A/c	Dr.	900	
To Sethu A/c			9,800

(e) This transaction involves correction of purchase as well as sales, and hence will affect profit. As the purchases were booked as sales, we will need to cancel sales by debiting and freshly debit purchase. So overall effect on profit will be 3,250 + 3,520 i.e. 6,770. The rectification enry will be:

P & L Adjustment A/c	Dr.	6,770	
To Evan Traders			6,770

(f) If discount is appearing on payment side of cash book, it indicates discount received while making payment and is an item of income. Hence, it will affect profit. The accounting entry will be:

Suspense A/c	Dr.	1,500	
To P & L Adjustment A/c			1,500

Illustration 33.

You are presented with a trial balance of S Ltd as on 30.06.2013 showing the credit is in exces by ₹ 415 which was been carried to Suspense Account. On a close scrutiny of the books, the following errors were revealed:

a. A cheque of ₹ 3,456 received from Sankar after allowing him a discount of ₹ 46 was endorsed to Sharma in full settlement for ₹ 3,500. The cheque was finally dishonored but no entries are passed in the books.

b. Goods of the value of ₹ 230 returned by Sen were entered in the Purchase Day Book and posted therefrom to Das as ₹ 320.

c. Bad debts aggregating ₹ 505 written off during the year in the Sales Ledger but were not recorded in the general ledger.

d. Bill for ₹ 750 received from Mukherjee for repairs to Machinery was entered in the Inward Invoice Book as ₹ 650.

e. Goods worth ₹ 1,234 Purchased from Mr. Y on 28.6.2013 had been entered in Day Book and credited to him but was not delivered till 5th June 2013. Stock being taken by the purchase on 30.06.2013. The title of the goods was, however, passed on 28.06.2013.

f. ₹ 79 paid for freight on Machinery was debited to freight account as ₹ 97.

You are required to pass the necessary journal entries for correcting the books.

Solution:

In the books of S Ltd.
Journal

Date	Particulars	L.F.	Dr. Amount (₹)	Cr. Amount (₹)
(a)	Sankar A/c Dr. Discount Received A/c Dr. To, Sharma A/c To Discount Allowed A/c (Cheque received from Sankar was endorsed to Sharma after allowing discount ₹46 , it was dishonored, now rectified)		3,502 44	 3500 46
(b)	Return Inward A/c Dr. Das A/c Dr. To, Purchase A/c To, Sen A/c To Suspense A/c (Goods returned by sen for ₹ 230 wrongly recorded in Purchase Day Book as an credit to Das as ₹ 320, now rectified.)		230 320	 230 230 90
(c)	Bad debts A/c Dr. To Suspense A/c (Bad debts written off but not recorded, now rectified)		505	 505
(d)	Repairs A/c Dr. To, Purchase A/c To, Mukherjee A/c (Repairs of machinery for ₹ 750, wrongly recorded as ₹ 650 on Purchase A/c, now rectified.)		750	 650 100
(e)	Goods- in- Transit A/c Dr. To Trading A/c (Goods were in Transit which were not considered, now rectified)		1,234	 1,234
(f)	Machinery A/c Dr Suspense A/c To Freight A/c (amount paid for freight on machinery was wrongly debited to freight account, now rectified)		79 18	 97

Illustration 34.

The books of accounts of A Co. Ltd. for the year ending 31.3.2013 were closed with a difference of ₹21,510 in books carried forward. The following errors were detected subsequently:

(a) Return outward book was under cast by ₹ 100.

(b) ₹ 1,500 being the total of discount column on the credit side of the cash book was not posted.

(c) ₹ 6,000 being the cost of purchase of office furniture was debited to Purchase A/c.

(d) A credit sale of ₹ 760 was wrongly posted as ₹ 670 to the customers A/c. in the sales ledger.

(e) The Sales A/c was under casted by ₹ 10,000 being the carry over mistakes in the sales day book.

(f) Closing stock was over casted by ₹ 10,000 being casting error in the schedule or inventory.

Pass rectification entries in the next year.

Prepare suspense account and state effect of the errors in determination of net profit of last year.

Solution:

In the Books of A Co. Ltd.

Journal

			Dr.	Cr.
Date	**Particulars**	**L/F**	**Amount (₹)**	**Amount (₹)**
(a) 2013 April 1	Suspense A/c Dr. To Profit & Loss Adjustment A/c (Returns outward book was under cast now rectified).		100	100
(b)	Suspense A/c Dr. To Profit & Loss Adjustment A/c (Discount received was not recorded, now rectified).		1,500	1,500
(c)	Office Furniture A/c Dr. To Profit & Loss Adjustment A/c (Office furniture purchased wrongly debited to Purchase A/c, now rectified.)		6,000	6,000
(d)	Debtors' A/c Dr. To Suspense A/c (Debtors account was posted ₹ 670 in place of ₹ 760, now rectified.)		90	90
(e)	Suspense A/c Dr. To Profit & Loss Adjustment A/c (Sales account was under casted, now rectified)		10,000	10,000
(f)	Profit & Loss Adjustment A/c Dr. To Closing Stock A/c (Closing Stock was overcastted, now rectified.)		10,000	10,000

Dr. **Suspense Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 April 1	To Profit & Loss Adjustment A/c To Pofit & Loss Adjustment A/c To Pofit & Loss Adjustment A/c To Pofit & Loss Adjustment A/c	100 1,500 10,000 10,000	2013 April 1	By Difference in Trial Balance By Debtors A/c.	21,510 90
		21,600			21,600

Effect on Profit

	Increase (+) ₹	Decrease (-) ₹
Item (a)………………………………..	-	100
(b)………………………………..	-	1,500
(c)………………………………..	-	6,000
(d) No effect	-	-
e)………………………………..	-	10,000
(f)………………………………..	10,000	-
	10,000	17,600
Profit will be decreased by	7,600	-
	17,600	17,600

Illustration 35.

The Trial Balance of a concern has agreed but the following mistakes were discovered after the preparation of final Accounts.

(a) No adjustment entry was passed for an amount of ₹ 2,000 relating to outstanding rent.

(b) Purchase book was overcast by ₹ 1,000.

(c) ₹ 4,000 depreciation of Machinery has been omitted to be recorded in the book.

(d) ₹ 600 paid for purchase of stationary has been debited to Purchase A/c.

(e) Sales books was overcast by ₹ 1,000.

(f) ₹ 5,000 received in respect of Book Debt had been credited to Sales A/c.

Show the effect of the above errors in Profit and Loss Account & Balance Sheet.

Solution:

Effects of the errors in profit and loss A/c. and Balance Sheet

Profit & Loss A/c.	Balance Sheet
(a) Profit was overstated by ₹ 2,000	(a) Capital was also overstated by ₹ 2,000 & outstanding Liability was understated by 2,000.
(b) Gross profit was under stated by ₹ 1,000 & also the Net Profit.	(b) Capital was understated by ₹ 1,000.
(c) Net Profit was overstated by ₹ 4,000.	(c) Machinery was overstated by ₹ 4,000 & so the Capital A/c was also overstated by ₹ 4,000.
(d) No effect on Net Profit.	(d) No effect in Balance Sheet.
(e) Gross Profit and Net Profit were overstated by ₹ 1,000.	(e) Capital was overstated by ₹ 1,000.
(f) Gross Profit & Net Profit were overstated by ₹ 5,000.	(f) Capital & Sundry Debtors were overstated by ₹ 5,000.

(v) Adjusting Entry

Adjusting Entries are passed in the journal to bring into the books of accounts certain unrecorded items like closing stock, depreciation on fixed assets, etc. These are needed at the time of preparing the final accounts.

E.g. Depreciation A/c Dr.
To, Fixed Assets A/c

Study Note - 2

ACCOUNTING STANDARDS

This Study Note includes			
2.1	AS-1	:	Disclosure of Accounting Policies
2.2	AS-2	:	Valuation of Inventories
2.3	AS-4	:	Contingencies and Events Occuring after The Balance Sheet Date
2.4	AS-5	:	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
2.5	AS-10	:	Accounting For Fixed Assets
2.6	AS-11	:	The Effects of Changes in Foreign Exchange Rates
2.7	AS-15	:	Employee Benefits
2.8	AS-16	:	Borrowing Costs

ACCOUNTING STANDARD

Accounting standard is a method or an approach established and issued by recognized expert accountancy body. It is used in preparing financial statement viz., Profit & Loss Account and Balance Sheet of various concerns operating different fields.

The main purpose of formulating accounting standard is to standardize the diverse accounting policies with views eliminating to the extent possible the incomparability of information provided in financial statements within or across the organization. So that the users of aforesaid statements don't get confused while evaluating the results to take various decisions viz., to subscribe in equality shares, or subscribe in debenture of that concern.

To discuss on whether such standards are necessary in present days it will be beneficial to go through the advantages and disadvantages which they are said to provide.

ADVANTAGES OF ACCOUNTING STANDARD

1. It provides the accountancy profession with useful working rules.
2. It assists in improving quality of work performed by accountant.
3. It strengthens the accountant's resistance against the pressure from directors to use accounting policy which may be suspected in that situation in which they perform their work.
4. It ensures the various users of financial statements to get complete crystal information on more consistent basis from period to period.
5. It helps the users compare the financial statements of two or more organisaitons engaged in same type of business operation.

DISADVANTAGES OF ACCOUNTING STANDARD

1. Users are likely to think that said statements prepared using accounting standard are infallible.
2. They have been derived from social pressures which may reduce freedom.
3. The working rules may be rigid or bureaucratic to some user of financial statement.
4. The more standards there are, the more costly the financial statements are to produce.

Accounting Standard No.	Title of Accounting Standard
Mandatory Standards	
AS-1	Disclosure of Accounting Policies
AS-2	Valuation of Inventories(Revised)
AS- 3	Cash Flow Statement
AS-4	Contingencies and Events Occurring after the Balance Sheet Date
AS-5	Net Profit or Loss for the Period, Prior Period Items and Change in Accounting Policies
AS-6	Depreciation Accounting
AS-7	Construction Contracts
AS- 8	Accounting for Research and Development (withdrawn)
AS-9	Revenue Recognition
AS-10	Accounting for Fixed Assets
AS-11	Effects of Changes in Foreign Exchange Rates
AS-12	Accounting for Government Grants
AS-13	Accounting for Investments
AS-14	Accounting for Amalgamation
AS-15	Employee Benefits
AS-16	Borrowing Costs
AS-17	Segment Reporting
AS-18	Related Party Disclosure
AS-19	Accounting for Leases
AS-20	Earnings Per Share
AS-21	Consolidated Financial Statements
AS-22	Accounting for Taxes on Income
AS-23	Accounting for Investment in Associates in Consolidated Financial Statements
AS-24	Discontinuing Operations
AS-25	Interim Financial Reporting
AS-26	Intangible Assets
AS-27	Financial Reporting of Interest in Joint Venture
AS-28	Impairment of Assets
AS 29	Provisions, Contingent Liabilities and Contingent Assets
Non-Mandatory Standards	
AS 30	Financial Instruments: Recognition and Measurement
AS 31	Financial Instruments: Presentation
AS 32	Financial Instruments: Disclosures

2.1 AS 1: DISCLOSURE OF ACCOUNTING POLICIES

This standard deals with disclosure of significant accounting policies followed in the preparation and presentation of the financial statements and is mandatory in nature.

The accounting policies refer to the specific accounting principles adopted by the enterprise.

Proper disclosure would ensure meaningful comparison both inter/intra enterprise and also enable the users to properly appreciate the financial statements.

Financial statements are intended to present a fair reflection of the financial position financial performance and cash flows of an enterprise.

Areas involving different accounting policies by different enterprises are:

- Methods of depreciation, depletion and amortization
- Treatment of expenditure during construction
- Treatment of foreign currency conversion/translation.
- Valuation of inventories
- Treatment of intangible assets
- Valuation of investments
- Treatment of retirement benefits
- Recognition of profit on long-term contracts
- Valuation of fixed assets
- Treatment of contingent liabilities

Fundamental Accounting Assumptions

Certain basic assumptions, in the preparation of financial statements are accepted and their use are assumed, no separate disclosure is required except for noncompliance in respect of —

(a) Going Concern: continuing operation in the foreseeable future and no interim necessity of liquidation or winding up or reducing scale of operation.

(b) Consistency: accounting policies are consistent from one period to another

(c) Accrual:

 (i) Revenues and costs are accrued i.e. they are earned or incurred (not actually received or paid) and recorded in the financial statements

 (ii) Extends to matching revenue against relevant costs.

Factors governing the selection and application of accounting policies are:

Prudence : Generally maker of financial statement has to face uncertainties at the time of preparation of financial statement. These uncertainties may be regarding collectability of receivables, number of warranty claims that may occur. Prudence means making of estimates, which is required under conditions of uncertainty.

Substance over form : It means that transaction should be accounted for in accordance with actual happening and economic relity of the transactions not by its legal form. Like in hire purchaser if the assets are purchased on hire purchase by the hire purchaser the assets are shown in the books of hire purchaser in spite of the fact that the hire purchaser is not the legal owner of the assets purchased. Under the purchase the purchaser, becomes the owner only on the payment of last instalment. Therefore the legal form of the transaction is ignored and the transaction is accounted as per as substance.

Materiality : Financial Statement should disclose all the items and facts which are sufficient enough to influence the decisions of reader or /user of financial statement.

(a) As to the disclosure of all material items, individually or in aggregate in the context of fair presentation of financial statements as a whole if its omission or misstatement could influence the economic or financial decision of the user relying upon the financial statements.

(b) Depends on the size of the items or errors judged in the particular circumstances of its omissions or misstatements.

(c) Is a cutoff point rather than being a primary qualitative characteristic which information must have.

(d) This is a matter of judgment, varies from one entity to another and over one period to another.

AS-1 requires that all "significant" (i.e. only accounting policy that is useful for an understanding by the user of the financial statements) accounting policies adopted in the preparation and presentation of financial statements, should be disclosed by way of 'Note in one place as the note No I (this is the basis of the preparation of financial statements.)

Changes in Accounting Policies :

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in the later period should be disclosed.

In the case of a change in accounting policies, having material effect in the current period, the amount by which any item in the financial statements, is affected by such change should also be disclosed to the extent as ascertainable, otherwise the fact that the effect is not (wholly or partially) ascertainable, should be disclosed.

The following are not considered as changes in accounting policies :

(a) Accounting policies adopted for events or transactions that differ in substance at present (introducing Group Gratuity Scheme for employees in place of adhoc ex-gratia payment earlier followed.)

(b) Accounting policies pertains to events or transactions which did not occur previously or that were immaterial.

Illustration 1.

Jivandeep Ltd. had made a right issue in 2010. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to be ended on 31st March 2012. The draft results for the year prepared on the hitherto followed accounting policies and presented for perusal of the Board of Directors showed a deficit of ₹ 10 crores. The Board, in consultation with the Managing Director, decided on the following:

(i) Value year-end inventory at works cost (₹50 crores) instead of the hitherto method of valuation of inventory at Prime Cost (₹ 30 crores).

(ii) Provide depreciation for the year on straight line basis or account of substantial additions in gross block during the year, instead of on the Reducing Balance Method, which had been hitherto adopted. As a consequence, the charge for depreciation at ₹ 27 crores is lower than the amount of ₹ 45 crones -which would have been provided had the old method been followed-by ₹ 18 crores.

(iii) Not to provide for "after-sales expenses" during the warranty period. Till the last year, provision at 2% on sales used to be made under the concept of "matching of cost against revenue" and actual expenses used to be charged against the provision. The Board now decided to account for expenses as and when actually incurred. Sales during the year total to ₹ 600 crores.

(iv) Provide for permanent fall in the value of investment-which fall had taken place over the past 5 years-the provision being ₹ 10 crores.

As chief accountant of the company, you are asked by the Managing Director to draft the Notes on Accounts for inclusion in the annual report for 2011-2012.

Solution:

According to AS 1: "in the case of a change in accounting policies which has a material effect in the current period should be disclosd, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable wholly or in part, the fact should be indicated." Naturally, the **Notes on Accounts** must disclose the change.

Notes on Accounts

(i) Till last year, it was the practice of valuing inventory at prime cost but during the year the same was valued at works cost. Due to this change the closing inventory was valued at ₹ 50 crores and, accordingly, profit was increased by ₹ 20 crores (i.e. ₹ 50 crores - ₹ 30 crores) due to the change of the method of valuation.

(ii) During the year the company decided to change the method of providing for depreciation from reducing balance method to straight line method. Due to this change, the amount of depreciation was undercharged i.e., instead of charging ₹ 45 crores it was charged by ₹ 27 crores and, as a consequence, the profit was increased by ₹ 18 crores (i.e., ₹ 45 crores minus ₹ 27 crores).

(iii) It was the practice of the company to make provision of @ 2% on sales for 'After-Sales expenses' during the warranty period. It may be assumed that as a result of improved techniques and methods in production the possibility of defects became very rare. Consequently, the company took decision not to make any provision for after -sales expense' during warranty period. As a result of this change, the profit would be increased by ₹ 12 crores.

(iv) As a result of permanent fall in the value of investments which took place over the last 5 years the company decided to make provision to the extent of ₹ 10 crores. Due to this effect the profit would be reduced by ₹ 10 crores.

Illustration 2.

Which one is the correct one? Fundamental accounting assumptions as per AS 1 are:

(a) Going Concern, Matching and Consistency;

(b) Money Measurement, Going Concern and Prudence;

(c) Accounting Period, Going Concern and Entity Concept; and

(d) Going Concern, Consistency and Accruals.

Solution:

As per As 1, the fundamental accounting assumptions are: Going Concern, Consistency and Accruals.

Illustration 3.

Explain, in short, the relevant Disclosures of Accounting Policies as per AS 1.

Solution:

As per AS 1, the Disclosures of Accounting Policies are: All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

If the fundamental accounting assumptions, viz, Going Concern, Consistency and Accruals, are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

Illustration 4.

Explain the methods/criteria for the selection and application of Accounting Policies.

Solution:

The major considerations governing the selection and application of accounting policies are:

Prudence – Generally maker of financial statement has to face uncertainties at the time of preparation of financial statement. These uncertainties may be regarding collectability of recoverable, number of warranty claims that may occur. Prudence means making of estimates that are required under conditions of uncertainty.

Substance over form – It means that transaction should be accounted for in accordance with actual happening and economic reality of the transactions not by its legal form.

Materiality – Financial Statement should disclose all the items and facts which are sufficient enough to influence the decisions of reader or/ user of financial statement.

2.2 AS 2 : VALUATION OF INVENTORIES

The objective of this standard is to formulate the method of computation of cost of inventories/stock, determine the value of closing stock/inventory at which, the inventory is to be shown in balance sheet till it is not sold and recognised as revenue.

At the outset AS-2 excludes the following though appears to be inventory in common parlance:

(a) Work-in-progress in construction contract and directly related service contract (ref: AS-7), inventories not forming part of construction work-in-progress will attract AS-2

(b) Work-in-progress arising in the ordinary course of business of service providers.

(c) Shares, debentures and other financial instruments held as stock-in-trade (ref: AS-13 as Current Investments)

(d) Producer's inventories like livestock, agricultural and forest product, mineral oil/gasses as measured at net realizable value as per trade practices at certain stage of production.

Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

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

Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only

in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

Measurement of inventories

Inventories should be valued at lower of cost and net realizable value.

Valuation of Inventories requires (i) determination of cost of inventories, (ii) Determination of net realizable value of inventories, and comparison between the two.

The following terms are used in this Standard with the meanings specified:

Cost of inventories includes:

- **Cost of Purchase**
- **Cost of Conversion**
- **Other costs**

Costs of Purchase

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

Costs of Conversion

The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials.

The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual usage of the production facilities.

A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other Costs

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Exclusions from the Cost of Inventories

In determining the cost of inventories in it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs.

Cost Formulas

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. However, when there are large numbers of items of inventory which are ordinarily interchangeable, specific Identification of costs is inappropriate since, in such circumstances, the method of selecting those items that remain in inventories could be used to predermined effects on profit obtain loss.

The cost of inventories, other than those dealt with specific projects should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

A variety of cost formulas is used to determine the cost of inventories other than those for which specific identification of individual costs is appropriate. The formula used in determining the cost of an item of inventory needs to be selected with a view to provide the fairest possible approximation to the cost incurred in bringing the item to its present location and condition. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

Techniques for the Measurement of Cost

Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency

and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the

inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

Disclosure under AS-2

(a) The accounting policy adopted in measuring inventories

(b) The cost formula used

(c) Carrying amount (value) of inventory commonly classified under Raw Material and Components, Work-in-Progress, Finished goods and Stores, Spares and Loose tools.

(d) Schedule-VI and AS-2 disclosure are at par

Illustration 5.

Flow do you deal with the following?

On 31.3.2012, the closing stock of Gourav Ltd. includes 10,000 units costing @ ₹ 10 i.e., ₹ 1,00,000. But the current market price as on that date was @ ₹ 9 i.e., ₹ 90,000.

Solution:

According to AS 2, Valuation of Inventories will be lower of cost and Net Realisable Value. In the present case the cost is ₹(10×10,000) i.e. ₹1,00,000 and the Net Realisable Value is ₹90,000. Therefore the inventories will be valued at ₹90,000 i.e. at Net Realisable Value.

Illustration 6.

From the following information presented by P Ltd. ascertain the value of stock to be included in Balance Sheet:

Cost Price of certain stock amounted to ₹ 60,000; being obsolete, it can be used for production purposes after incurring ₹ 10,000 for modification. The same could be used as a by-product for an existing product, the purchase price for the same amounts to ₹ 40,000.

Solution:

Cost price of the product (given) ₹ 60,000.

Net Realisable Value of the product ₹ 40,000 – ₹ 10,000 = ₹ 30,000. Inventories are valued at lower of Cost and Net Realisable value. Hence, ₹ 30,000 should be treated as the Value of Stock to be included in Balance Sheet.

Illustration 7.

How will you deal with the following situation?

“A company deals in purchase and sale of timber and has included notional interest charges calculated (on the paid-up share capital and free reserves) in the value of stock of timber as at the Balance Sheet date as part of cost of holding the timber”.

Solution:

According to para 12 of AS 2, **Valuation of Inventories**, interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories. Hence, the valuation of closing stock of timber cannot be considered as it is not in conformity with AS 2.

Illustration 8.

The company deals in three products A, B and C which are neither similar nor interchangeable. At the time of closing of its account for the year 2012-13, the historical cost and net realisable value of the items of closing stock are determined as:

Items	Historical cost (₹ In lakhs)	Net Realisable Value (₹ In lakhs)
A	40	28
B	32	32
C	16	24

What will be the value of closing stock?

Solution:

According to AS 2, **Valuation** of **Inventories,** para 5, inventories should be valued as per the cost or net realisable value, whichever is lower. Thus, inventories should be valued as per itemwise as:

Items	Historical cost (₹ In lakhs)	Net Realisable Value (₹ In lakhs)	Valuation of Closing Stock (₹ In lakhs)
A	40	28	28
B	32	32	32
C	16	24	16
	88	84	76

So, Closing Stock should be valued at ₹ 76 lakhs.

Illustration 9.

Z Co. Ltd. purchased goods at the cost of ₹ 40 lakhs in Oct. 2012, Till March 2013, 75% of the stocks were sold. The company wants to disclose closing stock at ₹ 10 lakhs. The expected sales value is ₹ 11 lakhs and a commission at 10% on sale is payable to the agent.

Advise: What is the correct closing stock to be disclosed as at 31.3.2013?

Solution:

The stand of the company to disclose the closing stock at ₹ 10 lakhs is not in line with AS-2. As per AS 2-Valuation of Inventories, para 5, inventory should be valued as per cost price or net realisable value, whichever is lower. In the problem, cost price is ₹ 10 lakhs, but the net realisable value is ₹ 11,00,000 x 90% = ₹ 9,90,000. So, the value of closing stock should be taken as ₹ 9,90,000 being the lower.

Illustration 10.

How would you deal with the following in the annual accounts of a company for the year ended 31.3.2013?

"The company has to pay delayed cotton clearing charges over and above the negotiated price for asking delayed delivery of cotton from the supplier's godown. Up to 2011-12, the company has

regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2012-13. This would result into decrease in profit by ₹ 7.60 lakhs."

Solution:

As per para 12, AS 2, *Valuation of Inventories,* interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories. Thus, it becomes quite clear that delayed cotton clearing charges which were treated in the nature of interest must not be included while valuing closing stock as per the provision of AS 2 and it is not in compliance with AS 2 which was done up to 2010-11.

But from year 2011-12, the company decided to change the earlier view i.e. they decided to exclude the same from the valuation of closing stock which is, no doubt, in compliance with AS 2.

As a result of change in accounting policy regarding valuation of stock the profit was reduced by is. 7.60 lakhs which must be disclosed in the financial statement or per AS 1 as Notes to Account.

Illustration 11.

Sonar Bhandar deals in old colour TVs. It has 4 TVs the particulars of which are given below :

You are asked to compute the value of stock to be included, in Balance Sheet for the year ended 31st March 2013:

TVs	Onida ₹	Philips ₹	EC ₹	Sony ₹	Total ₹
Cost Price	10,000	20,000	35,000	50,000	1,15,000
(Expenses incurred to bring into salable conditions)	3,000	2,000	5,000	-	10,000
Net Realisable Value	18,000	30,000	36,000	55,000	1,39,000

Solution:

As per para 5, AS 2 Valuation of Inventories, inventories should be valued at the lower of cost or net realisable value on an item-by-item basis, which are:

TVs	Onida ₹	Philips ₹	EC ₹	Sony ₹	Total ₹
Cost Price (including expenses)	13,000	22,000	40,000	50,000	1,25,000
Net Realisable Value	18,000	30,000	36,000	55,000	1,39,000
Value of Stock	13,000	22,000	36,000	50,000	1,21,000

Value of Stock to be included in Balance Sheet will be ₹ 1,21,000.

Illustration 12.

The following particulars are presented by M Ltd. (deals in clothing) as on 31.3.2013:

Compute the value of stock as per AS 2.

Stock held by M Ltd.	₹
(Cost Price)	10,550
(Net Realisable Value)	11,500

The details of such stocks were:

	Cost Price ₹	Net Realisable Value ₹
Cotton	5,600	4,960
Woolen	3,450	4,540
Synthetic	1,500	2,000
	10,550	11,500

Solution:

Valuation of Stock as per AS 2

As per AS 2, para 21, inventories are usually valued at lower of cost and net realisable value on an item-by-item basis:

	Cost Price ₹	Net Realisable ₹	Value of Closing Stock ₹
Cotton	5,600	4,960	4,960
Woolen	3,450	4,540	3,450
Synthetic	1,500	2,000	1,500
	10,550	11,500	9,910

Hence, value of stock will be considered for ₹ 9,910 as per AS 2.

Illustration 13.

The total stock of A Ltd. as on 31.3.2013 was ₹ 5,00,000 of which stock amounting to ₹ 31,000 were not ascertained as per AS 2.

Compute the value of the said stocks as per AS 2 for inclusion in financial statements as on that date.

Type of Product	Cost of Materials ₹	Production Expenses incurred ₹	Selling and Distribution expense to be incurred ₹	Estimated Selling Price ₹
P	10,000	2,000	1,000	15,000
S	5,000	---	500	4,500
T	12,000	3,000	2,000	18,000
	27,000	5,000	3,500	37,500

Solution:

As per para 21, AS 2, inventories are usually written-down to net realisable value on item-by-item basis. Thus, value of stock will be computed as:

Type of Product	Cost Price (including Production Exp.) ₹	Net Realisable Value (excluding Selling & Distribution Expenses from Selling Price) ₹	Value of Stock to be taken (lower of Cost Price & Net Realisable Value) ₹
P	12,000 (₹10,000 + ₹ 2,000)	14,000 (₹15,000 – ₹ 1,000)	12,000
S	5,000 (—)	4,000 (₹ 4,500 – ₹ 500)	4,000
T	15,000 (₹12,000 + ₹ 3,000)	16,000 (₹18,000 – ₹ 2,000)	15,000
			31,000

So, Value of Stock will be ₹ 31,000 for inclusion in financial statements as per AS 2.

Illustration 14.

X Ltd. presented the following particular as on 31.3.2013: Compute the value of stock as on 31.3.2013.

The total cost of product:

	Cost per unit ₹
Cost of materials (₹12 each)	50
Manufacturing inputs	30
Total Cost	80
Profit	20
Selling Price	100

On 31.3.2013, selling price has gone down suddenly from ₹ 100 to ₹ 70. Price of raw material has also gone down to ₹ 8 each. X Ltd. had in its stock 6,000, units of materials which was bought as per the above rate on the same date.

Solution:

according to para 24, AS 2, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written-down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value. In this case, the total cost of ₹ 80 exceeds the net realisable value, i.e., selling price, of ₹ 70 (as the price of raw materials had gone down from ₹ 12 to ₹ 8). So, inventories should be valued @ ₹ 70 each and, as such, the total value of stock would be ₹4,20,000 (i.e., ₹ 6,000 units x ₹ 70).

Illustration 15.

State with reference to accounting standards how you will value the inventories in the following cases:

(i) Raw materials were purchased at ₹ 100 per kilo. Prices of raw materials are on the decline. The finished goods in which the raw materials is incorporated is expected to be sold at below cost. 10,000 Kgs. of raw materials is on stock at the year end. Replacement cost is ₹ 80 per kg.

(ii) In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in a wastage of 300 MT. Cost per MT of input is ₹ 1,000. The entire quantity of waste is on stock at the year-end.

(iii) Per kg of finished goods consisted of:

	₹
Material Cost	100
Direct Labour	20
Direct Variable Production Overhead	10

Fixed production charges for the year on normal capacity of one lakh kg is ₹ 10 lakhs. 2,000 kg of finished goods are on stock at the year end.

Solution:

(i) As per para 24, AS 2, materials and other supplies held for use in the production of inventories are not written-down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value.

In this case, cost of raw material was ₹ 100 per kg. But the finished goods (which are produced from the said raw materials) are expected to realise at below the Cost Price. So, the value of 10,000 kg of raw materials will be @ ₹ 80 per kg (i.e. on the basis of replacement cost) ₹ 8,00,000.

(ii) As per para 13, AS 2, in determining the cost of inventories it is appropriate to exclude abnormal amount of wasted materials, labour or other production expenses in the period in which they are incurred.

Information

Input 5,000 MT; Normal loss 5% of 5,000 MT = 250 MT.

Wastage 300 MT; Abnormal loss = 300 MT – 250 MT = 50 MT

Cost of one MT of input = ₹ 1,000. So cost of 250 MT should be included in the cost of finished goods. But the cost of entire abnormal wastage (i.e. 1,000 x ₹ 50) ₹ 50,000 should be charged against Profit and Loss Account of the company.

(iii) As per para 9, AS 2, the allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Thus, the cost of finished goods per kg will be:

Cost per kg = Direct Material + Direct Labour + Variable Production overhead + Fixed production overhead*

= ₹ 100 + ₹ 20 + ₹ 10 + ₹10

= ₹ 140.

*Fixed Production overhead per kg = $\frac{₹10,00,000}{1,00,000}$ = ₹ 10 per kg.

Therefore, value of closing stock of finished goods will be ₹ 2,80,000 (i.e. 2,000 kg x ₹ 140)

2.3 AS 4 (REVISED): CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

Objective of this standard is to prescribe the accounting of contingencies and the event, which takes place after the balance sheet date but before approval of balance sheet by Board of Directors. The Accounting Standard deals with:

- Contingencies
- Events occurring after the balance sheet date.

Applicability of Accounting Standard

Accounting Standard does not apply in following cases:

- Liabilities of life assurance and general insurance.
- Obligations under retirement benefit plans.
- Commitments arising from long-term lease contracts.

Contingency

Contingency refers to –

- Existing conditions or situation.
- Result of which (contingency) is not known on the balance sheet date.
- Result of which (contingencies) would be known only on happening or non-happening of certain events in future.
- Result may be either or gain or loss.

Examples of Loss Contingency

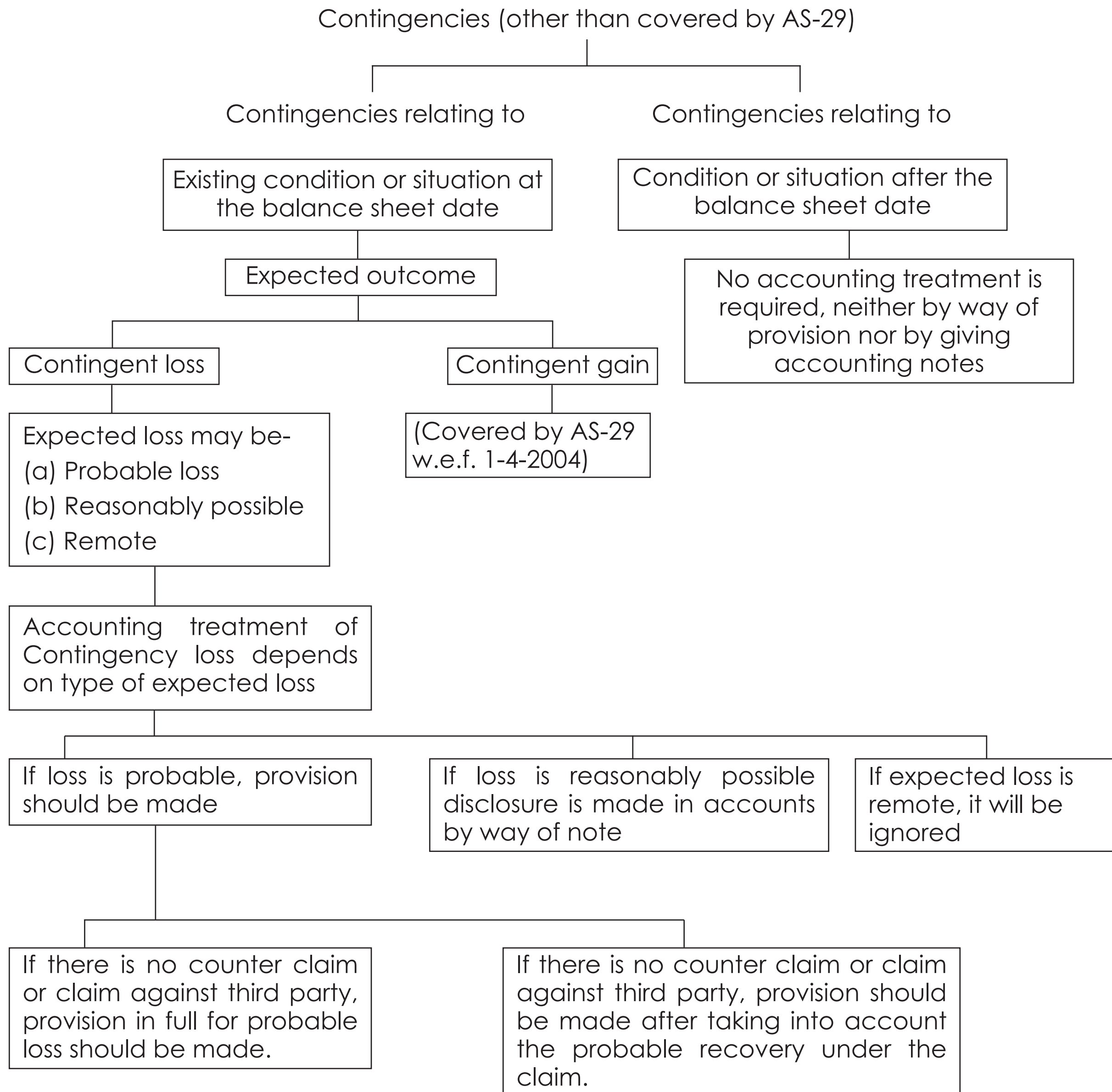
Following are some examples of loss contingency –

- Collectability of recoverable / debtors.
- Litigation, claims and assessments for recovery of assets.

Estimation of outcome of contingency is determined by management —

The estimates of outcome and financial effects of contingencies are determined by the management. The management makes decision on the basis of information available upto the date of approval of accounts.

Contingency loss can be estimated by following flow chart: -



Provision for loss is estimated on the basis of information available upto the date of approval of accounts by competent authority. But the contingency must exist on the date of balance sheet. If contingency does not exist on balance sheet date on provision nor notes to accounts is required.

Meaning of the words used in flow chart is as under:

- Probable – The future event or events are likely to occur.
- Reasonably possible – The chance of the future event or events occurring is more than remote but less than likely.
- Remote – The chance of the future event or events occurring is slight.

Provisions covered by AS – 4

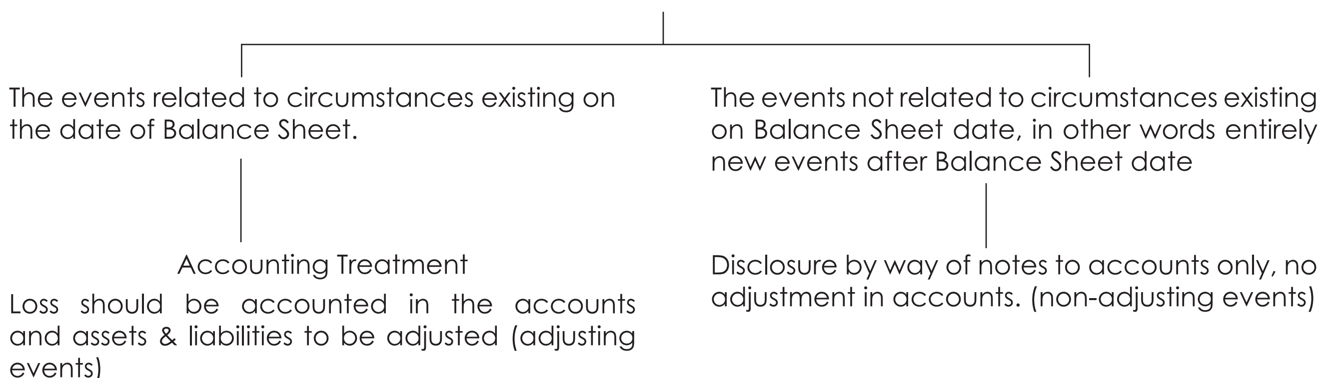
In view of non-applicability of AS-29 to provision for bad and doubtful debts and other similar provisions which are shown in the Balance Sheet as adjustment to the carrying amount of assets, the Institute of Chartered Accountants of India has made announcement that till Accounting Standards (AS – 30) on Financial instruments becomes applicable the provision for bad and doubtful debts would continue to be covered by AS-4.

Events occurring after the Balance Sheet date are as under:-

- Events, which occur between the balance sheet date and date on which financial statements are approved by competent authority.
- These events are significant events and it may be favourable and unfavourable.

For example: Balance Sheet dare is 31st March, 2013 and Board of Directors approved the accounts on 30th August, 2013. Any event that occurs between 31st March, 2013 and 31th August, 2013 is turned as event occurring after the balance sheet date. Suppose there was fire in company plant on 27th July, 2013, which destroyed plant worth ₹15 crores.

For the purpose of accounting treatment the events are classified in two categories.



Insolvency of a customer (Adjusting event) – Insolvency of a customer, which occurs after the balance sheet date usually, provides additional information on the condition that existed at the balance sheet date. Therefore, the carrying amount receivables should be adjusted for the event; assumptions are made as follows:

- The conditions of insolvency existed at the balance sheet date.
- The entity could not collect the complete information about the collectability of the receivable because of the unreasonable effort and cost required to collect information.
- Therefore, it could not estimate the insolvency of the customer.

However, insolvency caused by a major casualty occurring after the balance sheet date is not an adjusting event. For example, insolvency caused by a major fire in the factory and the warehouse is an un-adjusting event. Accordingly, the carrying amount of the receivable should not be adjusted for the event.

Event effecting going concern

Events occurring after the balance sheet date may indicate that the enterprise ceases to be going concern (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

Disclosure

If material contingent loss is not provided for, its nature and an estimate of financial effect should be disclosed by way of note.

If estimate of financial effect cannot be made, the fact should be disclosed.

Illustration 16.

Explain how the following matters will be dealt with in the financial statements:

Liability for sales-tax amounted to ₹ 5,00,000 against which the company made an appeal to the appellate authority. The reasons for which the appeal was made was covered to the extent of ₹ 3,00,000.

Solution:

It becomes clear from the question that there would not be any dispute about ₹ 2,00,000 which should be treated as an actual liability and it is certain. As a result the same must be disclosed in the financial statement. But the amount of ₹ 3,00,000 which was pending before the appellate authority should be treated as contingent liability and its accounting will be disclosed in the financial statement.

Illustration 17.

State how the amount of loss due to fire will be dealt with in the financial statement.

On 7.1.2013, the Plant and Machinery of T Ltd. was badly damaged by fire which caused an estimated loss amounting to ₹ 10,00,000. It was estimated/expected that 50% of the amount might be recovered from the insurance company as it was insured (accounts closes on 31st Dec. every year).

Solution:

The Plant and Machinery was destroyed by fire on 7.1.2013, i.e., after the closing of the books of account. The estimated loss was ₹ 10,00,000. It is quite clear that the fire broke out after the Balance Sheet date and did not affect the financial statements as on 31st Dec. 2012. Thus, as per AS 4, the events that occur after the Balance Sheet date cannot be adjusted in the financial statements any more as it had no effect while preparing the financial statement for the period ended 31st Dec. 2012. But as per the disclosure of AS 4, the same must be informed to the appropriate authority.

Illustration 18.

You are an accountant preparing accounts of P Ltd. as on 31.3.2013. After year-end the following events have taken place in April 2013:

(i) A fire broke out in the premises damaging un-insured stock worth ₹ 10 lakhs (Salvage value ₹ 2 lakhs).

(ii) A suit against the company's advertisement was filed by a party claiming damage of ₹ 20 lakhs.

(iii) Dividend approved @ ₹ 20 on share capital of ₹ 100 lakhs.

Describe how the above will be dealt with in the account of the company for the year ended 31st March 2013.

Solution:

(i) As per AS 4, **Events Occurring After the Balance Sheet Date,** events occurring after the Balance Sheet date that represent material changes and commitments which affect the financial position must be disclosed. Thus loss by fire must be disclosed but they do not require any adjustment since the event is not related to circumstances existing on the date of preparing Balance Sheet.

(ii) As per AS 4, an estimate of the financial effect and uncertainties which may affect the future outcome must be disclosed. As such, the claim which was filed against the company may be treated as contingent liability which must be disclosed in the financial statement.

(iii) As per AS 4, Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.

Thus, the dividends which were proposed or declared by the company after the Balance Sheet date but before approval of the financial statements should be adjusted.

Illustration 19.

What will be the treatment of the following in the financial statements of accounts for the year ended 31st May 2013 of a limited company?

On 15th April 2013 due to destruction of the factory by fire, Ajanta, one of the company's debtors, declared himself insolvent. He owned ₹ 2,00,000 to the company.

Solution:

Since the fire took place on 15th April i.e. after the Balance Sheet date, no adjustment for assets and liabilities is required. It does not have any material effect on the conditions existing at the Balance Sheet date although due to the incident Mr. Ajanta, one of the debtors, becames insolvent as a result of the loss by fire.

Illustration 20.

A company entered into an agreement to sell its immovable property included in the Balance Sheet at ₹ 5 lakhs, to another company for ₹ 20 lakhs. The agreement to sell was concluded on the 31st January while the actual sale deed was registered on 30th April.

Advice the treatment for these transactions.

Solution:

As per para 13 of AS 4, Assets and Liabilities should be adjusted for events occurring after the Balance Sheet date that provide additional evidence to assist the estimation of amount relating to conditions existing at the Balance Sheet Date. Thus, sale and profit on such sale would be recognised i.e., this is an item to be adjusted.

Illustration 21

What will be the treatment of the following in the final statement of account for the year ended 31st March 2013, of a limited company? "The company has taken a large size civil construction contract for a public sector undertaking valued at ₹ 2 crores. In the course of execution of the work, on 29th May 2013, the company found, while raising the foundation work, that it had met a rocky surface and cost of contract would go up by an extra ₹ 50 lakhs which would not be recoverable from the contractee."

Solution:

As per of AS 4, adjustments to assets and liability are required for events occurring after the Balance Sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the Balance Sheet date. Hence, the increased cost of construction amounting to ₹ 50 lakhs, due to rocky surface, is an existence of events occurring at the Balance Sheet date and should be adjusted in the financial statement and the same also must be disclosed in the said statement.

Illustration 22.

The financial statements of Ankita Ltd. for the year ended 31.3.2013 were considered and approved by the Board of Directors on 20.5.2013.

" The company was engaged in construction work involving ₹ 10 crores. In the course of execution of work a portion of factory shed under construction came crashing down on 30.5.2013. Fortunately there was no loss of life, but the company will have to rebuild the construction at an additional cost of ₹ 2 crores which cannot be recovered from the contractee."

How should this event be reported?

Solution:

As per AS 4 "Events Occurring After the Balance Sheet Date" are those significant events, both favourable and unfavourable, that occur between the Balance Sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in case of any other entity.

However, in the present case, financial statements were prepared for the year ended 31.3.2013, the final statements were approved by the Board of Directors on 20.5.2013, and a portion of construction crashed down on 30.5.2013, The present unfavourable event is not an event which comes under "Events Occurring After the Balance Sheet Date." As such, no adjustment is required against assets and liabilities and, at the same time, it does not require to disclose the matters in the financial statement. But as it is, no doubt, a material change which affects the financial position and which happened as a result of the event occurred after the Balance Sheet date, the same should be mentioned in the Directors' Report of the company.

Illustration 23.

In the following case of a company, whose accounting year ended 31st March 2013, the accounts for that period were considered and approved by the respective Board of Directors on 15.5.2013. The following events took place after April 2013 and you are required to state with reasons how the event would be dealt with in the financial statement for the year ended 31st March 2013. In case any disclosures are deemed necessary, you are required to draft the relevant notes also.

A claim for damage of ₹ 10 lakhs for breach of patents and copyrights had been served on the company in January 2013. The Directors sought competent legal advice for eligibility of the claim and were advised that the claim was highly frivolous, without any base and would not survive even in the first trial court. The company, however, anticipates a long drawn legal battle and huge legal costs.

Solution:

Under the circumstances, claim for damages amounting to ₹ 10 lakhs for breach of patents and copyrights cannot legally be enforceable as per legal advice. As the outcome is uncertain, it is a case of contingency. A reasonable provision for legal expenses should be made since the case will continue for a long period which requires huge legal expenses. Since it is a contingent liability, a note should be written on the footnote of the Balance Sheet as:

"Contingent liabilities not provided for" A claim for damages amounting to ₹ 10 lakhs for breach of patent and copyright had been served on the company. According to expert legal advice, the same was highly frivolous although the case will continue for a long period for which huge legal expenses (estimated ₹.........) will be required and for that purpose proper provisions should be made.

Illustration 24.

In preparing the financial statements of E Ltd. for the year ended 31st March 2013, you came across the following information. State, with reasons, how you would deal with them in the financial statement.

"The company invested ₹ 100 lakhs in April 2012 in the acquisition of another company doing similar business, the negotiations for which had started during the financial year."

Solution:

As per of AS 4, disclosure should be made in the report of the approving authority (i.e. Board of Directors) of the events occurring after the Balance Sheet date that represents material changes and commitments affecting the financial position of the enterprise. The same does not require long adjustments to assets and liabilities but must be disclosed in Directors' Report. Thus, the investment which was made by the company amounting to ₹ 100 lakhs in April 2013 for the acquisition of another company is nothing but an event which occurred after the Balance Sheet date. As such, it does not require any adjustments in the financial statements prepared on 31.3.2013, i.e. at the end of the year.

Illustration 25.

A major fire has damaged assets in a factory of Ink Co. Ltd. on 8.4.2013, 8 days after the year-end closing of accounts. The loss is estimated to be ₹ 16 crores (after estimating the recoverable amount of ₹ 24 crores from the insurance company). If the company had no insurance cover, the loss due to fire would be ₹ 40 crores.

Explain how the loss should be treated in the final accounts for the year ended 31.3.2013.

Solution:

As per of AS 4 (Revised), Events Occurring After the Balance Sheet Date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position or unusual changes affecting the existence of the enterprise after the Balance Sheet date (e.g. destruction of a major production plant by a fire after the Balance Sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumptions of going concern.

In the present case, no adjustment is required against assets and liabilities in the financial statement for the period ended on 31.3.2013. On the other hand, if the events occurring after Balance Sheet date reveals that this firm may cease to be a going concern, in that case, assets and liabilities need to be adjusted for the period ended 31.3.2013.

Thus, the loss can be considered to be an event which affects the substratum of the firm. Hence, proper disclosure must be made in the Directors' Report.

Illustration 26.

While preparing its final accounts for the year ended 31st March 2013 a company made a provision for bad debts @ 5% of its total debtors. In the last week of February 2013, a debtor for ₹ 2 lakhs has suffered huge loss due to an earthquake, the loss was not covered by any insurance policy. In April 2013, the debtor became bankrupt.

Can the company provide for the full loss arising out of insolvency of the debtors in the final account for the year ended 31st March 2013?

Solution:

As per para 3.2 of AS 4, "Contingencies and Events Occurring After the Balance Sheet Date", events occurring after Balance Sheet date are those significant events, both favourable and unfavourable, that occur between the Balance Sheet date and the date on which the financial statements are approved by the Board of Directors of a company.

Similarly, para 8.1 states that events which occur between the Balance Sheet Date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the Balance Sheet Date.

In the present case, the earthquake happened before the Balance Sheet Date. If the same had happened after the Balance Sheet Date simple disclosure was enough for the period 31.3.2013. Thus, the company should debit the whole amount of ₹ 2 lakhs as bad debts and, at the same time, balance of debtors should also be adjusted.

Illustration 27.

Earth Ltd. could not recover ₹ 10 lakhs from a debtor. The company is aware that the debtor is in great financial difficulty. The accounts of the company were finalised for the year ended 31.3.2013 by making a provision @ 20% of the amount due from the said debtor.

The debtor became bankrupt in April 2013 and nothing is recoverable from him.

Do you advice the company to provide for the entire loss of ₹ 10 lakhs in the books of account for the year ended 31st March 2013?

Solution:

As per para 8.2 of AS 4 (Revised), adjustment to assets and liabilities are required for events occurring after the Balance Sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the Balance Sheet date.

Thus, the debtor became insolvent in April 2013, which revealed that non-recovery of debt was an event occurring after the Balance Sheet date which materially affected the ascertainment of profit for the period ended 31.3.2013. As such, it is advised to the company that a provision for loss should be made for the whole amount of ₹ 10 lakhs.

Illustration 28.

Alpha Ltd. entered into an agreement to sell its immovable property included in the Balance Sheet at ₹ 10 lakhs to another company for ₹ 15 lakhs. The agreement to sell was concluded on 20th Feb. 2013 and the sale deed was registered on 1st May 2013.

Comment with reference to AS 4.

Solution:

As per para 13 of AS 4, Contingencies and Events Occurring After the Balance Sheet Date, assets and liabilities should be adjusted for events occurring after the Balance Sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the Balance Sheet date.

In the present case, before the closing of books of account, the immovable property was sold, i.e., the agreement was effected before the Balance Sheet date but the registration was done after the Balance Sheet date. So, the adjustment must be made in the books of account for the year ended 31st March 2013 for the sale of immovable property.

Illustration 29.

At the end of the financial year ending on 31st Dec. 2013, a company finds that there are twenty law-suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is:

	Probability	Loss
In respect of 5 cases (Win)	100%	—
Next Ten Cases (Win)	60%	—
Lose (low damage)	30%	1,20,000
Lose (high damage)	10%	2,00,000
Remaining 5 cases:		
Win	50%	
Lose (low damage)	30%	1,00,000
Lose (high damage)	20%	2,10,000

Outcome of each case is to be taken as a separate entity.

Ascertain the amount of contingent loss and the amounting treatment.

Solution:

As per para 3.1 of AS 4, a contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence or non-occurrence of one or more uncertain future events. As per para 4, 3, the uncertainty relating to future events can be experienced by a range of outcome. This range may be presented as quantified probabilities.

Similarly, para 5.1 states that the accounting treatment of a contingent loss is determined by the expected outcome of contingency. If it is likely that a contingency will result in a loss of the enterprise, then it is a preferred to provide for that loss in the financial statement.

However, in the present case, the expected loss may be ascertained as under:

		₹
First five Cases		Nil
Next ten Cases	Loss = ₹ 1,20,000 × $\frac{30}{100}$ × 10 = 3,60,000 Loss = ₹ 2,00,000 × $\frac{10}{100}$ × 10 = 2,00,000	5,60,000
Remaining Five Cases	Loss = ₹ 1,00,000 × $\frac{30}{100}$ × 5 = 1,50,000 Loss = ₹ 2,10,000 × $\frac{20}{100}$ × 5 = 2,10,000	3,60,000
	Expected loss for 20 cases	9,20,000

So ₹ 9,20,000 should be disclosed in the financial statement as contingent liability.

2.4 AS 5 (REVISED) : NET PROFIT OR LOSS FOR THE PRIOR, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

The objective of this standard is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this standard requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

Scope

(i) This standard should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.

(ii) This standard deals with, among other matters, the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.

(iii) This standard does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Components of net profit

Net profit or loss for the period consists of two components —

- Profit or loss from ordinary activities
- Extraordinary items.

These components should be disclosed on the face of statement of profit and loss account.

Ordinary activities are defined as any activities, which are undertaken by an enterprise as part of its business and incidental to main business.

Profit/loss from ordinary activities - Normally all items of income and expenses which are recognized in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and change in accounting estimates.

When items of income and expenditure from ordinary activities are of such size and nature that their disclosure is relevant to explain the performance of the enterprises for the period, the nature and amount of such items should be separately disclosed.

Examples of items that are not "extraordinary items":

- The write down of inventories to net realisable value or reversal of such write down
- Restructuring cost or reversal of provision of restructuring cost
- Profit or loss on disposal of fixed assets

Extraordinary items: Extraordinary items are income or expense that arise from transactions that are clearly distinct from ordinary activities. They are not expected to recur frequently or regularly. The nature and amount of extraordinary items should be separately disclosed in Profit and Loss Account so that its impact on current profit or loss can be perceived.

Examples of extraordinary items

- Loss due to earthquakes
- Attachment of property

Prior Period item

Prior Period items are income or expenses, which arise, in current period as a result of error or omission in the preparation of financial statement of one or more prior periods.

Disclosure of prior period items: The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on current profit or loss can be perceived.

Examples of prior period items

- Error in calculation in providing expenditure or income
- Omission to account for income or expenditure

Change in Accounting Estimate

It means that estimate is revised due to change in the circumstances/ conditions on which the estimates was based.

For example:

- Estimation of provision of Sundry Debtors
- Estimation of provision for any liabilities

Effect of Change in Accounting Estimate - The effect of a change in accounting estimate should be classified in following cases:

- If an estimate pertains to ordinary activities, then change in accounting estimate should be classified as ordinary activities.
- If estimates pertain to extraordinary item, then change in accounting estimates should be classified as extraordinary.

Disclosure of Accounting Estimate

- The effect of a change in accounting estimate disclosed in net profit or loss
- The period of change, if the change affects the period only
- The period of change and future periods, if the change affects both

Changes in Accounting Policies

In the following circumstances changes in accounting policies are made:

- For the compliance of accounting standard
- For the compliance of the statute or law
- For better and appropriate presentation of the financial statement.

Disclosure of change in Accounting Policies

- Material effect should be shown in financial statement to reflect the effect of such change.
- This effect should be disclosed in the year of change.
- If the effect of change is not ascertainable, the fact should be disclosed.
- If the effect of change is not material for current period, but it is material effect for the later period, then fact should be disclosed in the period of change.

Examples of change in accounting policies:

- Change of depreciation method from WDV to Straight-line method and vice versa.
- Change in cost formula in measuring the cost of inventories.

Illustration 30.

Explain 'Prior Period Items'.

Solution:

As per pars 4 of AS 5, Prior period Items are incomes or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior period(s).

Illustration 31.

Advise L & Co. Ltd., about the treatment of the following in the final statement of accounts for the year ended 31st March 2013:

The company finds that the stock sheet as on 31st March 2012 had included twice an item the cost of which was ₹ 55,000.

Solution:

As per para 4, AS 5, Prior period items are incomes or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior period(s). In this problem, the error was discovered in the current year i.e. 31.3.2013 which has happened in the financial statements on 31.3.2012 which was nothing but a prior period item.

It is needless to say that overvaluation of closing stock of 31.3.2012 means overvaluation of opening stock for the year ended 31.3.2013 as result of which profit was overstated by ₹ 55,000.

Similarly, as per of AS 5 (for prior period items) errors in the preparation of the financial statements of one or more prior period(s) may be discovered in the current period which should separately be disclosed in the current statement of profit and loss.

Illustration 32.

During the year 2012-13, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000.

Is a separate disclosure necessary?

Solution:

As per para 12, AS 5 *(Profit* or loss ***from ordinary activities)*** where items of income and expense, whether profit or loss, from ordinary activities are of such size, nature or incidence that their disclosure is relevant

to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Hence, in the present case, separate disclosure must be made.

Illustration 33.

Revision in the salary, effective from 1.4.2012, would cost the company an additional liability of ₹3,00,000 p.a. What will be the treatment in the final statement of account for the year ended 31st March 2013 of a limited company?

Solution:

As per AS 5 *(Extraordinary* Items), all items of incomes and expenses included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Only on rare occasion does an event or transaction give rise to an extraordinary item. In the present case, increase in salary arises from ordinary course of the business although its revision of pay requires a lot of funds. Even then, it cannot be considered as extraordinary item as per para 9 of AS 5. No separate disclosure is necessary for the purpose.

Illustration 34.

In preparing the financial statements of LT Ltd. for the year ended 31.3.2013, you come across the following information. State with reasons how you would deal with them in the financial statements.

There was a major theft of stores valued at ₹ 10 lakhs in the preceding year which was detected only during the current financial year.

Solution:

As per AS 5, prior period items are incomes and expenses which arise in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior period(s). In this case, it is a case of prior period items. As the theft was discovered in the subsequent year, the same was not adjusted in the previous year's account as a result of which profit was overstated. So opening stock of the current year should be adjusted as also the profit which was brought forward and the loss should also be adjusted against the profit of the current year accordingly.

Illustration 35.

A company signed an agreement with the employees' union on 1.9.2013 for revision of wages with retrospective effect from 30.9.2012. This would cost the company an additional liability of ₹ 5,00,000 p.a.

Is a disclosure necessary for the amount paid in 2012-13?

Solution:

For solution please see the Illustration 33 of AS 5.

Illustration 36.

X Co. Ltd. signed an agreement with its employees' union for revisions of wages in June 2013. The wage revision is with retrospective effect from 1.4.2009. The arrear wages up to 31.3.2013 amounts to ₹ 80 lakhs. Arrear wages for the period from 1.4.2013 to 30.6.2013 (being the date of agreement) amounts to ₹ 7 lakhs.

Decide whether a separate disclosure of arrear wages is required.

Solution:

From the problem it becomes quite clear that revision of wages took place in June 2013 with retrospective effect from 1.4.2009. Thus, the arrear wages from 1.4.2009 to 30.6.2013 cannot be treated as error or omission and, as such, the same cannot be considered as prior period item as per para 16 of AS 5. But the additional liability amounting to ₹ 87 lakhs (said period) should be included with the wages for the current year.

As per para 12 of AS 5, when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Thus additional wages appear from the ordinary activities of the enterprise which cannot be treated as an extraordinary item.

Moreover, current year's wages from (1.4.2013 to 30.6.2013) for ₹ 7 lakhs cannot be treated as prior period items, as such, it should not be necessary to be disclosed separately-rather they should be included with the wages for the current year.

Illustration 37.

State how you will deal with the following in the accounts of U Ltd. for the year ended 31.3.2013:

The company finds that the stock sheets of 31.3.2013 did not include two pages containing details of inventory worth ₹ 14.50 lakhs.

Solution:

As per para 17 of AS 5, errors in the preparation of the financial statements of one or more prior period may be discovered in the current period. So it is a case of prior period item. Hence, the same should be adjusted against profit or loss of the current year of after ascertaining the profit of the current year, the same should be recorded in the profit and loss statement.

Illustration 38.

A Ltd. created a provision for bad and doubtful debts at 2.5% on debtors in preparing the final statements for the year 2012-13.

Subsequently, on a review of the credit period allowed and financial capacity of the customers, the company decided to increase the provision to 5% on debtors as on 313.2013. The accounts were not approved by the Board of Directors till the date of decision.

While applying the relevant accounting standard can this revision be considered as an extra-ordinary item or prior period item?

Solution:

As per para 21, AS 5-Revised, Net Profit or Loss for the Prior Period Items and Changes in Accounting Policies, an estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based. The revision of the estimate, by its nature, does not bring the adjustment within the definition of an extraordinary item.

In this case, the company created a provision for bad debts @ 2.5% for the period 2012-13. Thereafter, in the next year, the company revised the estimate which is based on the changed circumstances. For this the company wants to make a provision @ 5% on debtors. So, as per AS 5, (Revised), this change cannot be considered either as extraordinary item or prior period item.

But as per para 27, AS 5, the nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in the subsequent periods, should be disclosed.

Illustration 39.

The difference between actual expenses or incomes and the estimated expenses or incomes as accounted for in earlier years' accounts does not necessarily constitute the item to be a prior period item.

Comment

Solution:

As per para 20 of AS 5, the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. As per para 21 of AS 5, an estimate may have to be revised if changes occur regarding, the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definition of an extraordinary item or prior period item. Thus, the statement given in the question is correct and is in accordance with AS 5.

Illustration 40.

Victory Ltd. purchased goods on credit from Lucky Ltd. for ₹ 250 crores for export. The export order was cancelled. Victory Ltd. decided to sell the same goods in the local market with a price discount. Lucky Ltd. was requested to offer a price discount of 15%. The Chief Accountant of Lucky Ltd. wants to adjust the sales figure to the extent of the discount requested by Victory Ltd.

Discuss whether this treatment is justified.

Solution:

Since the transaction relating to sales had already taken place the same cannot be negotiated further. 15% price discount given to Victory Ltd. may be treated as concession while paying of its debt. So no adjustment is to be made against sales and concession treated as bad debts and the same should be charged to the statement of Profit and Loss.

2.5 AS 10: ACCOUNTING FOR FIXED ASSETS

Fixed assets for the purpose of the statement are those held by an enterprise with the intention of being used for the purpose of producing or providing goods or services and not held for sale in the normal course of business and applies to financial statements prepared on historical cost/substituted cost basis.

The following items need special consideration and normally not covered under this statement unless the expenditure on individual items are separable and identified.

(a) forest, plantation and similar regenerative natural resources

(b) wasting assets and non-generative resources (mineral rights. exploration of mineral, oil and natural gas)

(c) expenditure on real estate development

(d) livestock

Fixed assets shall be shown in financial statement either at historical cost or revalued price.

Historical Cost consists the following:

- Purchase price
- Import duties and other non-refundable taxes
- Any directly attributable cost of bringing the asset to the working conditation for its intended use like:
  - Site preparation
  - Delivery and handling cost
  - Installation cost
  - Professional fees (i.e. Fees of Engineers and Architects)
  - Expenditure incurred on start up and commission of the project including the expenditure on test runs less income by sale of products
  - Administrative and other general overheads are specifically attributable for construction/ acquition/installation of the fixed assets.
  - Amount of Govt. grants received/receivable against fixed asset should be deducted from the cost of fixed assets
  - Loss/gain on deferred payment on foreign currency liability if option under AS – 11 is exercised.
  - Price adjustment, changes in duties or similar factors.

  Historical cost of a self-constructed fixed assets – Such fixed asset, which was constructed by in-house efforts, is called self-constructed fixed asset.

It includes the following:

- All costs which directly related to the specific asset.
- All costs that are attributable to the construction activity should be allocated to specific assets.
- Any internal profit included in the cost should be eliminated.

When fixed assets are revalued, these assets are shown at revalued price in financial statement. Generally, component valuer does revaluation through appraisal. Revaluations may be done using price index appropriate to the concerned fixed assets.

Apart from direct cost, all directly attributable cost to bring the asset concerned to their working condition for intended use also forms the part of fixed asset.

Subsequent expenditure after the initial capitalization that increases the future benefits from the existing assets beyond the previously assessed standard of performance (e.g. increase in quality of output, substantial reduction in operating cost) is capitalized to form the gross book value.

Financial statements are normally prepared on the basis of historical cost but sometimes a part or all of fixed assets, are restated (revalued) and substituted for historical cost. The commonly accepted and preferred method of restating is by appraisal by a competent valuer.

As per Schedule VI, every B/S subsequent to revaluation shall disclose the increased figure with the date of increase in place of the original cost for the first 5 (five) years, but the fact of such revaluation will continue to be disclosed till such time such assets appear in the B/S.

Revaluation is made for an entire class of assets or the selection of assets on a systematic basis (fact of which should be appropriately stated).

An increase in net book value arising on revaluation of fixed assets should be credited to "Owner's Fund" under "Revaluation Reserve" unless the decrease on any previously revaluation recorded as a change in P/L A/c or "Revaluation Reserve" if increase in previous occasion was credited thereto.

All material items retired from active use and not disposed off should be stated at the lower of net book value or net realizable value as a separate item in the Schedule of Fixed Assets.

Depreciation as per AS-6 should be charged on the total value of fixed assets including revalued portion.

Cost of asset acquired in exchange of existing assets: (i.e. consideration paid is non-monetary) - The cost of acquisition of fixed assets is determined under the different situations differently as under:—

- **Fixed Assets exchanged not similar.** - Assets acquired should be recorded either at fair market value of asset given up or fair market value of asset acquired, if this is more clearly evident
- **Fixed Assets exchanged are similar.** - Fixed assets acquired is recorded at fair market value of asset given up or Fair market value of asset acquired, if this is more clearly evident or Net Book value of the asset given up
- **Fixed Assets acquired in exchange of share or other securities.** - (when payment of fixed assets is made in shares or securities) Assets should be recorded at - either fair market value of asset purchased or fair market value of share or securities, whichever is more clearly available.

Maximum amount of revaluation - Revaluation of fixed assets should be restricted to the net recoverable amount of fixed asset.

Accounting treatment of revaluation - Treatment in accounting under different situations is as under:—

- First time revaluation (upward)
  - Increase in net book value is credited to owner's interest under the head 'Revaluation Reserve'.
- First time revaluation (Downward)
  - Decrease in net book value is charged to the profit & loss account.
- First revaluation (downward) subsequent revaluation (upward)
  - Decrease in net book value is charged to the Profit & Loss Account in the year in which downward revaluation was done.
  - Amount of revaluation that can be credited to Profit & Loss Account is restricted to the amount of devaluation earlier written off. Balance amount of revaluation should be credited to revaluation reserve.
- First revaluation (upward) subsequent revaluation (downward)
  - Increase in the net book value is credited to owner's interest under the head 'Revaluation Reserve'.

- Amount of devaluation can be charged to revaluation reserve to the extent the revaluation reserve earlier credited is unutilized, the balance amount of devaluation is charged to profit and loss account.

Valuation of fixed assets in special cases

- Assets acquired on hire purchase terms: Such assets are recorded at their cash price. However, the recording will be done as per AS-19.
- Cost of jointly held assets: Either the original cost, accumulated depreciation, and written down value should be stated in the balance sheet in the proportion in which the entity has right to utilize the asset. Or

  Pro rata cost of such jointly owned assets is grouped together with similar fully owned assets.
- Fixed assets acquired at consolidated price: Cost of each fixed asset should be determined on a fair basis as per valuation by competent valuers.

Improvements and Repair

There are two accounting treatments of cost of improvement and repairs. These accounting treatments depend upon the following conditions:

- After the improvements and repairs, expected future benefits from fixed assets do not change. The expenses of improvements and repairs are charged to profit & loss account.
- After the improvement and repairs, expected future benefits from fixed asset will increase beyond the previously assessed standard performance. These expenses on improvements and repairs are included in the gross book value of fixed asset.

Addition or extension of capital nature to an existing asset

- If integral part of existing asset- it is generally added to gross book value of existing assets.
- If separate identity and capable to be used after the disposal of existing asset - it is accounted for separately.

Retirement and disposals

- Fixed assets are deleted from the financial statement either on disposal or on expected economic benefit is over.
- Gains or losses arising on disposal are generally recognized in profit & loss account.

Treatment of Fixed assets are retired from active use and held for disposal—

- Such asset is stated at the lower of net book value and net realisable value in the financial statement.
- Any expected loss is recognized immediately in the profit & loss statement.
- It should be separately shown in financial statement i.e., balance sheet.

Disposal of previously revalued fixed assets -If there is profit, then it is credited to profit & loss account.

If there is loss, then it can be adjusted against the balance of revaluation reserve (arising out of revaluation of the same asset). If any.

Disclosure in addition to AS-1 and AS-6, should be made under AS-10 in the following lines :

(a) Gross and net book value of fixed assets at the beginning and end of an accounting period with additions, disposals, acquisitions and other movements.

(b) Expenditures incurred on account of fixed assets in the course of constructional acquisition

(c) Revalued amounts substituted for historical cost, the basis of selection for revaluation, the method adopted, the year of appraisal, involvement of external valuer.

(d) The revalued amounts of each class of fixed assets are presented in the B/S separately without netting off the result of revaluation of various classes of fixed assets.

Illustration 41.

Explain the provisions contained in the Accounting Standard in respect of Revaluation of Fixed Assets.

Solution:

As per paras 27, 28 and 29 and 30 of AS 10-Accounting for Fixed Assets the provisions relating to the revaluation of fixed assets are:

When a fixed assets is revalued in financial statements an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis and should be disclosed -para 27.

The revaluation in financial statements of a class of assets should not result in the net book value of that class being greater than the recoverable amount of assets of that class-para 28.

When a fixed asset is revalued upwards, any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss statements-para 29.

An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than decrease arising on revaluation previously recorded as charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on evaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reserved to utilise, it may be charged directly to that account para 30.

Illustration 42.

Explain the provisions for valuation of fixed assets in special cases as AS 10.

Solution:

As per paras 15.1, 15.2 and 15.3 of AS 10, Accounting for Fixed Assets, the provisions relating to the valuation of fixed asset in special cases are:

As per para 15.1- In the case of fixed assets acquired on hire-purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which, if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

Where an enterprise owns fixed assets jointly with other (otherwise than as a partner in a firm), the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written-down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register. - Para 15.2

Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers. - Para 15.3

Illustration 43.

During the current year 2012-13, X Ltd. made the following expenditure relating to its plant building:

₹ (in 00 000)

Routine Repairs	4
Repairing	1
Partial replacement of roof tiles	0.5
Substantial improvement to the electrical wiring system which will increase efficiency	10

How much amount should be capitalized?

Solution:

According to para 12.1, AS 10, Accounting for Fixed Assets, only expenditure that increases the future benefits from the existing assets beyond its previously assessed standard of performance is included in the gross book value i.e. an increase in capacity. Thus, in the present case, 'Repairs' amounting to ₹ 5 lakhs and partial replacement of roof tiles should be charged to Profit and Loss Account as revenue expenditure. But the amount incurred for substantial improvement to the electrical wiring system amounting to ₹ 10 lakhs which will increase efficiency should be treated as capital expenditure.

Illustration 44.

A company obtained term loan during the year ended 31.3.2012, to an extent of ₹ 650 lakhs for modernisation and development of its factory. Building worth ₹ 120 lakhs were completed and Plant and Machinery worth ₹ 350 lakhs were installed by 31.3.2012. A sum of ₹ 70 lakhs has been advanced for assets, the installation of which is expected in the following year. ₹ 110 lakhs has been utilised for Working Capital requirements. Interest paid on the loans of ₹ 650 lakhs during the year 2011-12 amounted to ₹ 58·50 lakhs.

Flow should the interest amount be treated in the accounts of the company?

Solution:

As per para 10.1 of AS 10, Accounting for Fixed Assets-Self-constructed fixed assets-while arising at the gross book value of self-constructed fixed assets, cost includes all direct costs and attributable costs which are required for the construction of such fixed assets (any internal profits are eliminated in arising at such costs).

In the present case, interest on borrowed Capital should be included with the gross book value of the assets. But interest paid which are related to Working Capital should be charged to Profit and Loss Account.

The particulars of the problem are:

Term loan taken ₹ 650 during the year ended 31.3.2012 and interest paid on such term loan ₹ 58.50 lakh during the said period.

Utilisation of Term Loan

	₹ (in lakh)	Allocation of Interest	₹ (in lakh)
Building	120	$\frac{₹ 120}{₹ 650}$ x ₹ 58.50	10.80
Plant and Machinery	350	$\frac{₹ 350}{₹ 650}$ x ₹ 58.50	31.50
Installation of Assets	70	$\frac{₹ 70}{₹ 650}$ x ₹ 58.50	6.30
— Advanced			
Working Capital	110	$\frac{₹ 110}{₹ 650}$ x ₹ 58.50	9.90
Total	650	Total	58.50

Illustration 45.

From the following particulars determine the amount of profit to be transferred to Profit and Loss Account in each of the companies for the period 2013:

In 1993, identical building space purchased for official purposes by X Ltd. and Y Ltd. for ₹ 10,00,000 for each space. X Ltd. revalued the same building for ₹ 15,00,000 in 1998 and recorded the revaluation in the books of accounts accordingly. Y Ltd. did not make any revaluation like X Ltd. Both X Ltd. and Y Ltd. however, sold their respective office space for ₹ 20,00,000 in 2013. (Ignore depreciation and tax).

Solution:

Statement for Ascertaining the Amount of Profit to be Transferred to Profit and Loss Account

	X Ltd. ₹		Y Ltd. ₹	
Sales Proceeds in 2012		20,00,000		20,00,000
Less: Cost :				
Cost Price	10,00,000		10,00,000	
Transferred to			---	
Revaluation Reserve	5,00,000			
(₹15,00,000 – ₹ 10,00,000)		15,00,000		10,00,000
Realised Profit in 2012		5,00,000		10,00,000

Therefore,

For X Ltd. (i) ₹ 5,00,000 to be credited to Profit & Loss Accounts of 2013.

(ii) Revaluation Reserve amounting to ₹ 5,00,000 to be transferred to General Reserve.

For Y Ltd. (i) ₹ 10,00,000 to be credited to Profit and Loss Account of 2013.

Illustration 46.

On 1.1.2008, Z Ltd acquired a freehold land & building for ₹ 10,00,000. It decided the following for the purpose of depreciation on such building:

(i) the building part, valued ₹ 8,00,000 depreciated on straight line method for 25 years having no scrap value.

(ii) the land part valued ₹ 2,00,000, no depreciation will be charged on it.

On 1.1.2013, it was decided that the value of land and building would be ₹ 20,00,000, divided into: Land ₹ 5,00,000 and building ₹ 15,00,000.

It has also been further estimated that the useful life of the Land and Building would be further 20 years.

Ascertain the amount of depreciation to be charged annually over the useful life of Land and Building, the WDV of the same to be shown in Balance Sheet of every year.

Calculate also the surplus on revaluation of land and building in (1) Before Revaluation, and (2) After the Revaluation.

Solution:

(i) **Before the Revaluation**

Annual depreciation on Building = $\frac{₹\ 8,00,000}{25\ \text{years}}$ = ₹ 32,000

Naturally, for the 1st 5 years, annual depreciations to be made @ ₹ 32,000 each.

The W.D.V of Building for the year ended:

Particulars	₹
(i) 31.12.2008 (₹ 10,00,000 – ₹ 32,000)	9,68,000
(ii) 31.12.2009 (₹ 9,68,000 – ₹ 32,000)	9,36,000
(iii) 31.12.2010 (₹ 9,36,000 – ₹ 32,000)	9,04,000
(iv) 31.12.2011 (₹ 9,04,000 – ₹ 32,000)	8,72,000
(v) 31.12.2012 (₹ 8,72,000 – ₹ 32,000)	8,40,000

(ii) **After the Revaluation**

Depreciation to be charged on building by the following new rate

$$\frac{₹\ 15,00,000}{20} = ₹\ 75,000\ \text{p.a.}$$

From 1.1.2013, the WDV of the building to be reduced by ₹ 75,000. The building part will totally be depreciated after 20 years but the value of the land will be ₹ 5,00,000.

Profit on Revaluation

	₹
Value of Land and Building	20,00,000
Less: Net Book Value as on 31.12.2012	8,40,000
∴ Surplus	**11,60,000**

As per para 30, AS, 10, this surplus amounting to ₹ 11,60,000 should be transferred to Revaluation Reserve.

Illustration 47.

Amrit Ltd. expects that a plant has become useless which is appearing in the books at ₹ 20 lakhs gross value. The company charges SLM depreciation on a period of 10 years estimated life and estimated scrap value of 3%. At the end of 7th year the plant has been assessed as useless. Its estimated net realisable value is ₹ 6,20,000. Determine the loss/gain on retirement of the fixed assets.

Solution:

Cost of the plant ₹ 20,00,000

Estimated realisable value ₹ 60,000

Depreciable amount ₹ 19,40,000

Depreciation per year ₹ 1,94,000

Written down value at the end of 7th Year = 20,00,000 - (1,94,000 X 7) = ₹ 6,42,000

As per of AS-10 items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognized immediately in the profit and loss statement. Accordingly, the loss of ₹ 22,000 (6,42,000-6,20,000) to be shown in the and loss account and asset of ₹6,20,000 to be shown in the balance sheet separately.

Illustration 48.

A company has purchased plant and machinery in the year 2009-10 for ₹ 90. A balance of ₹ 10 lakhs is still payable to the suppliers for the same. The supplier waived off the balance amount during the financial year 2012-13. The company treated it as income and credited to profit and loss account during 2012-13.

Whether accounting treatment of the company is correct. If not, state with reasons.

Solution:

As per AS-10 the cost of fixed assets may undergo changes subsequent to its acquisition or construction on account of exchange fluctuation, price adjustments, changes in duties or similar factors. Hence, the treatment done by the company is not correct. ₹ 10 lakhs should be deducted from the cost of fixed assets.

Illustration 49.

On December 1, 2013, Mitra Ltd. purchased ₹6,00,000 worth of land for a factory site. Mitra Ltd. razed an old building on the property and sold the materials it salvaged from the demolition. Mitra Ltd. incurred additional costs and realized salvage proceeds during December 2013 as follows:

Demolition of old building	₹ 50,000
Legal fees for purchase contract and recording ownership	₹ 10,000
Title guarantee insurance	₹ 12,000
Proceeds from sale of salvaged materials	₹ 8,000

In its December 31, 2013 Balance Sheet, Mitra Ltd. should report a balance in the land account.

Solution:

As per AS-10, the cost of land should include all expenditure incurred preparing it for its ultimate use (such as factory size) is considered part of the cost of land. Before the land can be used as a building site, it must be purchased (involving costs such as purchase price, legal fees, and title insurance) and the old building must be razed (cost of demolition less proceeds from sale of scrap). The total balance in the land account should be ₹ 6,64,000.

Purchase price	₹ 600,000
Legal Fees	₹10,000
Title Insurance	₹12,000
Net cost of demolition (₹ 50,000 - ₹ 8,000)	₹42,000
	₹ 6,64,000

Illustration 50.

On March 31, 2013, Winn Company traded in an old machine having a carrying amount of ₹ 1,68,000, and paid cash difference of ₹ 60,000 for a new machine having a total cash price of ₹ 2,05,000. On March 31, 2013, what amount of loss should Winn Company recognize on this exchange?

Solution:

As per AS-10, When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. The cash price of the new machine represents its fair market value (FMV). The FMV of the old machine can be determined by subtracting the cash portion of the purchase price (₹ 60,000) from the total cost of the new machine. ₹ 2,05,000 - ₹ 60,000 = ₹ 1,45,000. Since the book value of the machine ₹ 1,68,000 exceeds its FMV on the date of the trade in ₹ 1,45,000, the difference of ₹ 23,000 must be recognized as a loss, however, if the FMV of the old machine had exceeded its book value, the gain would not be recognized.

Illustration 51.

One customer from whom ₹ 10 lakhs are recoverable for credit sales given a motor car in full settlement of dues. The directors estimate that the market value of the motor car transferred is ₹ 10.50 lakhs. As on the date of the balance sheet the car has not been registered in the name of the auditee. As an auditor, what would you do in this situations?

Solution:

The motor car has been acquired in exchange for another assets i.e. receivables. The fair value of motor car is ₹ 10.50 lakhs and that of receivable ₹ 10 lakhs. As per AS-10 the asset acquired in an exchange of assets should be valued at the fair market value of assets acquired or the asset given up, whichever is more clearly evident. Here fair market value of the assets given up obviously more clearly evident. Hence, the motor car should be valued at ₹ 10 lakhs. Also the motor car should be recognised as an asset even though it is not yet registered in auditee's name. This is because legal title is not necessary for an asset to exist. What is necessary is control as per the framework for preparation and presentation of financial statements. Applying substance over form we find since price has been settled, the auditee has control, hence it should be reflected as an asset along with a note to the effect that the registration in auditee name is pending.

Illustration 52.

A publishing company undertook repair and overhauling of its machinery at a cost of ₹ 5.00 lakhs to maintain them in good condition and capitalized the amount, as it is more than 25% of the original cost of the machinery. As an auditor, what would you do in this situation?

Solution:

Size of the expenditure is not the criteria to decide whether subsequent expenditure should be capitalized. The important question is whether the expenditure increases the expected future benefits from the asset beyond its pre-assessed standard of performance as per AS-10. Only then it should capitalize. Since in this case, only the benefits are maintained at existing level, the expenditure should not be capitalized. If under the circumstances the amount is material the auditor should qualify his report.

Illustration 53.

Is Project under sale fixed or current asset?

Solution:

According AS-10, Accounting for Fixed Assets. Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realizable value and shown separately in the financial statements.

In view of the above, the ASB opined that project under sale, which was originally treated, as fixed asset would continue to be a fixed asset even if it is under sale and will not, therefore, be classified as a current asset. However, if an enterprise were a dealer of projects, then the project under sale would be an inventory and will be classified as a current asset.

2.6 AS 11: ACCOUNTING FOR THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES (REVISED IN 2003)

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be translated into the enterprise's reporting currency.

The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.

This Standard should be applied:

(a) In accounting for transactions in foreign currencies; and

(b) In translating the financial statements of foreign operations.

(c) This Standard also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

(b) This Standard does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this standard requires disclosure of the reason for using that currency. This Standard also requires disclosure of the reason for any change in the reporting currency.

(e) This Standard does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

(f) This Standard does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, Cash Flow Statements).

(g) This Standard does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see AS 16, Borrowing Costs).

What are foreign currency transactions?

Transaction denominated in a foreign currency or that require settlement in a foreign currency are called foreign currency transaction, examples of foreign currency transactions are—

- Buying or selling of goods or services priced in foreign currency.
- Acquisition or disposal of fixed assets denominated in foreign currency.
- Incurs or settles liabilities denominated in foreign currency.
- Lending or borrowings when the amounts are denominated in a foreign currency.
- Un-performed forward exchange contract.

Definition

- **Reporting Currency:** Currency of country where financial statements are reported, is called reporting currency. Reporting currency of the enterprise operating in India is Indian rupees.
- **Foreign Currency:** Currency other than reporting currency is called foreign currency.
- **Exchange Rate:** Rate at which foreign currency is converted into reporting currency or vice versa.
- **Average Rate:** It is the mean of exchange rate in force during the period. Period may be week, fortnight, months etc.
- **Forward Rate:** Agreed exchange rate between two parties for exchange of two currencies at a specified future date.
- **Closing Rate:** Exchange rate at the balance sheet date.
- **Monetary items:** Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amount of money. For example - cash, receivable and payable.
- **Non-Monetary items:** Non-monetary items are assets and liabilities other than monetary items. For example - fixed assets, inventories, and investment in equity shares.
- **Foreign operations:** Operational activities conducted in a country other than the country of the reporting enterprises by the reporting enterprises. These activities may be in the form of a subsidiary, associate, joint ventures or a branch of the reporting enterprises.

Classification for accounting treatment

For the purpose of accounting treatment for the effect of change in foreign exchange rates, the transaction can be classified into following categories—

Category-1 - Foreign currency transactions:

- Buying or selling the goods or services

- Lending and borrowing in foreign currency
- Acquisition and disposition of assets denominated in foreign currency.

Category-II- Foreign operations:

- Foreign branch
- An associate
- Joint venture
- Foreign subsidiary

For the purpose of accounting these will be further classified in two types—

- Integral operation
- Non-integral operation

Category-III- Forward exchange contracts

These contracts may be of two types—

- For managing risk/hedging.
- For trading and speculation.

Accounting treatment of foreign currency transactions (Category-I)

The accounting standard prescribes the accounting treatment for the following issues—

- Initial recognition of foreign transaction.
- Valuation at the balance sheet date.
- Contingent liabilities.
- Treatment of exchange difference.

Initial recognition of foreign currency transactions - Initially foreign currency transactions should be recorded by applying an exchange rate between the reporting currency and the foreign currency at the date of the transaction.

Alternatively average rate for a week or a month can be used if there is no significant fluctuation in the exchange rate.

Valuation at the Balance Sheet date - For the purpose of the valuation at the balance sheet date the foreign currency denominated transaction are divided into two categories—

- Monetary Items
- Non-monetary Items

Monetary Items - Monetary items should be converted at closing rate and reported as such. Closing rate is the exchange rate on the balance sheet date. Examples of monetary items are debtors, creditors, and loan.

However in case the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date, in such circumstances the conversion should be done at the rate likely to be realized.

As a result of applying the closing rate on the balance sheet date exchange fluctuations gain or loss will arise, which is the difference of the closing exchange rate and exchange rate used for initial recognition.

Non-monetary Item - For the purpose of conversion and reporting on the balance sheet date non-monetary items are further categorized into two categories—

- Items carried at historical cost
- Items carried at fair value.

Non-monetary items carried at historical cost- Examples of such nonmonetary items are fixed assets, long-term investment. These items should be continued to be reported at the actual rate used for initial recognition, thereafter in this case no exchange fluctuation gain or loss will arise out of such foreign currency denominated non-monetary items.

Non-monetary items carried at fair value - Examples of such nonmonetary items are inventory, current investment which are carried at fair value, these are converted and reported using the exchange rate when such fair value are determined. Generally fair value is determined at the balance sheet date.

Therefore, conversion should be made using exchange rate of the balance sheet date.

Contingent liabilities - These liabilities are reported at the exchange rate of the balance sheet date.

Treatment of exchange difference - Exchange difference arises because of—

- A transaction being reported at a rate different from the rate at which it was initially recorded.
- A transaction in monetary or non-monetary items being settled at a rate different from the rate at which it was initially recorded.
- A transaction being settled at a rate different from the one taken for the reporting in the last financial statement.

Translation of financial statement of foreign operation (Category-II)

For the purpose of the translation of financial statement of foreign operation, AS-11 classifies the foreign operation into two types:

- Integral foreign operation
- Non-integral foreign operation.

What is integral foreign operation - A foreign operation which is carried as if it were extensions of the reporting enterprise activities like dependent branches, sales depot, foreign arm which produces raw material and transfer it to head office (reporting enterprise) or foreign operation only raises finance to help the reporting enterprise.

Translation of financial statements of integral foreign operation-The individual items in the financial statements of the foreign operation are translated as if all these transactions had been entered into by the reporting enterprises. Therefore the financial statements should be translated by using the principles as prescribed for foreign currency transactions of the reporting entity (see para 11.7). It means—

- Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of the transaction; alternatively average rate can also be applied.
- The cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost.

- If tangible fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation.
- The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realisable value is translated applying exchange rate when realisable value is determined which is generally closing rate.
- Exchange difference arising on the translation of the financial statement of integral foreign operation should be charged to profit and loss account.
- Exchange difference arising on the translation of the financial statement of foreign operation may have tax effect which should be dealt with as per AS-22 "Accounting for taxes on income".

Non-integral foreign operation

Accounting Standard -11 does not define the non-integral foreign operation, however it describes the same. As per the accounting standard following are the indications of non-integral foreign operation—

- Control by reporting enterprises - While the reporting enterprise may control the foreign operation; the activities of foreign operation are carried independently without much dependence in reporting enterprise.
- Transactions with the reporting enterprises are not a high proportion of the foreign operation's activities.
- Activities of foreign operation are mainly financed by its operations or from local borrowings. In other words it raises its finance independently and is in no way dependent on reporting enterprises.
- Foreign operation sales are mainly in currencies other than reporting currency.
- All the expenses by foreign operations are primarily paid in local currency not in the reporting currency.
- Day to day cash flows of the reporting enterprises is independent of the foreign enterprises cash flows.
- Sales prices of the foreign enterprises are not affected by the day to day changes in exchange rate of the reporting currency of the foreign operation.
- There is an active sales market for the foreign operation product.

The above are only indicators and not decisive/conclusive factors to classify the foreign operations as non-integral, much will depend on factual information, situations of the particular case and therefore, judgment is necessary to determine the appropriate classification.

Controversies may arise in deciding the foreign branches of the enterprises into integral or non-integral. However there may not be any controversy that subsidiary associates and joint venture are non-integral foreign operation.

In case of branches classified as independent for the purpose of accounting are generally classified as non-integral foreign operations.

Translations of accounts of non-integral foreign operation –

Accounts of non-integral foreign operation are translated using the following principles :

- Balance sheet items i.e. Assets and Liabilities both monetary and non-monetary - apply closing rate.
- Items of income and expenses - at actual exchange rates on the date of transactions. However accounting standard allows average rate subject to materiality.

- Resulting exchange rate difference should be accumulated in a "foreign currency translation reserve" until the disposal of "net investment in non-integral foreign operation".
- What is net investment in a non-integral foreign operation- An item for which settlement is neither planned nor likely to occur in foreseeable future which is in substance a net investment in non-integral foreign operation, which may be calculated as - all assets exclude trade receivable less outside liabilities excluding trade payable.
- Contingent liability - at closing rate.
- Tax effects, if any may be accounted for as per AS-22.

Consolidation procedure (foreign subsidiary and joint venture) -when a non-integral foreign subsidiary, foreign jointly controlled entity (JV) is consolidated with the reporting enterprise, the reporting enterprises follow normal consolidation procedure such as—

- Goodwill/Capital Reserve arising on the acquisition, as a result of consolidation is translated using closing rate.
- Intra-group transactions are eliminated as per AS-21 and AS-27.
- Exchange difference arising on intra-group monetary items whether short-term or long-term cannot be set-off against a corresponding amount arising on other intra-group balances because the monetary items represents commitments to convert one currency into another and expose the reporting enterprises to gain or loss through currency fluctuation. Such exchange difference to be recognized as income or expense in consolidated financial statements.

  However if exchange difference arising on monetary items that in substance form part of net investment in non-integral foreign operation, should be accumulated in currency translation reserve.
- Procedure for different reporting date/policies shall be followed as mentioned in AS-21.

Disposal of non-integral foreign operations - When non-integral foreign operation is disposed fully or partially the corresponding exchange difference lying in the exchange translation reserve is recognized as income or expense.

- What is disposal - Disposal of a non-integral foreign operation includes—
  - Sales
  - Liquidation
  - Repayment of its share capital by non-integral foreign operation
  - Abandonment of all or part of the foreign operation by reporting enterprises
  - Payment of dividend by the non-integral foreign operation if it is treated as return on investment by the reporting enterprises (partial disposal).

- Disposal does not include - Write down of the carrying amount of non-integral foreign operation asset. For example write down due to impairment of asset (AS-28).
- Treatment of foreign currency translation reserve - On the disposal of non-integral foreign operation the translation reserve is treated as under—
  - On partial disposal proportionate foreign currency translation reserve is recognized as income or expense.
  - On full disposal, whole foreign currency translation reserve is recognized income or expense.

The above treatment of foreign currency translation is done in the period in which gain or loss on disposal is recognized.

Change in classification

When there is a change in classification from—

- Integral to non-integral
- Non-integral to integral.

The accounting treatment is as under—

- **Integral to non-integral**
  - Translation procedure applicable to non-integral shall be followed from the date of change.
  - Exchange difference arising on the translation of non-monetary assets at the date of re-classification is accumulated in foreign currency translation reserve.
- **From non-integral to integral**
  - Translation procedure as applicable to integral should be applied from the date of change.
  - Translated amount of non-monetary items at the date of change are treated as historical cost.
  - Exchange difference lying in foreign currency translation reserve is not to be recognized as income or expense till the disposal of the operation even if the foreign operation becomes integral.

What is forward contract - A forward contract is an agreement between two parties whereby one party agrees to buy from or sell to the other party an asset at future date for an agreed price, in case of forward exchange contract the asset is "foreign currency"]

For me purpose of the accounting treatment forward exchange contract has been classified in two types—

- Forward exchange contract entered for managing risk (hedging).
- Forward exchange contract entered for trading or speculation.

Transitional Provisions

When the AS-11 (revised) is applied first time and foreign branch is classified as a non-integral foreign operation then accounting treatment shall be made as per "Change in the classification of a foreign operation".

Disclosures

An enterprise should disclose—

- Amount of exchange difference included in the net profit or loss.
- Amount accumulated in foreign exchange translation reserve.
- Reconciliation of opening and closing balance of foreign exchange translation reserve.
- If the reporting currency is different from the currency of the country in which entity is domiciled, the reason for such difference.

- A change in classification of significant foreign operation needs following disclosures—
  - Nature of change in classification
  - The reason for the change
  - Effect of such change on shareholders fund
  - Impact of change on net profit or loss for each prior period presented
  - The disclosure is also encouraged of an enterprise's foreign currency risk management policy.

Illustration 54.

In the context of relevant accounting standards give your comment on the following matter for the financial year ending on 31.3.2013:

"Assets and Liabilities and income and expenditures items in respect of foreign branches are translated into Indian rupees at the prevailing rate of exchange at the end of the year. The resultant exchange difference in the case of profit is carried to other liabilities account and loss, if any, is charged to revenue."

Solution:

As per AS 11 (Revised), the financial statement of foreign operation presented in foreign currency must be translated into reporting currency of the enterprise in the following manner:

Revenue Item

All revenue items are to be converted to reporting currency at the average rates for the period covered by the amount with the exception of:

Opening Stock - at opening rate

Closing Stock - at closing rate

Depreciation - at the rate at which the fixed assets have been converted.

Monetary Items

As per para 11, AS 11, foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to be disbursed, a foreign currency monetary item at the Balance Sheet Date.

Non-Monetary Item

As per para 11, AS 11, non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction.

Exchange Difference

As per para 13, AS 11, exchange differences arising on the settlement of monetary items or on reporting and enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise with the exception of exchange difference dealt with in accordance with paragraph 15.

Contingent Liabilities

As per para 28, AS 11, a contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.

Illustration 55.

Calculate the amount of foreign exchange loss/gains for the year 2011-12 and 2012-13:

	Exchange Rate ₹
Goods purchased on 4.1.2012 for UK £10,000	78.80
Payment made to the creditors on 8.4.2012	80.00
Rate of exchange as on 31.3.2012	79.50

Solution:

(a) As per para 9, AS 11 (Revised), foreign currency transactions should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

As such, in the present case, the amount of creditors and purchase should be made as: £ 10,000 x ₹ 78.80 = ₹ 7,88,000

(b) Similarly, as per para 11(a), AS 11 (Revised), at each Balance Sheet date foreign currency monetary items should be reported using the closing rate.

As such, in this case, amount of creditors as on 31.3.2012 should be recorded at the closing rate i.e. @ ₹ 79.50.

Amount of Creditors will be = £ 10,000 x ₹ 79.50 = ₹ 7,95,000.

Amount of exchange loss will be = ₹ 7,95,000 - ₹ 7,88,000 = ₹ 7,000, which should be debited to the Profit and Loss statement for the year 2011-12.

(c) Again, as per para 13, AS 11 (Revised), Recognition of Exchange Difference, exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise.

Thus, in the present case, the position is ascertained as:

Particulars	₹
Creditors are paid for (£10,000 ₹ 80.00)	8,00,000
Less: Creditors are recorded in the books for (£10,000 x ₹ 79.50)	7,95,000
∴ Loss in Exchange	5,000

The loss in exchange amounting to ₹ 5,000 should be debited to the Profit and Loss statement for the period 2012-13.

Illustration 56.

A Ltd. purchased fixed assets costing ₹ 3,000 lakhs on 1.1.2013, and the same was fully financed by foreign currency loans (US $) payable in three annual equal installments. Exchange rates were $ 1 = ₹ 40 and ₹ 42.50 as on 1.1. 2013 and 31.12. 2013, respectively. First installment was paid on 31.12. 2013. The entire difference in foreign exchange has been charged to revenue for the year 2013.

You are required to state how these transactions would be accounted for.

Solution:

As per para 13, AS 11 (Revised), exchange difference should be adjusted against the amount of fixed assets which were acquired by the application of closing rate. According to AS 6 (Depreciation Accounting) depreciation should also be charged on it.

Exchange difference is calculated as:

On 1.1. 2013, Fixed Assets were purchased (when $ 1 = ₹ 40).

Loan was repaid by 3 equal annual installments.

The first installment was paid on 31.12. 2013 (when $ 1 = ₹ 42.50) ∴ Amount of revised foreign currency loan will be

= ₹ 3,000 lakhs ÷ ₹ 42.50 = $ 70.588 Lakhs

So, amount of exchange difference will be =

= 70.588 lakhs US $ x ₹ 2.50 (₹ 42.50 - ₹ 40.00)

= ₹ 176.47 lakhs

The exchange difference amounting to ₹ 176.47 lakhs should be charged against fixed assets on the revised unamortised value over the rest of its life. In short, exchange difference will be added to the cost of fixed assets and depreciation should be calculated accordingly.

Illustration 57.

Following was the Trial Balance on Dec. 2013 of Delhi Branch of an English firm having Head-Office in London:

	Dr. (₹)	Cr. (₹)
Stock Jan. 1, 2013	12,600	
Purchases and Sales	75,000	1,12,500
Debtors and Creditors	39,000	26,000
Bills Receivable and Bills Payable	10,400	9,100
Salaries and Wages	4,800	---
Rent, Rates and Taxes	5,100	---
Furniture	4,910	---
Cash at Bank	28,990	---
London Account	---	33,200
	1,80,800	1,80,800

On Dec. 31, 2013, the stock was valued at ₹ 32,500. The Debit Balance of the branch account in London books on Dec. 31, 2013 was £ 2,680 and Furniture Account appeared at £350. On Dec. 31, 2013, there was Cash-in-Transit from Delhi to London amounting to ₹2,600. The rate of exchange on 31.12. 2012 was ₹14 on 31.12. 2013 was ₹ 13. Average rate of 2013 was ₹ 12.

You are asked to convert the trial balance if the same is an integral foreign operation.

Solution:

As per para 21, AS 11 (Revised), the financial statements of an integral foreign operation should be translated using the principles and procedures as if the transactions of the foreign operation had been those of the reporting enterprise itself. The loss or gain in exchange should be adjusted against the statement of profit and loss.

In the Book, of Head Office
Converted Trial Balance

Heads of Accounts	Amount Dr. ₹	Amount Cr. ₹	Rate of conversion	Amount Dr. £	Amount Cr. £
Stock, Jan. 1, 2013	12,600	---	14	900	---
Purchases and Sales	75,000	1,12,500	12	6,250	9,375
Debtors and Creditors	39,000	26,000	13	3,000	2,000
Bills receivable and Bills payable	10,400	9,100	13	800	700
Salaries and Wages	4,800	---	12	400	---
Rent, Rates and Taxes	5,100	---	12	425	---
Furniture	4,910	---	Actual	350	---
Cash-in-Transit	2,600	---	13	200	---
Cash at Bank	28,990	---	13	2,230	---
London Account	---	35,800	Actual	---	2,680
Difference in Exchange (loss)	---	---		200	---
	1,83,400	1,83,400		14,755	14,755
Closing Stock	32,500		13	2,500	

Note:

But, in case of a Non-integral foreign operation, expenses and incomes should be converted as per average rate and assets and liabilities (Monetary and non-monetary) should be converted by closing rate. Fixed assets are to be translated at the their fair value, opening stock at the opening rate and the loss or gain in exchange should be transferred to foreign currency reserve and not to the statement of Profit and Loss like integral foreign operation.

2.7 AS-15: ACCOUNTING FOR EMPLOYEES' BENEFITS (Revised in 2005)

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits.

The Standard requires an enterprise to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Scope

1. This Standard should be applied by an employer in accounting for all employee benefits, except employee share-based payments.
2. This Standard does not deal with accounting and reporting by employee benefit plans.

3. The employee benefits to which this Standard applies include those provided:
   (a) under formal plans or other formal agreements between an enterprise and individual employees, groups of employees or their representatives;
   (b) under legislative requirements, or through industry arrangements, whereby enterprises are required to contribute to state, industry or other multi-employer plans; or
   (c) by those informal practices that give rise to an obligation. Informal practices give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. An example of such an obligation is where a change in the enterprise's informal practices would cause unacceptable damage to its relationship with employees.
4. Employee benefits include:
   (a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;
   (b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and postemployment medical care;
   (c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, longterm disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and
   (d) termination benefits.

   Because each category identified in (a) to (d) above has different characteristics, this Standard establishes separate requirements for each category.
5. Employee benefits include benefits provided to either employees or their spouses, children or other dependants and may be settled by payments (or the provision of goods or services) made either:
   (a) directly to the employees, to their spouses, children or other dependants, or to their legal heirs or nominees; or
   (b) to others, such as trusts, insurance companies.
6. An employee may provide services to an enterprise on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include whole-time directors and other management personnel.

Definitions

7. The following terms are used in this Standard with the meanings specified:

Employee benefits are all forms of consideration given by an enterprise in exchange for service rendered by employees.

Short-term employee benefits are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service.

Post-employment benefits are employee benefits (other than termination benefits) which are payable after the completion of employment.

Post-employment benefit plans are formal or informal arrangements under which an enterprise provides postemployment benefits for one or more employees.

Defined contribution plans are post-employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Multi-employer plans are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

(a) pool the assets contributed by various enterprises that are not under common control; and

(b) use those assets to provide benefits to employees of more than one enterprise, on the basis that contribution and benefit levels are determined without regard to the identity of the enterprise that employs the employees concerned.

Other long-term employee benefits are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

Termination benefits are employee benefits payable as a result of either:

(a) an enterprise's decision to terminate an employee's employment before the normal retirement date; or

(b) an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement).

Vested employee benefits are employee benefits that are not conditional on future employment.

The present value of a defined benefit obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Current service cost is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

Interest cost is the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement.

Plan assets comprise:

(a) assets held by a long-term employee benefit fund; and

(b) qualifying insurance policies.

Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting enterprise) that:

(a) are held by an entity (a fund) that is legally separate from the reporting enterprise and exists solely to pay or fund employee benefits; and

(b) are available to be used only to pay or fund employee benefits, are not available to the reporting enterprise's own creditors (even in bankruptcy), and cannot be returned to the reporting enterprise, unless either:

   (i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting enterprise; or

   (ii) the assets are returned to the reporting enterprise to reimburse it for employee benefits already paid.

A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in AS 18 Related Party Disclosures) of the reporting enterprise, if the proceeds of the policy:

(a) can be used only to pay or fund employee benefits under a defined benefit plan; and

(b) are not available to the reporting enterprise's own creditors (even in bankruptcy) and cannot be paid to the reporting enterprise, unless either:

   (i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

   (ii) the proceeds are returned to the reporting enterprise to reimburse it for employee benefits already paid.

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

The return on plan assets is interest, dividends and other revenue derived from the plan assets, together with realised and unrealized gains or losses on the plan assets, less any costs of administering the plan and less any tax payable by the plan itself.

Actuarial gains and losses comprise:

(a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and

(b) the effects of changes in actuarial assumptions.

Treatment of Voluntary Retirement Scheme payments :

(1) Termination benefits to be paid irrespective of the voluntary retirement scheme i.e. balance in P.F, leave encashment; gratuity etc.

(2) Termination benefits which are payable on account of VRS i.e. monetary payment on the basis of years of completed service or for the balance period of service whichever is less and notice pay.

Expert Advisory Committee (EAC) opines in favour of treating the costs (except gratuity which should have been provided for in the respective accounting period) as deferred revenue expenditure since it is construed upon as saving in subsequent periods, on some rational basis over a period, preferably over 3-5 year. However, the terminal benefit is, to the extent these are not deferred should be treated as expense in the P&L Account with disclosure

Disclosure under AS-15:

(a) In view of the varying practices, adequate disclosure of method of accounting for an understanding of the significance of such costs to an employer.

(b) Disclosure separately made for statutory compliance or otherwise the retirement benefit costs are treated as an element of employee remuneration without specific disclosure.

(c) Financial statements should disclose whether actuarial valuation is made at the end of the accounting period or earlier (in which case the date of actuarial valuation and the method used for accrual period if not based on actuary report)

Illustration 58.

Mention the prescribed accounting treatment in respect of gratuity benefits payable to employees as per AS 15.

Solution:

In respect of gratuity benefit and other defined benefit schemes, the accounting treatment will depend on the type of arrangement which the employer has chosen to make.

(i) If the employer has chosen to make payment for retirement benefits out of his own funds, an appropriate charge to the Statement of Profit and Loss for the year should be made through a provision for the accruing liability. The accruing liability should be calculated according to actuarial valuation. However, those enterprises which employ only a few persons may calculate the accrued liability by reference to any other rational method, e.g. method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

(ii) In case the liability for retirement benefits is funded through creation of a trust, the cost incurred for the year should be determined actuarially. Such actuarial valuation should normally be conducted at least once in every three years. However, where the actuarial valuations are not conducted annually, the actuary's report should specify the contributions to be made by the employer on annual basis during the inter-valuation period. This annual contribution (which is in addition to the contribution that may be required to finance unfunded past service cost) reflects proper accrual of retirement benefit cost for each of the years during the inter-valuation period and should be charged to the Statement of Profit and Loss for each such year. Where the contribution paid during a year is lower than the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the shortfall should be charged to the Statement of Profit and Loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the excess should be treated as a pre-payment.

(iii) In case the liability for retirement benefits is funded through a scheme administered by an insurer, an actuarial certificate or a confirmation from the insurer should be obtained that the contribution payable to the insurer is the appropriate accrual of the liability for the year. Where the contribution paid during a year is lower than amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the shortfall should be charged to the Statement of Profit and Loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the excess should be treated as a pre-payment.

Illustration 59.

Explain the provisions regarding Post-employment Benefit' as per AS 15.

Solution:

As per para 24, AS 15, post-employment benefits includes (a) retirement benefits (e.g. Gratuity and Pension) and (b) other benefits (i.e. post-employment life insurance and post-employment medical care). Arrangement whereby an enterprise provides post-employment benefits are post-employment benefits plan.

Post-employment benefit plans are classified as either defined contributions plans or defined benefits plan; depending on the economic substance of the plan as derived from its principal terms and condition;.

Under defined contribution plans;

(a) the enterprises's obligation is limited to the amount that it agrees to contribute to the Fund.

(b) in consequence, actuarial risk and invested risk fall on the employee.

Illustration 60.

The company revised an actuarial valuation for the first time for its pension scheme, which revalued a surplus of ₹ 12 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 4 lakhs instead of ₹ 10 lakhs. The average remaining life of the employees, if estimated to be 6 years, you are required to advise the company considering the Accounting Standards 15 and 5.

Solution:

As per para 92 of AS 15 (Revised in 2005), Employee Benefits, any actuarial gains or losses should be recognised immediately in the Profit and Loss Statement as incomes or expenses.

As such, in the present case, a surplus amounting to ₹ 12 lakhs from pension scheme is an actuarial gain. The same should be recognised as an income and, hence, should be adjusted against current year's Profit and Loss Account. It must not be adjusted against the contribution of the current year.

It is needless to say that the surplus that arises as a result of reviewing actual valuation of pension scheme by a company must be treated as a change in accounting policy. Application of AS 15 (Revised) may give rise to change in accounting policy as per para 32 of AS 5.

Illustration 61.

The fair value of plan assets at the beginning and end of the year were ₹ 5,600 and ₹ 6,172 respectively. The employer's contribution to the plan during the year as ₹ 580. Benefit payments to retirees were ₹ 640. Calculate the actual return on plan assets.

Solution:

The actual return is computed as follows:

Amount (₹)

Fair value of plan assets (beginning of year)	5,600
Plus: Employer Contribution	580
Plus: Actual Return	?
Less: Benefit Payments	(640)
Fair value of plan assets (ending of year)	6,172

The Actual Return equal to ₹ 632

Alternatively, the following formula may be used to derive the actual return:

Actual return = Fair Value of asset (end of year) - Fair Value of assets (beginning of the year) - Employer Contributions + Benefit Payments

Actual Return = ₹ 6,172 - ₹ 5,600 - ₹ 580 + ₹ 640 = ₹ 632

Illustration 62.

The following data apply to a company's defined benefit pension plan for the year:

Amount (₹)

Fair market value of plan assets (beginning of year)	40,000
Fair market value of plan assets	57,000
Employer Contribution	14,000
Benefit Paid	10,000

Calculate the Actual Return on plan assets.

Solution:

The actual return is computed as follows:

Amount (₹)

Fair Market Value of plan assets (end of year)		57,000
Fair Market Value of plan assets (beginning of year)		40,000
Change in plan assets		17,000
Adjusted for		
Employer Contributions	14,000	
Less: Benefit Paid	10,000	4,000
Actual Return on plan assets		13,000

Illustration 63.

Based on the following information, calculate the Actual Return on pension plan assets:

Amount (₹)

Benefit Payments	2,00,000	
Contribution	2,60,000	
Fair Market Value of plan assets		
End of year		12,00,000
Beginning of year		8,00,000

Solution:

The Actual Return on pension plan assets follows:

Amount (₹)

Change in Fair Market Value of plan assets		4,00,000
Adjustments:		
Employer Contribution	2,60,000	
Benefit Payments	2,00,000	60,000
Actual Return on plan assets		3,40,000

Illustration 64.

A company reports the following information regarding pension plan assets. Calculate the fair value of plan assets.

Amount (₹)

Fair Market Value of plan assets (beginning of year)	3,50,000
Employer Contribution	50,000
Actual Return on plan assets	25,000
Benefit payments to retirees	20,000

Solution:

The actual return on pension plan assets follows:

Amount (₹)

Fair Market Value of plan assets (beginning of year)	3,50,000
Employer Contribution	50,000
Actual Return	25,000
Benefit payments	(20,000)
Fair Market Value of plan assets (end of year)	4,05,000

2.8 AS 16: BORROWING COSTS

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

A qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use or sale.

Examples of qualifying assets :

- Any tangible fixed assets, which are in construction process or acquired tangible fixed assets, which are not ready for use or resale. Such as plants and machinery.
- Any intangible assets, which are in development phase or acquired but not ready for use or resale, such as patent.
- Investment property.
- Inventories that require a substantial period(i.e. generally more than one accounting period) to bring them to a saleable condition.

The standard is applied in accounting for borrowing costs which include:

1. Interest and commitment charges on bank borrowing and other short term borrowings;
2. Amortization of discounts/premium relating to borrowings;
3. Amortization of ancillary cost incurred in connection with arrangement of borrowings;
4. Finance charges for assets acquired under finance lease or other similar arrangement.
5. Exchange difference in foreign currency borrowing to the extent it relates to interest element;

Borrowing cost incurred on assets, which takes substantial period, is treated as cost of that asset in respect of (1) above.

As per the Guidance Note on Audit of Miscellaneous Expenditure issued by ICAI, deferment for amortization cost upto the time the asset is put to use, in respect of (2) and (3), should be capitalized (see below for AS-16 provision).

Finance charges as in (4) can be capitalized upto the time the asset is put to use (AS-19 deals with elaborate provision)

Conditions for capitalization of borrowing costs :

- Directly attributable costs for acquisition, construction or production of qualifying asset, are eligible for capitalization. Directly attributable costs are those costs that would have been avoided if the expenditure on qualifying asset have note been made.
- Qualifying assets will render future economic benefit to the enterprise and the cost can be measured reliably.

Amount of borrowing costs eligible for capitalization (specific borrowing) :

- Amount of borrowing cost eligible for capitalization = Actual borrowing cost incurred during the period **less** any income generated on the temporary investment of amount borrowed.

Commencement of capitalization of borrowing cost

Following three conditions must be fulfilled before the commencement of capitalization of borrowing cost:

- Activities, which are essential to prepare the asset for its intended use, should be in progress.
- Borrowing cost is incurred
- Expenditure for acquisition, construction or production of a qualifying asset is being incurred.

All other borrowing costs are charged to P&L Account :

AS-16 establishes a key test for capitalization which states that "borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those costs that would have been avoided if the expenditure on the qualifying asset had not been made".

Accounting treatment of borrowing cost as per AS-16 :

(a) Borrowing costs should either be capitalized or charged to P&L Account depending on the situation but deferment is not permitted.

(b) Borrowing costs are capitalized as part of cost of qualifying asset when it is probable that they will result in future economic benefits and cost can be measured reliably - other borrowing costs are charged to P&L Account in the accounting period in which they are incurred.

(c) Capitalization, on one hand reflects closely the total investment in the asset and on the other hand to charge the cost to future period against accrual of revenue.

(d) Notional interest cost are not allowed to be capitalized.

(e) A qualifying asset is an asset that necessarily takes a substantial period of time (usually a period of 12 months unless otherwise justified on the basis of facts and circumstances) to get ready for its intended use or sale.

(f) Capitalization should be suspended during extended period in which active development is interrupted.

(g) Capitalization should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

(h) Capitalization also ceases 'when part is completed, which is capable of being used independently of the whole.

Disclosure under AS-16

(a) Accounting Policy adopted

(b) Amount of borrowing cost capitalized during the accounting period

Illustration 65.

When should capitalisation of Borrowing Cost cease as per AS 16?

Solution:

As per AS 16, Capitalisation of Borrowing Costs should cease when substantially all the activities necessary to prepare the qualifying assets for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that, substantially, all the activities are complete.

When the construction of a qualifying asset is completed in parts and completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

Illustration 66.

Calculate the value of the qualifying assets from the following particulars as presented by X Ltd.:

A Ltd. incurred ₹ 25,00,000 to construct a factory premises which was ready for use on 31.12.2013. It used the funds from working capital facility given by a commercial bank on which interest was payable @12% p.a. It was found during the period of construction the average balance of loan for working capital had never fallen below ₹ 30 lakhs.

The expenditure which were incurred during the period from July 2013-Dec. 2013 are:

	₹
2013- July	3,00,000
August	4,00,000
September	6,00,000
October	5,00,000
November	4,00,000
December	3,00,000
	25,00,000

Solution:

Statement showing the Value of the Qualifying Assets

Year	Month	Expenditure Incurred on Qualifying Assets ₹	Interest ₹	Cumulative Expenditure Interest ₹
2013	July	3,00,000	---	3,00,000
	August	4,00,000	3,000	7,03,000
	September	6,00,000	7,030	13,10,030
	October	5,00,000	13,100	18,23,130
	November	4,00,000	18,231	22,41,361
	December	3,00,000	22,414	25,63,775
		25,00,000	63,775	

[Interest to be capitalised @ 12% p.a. i.e. 1% p.m.]

∴ The value of the qualifying asset is ₹ 25,63,775.

Illustration 67.

A Ltd. has undertaken a project for expansion of capacity as per the following details (all figures in rupees):

		Plan ₹	Actual ₹
April	2013	2,00,000	2,00,000
May	2013	2,00,000	3,00,000
June	2013	10,00,000	-
July	2013	1,00,000	-
August	2013	2,00,000	1,00,000
September	2013	5,00,000	7,00,000

The company pays to its bankers @ 12% p.a. interest being debited on a monthly basis. During the half-year the company had ₹ 10 lakhs overdraft up to 31st July, surplus cash in August as against overdraft of over ₹ 10 lakhs from 1.9.2013. The company had a strike during June and, hence, could not continue the work during June. Work was again commenced on 1st July and all the works were completed on 30th September. Assume that expenditures were incurred on 1st day of each month.

Calculate: (i) Interest to be capitalised; and (ii) Give reasons whenever necessary.

Assume: (a) Overdraft will be less if there is no capital expenditure: (b) The Board of Directors, based on the facts and circumstances of the case, has decided that any capital expenditure taking more than 3 months as substantial period of time.

Solution:

(i) **Interest to be Capitalised**

Calculation of Interest to be Capitalised

Period	Actual amount of Expenditure	Interest @ 12% p.a. i.e. 1% p.m.	Cumulative expenditure including Interest
2013	₹	₹	₹
April	2,00,000	2,000	2,02,000
May	3,00,000	5,020	5,07,020
June	—	5,070	5,12,090
July	—	5,121	5,17,211
August	1,00,000	—*	6,17,211
September	7,00,000	13,172	13,30,383

* Cash surplus and no overdraft hence no interest cost.

As per of AS 10:

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial, technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

(ii) In the present case, Board of Directors has decided that any capital expenditure taking more than 3 months as substantial period of time. Thus, strike period may be ignored and interest for that period may be capitalised accordingly. In the month of August, as there was surplus amount of cash, no interest should, as such, be capitalised.

Illustration 68.

In May 2012 Speed Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January 2013 and the building was put to use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was ₹18 lakhs, whereas the total interest payable to the bank on the loan for period till 31.3.2013 amounted to ₹ 25 lakhs.

Can ₹ 25 lakhs be treated as part of the cost of factory building and thus be capitalised on the place that the loan was specifically taken for the construction of the factory building?

Solution:

As per para 6 of AS 16, borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset should be capitalised as part of the cost of that asset. (A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale). Other borrowing costs should be recognised as expense in the period in which they are incurred.

In the present case the company incurred by way of interest charges ₹ 25 lakhs of which ₹ 18 lakhs should be capitalised (as a capital expenditure) and the balance ₹ 7 lakhs should be treated as an expense and adjusted against the statement of profit and loss in the period ended 31.3.2013.

Illustration 69.

On 20.4.2012, M Ltd obtained a loan from the bank for ₹ 50 lakhs to be utilised as:

Particulars	₹ (in lakhs)
Construction of a shed	20
Purchase of Machinery	15
Working Capital	10
Advance for purchase of Truck	5

In March 2013, construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ending 31.3.2013 was ₹ 9 lakhs.

Show the treatment of interest under AS 16.

Solution:

As per AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying assets should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing cost should be recognised as an expense in the periods in which they are incurred.

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. As per AS 16, if an asset is ready for its intended use or sale at the time of acquisition, the same cannot be treated as a qualifying asset.

Treatment of Interest

Items	Nature of Asset	Interest to be capitalized ₹ (in lakhs)	Interest to be charged to P&L A/c ₹ (in lakhs)
Constructions of a shed	Qualifying Asset	₹ 3.60($\frac{₹ 20}{₹ 50}$ x ₹ 9)	---
Purchase of a Machinery	Not a qualifying Asset	---	₹ 2.70($\frac{₹ 15}{₹ 50}$ x ₹ 9)
Working Capital	Not a qualifying Asset	___	₹ 1.80($\frac{₹ 10}{₹ 50}$ x ₹ 9)
Advance in purchase of Truck	Not a qualifying Asset	___	₹ 0.90($\frac{₹ 5}{₹ 50}$ x ₹ 9)
		₹ 3.60 lakhs	₹ 5.40 lakhs

Illustration 70.

M Ltd. has obtained an institutional loan of ₹ 680 lakhs for modernisation and renovation of its Plant and Machinery. Plant and Machinery acquired under the Modernisation Scheme and installation completed on 31.3.2013 amounted to ₹ 520 lakhs. ₹ 30 lakhs has been advanced to suppliers for additional assets and the balance loan of ₹ 130 lakhs has been utilised for Working Capital purpose. The total interest paid for the above loan amounted to ₹ 68 lakhs during 2012-2013.

You are required to state how the interest on the institutional loan is to be accounted for in the year 2012-2013.

Solution:

Interest on borrowed Capital which are used for the purpose of acquisition/construction of fixed asset during the period up to the completion stage or acquisition should be added to the gross book value of the concerned fixed assets. As such, the institution loan amounting to ₹ 520 lakhs together with interest of ₹ 52 lakhs (shown below) should be added to the gross book value of the fixed asset.

But, advance to supplier for additional assets amounting to ₹ 30 lakhs together with interest of ₹ 3 lakhs (shown below) may be treated as capital work-in-progress and the same should be capitalised at a subsequent date.

Similarly, loan taken for working capital purpose amounting to ₹ 130 lakhs and interest on it of ₹ 13 lakhs (shown below) should be charged against current year's Profit and Loss Account.

Thus, the whole matter stands as:

Items	Percentage of Term Loans to Total	Amount ₹	Amount of Interest ₹
Acquisition of Plant & Machinery	76.47%	520	52
Advance to Suppliers	4.41%	30	3
Working Capital Loan	19.12%	130	13
	100.00%	680	68

Illustration 71.

The Notes to account of M Ltd. for the year 2012-2013, include:

"Interest on bridge loan from banks and financial institutions and on debentures specially obtained for the company's fertiliser project amounting to ₹ 1,80,80,000 has been capitalised during the year, which include approximately ₹ 1,70,33,465 capitalised in respect of the utilisation of loan and debenture money for the said purpose".

Ascertain the amount of revenue expenditure.

Solution:

As per para 6, AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Statement. Other borrowing costs should be recognised as an expense in the period in which they are issued.

In the present case, however, M Ltd. incurred ₹ 1,80,80,000 on account of interest of which ₹ 1,70,33,465 is directly attributable to the construction of the project. As per AS 16, the said amount should be capitalised and the balance ₹ 10,46,535 (i.e. ₹ 1,80,80,000 - ₹ 1,70,33,465), is treated as expense, i.e. revenue in nature, and, as such, the same should be adjusted against the Profit and Loss Statement.

Illustration 72.

G Ltd. purchased machinery from P Ltd. on 30.9.2012. The price was ₹ 370.44 lakhs after charging 8% sales-tax and giving a trade discount of 2% on the Quoted price. Transport charges were 0.25% on the quoted price and installation charges came to 1% on the quoted price.

A loan of ₹ 300 lakhs was taken from the bank on which interest at 15% p.a. was to be paid. Expenditure incurred on the trial run was materials ₹ 35,000, wages ₹ 25,000 and overhead ₹ 15,000. Machinery was ready for use on 1.12.2012. However, it was actually put to use only on 1.5.2013.

Find out the cost of the machine and suggest the accounting treatment for the expenses incurred in the interval between the dates 1.12.2012 and 1.5.2013. The entire loan amount remain unpaid on 1.5.2013.

Solution:

As per para 6, AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as all expense in the period in which they are incurred.

The total cost of the machine is calculated as:

Cost of the Machine

Particulars	₹ (in lakhs)
Quoted Price (₹ 370.44 x $\frac{100}{108} \times \frac{100}{98}$) =	350.000
(Since the price was given after charging sales tax and trade discount)	
Less: Trade Discount @ 2% on ₹ 350 lakhs	7.000
	343.000
Add: Sales-Tax @ 8% on ₹ 3,43,000 lakhs	27.440
	370.440
Add: Transportation cost @ 0.25% on ₹ 350 lakhs	0.875
	371.315
Add: Installation Charges @ 1% on ₹ 350 lakhs	3.500
	374.815
Add: Expenditure to be incurred for Trial run	
Materials 0.350	
Wages 0.250	
Overheads 0.150	0.750
Add: Cost of borrowing @ 15% on ₹ 300 lakhs (from 30.9.2012 to 1.12.2012)	7.500
Cost of the machine	383.065

As per para 19 and para 20, of AS 16, capitalisations of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Similarly, an asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. Hence, capitalisation of borrowing cost @ 15% on ₹ 300 lakhs for 5 months amounting to ₹ 18.75 lakhs should be treated as an expense and, as such, should be adjusted against Profit and Loss Statement.

Study Note - 3

RECONCILIATION STATEMENTS

This Study Note includes

3.1 Bank Reconciliation
3.2 Receivable Reconciliation
3.3 Payable Reconciliation
3.4 Stock Reconciliation

3.1 BANK RECONCILIATION

We have studied the Cash Book which has two columns viz. Cash and Bank. The majority of transactions get settled through cash or Bank. For cash received or paid, the effect in the cash box is instant. The transactions settled through the medium of Bank (i.e. by way of cheque, pay order, draft etc) take a little longer time. If customer pays by cheque, it is deposited in the Bank who will sent it for clearance and then only it will be credited by the Bank into the A/c of business entity. This may take about a week. Similarly, when a cheque is issued to supplier, he will deposit in his Bank which in turn will clear it. Because of such time lag, there would be difference in the records.

The records here would mean Cash Book (in books of business entity) and Pass Book (maintained by the Bank). The contents of Bank Pass Book (or Bank statement) are exactly the same as that of Cash Book with a mirror image effect. When cheques is received the entry in books of accounts of business is

Bank A/c Dr.

To Customer A/c

For the Bank, this amount is collected through the clearing system and payable to the Business Entity's A/c. The entry in their books will be

Clearing A/c Dr.

To Business Entity's A/c

Hence they will show it as payable i.e. as a credit. Thus all debits in the Bank column of the Cash Book will correspond to the credit entries in the Bank Passbook and all credits in the Bank column of the Cash Book will correspond to the debit entries in the Bank Passbook. Due to the time differences, these entries may not exactly match at a given point of time. This necessitates that these two statements are reconciled regularly:

(1) To identify differences
(2) To know reasons for differences
(3) To ensure the required entries are made in the books of accounts
(4) To ensure that entries are made by the Bank in time.

A statement which is prepared to reconcile the causes of difference between Bank Balance as per Cash Book and Bank Balance as per Pass Book/ Bank Statement is known as a Bank Reconciliation statement.

It may be noted that before the final accounts are prepared, Bank Reconciliation is a must. It is a very important preparatory step. If an entity has A/c with more than one Bank, all such A/cs must be reconciled regularly i.e. weekly or monthly. In these days of internet Banking where the Bank statements are available online, the reconciliation also can be an online activity. In fact, modern accounting packages are equipped with automatic reconciliations. A Bank statement is entered in the computer

system (or a soft copy is uploaded) and then a programme is run which will throw up the transactions leading to the differences.

Features of a Bank Reconciliation Statement

1. It is a statement.
2. It is not a part of the process of Accounts.
3. It is prepared to reconcile the causes of difference between the Bank balance as per Cash Book and the Bank balance as per Pass Book.
4. It can be prepared at any time during the financial year, as and when it is required.
5. Since it is prepared on a particular date, it is written as Bank Reconciliation Statement as at/as on……………………

It is necessary for a beginner to understand the mechanism of how to prepare the Bank Reconciliation Statement. The first milestone on this journey is to understand the various reasons for differences between the two records.

3.1.1 Reasons for Differences between Cash Book and Pass Book

The differences are basically of two types:

(A) Items appear in Cash Book but not appearing in Pass Book and

(B) Items appear in Pass Book but not appearing in the Cash Book

Let us understand these reasons:

(A) Items not appearing in Bank Pass Book

(1) Cheques issued by business entity not debited by the Bank – This may be because they might not have been Banked by the payee or it may still be under clearance. The entry in Cash Book will be made immediately when the cheque is issued thereby reducing the Bank balance in the books of entity's books of A/cs. Here, Bank balance as per Cash Book will be less, but as per Bank Pass Book it will be more. This is also termed as unpresented cheques.

(2) Cheques deposited but not credited by the Bank – The business entity may receive cheques or draft which is deposited into the Bank for collecting the payment. Again entry in Cash Book will be instant thereby increasing the balance. Here, Bank balance as per Cash Book will be more than the balance as per Bank Pass Book. This is also called as outstanding cheques.

(3) Errors – The Bank may by mistake miss out entering the debit or credit which results in the difference.

(4) Standing Instructions – The entity may give standing instruction to the Bank for certain regular payments like loan repayment installment, transfer of funds etc. This may get entered in the Cash Book immediately, but Pass Book entry may be delayed.

(B) Items not appearing in the Cash Book

(1) Bank interest, Bank charges etc. – The Bank will charge interest on overdraft or also charges for services, issue of demand draft, pay orders etc. Here, being the source of transaction, the Bank will record in the Pass Book immediately and send the debit advice slips to the business entity. The entry in the Cash Book may be delayed. Similarly the Bank could credit interest on fixed deposits, which may get entered in business books at a later date.

(2) Direct deposits in Bank account – Sometimes customers or others may directly deposit an amount in the Bank for goods or services rendered. The Bank will enter it immediately, but entry in Cash Book will appear later.

(3) Bills for collection – The Business Entity may send bills of exchange for collection. The Bank will collect the payment and credit the same in the passbook. The entry in Cash Book will be made only after receipt of information from the Bank.

(4) Errors – The records may be missed out by the book-keeper of the Business Entity.

Need of Bank Reconciliation Statement

1. It helps to understand the actual Bank balance.
2. It helps to identify the mistakes in the Cash Book and the Pass Book.
3. It helps to detect and prevent frauds and errors in recording the Banking transactions.
4. It helps to incorporate certain expenditures/income debited/credited by Bank in the books of accounts.

Methods of preparation of Bank Reconciliation Statement

1. Rules of Addition and Subtraction.
2. Debit and Credit Method.

3.1.2 Steps in Preparing Bank Reconciliation Statement

One has to have a systematic approach towards preparation of the reconciliation. To avoid a lengthy reconciliation, one must ensure that the entries in the Cash Book are absolutely online. One also must obtain the Bank statements at regular intervals. Once this checking is done, Bank reconciliation could be done by following these steps:

(a) Identify the balances and the character thereof. Remember, a debit balance in Cash Book means asset where as a credit balance means a Bank overdraft. In Bank passbook, it's reverse. A debit balance in Pass Book means overdraft and a credit balance is a favourable balance. This must be carefully understood.

(b) Based on the above, start with the balance (or overdraft) as per one book and arrive at the balance (or overdraft) as per the other book. The items of differences will be added to or deducted from the balance (or overdraft) with which the reconciliation is started.

(c) The end result should be the balance (or overdraft) as per the other book e. g. if you start with balance as per Cash Book, then after adding or deducting items of differences, you should arrive at the balance (or overdraft) as per the Pass Book.

(d) One has to make sure that all the items of differences from Cash Book as well as Bank book are taken into account in the reconciliation statement.

(e) Whether the items of differences should be added or deducted will depend on the sequence you follow. This is shown in following table:

When reconciliation is started with →	**Bal. as per CB**	**OD as per CB**	**Bal as per PB**	**OD as per PB**
Cheques deposited in Bank, but not cleared	Less	Add	Add	Less
Cheques issued, but not presented in Bank	Add	Less	Less	Add
Bank charges debited in PB only	Less	Add	Add	Less
Interest debited in PB only	Less	Add	Add	Less
Payments by Bank debited in PB only	Less	Add	Add	Less
Direct payment by customer in PB only	Add	Less	Less	Add
Bills discounted & dishonoured in PB only	Less	Add	Add	Less
Cheques deposited, dishonoured in PB only	Less	Add	Add	Less
Interest, Dividend, Commission collected by Bank not recorded in the Cash Book	Add	Less	Less	Add
Overcasting of payment side of Cash Book or Undercasting of Receipt side of Cash Book	Add	Less	Less	Add

When reconciliation is started with →	Bal. as per CB	OD as per CB	Bal as per PB	OD as per PB
Undercasting of Payment side of Cash Book or overcasting of Receipts side of Cash Book	Less	Add	Add	Less
Deposits recorded twice in the Cash Book or excess amount recorded in the Cash Book	Less	Add	Add	Less
Undercasting of credit side of the Pass Book or overcasting of the debit side of the Pass Book	Less	Add	Add	Less
Cheques deposited into Bank and credited without recording in the Cash Book	Add	Less	Less	Add
Wrong debit in the Pass Book for issue of cheque, Bank charges, etc.	Less	Add	Add	Less
Wrong credit in the Pass Book for deposit of cheque, interest, etc.	Add	Less	Less	Add
Cheques drawn but not actually issued to the suppliers/ creditors	Add	Less	Less	Add
Bank charges recorded twice in the Cash Book	Add	Less	Less	Add
Amount withdrawn from Bank not recorded in the Cash Book	Less	Add	Add	Less

Please note the abbreviations CB – Cash Book, PB – Pass Book, OD – Overdraft

Illustration 1.

On 31.12.13, P. Roy's Bank Balance as shown by the Cash Book was ₹ 75,000. On receipt of Bank Statement it was found that :-

(i) Three cheques of ₹3,000, ₹4,000 and ₹1,500 drawn in favour of suppliers respectively on 28th, 29th and 30th December, 2013 had been debited in the Bank Statement on 2nd January 2014.

(ii) The Bank had credited ₹8,000 on 30th December, 2013, in respect of collection made by Bank directly from a customer, the intimation not having yet been received.

(iii) Two cheques of ₹5,000 and ₹6,000 were deposited into Bank on 30th December, 2013 had been credited in the Bank statement on 4th January, 2014.

(iv) The Bank had debited ₹30 as incidental charges on 30th December, 2013 but not entered in the Cash Book.

Show the reconciliation of the Bank Balance as per Cash Book with the Bank Balance as per Bank Statement as on 31st December, 2013.

Solution:

Bank Reconciliation Statement of Mr. P. Roy as on 31st December, 2013.

Particulars	Amount (₹)	Amount (₹)
Bank Balance as per Cash Book (Dr.)		75,000
Add: (i) Cheques issued but not presented for payment ₹3,000, ₹4,000 & ₹1500 respectively.	8,500	
(ii) Collection by Bank from a Customer not recorded in the Cash Book	8,000	16,500
		91,500
Less: (i) Cheques deposited but not credited in the Pass Book on 31.12.13 ₹5,000 + ₹6,000 respectively.	11,000	
(ii) Bank charges not recorded in the C.B.	30	11,030
Balance as per Pass Book (Cr.)		80,470

Illustration 2.

The Bank statement of Mr. J. White dated 31.12.2013 showed a balance with his Bank of ₹ 924, when checked with his Cash Book the following were noted :

(a) During December, the Bank had paid ₹200 for a yearly contribution of Mr. White, made to a local charity, as per his standing order. This amount appeared in the Bank statement but not in the Cash Book.

(b) The Bank had credited his account with ₹28 interest and had collected on his behalf ₹ 230 as dividends. No corresponding entries were made in the Cash Book.

(c) A cheque of ₹ 65 deposited into the Bank on 28.12.2013 was not cleared by the Bank till after 31.12.2013.

(d) A cheque of ₹150 deposited into and cleared by the Bank before 31.12.2013 was not entered in the Cash Book, through an oversight.

(e) Cheques drawn by and posted to parties by Mr. White on 31.12.2013 for ₹73, ₹119 and ₹ 46 were presented for payment to the Bank only on 3.1.2014.

Solution:

Bank Reconciliation Statement as on 31st December, 2013

	Particulars	Amount (₹)	Amount (₹)
	Bank balance as per Pass Book (Cr.)		924
Add: (i)	Payment of contribution by the Bank not entered in the Cash Book	200	
(ii)	Cheque deposited but not cleared	65	265
			1,189
Less: (i)	Interest and dividend collected by the Bank not entered in the		
	Cash Book - Interest	28	
	- Dividend	230	
(ii)	Cheque deposited and cleared but not entered in the Cash Book	150	
(iii)	Cheques issued but not presented ₹ (73+119+46)	238	646
	Bank balance as per Cash Book (Dr.)		543

Illustration 3.

Mr. Suresh request you to ascertain the Bank balance as per the Pass Book for January 2014, as his cash clerk reported a figure of ₹11,515 (credit) as on 31.1.2014. Scrutiny revealed the following discrepancies :

(i) Cheques issued and deposited by the cash clerk in January 2014, were ₹ 15,000 and ₹ 7,000 respectively. However, against the above, the Bank had paid out and debited cheques worth ₹9,000 only and cleared and credited cheques worth ₹ 4,000 only, by 31.1.2014.

(ii) A customer had paid in ₹ 6,400 directly into Suresh's Bank account, the effect of which was missing in the Cash Book.

(iii) Bank commission of ₹ 45 charged and interest earned ₹ 1,400 on investments of Mr. Suresh, where only recorded in the Pass Book.

(iv) Total cash withdrawals of ₹ 3,000 by self and bearer cheques for office use, were recorded erroneously as ₹ 5,000 in the Cash Book.

Solution:

Mr. Suresh

Bank Reconciliation Statement as on 31st January, 2014

Particulars	Amount (₹)	Amount (₹)
Overdraft as per Cash Book		11,515
Add: (i) Cheques deposited but not cleared (7,000 - 4,000)	3,000	
(ii) Bank commission charged by the Bank	45	3,045
		14,560
Less: (i) Cheques issued but not presented for payment (15,000-9,000)	6,000	
(ii) Direct deposit by a customer	6,400	
(iii) Interest on investment credited in the Pass Book only	1,400	
(iv) Withdrawals of ₹ 3,000 recorded in the Cash Book as ₹ 5,000	2,000	15,800
Bank balance as per Pass Book (Cr.)		1,240

Illustration 4.

The Bank Pass Book of Mr. Anil showed an overdraft of ₹ 6,000 on 31.12.2013. Prepare the Bank Reconciliation Statement based on the following details:

(a) Cheques issued but not presented upto 31.12.2013, ₹ 5,500

(b) Cheques deposited but not credited upto 31.12.2013, ₹ 9,000

(c) Bank commission ₹ 30 was entered only in the Pass Book.

(d) A cheque for ₹ 6,500 issued in settlement of a debt was encashed on 28.12.2013 but entered in the Cash Book as ₹ 8,500.

Solution:

Mr. Anil

Bank Reconcilliation Statement as on 31st December, 2013

Particulars	Amount (₹)	Amount (₹)
Overdraft as per Pass Book		6,000
Add: (i) Cheques issued but not presented for payment	5,500	
(ii) Cheque for ₹ 6,500 issued and encashed but entered in the Cash Book at ₹ 8,500 (8,500 - 6,500)	2,000	7,500
		13,500
Less: (i) Cheques deposited but not credited	9,000	
(ii) Bank commission entered in the Pass Book only	30	9,030
Overdraft as per Cash Book		4,470

Illustration 5.

From the following particulars of M/s Suresh Enterprises, prepare a Bank Reconciliation Statement:

(1) Bank overdraft as per Pass Book as on 31st March 2013 was ₹ 8,800

(2) Cheques deposited in Bank for ₹ 5,800 but only ₹ 2,000 were cleared till 31st March.

(3) Cheques issued were ₹ 2,500, ₹ 3,800 and ₹ 2,000 during the month. The cheque of ₹ 5,800 is still with supplier.

(4) Dividend collected by Bank ₹ 1,250 was wrongly entered as ₹ 1,520 in Cash Book.

(5) Amount transferred from fixed deposit A/c into the current A/c ₹ 2,000 appeared only in Pass Book.

(6) Interest on overdraft ₹ 930 was debited by Bank in Pass Book and the information was received only on 3rd April 2013.

(7) Direct deposit by M/s Rajesh Traders ₹ 400 not entered in Cash Book.

(8) Corporation tax ₹ 1,200 paid by Bank as per standing instruction appears in PB only.

Solution:

Bank Reconciliation Statement as on 31st March, 2013

Particulars	Amount (₹)	Amount (₹)
Overdraft as per Pass Book		8,800
Add: (i) Cheques issued but not presented till 31st March	5,800	
(ii) Transfer from fixed deposit	2,000	
(iii) Direct deposit by M/s Rajesh Traders	400	8,200
		17,000
Less: (i) Cheques deposited but not cleared (5,800 - 2,000)	3,800	
(ii) Dividend collected excess recorded in CB (1,520 - 1,250)	270	
(iii) Interest on overdraft debited in PB only	930	
(iv) Corporation tax paid appeared in PB only	1,200	6,200
Overdraft as per Cash Book		10,800

Illustration 6.

Mr. Narayan has given extract of his HDFC Bank statement for the month of December 2013 as follows:

Details	Withdrawal ₹	Deposit (₹)	Balance (₹)	
Balance as on 1-12-2013			12,500	Cr
Deposits realized:				
Cash		60,000	72,500	Cr
Customers' cheques : deposited in Nov 13		5,000	77,500	Cr
: deposited in Dec 13		1,70,000	2,47,500	Cr
Bank charges	400		2,47,100	Cr
Cash paid	10,000		2,37,100	Cr
Cheques honoured : issued before Dec 13	68,100		169,000	Cr
: issued in Dec 13	1,56,000		13,000	Cr

His Cash Book showed cash balance of ₹ 3,000 and Bank OD of ₹ 53,450 as on 1st December 2013. His transactions during December 2013 were as follows:

(a) Cash collected on sales ₹ 60,000 which was Banked on a daily basis. Credit sales were ₹ 1,90,000

(b) Cheques received from customers for ₹ 1,50,000 in full settlement of the invoices of ₹ 1,53,000

(c) Credit purchases were ₹ 1,55,000

(d) Cheques of ₹ 1,32,000 were issued against the November purchases of ₹ 1,34,000

(e) Advances received from customers ₹ 30,000 & advances paid to suppliers ₹ 25,000

(f) Amount withdrawn from Bank ₹ 10,000 of which ₹ 4,000 was for personal use of Mr. Narayan and balance was for business expenses.

(g) Expenses ₹ 9,000 of which ₹ 5,000 was by cheque and the rest by cash

(h) Cash paid on behalf of customer ₹ 4,500

(i) Bank charges ₹ 150 debited by Bank in November were recorded in Cash Book in December on receipt of Bank statement.

It was noticed that cheques ₹ 2,500 deposited and cheques ₹ 5,500 issued before 1st December were not cleared by 31st December. Prepare Cash Book for December 2013 with discount, cash and Bank columns. Also prepare Bank Reconciliation Statement as on 30th November and as of 31st December 2013.

Solution:

Dr. Cash Book of Mr. Narayan for the month of December 2013 Cr.

Particulars	Disc (₹)	HDFC (₹)	Cash (₹)	Particulars	Disc (₹)	HDFC (₹)	Cash (₹)
To Balance b/d			3,000	By Balance b/d (OD)		53,450	
To Cash sales			60,000	By Cash deposited in Bank (contra)			60,000
To Cash deposited in Bank (contra)		60,000		By Cheques issued to suppliers	2,000	1,32,000	
To Customers cheques deposited	3,000	1,50,000		By Advances to suppliers by cheque		25,000	
To Advance cheques from Customers		30,000		By Cash withdrawn (contra)		6,000	
To Cash withdrawn (contra)			6,000	By Drawings		4,000	
				By Expenses paid		5,000	4,000
				By Cash paid on behalf of Customer			4,500
				By Bank charges		150	
				By Balance c/d		14,400	500
	3,000	2,40,000	69,000		2,000	2,40,000	69,000

Please note here, the reconciliation statements are asked for 2 different dates. We must find out items of differences between Cash Book and Bank statement as on both dates and then should prepare the reconciliation statements. Transactions of credit sales and credit purchases for the month will have no relevance of posting in Cash Book.

HDFC Bank Reconciliation as on 30th November 2013

Particulars	Amount ₹	Amount ₹
Balance as per Bank statement (credit)		12,500
Add: (i) cheques deposited but not cleared (5,000+ 2,500)	7,500	
(ii) Bank charges not recorded in CB	150	7,650
		20,150
Less: (i) Cheques issued not presented (68,100 + 5,500)		73,600
Balance as per Cash Book (Overdraft)		(53,450)

HDFC Bank Reconciliation as on 31st December 2013

Particulars	Amount (₹)	Amount (₹)
Balance as per Cash Book		14,400
Add: (i) Cheques issued but not presented :		
Issued in November	5,500	
Issued in December (1,62,000 – 1,56,000)	6,000	11,500
		25,900
Less: (i) Cheques deposited but not cleared :		
Deposited in November	2,500	
Deposited in December (1,80,000 – 1,70,000)	10,000	
(ii) Bank charges for December not entered in CB	400	
		12,900
Balance as per Pass Book		13,000

3.1.3 Amendment in Cash Book

Sometimes, in order to find out the correct balance at Bank or cash to amend the Cash Book before the preparation of Bank Reconciliation Statement. In short, Bank Reconciliation Statement should be prepared by taking the balance shown by the amended Cash Book. The students should remember that usually two types of transactions are recorded in amended Cash Book i.e., (i) Items which were not at all recorded in Cash Book. (ii) Any error made by Cash Book. The transactions which are already recorded in Cash Book i.e., the rest of the transactions will go Bank reconciliation statement.

But it must be remembered that preparation of amended Cash Book is possible only when the balance as per Cash Book is given.

Step to be followed for preparation:

(a) Open the cash with the Balance as per Cash Book, whether favourable or unfavourable,

(b) Against the items (i.e., which are not recorded in Cash Book as any other error made by Cash Book.)

(c) Close the Cash Book and find out the balance,

(d) Prepare Bank Reconciliation Statement by taking the Cash Book balance and rest of the transaction which are not adjusted against amended Cash Book.

Illustration 7.

The Bank column of the Cash Book showed an overdraft of ₹ 5,000 on 31-03-2013, whereas as per Bank statement the overdraft is ₹ 4,200. The following differences were noticed between the two records:

(a) Cheques of ₹ 2,400 issued but not encashed by customers

(b) Cheques deposited but not cleared ₹ 1,200

(c) Collection charges debited by Bank not recorded in CB ₹ 100

(d) Bank interest charged by the Bank not recorded in CB ₹ 300

(e) Cheques dishonoured debited by Bank not in CB ₹ 400

(f) Interest directly received by Bank not entered in CB ₹ 400

Prepare Bank reconciliation statement after amending the CB.

Solution:

Here, please note that amended CB is asked. What it actually means is to record all revenue (expense or income) items of differences and those items that are recorded in PB only must first be recorded in the CB and then the reconciliation statement should be prepared by taking the revised balance as per CB. Here is the amended CB.

Dr. **Cash Book (Bank column only)** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Interest received	400	By Balance b/d (OD)	5,000
		By collection charges	100
		By Bank interest	300
To Balance c/d (OD)	5,400	By customer (chq dishonoured)	400
	5,800		5,800

Bank Reconciliation Statement as on 31-03-2013	₹
Bank OD as per CB	5,400
Add: Cheques deposited, but not cleared	1,200
Less: cheques issued but not encashed	(2,400)
Bank OD as per PB	4,200

Illustration 8.

The following is a summary from Cash Book of M/s Adarsh Trading for the month of Sept 2013

	₹		₹
Balance b/d	1,407	Payments	15,520
Receipts	15,073	Balance c/d	960
	16,480		16,480

On investigation it was found that

(a) Bank charges of ₹ 35 were not entered in the Cash Book.

(b) A cheque of ₹ 47 issued to supplier was entered by mistake as a receipt in the Cash Book.

(c) A cheque of ₹ 18 was returned by the Bank marked as 'refer to drawer' but it's not entered in Cash Book.

(d) The balance brought forward in Sept 2013 should have been ₹ 1,470.

(e) Cheques paid to suppliers ₹ 214, ₹ 370 and ₹ 30 have not been presented for payment.

(f) Deposits of ₹ 1542 on 30th Sept were cleared by the Bank on 2nd October.

(g) The Bank charged a cheque wrongly to Adarsh trading ₹ 72.

(h) Bank statement shows overdraft of ₹ 124 as on 30th Sept 2013.

Show what adjustments will you make in the Cash Book and prepare a Bank Reconciliation Statement as on 30-09-2013.

Solution:

As we know, the errors in the Cash Book must first be corrected and entries that have been missed out in the CB should be recorded.

Dr. **Cash Book for Sept 2013** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Original balance b/d	960	By Bank charges not recorded earlier	35
To Error in balance carried (1,470 - 1,407)	63	By Cheques issued recorded as receipt, now corrected (2×47)	94
		By Cheque returned	18
		By Revised balance c/d	876
	1,023		1,023

Now we can prepare the Bank Reconciliation Statement.

Bank Reconciliation of M/s. Adarsh Trading as on 30.9.2013

Particulars	Amount (₹)	Amount (₹)
Balance as per Cash Book		876
Add: Cheques issued but not presented (214 + 370 + 30)	614	614
		1,490
Less: (i) Deposits not cleared	1542	
(ii) Cheques charged by mistake	72	
		1,614
Overdraft as per Pass Book		(124)

Illustration 9.

D's Cash Book shows an overdrawn position of ₹ 3,630 on 31.3.2014, though the Bank Statement shows only ₹ 3,378 overdrawn. Detailed examination of two records revealed the following:

(a) A cheque for ₹ 1,560 in favour of Rath Associates has been omitted by the Bank from its statement, thus, cheque having been debited to another customer's account.

(b) The debit side of owned book has been under caste by ₹ 300.

(c) A cheque for ₹ 182 drawn in payment of electricity amount had been entered in the Cash Book on ₹ 128 & was shown correctly in the Bank statement.

(d) A cheque for ₹ 210 from S. Gupta having been paid into Bank, was dishonoured & shown as such on Bank statement, although no entry relating to dishonoured had been made in Cash Book.

(e) The Bank had debited a cheque for ₹ 126 to D's A/c, in error. It should have been debited to Sukhal's A/c.

(f) A dividend of ₹ 90 on D's holding of equity shares has been duly shown by Bank, no entry has been made in Cash Book.

(g) A lodgement of ₹ 1,080 on 31.3.2014 had not been credited by Bank.

(h) Interest on ₹ 228 had been directly debited by Bank not recorded in Cash Book.

You are required to prepare a Bank Reconciliation Statement after necessary amendment in Cash Book as on 31.3.2014.

Solution:

In the Books of Mr. D

Dr **Cash Book (Bank Column only)** Cr

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 March 31	To Dividend A/c.	90	2013 March 31	By Balance b/d.	3,630
	" Error (under casting in debited side)	300		" Electric Charges A/c. Cheque drawn for [₹ 182 wrongly recorded as ₹ 128 (₹ 182 – ₹ 128)]	54
	" Balance c/d.	3,732		" S. Gupta's A/c. -Cheque dishonoured	210
				`` Bank Interest	228
		4,122			4,122
				By Balance b/d.	3,732

Bank Reconciliation Statement as at 31st March 2014

Particulars	Amount (₹)	Amount (₹)
Overdraft as per Cash Book		3,732
Add: (i) A cheque for ₹ 126 wrongly debited by Bank.	126	
(ii) A lodgement not credited by Bank	1,080	
		1,206
		4,938
Less: (i) A cheque was issued in favour of Rath Associates not debited by Bank		1,560
Overdraft as per Pass Book.		3,378

Illustration 10.

Perfect Pvt. Ltd. has two accounts with Ever Bank Ltd. The accounts were known as 'Account-I' and 'Account-II'. As at December 31, 2013, the balance as per A/c books reflected the following:

Account-I ₹ 1,25,000 Regular balance.

Account-II ₹ 1,11,250 Overdraft balance.

The accountant failed to tally the balance with the Pass Book and the following information was available :

(a) The Bank has charged Interest on Account-II ₹ 11,375 and credited Interest on Account-I ₹ 1,250. These were not recorded by the accountant.

(b) ₹ 12,500 drawn on Dec.10, 2013, from Account-I was recorded in the books of Account-II.

(c) Bank charges of ₹ 150 and ₹ 1,125 for Account-1 and Account-II were not recorded in the books.

(d) A deposit of ₹ 17,500 in Account-I was wrongly entered in Account-II in the books.

(e) Two cheques of ₹ 12,500 and ₹ 13,750 deposited in Account-I, but entered in Account-II in the books, were dishonoured. The entries for dishonoured cheques were entered in Account-II.

(f) Cheques issued for ₹ 1,50,000 and ₹ 15,000 from Account-I and Account-II, respectively, were not presented until Jan. 5, 2014

(g) Cheques deposited ₹ 1,25,000 and ₹ 1,17,500 in Account-I and II, respectively, were credited by Bank on Feb. 2, 2014.

You are required to prepare the Bank Reconciliation Statement for Account-I and II.

Solution:

In the books of Perfect Pvt. Ltd.,
Bank Reconciliation Statement, Account-I
as at 31st December 2013

Particulars	Amount (₹)	Amount (₹)
Bank Balance as per Books of Account		1,25,000
Add : (i) Interest earned but not recorded in Cash Book	1,250	
(ii) Deposits not entered in Cash Book	17,500	
(iii) Cheques deposited but not entered (₹ 12,500 +₹13,750)	26,250	
(iv) Cheques issued but not presented for payment	1,50,000	1,95,000
		3,20,000
Less : (i) Withdrawals not entered in Cash Book	12,500	
(ii) Bank charges debited in Pass Book but not entered in Cash Book	150	
(iii) Cheques dishonoured but not recorded in Cash Book (₹12,500 + ₹13,750)	26,250	
(iv) Cheques deposited but not credited by the Bank	1,25,000	
		1,63,900
Bank Balance as per Pass Book		1,56,100.

Bank Reconciliation Statement, Account-II
as at 31st December 2013

Particulars	Amount (₹)	Amount (₹)
Overdraft Balance as per Books of Account		1,11,250
Add : (i) Interest charges on overdraft but not entered in Cash Book	11,375	
(ii) Bank charges debited by Bank but not entered in Cash Book	1,125	
(iii) Deposits wrongly entered	17,500	
(iv)Cheques deposited but not credited by the Bank	1,17,500	1,47,500
		2,58,750
Less : (i) Withdrawals wrongly recorded	12,500	
(ii) Cheques issued but not presented	15,000	
		27,500
Overdraft balance as per Pass Book		2,31,250

3.1.4 Preparation of Bank Reconcilation Statement where both Cash Book and Pass Book are given

(a) The books relate to the same period

When Cash Book and Pass Book of the identical period are given the following steps are needed.

1st step- Deposits sides of the Pass Book (Credit Side) and Cash Book (Debit side) should be checked thoroughly and put an asterisk mark on all the matching items. All the items without any signs in the Cash Book is an indication that it is required to be entered by the Bank. Separate the items under the heading "Cash / Cheques deposited but yet to be credited by the Bank" and in the same way , items without any sign in the Pass Book is indicating that deposits are yet to be entered in the Cash Book. Separate the items under the heading "Cheques/ Cash credited by the Bank are needed to be included in the Cash Book."

2nd Step- All the matching withdrawals on the Pass Book (Debit side) with the payments of the Cash Book (Credit side) should be marked with an asterisk one by one. All the items without any signs in the Cash Book indicate payments are needed to be included by the Bank. Separate the items under the heading "Cheques issued/ drawn and required to be presented in the Bank for payment" and in the same way, items without any sign in the Pass Book is an indication that withdrawals yet to be entered

in the Cash Book. Separate the items under the heading "Cheques/ Cash debited by the Bank yet to be entered in the Cash Book".

3rd Step- Separate list should be maintained for any other item under appropriate heading , e.g , errors in Cash Book, or, Pass Book, etc, which may cause any difference.

4th Step - after considering the separate listed items and closing balances of Pass Book and Cash Book Bank Reconciliation Statement should be prepared.

Procedure for Preparation of Bank Reconciliation Statement

1. Selection of a date : The last date of the month or accounting period is selected to reconcile the balances of Cash Book and Pass Book.
2. Comparison of entries : The transactions recorded in the Pass Book and Cash Book (Bank column) are compared. In most cases, the pay-in-slips (i.e. for deposits) and the counterpart of cheques are considered to find out the causes of discrepancies.
3. Selection of base : To select the starting point. To decide what balance to start with, Cash Book balance or Pass Book balance.

Illustration 11.

The following are the Cash Book and Bank Pass Book of Sri N for the month of April, 2013.

Dr. **Cash Book *(Bank Column only)*** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
April, 1	To Balance b/d	12,500	April, 1	By Salaries A/c	4,000
4	" Sales A/c	8,000		(Cheque No. 183)	
8	" P A/c	1,500	6	" Purchase A/c	3,200
13	" M A/c	3,400		(Cheque No. 184)	
18	" Kamal A/c	4,600	11	" Machinery A/c	6,000
21	" Furniture A/c	1,200		(Cheque No. 185)	
25	" Sales A/c	3,800	15	" Omprakash A/c	1,000
30	" F A/c	3,000		(Cheque No. 186)	
			19	" Drawings A/c	800
				(Cheque No. 187)	
			23	" K A/c	2,000
				(Cheque No. 188)	
			-	" S A/c	1,000
				(Cheque No. 189)	
			27	" Printing A/c	500
				(Cheque No. 190)	
			30	" Balance c/d	19,500
		38,000			38,000

Pass Book

Date	Particulars	Cheque No.	Debit (Withdrawals)	Credit (Deposits)	Dr. or Cr.	Balance
2013			₹	₹		₹
April, 1	By Balance bld				Cr.	12,500
2	To Cheque	183	4,000		Dr.	8,500
6	By Cheque			8,000	Cr.	16,500
6	To Cheque	184	3,200		Dr.	13,300
10	By Cheque			1,500	Cr.	14,800
16	" Cheque			3,400	Cr.	18,200
17	To Cheque	187	800		Dr.	17,400
20	By Cheque			4,600	Cr.	22,000
24	" Cheque			3,800	Cr.	25,800
28	To Cheque	185	6,000		Dr.	19 800
28	" Cheque	189	1,000		Dr.	18,800
30	By Interest			100	Cr.	18,900
30	" Deposit (K.Sen)			3,000	Cr.	21,900
30	" Charges		10		Dr.	21,890

Yes are required to prepare a Bank Reconciliation Statement as at 30th April 2013.

Solution:

Bank Reconciliation Statement of Sri N
as at 30th April, 2013

Particulars	Amount (₹)	Amount (₹)
Bank Balance as per Cash Book		19,500
Add : Cheques issued but not presented	3,500	
(₹ 1,000 + ₹ 2,000 + ₹ 500)		
Direct deposit made by the customer, Sri K. Sen	3,000	
Interest credited by Bank, but not entered in Cash Book	100	
		6,600
		26,100
Less : Cheques deposited but not credited	4,200	
(₹ 1,200 + ₹ 3,000)		
Bank charges debited by Bank but not entered in Cash Book	10	
		4,210
Bank Balance as per Pass Book		21,890

Illustration 12.

Following are the extracts of Cash Book and Pass Book of Mr. Sunil. Prepare a Bank Reconciliation Statement.

Dr. Cash Book (Bank column only) Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
1-Jan-13	To Balance b/d	1,080	2-Jan-13	By Wages A/c	850
2-Jan-13	To Interest A/c	52	6-Jan-13	By Investments A/c	1,000
5-Jan-13	To Kamdar A/c	900	8-Jan-13	By Purchases A/c	306
8-Jan-13	To Sales A/c	609	9-Jan-13	By Self A/c	160
10-Jan-13	To Rent A/c	56	10-Jan-13	By Bapat A/c	210
12-Jan-13	To Ganpat A/c	1,252	10-Jan-13	By Drawings A/c	80
13-Jan-13	To Ram A/c	888	14-Jan-13	By Fakir A/c	1,822
			15-Jan-13	By Mustafa A/c	810
15-Jan-13	To Balance c/d (OD)	401			
		5,238			5,238

Dr. Pass Book Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2-Jan-13	To Wages A/c	850	1-Jan-13	By Balance b/d	1,132
6-Jan-13	To Investments A/c	1,000	6-Jan-13	By Kamdar A/c	900
7-Jan-13	To Purchases A/c	306	8-Jan-13	By Sales A/c	609
9-Jan-13	To Self A/c	160	10-Jan-13	By Rent A/c	56
10-Jan-13	To Self A/c	80	10-Jan-13	By Jamdar A/c	200
13-Jan-13	To Bills Payable A/c	100			
15-Jan-13	To Balance c/d	401			
		2,897			2,897

Solution:

The reconciliation period is from 1st Jan to 15th Jan 2013. From comparison of both the extracts it can be found that:

(a) Cheques issued to Bapat, Fakir and Mustafa are not encashed till 15th Jan 2013 and will appear in reconciliation.

(b) Direct deposit by Jamdar is not appearing in Cash Book is also a reconciliation item

(c) Interest received of ₹ 52 is appearing in Cash Book only. This has to be dealt with carefully. Interest is normally credited by Bank first and then on the basis of credit advice an entry is made in Cash Book. Hence, it's probable that the interest must have been credited by Bank before 1st Jan and it would have appeared in the reconciliation statement of December. This item is thus not considered.

(d) Cheques received from Ganpat and Ram not cleared till 15th Jan and hence will appear in the reconciliation statement.

(e) Bills payable cleared by Bank not recorded in Cash Book will appear as item of reconciliation.

Bank Reconcilation Statement as on 15-1-13

Particulars	Amount (₹)	Amount (₹)
Overdraft as per Cash Book		401
Add: Cheques deposited but not cleared (1252+888)	2,140	
Bills payabloe not recorded in CB	100	2,240
		2,641
Less: Cheques issued not presented till 15th January (210+1822+810)	2,842	
Direct deposit by Jamdar	200	3,042
Balance as per Pass Book		**(401)**

Note : In this case, it is found that the sum total of subtractions (Less) is more than the sum total of additions (Add) which indicates opposite balance, i.e. favourable although it was started with an unfavourable balance.

B. The book relates to the succeding period

Under this method, we are to see that the transactions which appear in both the Cash Book and the Bank Statement but not in the same month. Thus, put a tick mark (✓) on the transactions which appeared on the debit side of Cash Book and debit side of the Pass Book or Bank Statement and vice-versa which need reconciliation.

Illustration 13.

In the books of Mr. P. Mukherjee

Dr. Cash Book (Bank Column only) Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2014 March 1	To Balance b/d.	5,000	2014 March 2	By Salaries A/c	3,000
3	`` A. Bose A/c	500	4	`` Drawings A/c	3,000
5	`` B. Banerjee A/c	1,000	8	`` P. Sen A/c	1,000
7	`` C. Sur A/c	4,000	12	`` S. Kumar A/c	2,000
9	`` D. Sen A/c	2,000	15	`` D. Saha A/c	1,000
20	`` P. Pal A/c	3,000	18	`` Wages A/c	3,000
			24	`` Rent A/c	500
			30	`` T. Koley A/c	1,500
			31	`` Balance c/d.	500
		15,500			15,500

Bank Pass Book

Dr. Mr. P Mukherjee in --------------- with Bank Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2014 April	To Balance b/d.	1,500	2014 April		
3	`` P. Sen A/c	1,000	1	By A. Bose A/c	500
5	`` S. Kumar A/c	2,000	3	`` C. Sur A/c	4,000
	`` T. Koley A/c	1,500	5	`` D. Sen A/c	2,000
6	`` D. Saha A/c	1,000	8	`` P. Paul A/c	3,000
	`` B. Saha A/c	2,000			

Prepare a Bank Reconciliation Statement as on 31st March, 2014.

Solution:

Bank Reconciliation Statement
as at 31st March, 2014

Particulars	Amount (₹)	Amount (₹)
Balance as per Cash Book		500
Add: Cheque issued but not passed:		
P. Sen	1,000	
S. Kumar	2,000	
D. Saha	1,000	
T. Koley	1,500	
B. Saha	2,000	7,500
		8,000
Less: Chequed deposited but not credited:		
A. Bose	500	
C. Sur	4,000	
D. Sen	2,000	
P. Paul	3,000	9,500
Overdraft as per Pass Book		1,500

3.2 RECEIVABLE RECONCILIATION

A business enterprise apart from cash sales, also provides/offers credit to its customers. During the number of transactions taking place on a daily basis, there is a need to reconcile the balance receivable from the customers/debtors. The process of reconciliation may be detailed as under:

Step 1: Ascertain total credit sales to customer

Step 2: Ascertain total collections – in cash, cheque or any other mode received

Step 3: Identify whether there is any Bills Receivable (B/R) accepted by the customer

Step 4: Identify any cheque return/ goods returned/ bills dishonoured during the accounting period

Step 5: Check whether any credit note is raised against the customer for short-supply of goods or for excess payment or allowing special discount

Illustration 14.

Mr. B sold goods on credit to various customers. Details related to one of the customer, Mr. Z, is as under:

(i) Goods sold on credit ₹ 5,00,000

(ii) Goods returned by the customer ₹30,000 due to defective quality, credit note raised but not recorded.

(iii) Payment received from customer in cash ₹1,00,000 and by cheques ₹ 2,30,000. Out of cheques received, a cheque of ₹ 38,000 was dishonoured by bank.

(iv) Customer accepted two Bills of ₹19,000 and ₹ 53,000 for 2 months and 3 months respectively.

(v) Credit note raised against the customer ₹ 3,400 for excess payment charged against one of the consignment.

Mr.Z, the customer is in need to ascertain the actual balance due to Mr.B. Prepare a Reconciliation Statement.

Solution:

Receivable from Mr.Z - Reconciliation Statement

Particulars	Amount (₹)
Credit Sales during the period	5,00,000
Less: Goods returned by the Customer, adjustment of credit note	30,000
Less: Payment received in cash	1,00,000
Less: Payment received by cheque less dishonored cheque (2,30,000 -38,000)	1,92,000
Less: Bills Receivable accepted by Customer, yet to be matured (19,000 +53,000)	72,000
Less : Adjustment of Credit Note raised	3,400
Net Receivable from Customer	**1,02,600**

Note: This reconciliation statement can be made against gross block of customers/debtors. However, it is advisable to ascertain individual reconciliation statements.

3.3 PAYABLE RECONCILIATION

A business enterprise apart from cash purchases also makes credit purchases from its vendors/suppliers. During the number of transactions taking place on a daily basis, there is a need to reconcile the balance payable to the vendors/suppliers. The process of reconciliation may be detailed as under:

Step 1: Ascertain total credit purchases made from different vendors/suppliers

Step 2: Ascertain total payments – in cash, cheque or any other mode remitted

Step 3: Identify whether there is any Bills Payable (B/P) accepted

Step 4: Identify any cheque return/ goods returned/ bills payable accepted but dishonorued during the accounting period

Step 5: Check whether any debit note is raised against the vendor/supplier for short-supply of goods or for excess payment or claiming special discount

Illustration 15:

Amaranth purchases goods on credit from various suppliers. However, there is a difference of opinion which has arised with one of its suppliers. While the Supplier claims that the amount receivable from Amarnath is ₹ 2,53,000, on the other hand, Amarnath claims that the amount payable is ₹ 2,35,000. On evaluation of records the following were identified:

(i) A purchase of ₹ 71,000 was recorded by the supplier as ₹ 78,000.

(ii) Goods returned by Amarnath amounting to ₹ 5,000, but the stock is in transit and has not reached the supplier/vendor.

(iii) Cheques issued to vendor for ₹ 28,000, in transit.

(iv) Bills raised for goods purchased from the supplier, amounting ₹ 22,000, but goods are yet to reach the warehouse/godown of Amarnath

Prepare a suitable Reconciliation statement.

Solution:

Amount due to Supplier – Payable Reconciliation Statement

Particulars	Amount (₹)
Amount due to supplier (as per books of the Supplier)	2,53,000
Less: Overstatement of sales figure in the books of supplier (i.e. goods sold by supplier to Amarnath for ₹ 71,000 but recorded as ₹ 78,000)	7,000
Less: Goods returned to supplier, now in transit	5,000
Less: Cheques issued to vendor, now in transit	28,000
Add: Bills raised against goods purchased, not stock-in-transit, i.e. not yet reached the warehouse of the supplier	22,000
Amount due to supplier (as per books of Amarnath)	2,35,000

Note: This reconciliation statement can be made against gross block of vendors/suppliers. However, it is advisable to ascertain individual reconciliation statements.

3.4 STOCK RECONCILIATION STATEMENT

It is the usual practice of all business houses that their stocks are valued at the closing date of the financial year. But this not always happened. Sometimes stocks are valued either before the closing date of the financial year or after the closing date of the financial year. However, in all the cases we are to prepare a reconciliation statement in order to ascertain the actual cost of stock at the closing date of the financial year. Otherwise, the financial statement which will be prepared will not show the true and fair view of statement of affairs of the concern. For example, if stocks are valued after the closing date of the financial year, in that case, the goods which are purchased now are to be adjusted, i.e., in case of purchase, the same is to be deducted and in case of sales the same in to be added to the value of sock.

(A) Where stocks are valued after the closing date of the Financial Year

If stocks are valued after the closing date of the financial year, in that case the method of preparing of Stock Reconciliation Statement will be:

Stock Reconciliation Statement as on .....

Value of Stock at the date of physical stock taking		XXX
Add: Goods Sold (i.e., adjusted sales)	XXX	
Returns outward	XXX	
Goods-in-transit etc.	XXX	
		XXX
		XXX
Less: Goods purchased (i.e., adjusted purchase)	XXX	
Returns inward	XXX	
Goods sent on consignment basis etc.	XXX	
		XXX
Value of Stock at the closing date of the financial year		XXX

Illustration 16.

Determine the value of stock on 31st March, 2014 from the following particulars:

Stock was valued on 15th April 2014 and the amount came to ₹ 1,00,000.

(a) Sales ₹ 82,000 (including cash sales ₹ 20,000)

(b) Purchase ₹ 10,068 (including cash purchase ₹ 3,980)

(c) Returns inward ₹ 2,000

(d) On 15th March, goods of the sale value of ₹ 20,000 were sent on sale or return basis to a customer, the period of approval being four weeks. He returned 40% of the goods on 10th April approving the rest, the customer was received on 16th April.

(e) Goods received value ₹ 16,000 in March for sale on consignment basis; 20% of the goods has been sold by 31st March, and another 50% by 15th April. These sales are not included in above sales.

Goods are sold at a profit of 20% on sales.

Solution:

Stock Reconciliation Statement as on 31st March 2013

Particulars	Amount (₹)	Amount (₹)
Value of Stock as on 15th April 2014		1,00,000
Add: Cost of Goods Sold from 31st March to 15th April :		
Net Sales (₹ 82,000 – ₹ 2,000)	80,000	
Less: Gross Profit @ 20%	16,000	64,000
Add: Cost of goods sent on approval basis (80% of ₹ 12,000)		9,600
		1,73,600
Less: Purchase from 31st March 2014 to 15th April 2014	10,068	
Less: Stock of Consigned goods (30% of ₹ 16,000)	4,800	14,868
Value of stock as on 31st March 2014		1,58,732

Illustration 17.

Mr. Sen closes his account on 30th June every year. Due to some unavoidable reasons he could not take his stock on 30th June 2013, and physical stock was taken on 7th July 2013 which was valued at ₹ 22,500.

Determined the value of stock on 30th June 2013. The following transactions took place from 1st July to 7th July 2013.

(a) Sales amounting to ₹ 1,250 made on 6th July has been delivered on 9th July.

(b) Sales during the period amounted to ₹ 5,100. These goods were sold at profit of 25% on cost with the exception of one sale of ₹ 600 which has been sold at a profit of 20% on cost.

(c) Purchase during the period were ₹ 4,000 of which goods costing ₹ 3,500 were delivered on or before 7th July.

(d) Return Inwards during the period amounted to ₹ 400 including ₹ 300 out of sales period to 30th June 2013 at a profit of 25% on cost.

(e) Goods sold on sale or return basis for ₹ 2,250 on 7th July were not included in the sales stated above.

(f) Mr. Sen received goods on consignment basis which was invoiced at ₹ 2,500 for Mr. Dey to be sold on his behalf on 6th July.

Solution:

Stock Reconciliation Statement as on 30th June 2013

Particulars	Amount (₹)	Amount (₹)
Value of Stock as on 7th July 2013		22,500
Add: Cost of sales from 1.7.2013 to 7.7.2013:		
Sales	5,100	
Less: Goods sold on 6th July but delivered on 9th July	1,250	
	3,850	
Less: Sales at differential Profit rate @20% on cost	600	
	3250	
Less: G.P. @ 25% on C.P. or 20% on S.P.	650	2,600
		25,100
Add: Cost of goods sold at differential profit rate (₹ 600 x $\frac{100}{120}$)	500	
Add: Cost of Goods sent on sale or Return basis (₹2,250 x $\frac{100}{125}$)	1,800	2,300
Less: Goods purchased from 1.7.2013 to 7.7.2013:		27,400
		3,500
Less: Returns inward (₹ 300 x $\frac{100}{125}$)		240
Less: Goods received on consignment basis		2,500
Value of stock as on 30th June 2013		21,160

(B) Where Stocks are valued before the closing date of the financial year

Under the circumstances the treatment will be reversed. Besides, in case any error appears, the same also must be rectified.

Illustration 18.

Determine the value of stock to be taken for Balance Sheet as at 31.03.2014 for the following information –

The stock was periodically verified on 23rd March 2014, and was valued at ₹ 6,00,000 between 23rd March and 31st March 2014, the following transactions had taken place:

(a) Purchase ₹ 50,000 worth of goods of which ₹ 20,000 was delivered on 5th April, 2014.

(b) Out of goods sent on consignment, goods worth ₹ 30,000 (at cost) were unsold.

(c) Sales amounted to ₹ 1,70,000. This includes goods worth ₹ 40,000 sent on approval, half of this were returned before 31st March. As regards, remaining no intimation is received.

(d) Normally firm sells goods on cost plus 25%. However, at cost of goods costing ₹ 30,000 were sold for ₹ 15,000.

Solution:

Statement Showing the Value of Physical Stock as on 31st March, 2014

Particulars	Amount (₹)	Amount (₹)	Amount (₹)
Stock as on 23rd March 2014			6,00,000
Add: Purchase between 23rd march to 31st March			
(₹ 50,000 – ₹ 20,000)	30,000		
Add: Stock-In-Transit	20,000	50,000	
Add: Goods in the hands of Consignee at cost		30,000	
Add: Goods sent on Approval basis (at cost)			
Goods sent	40,000		
Less: Returned [1/2 × 40,000]	20,000		
	20,000		
Less: G.P. @ 20% on sales or 25% of cost	4,000	16,000	96,000
			6,96,000
Less: Cost of goods sold between 23.03.14 – 31.03.14			
Goods sold	1,70,000		
Less: Sent on approval	20,000		
	1,50,000		
Less: Abnormal Sales	15,000		
	1,35,000		
Less: G. P. @ 20% on sales	27,000	1,08,000	
Less: Cost of goods sold at a loss		30,000	1,38,000
Value of Stock as on 31st March 2014			5,58,000

Study Note - 4

ACCOUNTING FOR DEPRECIATION

This Study Note includes

4.1 Introduction
4.2 Certain Useful Terms
4.3 Nature of Depreciation
4.4 Causes of Depreciation
4.5 Characteristics of Depreciation
4.6 Objective and Necessity for providing Depreciation
4.7 Measurement of Depreciation
4.8 Methods of Charging Depreciation
4.9 Provision for Depreciation Account
4.10 Disposal of an asset
4.11 Profit or Loss on sale of assets - Method of Depreciation Calculation
4.12 Change of Method - Prospective and Retrospective
4.13 Application of AS 6 - Depreciation Accounting
4.14 Application of AS 10 - Accounting for Fixed Asset
4.15 Application of AS 28 - Impairment of Assets

4.1 INTRODUCTION

A business or concern holds fixed assets for regular use and not for resale. The capability of a fixed asset to render service cannot be unlimited. Except land, all other fixed assets have a limited useful life. The benefit of a fixed asset is received throughout its useful life. So its cost is the price paid for the 'Series of Services' to be received or enjoyed from it over a number of years and it should be spread over such years.

Depreciation means gradual decrease in the value of an asset due to normal wear and tear, obsolescence etc. In short, depreciation means the gradual diminution, loss or shrinkage in the utility value of an asset due to wear and tear in use, effluxion of time or introduction of technology in the market. A certain percentage of total cost of fixed assets which has expired and as such turned into expense during the process of its use in a particular accounting period.

Indian Accounting Standard (AS 6) states that "Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset."

"Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total 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 the measurement of the effect of all such occurrences."

The above definition may be criticized as under:

i. It does not classify properly what is meant by systematic and rational manner. The word 'rational' may mean that it should reasonably be related to the expected benefits in any case.

ii. Historical cost and any other kind of cost should be allocated or not does not defined by this definition.

iii. Some Accountants are in a belief that depreciation is nothing but an arbitrary allocation of cost. According to them, all the conventional methods say allocation of historical cost over a number of years is arbitrary.

4.2 CERTAIN USEFUL TERMS

Amortization - Intangible assets such as goodwill, trademarks and patents are written off over a number of accounting periods covering their estimated useful lives. This periodic write off is known as *Amortization* and that is quite similar to depreciation of tangible assets. The term amortization is also used for writing off leasehold premises. Amortization is normally recorded as a credit to the asset account directly or to a distinct provision for depreciation account. Though the write off of intangibles that have no limited life is not approved by some Accountants, some concerns do amortize such assets on the ground of conservatism.

Depletion - This method is specially suited to mines, oil wells, quarries, sandpits and similar assets of a wasting character. In this method, the cost of the asset is divided by the total workable deposits of the mine etc. And by following the above manner rate of depreciation can be ascertained. Depletion can be distinguishable from depreciation in physical shrinkage or lessening of an estimated available quantity and the latter implying a reduction in the service capacity of an asset.

Obsolescence – The term 'Obsolescence' refers to loss of usefulness arising from such factors as technological changes, improvement in production methods, change in market demand for the product output of the asset or service or legal or medical or other restrictions. It is different from depreciation or exhaustion, wear and tear and deterioration in that these terms refer to functional loss arising out of a change in physical condition.

Dilapidation - In one sentence Dilapidation means a state of deterioration due to old age or long use. This term refers to damage done to a building or other property during tenancy.

4.3 NATURE OF DEPRECIATION

Depreciation is a term applicable in case of plant, building, equipment, machinery, furniture, fixtures, vehicles, tools etc. These long-term or fixed assets have a limited useful life, i.e. they will provide service to the entity (in the form of helping in the generation of revenue) over a limited number of future accounting periods. Depreciation implies gradual decrease in the value of an asset due to normal wear and tear, obsolescence etc. In short, depreciation means the gradual diminution, loss or shrinkage in the utility value of an asset due to wear and tear in use, effluxion of time or introduction of technology in the market. It makes a part of the cost of assets chargeable as an expense in profit and loss account of the accounting periods in which the assets helped in earning revenue.

Thus, **International Accounting Standard** (IAS)-4 provides that "Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life."

In Accounting Research Bulletin No. 22, **AICPA** observed that "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 the measurement of the effect of all such occurrences."

4.4 CAUSES OF DEPRECIATION

A. Internal Causes

(i) **Wear and tear :** Plant & machinery, furniture, motor vehicles etc. suffer from loss of utility due to vibration, chemical reaction, negligent handling, rusting etc.

(ii) **Depletion (or exhaustion)** : The utility or resources of wasting assets (like mines etc.) decreases with regular extractions.

B. External or Economic Causes

(i) **Obsolescence** : Innovation of better substitutes, change in market demand, imposition of legal restrictions may result into discarding an asset.

(ii) **Inadequacy :** Changes in the scale of production or volume of activities may lead to discarding an asset.

C. Time element : With the passage of time some intangible fixed assets like lease, patents, copy-rights etc., lose their value or effectiveness, whether used or not. The word "amortization" is a better term to speak for the gradual fall in their values.

D. Abnormal occurrences : An accident, fire or natural calamity can damage the service potential of an asset partly or fully. As a result the effectiveness of the asset is affected and reduced.

4.5 CHARACTERISTICS OF DEPRECIATION

The Characteristics of Depreciation are :

i. It is a **charge against profit**.

ii. It indicates **diminution in service potential**.

iii. It is an **estimated loss** of the value of an asset. It is not an **actual loss**.

iv. It depends upon different **assumptions**, like effective life and residual value of an asset.

v. It is a process of allocation and not of valuation.

vi. It arises mainly from an **internal cause** like wear and tear or depletion of an asset. But it is treated as any expense charged against profit like rent, salary, etc., which arise due to an **external transaction**.

vii. Depreciation on any particular asset is **restricted** to the working life of the asset.

viii. It is charged on **tangible fixed assets**. It is not charged on any current asset. For allocating the costs of intangible fixed assets like goodwill. etc, a certain amount of their total costs may be charged against periodic revenues. This is known as **amortization**.

4.6 OBJECTIVE AND NECESSITY FOR PROVIDING DEPRECIATION

Eric Kohler defined depreciation as "the lost usefulness, expired utility, the diminution in service yield." Its measurement and charging are necessary for cost recovery. It is treated as a part of the expired cost for an asset. For determination of revenue, that part or cost should be matched against revenue. The objects or necessities of charging depreciation are :

(i) Correct calculation of cost of production: Depreciation is an allocated cost of a fixed asset. It is to be calculated and charged correctly against the revenue of an accounting period. It must be correctly included within the cost of production.

(ii) Correct calculation of profits: Costs incurred for earning revenues must be charged properly for correct calculation of profits. The consumed cost of assets (depreciation) has to be provided for correct matching of revenues with expenses.

(iii) Correct disclosure of fixed assets at reasonable value: Unless depreciation is charged, the depreciable asset cannot be correctly valued and presented in the Balance Sheet. Depreciation is charged so that the Balance Sheet exhibits a true and fair view of the affairs of the business.

(iv) Provision of replacement cost: Depreciation is a non-cash expense. But net profit is calculated after charging it. Through annual depreciation cash resources are saved and accumulated to provide replacement cost at the end of the useful life of an asset.

(v) Maintenance of capital: A significant portion of capital has to be invested for purchasing fixed assets. The values of such assets are gradually reduced due to their regular use and passage of time. Depreciation on the assets is treated as an expired cost and it is matched against revenue. It is charged against profits. If it is not charged the profits will remain inflated. This will cause capital erosion.

(vi) Compliance with technical and legal requirements: Depreciation has to be charged to comply with the relevant provisions of the Companies Act and Income Tax Act.

Note: As per Companies Act 1956, a company have to provide for depreciation on fixed assets before declaration of dividends.

4.7 MEASUREMENT OF DEPRECIATION

It is quite difficult to calculate the exact amount of depreciation since they depend on a number of factors. Some of the factors are:

i. The actual cost of asset.

ii. The additions, if any, made to the assets during the year taking into consideration the date of purchase.

iii. The expected amount of interest of opportunity loss.

iv. The estimated life of the asset.

v. The scrap, break-up or the residual value of asset.

vi. Obsolescence, i.e. the chance of the asset going out of fashion.

vii. The renewals and repairment of the asset.

viii. The legal provisions relating to the depreciation.(Provision of Companies Act , Income Tax Act and others)

All the above said factors should be taken into consideration at the time of determining the amount of depreciation in such a way that a proper and reasonable estimate can be provided against the amount of depreciation.

4.8 METHODS OF CHARGING DEPRECIATION

There are different concepts about the nature of depreciation. Moreover, the nature of all fixed assets cannot be the same. As a result, different methods are found to exist for charging depreciation. A broad classification of the methods may be summarized as follows :

Capital/Source of Fund

(i) Sinking Fund Method

(ii) Annuity Method

(iii) Insurance Policy Method

Time Base

(i) Fixed Installment Method

(ii) Reducing Balance Method

(iii) Sum of Years' Digit Method

(iv) Double Declining Method

Use Base

(i) Working Hours Method

(ii) Mileage Method

(iii) Depletion Service Hours Method

(iv) Unit method

Price Base

(i) Revaluation Method

(ii) Repairs Provision Method

Some important Methods of Charging Depreciation are discussed as below :

I. Fixed/Equal Installment OR Straight Line Method

Features :

(i) A fixed portion of the cost of a fixed asset is allocated and charged as periodic depreciation.

(ii) Such depreciation becomes an equal amount in each period.

(iii) The formula for calculation of depreciation is :

Depreciation = (V-S)/n

Where,

V = Cost of the asset

S = Residual value or the expected scrap value of the asset

n = Estimated life of the asset

Illustration 1

Calculate the Rate of Depreciation under Straight Line Method (SLM) in each of the following:-

Machine No.	Cost of Machine (₹)	Expenses incurred at the time of purchase to be capitalized (₹)	Estimated Residual Value (₹)	Expected Useful Life in years
1	90,000	10,000	20,000	8
2	24,000	7,000	3,100	6
3	1,05,000	20,000	12,500	3
4	2,50,000	30,000	56,000	5

Solution

Machine No	Cost of Machine (₹)	Expenses incurred at the time of purchase to be capitalize (₹)	Total Cost of Asset = (b+c) (₹)	Estimated Residual Value (₹)	Expected Useful Life in years	Depreciation = (d-e)/f (₹)	Rate of Depreciation under SLM = (g/d)×100
a	b	c	d	e	f	g	h
1	90,000	10,000	1,00,000	20,000	8	10,000	10%
2	24,000	7,000	31,000	3,100	6	4,650	15%
3	1,05,000	20,000	1,25,000	12,500	5	22,500	18%
4	2,50,000	30,000	2,80,000	56,000	10	22,400	8%

Illustration 2

A machine is purchased for ₹ 7,00,000. Expenses incurred on its cartage and installation ₹ 3,00,000. Calculate the amount of depreciation @ 20% p.a. according to Straight Line Method for the first year ending on 31st March, 2014 if this machine is purchased on:

(a) 1st April, 2013

(b) 1st July, 2013

(c) 1st October, 2013

(d) 1st January, 2014

Solution:

Here, Total Cost of Asset = Purchased Price + Cost of Cartage and Installation

= ₹ 7,00,000 + ₹ 3,00,000 = ₹ 10,00,000

Amount of Depreciation :

$$= \text{Total Cost of Asset} \times \text{Rate of Depreciation} \times \frac{\text{Period from the date of purchase to date of closing accounts}}{12}$$

(a) The machine was purchased on 1st April, 2013:

Amount of Depreciation = ₹ 10,00,000 × 20% × $\frac{12}{12}$ = ₹ 2,00,000

(b) 1st July, 2013

Amount of Depreciation = ₹ 10,00,000 × 20% × $\frac{9}{12}$ = ₹ 1,50,000

(c) 1st October, 2013

Amount of Depreciation = ₹ 10,00,000 × 20% × $\frac{6}{12}$ = ₹ 1,00,000

(d) 1st January, 2014

Amount of Depreciation = ₹ 10,00,000 × 20% × $\frac{3}{12}$ = ₹ 50,000

II. Reducing / Diminishing Balance Method or Written Down Value Method

Features :

(i) Depreciation is calculated at a fixed percentage on the original cost in the first year. But in subsequent years it is calculated at the same percentage on the written down values gradually reducing during the expected working life of the asset.

(ii) The rate of allocation is constant (usually a fixed percentage) but the amount allocated for every year gradually decreases.

Illustration 3.

On 1.1.2011 a machine was purchased for ₹ 1,00,000 and ₹ 50,000 was paid for installation. Assuming that the rate of depreciation was 10% on Reducing Balance Method, calculate amount of depreciation upto 31.12.2013.

Solution:

Year	Opening Book Value (₹)	Rate	Depreciation (₹)	Closing Book Value (₹)
2011	1,50,000	10%	15,000	1,35,000
2012	1,35,000	10%	13,500	1,21,500
2013	1,21,500	10%	12,150	1,09,350

Note: Cost of the machine (i.e. Opening Book Value for the year 2011)

= Cost of Purchase + Cost of Installation

= ₹ 1,00,000 + ₹ 50,000 = ₹ 1,50,000

Illustration 4.

On 1.1.11 machinery was purchased for ₹ 80,000. On 1.7.12 additions were made to the amount of ₹ 40,000. On 31.3.2013, machinery purchased on 1.7.2012, costing ₹ 12,000 was sold for ₹ 11,000 and on 30.06.2013 machinery purchased on 1.1.2014 costing ₹ 32,000 was sold for ₹ 26,700. On 1.10.2013,

additions were made to the amount of ₹ 20,000. Depreciation was provided at 10% p.a. on the Diminishing Balance Method.

Show the Machinery Accounts for three years from 2011-2013. (year ended 31st December)

Solution:

Statement of Depreciation

Date	Particulars	Machines – I Cost = ₹ 80,000		Machines – II Cost = ₹ 40,000		Machines – III Cost = ₹ 20,000	Total Depreciation
		₹	₹	₹	₹	₹	₹
01.01.2011	Book Value	48,000	32,000				
31.12.2011	Depreciation	4,800	3,200				8,000
01.01.2012	W.D.V.	43,200	28,800				
01.07.2012	Purchase			28,000	12,000		
31.12.2012	Depreciation	4,320	2,880	1,400	600		9,200
01.01.2013	W.D.V.	38,880	25,920	26,600	11,400		
31.03.2013	Depreciation				285		285
	W.D.V.				11,115		
	Sold For				11,000		
	Loss on sale				115		
30.06.2013	Depreciation		1,296				1,296
	W.D.V.		24,624				
	Sold For		26,700				
	Profit on Sale		2,076				
01.10.2013	Purchase					20,000	
31.12.2013	Depreciation	3,888		2,660		500	7,048
01.01.2014	W.D.V.	34,992		23,940		19,500	

Dr. **Machinery Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
01.01.11	To, Bank A/c	80,000	31.12.11	By, Depreciation A/c	8,000
				,, Balance c/d	72,000
		80,000			80,000
01.01.12	To, Balance b/d	72,000	31.12.12	By, Depreciation A/c	9,200
01.07.12	,, Bank A/c	40,000		,, Balance c/d	1,02,800
		1,12,000			1,12,000
01.01.13	To, Balance b/d	1,02,800	31.3.13	By, Bank (Sale) A/c	11,000
30.06.13	,, P & L A/c (Profit on Sale)	2,076		,, Depreciation A/c	285
	,, Bank A/c	20,000	30.6.13	,, P & L A/c (Loss on Sale)	115
				,, Bank A/c (Sale)	26,700
			31.12.13	,, Depreciation A/c	1,296
				,, Depreciation A/c	7,048
				,, Balance c/d	78,432
		1,24,876			1,24,876

III. Sinking Fund Method

A sinking fund is a fund created with a specific purpose which may be :

(i) To redeem or repay a long term liability, e.g., debenture, long-term loans, etc. or

(ii) To replace a wasting asset, e.g., a mine; or

(iii) To replace an asset of depreciable nature; or

(iv) To renew a lease.

When a sinking fund is created to provide for replacement of wasting assets, it is in effect depreciation; the installments are charged against profits.

Under this method, the asset is kept in the books at its original cost. Every year during the estimated life of the asset, an equal amount of depreciation is charged to Profit and Loss Account and credited to a Depreciation Fund or Sinking Fund Account. At the same time a provision for replacement of the asset is made by investing an amount equal to the depreciation charged, in securities outside the business by debiting Depreciation Fund Investment or Sinking Fund Investment Account and crediting Bank. Interest received on the investment is credited to the Depreciation Fund Account and is also reinvested likewise. The amount that is annually provided as depreciation is such that this, with compound interest will be sufficient to provide a sum equal to the cost of asset, less residual value (if any), by the time the asset is expected to become useless.

At the end of the working life of the asset, the investment are sold away and the money realised therefrom is utilized for purchasing a new asset. Profit or Loss on such sale, if any, is transferred to the Depreciation Fund Account. The old asset account, standing in the books at original cost, is closed by setting it off against the Depreciation Fund Account.

The formula for calculation of the depreciation amount is as follows :

$$D = \frac{Ci}{(1+i)^n - 1}$$

Where,

D = Depreciation

C = Cost of the asset

i = Rate of Depreciation

n = Life of the asset

Journal Entries under the Sinking Fund method :

At the end of first year

(i) For annual depreciation

Profit & Loss A/c Dr.

To Depreciation Fund A/c (annual contribution)

or To Sinking Fund A/c

(ii) For investment of annual depreciation

Sinking Fund Investment A/c Dr.

To Bank A/c (invested amount)

At the end of second/subsequent years

(i) Profit & Loss A/c Dr.

To Sinking Fund A/c (annual contribution)

(ii) Bank A/c Dr.

To Interest on Investment A/c (annual interest)

(iii) Interest on Investment A/c Dr.

To Sinking Fund A/c (interest transferred)

(iv) Sinking Fund Investment A/c Dr.

To Bank A/c

[amount invested usually = annual contribution + annual interest]

When the working life of the asset ends (i), (ii) & (iii) same as above; (iv) not made in the last year

(v) Bank A/c Dr.

To Sinking Fund Investment A/c

(vi) Sinking Fund Investment A/c Dr.

To Sinking Fund A/c (Profit on Sale)

(Investments sold out) OR

(vii) Sinking Fund A/c Dr.

To Asset A/c [Asset A/c closed]

(viii) Sinking Fund A/c Dr.

To Sinking Fund Investment A/c (Loss on Sale)

Notes:

(i) No investment is made in the last year as the investments are to be sold out.

(ii) Sinking Fund Account may be called Depreciation Fund Account also. It is to be shown on the liability side of Balance Sheet.

(iii) Sinking Fund Investments Account may be called Depreciation Fund Investments Account also. It is to be shown on the Asset side of the Balance Sheet.

(iv) Annual Contribution (charged in lieu of annual depreciation) = Original Cost x Present Value of ₹ 1 at given interest rate.

Illustration 5.

On 1.7.2009 W Ltd. purchased a machinery for ₹ 1,10,000 and spent ₹ 6,000 on its installation. The expected life of the machine is 4 years, at the end of which the estimated scrap value will be ₹ 16,000. Desiring to replace the machine on the expiry of its life, the company establishes a Sinking Fund. Investments are expected to realize 5% interest.

On 30.06.2013, the machine was sold off as scrap for ₹ 18,000 and the investments were retained at 5% less than the book value. On 1.7.2013, a new machine is installed at a cost of ₹ 1,25,000.

Sinking Fund table shows that ₹ 0.2320 invested each year will produce ₹ 1 at the end of 4 years at 5%.

Show the necessary ledger accounts in the books of W Ltd.

Solution

Sum required	Annual contribution
1	0.2320
(₹ 1,10,000 + ₹ 6,000 - ₹ 16,000) = ₹ 1,00,000	= 0.2320 x 1,00,000
	= ₹ 23,200

In the Books of W Ltd.

Dr. **Sinking Fund Account** *Cr.*

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
30.6.10	To Balance c/d	23,200	30.6.10	By Profit and Loss A/c	23,200
		23,200			23,200
30.6.11	To Balance c/d	47,560	30.6.10	By, Balance b/d	23,200
			30.6.11	By, Bank (interest @ 5%)A/c	1,160
				By, Profit and Loss A/c	23,200
		47,560			47,560
30.6.12	To Balance c/d	73,138	01.7.11	By, Balance b/d	47,560
			30.6.12	By, Bank (interest @ 5%) A/c	2,378
				By, Profit and Loss A/c	23,200
		73,138			73,138
30.6.12	To, Sinking Fund Investment A/c		01.7.12	By, Balance b/d	73,138
	– Loss on sale	3,657	30.6.13	By, Bank interest @ 5%	3,657
	To, Machinery A/c. – Transfer	96,338		By, Profit and Loss A/c	23,200
		99,995			99,995

Dr. **Sinking Fund Investment Account** *Cr.*

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
30.6.10	To, Bank A/c.	23,200	30.6.10	By, Balance c/d	23,200
		23,200			23,200
01.07.10	To, Balance b/d	23,200	30.6.11	By, Balance c/d	47,560
30.6.11	To, Bank A/c. (₹1,160 + ₹ 23,200)	24,360			
		47,560			47,560
01.7.11	To, Balance b/d	47,560	30.6.12	By, Balance c/d	73,138
30.6.12	To, Bank A/c. (₹2,378 + ₹ 23,200)	25,578			
		73,138			73,138
01.7.13	To, Balance b/d	73,138	30.6.13	By, Bank A/c - Sales	69,481
				By, Sinking Fund A/c – Loss on sale (balancing figure)	3,657
		73,138			73,138

IV. Annuity Method

The annuity method considers that the business, besides losing the original cost of the asset also loses interest, on the amount used for buying the asset, which he would have earned in case the same amount would have been invested in some other form of investment. Thus, the asset account is debited with interest, which is ultimately credited with amount of depreciation which remains fixed year after year. The annual amount of depreciation is determined with the help of annuity table. The amount of depreciation is determined by adding the cost of the asset (i.e., purchase price) and interest thereon at an expected rate.

The Journal entries are as follows :

(i) Depreciation A/c Dr.
  To Asset A/c
 (for depreciation as calculated from annuity table)

(ii) Asset A/c Dr.
  To Interest A/c
 (for charging interest to asset as calculated on diminishing values)

(iii) Profit & Loss A/c Dr.
  To Depreciation A/c
 (for transfer of depreciation to P/L A/c)

(iv) Interest A/c Dr.
  To Profit & Loss A/c
 (for transfer of interest to P/L A/c)

Illustration 6.

Sri Tirthankar takes a lease for 5 years for ₹ 10,000. He decides to write off the lease by annuity method charging 5% interest p.a. Show the lease account for 5 years.

The annuity table shows that annual amount necessary to write off ₹1 in 5 years at 5% p.a. is ₹ 0.230975.

Solution:

Present Value	Annual Depreciation
1	0.230975
10,000	0.230975 x 10,000 = ₹ 2309.75 or ₹ 2310 (approx)

In the books of Sri Tirthankar

Dr. Lease Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Year- I Opening Closing	**To,** Bank A/c ,, Interest A/c	10,000 500	**Year- I** Closing	**By ,** Depreciation A/c ,, Balance c/d	2,310 8,190
		10,500			10,500
Year- II Opening Closing	**To,** Balance b/d ,, Interest A/c	8,190 410	**Year-II** Closing	**By ,** Depreciation A/c ,, Balance c/d	2,310 6,290
		8,600			8,600
Year- III Opening Closing	**To,** Balance b/d ,, Interest A/c	6,290 315	**Year-III** Closing	**By ,** Depreciation A/c ,, Balance c/d	2,310 4,295
		6,605			6,605
Year- IV Opening Closing	**To,** Balance b/d ,, Interest A/c	4,295 215	**Year-IV** Closing	**By ,** Depreciation A/c ,, Balance c/d	2,310 2,200
		4,510			4,510
Year- V Opening Closing	**To,** Balance b/d ,, Interest A/c	2,200 110	**Year-V** Closing	**By ,** Depreciation A/c	2,310
		2,310			2,310

V. Revaluation Method

This method should be adopted only where the asset is represented by a large number of small and diverse items of small unit cost, e.g., hand tools, live-stock, sacks etc. in such cases it is not possible to attempt to depreciate each individual item. In this method the following steps to be taken :

1st, at the end of financial year, all items, which are in good condition and can serve well, are valued at cost.

2nd, the cost, as calculated above, is compared with the opening balance and the difference is charged as depreciation.

3rd, purchases of asset are debited to asset account in a normal manner.

It is very important to note that under this method the total amount to be written off as depreciation is directly credited to asset account (not an accumulated depreciation account)

Illustration 7.

On 1.1.2013, A Ltd. has a stock of bottles valued at ₹ 8,000. On 1.7.13, they purchased additional bottles which amounted to ₹ 5,000. On Dec. 31, 2013, the entire stock of bottles was revalued at ₹ 10,500. Show the Bottle Account for the year 2013.

Solution :

In the book of A. Ltd.

Dr. Bottle Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Jan. 1	To, Balance b/d	8,000	Dec. 31	By Depreciation A/c (bal. fig.)	2,500
July 1	" Bank A/c	5,000		" Balance c/d	10,500
		13,000			13,000

VI. Depletion Unit Method

This method is specially suited to mines, oil wells, quarries, sandpits and similar assets of a wasting character. The cost of the natural resources is the price paid for its acquisition plus price paid for the development of such asset in order to bring it to a state suitable for production.

The periodic depletion is better not calculated in terms of year. Rather it is better to calculate the cost per unit and then multiply the cost of units produced in that particular year. Depletion for each unit extracted is determined as follows :

$$\text{Depletion per unit (U)} = \frac{\text{Acquisition cost (C) - Residual value (S)}}{\text{Estimated life in terms of production units (n)}}$$

Illustration 8.

In 2011, a company acquired a mine at a cast of ₹ 5,00,000. The estimated reserve of minerals is 50,00,000 tonnes, of which 80% is expected to be realised. The first three years raisings are 1,50,000; 2,00,000 and 2,50,000 tonnes, respectively. Show the Mines Account, charging depreciation under Depletion Method.

Solution :

Total quantity expected to be realized --- 80% of 50,00,000, i.e. 40,00,000 tonnes.

Cost of the mine ₹ 5,00,000

Hence, Charge per tonne $\frac{₹\ 5,00,000}{40,00,000}$ = ₹ 0.125 or 1/8.

Therefore, Depreciation for 2011 = 1,50,000 × 1/8 = ₹ 18,750

for 2012 = 2,00,000 × 1/8 = ₹ 25,000

for 2013 = 2,50,000 × 1/8 = ₹ 31,250

Dr. Mines Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2011			2011		
	To Bank A/c	5,00,000	Dec. 31	By, Depreciation A/c	18,750
				" Balance c/d	4,81,250
		5,00,000			5,00,000
2012			2012		
Jan. 1	To, Balance b/d	4,81,250	Dec. 31	By, Depreciation A/c	25,000
				" Balance c/d	4,56,250
		4,81,250			4,81,250
2013			2013		
Jan. 1	To Balance b/d	4,56,250	Dec. 31	By, Depreciation A/c	31,250
				" Balance c/d	4,25,000
		4,56,250			4,56,250
2014					
Jan. 1	To Balance b/d	4,25,000			

4.9. PROVISION FOR DEPRECIATION ACCOUNT

Provision of depreciation is the collected value of all depreciation. Provision of depreciation account is the account of provision of depreciation. With making of this account we are not credited depreciation in asset account, but transfer every year depreciation to provision of depreciation account. Every year we adopt this procedure and when assets are sold we will transfer sold asset's 'total depreciation' to credit side of asset account, for calculating correct profit or loss on fixed asset. This provision uses with any method of calculating depreciation.

There are following features of provision for depreciation account :

- Fixed asset is made on its original cost and every year depreciation is not transfer to fixed asset account.
- Provision of depreciation account is Conglomerated value of all old depreciation.
- This system can be used both in straight line and diminishing method of providing depreciation.

The journal entries will be :

(i) For purchase of asset

Asset's A/c Dr.

To Cash/Bank A/c

(ii) For providing depreciation at end of year

Depreciation A/c Dr.

To Provision for depreciation A/c

(iii) For sale of assets

Cash/Bank A/c Dr.

To Asset Sales A/c

(iv) Cost of assets sold transferred from Assets Account to Sale of Assets Account.

Assets Sales A/c Dr.

To Asset's A/c.

(v) Total depreciation on asset sold transferred from provision for depreciation account.
Provision for depreciation A/c Dr.

To Asset Sales A/c

(vi) Profit or loss on sale of assets will be transferred from asset sale account to Profit or Loss Account.

4.10 DISPOSAL OF AN ASSET

When an asset is sold because of obsolescence or inadequacy or any other reason, the cost of the asset is transferred to a separate account called "Asset Disposal Account". The following entries are to be made:

(i) When the cost of the asset is transferred:

Asset Disposal A/c Dr.

To, Asset A/c (original cost)

(ii) When depreciation provided on the asset is transferred:

Provision for Depreciation A/c Dr.

To, Asset Disposal A/c

(iii) For charging depreciation for the year of sale:

Depreciation A/c Dr.

To, Asset Disposal A/c

(iv) When cash received on sale of asset:

Bank/Cash A/c Dr.

To, Asset Disposal A/c

(v) When loss on disposal is transferred to Profit & Loss A/c:

Profit & Loss A/c Dr.

To, Asset Disposal A/c

(vi) When profit on disposal is transferred to Profit & Loss A/c:

Asset Disposal A/c Dr.

To, Profit & Loss A/c

Illustration 9.

S & Co. purchased a machine for ₹ 1,00,000 on 1.1.2011. Another machine costing ₹ 1,50,000 was purchased on 1.7.2012. On 31.12.2013, the machine purchased on 1.1.2011 was sold for ₹ 50,000. The company provides depreciation at 15% on Straight Line Method. The company closes its accounts on 31st December every year. Prepare – (i) Machinery A/c, (ii) Machinery Disposal A/c and (iii) Provision for Depreciation A/c.

Solution:

S & Co.

Machinery Account

Dr.					Cr.
Date	**Particulars**	**Amount (₹)**	**Date**	**Particulars**	**Amount (₹)**
1.1.2011	To, Bank A/c	1,00,000	31.12.2011	By, Balance c/d	1,00,000
		1,00,000			1,00,000
1.1.2012	To, Balance b/d	1,00,000			
1.7.2012	To, Bank A/c	1,50,000	31.12.2012	By, Balance c/d	2,50,000
		2,50,000			2,50,000
1.1.2013	To, Balance b/d	2,50,000	31.12.2013	By, Machinery Disposal A/c	1,00,000
			31.12.2013	By, Balance c/d	1,50,000
		2,50,000			2,50,000
1.1.2014	To, Balance b/d	1,50,000			

Provision for Depreciation Account

Dr.					Cr.
Date	**Particulars**	**Amount (₹)**	**Date**	**Particulars**	**Amount (₹)**
31.12.2011	To, Balance c/d	15,000	31.12.2011	By, Depreciation A/c	15,000
		15,000			15,000
31.12.2012	To, Balance c/d	41,250	1.1.2012	By, Balance b/d	15,000
			31.12.2012	By, Depreciation A/c (₹ 15,000 + ₹ 11,250)	26,250
		41,250			41,250
31.12.2013	To, Machinery Disposal A/c	30,000	1.1.2013	By, Balance b/d	41,250
31.12.2013	To, Balance c/d	33,750	31.12.2013	By, Depreciation A/c	22,500
		63,750			63,750
			1.1.2014	By, Balance b/d	33,750

Machinery Disposal Account

Dr.					Cr.
Date	**Particulars**	**Amount (₹)**	**Date**	**Particulars**	**Amount (₹)**
31.12.2013	To, Machinery A/c	1,00,000	31.12.2013	By, Provision for Depreciation A/c	30,000
				By, Depreciation A/c	15,000
				By, Bank A/c	50,000
				By, Profit & Loss A/c(Loss on Sale)	5,000
		1,00,000			1,00,000

Working Notes

1. Depreciation for the machine purchased on 1.7.2012

   For the year 2012 (used for 6 months) = ₹ 1,50,000 × 15% × 6/12 = ₹ 11,250

   For the year 2013 (used for full year) = ₹ 1,50,000 × 15% = ₹ 22,500

2. Depreciation for the machine purchased on 1.1.2011

   Depreciation = ₹ 1,00,000 × 15% = ₹ 15,000

   So, Depreciation for 2 years = ₹ 15,000 × 2 = ₹ 30,000

4.11. PROFIT OR LOSS ON SALE OF ASSETS – METHOD OF DEPRECIATION CALCULATION

Sometimes an asset is sold before the completion of its useful life for some unavoidable circumstances (due to obsolescence etc.) including a part of the asset which is no longer required in future. If the sale price is less than the WDV, there will be loss, and vice versa. The profit & loss on sale of asset is adjusted in the year of Sale in Profit & Loss Account.

Accounting Treatment

a. Where no provision for depreciation account is maintained:

WDV of the amount sold will be transferred to 'Assets Disposal Account'. The entries will be as follows:

(i) WDV of asset has been transferred to Asset Disposal A/c

Asset Disposal A/c Dr.
    To Asset A/c

(ii) In case of Sale of an Asset

Cash/Bank A/c Dr.
    To Asset Disposal A/c

(iii) For depreciation (if any)

Depreciation (P & L A/c) Dr.
    To Asset Disposal A/c

(iv) In case of Profit on Sale of Asset

Asset Disposal A/c Dr.
    To Profit & Loss A/c

(v) In case of Loss on Sale of Asset

Profit & Loss A/c Dr.
    To Asset Disposal A/c

b. Alternative Approach

In this situations, all adjustments are to be prepared through the assets account. The entries are as follows:

(i) In case of Assets sold

Cash/Bank A/c Dr.
    To Assets A/c

(ii) In case of Depreciation

Depreciation (Profit & Loss) A/c Dr.
    To Assets A/c

(iii) In case of Profit on Sale

Assets A/c Dr.
    To Profit & Loss

(iv) In case of Loss on Sale

Profit & Loss A/c Dr.
    To Assets A/c

Illustration 10.

On 1st April, 2011, Som Ltd. purchased a machine for ₹66,000 and spent ₹5,000 on shipping and forwarding charges, ₹7,000 as import duty, ₹1,000 for carriage and installation, ₹500 as brokerage and ₹500 for an iron pad. It was estimated that the machine will have a scrap value of ₹ 5,000 at the end of its useful life

which is 15 years. On 1st January, 2012 repairs and renewals of ₹ 3,000 were carried out. On 1st October, 2013 this machine was sold for ₹ 50,000. Prepare Machinery Account for the 3 years.

Solution

In the books of Som Ltd.

Dr. Machinery Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
01.04.2011	To, Bank A/c	66,000	31.03.2012	By, Depreciation A/c	5,000
	To, Bank A/c	14,000		By, Balance c/d	75,000
		80,000			80,000
01.04.2012	To, Balance b/d	75,000	31.03.2013	By, Depreciation A/c	5,000
				By, Balance c/d	70,000
		75,000			75,000
01.04.2013	To, Balance b/d	70,000	01.10.2013	By, Depreciation A/c	2,500
				By, Bank A/c (sale)	50,000
				By, Profit & Loss A/c (Loss)	17,500
		70,000			70,000

Working Note :

1. Total Cost = ₹ 66,000 + ₹ 5,000 + ₹ 7,000 + ₹ 1,000 + ₹ 500 + ₹ 500 = ₹ 80,000

$$\text{Depreciation} = \frac{\text{Total Cost - Scrap Value}}{\text{Expected life}} = \frac{80{,}000 - 5{,}000}{15} = ₹\ 5{,}000$$

The amount spent on repairs and renewals on 1st January, 2012 is of revenue nature and hence, does not form part of the cost of asset.

4.12. CHANGE OF METHOD - PROSPECTIVE AND RETROSPECTIVE

As per AS-6, the depreciation method selected should be applied consistently from period to period. Change in depreciation method should be made only in the following situations :

(i) For compliance of statute.

(ii) For compliance of accounting standards.

(iii) For more appropriate presentation of the financial statement.

The change in method may be made possible in two ways :

(i) With prospective effect, and

(ii) With retrospective effect

(i) With prospective effect – Under this method, the change in method is to be taken into consideration for the rest of the useful life of the asset commencing from the year in which such change is effected and not from the beginning of the year.

Illustration 11.

Rise Ltd. purchased a machinery for ₹ 1,00,000 on 1.1.2010. The machine was depreciated at 10% p.a. under the Straight Line Method. On 1.1.2013, the company decided to change the method of depreciation from Straight Line Method to Diminishing Balance Method without retrospective effect. Prepare Machine A/c from 2010 to 2013.

Solution:

In the books of Rise Ltd.
Machinery Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
01.01.10	To, Bank A/c	1,00,000	31.12.10	By, Depreciation A/c	10,000
				By, Balance c/d	90,000
		1,00,000			1,00,000
01.01.11	To, Balance b/d	90,000	31.12.11	By, Depreciation A/c	10,000
				By, Balance c/d	80,000
		90,000			90,000
			31.12.12	By, Depreciation A/c	10,000
01.01.12	To, Balance b/d	80,000		By, Balance c/d	70,000
		80,000			80,000
			31.12.13	By, Depreciation A/c - 10% on ₹ 70,000	7,000
01.01.13	To, Balance b/d	70,000		By, Balance c/d	63,000
		70,000			70,000

Illustration 12.

A second hand machine was purchased on 1.1.2009 for ₹ 4,00,000, overhauling and installation expenses for the same machine amounted to ₹ 1,00,000. Another machine was purchased for ₹ 2,00,000 on 1.7.2009.

On 1.7.2011, the machine installed on 1.1.2009 was sold for ₹ 2,50,000. Dismantling charges for the machine sold on 1.7.2011 was ₹10,000. On the same date, another machine was purchased for ₹ 8,00,000 and was commissioned on 30.9.2011. The company had adopted calendar year as its financial year. Under the existing practice, the company provides depreciation @ 10% p.a. on original cost. In 2012, it has been decided that depreciation will be charged on the overhauling balance @15% p.a.. The change is not to be made with retrospective effect.

Show Plant Account for 2009-2013.

Solution:

Statement of Depreciation

Date	Particulars	Machine-I (₹)	Machine-II (₹)	Machine-III (₹)	Total Depreciation (₹)
1.1.2009	Bank (including expenses)	5,00,000			
1.7.2009	Bank		2,00,000		
31.12.2009	Depreciation @10%	50,000	10,000		60,000
1.1.2010	WDV	4,50,000	1,90,000		
31.12.2010	Dep. @ 10%	50,000	20,000		70,000
1.1.2011	W.D.V.	4,00,000	1,70,000	8,00,000	
1.7.2011	Dep.@10%	25,000			
		3,75,000			
	Add : Dismantling Charges	10,000			
		3,85,000			
	Sold for	2,50,000			
	Loss on sale	1,35,000			
31.12.2011	Dep. @ 10%		20,000	40,000	85,000
1.1.2012	WDV		1,50,000	7,60,000	(20,000 + 40,000 + 25,000)
31.12.2012	Dep. @ 15%		22,500	1,14,000	1,36,500
1.1.2013	WDV		1,27,500	6,46,000	
31.12.2013	Dep. @15%		19,125	96,900	1,16,025
1.1.2014	WDV		1,08,375	5,49,100	

Dr. **Machinery Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
01.01.09	To Bank A/c	4,00,000	31.12.09	By Depreciation A/c	60,000
	To Bank A/c (Expenses)	1,00,000		By Balance c/d	6,40,000
01.07.09	To Bank A/c	2,00,000			
		7,00,000			7,00,000
01.01.10	To Balance b/d	6,40,000	31.12.10	By Depreciation A/c	70,000
				By Balance c/d	5,70,000
		6,40,000			6,40,000
01.01.11	To Balance b/d	5,70,000	01.07.11	By Bank A/c (Sale)	2,50,000
	To Bank A/c	8,00,000		By Depreciation A/c	25,000
01.07.11	To Bank A/c (Expenses)	10,000		By P & L A/c	1,35,000
			31.12.11	By Depreciation A/c	60,000
				By Balance c/d	9,10,000
		13,80,000			13,80,000
01.01.12	To Balance b/d	9,10,000	31.12.12	By Depreciation A/c	1,36,500
				By Balance c/d	7,73,500
		9,10,000			9,10,000
01.01.13	To Balance b/d	7,73,500	31.12.13	By Depreciation A/c	1,16,025
				By Balance c/d	6,57,475
		7,73,500			7,73,500
01.01.14	To Balance b/d	6,57,475			

(ii) With retrospective effect

Procedure to be followed in this case :

(i) Depreciation should be recalculated applying the new method from the date of its acquisition/ installation till the date of change of method.

(ii) Difference between the total depreciation under the new method and the accumulated depreciation under previous method till the date of change may be surplus/ deficiency.

(iii) The said surplus is credited to Profit & Loss Account under the head "depreciation written Back".

(iv) Deficiency is charged to Profit & Loss Account.

(v) The journal entries will be :

(a) If old value is less

Profit and Loss A/c. Dr.

To, Assets A/c.

(b) If old value is more

Asset A/c. Dr.

To, Profit and Loss A/c.

(vi) The above change of depreciation method should be treated as change in accounting policy and its post effect should be disclosed and quantified.

Illustration 13.

Ram Ltd. which depreciates its machinery at 10% p.a. on Diminishing Balance Method, had on 1st January, 2013 ₹ 9,72,000 on the debit side of Machinery Account.

During the year 2013 machinery purchased on 1st January, 2011 for ₹ 80,000 was sold for ₹ 45,000 on 1st July, 2013 and a new machinery at a cost of ₹ 1,50,000 was purchased and installed on the same date, installation charges being ₹ 8,000.

The company wanted to change the method of depreciation from Diminishing Balance Method to Straight Line Method with effect from 1st January, 2010. Difference of depreciation up to 31st December, 2013 to be adjusted. The rate of depreciation remains the same as before. Show Machinery Account.

Solution :

In the books of Ram Ltd.

Machinery Account

Dr. *Cr.*

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
01.01.13	To, Balance b/d (9,07,200+64,800)	9,72,000	01.07.13	By, Depreciation A/c [W.N.3]	3,240
				By, Bank A/c - Sale	45,000
				By, Loss on sale of Machine A/c	
01.07.13	To, Bank A/c (1,50,000 + 8,000)	1,58,000		[W.N.4]	16,560
			31.12.13	By, Depreciation A/c:	
				- For the year 2012	1,12,000
				- For ½ year [1,58,000×10%×½]	7,900
				By, Profit & Loss A/c : Adjustment	11,200
				By, Balance c/d :	
				- M_1 (9,07,200 – 1,12,000 – 11,200)	7,84,000
				- M_2	Nil
				- M_3 (1,58,000 – 7,900)	1,50,100
		11,30,000			11,30,000

Working Notes :

(1) At 10% depreciation on Diminishing Balance Method :	₹
If balance of machinery in the beginning of the year is	10
Depreciation for the year is	1
Balance of Machinery at the end of the year	9

By using the formula, balance of asset on 1st January 2010 will be calculated as follows :

	₹
Balance as on 1st January, 2013	9,72,000
Balance as on 1st January, 2012 is 9,72,000 × $\frac{10}{9}$ =	10,80,000
Balance as on 1st January, 2011 is 10,80,000 × $\frac{10}{9}$ =	12,00,000

This balance, ₹ 12,00,000 is composed of 2 machines, one of ₹ 11,20,000 and another of ₹ 80,000.

	₹
Depreciation at 10% p.a. on Straight Line Method on ₹ 11,20,000	1,12,000
Total Depreciation for 2011 and 2012 (₹ 1,12,000 x 2)	2,24,000
Total Depreciation charged for 2011 and 2012 on Diminishing Balance Method (1,12,000 + 1,00,800)	2,12,800
Balance to be charged in 2013 to change from Diminishing Balance Method to Straight Line Method	11,200

(2) Machine purchased on 1st January, 2011 for ₹ 80,000 shows the balance of ₹ 64,800 on 1st January 2013 as follows :

	₹
Purchase price	80,000
Less : Depreciation for 2011	8,000
	72,000
Less : Depreciation for 2012	7,200
Balance as on Jan. 1, 2013	64,800

(3) On second machine (original purchase price ₹ 80,000), depreciation at 10% p.a. on ₹ 64,800 for 6 months, *viz.*, ₹ 3,240 has been charged to the machine on July 1 2013 *i.e.*, on date of sale.

(4) Loss on sale of (ii) machine has been computed as under :

	₹
Balance of the machine as on 1.1.2013	64,800
Less : Depreciation for 6 months up to date of sale	3,240
Balance on date of sale	61,560
Less : Sale proceeds	45,000
Loss on sale	16,560

Illustration 14

M/s. Hot and Cold commenced business on 01.07.2008. When they purchased a new machinery at a cost of ₹ 8,00,000. On 01.01.2010 they purchased another machinery for ₹ 6,00,000 and again on 01.10.2012 machinery costing ₹ 15,00,000 was purchased. They adopted a method of charging depreciation @ 20% p.a. on diminishing balance basis.

On 01.07.2012, they changed the method of providing depreciation and adopted the method of writing off the Machinery Account at 15% p.a. under straight line method with retrospective effect from 01.07.2008, the adjustment being made in the accounts for the year ended 30.06.2013.

The depreciation has been charged on time basis. You are required to calculate the difference in depreciation to be adjusted in the Machinery on 01.07.2012, and show the Machinery Account for the year ended 30.06.2013.

Solution

In the books of M/s Hot and Cold

Dr. Machinery Account Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
01.07.12	To, Balance b/d	6,73,280	30.6.13	By Depreciation A/c	3,78,750
	To, Profit and Loss A/c (Depreciation Overcharged)	21,720		By Balance c/d	18,16,250
01.10.12	To, Bank A/c (Purchase)	15,00,000			
		21,95,000			21,95,000

Workings:

1. Statement of Depreciation:

Date	Particulars	Machine – I ₹	Machine – II ₹	Total Depreciation ₹
01.07.2008	Book Value	8,00,000		
30.06.2009	Depreciation @ 20%	1,60,000		1,60,000
01.07.2009	**W.D.V.**	6,40,000		
01.01.2010	Bank (Purchase)		6,00,000	
30.06.2010	Depreciation @ 20%	1,28,000	60,000	1,88,000
01.07.2010	**W.D.V.**	5,12,000	5,40,000	
30.06.2011	Depreciation @ 20%	1,02,400	1,08,000	2,10,400
01.07.2011	**W.D.V.**	4,09,600	4,32,000	
30.06.2012	Depreciation @ 20%	81,920	86,400	1,68,320
01.07.2012	**W.D.V.**	3,27,680	3,45,600	
		6,73,280		7,26,720

2. Depreciation Overcharged:

Now depreciation under Straight Line Method

On ₹ 8,00,000 @ 15% = ₹ 1,20,000 x 4 years (from 01.07.2008 to 30.06.2012) = ₹ 4,80,000
On ₹ 6,00,000 @ 15% = ₹ 90,000 x 2.5 years (from 01.01.2010 to 30.06.2012) = ₹ 2,25,000

₹ 7,05,000

Depreciation overcharged = Reducing Balance Basis – Straight Line Basis
= ₹ (7,26,720 – 7,05,000)
= ₹ 21,720

3. Depreciation for the year:

On ₹ 14,00,000 @ 15% for the year = ₹ 2,10,000
On ₹ 15,00,000 @ 15% for the 9 months = ₹ 1,68,750

₹ 3,78,750

4.13. APPLICATION OF AS 6- DEPRECIATION ACCOUNTING

"Depreciation Accounting" (AS 6) (Revised)

The Accounting Standard regarding depreciation was issued at first in 1982. But it was revised in 1994. The revised standard (AS 6) is now mandatorily applicable to all concerns in India for accounting periods commencing on or after 1.4.1995. The important matters to be noted from (AS 6) are :

What is Depreciation as per AS-6?

Depreciation is a measure of wearing out, consumption or other loss of value of a **depreciable asset** arising from use and passage of time. Depreciation is nothing but distribution of total cost of assets over its useful life.

"**Depreciable Assets**" are the assets which : -

(a) are expected to be used for more than one accounting period;

(b) have limited useful life;

(c) are held by an enterprise for use in production or supply of goods and services, for rental to others or for administrative purposes but not for sale in the ordinary course of business.

AS-6 is not applicable to the following assets:

- Forests, Plantations
- Wasting Assets, Minerals and Natural Gas
- Expenditure on research and development
- Goodwill
- Live stock – Cattle, Animal Husbandry.

How to calculate Depreciation?

Following are required to ascertain the depreciation of a Depreciable Asset :

- Historical cost or other amount in place of historical cost like revalued amount
- Estimated useful life of depreciable assets
- Estimated residual or scrap value of depreciable assets

Computation of Depreciation:

$$= \frac{\text{Cost - (Residual Value at the end of usueful life)}}{\text{Estimated useful in no. of years}}$$

How to ascertain the cost of depreciable assets?

Cost of depreciable assets is the total cost spent in connection with the acquisition; installation and commissioning of the assets as well as for add item or improvement of the depreciable assets.

"**Useful Life**" of a depreciable asset is the period over which the assets are expected to be used by the enterprise, which is generally shorter than the physical life.

Useful Life of a depreciable asset depends on the following factors –

- Predetermined by legal contractual limits
- Depends upon the number of shifts for which the asset is to be used
- Repair and Maintenance policy of the enterprise
- The theological obsolescence
- Innovation/improvement in the production method
- Change in demand of output
- Legal or other restrictions.

Estimated residual or scrap value:

This is the estimated value of a depreciable asset at the end of its useful life.

Change in Method of Depreciation:

The method selected for charging depreciation should be consistently followed. However, if situations demand (like change of statute, compliance with Accounting Standard, etc.) a change of method may be made, that would result in change in accounting policy (which may be required by statute or for compliance with an Accounting Standards or for more appropriate presentation of financial statement), In that case -

(i) if the change affects the state of affairs of Balance Sheet and Profit and Loss account of the current period or the Financial Statements of later period, then such change must be disclosed in financial statement. The amount, by which the financial statement is affected, should be disclosed to the extent it is ascertainable.

(ii) the depreciation should be recalculated under the new method with effect from the date of the asset coming into use till the date of change of method, that is, with retrospective effect. Difference between the total depreciation under new method and the accumulated depreciation under the old method till the date of change of method should be computed first. Then the resultant surplus or deficiency is to be charged to credit and debit side of the Profit and Loss A/c respectively.

Change in Useful Life:

If there is a change in useful life of an asset, outstanding depreciable amount on the date of change in estimated useful life of asset is required to be allocated over the revised remaining useful life.

Any addition or extension essential for an existing asset, should be depreciated over the remaining life of the asset.

If the historical cost of an asset changes due to exchange fluctuations, price adjustments, etc. the depreciation on the revised unamortized depreciable amount should be provided prospectively for the rest of the life of the asset.

For any asset revalued, the provision for depreciation should be made on the revalued amount for the remaining useful life of the asset.

In the financial statements, the matters to be disclosed are-

(i) The historical cost or any amount substituting it;

(ii) Total depreciation for the period for each class of assets;

(iii) The related accumulated depreciation.

The method of charging depreciation should also be disclosed.

4.14. APPLICATION OF AS 10- ACCOUNTING FOR FIXED ASSET

Accounting Standard for Fixed Assets (AS 10)

Accounting Standard 10 is related with accounting of Fixed Assets. The important matters to be noted from (AS 10) are :

Fixed asset is an asset

- which is held with an intention of being used for the purpose of producing and providing goods and services
- which is not held for sale in the normal course of business
- which is expected to be used for more than one accounting period

Examples of Fixed Assets are-

- Land
- Building- Freehold/Leasehold
- Plant and Machinery
- Furniture & Fitting etc.

This accounting standard is applicable to all assets except the following:

- Forest, plantations and similar regenerative natural resource.
- Wasting assets like minerals,oil and natural gas
- Expenditure on real estate development
- Live stock

Fixed assets shall be shown in financial statement either at historical cost or revalued price.

(a) The gross book value of a fixed asset should be either historical cost or a revaluation computed in accordance with the Accounting Standard. [Set out in paragraphs 20 to 26 and 27 to 32 of the Standards]

Historical cost of a Fixed Asset: It consist of the following:

- Purchase price
- Import duties and other taxes which is non-refundable in nature
- Any cost which is directly attributable to bring the asset to the working condition for its intended use.

In case of any self-constructed assets costs attributable to its construction and allocable to it, should be included in its value.

Items fixed assets retired from active use and held for disposal should be shown separately in the financial statements and stated at net book value or realizable value, whichever is lower.

If any subsequent expenditure causes an addition to the already expected future benefits of an asset, such expenditure should be added with the value of the asset.

Cost of assets acquired in exchange of existing assets:

- **Fixed assets exchanged not similar**

  In case a new asset is acquired in part exchange of an old asset the exchange price should be recorded at fair market value of the asset acquired or at fair market value of the asset given up, if it is more clearly evident.

- **Fixed assets exchanged are similar**

  In case a new asset is acquired in part exchange of an old asset the exchange price should be recorded at fair market value of the asset acquired or at fair market value of the asset given up, if it is more clearly evident or net book value of the old asset.

- **Fixed asset acquired in exchange of shares, etc**. should be recorded at its fair market value or the fair market value of the shares, etc. whichever is more clearly available.

Any loss or gain on the retirement or disposal of any fixed asset carried at cost should be recognized in the profit and loss account if the value of any asset increases on revaluation, its accumulated depreciation should not be debited to Profit & Loss Account. The depreciation on such revalued amount should be adjusted against Revaluation Reserves.

Disclosure requirement as per Accounting Standard 10:

- Gross and the net book values of fixed assets at the beginning and at the end of the accounting period showing there in any additions, disposal, acquisition and other movement.
- Expenditure incurred on account of fixed assets in the course of construction or acquisition.
- Revalued amount which is substituted for historical cost of the fixed asset, method adopted to compute the revalued amount, and whether an external valuer has valued the fixed assets, in case where fixed assets are stated at revalued amount.

4.15. APPLICATION OF AS 28 - IMPAIRMENT OF ASSETS

Impairment of Asset means weakening in value of asset i.e. when the value of asset decreases we may call it "Impairment of an Asset". According to AS-28, asset is said to be impaired when carrying amount of asset is more than its recoverable amount.

Objectives of AS-28: "Impairment of Asset" is three fold:

(a) To prescribe procedures to ensure that the Carrying Value of the assets of an enterprise is restricted to their Recoverable Value;

(b) To specify the circumstances and conditions for reversal of Impaired Assets; and

(c) To prescribe appropriate disclosure requirements for Impaired Assets.

Applicability of AS-28:

It is applicable for all the following assets	It is not applicable for all the following items
(i) Fixed Assets.	(i) Inventories (AS -2).
(ii) Goodwill and other Intangible Assets.	(ii) Asset arising from Construction Contract (AS-7).
(iii) Assets under Finance Lease of a Lessee.	(iii) Financial Assets within the scope of AS-13.
(iv) Assets of a Lessor under an Operating Lease.	(iv) Contractual right to receive cash.
(v) Prepaid Asset.	(v) Deferred Tax Assets (AS-22).
(vi) Financial Assets classified as Investments in [Para 2A]: (a) Subsidiaries as defined under AS-21 (b) Associates as defined under AS-23 (c) Joint Ventures as defined under AS-27	As per Para-2, for the above assets, the respective Accounting Standards stated above shall apply.

Definitions:

Impaired Asset: Impaired Asset means the asset, the carrying amount of which exceeds its recoverable amount.

Impairment Loss: Impairment Loss is the excess of the carrying value of an asset over its recoverable amount. In other words, Impairment Loss= Carrying Value – Recoverable Amount.

So, if the carrying value of an asset is less than or equal to its recoverable amount, the asset is not impaired and there is no impairment loss.

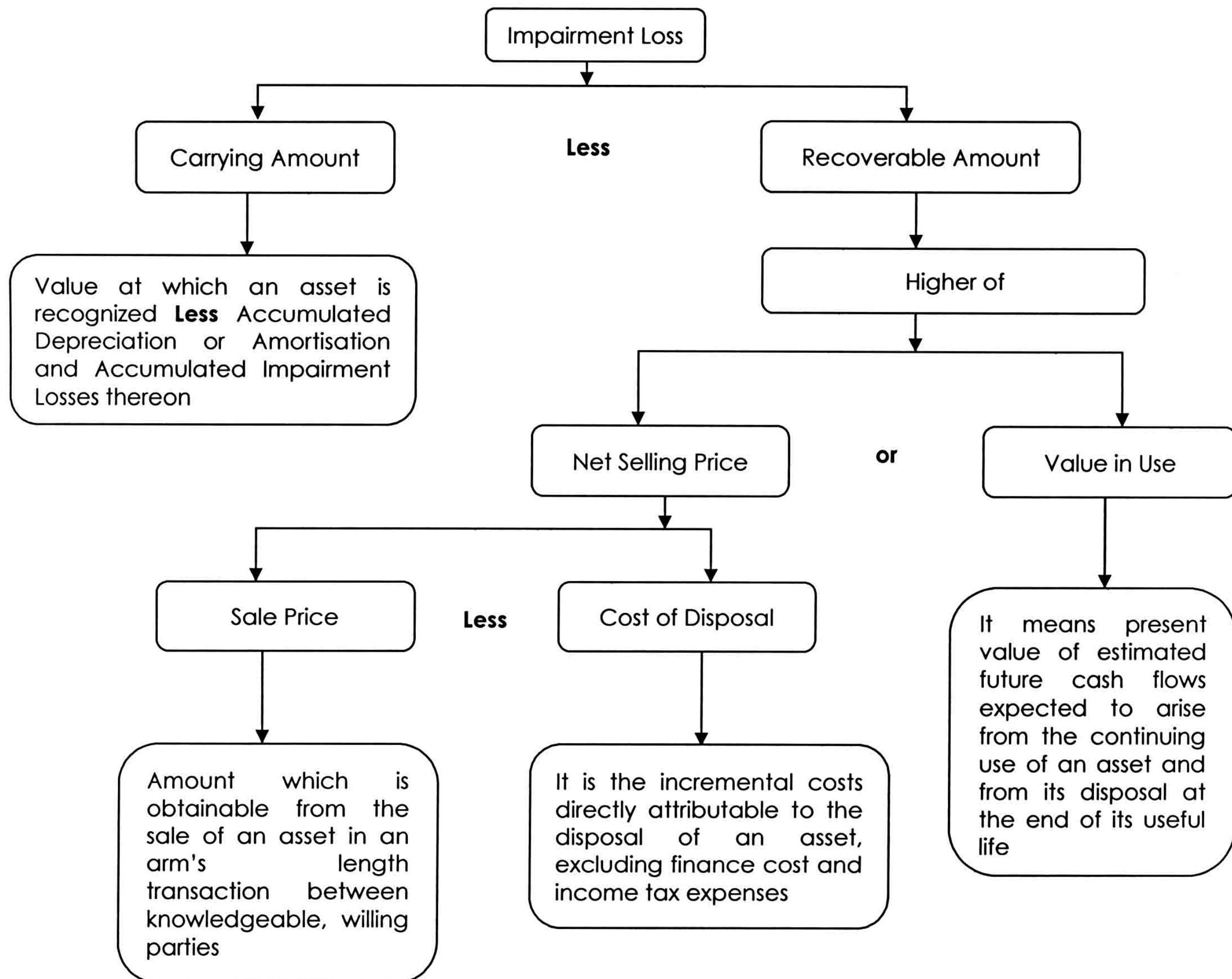
Carrying Amount: Carrying amount is the amount by which an asset is recognized in the Balance Sheet after deducting accumulated depreciation or amortisation and accumulated impairment losses thereon, if any.

Recoverable Amount: Recoverable amount of an asset is the higher of its net selling price and its value in use.

Net Selling Price: Net selling price refers the amount obtainable from the sale of an asset in an amr's length transaction between knowledgeable, willing parties, less the costs of disposal. Here, the cost of disposal means the incremental costs directly attributable to the disposal of the asset. However, it does not include finance cost and income tax expenses. Net selling price excludes forced sale or distress sale, unless management is compelled to sell immediately.

Value in Use: Value in use refers to the present value of all estimated cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. The present value of estimated future cash flows is calculated by multiplying discount rates with the estimated future cash flows.

Methods for Calculating Impariment Loss:



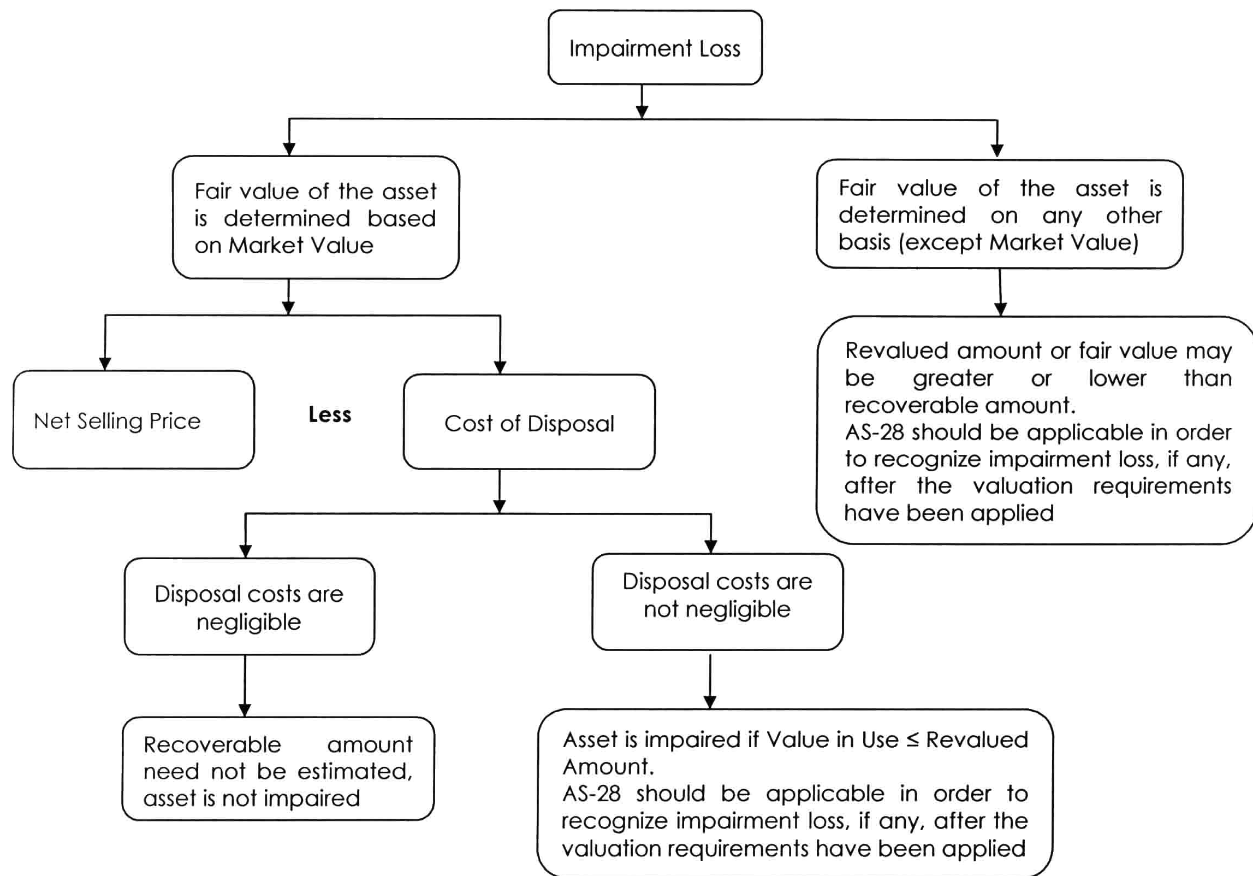
If either the net selling price or value in use exceeds the carrying amount, the asset is not impaired and calculation of the other amount is not required.

Net Selling Price can be determined based on price quoted in a binding sale agreement. If binding sale agreement does not exist but active market exits, it can be calculated based on current bid price or the price of the most recent transaction(in case current bid price is not available). However, where neither binding sale agreement nor active market exist, it can be determined based on the best information available.

Value in use = Present value of future cash flows from the continuing use of the asset + Present value of cash flow to be received for the disposal of the asset at the end of its useful life in an amr's length transaction between knowledgeable, willing parties after deducting the cost of disposal.

Methods for Calculating Impairment Loss in case of Revalued Assets:

AS-28 shall also apply for revalued assets. In this case fair value is determined either on Market Value or on Any Other Methods. Impairment loss can be determined as follows:



Identification of Impairment:

At each Balance Sheet date, an enterprise should assess whether there is any indication of impairment of an asset. If the indication exists, the enterprise should estimate the recoverable amount and if there is no such indication, the enterprise needs not to calculate the recoverable amount. The indications of impairment may come from external or internal sources.

External Sources:

(a) Due to passage of time or normal use, there is a significant decline in the market value of the asset during the period.

(b) There is an adverse effect on the enterprise due to change in technology, market conditions and legal regulations.

(c) There is a change in discount rate used in calculating the asset's value in use and significant decrease in the asset's recoverable amount due to increase in market interest rates or increase in market rates of return on investments.

Internal Sources:

(a) Obsolescence or physical damage of an asset is evidenced.

(b) Economic performance of the asset is lower than the expectations.

(c) Significant changes like discontinuance plans, operational reconstruction, etc are occurred.

(d) A history of continued asset losses or cash flow losses or significant increase in budgeted losses.

The given indications are only illustrative and not to be taken as exhaustive or conclusive.

However, in the following situation, an enterprise is not required to make formal estimate of an asset's Recoverable Amount:

(i) There is no indication that an asset may be impaired.

(ii) Where the effect of the various indications on the assets's recoverable amount is not material.

(iii) If in the previous calculation it is observed that an asset's recoverable amount is significantly greater than its carrying amount and the events occurred is not enough to eliminate the difference.

(iv) If the discount rate used in calculating the asset's value in use is not affected by the increase in market interest rate or other market rates of return on investments.

(v) If the discount rate used in calculating the asset's value in use is affected but sensitivity analysis of recoverable amount shows that future cash flows will also increase thereby nullifying that increase or recoverable amount does not significantly decrease.

Steps in determining impairment loss of an individual asset:

In determining the impairment loss of an individual asset, the following steps are involved:

Step 1: Indentify the asset or the cash generating unit.

Step 2: Determine the net selling price.

Step 3: Determine value in use.

Step 4: Determine recoverable amount i.e. higher of Step 2 and Step3.

Step 5: Ascertain carrying amount.

Step 6: If, Step 4 ≥ Step 5, the asset is not impaired.

If, Step 5 ≥ Step 4, go to next step.

Step 7: Impairment Loss = Step 5 – Step 4.

Step 8: Accounting treatment of Impairment Loss:

(i) Charge to Profit & Loss Account as an expense.

(ii) In case of Revalued Asset, adjust against Revaluation Surplus.

(iii) If the amount of impairment loss is greater than the carrying amount of the asset or if it is required by any other Accounting Standards, recognise the loss as liability.

(iv) Adjust Depreciation or Amortisation Charge in future period.

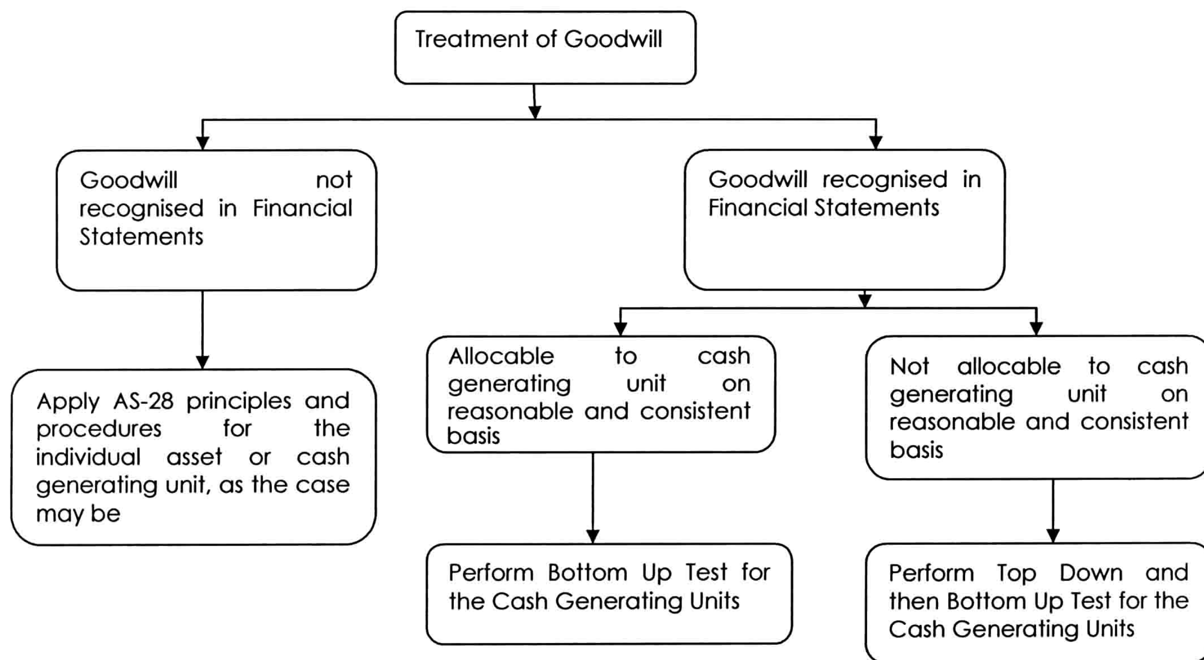
(v) Recognise any related Deferred Tax Asset or Liability as per AS-22.

Step 9: Follow up with annual impairment review.

Note: Cash Generating Unit (CGU) is the smallest identifiable group of asset that generates cash inflows from its continuing use.

Impairment Loss for Goodwill:

Goodwill does not generate cash flow independently without other assets or group of assets. Hence, its recoverable amount cannot be determined as an individual asset. If there is an indication that goodwill may impair, recoverable amount is determined for the assets or group of assets to which it belongs. The recoverable amount is then compared with the carrying amount of the assets or group of assets. Impairment loss, if any, is recognised as per AS-28.



Top Down Test ensures that the enterprise recognises first any impairment loss that exists for the cash generating unit, excluding any consideration of goodwill and then any impairment loss that exits for goodwill.

Bottom Up Test ensures that the enterprise recognises any impairment loss that exists for a cash generating unit, including for the goodwill that can be allocated on a reasonable and consistent basis.

Impairment Loss for Corporate Assets:

Corporate Assets mean assets other than goodwill that contribute to the future cash flows of both the cash generating unit under review and other cash generating units.

When the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash generating unit under review, an enterprise should apply the bottom-up test only. However, when the carrying amount of the corporate asset cannot be allocated on a reasonable and consistent basis to the cash generating unit under review, an enterprise should apply both the bottom-up test and top-down test.

Reversal of Impairment Loss:

At each Balance Sheet date, an enterprise should assess whether there is an indication that an impairment loss recognised for an asset in a prior accounting periods may no longer exist or may have decreased. If any of such indication exists, the enterprise should estimate the recoverable amount of the asset. Such indications are:

External:

1. The asset's market value has increased significantly.
2. Significant favourable changes in technological, market, economic or legal environment in which the enterprise operates.
3. Market interest rates have decreased during the period.

Internal:

Economic performance of the asset is better than the expectations

Amount of Impairment Loss = Recoverable Amount Less Carrying Amount.

Due to a reversal of an impairment loss, the increased carrying amount of an asset should not exceed the carrying amount that would have been determined if there had no impairment loss been recognised.

Disclosure Requirements:

The following financial statements should disclose for each class of asset:

1. The amount of impairment losses in Profit and Loss A/c.
2. The amount of impairment losses against revaluation.
3. The amount of reversals of impairment.
4. The amount of reversals of impairment losses against revaluation surplus.

Again, if an impairment loss is material to the financial statements an enterprise should disclose the events and circumstances that led to impairment loss, the nature of the asset, the reportable segment to which the asset belongs and whether the recoverable amount of the asset is its net selling price or value in use.

Illustration 15

Z Ltd. acquired a machine for ₹ 31,00,000 on 01.04.2010. The machine has ten years life with ₹ 1,00,000 salvage value and was depreciated using straight-line method. On 31.03.2012 a test for impairment reveals the following :-

1. Present value of future cash flow ₹ 14,50,000
2. Net Selling Price ₹ 16,00,000
3. Estimated salvage value Nil

Assuming loss for impairment is recognized for the year 31.03.2012. What should be the depreciation expenses for the year ended 31.03.2013?

Solution:

Impairment loss for the year ended 31.03.2012

Particulars	₹
Carrying amount of the Machine [31,00,000 – {(31,00,000 – 1,00,000)/120×24}]	25,00,000
Value in Use (i.e. Present Value of future cash flow + Present value of estimated salvage value)	14,50,000
Net Selling Price	16,00,000
Recoverable Amount (higher of Value in Use and Net Selling Price)	16,00,000
Impairment Loss (Carrying Amount – Recoverable Amount)	9,00,000
Revised Carrying Amount	16,00,000
Depreciation for the year 31.03.2013 [(16,00,000 – Nil) × 12/96]	2,00,000

Illustration 16

N Ltd. gives the following estimates of cash flows relating to fixed asset on 31.03.2012. The discount rate is 10%.

Year	Cash Flow (₹)
2012-13	2,00,000
2013-14	5,00,000
2014-15	8,00,000
2015-16	5,00,000
2016-17	2,00,000
Salvage value as at 31.03.2017	50,000

The Asset was purchased on 01.04.2010 for ₹ 25,00,000. The useful life of the asset is 7 years. The salvage value of the asset is ₹ 50,000. Net Selling Price is ₹ 10,00,000 after incurring an cost of ₹ 50,000.

Calculate impairment loss and the amount of depreciation to be charged for the year 2012-13.

Solution:

Computation of Value in Use

Year	Cash Flow (₹)	Discount as per 10%	Discounted Cash Flow (₹)
2012-13	2,00,000	0.909	1,81,800
2013-14	5,00,000	0.826	4,13,000
2014-15	8,00,000	0.751	6,00,800
2015-16	5,00,000	0.683	3,41,500
2016-17	(2,00,000+50,000) 2,50,000	0.621	1,55,250
Total			16,92,350

∴ Value in Use = ₹ 16,92,350

Net Selling Price = ₹ (10,00,000 – 50,000) = ₹ 9,50,000

Recoverable Amount = Higher of Value in Use or Net Selling Price
= Higher of ₹ 16,92,350 or ₹ 9,50,000
= ₹ 16,92,350

Carrying Amount = ₹[25,00,000 – {(25,00,000 – 50,000) × 24/84}]
= ₹ 18,00,000

Impairment Loss = Carrying Amount – Recoverable Amount
= ₹ 18,00,000 - ₹ 16,92,350
= ₹ 1,07,650

∴ Revised Carrying Amount = ₹ 18,00,000 - ₹ 1,07,650
= ₹ 16,92,350

Depreciation for year 2012-13= ₹ (16,92,350 – 50,000)×12/60
= ₹ 3,28,470

Illustration 17

AB Ltd. acquired C Ltd. as on 31.03.2010 for ₹ 6,000 Lakhs [Goodwill (to be amortised in 5 years) ₹ 1,000 Lakhs and other Fixed Assets ₹ 5,000 Lakhs]. The anticipated useful life of the acquired assets is 8 years. The company uses straight-line method of depreciation with no residual values. On 31.03.2012, due to change in Government policies, the company estimates the significant decline in production. The Net Selling Price is ₹ 3,000 Lakhs. The cash flow forecast based on recent financial budget for the next 6 years after considering changed Government policies are as follows, incremental financing cost is 10% which represent current market assessment of the time value of money.

Year	Cash Flow (₹ in Lakh)
2012-13	700
2013-14	700
2014-15	600
2015-16	500
2016-17	500
2017-18	400

You are required to calculate the amount of impairment loss and revised carrying amount.

Solution:

Computation of Value in Use **[₹ in Lakh]**

Year	Cash Flow	Discount as per 10%	Discounted Cash Flow
2012-13	700	0.909	636.3
2013-14	700	0.826	578.2
2014-15	600	0.751	450.6
2015-16	500	0.683	341.5
2016-17	500	0.621	310.5
2017-18	400	0.564	225.6
Total			2,542.7

Computation of Impairment Loss and Revised Carrying Amount **[₹ in Lakh]**

	Goodwill	Other Fixed Assets	Total
Cost of Acquisition	1,000	5,000	6,000
Less : Depreciation for 2 years	400	1,250	1,650
Carrying Amount	600	3,750	4,350
Recoverable Amount (Higher of Value in Use ₹ 2,542.7 Lakhs or Net Selling Price ₹ 3,000 Lakhs			3,000
Impairment Loss			1,350
Allocation of Loss	600	750	
Carrying Amount after Impairment Loss	Nil	3,000	3,000

Illustration 18

Shiva Ltd recognises Goodwill at ₹ 25 lakhs in the Balance Sheet. An amount of ₹ 9 lakhs is allocable on a reasonable and consistent basis to a CGU. The carrying amount of the CGU is ₹ 27 lakhs before allocation of goodwill. What will be the treatment of Impairment Loss if the recoverable amount of the CGU is — (1) ₹ 32 lakhs, (2) ₹ 22 lakhs and (3) (₹ 2 lakhs).

Solution:

Particulars	Situation 1	Situation 2	Situation 3
1. Carrying amount of the CGU	₹ 27 lakhs	₹ 27 lakhs	₹ 27 lakhs
2. **Add:** value of goodwill allocated to the CGU	₹ 9 lakhs	₹ 9 lakhs	₹ 9 lakhs
3. Revised carrying amount of CGU (1+3)	₹ 36 lakhs	₹ 36 lakhs	₹ 36 lakhs
4. Recoverable amount of the CGU	₹ 32 lakhs	₹ 22 lakhs	(₹ 2 lakhs)
5. Impairment Loss = (3-4)	₹ 4 lakhs	₹ 14 lakhs	₹ 36 lakhs
6. Treatment of Impairment Loss	Goodwill reduced by ₹4 lakhs	• Goodwill reduced by ₹ 9 lakhs • Assets of the CGU reduced by ₹ 5 lakhs on pro-rata basis.	• Goodwill reduced by ₹9 lakhs • Assets of CGU reduced by ₹ 27 lakhs on pro-rata basis • Liability recognised for ₹ 2 lakhs if required by another Accounting Standard

Note: A total of ₹ 38 lakhs will be charged in the Profit and Loss Account i.e. ₹ 36 lakhs for Impairment Loss and ₹ 2 lakhs for Provision of Liability.

Illustration 19

Ayushman Ltd is engaged in a business of genetically creating high breed food products and manufacturing. A major portion of its output is exported.

During April 2008, to support its activities, the company had acquired a R&D cum Manufacturing Plant for a total consideration of ₹ 7.50 crores. Identifiable Assets were worth ₹ 5 crores and the balance was treated as Goodwill, to be amortised over a period of 5 years. The useful life of the plant was estimated at 20 years. The company adopts a Straight Line Method of depreciation for its assets with a NIL residual value.

In March 2011, new Government had sworn in and put a restriction on export of all agricultural produces. This had let to impairment of Ayushman's assets. Ayushman had recognised the Impairment Loss by determining the recoverable amount of assets at ₹ 3.40 crores.

In March 2013, due to change in policy, the restriction was removed and the recoverable amount of the plant is estimated at ₹ 4.27 crores.

If the company's financial year ends on 31st March —

(a) Compute the Impairment Loss recognised for the year ending 31st March,2011 and determine its allocation.

(b) Compute the reversal of Impairment Loss for the year ending 31st March 2013 and determine its allocation.

(c) If the recoverable amount on 31st March 2013 is determined at 3.40 crores, what is the amount of reversal to be recognised?

Solution:

1. **Computation and allocation of Impairment Loss as on 31st March,2011 (₹ in crores)**

Particulars	Goodwill	Identifiable Assets	Total
1. Cost of acquisition in April,2008	2.50	5.00	7.50
2. **Less:** Amortisation/Depreciation	(1.50) [(2.50/5 yrs)×3 yrs]	(0.75) [(5.00/20 yrs)×3 yrs]	(2.25)
3. Carrying amount as on 31.03.2011	1.00	4.25	5.25
4. Recoverable amount on 31.03.2011			3.40
5. Impairment Loss (3-4)**(Note)**	1.00	0.85 (Balancing Figure)	1.85
6. Carrying amount after recognizing Impairment Loss (3-5)	NIL	3.40	3.40

Note: Impairment Loss should be ascertained as a whole for the CGU and not separately for Goodwill and other Identifiable Assets. The amount of Impairment Loss to be recognised is first adjusted against Goodwill and thereafter allocated to other Identifiable Assets.

2. Computation and allocation of Reversal of Impairment Loss as on 31st March,2013

(₹ in crores)

Particulars	Goodwill	Identifiable Assets	Total
1. Carrying amount as at 30.03.2011 after recognition of Impairment Loss (as above)	NIL	3.40	3.40
2. **Less:** Amortisation/Depreciation for 2 years	NIL	(0.40) [(3.40/17 yrs)×2 yrs]	(0.40)
3. Carrying amount as on 31.03.2013 (1-2)	NIL	3.00	3.00
4. Carrying amount as on 31.03.2013 had there been no impairment (cost-accumulated depreciation)	NIL **(Note-1)**	3.75 **(Note-1)**	3.75
5. Recoverable amount as on 31.03.2013 (given)			4.27
6. Total Impairment Loss to be reversed (5-3)			1.27
7. Impairment Loss that can be reversed (4-3) **(Note-2)**			0.75
8. Revised carrying amount on 31.03.2013 (3+7) [This amount should not exceed (4)]	NIL	3.75	3.75

Note1: Carrying amount as on 31.03.2013 as if no impairment had occurred earlier, will be computed as under:

(a) Goodwill (Original Cost ₹ 2.50 crores – Accumulated Amortisation 0.50×5 years) = NIL

(b) Other Assets (Original Cost ₹ 5.00 crores – Accumulated Amortisation 5.00×5/20 years) =₹ 3.75 Crores

Note 2: The entire amount of excess should not be reversed. Reversal can be done only to the extent of the value of the asset if there had been no impairment.

3. Reversal of Impairment Loss as on 31.03.2013, if Recoverable Amount = ₹ 3.40

(₹ crores)

Particulars	Goodwill	Identifiable Assets	Total
1. Carrying amount as at 30.03.2011 after recognition of Impairment Loss (as above)	NIL	3.40	3.40
2. **Less:** Amortisation/Depreciation for 2 years	NIL	0.40 [(3.40/17 yrs)×2 yrs]	0.40
3. Carrying amount as on 31.03.2013 (1-2)	NIL	3.00	3.00
4. Carrying amount as on 31.03.2013 had there been no impairment (cost-accumulated depreciation)	NIL	3.75	3.75
5. Recoverable amount as on 31.03.2013 (given)			3.40
6. Total Impairment Loss to be reversed (5-3)			0.40
7. Impairment Loss that can be reversed			0.40
8. Revised carrying amount on 31.03.2013 (3+7)	NIL	3.40	3.40

Study Note - 5

PREPARATION OF FINANCIAL STATEMENTS

This Study Note includes

5.1 Introduction
5.2 Preparation of Financial Statements
5.3 Bad Debts
5.4 Preparation of Financial Statement of Non-Trading Concern
5.5 Preparation of Financial Statement under Single Entry System including Conversion of Single Entry into Double Entry System
5.6 Application of AS 3 – Cash Flow Statement

5.1 INTRODUCTION

Preparation of final accounts is the final destination of the accounting process. As discussed earlier these final accounts include two statements – Income statement which reflects the outcome of business activities during an accounting period (i.e. profit or loss) and the balance sheet which show the position of the business at the end of the accounting period (i.e. resources owned as assets and sources of funds as liabilities plus capital). The objective of financial statements is to provide information about the financial strength, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements should be understandable, relevant, reliable and comparable. Reported assets, liabilities and equity are directly related to an organization's financial position. Reported income and expenses are directly related to an organization's financial performance.

Financial statements are intended to be understandable by readers who have "a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently".

In this chapter, we will see how conceptually these statements are prepared and what each of them contains.

5.2 PREPARATION OF FINANCIAL STATEMENTS

5.2.1 Profitability Statement – This statement is related to a complete accounting period. It shows the outcome of business activities during that period in a summarized form. The activities of any business will include purchase, manufacture, and sell.

5.2.1.1 Balance Sheet – Business needs some resources which have longer life (say more than a year).

Such resources are, therefore, not related to any particular accounting period, but are to be used over the useful life thereof. The resources do not come free. One requires finance to acquire them. This funding is provided by owners through their investment, bank & other through loans, suppliers by way of credit terms. The Balance Sheet shows the list of resources and the funding of the resources i.e. assets and liabilities (towards owners and outsiders). It is also referred as sources of funds (i.e. liabilities & capital) and application of funds (i.e. assets). Let us discuss these statements in depth.

5.2.1.2 Trading Account: It is an account which is prepared by a merchandising concern which purchases goods and sells the same during a particular period. The purpose of it to find out the gross profit or gross loss which is an important indicator of business efficiency.

The following items will appear in the debit side of the Trading Account:

(i) Opening Stock: In case of trading concern, the opening stock means the finished goods only. The amount of opening stock should be taken from Trial Balance.

(ii) Purchases: The amount of purchases made during the year. Purchases include cash as well as credit purchase. The deductions can be made from purchases, such as, purchase return, goods withdrawn by the proprietor, goods distributed as free sample etc.

(iii) Direct expenses: It means all those expenses which are incurred from the time of purchases to making the goods in suitable condition. This expenses includes freight inward, octroi, wages etc.

(iv) Gross profit: If the credit side of trading A/c is greater than debit side of trading A/c gross profit will arise.

The following items will appear in the credit side of Trading Account:

(i) Sales Revenue: The sales revenue denotes income earned from the main business activity or activities. The income is earned when goods or services are sold to customers. If there is any return, it should be deducted from the sales value. As per the accrual concept, income should be recognized as soon as it is accrued and not necessarily only when the cash is paid for. The Accounting standard 7 (in case of contracting business) and Accounting standard 9 (in other cases) define the guidelines for revenue recognition. The essence of the provisions of both standards is that revenue should be recognized only when significant risks and rewards (vaguely referred to as ownership in goods) are transferred to the customer. For example, if an invoice is made for sale of goods and the term of sale is door delivery; then sale can be recognized only on getting the proof of delivery of goods at the door of customer. If such proof is pending at the end of accounting period, then this transaction cannot be taken as sales, but will be treated as unearned income.

(ii) Closing Stocks: In case of trading business, there will be closing stocks of finished goods only. According to convention of conservatism, stock is valued at cost or net realizable value whichever is lower.

(iii) Gross Loss: When debit side of trading account is greater than credit side of trading account, gross loss will appear.

Dr **Trading Account for the year ended** **Cr**

Particulars	Amount	Particulars	Amount
Opening stock:		Sales	
Finished goods		less sales returns	
Purchases		Closing stock	
Less: purchase returns		Finished goods	
Gross Profit		Gross Loss	
(transferred to P & L A/c)		(transferred to P & L A/c)	
Total		Total	

Preparation of Trading Account

Illustration 1.

Following are the ledger balances presented by M/s. P. Sen as on 31st March 2013.

Particulars	Amount (₹)	Particulars	Amount (₹)
Stock (1.4.2012)	10,000	Sales	3,00,000
Purchase	1,60,000	Return Inward	16,000
Carriage Inwards	10,000	Return Outward	10,000
Wages	30,000	Royalty on Production	6,000
Freight	8,000	Gas and Fuel	2,000

Additional Information:

(1) Stock on 31.3.2013: (i) Market Price ₹ 24,000; (ii) Cost Price ₹ 20,000;

(2) Stock valued ₹ 10,000 were destroyed by fire and insurance company admitted the claim to the extent of ₹ 6,000.

(3) Goods purchased for ₹ 6,000 on 29th March, 2013, but still lying in-transit, not at all recorded in the books.

(4) Goods taken for the proprietor for his own use for ₹ 3,000.

(5) Outstanding wages amounted to ₹ 4,000.

(6) Freight was paid in advance for ₹ 1,000.

Solution:

In the books of M/s. P. Sen
Trading Account
Dr. **For the year ended 31st March, 2013.** Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Openign Stock		10,000	By, Sales	3,00,000	
To Purchase	1,60,000		Less: Return Inward	16,000	2,84,000
Less: Return Outward	10,000				
	1,50,000		By, Closing Stock	20,000	
Less: Goods taken by Proprietor	3,000		Add: Stock Destroyed	10,000	
	1,47,000			30,000	
Add: Goods-in-transit	6,000	1,53,000	Add: Goods-in-Transit	6,000	36,000
To Wages	30,000				
Add: Outstanding	4,000	34,000			
To, Carriage Inwards		10,000			
To, Freight	8,000				
Less: Prepaid	1,000	7,000			
To, Royalty on production		6,000			
To, Gas & fuel		2,000			
To, Profit & Loss A/c. - Gross profit transferred		98,000			
		3,20,000			3,20,000

Note: (a) Stock should be valued as per cost price or market price whichever is lower.

(b) The claim which was admitted by insurance company and the loss of stock, will not appear in Trading Account.

5.2.1.3 Profit and Loss Account:

The following items will appear in the debit side of the Profit & Loss A/c:

(i) Cost of Sales: This term refers to the cost of goods sold. The goods could be manufactured and sold or can be directly identified with goods.

(ii) Other Expenses: All expenses which are not directly related to main business activity will be reflected in the P & L component. These are mainly the Administrative, Selling and distribution expenses. Examples are salary to office staff, salesmen commission, insurance, legal charges, audit fees, advertising, free

samples, bad debts etc. It will also include items like loss on sale of fixed assets, interest and provisions. Students should be careful to include accrued expenses as well.

(iii) Abnormal Losses: All abnormal losses are charged against Profit & Loss Account. It includes stock destroyed by fire, goods lost in transit etc.

The following items will appear in the credit side of Profit & Loss A/c:

(i) Revenue Incomes: These incomes arise in the ordinary course of business, which includes commission received, discount received etc.

(ii) Other Incomes: The business will generate incomes other than from its main activity. These are purely incidental. It will include items like interest received, dividend received, etc .The end result of one component of the P & L A/c is transferred over to the next component and the net result will be transferred to the balance sheet as addition in owners' equity. The profits actually belong to owners of business. In case of company organizations, where ownership is widely distributed, the profit figure is separately shown in balance sheet.

Dr **Profit and Loss Account for the year ended** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
Gross Loss		Gross Profit	
(transferred from Trading A/c)		(transferred from Trading A/c)	
Administrative expenses		Other Income	
Office salaries		Interest received	
Communication		Commission received	
Travel & Conveyance		Profit on sale of assets	
Office rent		Rent received	
Depreciation of office assets		Net loss	
Audit fees			
Insurance			
Repairs & maintenance			
Selling & Distribution expenses			
Advertising			
Salesmen commission			
Delivery van expenses/Depreciation on delivery vans/Bad debts			
Financial expenses			
Bank charges			
Interest on loans			
Loss on sale of assets			
Net profit			
Total		**Total**	

Preparations of Profit & Loss Account

Illustration 2.

From the following particulars presented by Sri Tirlhankar for the year ended 31st March 2013, Prepare Profit and Loss Account.

Gross Profit ₹ 1,00,000, Rent ₹ 22,000; Salaries, ₹ 10,000; Commission (Cr.) ₹ 12,000; Insurance ₹ 8,000; Interest (Cr.) ₹ 6,000; Bad Debts ₹ 2,000; Provision for Bad Debts (1.4.2012) ₹ 4,000; Sundry Debtors ₹40,000; Discount Received ₹ 2,000; Plant & Machinery ₹ 80,000.

Adjustments:

(a) Outstanding salaries amounted to ₹ 4,000;

(b) Rent paid for 11 months;

(c) Interest due but not received amounted to ₹ 2,000

(d) Prepaid Insurance amounted to ₹ 2,000;

(e) Depreciate Plant and Machinery by 10% p.a.

(f) Further Bad Debts amounted to ₹ 2,000 and make a provision for Bad Debts @5% on Sundry Debtors.

(g) Commissions received in advance amounted to ₹ 2,000.

Solution

In the Books of Sri Tirlhankar
Profit and Loss Account
for the year ended 31st March 2013

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Rent	22,000		By Trading A/c.		1,00,000
Add: Outstanding	2,000	24,000	-Gross Profit		
" Salaries	10,000		" Commission	12,000	
Add: Outstanding	4,000	14,000	Less: Received in advance	2,000	10,000
" Insurance	8,000		" Interest	6,000	
Less: Prepaid	2,000	6,000	Add: Accrued Interest	2,000	8,000
" Bad Debts	2,000				
Add: further Bad Debts	2,000	4,000	" Discount received		2,000
" Depreciation on Plant & Machinery @10% on ₹ 80,000		8,000	" Provisions for Bad Debts	4,000	
" Capital A/c. (Net Profit Transferred)		66,100	Less: New Provision @ 5% on (₹ 40,000 – ₹ 2,000)	1,900	2,100
		1,22,100			**1,22,100**

5.2.1.4 Profit and Loss Appropriation Account:

We know that the net profit or loss is added to or deducted from owner's equity. The net profit may be used by the business to distribute dividends, to create reserves etc. In order to show these adjustments, a P & L Appropriation A/c is maintained. Distribution of profits is only appropriation and does not mean expenses. After passing such distribution entries, the remaining surplus is added in owner's equity.

The format of P & L Appropriation A/c is given below

Dr. Profit and Loss Appropriation Account for the year ended ———————— Cr.

Particulars	Amount	Particulars	Amount
To Proposed dividend To Transfer to General Reserve To Surplus carried to Capital A/c		By Net profit transferred from P & L A/c	
Total		Total	

Illustration 3

X,Y and Z are three Partners sharing profit and Losses equally. Their capital as on 01.04.2012 were: X ₹ 80,000 ; Y ₹ 60,000 and Z ₹ 50,000.

They mutually agreed on the following points (as per partnership deed)

(a) Interest on capital to be allowed @ 5% P.a. (b) X to be received a salary @ ₹ 500 p.m. (c) Y to be received a commission @ 4% on net profit after charging such commission. (d) After charging all other items 10% of the net profit to be transferred General Reserve.

Profit from Profit and Loss Account amounted to ₹ 66,720. Prepare a Profit and Loss Appropriation Account for the year ended 31st March, 2013.

Solution:

In the books of X,Y and Z
Profit and Loss Appropriation Account
Dr. For the year ended 31st March, 2013 Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Interest on Capital:			By, Profit and Loss A/c		66,720
X	4,000				
Y	3,000				
Z	2,500	9,500			
" Salaries X : (₹500 x 12)		6,000			
" Commission Y		1970[1]			
" General Reserve		4,925[2]			
" Net Divisible Profit					
X	14,775				
Y	14,775				
Z	14,775	44,325			
		66,720			66,720

Workings:

1. **Net Profit before charging Y's Commission =** ₹ (66,720 – 15,500) = ₹ 51,220

   Less: Y's Commission @ 4% i.e.-($\frac{4}{104}$ X ₹ 51,220) = ₹ 1,970

   49,250

2. **Transfer to General Reserve =** ₹ 49,250 x 10% = ₹ 4,925

5.2.1.5 Balance Sheet: Horizontal format of Balance Sheet is also used by the business other than company

A. Liabilities

(a) Capital: This indicates the initial amount the owner or owners of the business contributed. This contribution could be at the time of starting business or even at a later stage to satisfy requirements of

funds for expansion, diversification etc. As per business entity concept, owners and business are distinct entities, and thus, any contribution by owners by way of capital is liability.

(b) Reserves and Surplus: The business is a going concern and will keep making profit or loss year by year. The accumulation of these profit or loss figures (called as surpluses) will keep on increasing or decreasing owners' equity. In case of non-corporate forms of business, the profits or losses are added to the capital A/c and not shown separately in the balance sheet of the business.

(c) Long Term or Non-Current Liabilities: These are obligations which are to be settled over a longer period of time say 5-10 years. These funds are raised by way of loans from banks and financial institutions. Such borrowed funds are to be repaid in installments during the tenure of the loan as agreed. Such funds are usually raised to meet financial requirements to procure fixed assets. These funds should not be generally used for day-to-day business activities. Such loan are normally given on the basis of some security from the business e.g. against a charge on the fixed assets. So, long term loan are called as "Secured Loan" also.

(d) Short Term or Current Liabilities: A liability shall be classified as Current when it satisfies any of the following :

- It is expected to be settled in the organisation's normal Operating Cycle,
- It is held primarily for the purpose of being traded,
- It is due to be settled within 12 months after the Reporting Date, or
- The organization does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Current liabilities comprise of :

(i) Sundry Creditors - Amounts payable to suppliers against purchase of goods. This is usually settled within 30-180 days.

(ii) Advances from customers – At times customer may pay advance i.e. before they get delivery of goods. Till the business supplies goods to them, it has an obligation to pay back the advance in case of failure to supply. Hence, such advances are treated as liability till the time they get converted to sales.

(iii) Outstanding Expenses: These represent services procured but not paid for. These are usually settled within 30–60 days e.g. phone bill of Sept is normally paid in Oct.

(iv) Bills Payable: There are times when suppliers do not give clean credit. They supply goods against a promissory note to be signed as a promise to pay after or on a particular date.

These are called as bills payable or notes payable.

(v) Bank Overdrafts: Banks may give fund facilities like overdraft whereby, business is permitted to issue cheques up to a certain limit. The bank will honour these cheques and will recover this money from business. This is a short term obligation.

B. Assets

In accounting language, all debit balances in personal and real accounts are called as assets. Assets are broadly classified into fixed assets and current assets.

(a) Fixed Assets: These represent the facilities or resources owned by the business for a longer period of time. The basic purpose of these resources is not to buy and sell them, but to use for future earnings. The benefit from use of these assets is spread over a very long period. The fixed assets could be in tangible form such as buildings, machinery, vehicles, computers etc, whereas some could be in intangible form viz. patents, trademarks, goodwill etc. The fixed assets are subject to wear and tear which is called as depreciation. In the balance sheet, fixed assets are always shown as "original cost less depreciation".

(b) Investments: These are funds invested outside the business on a temporary basis. At times, when the business has surplus funds, and they are not immediately required for business purpose, it is prudent to invest it outside business e.g. in mutual funds or fixed deposit. The purpose if to earn a reasonable return on this money instead of keeping them idle. These are assets shown separately in balance sheet.

Investments can be classified into Current Investments and Non-current Investments.

Non-current Investments are investments which are restricted beyond the current period as to sale or disposal.

Whereas, current investments are investments that are by their nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made.

(c) Current Assets: An asset shall be classified as Current when it satisfies any of the following :

- It is expected to be realised in, or is intended for sale or consumption in the organisation's normal Operating Cycle,
- It is held primarily for the purpose of being traded,
- It is due to be realised within 12 months after the Reporting Date, or
- It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Current assets comprise of:

(i) Stocks: This includes stock of raw material, semi-finished goods or WIP, and finished goods.

Stocks are shown at lesser of the cost or market price. Provision for obsolescence, if any, is also reduced. Generally, stocks are physically counted and compared with book stocks to ensure that there are no discrepancies. In case of discrepancies, the same are adjusted to P & L A/c and stock figures are shown as net of this adjustment.

(ii) Debtors: They represent customer balances which are not paid. The bad debts or a provision for bad debt is reduced from debtors and net figure is shown in balance sheet.

(iii) Bills receivables: Credit to customers may be given based on a bill to be signed by them payable to the business at an agreed date in future. At the end of accounting period, the bills accepted but not yet paid are shown as bills receivables.

(iv) Cash in Hand: This represents cash actually held by the business on the balance sheet date. This cash may be held at various offices, locations or sites from where the business activity is carried out. Cash at all locations is physically counted and verified with the book balance. Discrepancies if any are adjusted.

(v) Cash at Bank: Dealing through banks is quite common. Funds held as balances with bank are also treated as current asset, as it is to be applied for paying to suppliers. The balance at bank as per books of accounts is always reconciled with the balance as per bank statement, the reasons for differences are identified and required entries are passed.

(vi) Prepaid Expenses: They represent payments made against which services are expected to be received in a very short period.

(vii) Advances to suppliers: When amounts are paid to suppliers in advance and goods or services are not received till the balance sheet date, they are to be shown as current assets. This is because advances paid are like right to claim the business gets.

Please note that both current assets and current liabilities are used in day-to-day business activities. The current assets minus current liabilities are called as working capital or net current assets. The following report is usual horizontal form of balance sheet. Please note that the assets are normally shown in descending order of their liquidity. Also, capital, long term liabilities and short term liabilities are shown in that order.

In case other than Company :

Liabilities	Amount	Assets	Amount
Capital (separate figures are shown for each owner) Long term Liabilities: Loans from banks or financial Institutions Current Liabilities: Sundry creditors Bills payable Advances from customers Outstanding expenses		Fixed Assets: Land less depreciation Building less depreciation Plant and Machinery less depreciation Vehicles less depreciation Computer systems less depreciation Office equipments less depreciation Current Assets: Stocks Sundry debtors less provisions Bills receivables Cash in hand Cash at bank Prepaid expenses Advances to suppliers	
Total		**Total**	

Illustration 4.

From the following particulars prepare a Balance Sheet of Mr. X, for the year ended 31st March, 2013.

Capital : ₹ 2,00,000: Drawings : ₹ 40,000 ; Cash In Hand : ₹ 20,000 ; Loan from Bank : ₹ 40,000; Sundry Creditors : ₹ 40,000; Bills Payable : ₹ 20,000; Bank Overdraft : ₹ 20,000; Goodwill : ₹ 60,000; Sundry Debtors : ₹ 80,000; Land and Building : ₹ 50,000; Plant and Machinery : ₹ 80,000; Investment : ₹ 20,000; Bills Receivable : ₹ 10,000.

The following adjustments are made at the time of preparing final accounts:

I. Outstanding Liabilities for : Salaries ₹ 10,000; wages ₹ 20,000; Interest on Bank Overdraft ₹ 3,000; and Interest on Bank Loan ₹ 6,000.

II. Provide Interest on Capital @ 10% p.a.

III. Depreciation on Plant and Machinery by 10% p.a.

IV. Bad Debts amounted to ₹ 10,000 and make a provision for Bad Debts @ 10% on Sundry Debtors.

V. Closing stock amounted to ₹ 1,20,000.

Net profit for the year amounted to ₹ 96,000 after considering all the above adjustments.

Solution:

In the books of Mr. X
Balance Sheet as at 31.03.2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital	2,00,000		Goodwill		60,000
Add: Interest on Capital @ 10%	20,000		Land and Building		50,000
Add: Net Profit	96,000		Plant and Machinery	80,000	
	3,16,000		Less: Depreciation@ 10%	8,000	72,000
Less: Drawings	40,000	2,76,000	Investment		20,000
			Closing Stock		1,20,000
Bank Overdraft	20,000				
Add: Out. Interest	3,000	23,000	Sundry Debtors	80,000	
Bank Loan	60,000		Less: Bad Debts	10,000	
Add: Out. Interest	6,000	66,000		70,000	
			Less: Prov. for Bad debts@10%	7,000	63,000
			Bills Receivable		10,000
Sundry Creditors		40,000	Cash at Bank		40,000
Bills Payable		20,000	Cash in Hand		20,000
Outstanding Liabilities:					
Salaries	10,000				
Wages	20,000	30,000			
		4,55,000			4,55,000

Example

Indicate where the following items will be shown in various components of P & L A/c :

(1) Wages	(2) Salaries to office staff
(3) Depreciation on office car	(4) Neon sign advertisement
(5) Power & fuel	(6) Repairs to machinery
(7) Maintenance of office building	(8) Purchase returns or return outwards
(9) Closing stock of WIP	(10) Opening stock of finished goods
(11) Interest received	(12) Commission paid
(13) Telephone	(14) Travel & conveyance
(15) Insurance	(16) Audit fees
(17) Carriage inward	(18) Freight outward
(19) Bad debts	(20) Provision for outstanding rent
(21) Return inwards or sales returns	(22) Discount earned
(23) Depreciation on delivery van	(24) Printing and stationery
(25) Sales	

Solution :

Item	Treatment	Where
Wages	Trading A/c	Dr
Salaries to office staff	P & L A/c	Dr
Depreciation on office car	P & L A/c	Dr
Power & fuel	Trading A/c	Dr
Repairs to machinery	Trading A/c	Dr
Maintenance of office building	P & L A/c	Dr
Purchase returns or return outwards	Trading A/c	Dr less from purchases
Closing stock of WIP	Trading A/c	Cr
Opening stock of finished goods	Trading A/c	Dr
Interest received	P & L A/c	Cr
Commission paid	P & L A/c	Dr
Telephone	P & L A/c	Dr
Travel & conveyance	P & L A/c	Dr
Insurance	P & L A/c	Dr
Audit fees	P & L A/c	Dr
Carriage inward	Trading A/c	Dr
Freight outward	P & L A/c	Dr
Bad debts	P & L A/c	Dr
Provision for outstanding rent	P & L A/c	Dr
Return inwards or sales returns	Trading A/c	Cr less from sales
Discount earned	P & L A/c	Cr
Depreciation on delivery van	P & L A/c	Dr
Printing and stationery	P & L A/c	Dr
Sales	Trading A/c	Cr

Illustration 5.

Indicate where the following items will be shown in the balance sheet.

(1) Credit balance in the bank column of the cash book

(2) Debit balance to the account of A who is a customer

(3) Credit balance in A/c of B who is supplier

(4) Debit balance in A/c of C who is a supplier

(5) Credit balance in A/c of D who is a customer

(6) Outstanding rent

(7) Insurance paid for the next year

(8) Loan from HDFC bank for 7 years

(9) Interest due on loan

(10) Provision for doubtful debtors

(11) Net Profit for the year

(12) Machinery

(13) Accumulated depreciation on vehicle

(14) Cash at Bangalore office

(15) Balance with Citi Bank

Solution:

(1) Credit balance in the bank column of cash book indicates a liability towards bank. This is actually a bank overdraft. Hence, it should be shown as Current Liability.

(2) Debit balance in A's A/c means amount due from him as a customer. To be shown as Sundry Debtors.

(3) Credit balance in supplier's A/c is a liability, hence will be shown under Current Liabilities.

(4) Debit balance in supplier's A/c reflects an advance given to supplier, hence will be shown under Current Asset.

(5) Credit balance in customer's A/c means advance from customer, hence will be shown as Current Liability.

(6) Outstanding rent will be shown under Current Liability.

(7) Insurance paid for next year is 'prepaid' for current year, hence will be taken as Current Asset

(8) Loan from HDFC is for 7 years which is a long term loan, hence will be shown as Long Term Liability.

(9) Interest due on loan is Current Liability.

(10) Provision for doubtful debts will be reduced from the sundry debtor's amount under Current Assets as it denotes chances of not receiving the money from customers.

(11) Net Profit for the year will be added to the Capital or to Reserves and Surplus in Balance Sheet.

(12) Machinery is a Fixed Asset.

(13) Accumulated depreciation on vehicle is reduction in its value, so will be shown as deduction from vehicle under Fixed Assets.

(14) Cash at Bangalore office is a Current Asset.

(15) Balance with Citi Bank is Current Asset.

Illustration 6.

Mahindra Traders operates in an industry that has a high rate of bad debts. On 31st March 2013, the Accounts Receivables showed a balance of ₹ 7,50,000 before any year end adjustment and the balance in the Reserve of doubtful debts was ₹ 37,500. The year end balance in the Reserve for Doubtful Debts A/c will be based on the following ageing schedule.

Days outstanding	Amount (₹)	Probability of collection
Less than 16	4,50,000	0.99
16 – 30	1,50,000	0.94
31 – 45	75,000	0.80
46 – 60	45,000	0.65
61 – 75	15,000	0.50
Over 75	15,000	0.00

Find out the appropriate balance in the Reserve for Doubtful Debts Account as on 31st March 2013. Show how Debtors balance be shown in the Balance Sheet. Calculate the effect of year end adjustment on Account of Reserve for Doubtful Debts.

Solution:

We need to work out the provision for doubtful debts based on the collection probability given e.g. in the first ageing band, the probability of collection is given as 0.99 which means 1% of the outstanding amount in this band is unlikely to be collected, so a provision of 1% will be needed. The total provision required based on the ageing is shown in the following table.

Days outstanding	Amount (₹)	Probability of collection	Provision required	Provision Amount (₹)
Less than 16	4,50,000	0.99	1%	4,500
16 – 30	1,50,000	0.94	6%	9,000
31 – 45	75,000	0.80	20%	15,000
46 – 60	45,000	0.65	35%	15,750
61 – 75	15,000	0.50	50%	7,500
Over 75	15,000	0.00	100%	15,000
Total	7,50,000			66,750

It will be seen that the existing provision in the books stands at ₹ 37,500, as against the required provision of ₹ 66,750. This means additional provision of ₹ 29,250 will be required to be made as year end adjustment for the year ended 31-03-2013. The answer will be:

(a) Appropriate balance in Reserve for Doubtful Debts A/c as on 31-03-2013 is ₹ 66,750.

(b) Debtors amount will be shown in the Balance Sheet as under:

Outstanding debtors		7,50,000
Less: Reserve for doubtful debts	37,500	
Additional provision required	29,250	66,750
Net Debtors		6,83,250

(c) The effect of this additional provision of ₹ 29,250 will reduce the profit for the year by the same amount

Illustration 7.

A property dealer owned many properties which it had acquired by taking bank loans. There were separate loan agreements for different properties. In some cases, interest was paid in advance and in other cases it was payable in arrears. These properties were let out to different tenants on various agreements. Some agreements provided for rentals in advance while the others provided for rent payable in arrears. The dealer has given the following balances:

	31-03-2012	31-03-2013
Interest payable	12,000	14,500
Interest prepaid	8,000	6,400
Rentals due from tenants	15,000	19,000
Rentals received in advance	3,000	2,500

During the year 2012-13, the amount of interest payable transferred to P & L A/c was ₹ 56,000 and cash collected from tenants for rentals was ₹ 1,16,000.

You are required to prepare Interest Payable A/c and Rental Income A/c for the year ended 2011-12

Solution: Please note although 4 different figures are given, we are asked to prepare only two accounts. This means the opening as well as closing balances will have to be written in these 2 accounts only. Thus, we should find out what these 4 figures represent. This is shown in following table:

	31- 03- 20 12 Opening	31- 03- 20 13 Closing
Interest payable	Liability	Liability
Interest prepaid	Asset	Asset
Rentals due from tenants	Asset	Asset
Rentals received in advance	Liability	Liability

Please be careful to notice how the opening and closing balances are shown. Now, students should be able to interpret the balancing figures in these accounts.

Dr. **Interest payable Account** **Cr.**

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
	To, Balance b/d (prepaid)		8,000		By, Balance b/d (due)		12,000
	To, Cash paid (balancing figure)		51,900		By P & L A/c		56,000
	To Balance c/d (due)		14,500		By, Balance c/d (prepaid)		6,400
			74,400				74,400
	To, Balance b/d (prepaid)		6,400		By, Balance b/d (due)		14,500

Dr. **Rental Income Account** **Cr.**

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
	To, Balance b/d (receivable)		15,000		By, Balance b/d (advance)		3,000
	To, P & L A/c (balancing figure)		1,20,500		By, Cash received		1,16,000
	To, Balance c/d (advance)		2,500		By, Balance c/d (receivable)		19,000
			1,38,000				1,38,000
	To, Balance b/d (receivable)		19,000		By, balance b/d (advance)		2500

The balancing figure in Interest Payable A/c will reflect interest actually paid during the year, whereas the balancing figure in Rentals Income is the income taken to P & L A/c for the year.

Illustration 8.

The book-keeper of a supermarket prepared a schedule of balances of individual suppliers' accounts in the creditors' ledger as on 31st March 2013 and arrives at the total of ₹ 69,23,062.40. The accountant was in charge of general ledger. He maintained the Sundry Creditors' Account in the general ledger which is given below:

Dr **Sundry Creditors Control Account** **Cr**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
30.04.2013	To, Purchase returns	44,814.40	01.04.2013	By, Balance b/d	71,41,690.40
30.04.2013	To, Bank	77,05,016.00	30.04.2013	By, Purchase	80,38,679.20
30.04.2013	To, Balance c/d	67,75,064.80	30.04.2013	By, Discount received	2,12,545.60
			30.04.2013	By, Debtors control A/c (contra)	2,43,980.00
		1,45,24,895.20			1,56,36,895.20

Subsequently, on investigation, the accountant discovered several mistakes in the Control A/c as well as individual Creditors' A/c as given below:

(i) One supplier was paid ₹ 817.60 out of petty cash. This was correctly recorded to his personal A/c, but was omitted to be posted to control A/c

(ii) Credit side of a supplier's A/c was under-cast by ₹ 2,400

(iii) A supplier's credit balance of ₹ 43,851.20 was by mistake taken as ₹ 46,752.80 while preparing the schedule of balances of all suppliers A/cs.

(iv) There was an omission of a supplier credit balance of ₹ 53,945.60 from the schedule.

(v) Discounts received of ₹ 1,004.80 and ₹ 650.40 were posted to wrong side of suppliers' A/cs.

(vi) Goods of ₹ 316.80 were returned to a supplier not entered in purchase return book.

(vii) Debtors control contra represents the sale of goods to suppliers.

Prepare a statement rectifying the errors and prepare the Control A/c.

Solution:

First of all, there's a totaling error in the control A/c. Total of debit side should be ₹ 14,524,895.20 and credit side is ₹ 15,636,895.20. This needs to be corrected. There is a difference of ₹ 1,112,000 due to this. The revised credit balance should be ₹ 7,887,064.80 instead of ₹ 6,775,064.80 as shown in the Control A/c.

In addition, the errors that have affected the Control A/c should be corrected. These are:

(a) Discounts received will reduce the balance due to creditors, hence should appear on the debit side in Control A/c. Here, it appears on credit side. We must show double the amount on dedit side to rectify this error.

(b) Payment to a supplier of ₹ 817.60 were omitted hence, it must be written on debit side of Control A/c

(c) Purchase return of ₹ 316.80 omitted should be recorded.

The other errors will affect only individual A/cs and not Control A/c. The revised Control A/c is shown below:

Dr. **Sundry Creditors Control Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
30.04.2013	Purchase returns	44,814.40	01.04.2013	By balance b/ d	7,141,690.40
30.04.2013	Bank	7,705,016.00	30.04.2013	Purchases	8,038,679.20
30.04.2013	Discount received (rectified)	425,091.20	30.04.2013	Discount received	212,545.60
30.04.2013	Debtors control A/c (contra) rectified	487,960.00	30.04.2013	Debtors control A/c (contra)	243,980.00
30.04.2013	Purchase returns (omission rectified)	316.80			
30.04.2013	Bank (Payment recorded)	817.60			
30.04.2013	To Balance c/d	6,972,879.20			
		1,56,36,895.20			1,56,36,895.20

The effect on individual accounts will be as follows:	**Amount (₹)**
Total of the schedule as given	69,23,062.40
Add: under-casting of credit side	2,400.00
Add: omission of a supplier in schedule	53,945.60
Less: Wrong amount taken (43,851.20 – 46,752.80)	(2,901.60)
Less: Discounts received recorded on wrong side rectified (1,004.80)*2 + (650.4)*2	(3,310.40)
Less: purchase return omitted, now rectified	(316.80)
Revised balance in individual A/cs tallied with Control A/c	69,72,879.20

Illustrations 9.

Following is the Trial Balance of M/s Brijesh and Sons. Prepare final accounts for the year ended on 31st March 2013.

Particulars	Debit (₹)	Credit (₹)
Stock as on 01.04.2012: Finished goods	2,00,000	
Purchases and Sales	22,00,000	35,00,000
Bills receivables	50,000	
Returns	1,00,000	50,000
Carriage Inwards	50,000	
Debtors and Creditors	2,00,000	4,00,000
Carriage Outwards	40,000	
Discounts	5,000	5,000
Salaries and wages	2,20,000	
Insurance	60,000	
Rent	60,000	
Wages and salaries	80,000	
Bad debts	10,000	
Furniture	4,00,000	
Brijesh's capital		5,00,000
Brijesh's drawing	70,000	
Loose tools	1,00,000	
Printing & stationery	30,000	
Advertising	50,000	
Cash in hand	45,000	
Cash at bank	2,00,000	
Petty Cash	5,000	
Machinery	3,00,000	
Commission	10,000	30,000
Total	**44,85,000**	**44,85,000**

Adjustments: (i) Finished goods stock. Stock on 31st March was valued at Cost price ₹ 4,20,000 and market price ₹ 400,000. (ii) Depreciate furniture @ 10% p.a. and machinery @ 20% p.a. on reducing balance method. (iii) Rent of ₹ 5,000 was paid in advance. (iv) Salaries & wages due but not paid ₹ 30,000. (v) Make a provision for doubtful debts @ 5% on debtors. (vi) Commission receivable ₹ 5,000.

Solution :

Dr. **Trading Account for the year ended 31st March 2013** **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
Opening stock :			Sales	35,00,000	
Finished goods		2,00,000	*Less:* Sales Returns	1,00,000	34,00,000
Purchases	22,00,000				
Less: Purchases returns	50,000	21,50,000	Closing stock		
Carriage inwards		50,000	Finished goods		4,00,000
Wages & salaries		80,000			
Gross Profit c/d		**13,20,000**			
		38,00,000			38,00,000

Dr. **Profit & Loss Account for the year ended 31st March 2013** **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
Administrative expenses	-		Gross Profit b/d		13,20,000
Salaries & wages	2,20,000		Discount received		5,000
Add: Not paid	30,000	2,50,000	Commission received	30,000	
Depreciation on furniture		40,000	Add : receivable	5,000	35,000
Depreciation of Machinery		60,000			
Insurance		60,000			
Rent	60,000				
Less: Paid in advance	5,000	55,000			
Printing & Stationery		30,000			
Selling & Distribution expenses:					
Advertising		50,000			
Carriage Outwards		40,000			
Discounts		5,000			
Bad debts		10,000			
Commission		10,000			
Provision for doubtful debts		10,000			
Net profit		740,000			
		13,60,000			13,60,000

Dr. **Balance Sheet as on 31st March 2013** **Cr.**

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Brijesh's Capital	5,00,000		Fixed Assets:		
Less : Drawings	70,000		Furniture	400,000	
Add : Net Profit for the year	7,40,000	11,70,000	Less: Depreciation	40,000	3,60,000
Long term Liabilities:		-	Machinery	300,000	
			Less: Depreciation	60,000	2,40,000
			Loose tools		1,00,000
Current Liabilities:					
Sundry creditors		4,00,000			
Outstanding salaries & wages		30,000	Current Assets:		
			Stocks		4,00,000
			Sundry debtors	200,000	
			Less: Provision for doubtful debts	10,000	1,90,000
			Bills receivables		50,000
			Cash in hand		45,000
			Cash at bank		2,00,000
			Petty cash		5,000
			Prepaid Rent		5,000
			Commission receivable		5,000
		16,00,000			16,00,000

Notes :

(1) Closing stock is valued at market price here as it is less than cost price (conservatism concept)

(2) Returns in debit column mean sales return, while that in credit column means purchase returns

(3) Discounts in debit column mean allowed (expense) and that in credit means received (income)

(4) Commission in debit column mean allowed (expense) and that in credit means received (income)

(5) There are two peculiar items given in the TB. One is Salaries & wages and the other is Wages and salaries. The interpretation is – where first reference is made to wages, it's assumed to be directly for goods and taken to Trading A/c. If the first reference is to salaries, it's assumed to be related to office and taken to P & L.

Illustrations 10.

Mr. Arvindkumar had a small business enterprise. He has given the trial balance as at 31st March 2013

Particulars	Debit (₹)	Credit (₹)
Mr. Arvinkumar's Capital		1,00,000
Machinery	36,000	
Depreciation on machinery	4,000	
Repairs to machinery	5,200	
Wages	54,000	
Salaries	21,000	
Income tax of Mr. Arvindkumar	1,000	
Cash in had	4,000	
Land & Building	1,49,000	
Depreciation on building	5,000	
Purchases	2,50,000	
Purchase returns		3,000
Sales		4,98,000
Citi Bank		7,600
Accrued Income	3,000	
Salaries outstanding		4,000
Bills receivables	30,000	
Provision for doubtful debts		10,000
Bills payable		16,000
Bad debts	2,000	
Discount on purchases		7,080
Debtors	70,000	
Creditors		62,520
Opening stock	74,000	
Total	7,08,200	7,08,200

Additional information:

(1) Stock as on 31st March 2013 was valued at ₹ 60,000

(2) Write off further ₹ 6,000 as bad debt and maintain a provision of 5% on doubtful debt.

(3) Goods costing ₹ 10,000 were sent on approval basis to a customer for ₹ 12,000 on 30th March, 2013. This was recorded as actual sales.

(4) ₹ 2,400 paid as rent for office was debited to Landlord's A/c and was included in debtors.
(5) General Manager is to be given commission at 10% of net profits after charging his commission.
(6) Works manager is to be given a commission at 12% of net profit before charging General Manager's commission and his own.

You are required to prepare final accounts in the books of Mr. Arvindkumar.

Solution :

In the books of Mr. Arvindkumar

Dr. Trading Account for the year ended 31st March 2013 Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
Opening stock:			Sales	4,98,000	
Finished goods		74,000	Less: Sent on approval	(12,000)	4,86,000
Purchases	2,50,000				
Less: Purchases returns	(3,000)	2,47,000	Closing stock:		
			Finished goods	60,000	
Wages		54,000	Add sent on approval	10,000	70,000
Gross Profit c/d		181,000			
		5,56,000			5,56,000

Dr. Profit and Loss Account for the year ended 31st March 2013 Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
Administrative expenses:			Gross Profit b/d		1,81,000
Salaries		21,000	Discount received		7,080
Repairs to machinery		5,200			
Depreciation of Machinery		4,000			
Depreciation of Building		5,000			
Rent		2,400			
Selling & Distribution expenses:					
Bad debts	2,000				
Additional bad debts	6,000				
Provision for doubtful debts	2,480				
Less: Provision opening	(10,000)	480			
Commission to works manager		18,000			
Commission to General Manager		12,000			
Net profit		1,20,000			
		1,88,080			1,88,080

Balance Sheet as on 31st March 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Arvind kumar's Capital	1,00,000		Fixed Assets:		
Less: drawings (income tax)	(1,000)		Land & building		1,49,000
Add: Net Profit for the year	1,20,000	2,19,000	Machinery		36,000
Long term Liabilities:		-	Current Assets:		
Current Liabilities:			Stocks	60,000	
Sundry creditors		62,520	Add: Sent on approval	10,000	70,000
Outstanding salaries		4,000	Sundry debtors	70,000	
			Less: Goods on approval	(12,000)	
Citi Bank Overdraft		7,600	Less: Bad debts	(6,000)	
Bills payable		16,000	Less: Related to landlord	(2,400)	
Commission payable		30,000	Less: Provision for doubtful debts	(2,480)	47,120
			Bills receivable		30,000
			Cash in hand		4,000
			Accrued Income		3,000
		3,39,120			3,39,120

Notes:

(1) The closing entries are passed for the items: depreciation, accrued income, outstanding salary. Hence, they are directly taken to the respective places in Balance sheet and P & L A/c.

(2) Income tax paid for Mr. Arvindkumar will be treated as drawings.

(3) Commission payable to works manager & general manager is computed as below:

	₹
Profit before charging any commission	1,50,000
Commission to works manager @ 12% on 1,50,000	18,000
Profit after works manager's commission	1,32,000
Commission to General Manager (1,32,000/110 x 100)	12,000

Illustration 11.

Jamnadas provides you with the following T. B. as on 31st March 2013.

Particulars	Debit (₹)	Credit (₹)
Stock as on 1st April 12	35,000	
Depreciation	5,000	
Accumulated depreciation		40,000
Fixed asset	50,000	
Loss on sale of fixed asset	8,000	
Investments	1,25,000	
Profit on sale of investments		80,000

Particulars	Debit (₹)	Credit (₹)
Sales (at 20% gross margin)		800,000
Purchases	7,50,000	
Customers' accounts	1,00,000	20,000
Creditors' accounts	5000	60,000
Expenses	42,000	
Discount	18,000	12,000
Commission	50,000	80,000
Amounts due to principals		8,000
Amounts due from dealers	75,000	
Deposits with Principals	1,00,000	
Deposits from dealers		1,50,000
Cash	7,000	
Income on investments		5,000
Interest on deposits with Principals		12,000
Interest on deposits from dealers	18,000	
Prepaid/outstanding expenses As on 31st March 2012 As on 31st March 2013	 7,000 9,000	 13,000 6,000
Fixed deposits with bank	2,00,000	
Interest on fixed deposits with bank		20,000
Drawings/Capital	60,000	3,00,000
Banks		58,000
Total	16,64,000	16,64,000

The cost of fixed assets sold is ₹ 30,000, accumulated depreciation being ₹ 9,000.

Prepare the financial statements. Also, separately show Accumulated depreciation A/c, and Expenses A/c.

Solution:

Dr. **Accumulated Depreciation Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.2013	To, Asset (sold)	9,000	01.04.2012	By Balance b/d (balancing figure)	44,000
			31.03.2013	By P & L (depreciation)	5,000
31.03.2013	To, Balance c/d	40,000			
		49,000			49,000
				By balance b/d	40,000

Dr. **Expenses Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
01.04.2012	To, Balance b/d (pre paid)	7,000	01.04.2012	By, Balance b/d (due)	13,000
31.03.2013	To, Cash paid (balancing figure)	51,000	31.03.2013	By, P & L A/c	42,000
31.03.2013	To, Balance c/d (due)	6,000	31.03.2013	By, Balance c/d (pre paid)	9,000
		64,000			64,000
	To Balance b/d (pre paid)	9,000		By, Balance b/d (due)	6,000

Dr. Trading Account for the year ended 31st March 2013 Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening stock		By Sales	8,00,000
Finished goods	35,000		
Purchases	7,50,000		
		By Closing stock:	
To P/L A/c	1,60,000	Finished goods (Balance in fig.)	1,45,000
Gross Profit c/d (8,00,000×20%)			
	9,45,000		9,45,000

Dr. Profit and Loss Account for the year ended 31st March 2013 Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Administrative expenses	-	By Gross Profit b/d	1,60,000
" Expenses	42,000	" Profit on sale of investment	80,000
" Depreciation	5,000	" Discount received	12,000
" Loss on sale of fixed asset	8,000	" Commission received	80,000
" Discount allowed	18,000	" Income from investments	5,000
" Commission given	50,000	" Interest deposits with principals	12,000
" Interest on deposits to dealers	18,000	" Interest bank deposits	20,000
To Capital A/c	2,28,000		
Net profit			
	3,69,000		369,000

Sales	8,00,000	
Gross margin on sales @ 20%	1,60,000	
Cost of goods sold	6,40,000	
Goods available for sale	7,85,000	(this is op stock 35,000 + purchases 750,000)
Hence, closing stock should be	1,45,000	(785,000- 640,000)

Now, the balance sheet is given below.

Balance Sheet as on 31st March 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Jamnadas's Capital	3,00,000		Fixed Assets:	80,000	
Less: Drawings	(60,000)		Less: Acc. Dep for sold	(30,000)	
Add: Net Profit for the year	2,28,000	4,68,000	Balance of assets	50,000	
			Depreciation opening	44,000	
Long term Liabilities:			Less: Acc Dep for sold	(9,000)	
Current Liabilities:			Add for the year	5,000	
Sundry creditors		60,000	Net Acc. Dep	40,000	
Advance from Customers		20,000	Net fixed Asset		10,000
Dues to Principals		8,000			
Bank overdraft		58,000	Investments		1,25,000

Outstanding expenses		6,000			
Deposits from dealers		1,50,000	Current Assets:		
			Stocks		1,45,000
			Sundry debtors		1,00,000
			Deposits with Principals		1,00,000
			Cash in hand		1,000
			Fixed deposit with Bank		2,00,000
			Dues from dealers		75,000
			Advance to suppliers		5,000
			Prepaid expenses		9,000
		7,70,000			7,70,000

Please carefully interpret the balances given. Customer balances are in debit as well as credit column. While debit indicates Debtor and credit means advances received from customers. Same logic will apply to suppliers, commission, discounts. Computation of closing stock was very important in this case.

Illustrations 12.

Abhay runs a small shop and deals in various goods. He has not been able to tally his trial balance and has closed it by taking the difference to Suspense A/c. It is given below.

Particulars (as on 31st March 2013)	**Debit (₹)**	**Credit (₹)**
Abhay's capital		1,50,000
Drawings	75,000	
Fixed assets	1,35,000	
Opening stock	36,500	
Purchases & returns	6,75,000	13,500
Sales & returns	34,000	8,50,000
Due from customer & to creditors	95,000	3,25,000
Expenses	45,750	
Cash		3,000
Bank deposits & interest earned	55,000	5,750
Suspense A/c		4,000
Advertising	2,00,000	
Total	**13,51,250**	**13,51,250**

Mr. Abhay has requested you to help him in tallying his trial balance and also prepare his final accounts. On investigation of his books you get the following information:

(i) Closing Stock on 31st March 2013 was ₹ 45,000 at cost and could sell over this value.

(ii) Depreciation of ₹ 13,500 needs to be provided for the year.

(iii) A withdrawal slip indicated a cash withdrawal of ₹ 15,000 which was charged as drawing. However, it was noticed that ₹ 11,000 was used for business purpose only and was entered as expenses in cash book.

(iv) Goods worth ₹ 19,000 were purchased on 24th March 2013 and sold on 29th March 2013 for ₹23,750. Sales were recorded correctly, but purchase invoice was missed out.

(v) Purchase returns of ₹ 1,500 were routed through sales return. Party's A/c was correctly posted.

(vi) Expenses include ₹ 3,750 related to the period after 31st March 2013.

(vii) Purchase book was over-cast by ₹ 1,000. Posting to suppliers' A/c is correct.

(viii) Advertising will be useful for generating revenue for 5 years.

Solution: Rectification of errors:

(a) Cash withdrawn was recorded as

Cash A/c	Dr	15,000	
To Bank			15,000

But it was charged to drawing and ₹ 11,000 was recorded as expenses as well i.e.

Drawings A/c	Dr	15,000	
Expenses A/c	Dr	11,000	
To Cash			26,000

This resulted in negative cash of ₹ 11,000. The rectification entry to be passed is

Cash A/c	Dr	11,000	
To Drawings			11,000

(b) Omitted transaction to be recorded

Purchases A/c	Dr	19,000	
To Suppliers' A/c			19,000

(c) Incorrect recording of purchase returns corrected by

Suspense A/c	Dr	3,000	
To Purchase return A/c			1,500
To sales return A/c			1,500

(d) Incorrect expenses rectified by

Prepaid expenses A/c	Dr	3,750	
To Expenses A/c			3,750

(e) Over-casting of purchase book rectified by

Suspense A/c	Dr	1,000	
To Purchases			1,000

Based on these rectifications we can now proceed to complete the final accounts.

Dr. **Trading Account for the year ended 31st March, 2013** **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening stock	-	36,500	By Sales	8,50,000	
To Purchases	6,75,000		Less: Returns	(34,000)	
Less: Returns	(13,500)		Add: Rectification	1,500	8,17,500
Less: Additional returns	(1,500)		By Closing stock		45,000
Add: Purchases missed out	19,000				
Less: Over-casting rectified	(1,000)	6,78,000			
To Gross Profit c/d		1,48,000			
		8,62,500			8,62,500

Dr. Profit and Loss Account for the year ended 31st March, 2013 Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Expenses	45,750		By, Gross Profit b/d		1,48,000
Less : Prepaid	3,750	42,000			
To. Depreciation		13,500	By, Interest on Bank deposits		5,750
To, Advertising		2,00,000	By, Net Loss		1,01,750
		2,55,500			2,55,500

Balance Sheet as on 31st March, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Abhay's Capital	1,50,000		Fixed Assets		
Add: Wrong charge to drawing	11,000		Gross Block	1,35,000	
			Less: Depreciation	13,500	
	1,61,000				1,21,500
Less: Drawings	75,000	86,000			
			Current Assets:		
Current Liabilities:			Stocks		45,000
Sundry Creditors	3,25,000		Sundry Debtors		95,000
Add: Missed out purchase	19,000	3,44,000	Cash in hand	(3,000)	
			Add: Rectification	11,000	8,000
			Fixed deposit with Bank		55,000
			Prepaid expenses		3,750
			Miscellaneous Expenditure:		
			Profit & Loss (Dr.)		1,01,750
		4,30,000			4,30,000

Note : The expenditure incurred on intangible items after the date AS 26 became/becomes mandatory (01.04.2003 or 01.04.2004, as the case may be) would have to be expensed when incurred since these do not meet the definition of an 'asset' as per AS 26. Hence, full amount of Advertisement expense is charged to Profit & Loss Account.

Illustration 13.

Mr. Oswal maintains his accounts on Mercantile basis. The following Trial Balance has been prepared from his books as at 31st March, 2013 after making necessary adjustments for outstanding and accrued items as well as depreciation:

Trial Balance

as at 31st March, 2013

Particulars	Dr. (₹)	Cr. (₹)
Plant and Machinery	2,12,500	
Sundry Creditors		2,64,000
Sales		6,50,000
Purchases	4,20,000	
Salaries	40,000	
Prepaid Insurance	370	
Advance Rent	2,000	
Outstanding Salary		6,000
Advance Salary	2,500	
Electricity Charges	2,650	
Furniture and Fixtures	72,000	
Opening Stock	50,000	
Outstanding Electricity Charges		450
Insurance	1,200	
Rent	10,000	
Miscellaneous Expenses	14,000	
Cash in hand	3,000	
Investments	80,000	
Drawings	24,000	
Dividend from Investments		8,000
Accrued Dividend from Investments	1,500	
Depreciation on Plant and Machinery	37,500	
Depreciation on Furniture	8,000	
Capital Account		2,11,970
Telephone Charges	6,000	
Sundry Debtors	1,70,500	
Stationery and Printing	1,200	
Cash at Bank	65,000	
Interest on Loan	8,000	
Interest Due but not paid on loan		1,500
Loan Account		90,000
	12,31,920	12,31,920

Additional Information:

(i) Salaries include ₹ 10,000 towards renovation of Proprietor's residence.

(ii) Closing Stock amounted to ₹ 75,000.

Mr. Oswal, however, request you to prepare a Trading and Profit & Loss Account for the year ended 31st March, 2013 and a Balance Sheet as on that date following cash basis of accounting.

Solution:

In the books of Mr. Oswal
Trading and Profit and Loss Account
for the year ended 31st March, 2013

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Opening Stock		50,000	By, Sales		6,50,000
`` Purchases		4,20,000	`` Closing Stock		75,000
`` Profit & Loss A/c. Gross Profit transferred		2,55,000			
		7,25,000			7,25,000
To, Salaries	40,000		By, Trading A/c.		
Less: Outstanding	6,000		-Gross Profit transferred		2,55,000
Salaries	34,000		`` Dividend	8,000	
Add: Advance Salary	2,500		Less: Accrued Dividend	1,500	6,500
	36,500				
Less: Renovation (Drawings)	10,000	26,500			
``Insurance	1,200				
Add: Prepaid	370	1,570			
``Rent	10,000				
Add: Advance Rent	2,000	12,000			
``Electricity Charges	2,650				
Less: Outstanding	450	2,200			
``Miscellaneous Expenses		14,000			
``Stationery & Printing		1,200			
``Depreciation:					
Plant & Machinery	37,500				
Furniture & Fixtures	8,000	45,500			
``Interest on Loan	8,000				
Less: Outstanding	1,500	6,500			
``Telephone Charges		6,000			
`` Capital Account Net Profit transferred		1,46,030			
		2,61,500			2,61,500

Balance Sheet as at 31st March, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital Account	2,11,970		Plant and Machinery (at cost less depreciation)		2,12,500
Add: Net Profit	1,46,030		Furniture & Fixtures (at cost less depreciation)		72,000
	3,58,000		Investments		80,000
Less: Drawings (24,000+10,000)	34,000	3,24,000	Stock-in-Trade		75,000
			Debtors		1,70,500
Loan Account		90,000	Cash at Bank		65,000
Sundry Creditors		2,64,000	Cash in hand		3,000
		6,78,000			6,78,000

Illustration 14.

The following Trial Balance has been prepared from the books of Mr. Sexena as on 31st March, 2013 after making necessary adjustments for depreciation on Fixed Assets, outstanding and accrued items and difference under Suspense Account.

Trial Balance as at 31st March, 2013

Particulars	Dr. (₹)	Particulars	Cr. (₹)
Machineries	1,70,000	Sundry Creditors	82,000
Furniture	49,500	Capital Account	2,45,750
Sundry Debtors	38,000	Outstanding Expenses:	
Drawings	28,000	Salaries	1,500
Travelling Expenses	6,500	Printing	600
Insurance	1,500	Audit Fees	1,000
Audit Fees	1,000	Bank Interest	1,200
Salaries	49,000	Discounts	1,800
Rent	5,000	Sales (Less Return)	6,80,000
Cash in hand	7,800		
Cash at Bank	18,500		
Stock-in-trade (1-4-2012)	80,000		
Prepaid Insurance	250		
Miscellaneous Expenses	21,200		
Discounts	1,200		
Printing & Stationery	1,500		
Purchase (Less Returns)	4,60,000		
Depreciation:			
Machineries	30,000		
Furniture	5,500		
Suspense Account	39,400		
	10,13,850		10,13,850

On the subsequent scrutiny following mistakes were noticed:

(i) A new machinery was purchase for ₹ 50,000 but the amount was wrongly posted to Furniture Account as ₹ 5,000.

(ii) Cash received from Debtors ₹ 5,600 was omitted to be posted in the ledger.

(iii) Goods withdrawn by the proprietor for personal use but no entry was passed ₹ 5,000.

(iv) Sales included ₹ 30,000 as goods sold cash on behalf of Mr. Thakurlal who allowed 15% commission on such sales for which effect is to be given.

You are further told that:-

(a) Closing stock on physical verification amounted to ₹ 47,500.

(b) Depreciation on Machineries and Furniture has been provided @ 15% and 10%, respectively, on reducing balancing system.

Full year's depreciation is provided on addition.

You are requested to prepare a Trading and Profit & Loss Account for the year ended 31st March 2013 and a Balance Sheet as on that date so as to represent a True and Correct picture.

Solution:

In the books of Mr. Sexena
Trading and Profit and Loss Account
for the year ended 31st March, 2013

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Opening Stock		80,000	By, Sales (₹ 6,80,000 - ₹ 30,000)		6,50,000
`` Purchases	4,60,000		`` Closing Stock		47,500
Less: Drawings	5,000	4,55,000			
`` Profit & Loss A/c.					
Gross Profit transferred		1,62,500			
		6,97,500			6,97,500
To, Salaries:		49,000	By, Trading A/c. (Gross Profit)		1,62,500
`` Rent		5,000	`` Bank Interest		1,200
`` Insurance		1,500	`` Selling Commission		
`` Audit Fees		1,000	(15% on ₹ 30,000)		4,500
`` Printing & Stationery		1,500	`` Discount Received		1,800
`` Miscellaneous Expenses		21,200			
`` Discount Allowed		1,200			
`` Travelling Expenses		6,500			
`` Depreciation:					
Machinery	37,500				
Furniture	5,000	42,500			
`` Capital Account (Net Profit transferred)		40,600			
		1,70,000			1,70,000

Balance Sheet
as at 31st March, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital Account	2,45,750		Machinery	2,50,000[1]	
Add: Net Profit	40,600		Less: Depreciation	37,500	2,12,500
	2,86,350				
Less: Drawings (28,000+5,000)	33,000	2,53,350	Furniture	50,000[2]	
			Less: Depreciation	5,000	
					45,000
Sundry Creditors		82,000	Stock		47,500
Outstanding Liabilities:			Debtors (38,000-5,600)		32,400
Salaries	1,500		Cash		7,800
Audit Fees	1,000		Bank		18,500
Printing	600	3,100	Prepaid Insurance		250
Thakurlal's A/c. (30,000 – 4,500)		25,500			
		3,63,950			3,63,950

Notes:

		₹
1.	Machinery as per Trial Balance	1,70,000
	Add: Depreciation	30,000
		2,00,000
	Additions	50,000
		2,50,000
2.	Furniture	49,500
	Add: Depreciation	5,500
		55,000
	Less: Wrong Debit	5,000
3.	Suspense A/c. is eliminated by item	50,000

(i) ₹ 45,000 (50,000 – 5,000) and item

(ii) by 5,600 (debited), respectively.

Illustration 15.

The following Trail Balance has been extracted from the books of Mr. Agarwal as on 31.3.2013:

Trial Balance as on 31.3.2013

Particulars		Dr. (₹)	Particulars	Cr. (₹)
Purchase		6,80,000	Sales	8,38,200
Sundry Debtors		96,000	Capital Account	1,97,000
Drawings		36,000	Sundry Creditors	1,14,000
Bad Debts		2,000	Outstanding Salary	2,500
Furniture & Fixtures		81,000	Sale of Old Papers	1,500
Office Equipments		54,000	Bank Overdraft (UBI)	60,000
Salaries		24,000		
Advanced Salary		1,500		
Carriage Inward		6,500		
Miscellaneous Expenses		12,000		
Travelling Expenses		6,500		
Stationery & Printing		1,500		
Rent		18,000		
Electricity & Telephone		6,800		
Cash In Hand		5,900		
Cash at Bank (SBI)		53,000		
Stock (1.4.2012)		50,000		
Repairs		7,500		
Motor Car		56,000		
Depreciation:				
Furniture	9,000			
Office Equipment	6,000	15,000		
		12,13,200		12,13,200

Additional Information:

(i) Sales includes ₹ 60,000 towards goods for cash on account of a joint venture with Mr. Reddy who incurred ₹ 800 as forwarding expenses. The joint venture earned a profit of ₹ 15,000 to which Mr. Reddy is entitled to 60%

(ii) The motor car account represents an old motor car which was replaced on 1.4.2012 by a new motor car costing ₹1,20,000 with an additional cash payment of ₹ 40,000 laying debited to Purchase Account.

(iii) UBI has allowed an overdraft limit against hypothecation of stocks keeping a margin of 20%. The present balance is the maximum as permitted by the Bank.

(iv) Sundry Debtors include ₹ 4,000 as due from Mr. Trivedi and Sundry Creditors include ₹ 7,000 as payable to him.

(v) On 31.3.2013 outstanding rent amounted to ₹ 6,000 and you are informed that 50% of the total rent is attributable towards Agarwal's resident.

(vi) Depreciation to be provided on motor car @ 20% (excluding sold item).

Mr. Agarwal requests you to prepare a Trading and Profit & Loss Account for the year ended 31.3.2013 and a Balance Sheet as on that date.

Solution.

In the books of Mr. Agarwal
Trading and Profit and Loss Account
for the year ended 31st March, 2013

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Opening Stock		50,000	By, Sales	8,38,200	
`` Purchases	6,80,000		Less: Sale on account of Joint Venture	60,000	7,78,200
Less: Motor Car	40,000	6,40,000			
			`` Closing Stock (W.N. 1)		75,000
`` Carriage Inward		6,500			
`` Profit & Loss A/c -Gross Profit transferred		1,56,700			
		8,53,200			8,53,200
To, Salaries		24,000	By, Trading A/c. -Gross Profit transferred		1,56,700
`` Travelling Expenses		6,500	`` Sale of old papers		1,500
`` Printing & Stationery		1,500	`` Profit on Joint Venture (40% of ₹ 15,000)		6,000
`` Electricity & Telephone		6,800	`` Profit on replacement of Motor Car (W. N. 2) [(1,20,000–(56,000+40,000)]		24,000
`` Rent	18,000				
Add: Outstanding	6,000				
	24,000				
Less: Drawings	12,000	12,000			
`` Bad Debts		2,000			
`` Miscellaneous Expenses		12,000			
`` Repairs		7,500			
`` Depreciation on:					
Furniture	9,000				
Office Equipment	6,000				
Motor Car (W.N. 3)	24,000	39,000			
`` Capital Account - Net Profit transferred		76,900			
		1,88,200			1,88,200

Balance Sheet
as at 31st March, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital Account	1,97,000		Furniture & Fixtures	90,000	
Add: Net Profit	76,900		Less: Depreciation	9,000	
	2,73,900				81,000
Less: Drawings (36,000+12,000)	48,000		Office Equipment	60,000	
		2,25,900	Less: Depreciation	6,000	
Bank Overdraft		60,000			54,000
Creditors	1,14,000		Motor Car	56,000	
Less: Due to Trivedi	4,000		Additions	1,20,000	
		1,10,000		1,76,000	
			Less: Sold	56,000	
				1,20,000	
			Less: Depreciation	24,000	
Amount payable to Reddy (60,000 - 6,000)		54,000			96,000
Outstanding Liabilities:			Stock		75,000
Salaries	2,500		Debtors	96,000	
Rent	6,000		Less: Due from Trivedi	4,000	
		8,500			92,000
			Cash		5,900
			Bank		53,000
			Prepaid Salary		1,500
		4,58,400			4,58,400

Workings

1. **Depreciation on Motor Car**

   on new motor car i.e., @ 20% on ₹ 1,20,000 = ₹ 24,000

2. **Profit on Replacement of Motor Car**

		₹
Cost of new Motor Car		1,20,000
Less: Exchange Value	56,000	
Cash Payment	40,000	96,000
Profit on replacement		**24,000**

3. **Closing Stock**

   Maximum allowable limit (100 – 20)% = 80% of stock.

   Overdraft is ₹ 60,000 which is equal to 80%.

   So, closing stock $= ₹\ 60,000 \times \frac{100}{80}$

   $= ₹\ 75,000.$

FINAL ACCOUNTS OF PARTNERSHIP FIRM

Illustration 16.

From the following particulars prepare a Final Accounts of M/s. X & Y for the year ended 31st March 2013.

Particulars	Amount (₹)	Particulars	Amount (₹)
Sales	8,20,000	Land	11,000
Opening Stock	3,00,000	Purchase	3,80,000
Loan (Dr.)	20,000	Interest (Cr.)	1,000
Wages	60,000	Salaries	40,000
Carriage Inwards	4,000	Carriage Outward	2,000
Returns inward	4,000	Returns Outwards	3,000
Furniture	10,000	Trade charges	8,000
Drawings		Capital	
– X	12,000	– X	24,000
– Y	10,000	– Y	16,000
Cash	3,000		

Additional Information:

(i) Closing Stock amounted to ₹ 1,20,000;

(ii) Provide Interest on drawings (on an average 6 months) and interest on capital @ 6% and 4% respectively.

(iii) Y is to get a salary of ₹ 400 p.m.

(iv) X is to get a commissions @ 2% on gross sales

(v) 50% of the profit is to be transferred to Reserve Fund.

(vi) Depreciations on furniture @ 10% p.a.

The partners share profit and loss equally.

Solution:

In the books of M/s. X & Y

Dr. **Trading and Profit and Loss Account for the year ended 31st March, 2013** Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Opening Stock		3,00,000	By, Sales	8,20,000	
`` Purchases	3,80,000		Less: Return Inwards	4,000	8,16,000
Less: Returns Outwards	3,000	3,77,000	`` Closing Stock		1,20,000
`` Wages		60,000			
`` Carriage Inward		4,000			
`` Profit & Loss A/c					
-Gross Profit transferred		1,95,000			
		9,36,000			9,36,000
To, Salaries		40,000	By, Trading A/c.		
`` Carriage Outward		2,000	- Gross Profit		1,95,000
`` Trade Charges		8,000	`` Interest		1,000
`` Depreciation on:					
- Furniture		1,000			
To, P&L Appropriation A/c.					
- Net Profit transferred		1,45,000			
		1,96,000			1,96,000

Profit and Loss Appropriation Account
for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Interest on Capital			By, Profit and Loss A/c		1,45,000
X:	960		-Net Profit		
Y:	640	1,600	By, Interest on Drawings:		
			X:	360	
To, Salary			Y:	300	660
Y:		4,800			
To, Commission – X		16,400			
`` Reserve Fund (50%)		61,430			
`` Net Divisible Profit					
X:	30,715				
Y:	30,715				
		61,430			
		1,45,660			1,45,660

Capital Account

Dr. **Cr.**

Particulars	X (₹)	Y (₹)	Particulars	X (₹)	Y (₹)
To, Drawings	12,000	10,000	By, Balance b/d.	24,000	16,000
`` Interest on Drawings	360	300	`` Interest on Capital	960	640
`` Balance c/d.	59,715	41,855	`` Salary	---	4,800
			`` Commission	16,400	---
			`` Share of Profit	30,715	30,715
	72,075	52,155		72,075	52,155

Balance Sheet

as at 31st March, 2013

Liabilities	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital :		Land		11,000
X	59,715	Furniture	10,000	
Y	41,855	Less: Depreciation	1,000	9,000
Reserve Fund	61,430			
		Loan		20,000
		Closing Stock		1,20,000
		Cash		3,000
	1,63,000			1,63,000

Illustration 17.

A and B are partners sharing profits in proportion to their Capitals. At the close of their financial year on 30th September, 2012, the following balances stood to the credit of the partners:

		₹
Capital Accounts	A	20,000
	B	5,000
Current Accounts	A	1,060
	B	2,800

The Partnership deed provided :-

(a) B shall be credited with a partnership salary of ₹ 1,000 per annum for running business.

(b) B shall be entitled to a commission of 10% of the Divisible Profit before charging such commission.

(c) Interest at 5% per annum to be allowed on Capital and Current Account.

(d) The partners' drawings were:

	₹
A	10,000
B	3,000

The Interest to be charged on such drawings were:

	₹
A	330
B	80

In addition to the entries necessary to record the above particulars the following balances were extracted from the books of the firm as on 30th September, 2013:

Particulars	Amount (₹)
Freehold Premises	15,000
Sundry Creditors	24,150
Advertising	4,339
Office Salaries	2,189
Sundry Debtors	16,020
Office Expenses	622
Insurance	364
Delivery Expenses	2,203
Stock	21,069
Provision for Doubtful Debts – as on 30-9-2012	600
Trading Account Credit Balance	34,628
Machinery and Plant – balance at the beginning	13,280
Machinery – additions	1,560
Motor Vans	900
Factory Expenses paid in advance	70
Cash at bank	2,841
Cash in hand	31
Mortgage on freehold premises at 6% per annum	10,000
Office Furniture	300
Mortgage interest	450
Patents	4,000

You are required to prepare a Profit & Loss Account for the year ended 30th September, 2013 and the Balance Sheet as on that date.

Given below are the additional information towards the preparation of the required Final Accounts.

(i) Depreciation to be provided as follows:

Plant, old balance	10% per annum
Plant – additions (for full year)	25% per annum
Office Furniture	10% per annum
Patents	10% per annum

(ii) Motor Vans are to be taken at ₹ 800 for the purpose of Final Accounts.

(iii) The Provision for Bad Debts is to be made up to 5% on Sundry Debtors.

(iv) Interest on the mortgage has been paid up to 30the June, 2013.

(v) The following amounts are to be carried forward to next year:
Insurance ₹ 62, Advertising ₹ 878.

(vi) Office Salaries ₹ 69 were owing at the end of the year.

Solution:

In the books of A & B
Profit and Loss Account
Dr. for the year ended 30th Sept., 2013 Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Office Salaries	2,189		By, Gross Profit		34,628
Add: Outstanding	69	2,258	(Trading A/c -		
			Credit Balance)		
`` Office Expenses		622			
`` Insurance	364				
Less: Prepaid	62	302			
`` Delivery Expenses		2,203			
``Advertising		4,339			
`` Provision for Bad Debts					
(5% of ₹ 16,020)	801				
Less: Old Reserve	600	201			
`` Mortgage Interest	450				
Add: Outstanding					
(@ 6% on ₹ 10,000 for 3 months)	150	600			
`` Depreciation on:					
Plant & Machinery	1,718				
Office Furniture (10% on ₹ 300)	30				
Patents (10% on ₹ 4,000)	400				
Motor Vans (₹ 900 - ₹ 800)	100	2,248			
`` Profit and Loss					
Appropriation Account					
Net Profit transferred		21,855			
		34,628			34,628

Profit and Loss Appropriation Account
for the year ended 30th September, 2013

Dr. | Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Salary – B		1,000	By, Profit and Loss A/c		21,855
`` Interest on Capital[2]			Net Profit transferred		
A:	1,000		Interest on Drawings:		
B:	250	1,250	A:	330	
To, Interest on Current A/c			B:	80	410
A:	53				
B:	140	193			
To, Commission – B[4]		1,982			
`` Divisible Profit[5]					
A:	14,272				
B:	3,568	17,840			
		22,265			22,265

Balance Sheet
as at 30th September, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital Account			Fixed Assets:		
A:	20,000		Freehold Premises		15,000
B:	5,000		Patents	4,000	
		25,000	Less: Depreciation	400	3,600
Current Accounts:					
A:	1,060				
Add: Interest on Capital	1,000		Plant and Machinery	13,280	
Interest on Current A/c	53		Addition during the year	1,560	
Profit	14,272			14,840	
	16,385		Less: Depreciation	1,718	13,122
Less: Drawings	10,000				
	6,385		Motor Vans	900	
Less: Interest on Drawings	330	6,055	Less: Depreciation	100	800
B:	2,800		Office Furniture	300	
Add: Interest on Capital:	250		Less: Depreciation	30	270
Interest on Current A/c:	140				
Salary	1,000		Current Assets:		
Commission:	1,982		Stock		21,069
Profit	3,568		Sundry Debtors	16,020	
	9,740		Less: Provision for Bad Debts	801	15,219
Less: Drawings	3,000				
	6,740		Prepaid Factory Expenses		70
Less: Interest on Drawings	80	6,660	Prepaid Insurance		62
Mortgage on Freehold Premises	10,000				
Add: Interest Accrued	150	10,150	Cash at Bank		2,841
Sundry Creditors		24,150	Cash in hand		31
Salaries Accrued		69			
		72,084			72,084

Workings:

(1) Depreciation on Plant and Machinery

Old balance:	10% on ₹ 13,280	= ₹ 1,328
Additions:	25% on ₹ 1,560	= ₹ 390
		₹ 1,718

(2) Interest on Capital:

A:	5% on ₹ 20,000	= ₹ 1,000
B:	5% on ₹ 5,000	= ₹ 250
		₹ 1,250

(3) Interest on Current Account:

A:	5% on ₹ 1,060	= ₹ 53
B:	5% on ₹ 2,800	= ₹ 140
		₹ 193

(4) B's Commission:

Divisible Profit before charging commission:

₹ (21,855 + 410) – ₹ (1,000 + 1,250 + 193)

= ₹ 22,265 – ₹ 2,443 = ₹ 19,822

∴ Commission = 10% of ₹ 19,822 = ₹ 1,982

(5) Apportionment of divisible Profit:

Capital Ration A : B = ₹ 20,000 : ₹ 5,000 = 4: 1

A's share of profit $= ₹\ 17,840 \times \frac{4}{5}$ = ₹14,272

B's share of profit $= ₹\ 17,840 \times \frac{1}{5}$ = ₹ 3,568

Note: As per AS 26, the expenditure incurred on intangible items would have to be expensed off when they are incurred. So the Advertisement Expenses is not carried forward to the next year and the full amount is shown in the Profit & Loss Account.

Illustration 18:

The following is the Trial Balance of M/s. Roy Traders as at 31st Dec., 2013. You are asked to prepare the Trading and Profit & Loss Account for the year ended 31st Dec., 2013 and Balance Sheet as on that date :

	Dr.	Cr.
	₹	₹
Roy's Capital	-	2,16,000
Stock as on 1st January, '13	93,600	-
Sales and Sales Returns	17,200	5,79,200
Purchases and Purchases Returns	4,86,200	11,600
Freight and Carriage	37,200	-
Rent and Tax	11,400	-
Salaries and Wages	18,600	-
Sundry Debtors	48,000	-
Sundry Creditors	-	29,600
Bank Loan (at 12% p.a.)	-	40,000
Bank Interest on above	3,800	-
Printing & Advertisement	20,200	-
Income from Investments	-	500
Cash at Bank	23,000	
Discount Received	-	8,560
Investments	10,000	-
Furniture & Fittings	13,600	-
Discount Paid	5,080	-
General Expenses	7,820	-
Audit Fees	1,400	-
Insurance	1,200	-
Travelling Expenses	4,660	-
Postage & Telegram	1,740	-
Cash in Hand	20,760	-
Fixed Deposit with State Bank of India	40,000	-
Drawings	20,000	-
	8,85,460	**8,85,460**

Additional Information :

(a) Closing Stock as on 31.12.13 ₹1,57,200.

(b) Included amongst the Debtors is ₹ 6,000 from Mr. S. Naha and included amongst the Creditors is ₹ 2,000 to Mr. S. Naha.

(c) The effect of advertisement being not yet expired, a quarter of the amount of "Printing and Advertisement" is to be carried forward to the next year.

(d) Provide 2% for Discount on Debtors and create a provision for Bad and Doubtful Debts at 5% on Debtors.

(e) Depreciation of 10% is to be written off on Furniture and Fittings.

(f) Wages owing on 31st December, 2012, ₹ 600 and Salaries owning ₹ 1,000.

(g) Insurance was paid in advance upto 31st March, 2014.

(h) Furniture which stood at ₹ 1,200 in the books on 1st January, 2013 was disposed of at ₹ 580 on 30th June, 2013 in part exchange for a new furniture costing ₹ 1,040. The net amount payable ₹ 460 was passed through the Purchase Book by mistake.

(i) Two dishonoured cheques for ₹ 400 and ₹ 600 respectively had not been entered in the cash book. The first for ₹ 400 is known to be bad. In the case of the second cheque for ₹ 600, it is expected that the Debtors would be in a position to pay a dividend of 60 paise in the rupee.

(j) Interest receivable from Fixed Deposit with State Bank of India @ 12% p.a. and provide for interest on Bank Loan for the whole year (working notes must be shown).

(k) Commission to Works Manager @ 5% after providing commission of General Manager and his own on net profits.

(l) General Manager is to be given commission @ 10% after charging the commission of Works Manager and his own on net profits.

Solution:

In the books of M/s. Roy Traders

Trading and Profit and Loss Account for the year ended 31st December, 2013

Dr. **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening Stock		93,600	By Sales	5,79,200	
" Purchase	4,86,200		Less: Return	17,200	5,62,000
Less: Return	11,600				
	4,74,600				
Less: P & L Adjustment	460	4,74,140	" Closing Stock		1,57,200
" Freight and Carriage		37,200			
" Gross Profit c/d		1,14,260			
		7,19,200			**7,19,200**
To Rent and Taxes		11,400	By, Gross Profit c/d		1,14,260
" Salaries and Wages	18,600		" Discount Received		8,560
Add: Outstanding	1,600	20,200			
			" Income from Investment		500
" Bank Interest	3,800				
Add: Outstanding	1,000	4,800	" Accrued Interest		
" Printing andAdvertisement		20,200	Received for F.D. with		
" Discount Paid		5,080	S.B.I.		4,800
" General Expenses		7,820			
" Audit Fees		1,400			
" Insurance	1,200				
Less: Prepaid	240	960			
" Travelling Expenses		4,660			
" Postage & Telegram		1,740			
" Bad Debts (Dishonour of cheque)		400			
" Prov. for Bad and Doubtful Debts		2,540			
" Prov. for Disc on Debtors		874			
" Depreciation on Furniture and Fittings		1,352			
" Loss on sale of furniture		560			
" Works manager commission		1,919			
" General Manager Commission		3,838			
" Capital A/c (Net profit Transferred)		38,377			
		1,28,120			**1,28,120**

Balance Sheet as at 31.12.13

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital	2,16,000		Furniture	13,600	
Add: Net Profit	38,377		Less: Exchange	1,140	
	2,54,377			12,460	
			Add: Additions	1,040	
Less: Drawings	20,000	2,34,377		13,500	
			Less: Depreciation	1,352	12,148
Sundry Creditors	29,600		Investment		10,000
Less: Wrong Credit for furniture	460		F.D. with SBI	40,000	
	29,140		Add: Accrued Interest	4,800	44,800
			Closing Stock		1,57,200
Less: set off	2,000				
		27,140	Sundry Debtors		43,186
Creditors for Furniture		460	Prepaid Insurance		240
12% Bank Loan	40,000		Cash at Bank	23,000	
Add: Outstanding Interest	1,000	41,000	Less: Dishonored Cheque	1,000	22,000
Outstanding Liabilities:					
Salary	1,000		Cash In Hand		20,760
Wages	600	1,600			
Works manager Commission	1,919				
General Manager Commission	3,838	5,757			
		3,10,334			**3,10,334**

Workings:

(1) As per As 26 the expenditure incurred on intangible assets would have to be expensed off when they are incurred. So, the Printing and Advertisement expenses is not carried forward to the next year and the full amount is shown in the profit and Loss Account.

(2) **Loss on Exchange of Furniture and Fittings**

	₹
Book Value of sold Furniture	1,200
Less: Depreciation for 6 months	
(1200 x 10/100 x 6/12)	60
W.D.V.	1,140
Less: Sold for	580
Loss on Exchange	560

(3) **Total Depreciation on Furniture and Fittings**

On ₹ 1,040 x10/100 x 6/12	=	52
Sale Furniture	=	60
On ₹ 12,400 (13,600 – 1,200) x 10/100	=	1,240
		1,352

(4) **Calculation of Sundry Debtors**

Sundry Debtors	=	48,000
Less: Set off	=	2,000
		46,000
Add: Cheque dishonor (400+600)	=	1,000
		47,000
Less: Bad Debts	=	400
	=	46,600
Less: Prov. for bad debts	=	2,540*
	=	44,060
Less: Prov. for disc on debtors	=	874
		43,186

* 60% of ₹600 is expected to be realized i.e. 40% is doubtful nature and so full provision should be made. Balance of Sundry Debtors after writing off bad debts is ₹ 46,600. Thus, total provision will be both on specific Debtors + General Debtors i.e. 40% of ₹ 600 + 5% of 46,000 = 240 + 2,300 = 2,540.

(5) **Accrued Interest on Fixed Deposit**

40,000 x 12/100 = 4,800

(6) **Commission paid**

Profit before charging commission: ₹ 44,134

Commission for Work Manager = 44,134 x 5/115 = 1,919

Commission for General Manager = 44,134 x 10/115 = 3,838

Illustration 19 :

The following Trial Balance has been prepared by Sm. Bijolly Acharya as on 31.3.2013 :

	Dr. ₹	Cr. ₹	
Capital & Drawings	3,600	90,400	
Stock (1.4.12)	12,300	—	
Wages	16,400	—	
Plant & Machinery	34,000		
Sundry Debtors	13,160	1,000	(advance)
Sundry Creditors	—	12,750	
Purchases & Sales	52,300	99,150	
Freehold Property	29,700	—	
Returns	320	540	
Salaries	12,800	—	
Rent	2,400	—	
Outstanding Rent	—	200	
Trade Expenses	2,060		
Furniture & Fixtures	3,100		
Bad Debts	560		
Provision for Bad Debts	—	480	
Patent & Trade Mark	4,100		
Electricity	1,290		
Loose Tools	1,510		
Advertisement Suspense	4,200		
Gas & Fuel	2,050		
Insurance	1,330		
Cash at Bank	5,200		
Cash in Hand	2,140		
	2,04,520	**2,04,520**	

Additional Information :

(i) Stock was not taken on 31.3.2013 but actually taken on 7.4.2013 at ₹10,200. Transactions during the week ended 7.4.12 were : Sales – ₹ 12,800; Purchase – ₹ 8,100. A uniform 16 2/3 % profit is made on the selling price.

(ii) Rs.510 received from a debtor whose balance had been written off as bad, was recorded as cash sale.

(iii) Private goods of Sm. Acharya costing ₹ 2,400 and sold for ₹ 2,880 was included in sales.

(iv) Advance from customers is entitled to 12% interest which is due for 2 months.

(v) Electricity expenses include a deposit of ₹ 600 to the W.B. State Electricity Board.

(vi) The effect of advertisement is expected to last for the coming two years also.

(vii) A furniture costing ₹ 1,600 purchased on 31.12.12 from M/s. Assam Furniture Mart on credit was omitted to be recorded.

(viii) Cash embezzled by a dishonest employee – ₹ 900.

(ix) Patent & Trade Mark is to be amortized in 10 equal instalments.

(x) Provision for Bad Debts is to be adjusted to 5% of Sundry Debtors; Loose Tools are valued at ₹1,020; Provide depreciation @ 10% on Plant & Machinery, @ 15% on Furniture.

You are required to prepare Trading and Profit & Loss Account for the year and a Balance Sheet as at the end of the year.

In The Books of Sm. Bijolly Acharya

Trading and Profit Loss Account for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening Stock		12,300	By Sales	99,150	
" Purchase	52,300		Less: Return	320	
				98,830	
Less: Return	540	51,760	Less: Bad Debt Recovery	510	
" Wages		16,400			
" Gas and Fuel	2,050			98,320	
			Less: Private Sales	2,880	95,440
			" Closing Stock		12,767
" **Gross profit C/d**		**25,697**			
		1,08,207			1,08,207
To Salaries		12,800	**By Gross Profit b/d**		**25,697**
" Rent		2,400	" Provision for Bad debts		480
" Trade Expenses		2,060	" Bad Debts Recovery		510
" Bad debts		560			
" Electricity	1,290				
Less: Deposit on W.B.S.E.B	600	690			
" Advertisement Suspense		4,200			
" Insurance		1,330			
" Cash Embezzled		900			
" Amortization Patent & Trade		410			
" Prov. for Bad debts		658			
" Outstanding Interest for Advance		20			
" Depreciation:					
Plant and Machinery	3,400				
Furniture & Fixture	525				
Loose Tools	490	4,415			
			" Capital A/c (Net Loss)		3,756
		30,443			**30,443**

Balance Sheet as at 31.03.13

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital	90,400		Freehold Property		29,700
Add: Private Sale	2,880		Plant and Machinery	34,000	
	93,280		Less: Depreciation	3,400	30,600
Less: Net Loss	3,756		Furniture & Fixture	3,100	
	89,524		Add: Furniture Purchase	1,600	
Less: Drawings	3,600	85,924		4,700	
			Less: Depreciation	525	4,175
Advance from sundry Debtors	1,000		Loose Tools	1,510	
			Less: Depreciation	490	1,020
Add: Outstanding Interest	20	1,020	Patents and Trade Mark	4,100	
Outstanding Rent		200	Less: Amortization	410	3,690
Sundry Creditors	12,750		Deposit in Electricity Board		600
Add: Creditors for furniture	1,600	14,350	Closing Stock		12,767
			Sundry Debtors	13,160	
			Less: Provision for Bad Debts	658	12,502
			Cash at Bank		5,200
			Cash In Hand	2,140	
			Less: Cash Embezzled	900	1,240
		1,01,494			**1,01,494**

Working Note:

(1)

		₹
Stock as on 07/04/2013 —		10,200
Add: Sales:	12,800	
Less: Profit (12,800 ×$16^2/_3$%)	2,133	10,667
		20,867
Less: Purchase		8,100
		12,767

(2) ₹ 510 which was received against bad debts should be treated as recovery of Bad Debt. But it was wrongly credited to sales Account, the rectifying entry will be :

Sales A/c …….. Dr.		510	
To, Bad Debt Recovery A/c			510

(3) Selling of Private goods amounting to ₹ 2,880 to be deducted from the sales and the same is added to capital as further Capital.

(4) Calculation of Depreciation of Furniture

Depreciation for Furniture = (3,100 × 15%)	465.00
Add: Depreciation for New Furniture and Fixture = (1,600x15% x 3/12)	60.00
	525.00

(5) As per As 26 the expenditure incurred on intangible assets would have to be expensed off when they are incurred. So, the Printing and Advertisement expenses is not carried forward to the next year and the full amount is shown in the profit and Loss Account.

Illustration 20 :

Singh has extracted the following Trial Balance from his books on 31st March, 2013 :

	Dr.	Cr.
	₹	₹
Drawing	16,000	
Cash	6,760	
Petty Cash	1,000	
Leasehold Land	20,000	
Opening Stock (at market value)	50,000	
Salary	12,000	
Sundry Debtors	50,000	
Wages	40,000	
Bank	21,000	
Capital		34,000
Rent	9,000	
Electricity	6,000	
Motor Car	10,240	
Advertising	9,000	
Sundry Creditors		35,000
Purchases	4,00,000	
Postage & Telephone	3,000	
Sales		6,00,000
Discounts	11,400	
General Charges	4,000	
Petty Cash Expenses	9,600	
Suspense		10,000
	6,79,000	**6,79,000**

You are required to prepare a Trading and Profit & Loss Account and Balance Sheet using the following additional information :

(1) Closing Stock at market value as on 31st March, 2013, was ₹ 80,000 (Cost ₹ 75,000). Stock is being valued on a consistent basis of cost or net realisable (market) price whichever is lower.

(2) The petty cash balance represents the month-end imprest account. As on the closing date the petty cashier had vouchers totalling to ₹ 400 for which he had received reimbusement from the main cashier.

(3) Discount allowed amounting to ₹ 1,000 had been posted to the debit of Sundry Debtors.

(4) Cash withdrawn from Bank ₹ 4,000 had not been entered in the Bank Column of the Cash Book.

(5) Sales Account had been undercaset by ₹ 4,000.

(6) The motor car which had been purchased in 2009-2010 was being depreciated at 20% on the Reducing Balance Method. The original cost of the car was ₹ 20,000. It is now decided to charge depreciation at 6% on the Straight Line Method and to made this change effective from the year of purchase of the car.

(7) The leasehold land was purchased during the year. On the date of purchase the unexpired period of the lease was five years.

(8) No entry had been passed in the books for stock withdrawn form the business by the proprietor valued at ₹ 10,000.

(9) Advertising includes cost of a campaign run during the year ₹ 6,000. It is expected that the effect of this campaign will be felt for at least three years.

(10) Telephone bills amounting to ₹ 1,000 remain unpaid.

Solution :

In The Books of Singh

Trading and Profit Loss Account for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Opening Stock		50,000	By, Sales	6,00,000	
			Add: Under cast	4,000	
					6,04,000
" Purchase	4,00,000		" Closing Stock		75,000
Less: Drawings	10,000				
		3,90,000			
" Wages		40,000			
" **Gross profit c/d**		**1,99,000**			
		6,79,000			6,79,000
To, Salaries		12,000	**By, Gross Profit b/d**		**1,99,000**
" Rent		9,000	" Excess depreciation written Back		6,160
" General Charges		4,000			
" Postage and Telephone	3,000				
Add: Outstanding	1,000	4,000			
" Electricity		6,000			
" Advertisement		9,000			
" Discount		11,400			
" Petty cash Expenses	9,600				
Add: Reimburse	400	10,000			
" Amortization of Lease (1/5 × 20,000)		4,000			
" Depreciation of Motor car		1,200			
" Capital A/c (Net Profit Transfer)		1,34,560			
		2,05,160			**2,05,160**

Balance Sheet as at 31.03.13

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital	34,000		Leasehold Land	20,000	
Add: Net Profit	1,34,560		Less: Amortization	4,000	16,000
	1,68,560		Motor Car	10,240	
Less: Drawings (16,000+10,000)	26,000	1,42,560	Add: Excess Depreciation	6,160	
				16,400	
			Less: Deprecation	1,200	15,200
			Closing Stock		75,000
Sundry Creditors		35,000	Sundry Debtors (50,000 – 2,000)		48,000
Outstanding Postage and Telephone		1,000	Cash at Bank (21,000 – 4,000)		17,000
			Cash In Hand (6,760 + 1,000-400)		7,360
		1,78,560			**1,78,560**

Workings :

(1)

Dr. **Suspense Account** **Cr.**

Particulars	₹	Particulars	₹
To, Balance b/d	10,000	By, Discount allowed (wrongly entered)	2,000
		,, Bank A/c (not entered in the bank column)	4,000
		,, Sales A/c (Under cast)	4,000
	10,000		**10,000**

(2) Written Down value Of Motor car → 10,240

So, Cost of Motor Car → 10,240x100/80 x 100/80 x 100/80 = 20,000

	₹	Depreciation
on 01.04.2009 →	20,000	
Less: Depreciation for 1st Year @ 20%	4,000	4,000
	16,000	
Less: Depreciation for 2nd Year @ 20%	3,200	3,200
	12,800	
Less: Depreciation for 3rd Year @ 20%	2,560	2,560
	10,240	9,760

On S.L.M. Basis = 20,000 x 6% x 3 = 3,600

∴ Overcharged (9,760 – 3,600) = 6,160

Illustration 21:

The Trial Balance of Deepanjan as on 31.3.13 is given below. Prepare his Trading and Profit & Loss Account for the year ended 31.03.13 and his Balance Sheet on that date.

	Dr.	Cr.
	₹	₹
Building	75,000	
Machinery	82,500	
Furniture	6,400	
Capital		1,25,000
Stock (01.04.2012)	34,600	
Debtors & Creditors	38,000	25,000
Bad Debts	1,250	
Provision for Bad Debts		2,000
Purchases and Sales	54,750	1,54,500
Returns Inward & Outward	2,000	1,250
Bank Overdrft		28,500
Advertisement	4,500	
Commission		3,750
Salary	33,000	
Bills Receivable & Payable	6,000	3,500
Cash	3,200	
Sundry Trade Expenses	2,300	
	3,43,500	**3,43,500**

The following further information is made available:

(i) Stock at the end of the year on 31.03.13 was valued at ₹ 45,000.

(ii) A customer for ₹ 6,000 included in sales ledger, returned 50% of the goods which were sold at 20% profit on cost. No entry had been made in the books for this return while goods were taken to stock at selling price.

(iii) A purchase of ₹ 3,000 was made for the manager and included in purchases. A deduction of similar amount was made from his salary and the net payment to him was posted to salary account.

(iv) A machinery worth ₹ 20,000 purchased on 01.4.10 was wrongly written off against Profit & Loss Account for the year ended 31.03.11. It is decided to bring the asset into account on 01.04.2012 taking depreciation at 10% p.a. on reducing balance method.

(v) A bill for ₹ 1,000 endorsed to a creditor was returned dishonoured but no entry had been made in the books.

(vi) Sales included ₹ 15,000 for sale of goods in cash on behalf of Neelanjan, Deepanjan are entitled to a commission @ 10% on sales in addition to expenses incurred by him in connection with these sales for which no adjustment had been made. His trade expenses included ₹ 500 as selling expenses for these goods.

(vii) On comparing the Cash Book with the Bank Pass Book the following discrepancies were noted:

(a) A bill for ₹ 1,500 discounted with the bank in January, 2013 was dishonoured on 28th March, 2013 but no entry had been made in the Cash Book.

(b) Bank charges ₹ 50 and interest on overdraft ₹ 450 had not been recorded in the Cash Book.

(c) An amount of ₹ 17,500 was collected by the bank on maturity of a life insurance policy but the advice for the same had not been received within 31st March, 2013.

(viii) Charge depreciation on building @ 2% and on other fixed assets @ 10% p.a. on reducing balance method.

Solution :

In the books of Deepanjan
Trading A/c for the year ended 31st March, 2013

Dr. Cr.

Particulars	₹	₹	Particulars	₹	₹
To, Opening Stock		34,600	By, Sales	1,54,500	
To, Purchase	54,750		Less: Return In Ward	2,000	
Less: Purchase made				1,52,500	
for Manager	3,000		Less: Return In Ward not recorded		
	51,750		(50% of ₹ 6,000)	3,000	
Less: Return Out Ward	1,250	50,500		1,49,500	
			Less: Sale of Consignment	15,000	1,34,500
			By, Closing Stock	45,000	
To, Profit & Loss		93,900	Less: Profit on Goods returned	500	
- G. P. transferred			[3,000×(20/120)]		44,500
		1,79,000			1,79,000

Profit & Loss A/c for the year ended 31st March, 2013

Dr. Cr.

Particulars	₹	₹	Particulars	₹	₹
To, Advertisement		4,500	By, Trading A/c		93,900
To, Salary	33,000		- G. P. transferred		
Add: Purchase made			By, Commission		3,750
for Manager	3,000	36,000	By, Commission on		
To, Bad Debts		1,250	Consignment		1,500
To, Bank Charges		50	By, Provision for Bad Debts		2,000
To, Interest on Bank O/d		450			
To, Sunday Expenses	2,300				
Less: Expenses on					
Consignment	500	1,800			
To, Depreciation:					
Building	1,500				
Machinery	9,870				
Furniture	640	12,010			
To, Capital A/c		45,090			
- N. P. transferred					
		1,01,150			1,01,150

Balance Sheet as at 31st March, 2013

Liabilities	₹	₹	Assets	₹	₹
Capital	1,25,000		Building	75,000	
Add: Life Insurance Policy			Less: Depreciation @ 2%	1,500	73,500
Matured	17,500		Machinery	82,500	
	1,42,500		Add: Machinery written	16,200	
Add: Machinery written			back(W.N. 2)	98,700	
back(W.N. 2)	16,200		Less: Depreciation @ 10%	9,870	88,830
	1,58,700		Furniture	6,400	
Add: Net Profit	45,090		Less: Depreciation @ 2%	640	5,760
Creditors	25,000	2,03,790	Stock		44,500
Add: Bill endorsed			Debtors	38,000	
dishonoured	1,000	26,000	Add: Bill endorsed	1,000	
Consignment Creditors		13,000	dishonoured	39,000	
Bills Payable		3,500	Add: Bill dishonoured not	1,500	
Bank Overdraft(W.N. 1)		13,000	recorded		
				40,500	
			Less: Return In Ward not		
			recorded	3,000	37,500
			Bills Receivable		6,000
			Cash		3,200
		2,59,290			2,59,290

Working Notes :

1. Statement showing Adjustment in Bank Balance

Particulars	₹	₹
Bank Balance as per Cash Book (O/d)		28,500
Add : Bills dishonoured not entered into the Cash Book	1,500	
Bank charges not recorded in the Cash Book	50	
Interest on Overdraft not recorded in the Cash Book	450	2,000
		30,500
Less: Amount collected on maturity of Life Insurance Policy not recorded in the Cash Book		17,500
Bank Balance after adjustment (O/d)		13,000

2. Statement showing calculation of value of machinery written back

Particulars	₹	₹
Cost of Machiney on 01.04.2010		20,000
Less: Depreciation @10% for the years 2010-11		2,000
W.D.V. on 01.04.2011		18,000
Less: Depreciation @10% for the years 2011-12		1,800
Value of Machinery written back		16,200

Illustration 22:

Mr. Gavaskar is the proprietor of a large business. The following Trial Balance was prepared from his books as on 30th June, 2013:

	₹		₹
Land & Buildings	80,000	12% Bank Loan (U.B.I.)	1,00,000
Cash at Bank	50,000	(No movement during the year)	
Motor Car	40,000	Capital Accounts	1,50,000
Furniture	20,000	Bills Payable	10,000
Sundry Debtors	1,20,000	Sundry Creditors	1,30,000
Cash in hand	10,000	Returns Outward	8,000
Stock (1.7.12)	1,10,000	Discount Received	2,000
Return Inward	10,000	Sales	9,00,000
Printing & Stationery	4,000		
Drawings	16,000		
Bills Receivable	10,000		
Travelling Expenses	12,000		
Discount Allowed	4,000		
Miscellaneous Expenses	38,000		
Postage	2,000		
Joint Venture Suspense A/c	2,000		
Investments (Market value ₹ 28,000)	30,000		
Interest on Bank Loan	8,000		
Salaries (including advance For ₹ 4,000)	54,000		
Entertainment Expenses	4,000		
Purchases	6,50,000		
Carriage Inwards	8,000		
Advertisements	18,000		
	13,00,000		**13,00,000**

Additional Information:

(1) On 2nd January, 2013, Mr. Gavaskar entered into a Joint Venture with Mr. Shastri with an agreement to share the profits and losses equally. Shastri supplied goods totalling ₹ 60,000 which wrongly passed through the Purchase Day Book. The goods were sold for cash at profit of 25% on sales and stood credited to Sales Account. Shastri had earlier incurred an amount of ₹ 4,000 on account of Freight and Insurance. Joint Venture Suspense Account represents expenses incurred by Gavaskar on Joint Venture.

(2) Bills Receivable for ₹ 8,000 endorsed on 21st March, 2013 in favour of creditors were subsequently dishonoured but no entry for the dishonoured has been passed.

(3) Three cheques of ₹ 3,000, ₹ 4,000 and ₹ 6,000 issued to parties on 29th June, 2013, were lying unpresented on 30th June, 2013.

(4) Sales included a sum of ₹ 60,000 received from sale of goods on behalf of Mr. Kapil, the cost of these goods to Mr. Kapil was ₹ 50,000. Mr. Gavaskar is entitled to a commission of 5% on sales, for which effect should be given and reimbursement of selling expenses of ₹ 2,000 were debited to Miscellaneous Expenses Account.

(5) 1/3rd of the advertisement expenses are to be carried forward.

(6) Of the Debtors a sum of ₹ 2,000 is to be written off as bad debt. Create provision for doubtful debts @ 2%.

(7) Depreciate fixed assets by 10% except Motor Car which is to be depreciated at 20%.

(8) Value of Stock at the end is ₹ 90,000.

(9) During the year some goods (Invoiced at ₹ 1,00,000) were sent to sundry customers on sales on approval. On 30th June, 2013 of these goods ₹ 20,000 remained with customers as the period of approval did not expire as yet. Proper adjustment should be made in respect of the above. Mr. Gavaskar makes his invoices at cost plus 25%.

You are required to prepare Trading and Profit & Loss Account for the year ended 30th June, 2013 and a Balance Sheet as at 30th June, 2013.

Solution :

In the books of Mr. Gavaskar
Trading A/c for the year ended 30th June, 2013

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Opening Stock		1,10,000	By, Sales	9,00,000	
To, Purchase	6,50,000		Less : Return Inward	10,000	
Less : Return Outward	8,000			8,90,000	
	6,42,000		Less : Joint Venture sales	80,000	
Less : Supplied by Mr. Sastri	60,000	5,82,000		8,10,000	
To, Carriage Inward		8,000	Less : Sales on Consignment	60,000	7,50,000
To, Profit & Loss A/c		1,56,000	By, Closing Stock	90,000	
- G. P. transferred			Add : Goods sold on		
			Approval	16,000	1,06,000
			[₹ 20,000 ×(100/125)]		
		8,56,000			8,56,000

Profit & Loss A/c
for the year ended 30th June, 2013

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Printing & Stationery		4,000	By, Trading A/c		1,56,000
To, Travelling Expenses		12,000	- G. P. transferred		
To, Discount Allowed		4,000	By, Discount Received		2,000
To, Miscellaneous			By, Profit on Joint Venture		7,000
Expenses	38,000		(W.N. 1)		
Less : Consignment			By, Commission Received		3,000
Expenses	2,000	36,000	(₹ 60,000 × 5%)		
To, Postage		2,000			
To, Interest on Bank Loan		8,000			
To, Salaries	54,000				
Less : Advance Salary	4,000	50,000			
To, Entertainment					
Expenses		4,000			
To, Advertisement		18,000			
(W.N. 3)					
To, Bad Debts		2,000			
To, Provision for Doubtful					
Debts		2,520			
To, Depreciation:					
Land & Building	8,000				
Motor Car	8,000				
Furniture	2,000	18,000			
To, Capital A/c		7,480			
- N. P. transferred					
		1,68,000			1,68,000

Balance Sheet as at 30th June, 2013

Liabilities	₹	₹	Assets	₹	₹
Capital	1,50,000		Land & Building	80,000	
Less: Drawings	16,000		Less: Depreciation @ 10%	8,000	72,000
	1,34,000		Motor Car	40,000	
Add: Net Profit	7,480	1,41,480	Less: Depreciation @ 20%	8,000	32,000
12% Bank Loan (U.B.I.)		1,00,000	Furniture	20,000	
			Less: Depreciation @ 10%	2,000	18,000
Creditors	1,30,000		Investment		30,000
Add: Bill endorsed			Stock		1,06,000
Dishonoured	8,000		Debtors	1,20,000	
	1,38,000		Add: Bill endorsed	8,000	
Less : Supplies by Mr. Sastri	60,000	78,000	dishonoured	1,28,000	
Consignment Creditors		55,000			
Amount due to Mr. Sastri (W.N. 2)		71,000	Less: Further Bad Debt	2,000	
				1,26,000	
Bills Payable		10,000	Less: Provission for Bad		
			Debts	2,520	1,23,480
			Bills Receivable		10,000
			Cash at Bank		50,000
			Cash in hand		10,000
			Advance Salary		4,000
		4,55,480			4,55,480

Working Note

1.

In the books of Mr. Gavaskar Joint Venture Account

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Mr. Sastri A/c		60,000	By, Cash A/c		80,000
To, Mr. Sastri A/c		4,000	(Sales Proceeds)		
- Freight & Insurance			[₹ 60,000 × (100/75)]		
To, Bank A/c		2,000			
- Expenses					
To, Profit on Venture :					
Mr. Sastri A/c	7,000				
Profit & Loss A/c	7,000	14,000			
		80,000			80,000

2.

Mr. Sastri Account

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
			By, Joint Venture A/c		60,000
			By, Joint Venture A/c		4,000
To, Balance c/d		71,000	- Freight & Insurance		
			By, Joint Venture A/c		7,000
			- Share of Profit		
		71,000			71,000

3. After the date on which AS 26 became mandatory, the expenditure incurred on intangible items would have to be expensed off when they are incurred (as per Para 56 of AS 26). So, the Advertisement Expense is not carried forward to the next year and the full amount is shown in the Profit & Loss A/c.

Illustration 23 :

The following Trial Balance extracted from the books of Mr. Oberoi as on 31st March, 2013:

		₹		₹
Purchases		6,88,000	Sales	8,46,200
Drawings		36,000	Capital Account	1,97,000
Sundry Debtors		96,000	Sundry Creditors	1,14,000
Bad Debts		2,000	Outstanding Salary	4,000
Furniture & Fixtures		81,000	Bank Overdraft (U.B.I.)	60,000
Office Equipments		54,000		
Salaries		24,000		
Advance Salary		1,500		
Carriage Inward		6,500		
Misc. Expenses		6,000		
Carriage Outward		6,000		
Travelling Expenses		8,000		
Rent		18,000		
Electricity & Telephone		6,800		
Cash in hand		5,900		
Cash at Bank (S.B.I.)		53,000		
Stock (1.4.12)		50,000		
Repairs		7,500		
Motor Car		56,000		
Depreciation :				
Furniture	9,000			
Office Equipment	6,000	15,000		
		12,21,200		**12,21,200**

Additional information :

(i) Sales include ₹ 60,000 towards goods sold each on account of a joint venture with Mr. Ajmani who incurred ₹ 8,000 as forwarding expenses. The joint venture earned a profit of ₹ 15,000 to which Mr. Ajmani is entitled to 60%.

(ii) The motor car account represents an old motor car which was replaced on 1.4.12 by a new one, costing ₹ 1,20,000 with an additional cash payment of ₹ 40,000 lying debited to purchases account.

(iii) UBI has allowed an overdraft limit against hypothecation of stock keeping a margin of 20%. The present balance is 80% of the overdraft limit as permitted by the bank.

(iv) Sundry Debtors include ₹4,000 as due from Mr. Jha and Sundry Creditors include ₹ 7,000 as payable to him.

(v) On 31.3.13 Outstanding rent amounted to ₹ 6,000 and you are informed that 50% of the total rent is attributable to Oberoi's residence.

(vi) Depreciation to be provided on motor car @ 20% (excluding sold item).

(vii) Credit sales of ₹ 14,000 wrongly recorded as credit purchases.

Mr. Oberoi requests you to prepare a Trading and Profit & Loss Account for the year ended 31st March, 2013 and a Balance Sheet as on that date.

Solution :

In the books of Mr. Oberoi
Trading A/c for the year ended 31st March, 2013

Dr **Cr**

Particulars	₹	₹	Particulars	₹	₹
To, Opening Stock		50,000	By, Sales	8,46,200	
To, Purchase	6,88,000		Less: Joint venture Sales	60,000	
Less: Paid for Motor Car Replacement	40,000			7,86,200	
	6,48,000		Add: credit sales	14,000	8,00,200
Less: Wrongly entered in purchase	14,000		By, Closing Stock (W.N. 1)		93,750
		6,34,000			
To, Carriage Inward		6,500			
To, Gross Profit		2,03,450			
		8,93,950			**8,93,950**

Profit and Loss A/c for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Salaries		24,000	By, Trading A/c - G.P. Transferred		2,03,450
To, Bad Debts		2,000	By, Profit on Joint Venture (₹ 15,000 x 40%)		6,000
To, Misc. expenditure		6,000	By, Profit on Machinery (W.N.3)		24,000
To, Carriage Outward		6,000			
To, Travelling Exp		8,000			
To, Rent	18,000				
Add: outstanding	6,000				
	24,000				
Less: Rent for Oberoi's residence	12,000	12,000			
To, Electricity & Telephone		6,800			
To Repairs		7,500			
To, Depreciation:					
- Furniture & Fixture	9,000				
- Office Equipment	6,000				
- Motor Car	24,000	39,000			
To, Capital A/c - N.P. Transferred		1,22,150			
		2,33,450			**2,33,450**

Balance Sheet as at 31st March, 2013

Liabilities	₹	₹	Assets	₹	₹
Capital	1,97,000		Motor Car	56,000	
Less: Drawings	36,000		Add: Replacement Cost ₹(40,000 + 24,000)	64,000	
	1,61,000			1,20,000	
Less: Rent for Own residence	12,000		Less: Depreciation @ 20%	24,000	96,000
	1,49,000		Furniture & Fixture		81,000
Add: Net Profit	1,22,150	2,71,150	Office Equipment		54,000
			Stock		93,750
Amount due to Mr. Ajmani (W.N. 2)		54,000	Sundry Debtors	96,000	
Sundry Creditors	1,14000		Less: Mutual Indebtness	4,000	
Less: Mutual Indebtness	4,000			92,000	
	1,10,000		Add: wrongly entered in purchase	14,000	1,06,000
Less: Wrongly entered in the credit sales	14,000	96,000	Cash at Bank		53,000
Bank overdraft (UBI)		60,000	Cash in hand		5,900
Outstanding Salary		4,000	Advance Salary		1,500
Outstanding Rent		6,000			
		4,91,150			**4,91,150**

Workings:

(1) Calculation of Closing Stock:

Let, Closing Stock = 100

(-) Margin @ 20% = 20

80

O/D balance on percent = 80% of 80 = 64.

When Bank Overdraft 64 , Closing stock is 100

When Bank Overdraft 60,000, Closing Stock is 100/64 x 60,000 = 93,750.

(2) Ajmani Balance = Cost + Expensed incurred by Ajmani + Share of Profit

= ₹ [(60,000 – 8,000 – 15,000) + 8,000 + (15,000 x 60%)]

= 54,000

(3) Calculation for Profit or Loss on Replacement of machine

Particulars	₹
Book value of old machine	56,000
Add: Amount Paid extra	40,000
	96,000
Less: Cost of Machinery received on Replacement	1,20,000
Profit on Replacement	**24,000**

Illustration 24 :

R retired from a company and started a business in Chennai. On retirement he got ₹ 1,00,000 from his employer which he invested in his business on 1.1.13. He got from Life Insurance Corporation ₹ 20,000 on the maturity of his policy which he also invested in his business. He draws ₹ 1,000 for his personal expenses every month from 30th April, 2013.

The following figures are extracted from his books on 31st December, 2013 :

	₹		₹
Purchases	3,10,000	Bad Debts	2,000
Cartage	5,000	Sundry Debtors	45,000
Salaries & Wages	24,000	Bills Receivable	30,000
Electricity Charges	4,500	Cash in hand	8,997
Travelling	8,900	Sales	3,00,000
Telephone	4,300	Income from Personal Investments	20,000
Advertisement	10,000	Creditors	85,000
Repairs & Renewal	3,303	Bank Overdraft	80,000
Plant & Machinery	1,50,000	Buildings (Cr.)	10,000

You are requested to prepare a Trading and Profit & Loss Account of the business for the period ended 31st December, 2013 and also the Balance Sheet as on that date after taking into considertion the following further information :

(1) Purchases include ₹ 10,000 representing the value of Furniture purchased.

(2) ₹ 4,000 representing erection wages on Plant & Machinery are debited to Salaries & Wages.

(3) Electricity charges include ₹ 2,500 paid as deposits to Electric Supply Company. There are bills outstanding to the extent of ₹ 500.

(4) Advertisement includes ₹ 4,000 representing the cost of a Neon Sign.

(5) A dishonoured bill of ₹ 5,000 stands debited to the debtor. 50% thereof considered doubtful and has to be provided accordingly.

(6) A debtor of ₹ 1,000 was declared insolvent on 30.12.13 and it is expected that nothing would be recovered from his estate.

(7) Provide 5% discount on net realisable debtors.

(8) R received ₹ 25,000 in respect of a business with B. The sum received stood credited to Sundry Creditors. It is noted that a sum of ₹ 5,000 was due to R as his share of profit from that business.

(9) During the period there was a fire damaging stock costing ₹ 50,000. The damaged goods were sold for ₹ 20,000. This sum of ₹ 20,000 is included in Sales. The Insurance Company paid ₹ 25,000 towards the loss of stock. The godown containing the stock was also damaged to the extent of ₹ 15,000, which has also been paid by the Insurance Company. The total amount received from the Insurance Company was credited to Building Account.

(10) Bank overdraft represents 80% of the drawing power, which is fixed after a margin of 20% on the value of stock.

(11) The bank overdraft was given on the hypothecation of stock-in-trade. You are informed that the bank had a margin of 331/3 % and the overdraft balance on 31.12.13 was the maximum which could have been drawn on the basis of this margin.

(12) The manager of the business is entiled to a commission of 5% on the gross profit.

(13) Provide 10% depreciation on Plant & Machinery and on Furniture & Fittings and 5% on Building. Depreciation to be provided on closing balance for full year.

Solution :

In the books of R

Trading Account for the year ended 31st December, 2013

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Purchase	3,10,000		By, Sales	3,00,000	
Less: Furniture purchase	10,000	3,00,000	Less: Sale of damaged		
To, Cartage		5,000	goods	20,000	2,80,000
			By, Abnormal Loss		50,000
To, Profit & Loss A/c		1,75,000	- Stock damaged on fire		
- G. P. transferred			By, Closing Stock		1,50,000
			[₹ 80,000 × (100/80 × 100/66.66667)]		
		4,80,000			4,80,000

Profit & Loss Account
for the year ended 31st December, 2013

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Salaries & Wages	24,000		By, Trading A/c		1,75,000
Less: for erection of Plant			- G. P. transferred		
& Machinery	4,000	20,000	By, Profit on Joint Venture		5,000
To, Electricity Charges	4,500				
Add: Outstanding	500				
	5,000				
Less: Deposit to Electric					
Supply Company	2,500	2,500			
To, Travelling Expenses		8,900			
To, Telephone Expenses		4,300			
To, Advertisement	10,000				
Less: Cost of Neon Sign	4,000	6,000			
To, Repairs & Renewal		3,303			
To, Bad Debts	2,000				
Add: New	1,000	3,000			
To, Loss on Fire		5,000			
(50,000 – 25,000 – 20,000)					
To, Manager's					
Commission		8,750			
(5% on G.P.)					
To, Provision for Doubtful		2,500			
Debts (₹5,000 × 50%)					
To, Provision for Discount		2,075			
To, Depreciation:					
Plant & Machinery	11,550				
Furniture	1,050				
Building	563	13,163			
To, Capital A/c		1,00,509			
- N. P. transferred					
		1,80,000			1,80,000

Balance Sheet
as at 31st December, 2013

Liabilities	₹	₹	Assets	₹	₹
Capital	1,20,000		Building	(10,000)	
(₹ 1,00,000 + ₹ 20,000)			Add: Amount of insurance received (₹25,000 + ₹15,000)	40,000	
Less: Drawings (₹1,000 × 9)	9,000			30,000	
	1,11,000		Less: Godown destroyed	15,000	
Add: Net Profit	1,00,509			15,000	
	2,11,509				
Add: Income from personal Investment	20,000	2,31,509	Less: Depreciation @ 5%	563	14,437
Creditors	85,000		Plant & Machinery	1,50,000	
Less: Amount due to B			Add: Wages for erecting	4,000	
including profit of R	5,000	80,000	Plant & Machinery	1,54,000	
Bank Overdraft		80,000	Less: Depreciation @ 10%	11,550	1,42,450
Outstanding Expenses:			Furniture	10,000	
Electricity charges	500		Add: Cost of Neon Sign	4,000	
Manager's commission	8,750	9,250		14,000	
			Less: Depreciation @ 10%	1,050	12,950
			Deposit to Electric Supply Company		2,500
			Stock		1,50,000
			Debtors	45,000	
			Less: Bad Debts (New)	1,000	
				44,000	
			Less: Provision for Doubtful Debts	2,500	
				41,500	
			Less: Provision for Discount @ 5%	2,075	39,425
			Bills Receivable		30,000
			Cash in Hand		8,997
		4,00,759			4,00,759

Illustration 25 :

JNB & Sons. A proprietory concern, submitted the following Trial Balance on 31st March, 2013 along with some addditional information :

Debit	₹	Credit	₹
Plant & Machinery	10,000	Sales	2,00,000
Purchases	90,000	Capital	81,000
Buildings	50,000	Interest on Advance Tax	400
Sundry Expenses	10,000	Suspense Account of Guruji	30,000
Freight Inward	2,000	Advance Interest Received	3,600
Commission to Purchase Manager	2,000	Creditors	15,000
Tax & Insurance	4,000		
Life Insurance	1,000		
Goodwill	30,000		
Debtors	70,000		
Bad Debts	1,000		
Advance Tax	4,000		
Income Tax	10,000		
Petty Cash	3,300		
Cash at Bank	11,700		
Stock on 31st March, 2013	20,000		
Suspense Account of Sadhuji	10,000		
Advance Commission paid	1,000		
	3,30,000		**3,30,000**

Additional Information :

(1) Goods costing ₹ 60,000 were consigned to Guruji for sale on 10% commission basis. The latter sold ¾ ths of the goods at a profit 25% on sales. The unsold stock was to be valued at cost. Guruji sent an advance of ₹ 30,000 which was credited to his Suspense Account.

(2) A Joint Venture was made with Sadhuji for which an advance of ₹ 10,000 was entered. The venture was made with Sadhuji for which an advance of ₹ 10,000 entered. The venture yielded a profit of ₹ 9,000. 2/3rds of which are attributable to JNB & Sons.

(3) Goods costing ₹ 1,600 (Sale Price ₹ 2,000) were sent to approval on 28th March, 13 and recorded through the Sales Day Book, but no consent had been received up to 31st March,13.

(4) Petty Cash had been controlled under Imprest system and whenever cheques were issued to the Petty Cashier, Petty Cash was debited. However, no entries had been made on the credit side of the Petty Cash Account during the entire year. Payments from Petty Cash in March, 2013 was ₹ 200, the imprest being ₹ 300. All payments from the Petty Cash are to be charged to Sundry Expenses Account.

(5) A difference in books that arose due to the following errors was written off against Sundry Expenses Account :

   (i) A cheque of ₹ 1,500 received from a Debtor was wrongly posted to Customer A/c as ₹ 150.

   (ii) The Sales Day Book was undercast by ₹ 500.

(6) Provision for Doubtful Debts to be made at 5% and depreciation on Plant & Machinery and Buildings to be provided at 10%.

(7) A purchase invoice of ₹ 5,000 received from a Sundry Creditor has not been entered through oversight.

(8) Goods were despatched in March, 2013 for which the sale Rs. 7,500 (including a profit of 331/3% on sales) materialised on 2nd April, 2013.

Prepare the Trading and Profit & Loss Account for the year ended 31st March, 2013 and a Balance Sheet on that date.

Solution :

In the books of JNB & Sons.
Trading Account for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Purchase	90,000		By, Sales	2,00,000	
Add: Unrecorded credit			Add: Sales Day Book		
purchase	5,000	95,000	Undercast	500	
To, Freight Inward		2,000		2,00,500	
To, Commission to			Less: Goods sent on		
Purchase Manager		2,000	Approval	2,000	1,98,500
			By, Goods sent on		
			Consignment		60,000
To, Profit & Loss A/c		1,66,100	By, Goods sent on		
- G. P. transferred			Approval (Cost Price)		1,600
			By, Goods in Transit		
			(at cost)		5,000
			[₹7,500×(100-33.3333)%]		
		2,65,100			2,65,100

Profit & Loss Account
for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Sundry Expenses		14,650	By, Trading A/c		1,66,100
(W.N. 1)			- G. P. transferred		
To, tax & Insurance		4,000	By, Profit on Consignment		9,000
To, Bad Debts		1,000	(W.N. 2)		
To, Petty Cash Expenses		200	By, Profit on Joint Venture		6,000
To, Provision for Doubtful					
Debts		3,333			
To, Depreciation:					
Plant & Machinery	1,000				
Building	5,000	6,000			
To, Capital A/c		1,51,917			
- N. P. transferred					
		1,81,100			1,81,100

Balance Sheet
as at 31st March, 2013

Liabilities	₹	₹	Assets	₹	₹
Capital	81,000		Goodwill		30,000
Less: Life Insurance	1,000		Building	50,000	
premium paid	80,000		Less: Depreciation @ 10%	5,000	45,000
			Plant & Machinery	10,000	
Add: Net Profit	1,51,917		Less: Depreciation @ 10%	1,000	9,000
	2,31,917		Stock	20,000	
Less: Income Tax paid	10,000		Add: Goods sent on		
	2,21,917		Approval	1,600	
Less: Advance Tax paid	4,000			21,600	
	2,17,917		Add: Goods in Transit	5,000	26,600
Add: Interest on Advance			Stock on Consignment		15,000
Tax received	400		Debtors	70,000	
		2,18,317	Less: Cheque received		
Creditors	15,000		but wrong amount		
Add: Unrecorded credit			recorded	1,350	
Purchase	5,000	20,000		68,650	
			Less: Goods sent on		
Advance Interest received		3,600	Approval	2,000	
				66,650	
			Less: Provision for		
			Doubtful Debts @5%	3,333	63,317
			Due from Guruji (W.N. 3)		24,000
			Advance to Sadhuji	10,000	
			Add: Share of Profit	6,000	16,000
			Cash at Bank		11,700
			Petty Cash		300
			Advance Commission paid		1,000
		2,41,917			2,41,917

Working Note:

1. Calculation for amount of Sundry Expenses:

Particulars	₹
Sundry Expenses as per Ledger Balance	10,000
Add: Petty Cash Expenses (₹3,300 – ₹300 – ₹200)	2,800
Add: Adjustments for errors (₹1,500 – ₹150 + ₹500)	1,850
Amount appear in Profit & Loss A/c	14,650

2.

In the books of JNB & Sons
Consignment to Guruji Account

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Goods sent on Consignment		60,000	By, Guruji A/c - Sales proceeds [₹60,000 × ($^3/_4$ × $^{100}/_{75}$)]		60,000
To, Guruji A/c - Commission		6,000	By, Stock on Consignment [₹60,000 × ($^1/_4$)]		15,000
To, Profit on Consignment		9,000			
		75,000			75,000

3.

Guruji Account

Dr. **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Consignment to Guruji A/c		60,000	By, Consignment to Guruji A/c - Commission		6,000
			By, Bank A/c - Advance paid		30,000
			By, Balance c/d		24,000
		60,000			60,000

Illustration 26:

Sri Z retired Government Officer, who started a business in Kolkata a few years back, gives you the following Trial Balance relating to the year ended on 31st March 2013.

Dr. ***Cr.***

Particulars	Amount (₹)	Particulars	Amount (₹)
Sundry Debtors	84,000	Sundry Creditors	38,000
Stock on 01.04.20012	40,000	Bill Payable	3,700
Stock on 31.03.2013	50,000	Capital	90,000
Machinery	56,000	Provision for Bad Debts	3,200
Furniture	8,500	Sales	6,76,000
Bills receivable	4,900		
Building Rent	9,600		
Cash in Hand	4,250		
Cash at Bank	17,394		
Drawings	11,000		
Salaries	18,910		
Bad Debts	1,200		
Purchases	4,45,000		
Printing charges	2,300		
Postage	1,500		
Telephone	1,600		
Miscellaneous Expenses	41,806		
Insurance	2,040		
Travelling Expenses	7,900		
Suspense	3,000		
	8,10,900		**8,10,900**

Additional Information:

(1) An old furniture stood at ₹ 1,200 in the books on 1st April 2013, was disposed of at ₹ 580 on 30th September 2013 in part exchange for a new furniture costing ₹ 1,040.A net invoice of ₹ 460 was passed through the Purchase Day Book.

(2) Sales include ₹ 20,000 on hire purchase sale. Hire-purchase sales prices are fixed after adding 33% on cost. 40% of the instalments have not fallen due as yet (Profit or Loss on hire-purchase sale should be shown in Profit and Loss Account).

(3) Suspense account represents money advanced to Sales Manager who was sent to Delhi in March 2013 for sales promotion. On returning to Kolkata he submitted a statement disclosing that ₹ 1,200 was incurred for travelling, ₹ 500 for legal expenses and ₹ 900 for miscellaneous expenses. The balance lying with him was yet to be refunded.

(4) Sri Z desires to change in the method of depreciation on machinery from Straight Line Method to Diminishing Balance Method with retrospective effect from April 2008 when the machinery were bought, and the difference is to be adjusted in the accounting year 2012-13. The rate of depreciation will, however, remain unchanged.

(5) Business is carried on in a rented house. The ground floor, being 50% of the accommodation, used for business. Sri Z lives with his family on the first floor.

(6) The bad debts for the year amounted to ₹ 2,000. Provision for doubtful debts to be increased by ₹800.

(7) Insurance premium includes ₹ 1,000 being premium of Z's personal policy and the balance of insurance covers a period up to 30th June 2013.

(8) Sundry Debtors include ₹ 5,100 due from Shri Ramkumar and Sundry creditors include ₹ 6,300 due to Shri Ramkumar.

(9) Two cheques of ₹ 1,200 and ₹ 1,000 were returned dishonoured on 30th March 2013, but were not recorded in Cash Book.

(10) Depreciation on time basis is to be provided on machinery at 10% as instructed and on furniture at 5% on diminishing balance.

You are required to prepare a Trading and Profit & Loss Account for the year ended 31st March and Balance Sheet as on that date.

Solution:

In the books of Sri Z

Trading and Profit & Loss Account for the year ended 31st March, 2013

Dr. *Cr.*

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening Stock		40,000	By Sales	6,76,000	
" Purchase	4,45,000		Less : H. P. Sales	20,000	
Less : Sale of Furniture	460				6,56,000
	4,44,540				
Less : Cost of H.P. Sales	15,000	4,29,540			
" Profit and Loss A/c					
Gross Profit transferred		1,86,460			
		6,56,000			**6,56,000**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Building Rent	9,600		By Trading A/c (Gross Profit transferred)		1,86,460
Less: For personal living of Proprietor	4,800	4,800			
" Salaries,		18,910			
			" Profit on H.P. Sales		3,000
" Bad Debts	1,200		" Depreciation over-charged		2,320
Add : Further Bad Debts	800	2,000			
" Printing Charges		2,300			
" Postage		1,500			
" Telephone		1,600			
" Misc. Expenses	41,806				
Add : Incurred by Sales Manager	900	42,706			
" Insurance	2,040				
Less : Personal L.I.P. of Proprietor	1,000				
Less: Prepaid	260	780			
" Travelling Expenses	7,900				
Add : Incurred by Sales Manager	1,200	9,100			
" Legal Expenses		500			
" Provision for Bad Debts:					
New Provision	4,000				
Less: Old Provision	3,200	800			
,, Loss on Exchange of Furniture		590			
Depreciation :					
On Machinery	5,832				
On Furniture	447	6,279			
,, Capital A/c					
Net Profit transferred		99,915			
		1,91,780			**1,91,780**

Balance Sheet as on 31.03.2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital	90,000		Machinery	56,000	
Add: Net Profit	99,915		Add: Depreciation overcharged	2,320	
	1,89,915			58,320	
Less: Drawings	11,000		Less: Depreciation	5,832	52,488
	1,78,915		Furniture	8,500	
Less: Personal LIC Insurance Premium	1,000		Less: exchanged during the year	1,170	
				7,330	
	1,77,915		Add: Additions during the year	1,040	
Less: Rent for Living accommodation	4,800	1,73,115		8,370	
			Less: Depreciation	447	7,923
Sundry Creditors	38,000				
Less: Mutual Indenters	5,100	32,900	Stock in hand		50,000
			Stock on Hire Purchase	8,000	
Bills Payable		3,700	Less: Stock Reserve	2,000	6,000
			Sundry Debtors	84,000	
			Less: Debtars on H.P.	8,000	
				76,000	
			Add: value of dishonour cheque	2,200	
				78,200	
			Less: Bad debts	800	
				77,400	
			Less: Mutual indebtedness	5,100	
				72,300	
			Less: Prev. for Bad debts	4,000	68,300
			Bills receivable		4,900
			Advance to sales Manager		400
			Prepaid Insurance		260
			Cash in hand		4,250
			Cash at bank	17,394	
			Less: value of dishonor cheque	2,200	15,194
		2,09,715			**2,09,715**

Workings:

1. **Closing Stock**

Since Closing Stock has appeared in Trial Balance, it means adjustment entry (Closing Stock A/c Dr. and Purchase A/c Cr.) had already passed. As such, Closing Stock will simply appear in the assets side of the Balance Sheet.

2. **Loss Exchange of Furniture and Depreciation on Furniture**

Particulars	₹
Book Value on 01.04.2012	1,200
Less: Dep. For 6 months (01.04.2012 to 30.09.2012) @ 5% (₹1,200 x $\frac{5}{100} \times \frac{6}{12}$)	30
W.D.V. on 30.09.2012	1,170
Less: Exchange for	580
∴Loss on exchange	590

Depreciation on Furniture

Particulars	₹
Old Furniture (₹8,500 – ₹1,200) ₹7,300 x 5% =	365
On Furniture Exchange =	30
On New Furniture for 6 months = ₹1,040 x $\frac{5}{100} \times \frac{6}{12}$	52
	447

3. **Hire – Purchase Transactions**

H.P. Sales amount to ₹ 20,000 (included in sales) which has already been arrived at after adding $33\frac{1}{3}$% on cost.

It will be 25% on ₹ 20,000 = ₹ 5,000.

Profit on H.P. Sales

Since 40% of the investment is not yet matured, so 60% of the same may be treated as profit on H. P. Sale, i.e., ₹ 5,000 x 60% = ₹ 3,000.

Stock Reserve

Particulars	₹
H.P. Stock 40% of ₹ 20,000 =	8,000
Less: Stock on Reserve @ 25% on ₹8,000	2,000
H.P. Stock at Cost	6,000

4. **Suspense Account**

The details of Suspense Account is shown below :

Suspense Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	3,000	By Travelling Exp. By Legel Exp. By Mis. Exp. By Balance c/d (Left as Cash)	1,200 500 900 400
	3,000		3,000

So, Travelling Expenses, Legal Expenses, and Misc. Expenses will appear in the debit side of P & L A/c, balance ₹ 400 will appear in the assets side of the Balance Sheet as Advance to Sales Manager.

5. **Depreciation Overcharged**

Depreciation @ 10% for 3 years under Straight Line Method is 30%. So, the balance left 70%, which is equal to ₹ 56,000. So original Cost was ₹ 80,000 (i.e.,₹ 5,600 x $\frac{100}{70}$). Thus, depreciation @ 10% on ₹80,000; i.e., ₹ 8,000 for 3 years = ₹ 24,000 has already been charged. So, depreciations under Straight Line Method = ₹24,000

Depreciation under Reducing Balance Method

Particulars	₹	₹
Cost Price	80,000	
Less: Depreciation	8,000	8,000
WDV	72,000	
Less : Depreciation	7,200	7,200
WDV	64,800	
Les: Depreciation	6,480	6,480
	58,320	21,680

∴ Depreciation overcharged = (24,000 – 21,680)
= ₹ 2,320

The entry is:

Particulars	₹	₹
Fixed Assets A/c Dr.	2,320	
To Profit and Loss A/c		2,320

6. **Rent Paid**

Since 50% of the accommodation is used by the proprietor, the entry will be:

Particulars	₹	₹
Rent A/c Dr.	4,800	
Drawings A/c Dr.	4,800	
To cash A/c		9,600

7. **Mutual Indebtedness**

Since Ramkumar is the debtor as well as the creditor, the lower amount will be set off both from Sundry Debtors and Sundry Creditors i.e., is 5,100

5.3 BAD DEBTS

5.3.1 Debts : The amount which is receivable from a person or a concern for supplying goods or services is called Debt.

Debts may be classified into :

(i) Bad debts;

(ii) Doubtful debts and

(iii) Good debts

(i) Bad Debts : Bad debts are uncollectable or irrecoverable debt or debts which are impossible to collect is called Bad Debts. If it is definitely known that amount recoverable from a customer can not be realized at all, it should be treated as a business loss and should be adjusted against profit. In short, the amount of bad debt should be transferred to Profit and Loss Account for the current year to confirm the principles of matching.

Accounting Steps :

(a) **When goods are sold on credit**

Debtors A/c Dr.

To Sales A/c

(b) **When cash is realised from debtors**

Cash A/c Dr.

To Debtors A/c

(c) **For actual amount of bad debts (if there is no provision)**

Bad Debt A/c. Dr.

To Sundry Debtors A/c.

(d) **For transferring Bad debts**

Profit and Loss A/c. Dr.

To Bad Debts A/c.

Illustration 27.

On 1.4.2012, P sold goods to Z for ₹ 4,000; On 15.4.2012 Z paid ₹ 3,000 to P. On 8.8.2012 Z became insolvent and nothing was realized from his estate. Show the journal entries, ledger accounts, Profit and Loss Account and the Balance Sheet.

Solution:

In the Books of P

Journal

Date	Particulars	L.F	Debit (₹)	Credit (₹)
1.4.2012	Z A/c Dr. To, Sales A/c (Being goods sold on credit to Z)		4,000	 4,000
15.4.2012	Cash A/c Dr. To, Z A/c (Being cash realized from Z)		3,000	 3,000
8.8.2012	Bad Debts A/c Dr. To, Z A/c (Being amount due from Z was proved bad)		1,000	 1,000

Dr. **Z Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2012 Apr. 1	To, Sales A/c	4,000	2012 Apr 15 Aug 8	By, Cash A/c "Bad Debt A/c	3,000 1,000
		4,000			**4,000**

Dr. **Sales Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 Mar. 31	To, Balance c/d	4,000	2012 Apr. 1	By, Z A/c	4,000
		4,000			**4,000**

Dr. **Bad Debts Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2012 Aug. 8	To, Z A/c	1,000	2013 Mar. 31	By, Profit and Loss A/c	1,000
		1,000			**1,000**

Profit and Loss Account (Extract)
For the year ended 31st March, 2013

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Bad Debts A/c	1,000		

Balance Sheet (Extract)

As at 31st March, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
			Debtors Less : Bad debts	1,000 1,000	nil

(ii) **Doubtful Debts :** The debts which will be receivable or cannot be ascertainable at the date of preparing the final accounts (i.e., the debts which are doubtful to realise) is known as doubtful debts. Practically it cannot be treated as a loss on that particular date, as such, it cannot be written off. But, it should be charged against Profit and Loss Account on the basis of past experience of the firm.

(iii) **Good Debts** : The debts which are not bad i.e., there is neither any possibility of bad debts nor any doubts about its realization, is called good debts. As such, no provision is necessary for it.

5.3.2 Provisions for Bad (and Doubtful) Debts

It has already been stated above that for any unknown/ known part of doubtful debts provisions must be made against Profit and Loss Account on the basis of past experience. This is known as Provision for Bad Debts; Reserve for Bad Debts or Provision for Bad and Doubtful Debts. It must be noted that Provision should be calculated on the basis of certain percentage on total doubtful debts(after adjusting bad debts , if any). It is nothing but a loss of the current year which actually written off in the next year. This is done on the reason that the amount of loss is impossible to ascertain until it is proved bad. That is why, it is charged against Profit and Loss Account in the form of Provision.

There are two methods to record the transactions relating to Bad Debts and Provision for Bad Debts.

Accounting Steps

First Method

The 1st year

(a) For Bad Debts

Bad Debts A/c Dr.

To Sundry Debtors A/c

(b) For managing provision for Bad Debts

Profit and Loss A/c Dr.

To Provision for Bad Debts A/c

(c) For Transferring Bad Debts

Profit and Loss A/c Dr.

To Bad Debts A/c

The Second/ subsequent year

(a) (i) For Bad Debts

Bad Debts A/c Dr.

To Sundry Debtors A/c

(ii) Profit and Loss A/c Dr.

To Bad Debts A/c

(b) For provision of Bad Debts

(i) If closing provision is more than the opening provision-

Profit and Loss A/c Dr.

To Provision for Bad debts A/c

(ii) If Closing Balance is less than opening provision -

Provision for Bad Debts A/c Dr.

To Profit and Loss A/c

Second Method

The 1st year

(a) (i) For Bad Debts

Bad Debts A/c Dr.

To Sundry Debtors A/c

(ii) Profit and Loss A/c Dr.

To Bad Debts A/c

(b) For provision for Bad Debts

Profit and Loss A/c Dr.

To Provision for Bad Debts A/c

The Second/subsequent year

(a) For Bad Debts

Provision for Bad Debts A/c Dr.

To Sundry Debtors A/c

(b) For provision of Bad Debts

(i) If new provision is more than the old provision-

Profit and Loss A/c Dr

To Provision for Bad debts A/c

(ii) If new provision is less than old provision -

Provision for Bad Debts A/c Dr.

To Profit and Loss A/c

Illustration 28:

Prepare Bad Debts Accounts, Provision for Bad Debts Accounts under each of the above methods from the following information and also the Profit and Loss Account and Balance sheet:-

01.01.2012	Provision for Bad Debts	₹ 5,000
31.12.2012	Bad Debts written off	₹ 3,000
	Sundry Debtors	₹ 1,25,000
31.12.2013	Bad Debts written off	₹ 2,500
	Sundry Debtors	₹ 1,00,000

Provision for Doubtful debts to be provided for @ 5% for 2012 and 2.5% for 2013.

Solution: First Method

In the Books of ....

Dr. Bad Debts Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.12.2012	To, Sundry Debtors A/c	3,000	31.12.2012	By, Profit and Loss A/c	3,000
		3,000			3,000
31.12.2013	To, Sundry Debtors A/c	2,500	31.12.2013	By, Profit and Loss A/c	2,500
		2,500			2,500

Dr. Provision for Bad Debts Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.12.2012	To, Balance c/d (5% on ₹1,25,000)	6,250	01.01.2012 31.12.2012	By, Balance b/d "Profit and Loss A/c (Bal Trf)	5,000 1,250
		6,250			6,250
31.12.2013	To, Profit and Loss A/c "Balance c/d (2.5% on 1,00,000)	3,750 2,500	01.01.2013	By, Balance b/d	6,250
		6,250			6,250

Dr. Profit and Loss Account (Extract) for the year ended 31st Dec, 2012 Cr.

Particulars		(₹)	Particulars	(₹)
To Bad Debts A/c		3,000		
" Provision for Bad Debts	6,250			
Less: Existing Provision	5,000	1,250		

Dr. Profit and Loss Account (Extract) for the year ended 31st Dec., 2013 Cr.

Particulars	(₹)	Particulars	(₹)
To Bad Debts A/c	2,500	By, Provision for Bad Debts 6,250 Less: Existing Provision 2,500	2,750

Balance Sheet (Extract) as at 31st December, 2012

Liabilities	(₹)	(₹)	Assets	(₹)	(₹)
			Debtors Less : Bad debts	1,25,000 6,250	1,18,750

Balance Sheet (Extract) as at 31st December, 2013

Liabilities	(₹)	(₹)	Assets	(₹)	(₹)
			Debtors Less : Bad debts	1,00,000 2,500	97,500

Second Method

Dr. **Bad Debts Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2012 Dec. 31	To, Sundry Debtors A/c	3,000	2012 Dec. 31	By, Provision for Bad Debts A/c - Transfer	3,000
		3,000			3,000
2013 Dec. 31	To, Sundry Debtors A/c	2,500	2013 Dec. 31	By, Provision for Bad Debts A/c - Transfer	2,500
		2,500			2,500

Dr. **Provision for Bad Debts Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2012 Dec. 31	To, Bad Debts A/c "Balance c/d (5% on ₹1,25,000)	3,000 6,250	2012 Jan. 1 2012 Dec. 31	By, Balance b/d "Profit and Loss A/c (Bal fig)	5,000 4,250
		9,250			9,250
2013 Dec. 31	To, Bad debts A/c "Profit and Loss A/c "Balance c/d (2.5% on 1,00,000)	2,500 1,250 2,500	2013 Jan.1	By, Balance b/d	6,250
		6,250			6,250

Profit and Loss Account (Extract)

Dr. **For the year ended 31st December, 2012** **Cr.**

Particulars		(₹)	Particulars	(₹)
To Bad Debts		3,000		
To Provision for Bad Debts:				
— New	6,250			
Less: Old	5,000	1,250		
		4,250		

Profit and Loss Account (Extract)

Dr. **For the year ended 31st Dec, 2013** **Cr.**

Particulars	(₹)	Particulars		(₹)
To Bad Debts A/c.	2,500	By, Provision for Bad Debts	6,250	
		Less: Provision required	2,500	3,750

The Balance Sheet under this method will be similar to the First Method stated above.

Illustration 29:

On 01.01.2013 the balance of Provision for doubtful debts was ₹ 5,000. The Bad Debts during the year were ₹ 900. The Sundry Debtors as on 31.12.2013 stood at ₹ 40,400 out of these debtors of ₹ 400 are bad and cannot be realized. The Provision for Doubtful Debts is to be raised to 5% on Sundry Debtors. Show the necessary ledger accounts and the balance sheet.

Solution:

In the Books of ....

Dr. Bad Debts Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 Dec 31	To, Balance b/d	900	2013 Dec 31	By, Provision for Bad debts A/c	1,300
"	To, Sundry Debtors A/c	400			
		1,300			1,300

Dr. Provision for Bad Debts Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 Dec 31	To, Bad Debts A/c	1,300	2013 Jan 1	By, Balance b/d	5,000
"	To, Profit and Loss A/c	1,700			
"	To, Balance c/d [5% on (40,400-400)]	2,000			
		5,000			5,000

Dr. Sundry Debtors Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 Dec 31	To, Balance b/d	40,400	2013 Dec 31	By, Bad debts A/c	400
			"	By Balance c/d	40,000
		40,400			40,400

Profit and Loss Account (Extract)

Dr. For the year ended 31st Dec, 2013 Cr.

Particulars	(₹)	Particulars	(₹)
To Bad Debts A/c. 900 Add: Further Bad Debts 400	1,300	By, Provision for Bad Debts A/c Existing Provision 5,000 Less: New Provision 2,000	3,000

Balance Sheet (Extract)

As at 31st December, 2013

Liabilities	(₹)	(₹)	Assets	(₹)	(₹)
			Debtors Less : Bad debts	40,400 400 40,000	
			Less: Provision for Bad debts	2,000	38,000

Illustration 30.

It was decided to make a specific provisions in the accounts for the year ended 31.03.13 for the following doubtful debts after examining the sales ledger of the firm:

A ₹ 1,900; B ₹ 300 ; C ₹ 2,680 and D ₹ 1,380.

It was decided to make also a general provision of 5% on the other debtors who were on 31st March 2012 amounted to ₹ 2,16,000.

No other transaction relating to the debtors were made but successors of A and D sent final dividend of ₹ 600 and ₹ 840 respectively and C paid his debt in full.

On 31.03.2013, it was decided to maintain the provision against B's debt and make further provision for the following debts considered doubtful:

E ₹ 1,300; F ₹ 680 and G ₹ 1,020.

The other debtors amounted to ₹ 2,60,000 and it was required to make the general provisions for doubtful debts equal to 5% of these debts. Show Bad Debts Account and Provision for Bad Debts Account.

Solution:

In the Books of ....

Dr. Bad Debts Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 Mar, 31	To, Sundry Debtors A/c (W.N. 1)	1,840	2013 Mar 31	By, Provision for Bad debts A/c	1,840
		1,840			1,840

Dr. Provision for Bad Debts Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 Mar, 31	To, Bad Debts A/c	1,840	2012 April 1	By, Balance b/d (W.N. 2)	17,060
			2013 Mar, 31	,,Profit and Loss A/c (further provision required)	1,080
Mar, 31	To, Balance c/d (W.N. 3)	16,300			
		18,140			18,140

Workings:

1. Bad Debts

	₹
A: ₹(1,900 – 600)	1,300
D: ₹ (1,380- 840)	540
	1,840

2. Opening Balance of provision for Bad debts

	₹
A:	1,900
B:	300
C:	2,680
D:	1,380
General provision (5% of ₹ 2,16,000)	10,800
	17,060

3. Closing Balance of provision for Bad debts

	₹
B:	300
E:	1,300
F:	680
G:	1,020
General provision (5% of ₹ 2,60,000)	13,000
	16,300

5.3.3 Provision for Discount On Debtors:

We know that Cash discount is allowed by the suppliers to customer for prompt settlement of cash. Naturally a provision is created for this purpose. Thus, the provision which is created on Sundry Debtors for allowing discount on receipt of Cash in that accounting period is called Provision for Discount on Debtors. It is needless to say that if the customer pays their debts before the due dates, they may claim discounts and that is why discount is allowed to debtors for prompt settlement is an usual way. Where goods are sold on credit, debtors accounts are debited but the amount may not be realized in this same accounting periods. Naturally, a possible aims to allow discount whether cash is received. The same will happen in the next accounting period. Due to this reason a provision for discount on debtors is made on the basis of past experience at an estimate rate on Sundry Debtors. Care should be taken while calculating discount. Discount should be calculated at a specified rate on of debtors (i.e. after discounting bad debts and provision for bad debts)

Accounting Steps

For the First year

(a) (i) For Discount Allowed-

Discount Allowed A/c Dr.

To, Sundry Debtors A/c

(ii) When Discount Allowed is transferred

Discount Allowed A/c Dr.

To, Sundry Debtors A/c

(b) For Provision for Discount on Debtors –

Profit & Loss A/c Dr.

To, Provision for Disc on Debtors A/c

For the Second/ Subsequent year

(a) (i) For Discount Allowed-

Discount Allowed A/c Dr.

To, Sundry Debtor A/c

(ii) For Provision for Discount on Debtors –

Provision for Discount on Debtor A/c Dr.

To, Discount Allowed A/c

(b) Next year provision is estimated-

(i) If new provision is more than old one-

Profit and Loss A/c Dr.

To, Provision for Discount on Debtor A/c

(ii) If new provision is less than old one-

Provision for Discount on Debtor A/c Dr.

To, Profit and Loss A/c

Illustration 31:

On 01.04.2012, M/s Singh Bros. had a provision for bad debts of ₹ 6,500 against their book debts. During 2012-13, ₹ 4,200 proved irrecoverable and it was desired to maintain the provision for bad debts @4% on debtors which stood at ₹ 1,95,000 before writing off Bad Debts. They also decided to maintain a provision for discount on debtors @2%. Show Provision for Bad Debt Account and Provision for Discount on Debtors Account as would appear in the books of the firm in 2012-13.

Solution:

In the books of …………….

Dr. Provision for Bad Debt Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31-3-2013	To, Bad Debts A/c	4,200	1-4-2012	By, Balance b/d	6,500
31-3-2013	" Balance c/d (4% on ₹1,95,000-₹4,200 or ₹1,90,800)	7,632	31-3-2013	" Profit & Loss A/c -further provision required	5,332
		11,832			11,832

Dr. Provision for Discount on Debtors Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31-3-2013	To, Balance c/d [2% on (₹1,95,000-₹4,200 - ₹ 7,632)]	3,663	1-4-2012	By, Balance b/d	—
			31-3-2013	" Profit & Loss A/c -further provision required	3,663
		3,663			3,663

Illustration 32.

A company maintains its reserve for bad debts @ 5% and a reserve for discount on debtors @ 2%.

You are given the following details :

	2012 (₹)	2013 (₹)
Bad debts	800	1,500
Discount allowed	1,200	500

Sundry debtors (before providing all bad debts and discounts) amounted to ₹ 60,000 on 31.12.2012 and ₹ 42,000 on 31.12.2013.

On 1.1.2012, Reserve for bad debts and Reserve of discount on debtors had balance of ₹ 4,550 and ₹ 800 respectively.

Show Reserve for Bad Debts and Reserve for Discount on Debtors Account.

Solution.

In the books of …………..

Dr. Reserve for Bad Debts Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31-12-2012	To, Bad Debts A/c.	800	1-1-2012	By, Balance b/d	4,550
31-12-2012	To, Profit and Loss A/c. (provision found excess)	850			
31-12-2012	To, Balance c/d (5% on ₹ 58,000)	2,900			
		4,550			4,550
31-12-2013	To, Bad Debt A/c.	1,500	1-1-2013	By, Balance b/d	2,900
	To, Balance c/d (5% on ₹ 40,000)	2,000	31-12-2013	By, Profit and Loss A/c. (for the provision required)	600
		3,500			3,500

Dr. Reserve for Discount on Debtors Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31-12-2012	To, Discount Allowed A/c.	1,200	1-1-2012	By, Balance b/d	800
31-12-2012	To Balance c/d (2% on ₹ 58,000-₹ 2,900)	1,102	31-12-2013	" Profit & Loss A/c -further provision required	1,502
		2,302			2,302
31-12-2013	To, Discount Allowed A/c.	500	1-1-2013	By, Balance b/d	1,102
31-12-2013	To Balance c/d (2% on ₹ 40,000-₹ 2,000)	760	31-12-2013	" Profit & Loss A/c -further provision required	158
		1,260			1,260

5.3.4 Provision for Discount on Creditors

We also know that cash discount is received by the customer which is allowed by the creditors for prompt settlement of debts. So, a provision should be created for the purpose. Thus, the provision which is created on Sundry Creditors for securing discount for payment of cash in the next accounting period is called Provisions for Discount on Creditors. When goods on purchased on credit creditors accounts are debited and discount received account is credited. But the amount may not be paid in full in the same accounting period. Thus, a question arises to receive discount when cash is paid. The same will happen in the next accounting period. As much, a provision is to be made for discount on creditors on the basis of past experience at an estimated rate on sundry creditors.

Accounting Steps

In the first year

(a) (i) For Discount Received -

Sundry Creditors A/c. ……… Dr.

To Discount Received A/c.

(ii) When transferred

Discount Received A/c. Dr.

To Profit & Loss A/c.

(b) When Provision is made for Discount

Provisions for Discount on Creditors A/c. Dr.

To Profit and Loss A/c.

In the second/subsequent years

(a) For Discount Received

(i) Sundry Creditors A/c. Dr.

To Discount Received A/c.

(ii) Discount for Transfer

Discount Received A/c. Dr.

To Provision for discount on Creditors A/c.

Next Provision is estimated

(i) If new provision is more than old provision,

Provision for Discount on Creditor A/c Dr.

To Profit and Loss A/c.

(ii) If new provision is less than old one

Profit and Loss A/c. Dr.

To Provision for Discount on Creditors A/c.

Illustrations 33:

Prepare necessary ledger accounts from the following:

Provisions for Discount on Creditors as on 1.1.2012 ₹ 4,000

Discount Received during the year 2012 ₹ 2,000

Sundry Creditors as on 31.12.2012 ₹ 1,20,000

Discount Received during 2013 ₹ 500

Sundry Creditors as on 31.12.2013 ₹ 40,000

Provision to be made for discount on creditors @ 5%

Show also the Profit and Loss Account and Balance Sheet.

Solution:

In the books of ....

Dr. Discount Received Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.12.2012	To, Provision for discount on creditors A/c. (Transfer)	2,000	31.12.2012	By, Sundry Creditors A/c.	2,000
		2,000			2,000
31.12.2013	To Provision for discount on creditors A/c.	500	31.12.2013	By, Sundry Creditors A/c.	500
		500			500

Dr. **Provision for Discount on Creditors Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
1-1-2012	To Balance b/d	4,000	31-1-2012	By, Discount Received A/c	2,000
31-1-2012	" Profit & Loss A/c (Further provision required)	4,000	31-1-2012	" Balance c/d (5% on ₹ 1,20,000)	6,000
		8,000			8,000
1-1-2013	To Balance b/d	6,000	31-12-2013	By, Discount Received A/c	500
			31-12-2013	" Profit & Loss A/c (Provision formed in excess)	3,500
			31-12-2013	" Balance c/d (5% on ₹ 40,000)	2,000
		6,000			6,000

Profit & Loss Account (Extract)

Dr. **For the year ended 31st December 2012** **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
			By Discount Received		2,000
			" Provision for Discount on Creditors:		
			Provision Required	6,000	
			Less: Existing Provision	4,000	2,000

Profit & Loss Account (Extract)

Dr. **For the year ended 31st December 2013** **Cr.**

Particulars	Amt. (₹)	Amt. (₹)	Particulars	Amt. (₹)
To, Provision for Discount on Creditors A/c	6,000		By, Discount Received A/c	500
Existing Provision	2,000			
Less: Provision required		4,000		

Balance Sheet (Extract)

As at 31.12.2012

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)
Sundry Creditors	1,20,000			
Less: Provision for Discount on Creditors	6,000	1,14,000		

Balance Sheet (Extract)

As at 31.12.2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)
Sundry Creditors	40,000			
Less: Provision for Discount on Creditors	2,000			
		38,000		

5.3.5 Recovery of Bad Debts

We know that bad debt is a loss and as much, transferred to current year's Profit and Loss Account. Now, if the amount of bad dent is received in any succeeding year the same will be credited to Profit and Loss of that year as an income that is, recovery of bad debt is as income i.e., clear profit.

Accounting Steps

(a) When bad debts are recovered

Cash/Bank A/c. Dr.
To Bad Debts Recovery A/c.

(b) When the same is transferred

Bad Debts Recovery A/c. Dr.
To Profit & Loss A/c.

Illustration 34:

On 31.12.2012, Sundry Debtors and Provision for Bad Debts are ₹ 50,000 and ₹ 5,000 respectively. During the year 2013, ₹ 3,000 are bad and written off on 30.9.2013, an amount of ₹ 400 was received on account of a debt which was written off as bad last year on 31.12.2013, the debtors left was verified and it was found that sundry debtors stood in the books were ₹ 40,000 out of which a customer Mr. X who owed ₹ 800 was to be written off as bad.

Prepare Bad Debt A/c. Provision for bad A/c. assuming that some percentage should be maintained for provision for bad debt as it was on 31.12.2012.

Show also how the illustration appear in Profit & Loss A/c. and Balance Sheet.

Solution:

In the books of ....

Dr. Bad Debt Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 Sept. 30	To, Sundry Debtors A/c	3,000	2013 Dec. 31	By, Provision for Bad Debt A/c	3,800
Dec. 31	To, X A/c.	800			
		3,800			3,800

Dr. Provision for Bad Debt Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 Dec. 31	To, Bad Debt A/c " Balance c/d	3,800 3,920	2013 Dec. 31	By, Balance b/d	5,000
	[10% on ₹ 39,200 (₹ 40,000 - ₹ 800)]			" Profit & Loss A/c -for the provision required	2,720
		7,720			7,720

Workings : Calculation of '%' of Provision for bad debts —

(5,000/50,000 × 100) = 10%

Profit & Loss Account (Extract)

Dr. For the year ended 31.12.2012 Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Bad Debts		3,400	By Bad Debts Recovery A/c		400
			" Provision for Bad Debts:		
			Existing	5,000	
			Less: Provision Required	3,920	1,080

Balance Sheet (Extract)
As at 31.12.2013

Liabilities	Amount (₹)	Assets	Amount (₹)	Amount (₹)
		Sundry Debtors	40,000	
		Less: Bad Debts	800	
			39,200	
		Less: Provision for Bad Debts	3,920	35,280

Illustration 35:

A & Company limited maintains provision for bad debts at 5% & provision for discount at 2.5%. The company also maintains a reserve for discount on creditors at 2%.

From the following particulars write up bad debt account, provision for bad debt account, provision for discount on debtors account, and provision for discount on creditors account.

Balance on 1.1.2012:

Provision for bad debts ₹ 10,000

Provision for Discount on Debtors ₹ 5,000

Provision for Discount on Creditors ₹ 4,000

Total Debtors as on 31.12.2012 were ₹ 2,40,000 after writing of bad debts ₹ 6,000 & allowing discount ₹ 2,000.

On 31.12.2013 total debtors were ₹ 2,00,000 after writing of bad debt ₹ 1,000 in allowing discount ₹ 500.

Total creditors as on 31.12.2012 & 31.12.2013 were ₹ 1,00,000 & 1,50,000 respectively.

Discount received during each of the years amounted to ₹ 500 & 3,000 respectively.

Solution:

In the Books of A & Co. Ltd.

Dr. **Bad Debts Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2012 Dec, 31	To, Sundry Debtors A/c	6,000	2012 Dec, 31	By, Provision for Bad Debts A/c -Transfer	6,000
		6,000			6,000
2013 Dec, 31	To, Sundry Debtors A/c	1,000	2013 Dec, 31	By, Provision for Bad Debts A/c -Transfer	1,000
		1,000			1,000

Dr. **Provision for Bad Debts Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.12.2012	To, Bad Debts A/c.	6,000	01.01.2012	By, Balance b/d	10,000
	" Balance c/d (5% on ₹ 2,40,000)	12,000		" Profit & Loss A/c.	8,000
		18,000			18,000
			01.01.2013	By, Balance b/d	12,000
31.12.2013	To, Bad Debts A/c.	1,000			
	" Profit & Loss A/c. --Provision formed in excess (balancing figure)	1,000			
	" Balance c/d (5% on ₹ 2,00,000)	10,000			
		12,000			12,000

Dr. **Provision for Discount on Debtors Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.12.2012	To, Discount allowed A/c.	2,000	01.01.2012	By, Balance b/d	5,000
	" Balance c/d (2.5% on ₹ 2,40,000 - ₹ 12,000)	5,700		" Profit & Loss A/c. Further provision required	2,700
		7,700			7,700
31.12.2013	To, Discount allowed A/c.	500	01.01.2013	By, Balance b/d	5,700
31.12.2012	" Profit & Loss A/c. - Provision formed in excess (balancing figure)	450			
31.12.2012	" Balance c/d (2.5% on ₹ 2,00,000 - ₹ 10,000)	4,750			
		5,700			5,700

Dr. **Provision for Discount on Creditors Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
1.1.2012	To Balance b/d	4,000	31.12.2012	By Discount Received A/c	500
			31.12.2012	By Profit & Loss A/c (bal. fig.)	1,500
			31.12.2012	By Balance c/d [1,00,000 × 2%]	2,000
		4,000			4,000
1.1.2013	To Balance b/d	2,000	31.12.2012	By Discount Received A/c	3,000
31.12.2013	To Profit & Loss A/c (bal. fig.)	4,000	31.12.2012	By Balance c/d [1,50,000 × 2%]	3,000
		6,000			6,000

5.4 PREPARATION OF FINANCIAL STATEMENTS OF A NON-TRADING CONCERN

Until now, we have seen accounting treatment for business transaction of business entities whose main objective is to earn profit. There are certain organisations that are not established for making profit but to provide some service. These services are generally given to members who make subscriptions to avail them. These are also called as non-trading entities. The examples of such organisations are:

Gymkhana / sports clubs; Educational institutions; Public hospitals; Libraries; Cultural clubs like Rotary or Lions club; Religious institutions; Charitable trusts

These organisations get their funds in the form of contributions by way of entrance fees, life membership fees, annual subscriptions, donations, grants, legacies etc. The accounting of such organisations is based on similar principles followed by the other organisations. Given the nature of these institutions, there are certain items of revenue and expenses that need special understanding so that accounting treatment could be correctly decided.

5.4.1 Special Items

There are certain items of revenue and expenses that are unique for the non-trading entities. They could be listed as:

Revenue items	Expenditure items
Donations	Upkeep of grounds
Entrance fees	Tournament expenses
Subscriptions	Prizes
Grants received	Events

Let us see what accounting treatment should be given to some of the special items:

(a) Entrance Fees – These are received at the time of admission of a new member and thus are one-time fees. They are non-recurring in nature. It could be either capitalized as they are non-recurring or taken as revenue as per the rules of the institution. There's a view that addition of member is an ongoing activity and thus every year the institute will get entrance fees. So it may be taken as a normal revenue receipt.

(b) Donations – They could be used for meeting capital or revenue expenses. If donations are received for a special purpose, the amount is credited to a fund from which the amounts are disbursed. The fund may be invested in specified securities. Income from such investments is credited to the fund A/c only. Small donation amounts which are not earmarked for any specific purpose may be treated as revenue receipts.

(c) Legacy – Many times trusts are formed in the memory of certain persons by their will. In such case after the demise of the person, the funds pass on to the institution. Such legacies are of course one-time and therefore should be taken to the capital fund.

(d) Endowments – Sometimes, donations are also in the form of endowments to be used as per instructions of the donor. These are to be treated as capital receipts.

(e) Life membership fees – These could be taken as capital receipts and every year a charge is debited based on some logic. In other words, when received, it could be treated as deferred receipt in the balance sheet and every year a specific amount is credited to I & E A/c.

(f) Subscriptions – These are annual receipts and therefore taken as revenue receipts. These must be recognised as revenue on the accrual concept.

5.4.2 Financial Statements

These non-profit organisations prepare:-

5.4.2.1 Receipt and Payment Account – This is similar to cash book. Entries are made on cash basis and items pertaining to previous year or current year or subsequent years are also recorded. Receipts are shown on debit side and payments are shown on credit side. Capital as well as revenue items are entered in the R & P A/c. This account is real account in nature. No provisions are recorded in this account. The account has an opening and a closing balance which is reflected as an asset in the balance sheet.

Features of Receipts and Payments Account

1. It is an Account which contains all Cash and Bank transactions made by a nonprofit organization during a particular financial period.
2. It starts with the opening balances of Cash and Bank. All Cash Receipts both capital & revenue during the period are debited to it.
3. All Cash Payments both capital & revenue during the period are credited to this Account. It ends with the closing Cash and Bank Balances.
4. While recording the Cash and Bank transactions all entries are made on Cash Basis.
5. It is a summary of Cash Book.
6. It follows Real Account.

5.4.2.2 Income and Expenditure Account – This is similar to the Profit and loss A/c and is prepared exactly based on same principles. As the name suggests only revenue items are recorded herein. Incomes are recorded on the credit side while the expenses on the debit side. Both incomes and expenses must be taken on the basis of accrual concept. This account should reflect only items that are pertaining to current period. Previous and subsequent year items are to be excluded. This account shows either a surplus or deficit. Excess of income over expenditure is called surplus and excess of expenditure over income is called as deficit.

Features of Income and Expenditure Account

1. It follows Nominal Account.
2. All expenses of revenue nature for the particular period are debited to this Account on accrual basis.
3. Similarly all revenue incomes related to the particular period are credited to this account on accrual basis.
4. All Capital incomes and Expenditures are excluded.
5. Only current year's incomes and expenses are recorded. Amounts related to other periods are deducted. Amounts outstanding for the current year are added.
6. Profit on Sale of Asset is credited. Loss on Sale of Asset is debited. Annual Depreciation on Assets is also debited.
7. If income is more than expenditure, it is called a Surplus, and is added with Capital or General Fund etc. in the Balance Sheet.
8. If expenditure is more than income, it is a deficit, and is deducted from Capital or General Fund etc. in the Balance Sheet.

5.4.2.3 Balance Sheet – It is prepared as on the last day of the accounting period. It also has assets and liabilities and prepared based on accounting equation. But, there's no capital account. Instead there is a capital fund. The surplus or deficit from Income & Expenditure A/c is adjusted against this capital fund at the end of the year.

5.4.2.4 Receipt and Payment Account

Receipts	Amount (₹)	Payments	Amount (₹)
Starts with opening balance			
All receipts - capital or revenue		All payments - Capital or revenue	
May be related to any period previous, current or subsequent.		May be related to any period previous, current or subsequent.	
		Ends with closing balance	

5.4.2.5 Income and Expenditure Account

Expenses	Amount (₹)	Income	Amount (₹)
Only revenue expenses		Only revenue receipts	
Only related to current period		Only related to current period	
Shows either surplus		Or shows deficit	

5.4.2.6 Difference between Receipts and Payments Account and Income and Expenditure Account

	Receipts & Payments Account	**Income & Expenditure Account**
1.	It is a summarised Cash Book	It closely resembles the Profit & Loss Account of a Trading concern.
2.	Receipts are debited and Payments are credited.	Incomes are credited and Expenditures are debited.
3.	Transactions are recorded on Cash basis.	Transactions are recorded on Accrual Basis
4.	Amounts related to previous period or future period may remain included. Outstanding amount for current year is excluded.	Transactions are recorded on accrual basis. All amounts not related to the current period are excluded. Outstanding amounts of current period are added.
5.	It records both Capital and Revenue transactions.	It records Revenue transactions only.
6.	It serves the purpose of a Real Account.	It serves the purpose of a Nominal Account.
7.	It starts with opening Cash and Bank Balances and ends with closing Cash and Bank Balances.	It does not record such balances,rather its final balance shows a surplus or a deficit for the period.
8.	It does not record notional loss or noncash expenses like bad debts, depreciations etc.	It considers all such expenses for matching against revenues
9.	Its closing balance is carried forward to the same account of the next accounting Period.	Its closing balance is transferred to Capital Fund or General Fund or Accumulated Fund in the same period's Balance Sheet.
10.	It helps to prepare an Income & Expenditure A/c.	It helps to prepare a Balance Sheet.

5.4.2.7 Difference between Profit and Loss Account and Income and Expenditure Account

	Profit and Loss Account	**Income & Expenditure Account**
1.	It is prepared by business undertaking.	It is prepared by non-trading organizations.
2.	The credit balance of Profit and Loss A/c is known as "net profit" and added to opening capital.	Credit balance of Income and Expenditure A/c is known as excess of income over expenditure or surplus and added to opening capital fund.
3.	The debit balance of this Profit and Loss A/c is known as "net loss" and deducted from opening capital.	Debit balance of this Income and Expenditure A/c is known as "excess of expenditure over income' or deficit and deducted from opening capital fund.
4.	To, check correctness of accounts trial balance is prepared before preparing this account.	To check correctness of accounts, receipts and payments account is prepared before preparing this account.

5.4.2.8 Fund Asset Accounting and its peculiarities:

Following are the concepts of some funds which are generally maintained by organizations:

(i) **Capital Fund :** It is also called "General Fund" or "Accumulated Fund." It is actually the Capital of a non-profit concern. It may be found out as the excess of assets over liabilities. Usually "Surplus" or "Deficit" during a period is added with or deducted from it. A portion of Capitalised incomes like donations may be added with it.

(ii) **Special Fund:** It may be created out of special donation or subscription or out of a portion of the "Surplus". For example a club may have a "Building Fund". It may be used for meeting some specific expenses or for acquiring an asset. If any income is derived out of investments made against this fund or if any profit or loss occurs due to sale of such investments, such income or profit or loss is transferred to this fund.

Other Treatments

(a) If the Special Fund is used to meet an expense

Special Fund A/c Dr.

To Bank A/c (amt. of expense)

The balance of the Fund is shown as a liability.

If the balance is transferred to Capital Fund, the entry will be—

Special Fund A/c Dr.

To Capital Fund A/c (Balance of Special Fund)

(b) If the Special Fund is used to purchase an asset

Asset A/c Dr.

To Bank A/c (Cost of the asset)

Special Fund A/c Dr.

To Capital Fund A/c (Special Fund closed)

(iii) Donations

(a) Donation received for a particular purpose should be credited to Special Fund. For example, Donation received for Building should be credited to Building Fund A/c.

(b) For other donations received the by-laws or rules of the concern should be followed.

(c) If there is no such rule, donations received of non-recurring nature should be credited to Capital Fund. Recurring donations received should be credited to Income & Expenditure Account.

(d) Donation paid by the concern should be debited to Income & Expenditure Account.

(iv) Legacy received : It is to be directly added with Capital Fund after deduction of tax,(if any). It is a kind of donation received according to the will made by a deceased person.

(v) Entrance Fees or Admission Fees

(a) The rules or by-laws of the concern should be followed.

(b) If there is no such rule, Admission or Entrance Fees paid once by members for acquiring membership should be added with Capital Fund.

(c) If such fees are of small amounts covering the expenses of admission only, the fees may be credited to Income & Expenditure Account.

(vi) Subscriptions

(a) Annual subscriptions are credited to Income & Expenditure Account on accrual basis.

(b) Life membership subscription is usually credited to a separate account shown as a liability.

Annual Subscription apportioned out of that is credited to Income & Expenditure Account and deducted from the liability. Thus the balance is carried forward till the contribution by a member is fully exhausted. If any member dies before hand, the balance of his life Membership contribution is transferred to Capital Fund or General Fund.

Illustration 36:

Ujjwal Vavishwa Club was holding a building valuing ₹ 10 lakhs as on 31.03.2012.

Building Fund stands ₹ 8 lakhs and Cash at Bank is ₹ 15 lakhs as on 01.04.2012.

During the year 2012-13 donation received for the building fund is ₹ 20 lakhs.

Give the journal entries and the effect in the Balance Sheet as on 31.03.2013

If (i) It purchases building of ₹ 15 lakhs during 2012-13

(ii) It purchases building of ₹ 30 lakhs during 2012-13

Solution:

Journal entries

(₹ in Lakhs)

Date	Particulars	L.F	Debit	Credit
	Bank A/c Dr. To, Donation for Building Fund A/c (Donation received for Building Fund)		20	 20
	Building A/c Dr. To, Bank A/c (Building purchased utilizing the Building Fund)		15	 15
	Building Fund A/c Dr. To, Capital Fund A/c (Being the capital expenditure transferred to the Capital Fund)		15	 15

Balance Sheet as on 31.03.2013 (Extracts) **(₹ Lakh)**

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital Fund			Building	10.00	
Add: Building	15.00		Add: Purchase of building	15.00	25.00
Fund (Amount Transferred)			Bank	15.00	
Building Fund	8.00		Add: Donation Received	20.00	
Add: Donation	20.00				
	28.00			35.00	
Less: Amount transferred to Capital Fund	15.00	13.00	Less: Purchase of Building	15.00	20.00

Journal entries

(₹ in Lakhs)

Date	Particulars	L.F	Debit	Credit
	Bank A/c Dr. To, Donation for Building Fund A/c (Donation received for Building Fund)		20	 20
	Building A/c Dr. To, Bank A/c (Building purchased utilizing the Building Fund)		30	 30
	Building Fund A/c Dr. To, Capital Fund A/c (Being the capital expenditure transferred to the Capital Fund)		28	 28

Balance Sheet as on 31.03.2013 (Extracts)

Liabilities	Amount (₹ Lakh)	Amount (₹ Lakh)	Assets	Amount (₹ Lakh)	Amount (₹ Lakh)
Capital Fund					
Add: Building	28.00		Building	10.00	
Fund (Amount Transferred)			Add: Purchase of building	30.00	40.00
Building Fund	8.00		Bank	15.00	
Add: Donation	20.00		Add: Donation Received	20.00	
	28.00			35.00	
			Less: Purchase of Building	30.00	5.00
Less: Amount transferred to Capital Fund	28.00	NIL			

Illustration 37:

On 31st December 2012, a club had subscription in arrears of ₹16,000 and in advance ₹4,000. During the year ended 31-12-2013, the club received subscription of ₹2,08,000 of which ₹10,400 was related to 2014. On 31st December 2012, there were 4 members who had not paid subscription for 2013 @ ₹1,600 per person. Write up subscription A/c for the year 2013.

Solution

A single subscription account should be prepared to reflect both advance and arrears figures. The balancing figure will reflect the subscription amount that will be recognised as Income and transferred to I & E A/c as shown below:

Dr. **Subscription Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Balance b/d (arrears)	16,000	By, Balance b/d (advance)	4,000
To, I & E A/c (income for 2013)	1,92,000	By, R & P A/c (received)	2,08,000
To, Balance c/d (advance)	10,400	By, Balance c/d (arrears)	6,400
	2,18,400		2,18,400

Illustration 38:

The sports club of Orissa had received in 2012-2013 ₹ 2,000 towards subscription. Subscription for 2011-12 unpaid on 1.4.2012 were ₹ 200.

Subscriptions paid in advance on 31.3.2012 were ₹ 50 and the same on 31.3.2013 was ₹ 40. Subscriptions for 2012-2013 unpaid on 31.3.2013 were ₹ 90.

Show how the subscriptions item will appear in the Income and Expenditure Account.

Solution:

Particulars	Amount (₹)
Subscriptions received during the year 2012-2013	2,000
Add : Subscription outstanding on 31.3.2013	90
	2,090
Less : Subscription outstanding on 1.4.2012	200
	1,890
Add : Subscription paid in advance on 31.3.2012	50
	1,940
Less : Subscription received in advance on 31.3.2013	40
Subscription Income for 2012-2013	1,900

Illustration 39:

The amount of Subscription appears in the Income and Expenditure Account of South Indian Club is ₹ 3,000.

Adjustments were made in respect of the following:

Subscription for 2012 unpaid at 1st Jan. 2013, ₹ 400; ₹ 200 of which was received in 2013.

Subscription paid in advance at 1.1.2013 ₹ 100.

Subscription paid in advance at 31.12.2013 ₹ 80.

Subscription for 2013 unpaid at 31.12.2013 ₹ 140.

Prepare Subscription Account.

Solution:

Dr. **Subscription Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Balance b/d	400	By, Balance b/d	100
To, Income & Expenditure A/c	3,000	By, Cash Received (bal fig)	3,040
To, Balance (paid in advance to 2013)	80	By, Balance c/d [200 + 140]	340
	3,480		3,480
To, Balance b/d:		By, Balance b/d (2013)	80
For 2012	200		
For 2013	140		

Note: Opeaning Outstanding Subscription = ₹ 400, ₹ 200 received in 2013.

Illustration 40:

From the following information, prepare the Subscription Account for the year ending on March, 31, 2013

(i) Subscription in arrears on 31.03.2012 ₹ 1,500

(ii) Subscription received in advance on 31.03.2012 ₹ 1,000

(iii) Amount of Subscription received during 2012-13 ₹ 40,000, which includes ₹500 for the year 2011-12, ₹ 1,500 for the year 2013-14.

(iv) Subscription outstanding ₹ 1,000.

Solution:

Dr. **Subscription Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Balance b/d	1,500	By, Balance b/d	1,000
To, Income & Expenditure A/c	39,500	By, Bank A/c	40,000
		By, Balance c/d	
		For 2011-12	500
To, Balance c/d		For 2012-13	1,000
For 2013-14	1,500		
	42,500		42,500

Illustration 41:

The accumulated balance of Life Membership fees at the beginning of the year 2012 was ₹6,40,000. This represents the balance of life membership fees paid by 20 members since the club started about 6 years ago. In the current year, 10 new life memberships were received totaling ₹ 4,00,000.

It's the policy of the club to spread these fees over 20 years to income. The amount payable per person is always ₹40,000.

What is the amount to be recognised as income for the current year and what amount will be deferred through the balance sheet?

Solution:

Income to be recognised for new members	
Life membership fees per person	₹40,000
Income to be spread over	20 years
Income to be recognised each year	₹2,000
Members added during the year	10
Income to be recognised (10*2000)	₹20,000
Amount to be carried forward	₹3,80,000
Income to be recognised for old members	
No. of members	20
Income to be recognised each year	₹2,000
Income to be recognised (20*2000)	₹40,000
Total income to be recognised (20,000+40,000)	₹60,000
Amount to be shown in the balance sheet	
Accumulated Balance	₹6,40,000
Add: New fees received	₹4,00,000
Less: Recognised as income	(₹60,000)
Balance to be carried forward	**₹9,80,000**

5.4.2.9 Restaurant Trading and Bar Trading

Some clubs have Restaurant and Bar facilities for members and outsiders. Under the circumstances, Restaurant Trading or Bar Trading Account is opened to ascertain the Restaurant or Bar profit, it is just like Trading Account which is opened in case of a trading concern. The Restaurant or Bar profit so ascertained from Restaurant Trading or Bar Trading is transferred to the Income and Expenditure Account as we generally transfer the Gross Profit from Trading Account to Profit and Loss Account in case of Trading concern. Hence, the method of preparing a Restaurant or Bar Trading Account is just like the method of preparing a Trading Account.

Illustration 42:

The following summary of the Cash Book has been prepared by the treasurer of a club:

Receipts	Amount (₹)	Payments	Amount (₹)
To Balance b/d	4,740	By Wages – outdoor staff	13,380
" Subscriptions	29,720	" Restaurant Purchase	50,400
" Entrance Fees	3,200	" Rent – 18 months' to July 30, 2013	7,500
" Restaurant Receipts	56,800	" Rates	2,700
" Games & Competition Receipts	13,640	" Secretary's Salary	3,120
" Due to Secretary for Petty Expenses	80	" Lighting	7,200
		" Competition Prizes	4,000
		" Printing & Postage etc.	6,000
		" Placed in Fixed Deposit	8,000
		" Balance c/d	5,880
	1,08,180		**1,08,180**

On April 1, 2012 the club's assets were:- Furniture ₹ 48,000, Restaurant stock ₹ 2,600; Stock of prizes ₹ 800; ₹ 5,200 was owing for supplies to the restaurant.

On March, 31, 2013, the Restaurant stocks were ₹ 3,000 and prizes in hand were ₹ 500, while the club owed ₹ 5,600 for restaurant supplies.

It was also found that subscriptions unpaid at March 31, 2013, amounted to ₹ 1,000 and that the figure of ₹ 29,720 shown in the Cash Book included ₹ 700 in respect of previous year and ₹ 400 paid in advance for the following year.

Prepare an account showing the Profit or Loss made on the Restaurant and a General Income and Expenditure Account for the year ended 31.3.2013, together with a Balance Sheet as at that date, after writing 10% off the Furniture.

Solution:

Restaurant Trading Account

For the year ended 31st March, 2013

Dr. **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening Stock A/c		2,600	By Restaurant Receipts A/c		56,800
" Purchases A/c	50,400		" Closing Stock A/c		3,000
" Add: Outstanding for 31.3.13	5,600				
	56,000				
Less: Outstanding for 01.04.12	5,200				
		50,800			
" Income & Expenditure A/c (G.P. transferred)		6,400			
		59,800			**59,800**

Balance Sheet

as at 1st April, 2012

Liabilities	Amount (₹)	Assets	Amount (₹)
Accumulated Fund: (bal. fig.)	50,390	Furniture and Equipment	48,000
Owing for supplies to Restaurant	5,200	Restaurant Stock	2,600
Outstanding Rent (Jan. to March 2012)	1,250	Stock of Prize	800
		Outstanding Subscriptions	700
		Cash and Bank	4,740
	56,840		**56,840**

Income and Expenditure Account

For the year ended 31st March, 2013

Dr. Expenditure	Amount (₹)	Amount (₹)	Income	Amount (₹)	Cr. Amount (₹)
To Wages		13,380	By Subscription : Subscription already received	29,720	
`` Rent	7,500		Less: Outstanding for 1.4.12	700	
`` Less: Outstanding on 1.4.2012	1,250			29,020	
	6,250		Add: Outstanding for 2013	1,000	
`` Less: Prepaid for 3 months				30,020	
(7,500 x 3/18)	1,250	5,000			
`` Rates		2,700	Less: Received in advance	400	29,620
``Secretary's Salary		3,120	`` Games Competition Receipts		13,640
`` Lighting, Cleaning, Services		7,200	`` Restaurant Trading – Gross Profit		6,400
`` Competition Prize	4,000				
`` Add: Opening Stock	800				
	4,800				
`` Less: Closing Stock	500	4,300			
`` Printing, Postage and Sundries		6,000			
`` Dep. on Furniture and Equipment @ 10%		4,800			
`` Surplus – Excess of income over expenditure		3,160			
		49,660			**49,660**

Balance Sheet as at 31st March, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Accumulated Fund:			Furniture and Equipment	48,000	
Balance on 1.4.2012	50,390		Less: Depreciation	4,800	43,200
Add: Surplus	3,160	53,550	Restaurant Stock		3,000
Entrance fees		3,200	Stock of Prize		500
Subscription received in advance		400	Outstanding Subscriptions		1,000
Owing for supplies to Restaurant		5,600	Prepaid Rent		1,250
Outstanding Petty Expenses		80	Fixed Deposit with Bank		8,000
			Cash and Bank		5,880
		62,830			62,830

Illustration 43:

'Citizen Club' was registered in a city and the accountant prepared the following Receipts and Payments Account for the year ended Dec. 31, 2013 and showed a deficit of ₹ 14,520 :

		(₹)	(₹)
Receipts :	Subscriptions	62,130	
	Fair Receipts	7,200	
	Variety Show Receipts (net)	12,810	
	Interest	690	
	Bar Collection	22,350	
	Cash spent more	1,000	1,06,180

Payments :			
	Premises	30,000	
	Honorarium to Secretary	12,000	
	Rent	2,400	
	Rates and Taxes	3,780	
	Printing and Stationery	1,410	
	Sundry Expenses	5,350	
	Wages	2,520	
	Fair Expenses	7,170	
	Bar Purchase- payments	17,310	
	Repairs	960	
	New Car (less proceeds of old car ₹ 9,000)	37,800	
			1,20,700
		Deficit	14,520

The additional information should be obtained:

	1.1.2013	31.12.2013
	(₹)	(₹)
Cash in hand	450	–
Bank balance as per Pass Book	24,690	10,440
Cheques issued not presented for Sundry Expenses	270	90
Subscriptions due	3,600	2,940
Premises at Cost	87,000	1,17,000
Accumulated dep. on Premises	56,400	–
Car at Cost	36,570	46,800
Accumulated dep. on Car	30,870	–
Bar Stock	2,130	2,610
Creditors for Bar Purchases	1,770	1,290

Cash overspent represents honorarium to secretary not withdrawn due to Cash deficit. His annual honorarium is ₹ 12,000. Depreciation on premises and car is to be provided at 5% and 20% on written-down value.

You are required to prepare the correct Receipts and Payments Account, Income and Expenditure Account and Balance Sheet as at Dec. 31, 2013.

Solution:

In the Books of Citizen Club
Receipts and Payments Account
for the year ended 31st December, 2013

Dr. **Cr.**

Receipts	Amount (₹)	Payments	Amount (₹)
To Balance b/d	450	By, Premises	30,000
" Bank (24,690 – 270)	24,420	" Honorarium to Secretary	11,000
" Subscription	62,130	" Rent	2,400
" Fair Receipts	7,200	" Rates and Taxes	3,780
" Variety Show Receipts	12,810	" Printing and Stationery	1,410
" Interest	690	" Sundry Expenses	5,350
" Bar Receipts	22,350	" Wages	2,520
		" Fair Expenses	7,170
		" Bar Purchases	17,310
		" Repairs	960
		" New Car	37,800
		" Bank Balance (10,440 – 90)	10,350
	1,30,050		1,30,050

Income and Expenditure Account
Dr. **for the year ended 31st December, 2013** **Cr.**

Expenditure	Amount (₹)	Amount (₹)	Income	Amount (₹)	Amount (₹)
To Honorarium to Secretary	11,000		By, Subscriptions	62,130	
Add: Outstanding	1,000	12,000	Add: Outstanding for 2012	2,940	
" Rent		2,400		65,070	
" Rates and Taxes		3,780	Less: Outstanding for 2011	3,600	61,470
" Printing and Stationery		1,410	" Fair receipts		7,200
" Sundry Expenses		5,350	" Variety show receipts		12,810
" Wages		2,520	" Interest		690
" Fair Expenses		7,170	" Profit on sale of old car [(₹ 9,000 - (36,570 - 30,870)]		3,300
"Repairs		960	" Profit on Bar Trading		6,000
"Depreciation on:					
Premises@ 5% on 60,600		3,030			
Car @20% on 46,800		9,360			
" Surplus—Excess of Income over Expenditure		43,490			
		91,470			91,470

Balance Sheet
as at 31st December, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital Fund as on 1.1.13	65,130		Premises at Cost	1,17,000	
Add: Surplus	43,490	1,08,620	Less: Depreciation	59,430	57,570
Creditors (for bar purchase)		1,290	Car at Cost	46,800	
Secretary's honorarium			Less: Depreciation	9,360	37,440
outstanding		1,000	Bar Stock		2,610
			Outstanding Subscription		2,940
			Cash at bank		10,350
		1,10,910			1,10,910

Balance Sheet
as at 1st January, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital Fund (bal. in figure)		65,130	Premises at Cost	87,000	
Creditors (for bar purchase)		1,770	Less: Depreciation	56,400	30,600
			Car at Cost	36,570	
			Less: Depreciation	30,870	5,700
			Bar Stock		2,130
			Outstanding Subscription		3,600
			Cash at bank		24,420
			Cash in Hand		450
		66,900			66,900

Dr. **Bar Trading Account for the year ended 31.12.2013** *Cr.*

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)
To, Opening stock		2,130	By, Bar Receipts	22,350
To, Bar Purchase	17,310		By, Closing Stock	2,610
Add: closing creditors for bar purchase	1,290			
	18,600			
Less: Opening creditors for purchase	1,770	16,830		
To, Income and Expenditure A/c (Gross profit Transferred)		6,000		
		24,960		24,960

2. Calculation of Depreciation of Premises

W.D.V	₹
Cost Price	87,000
Less: Accumulated Dep	56,400
	30,600
Add: Purchase	30,000
	60,600

Depreciation of Premises: 60,600 x 5% = 3,030

Illustration 44:

Prepare Income & Expenditure A/c for the year ended 31-12-2013 and the balance sheet as on 31-12-2013 in the books of an Education society.

Particulars	Debit (₹)	Credit (₹)
Library Books	2,30,000	
Books Added during the year	52,200	
Furniture	1,59,500	
Addition to Furniture	35,500	
Buildings	37,89,000	
Investment	21,25,000	
Creditors		1,77,900
Debtors	59,700	
Investment Reserve Fund		1,85,000
Entrance Fees		2,02,600
Examination Fees		32,500
Certificate Fees		7,800
Subscriptions Received		2,75,800
Hire Charges		95,500
Interest		85,000
Other Receipts		4,400
Salary	1,55,900	
Printing & Stationery	8,500	
Postage & Telephone	2,500	
Insurance	10,400	
Examination Expenses	24,000	
Periodicals	15,600	
Prizes Fund		2,15,000
Prizes Investments	2,10,400	
Prizes Investment Income		10,200
Prizes Given	9,500	
Prizes Bank Balance	2,450	
Donations (capital)		1,99,000
General Expenses	5,250	
Capital Fund		54,71,720
Bank Balance	65,500	
Cash in Hand	1,520	
Total	69,62,420	69,62,420

Additional information :

Subscription receivable ₹22,500, subscription received for 2014 ₹7,850, Interest accrued on investments ₹6,250, salary outstanding for 2013 ₹12,500, Prepaid insurance ₹4,500.

Depreciate Books @ 15%, Building @ 1% and Furniture @ 10%.

Solution:

Dr. Income & Expenditure Account for the year ended 31.12.2013 Cr.

Expenditure	Amount (₹)	Amount (₹)	Income	Amount (₹)	Amount (₹)
To Salary	1,55,900		By Examination fees		32,500
Add: Outstanding	12,500	1,68,400	By Certificate fees		7,800
To Printing & Stationery		8,500	By Subscriptions	2,75,800	
To Postage & Telephone		2,500	Add: Receivable	22,500	
To Insurance	10,400		Less: Pre-received	(7,850)	2,90,450
Less: Prepaid	(4,500)	5,900	By Hire charges		95,500
To Examination Expenses		24,000	By Interest		85,000
To Periodicals		15,600	By Other Receipts		4,400
To General Expenses		5,250	By Accrued interest		6,250
To Depreciation on Books		38,415			
To Depreciation on Building		37,890			
To Depreciation on Furniture		17,725			
To Surplus		1,97,720			
		5,21,900			5,21,900

Balance Sheet as at 31.12.2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
			Buildings	37,89,000	
			Less: Depreciation @ 1%	(37,890)	37,51,110
Capital Fund	54,71,720		Library Books	2,30,000	
Add: Entrance fees	2,02,600		Add: Purchased in 2012	52,200	
Add: Donations	1,99,000		Less: depreciation @ 15%	(38,415)	2,43,785
Add: Surplus	1,97,720	60,71,040	Furniture & fixture	1,59,500	
			Add: Purchased in 2012	35,500	
			Less: Depreciation @ 10%	(17,725)	1,77,275
Investment Reserve Fund		1,85,000			
Prize Fund	2,15,000		Investment		21,25,000
Add: Fund Income	10,200		Prize Investments		2,10,400
Less: Fund Expenses	(9,500)	2,15,700	Debtors		59,700
Creditors		1,77,900	Prize Bank balance		2,450
Subscription received in advance		7,850	Bank balance		65,500
Salary Outstanding		12,500	Cash in hand		1,520
			Subscription receivable		22,500
			Interest Accrued		6,250
			Prepaid Insurance		4,500
		66,69,990			66,69,990

Illustration 45:

The following information was obtained from the books of Young Bengal Club as on 31-03-2013 at the end of first year of the club. Prepare the Receipts & Payments A/c, Income & Expenditure A/c and Balance sheet of the club

(1) Donations received for Building & Books - ₹ 2,00,000

(2) Other revenue incomes and receipts were:

	Rev. Income (₹)	Actual Receipts (₹)
Entrance fees	17,000	17,000
Subscription	20,000	19,000
Locker rent	600	600
Sundry Income	1,600	1,060
Refreshment account	Nil	16,000

(3) Other revenue expenditure and actual payments were

	Rev. Exp (₹)	Actual Payment (₹)
Land (cost ₹10,000)	Nil	10,000
Furniture (cost ₹ 146,000)	Nil	130,000
Salaries	5,000	4,800
Maintenance of play ground	2,000	1,000
Rent	8,000	8,000
Refreshment account	Nil	8,000

Donations were utilized to the extent of ₹25,000 for buying books, balance were unutilized. In order to keep it safe, 9% Govt. Securities were purchased on 31-3-2013 for ₹1, 60,000. Remaining amount was put in bank as term deposit on 31-3-2013. Depreciate Furniture and books @ 10% for the whole year.

Solution:

Dr. **Receipt and Payments for the year ended 31.3.2013** **Cr.**

Receipts	Amount (₹)	Payments	Amount (₹)
To Donations	2,00,000	By Library books	25,000
To Entrance fees	17,000	By Land	10,000
To Subscription	19,000	By Furniture	1,30,000
To Locker Rent	600	By Salaries	4,800
To Sundry income	1,060	By Maintenance	1,000
To Refreshment A/c	16,000	By Rent	8,000
		By Refreshment A/c	8,000
To Balance c/d (Overdraft) (Bal. fig.)	1,08,140	By 9% Govt. Securities	1,60,000
		By Term deposits	15,000
	3,61,800		3,61,800

Income and Expenditure Account for the year ended 31.3.2013

Dr. *Cr.*

Expenditures	₹	₹	Incomes	₹	₹
To Salary	4,800		By Subscriptions	19,000	
Add: Outstanding	200	5,000	Add: Outstanding	1,000	20,000
`` Playground maintenance	1,000		`` Locker Rent		600
Add: Outstanding	1,000	2,000	`` Sundry Income	1,060	
`` Rent		8,000	-Add: Outstanding	540	1,600
`` Depreciation on:			`` Profit on Refreshment		8,000
Furniture	14,600				
Library Books	2,500	17,100	`` Deficit		
			(Excess of Expenditure over Income)		1,900
		40,100			40,100

Balance Sheet as at 31st March 2013

Liabilities	₹	₹	Assets	₹	₹
Capital Fund		---	Land		10,000
Entrance Fees		17,000	Furniture	1,46,000	
Donation for Building. Library Room Fund			Less: Depreciation	14,600	1,31,400
		2,00,000	Library Books	25,000	
Creditors for Furniture		16,000	Less: Depreciation	2,500	22,500
Outstanding Salaries		200	9% Govt. Bond		1,60,000
Outstanding Expenses for Playground		1,000	Subscription Receivable		1,000
			Accrued Sundry Income		540
Bank overdraft		1,08,140	Bank Term Deposit		15,000
			Deficit		1,900
		3,42,340			3,42,340

Workings:

(1) **Refreshment Account**

Dr. *Cr.*

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Payment for Refreshment	8,000	By, Refreshment Receipts	16,000
To, Income and Expenditure A/c (Profit on Refreshment)	8,000		
	16,000		16,000

(2) **Calculation of Term Deposit:**

Donation Recd – (library books purchase + 9% Govt. Securities)
= 2,00,000 – (25,000 + 1,60,000)
= 2,00,000 – 1,85,000
=15,000

(3) Since there was no capital fund

(4) Donation received for Building and Library Room is treated as capital item.

(5) Since the investment in Govt. Securities has been made at the closing date of the year, no interest has accrued.

Illustration 46:

Surya Trust runs a charitable hospital and a dispensary. The following balances were extracted from their books

Particulars	(₹)	Debit (₹)	Credit (₹)
Capital Fund			18,00,000
Donation received			12,00,000
Fees received from Patients			600,000
Recovery from amenities – rent etc.			5,50,000
Recovery for food supplies			2,80,000
Surgical equipments		9,10,000	
Building, theatres etc.		6,40,000	
Consumption of			
Medicines	2,40,000		
Foodstuff	1,80,000		
Chemicals	60,000	4,80,000	
Closing stock of			
Medicines	40,000		
Foodstuff	8,000		
Chemicals	2,000	50,000	
Sale of medicines from dispensary			6,20,000
Opening stock of medicines (dispensary)		1,10,000	
Purchase of medicines (dispensary)		6,00,000	
Salaries			
Administrative staff	60,000		
Doctors, nurses etc	3,00,000		
Assistants in dispensary	30,000	3,90,000	
Electricity and power charges			
Hospital	2,10,000		
Dispensary	4,000	2,14,000	
Furniture, fittings and equipments		1,60,000	
Ambulance		60,000	
Postage & Telephone (net of recover)		52,000	
Medical Journals		42,000	
Ambulance maintenance (net of recovery)			1,600
Consumption of linen, bedsheets etc.		1,80,000	

Particulars	(₹)	Debit (₹)	Credit (₹)
3-year 11% Fixed deposit (kept on 01-04-2012)		10,00,000	
Cash in hand		12,100	
Cash at bank		70,500	
Debtors (dispensary)		1,21,000	
Creditors (dispensary)			82,000
Remuneration to trustees, trust expenses		42,000	
Total		51,33,600	51,33,600

Additional information

(i) Dispensary supplies medicines to hospital on requisition and delivery notes; for which no adjustment has been made in books. Cost of such supplies was ₹1,20,000.

(ii) Stock of medicines as close at dispensary was ₹80,000.

(iii) Donations were received towards corpus of the trust.

(iv) Stock of medicines on 31st March 2013 included ₹8,000 of medicines belonging to patients that have not been considered while calculating the consumption.

(v) One of the well-wisher donated surgical equipments the market value of which was ₹80,000 as on 31-3-2013.

(vi) The hospital is to receive a grant of 25% of the amount spent on poor people. Such expenditure in the year was ₹1,00,000.

(vii) Out of fees recovered from patients, 10% is given to specialists.

(viii) Depreciation on Surgical equipment is 20%, buildings 5%, Furniture 10% and Ambulance 30%.

Prepare Income & Expenditure accounts for dispensary, trust and hospital separately for the year ended 31-3-2013 and the Balance Sheet as on 31-03-2013.

Solution:

Dr. Trust - Income & Expenditure Account for the year ended 31.3.2013 Cr.

Expenditure	Amount (₹)	Income	Amount (₹)
To Deficit in hospital	2,67,400	By Profit from dispensary	76,000
To Postage, telephone etc.	52,000	By Interest due on F. D.	1,10,000
To Trustee remuneration etc.	42,000	By Net deficit for the year	175,400
	3,61,400		3,61,400

Dr. Dispensary - Income & Expenditure Account for the year ended 31.3.2013 Cr.

Expenditure	Amount (₹)	Income	Amount (₹)
To Opening stock	1,10,000	By Sales	6,20,000
To Purchases	600,000	By Issues to hospitals	1,20,000
To Gross profit c/d	1,10,000	By Closing Stock	80,000
	8,20,000		8,20,000
To Salaries	30,000	By Gross Profit b/d	1,10,000
To Electricity charges	4,000		
To Trust A/c (surplus transferred)	76,000		
	1,10,000		1,10,000

Dr. Hospital - Income & Expenditure Account for the year ended 31.3.2013 Cr.

Expenditure	Amount (₹)	Income	Amount (₹)
To Consumption:		By Fees from patients	6,00,000
Medicines	3,68,000	By Room rents etc	5,50,000
[2,40,000+1,20,000+ 8,000]			
Food stuff	1,80,000	By Food recoveries	2,80,000
Chemicals	60,000	By Ambulance receipts	1,600
To Salaries		By Grants	25,000
Doctors	3,00,000	[1,00,000 × 25%]	
Administrative staff	60,000		
To Due to specialists	60,000		
(10 % on 6 lacs)			
To Electricity & Power	2,10,000		
To Medical journals	42,000		
To Linens, bed sheets	1,80,000		
To Depreciation on:			
Surgical equipment @ 20% on 9.90 lacs	1,98,000		
Building @ 5%	32,000		
Furniture @10%	16,000		
Ambulance @ 30%	18,000	By Trust A/c	2,67,400
		(deficit transferred)	
	17,24,000		17,24,000

Balance Sheet as at 31.3.2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)
Capital Fund			Cash in hand	12,100
Opening Balance	18,00,000		Cash at Bank	70,500
Add: Donations	12,00,000		Fixed Deposit	10,00,000
Add: Value of gift	80,000		Interest accrued on F. D.	1,10,000
Less: Deficit	(1,75,400)	29,04,600	Debtors	1,21,000
			Grants due	25,000
Creditors:			Stocks:	
			[Dispensary 80,000 + hospital	
Dispensory		82,000	32,000+8,000+2,000]	1,22,000
			Surgical Equipment (990,000-198,000)	7,92,000
Due to specialists		60,000		
			Building (640,000-32,000)	6,08,000
			Furniture (160,000-16,000)	1,44,000
			Ambulance (60,000-18,000)	42,000
		30,46,600		30,46,600

Illustration 47:

Following is the receipt and payment A/c of a club for the year ended 31-03-2013

Dr. Receipt and Payments for the year ended 31.3.2013 Cr.

Receipts	Amount (₹)	Payments	Amount (₹)
To Opening balance:		By Administrative expenses	1,25,000
Cash	3,000	" Programme expenses	2,75,000
Bank	7,000	" F.D. with bank	1,25,000
" Membership fees received:		" Investment in ICICI Bonds	3,00,000
		" Fixed assets	
up to 31-03-2012	14,000	purchased	80,000
for 2012-13	1,50,000		
for 2013-14	16,000		
" Advertisements	5,00,000		
" F.D. with bank	75,000		
" Interest on savings A/c	700		
" Interest on F.D	22,000	" Closing balance:	
" Sale of tickets - Programmed	25,000	Cash	2,700
" Govt. Security Maturity		Bank	5,000
(cost 80,000 & interest 8,000)	1,00,000		
	9,12,700		9,12,700

The club informs you that:

(a) Membership fee for 2012-13 due is ₹25,000; and ₹1,000 from a member who has not yet paid for 2011-12 as well. A provision needs to be done on this.

(b) Income receivable on 31-03-2013 on ICICI bond is ₹30,000 and on Govt. Securities is ₹24,000

(c) Prepaid expenses on 31-3-2013 amounts to ₹7,000

(d) Outstanding expenses as on 31-3-2013 ₹8,000

(e) Depreciation to be provided is ₹12,500

(f) Programme is an annual feature.

The Balance Sheet as on 31-3-2012 is also provided as below:

Balance Sheet as at 31.03.2012

Liabilities	Amount (₹)	Assets	Amount (₹)
Trust fund	5,00,000	Cash	3,000
Accumulated surplus	1,05,000	Bank Account	7,000
Subscriptions in advance	10,000	Fixed Deposit	2,00,000
Outstanding Expenses	10,000	Govt. Securities	3,00,000
		Fixed Assets	95,000
		Subscription receivable	15,000
		Prepaid expenses	5,000
	6,25,000		6,25,000

Prepare Income and Expenditure Account and the Closing Balance Sheet for the year 2012-13.

Solution:

Dr. **Subscription Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Opening receivable	15,000	By, Opening advance received	10,000
To, I & E A/c	1,85,000	By, Received during year	1,80,000
(balancing figure)		By, Closing receivable :	
To, Closing advance received	16,000	for 2011-12	1,000
		for 2012-13	25,000
	2,16,000		2,16,000

Dr. **Expenses Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Opening prepaid	5,000	By, Opening outstanding	10,000
To, Bank	1,25,000	By, I & E A/c (balancing figure)	1,21,000
To, Closing outstanding	8,000	By, Closing prepaid	7,000
	1,38,000		1,38,000

Provision for doubtful Subscriptions Account

Particulars	Amount (₹)	Particulars	Amount (₹)
For 2011-12	1,000	By Balance c/d	2,000
For 2012-13	1,000		
	2,000		2,000

Dr. **Income & Expenditure Account for the year ended 31.3.2013** **Cr.**

	Expenditures	₹		Incomes	₹
To	Administrative Expenses	1,21,000	By	Subscriptions	1,85,000
"	Depreciation on Assets	12,500	"	Interest Income	84,700
"	Provision on subscription	2,000		[700+22,000+30,000+24,000+8,000]	
"	Surplus	3,96,200	"	Surplus from Programme	2,50,000
				[25,000 + 5,00,000 – 2,75,000]	
			"	Profit on sale of investment	12,000
		5,31,700			5,31,700

Balance Sheet as at 31st March 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Trust Fund		5,00,000	Cash		2,700
Accumulated surplus	1,05,000		Bank		5,000
Add: surplus for 2012-13	3,96,200	5,01,200	Govt. Securities	3,00,000	
Subscription Recd in Advance			Less: sold	80,000	2,20,000
		16,000	Fixed Deposit	2,00,000	
Outstanding Expenses		8,000	Add: Addition	1,25,000	
				3,25,000	
			Less: Matured	75,000	2,50,000
			ICICI Bond		3,00,000
			Accrued Interest:		
			Govt. Securities	24,000	
			ICICI Bonds	30,000	54,000
			Outstanding Subscription:		
			2011 -12	1,000	
			2012 -13	25,000	
				26,000	
			Less: Prov. for doubtful debt	2,000	24,000
			Prepaid Expenses		7,000
			Fixed Assets	95,000	
			Add: Additions	80,000	
				1,75,000	
			Less: Depreciation	12,500	1,62,500
		10,25,200			10,25,200

Profit on disposal of Investment	₹
Amount received	1,00,000
Less: Interest	8,000
Net received	92,000
Cost of disposed investment	80,000
Profit on disposal	12,000

Illustration 48:

The Ranchi cricket club has given below its Receipt and Payment A/c for the year ended 31st December 2013.

Dr. Receipt & Payment Account for the year ended 31st December 2013 Cr.

Date	Receipts	Amount (₹)	Date	Payments	Amount (₹)
2013			2013		
1st Jan	Balance b/d – cash	56,000	1st Jan to 31st Dec	Groundman's wages	3,00,000
	Balance b/d – bank	35,000		Ground rent	1,50,000
	Balance b/d – F. D.	75,000		Repairs to pavilion	12,000
1st Jan to 31st Dec	Subscriptions	4,15,000		Cricket equipment	40,000
	Bar takings	4,25,000		8% Govt. securities	1,00,000
	Surplus on tournaments	38,800		Bar purchases	3,05,000
	Bank interest	3,500		Sundry expenses	7,800
	Donations	25,000		Insurance	3,500
			31st Dec	Balance c/d – Cash	42,000
				Balance c/d – Bank	13,000
				Balance c/d – F.D.	1,00,000
		10,73,300			10,73,300

Additional information:

- Pavilion was the only asset having a book value of ₹4,50,000 (cost 7,50,000 less depreciation 3,00,000). Depreciation for the year amounted to ₹25,000.
- Expenditure on cricket equipment is to be written off in the year in which incurred.
- Other assets and liabilities were as follows:

	31st December	
	2012	**2013**
	₹	₹
Bar stocks	15,000	25,000
Creditors for Bar purchases	46,000	67,000
Creditors for sundry expenses	900	1200
Insurance in advance	750	600
Rent owing	35,000	40,000

The club does not wish to take any credit for subscriptions. In December 2013, the club decided to set up a special fund of ₹100,000 as endowment for the best player award. This was invested in 8% Govt. securities as shown above.

Prepare (a) Statement showing Capital fund as on 31-12-2012, (b) Income and expenditure A/c for the year ended 31-12-2013 and (c) the Balance Sheet as on that date.

Solution:

Capital fund as on 31-12-2012	
Bar Stock	15,000
Insurance prepaid	750
Pavilion	450,000
Cash in hand	56,000
Cash at Bank	35,000
Cash in F D	75,000
Less: Creditors & accrued exp. [46,000+900+35,000]	(81,900)
Capital Fund	5,49,850

Dr. Income & Expenditure Account for the year ended 31.12.2013 Cr.

Expenditure	Amount (₹)	Income	Amount (₹)
To, Ground man's wages	3,00,000	By, Subscriptions	4,15,000
To, Rent [1,50,000+40,000 - 35,000]	1,55,000	By, Surplus on tournaments	38,800
To, Repairs to pavilion	12,000	By, Bank Interest	3,500
To, Cricket equipment	40,000	By, Donations	25,000
To, Sundry expenses [7,800+1,200 - 900]	8,100	By, Profit on Bar takings	1,09,000
To, Insurance [750+3,500 - 600]	3,650		
To, Depreciation on pavilion	25,000		
To, Surplus	47,550		
	5,91,300		5,91,300

Balance Sheet as at 31.12.2013

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors for bar Purchases	67,000	Cash	42,000
Creditors for expenses	1,200	Bank	13,000
Outstanding rent	40,000	Fixed deposit	1,00,000
Capital Fund (549,850+47,550)	5,97,400	Bar stocks	25,000
		Prepaid Insurance	600
		8% Govt. Securities	1,00,000
		Pavilion (4,50,000-25,000)	4,25,000
	7,05,600		7,05,600

Notes:

(a) The rent, sundry expenses and insurance are to be arrived at as follows:

Item	Paid	Last/next year	Current year	Working	Recognized
Rent	1,50,000	35,000	40,000	1,50,000-35,000+40,000	1,55,000
Sundry Expenses	7,800	900	1,200	7,800-900 +1,200	8,100
Insurance	3,500	600	750	3,500-600 +750	3,650

(b) The profit on Bar takings is calculated as follows:

	₹
Opening bar stocks	15,000
Add: purchases (3,05,000-46,000+67,000)	3,26,000
Less: Closing bar stocks	(25,000)
Consumption	3,16,000
Bar takings	4,25,000
Surplus on Bar takings	1,09,000

(c) The figure of surplus in the I & E A/c is the balancing figure.

Illustration 49:

Prepare the Balance Sheet of Ocean Blue club based on following information: ₹

Furniture (before depreciation)	8,000	Outstanding consultancy	1,000
Depreciation on furniture	800	Allowances outstanding	800
Building fund	30,000	Capital Grants	10,000
Income from building fund	2,000	Entrance fees (50% be funded)	4,000
Fixed deposits	20,000	Legacies received(funded)	8,000
Opening General fund	10,000	Prize fund	10,000
Excess of income over expenditure	20,000	Income of prize fund	1,000
Opening balance of capital fund	60,000	Expenses of prize fund	800
Cost of swimming pool	40,000	Investment of prize fund	10,000
Equipments	20,000	Balance in current A/c	10,000
Investment of general fund	36,000	Cash in hand	800
Subscription outstanding	10,000		

Solution:

Balance Sheet as at ....

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital Fund			**Fixed Assets:**		
Op balance	60,000		Swimming Pool		40,000
Add: Capital grants	10,000		Equipments		20,000
Add: Legacies	8,000		Furniture	8,000	
Add: Entrance fees (50%)	2,000	80,000	Less: Depreciation	800	7,200
General Fund			**Investment**		
Op balance	10,000		General fund	36,000	
Surplus	20,000	30,000	Prize fund	10,000	46,000
Building Fund			**Receivables**		
Op balance	30,000		Subscription		10,000
Add: Income	2,000	32,000	**Cash & bank**		
Prize Fund			Cash in hand	800	
Op balance	10,000		Current A/c	10,000	
Add: Income	1,000		Fixed deposit	20,000	30,800
Less: Expenses	800	10,200			
Allowances					
Outstanding		800			
Consultancy					
Outstanding		1,000			
		1,54,000			1,54,000

5.4.2.10 Preparation of opening and closing Balance Sheet from a given Receipt and Payment Account and Income and Expenditure Account

Students must remember –

A. While preparing opening Balance Sheet

(a) At first, take the opening balance of Cash and Bank which are given in the Receipts and Payments Account as "Balance b/d". The same will appear in the assets side of the opening Balance Sheet.

(b) All the opening assets will appear in the assets side of the opening Balance Sheet which are given in the form of adjustments. Similarly, all the opening liabilities will also appear in the liabilities side of the opening Balance Sheet.

(c) Ascertain the difference between the assets side and the liabilities side of the opening Balance Sheet which will be treated as "Capital Fund".

B. While preparing closing Balance Sheet

(a) At first, take the closing balance of Cash and Bank which are given in the Receipts and Payments Account as "Balance c/d". The same will appear in the asset side of the closing Balance Sheet.

(b) All the opening fixed asset which have appeared in the asset side of the opening Balance Sheet (after charging all adjustments), if not sold or cost, including addition, if any.

(c) All the closing current liabilities including capital fund, surplus or deficit (which we get from income and Expenditure Account), other funds like, Donation, Entrance Fees etc. also appear in the liabilities side of the closing Balance Sheet.

(d) Now, each individual item of Receipts and Payments Account should be compared with each individual item of Income and Expenditure Account and the same is to be adjusted accordingly. It must be remembered that items which are appeared in the credit side of the Receipts and Payments Account must be compared with the items which is appeared in the debit side of Income and Expenditure and vice-versa.

Illustration 50

The following are the items of Receipts and Payments of the Bengal Club as summarized from the books of account maintained by the Secretary:

Receipts	Amount (₹)	Payments	Amount (₹)
Opening Balance 1.1.2013	4,200	Manager's Salary	1,000
Entrance Fees 2012	1,000	Printing and Stationery	2,600
Do 2013	10,000	Advertising	1,800
Subscriptions 2012	600	Fire Insurance	1,200
Do 2013	15,000	Investments Purchased	20,000
Interest Received on Investments	3,000	Closing Balance 31.12.2013	7,600
Subscriptions 2014	400		
	34,200		**34,200**

It was ascertained from enquiry that the following represented a fair picture of the Income and Expenditure of the Club for the year 2013 for audit purpose:

Expenditure	Amount (₹)	Amount (₹)	Income	Amount (₹)
Manager's Salary		1,500	Entrance Fees	10,500
Printing & Stationery	2,000		Subscription	15,600
Add: Accrued	400	2,400	Interest on Investments	4,000
Advertising (accrued Nil)		1,600		
Audit Fees		500		
Fire Insurance		1,000		
Depreciation		4,940		
Excess of Income over Expenditure		18,160		
		30,100		**30,100**

You are required to prepare the Balance Sheet of the Club as on 31.12.2012 and 31.12.2013, it being given that the values of the Fixed Assets as on 31.12.2012 were: Building ₹ 44,000, Cricket Equipment ₹ 25,000 and Furniture ₹ 4,000. The rates of depreciation are Building 5%, Cricket Equipments 10%, Furniture 6%. Your are entitled to make assumptions as may be justified.

Solution:

In the books of Bengal Club
Balance Sheet as at 31st December, 2012

Liabilities	Amount (₹)	Assets	Amount (₹)
Outstanding Liabilities:		Building	44,000
Advertisement (1,800 – 1,600)	200	Furniture	4,000
Printing and Stationery (2,600 – 2,000)	600	Cricket Equipment	25,000
Capital Fund	78,000	Entrance Fees in arrear	1,000
(Balancing figure)		Subscription in arrear	600
		Cash	4,200
	78,800		**78,800**

Balance Sheet as at 31st December, 2013

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital Fund:			Building	44,000	
Balance on 1.1.2012	78,000		Less: Depreciation 5%	2,200	41,800
Add: Excess of Income					
over Expenditure	18,160	96,160	Furniture	4,000	
Subscription Received in Advance		400	Less: Depreciation 6%	240	3,760
Outstanding Liabilities:					
Printing and Stationery		400	Cricket Equipment	25,000	
Manager's Salary:			Less: Depreciation 10%	2,500	22,500
(1,500 – 1,000)		500	Investments		20,000
Audit Fees		500	Subscriptions in arrear (15,600 – 15,000)		600
			Entrance Fees in arrear (10,500 – 10,000)		500
			Accrued Interest on Investments (4,000 – 3,000)		1,000
			Prepaid Insurance (1,200 – 1,000)		200
			Cash		7,600
		97,960			**97,960**

Note: Advertisement expenses and Printing and Stationery which were paid in excess over Income and Expenditure A/c are assumed to be outstanding for the previous year.

5.4.2.11 Preparation of Receipts and Payments Account from a given Income and Expenditure Account and a Balance Sheet

Preparation of Receipts and Payments Account

Preparation of Receipts and Payments Account has already been highlighted in the previous paragraph. But if we are asked to prepare a Receipts & Payments Account from a given Income and Expenditure Account and the opening Balance Sheet, in that case, we are to consider each and individual items both from Income and Expenditure Account and the Balance Sheet.

Illustration 51.

The Income and Expenditure Account of the Calcutta Club is:

Income and Expenditure Account
for the year ended 31st December, 2013

Dr. **Cr.**

Expenditure	Amount ₹	Income	Amount ₹
To Salaries	1,750	By Subscription	2,000
,, General Expenses	500	,, Donation	1,050
,, Depreciation	300		
,, Excess of Income over expenditure	500		
	3,050		3,050

Adjustments are made in respect of the following:

(1) Subscription for 2012 unpaid at 1.1.2013 ₹ 200; ₹ 180 of which was received in 2013.

(2) Subscription paid in advance at 1.1.2013 ₹ 50.

(3) Subscription paid in advance at 31.12.2013 ₹ 40.

(4) Subscription for 2012 unpaid at 31.12.2013 ₹ 70.

(5) Sundry Asset at the beginning of the period ₹ 2,600; Sundry Asset after depreciation ₹ 2,700 at the end of the period.

(6) Cash balance at 1.1.2013 ₹ 160.

Prepare a Receipts and Payments Account.

Solution:

In the books of Calcutta Club
Receipts and Payments Account
for the year ended 31st December, 2013

Dr. **Cr.**

Receipts	Amount ₹	Payments	Amount ₹
To Balance b/d	160	By Salaries	1,750
,, Donations	1,050	,, General Expenses	500
,, Subscriptions (Cash received)	2,100	,, Sundry Assets	400
		,, Balance c/d	660
	3,310		3,310

Workings:

Subscription Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	200	By balance b/d	50
,, Income & Expenditure A/c	2,000	,, Cash Received (bal. fig.)	2,100
,, Balance (received in advance for 2014)	40	,, Balance (Unpaid for 2012)	20
		(200 - 180)c/d	
		,, Balance (Unpaid for 2013) c/d	70
	2,240		2,240
To Balance b/d		By Balance b/d	40
for 2012	20		
for 2013	70		

Sundry Assets Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	2,600	By Depreciation	300
,, Purchase (bal. fig.)	400	By Balance c/d	2,700
	3,000		3,000

Illustration 52:

You are given:

(i) Income and Expenditure Account;

(ii) Opening Balance Sheet;

(iii) Closing Balance Sheet relating to the year 2013.

(i) **Income and Expenditure Account**

Dr. ***Cr.***

Expenditure	Amount (₹)	Amount (₹)	Income	Amount (₹)
To Salaries	1,100		By Subscriptions	800
Add: Outstanding	100		`` Medical Fees	1,400
		1,200		
`` Insurance	150			
Less: Prepaid	13			
		137		
`` Medicines		600		
`` Surplus		263		
		2,200		**2,200**

(ii) **Opening Balance Sheet**

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital Fund	4,050	Medical Equipment	3,250
Outstanding Salary	100	Furniture	500
		Cash	300
		Outstanding Subscriptions	100
	4,150		**4,150**

(iii) **Closing Balance Sheet**

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital Fund:	4,050		Medical Equipment	3,250	
Add: Surplus	263		Additions	500	
		4,313			3,750
Donations		550	Investments		500
Outstanding Salary		100	Furniture		500
			Prepaid Insurance		13
Subscription Received in Advance		50	Cash		250
		5,013			**5,013**

Prepare from the above information the Receipts and Payments Account for 2013.

Solution:

Dr. **Receipts and Payments Account for the year ended 2013** **Cr.**

Receipts	Amount (₹)	Payments	Amount (₹)
To, Balance b/d	300	By, Salaries (1,200 + 100 – 100)	1,200
`` Subscription (800 + 100 + 50)	950	`` Insurance (137 + 13)	150
`` Medical Fees	1,400	`` Medicines	600
`` Donations	550	`` Medical Equipment	500
		`` Investment	500
		`` Balance c/d	250
	3,200		**3,200**

Illustration 53:

Following is the summary of bank transactions of a club during the year 2013:

Dr. **Receipts and Payments Accounts** ***Cr.***

Particulars	₹	Particulars	₹
To Petty Cash in hand	1,500	By Rent	6,000
`` Balance as per Pass Book	20,000	`` Entertainment	8,000
`` Subscriptions	25,000	`` Advertisement (for 2012 ₹ 500)	2,000
`` Entertainment	19,000	`` Capital Expenditure	20,000
`` Legacy	8,000	`` Upkeep of Grounds	3,000
`` Donation for Books	5,000	`` Salary	15,000
`` General Donation	5,000	`` Bank Charges	300
		`` Petty Expenses	800
		`` Balance as per Pass Book	27,700
		`` Petty Cash in hand	700
	83,500		83,500

Additional Information:

	On 1.1.2013 ₹	31.12.2013 ₹
(i) Unrepresented cheques, being payment of Rent	1,000	50
(ii) Interest or fixed deposit of ₹ 1,00,000 not entered in the Pass Book	---	6,000
(iii) Entry in respect of bank charges was not passed through the Cash Book	---	300
(iv) A member deposited subscription for 2014 direct into bank, not passed through the cash book	---	200
(v) Cheques deposited for subscription nut not cleared by the bank	8,000	6,000

You are required to prepare Income and Expenditure account for the year ended 31st December 2013 and a Balance Sheet as on that date.

Solution:

In the books of ....
Balance Sheet as at 1st January 2013

Liabilities	₹	Assets	₹
Outstanding Advertisement	500	Fixed Deposit	1,00,000
Capital Fund (bal. fig.)	1,28,000	Cash at Bank (as per Cash Book)	27,000[1]
		Petty Cash	1,500
	1,28,500		1,28,500

1. Cash at Bank as per Cash Book (as on 01.01.2013) is ascertained as under:

Bank Reconciliation Statement
as at 1st January, 2013

	₹	₹
Balance as per Pass Book		20,000
Add: Cheque deposited but not credited (for Subscription)	8,000	8,000
		28,000
Less: Cheque issued but not presented (for Rent)	1,000	1,000
		27,000

Income and Expenditure Account for the year ended 31st December 2013

Dr. *Cr.*

Expenditures	₹	₹	Incomes	₹	₹
To Rent (as per Pass Book)	6,000		By Subscriptions	25,000	
Add: Outstanding	500		(as per Pass book)		
	6,500		Less: Collected for last year	8,000	
Less: For last year	1,000	5,500	Add: Outstanding	17,000	
`` Entertainment		8,000		6,000	
`` Advertisement		1,500	Less: Received in Advance	23,000	
(₹ 2,000 – ₹ 500)				200	22,800
`` Upkeep of Grounds		3,000	`` Entertainment		19,000
`` Bank Charges		300	`` General Donation		5,000
`` Salary		15,000	`` Interest on Deposits		6,000
`` Petty Expenses		800			
`` Surplus –					
Excess of Income over		18,700			
Expenditure					
		52,800			52,800

Balance Sheet as at 31st December 2013

Liabilities	₹	₹	Assets	₹	₹
Capital Fund	1,28,000		Fixed Deposit		1,00,000
Add: Surplus	18,700	1,46,700	Capital expenditure		20,000
Donation for books		5,000	Cash at Bank		39,300[2]
Legacy		8,000	(as per Cash Book)		
Outstanding Bank Charges		300	Petty Cash		700
		1,60,000			1,60,000

2. Cash at Bank (as on 31.12.2013) is ascertained as:

Bank Reconciliation Statement as at 31st December 2013

Particulars	₹	₹
Balance as per Pass Book		27,700
Add: Cheque deposited but not credited (for Subscription)	6,000	
Interest on fixed deposit not entered in Pass Book	6,000	
Bank Charges not entered in Cash Book	300	12,300
		40,000
Less: Cheque issued but not presented (for Rent)	500	
Cheque directly deposited into Bank	200	700
		39,300

5.5 PREPARATION OF FINANCIAL STATEMENT UNDER SINGLE ENTRY SYSTEM INCLUDING CONVERSION OF SINGLE ENTRY INTO DOUBLE ENTRY SYSTEM

Introduction

Many times small business organizations do not maintain a comprehensive accounting system which is based on the double entry principle. The businessman is usually happy with the minimum information like the balances of cash and bank accounts and whether he has made a profit or loss. These people maintain rough or sketchy records that serve a limited purpose. Because, the principle of double entry is not followed, it is often referred to as a 'single entry system'. Such system maintains only personal accounts and cash book. Expenses and incomes are reflected in the cash book, whereas personal accounts reflect the debtors' and creditors' position. This system usually follows the principle of 'cash basis accounting' and hence no accrual or non-cash entries are passed. For example, entries like depreciation, provision for expenses, accrued incomes have no place under such system.

Features of Single Entry System:

Single Entry System has the following features.

(a) **Maintenance of books by a sole trader or partnership firm :** The books which are maintained according to this system can be kept only by a sole trader or by a partnership firm.

(b) **Maintenance of cash book :** In this system it is very often to keep one cash book which mixes up business as well as private transactions.

(c) **Only personal accounts are kept :** In this system, it is very common to keep only personal accounts and to avoid real and nominal accounts. Therefore, sometimes, this is precisely defined as a system where only personal accounts are kept.

(d) **Collection of information from original documents :** For information one has to depend on original vouchers, example, in the case of credit sales, the proprietor may keep the invoice without recording it anywhere and at the end of the year the total of the invoices gives an idea of total credit sales of the business.

(e) **Lack of uniformity :** It lacks uniformity as it is a mere adjustment of double entry system according to the convenience of the person.

(f) **Difficulty in preparation of final accounts :** It is much difficult to prepare trading, profit and loss account and balance sheet due to the absence of nominal and real accounts in the ledger.

5.5.1 Difference between single entry system and double entry system:

The distinctions between double entry system and single entry system are as follows:

(i) In double entry system both the aspects (debit and credit) of all the transactions are recorded. But in single entry system, there is no record of some transactions, some transactions are recorded only in one of their aspects whereas some other transactions are recorded in both of their aspects.

(ii) Under double entry system, various subsidiary books such as sales book, purchases book etc are maintained. Under single entry system, no such subsidiary books except cash book which is also considered as a part of ledger is maintained.

(iii) In the case of double entry system, there is a ledger which contains personal, real and nominal accounts. But in single entry system, the ledger contains some personal accounts only.

(iv) Under double entry system, preparation of trial balance is possible whereas it is not possible to prepare a trial balance in single entry system. Hence accuracy of work is uncertain.

(v) Under double entry system, Trading A/c, Profit & Loss A/c and the Balance Sheet are prepared in a scientific manner. But under single entry system, it is not possible – only a rough estimate of profit or loss is made and a Statement of Affairs is prepared which resembles a balance sheet in appearance but which does not present an accurate picture of the financial position of the business.

5.5.2 Benefits of single entry system

(a) It's quick and easy to maintain.

(b) One doesn't require employing a qualified accountant.

(c) This is extremely useful for business run by individuals where the volume of activity is not large,

(d) It is economical as it does not need a comprehensive record keeping.

5.5.3 Weaknesses of single entry system

(a) As principle of double entry is not followed, the trial balance cannot be prepared. As such, arithmetical accuracy cannot be guaranteed.

(b) Profit or loss can be found out only by estimates as nominal accounts are not maintained.

(c) It is not possible to make a balance sheet in absence of real accounts. d) It is very difficult to detect frauds or errors.

(d) Valuation of assets and liabilities is not proper.

(e) The external agencies like banks cannot use financial information. A bank cannot decide whether to lend money or not.

(f) It is quite likely that the business and personal transactions of the proprietor get mixed.

5.5.4 The method

As the records are incomplete, how does a businessman find out whether he has made a profit or loss? There is no fixed methodology but some techniques can give rough calculations that help assessing the business results. Consider a businessman had cash of ₹15,000. He purchased goods for ₹10,000, sold the same for ₹17,000. Here, the estimate of profit is ₹7,000 (17,000-10,000) and a closing cash of ₹22,000. Another way is to find out the increase or decrease in capital (or net assets).

This method is called statement of affairs method. The statement of affairs is similar to the Balance Sheet with regard to the format and is based on the same accounting equation of

Capital = Assets *less* Liabilities

The opening as well as closing statement of affairs is made on the basis of information available. Then a statement of profit or loss is prepared. This is made by considering the changes in capital due to additional money brought in by the businessman and the drawings made by him during the period.

Statement of Profit and Loss for the year ended.....

Particulars	Amount (₹)	Amount (₹)
Capital (at the end)	xx	
Less : Capital (at the beginning)	xx	xx
Add : Drawings		xx
		xx
Less : Further Capital (if any)		xx
Profit/Loss		xx
Less : Adjustments, if any say, Bad debts, Depreciation etc.		xx
Net Profit/Loss for the period		xx
Less : Appropriation items :		
(i) Interest on partner's capital	xx	
(ii) Partners' salaries etc.	xx	xx
Divisible Profit		xx

Illustration 54:

Mr. Prakash keeps his accounts on single entry system. He has given following information about his assets and liabilities.

Item	On 31-3-2012	On 31-3-2013
Creditors	55,200	58,500
Cash at bank	600	1500
Bills payable	26,400	28,200
Bills receivables	16,200	18,300
Debtors	45,600	56,000
Stock in trade	31,000	47,300
Machinery	66,200	78,000
Computer	18,000	17,000

During the year, Prakash brought in additional ₹7,500 cash in business. He withdrew goods of ₹2,100 and cash of ₹7,200 for his personal use. Interest on opening capital is to be given at 5% and interest on drawing is to be charged at 10%.

Prepare statement of profit or loss for the year ended 31-03-2013.

Solution

Here the information about opening and closing capital is not given. Both these figures can be computed based on statement of affairs as on 31-03-2012 and 31-03-2013. These can be worked out on the basis of information given. The balancing figures in both statements will represent capital figures as on those two days.

These figures will then be used together with the information to find out profit or loss. The interest on capital will increase it while, interest on drawings will result in decrease in capital. This will be included in the statement of profit or loss for the year ended 31-03-2013.

Statement of Affairs as on 31-3-2012

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	55,200	Cash at Bank	600
Bills payable	26,400	Bills receivables	16,200
Capital (balancing figure)	96,000	Debtors	45,600
		Stock in trade	31,000
		Machinery	66,200
		Computers	18,000
	1,77,600		1,77,600

Statement of Affairs as on 31-3-2013

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	58,500	Cash at Bank	1,500
Bills payable	28,200	Bills receivables	18,300
Capital (balancing figure)	131,400	Debtors	56,000
		Stock in trade	47,300
		Machinery	78,000
		Computers	17,000
	2,18,100		2,18,100

Statement of profit or loss for the year ended 31-03-2013

Particulars	Amount (₹)
Closing Capital as per statement of affairs as on (31-3-2013)	1,31,400
Less: Opening Capital as per statement of affairs as on (31-3-2012)	(96,000)
Increase or decrease in capital	35,400
Add: Drawings (goods + cash)	9,300
Add: Interest on drawings @ 10%on ₹ 9,300	930
Less: Interest on opening capital @ 5% (96,000 * 5%)	(4,800)
Less: Fresh capital introduced	(7,500)
Net Profit or loss for the year	**33,330**

Illustration 55:

On 1st April 2012, Neha started a beauty Parlour. She acquired a shop for ₹12,00,000 and paid ₹2,00,000 for interior fittings. She put ₹4,00,000 into business bank A/c. She carried on till 31st March 2013, when she wanted to know what the parlour has earned over the period. She has approached you to find out the business results with following information as on 31-03- 2013:

In addition to the shop and fitting she had following possessions: Stock ₹6,00,000, Motor car (purchased on 30-09-2012) ₹5,50,000, Cash at bank ₹2,50,000. Based on her limited knowledge she has told you to charge depreciation of 2% p.a. on shop, 5% p.a. on fittings and 20% on car.

On 31-3-2013, ₹ 1,40,000 was payable to creditors, and ₹ 1,00,000 to a friend for money borrowed for business. She had withdrawn ₹ 2,000 per month from the business.

Prepare her statement of profit or loss for the year.

Solution:

Statement of Affairs as on 01-04-2012

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital (balancing figure)	18,00,000	Shop	12,00,000
		Fittings	2,00,000
		Bank	4,00,000
	18,00,000		18,00,000

Statement of Affairs as on 31-3-2013

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	1,40,000	Shop (12,00,000 Less 2% of 12,00,000)	11,76,000
Loan from Friend	1,00,000	Fittings (2,00,000 Less 5% of 2,00,000)	1,90,000
Capital (balancing figure)	24,71,000	Cash at Bank	2,50,000
		Motor car [5,50,000 × 20% × ½]	4,95,000
		Stock in trade	6,00,000
	27,11,000		27,11,000

Statement of profit or loss for the year ended 31.03.2013

Particulars	Amount (₹)
Closing Capital as per statement of affairs as on 31-3-2013	24,71,000
Less: Opening Capital as per statement of affairs as on 31-3-2012	(18,00,000)
Increase or (decrease) in capital	6,71,000
Add: drawings (2000*12)	24,000
Net Profit or loss for the year	6,95,000
Note:	
Depreciation calculation	
Shop @ 2% for 1 year on ₹ 1,200,000	24,000
Fittings @ 5% for 1 year on ₹ 200,000	10,000
Car @20% for 6 months on ₹ 550,000	55,000

Illustration 56:

Rani, Priti and Deepa started a business in partnership on 1st April 2012 and agreed to share profits or losses in the ratio of 5:3:2. They brought in capital as – Rani ₹50,000, Priti ₹30,000 and Deepa ₹20,000.

On 31-03-2013 their state of affairs was: Cash in hand ₹2500, Bank Overdraft ₹15,000, creditors ₹10,200, Debtors ₹17,300 and Bills payable ₹3,500. Bills receivables ₹4,000, stock ₹20,400, Machinery ₹30,000, Furniture ₹9,800, Loan from Central Bank ₹20,000, Building ₹70,000 and outstanding salaries ₹1,000.

On verification of records, it's found that out of debtors ₹300 is bad & should be written off. Stocks were overvalued by ₹400 and furniture was undervalued by ₹200. Interest on loan was ₹1,000. A provision of 10% on remaining debtors needs to be made.

During the year, the cash withdrawal by partners for their personal use was – Rani ₹4,500, Priti ₹3,500 and Deepa ₹6,900. Salary of ₹500 per month was payable to Deepa.

Prepare statement of profit or loss made by the partnership firm.

Solution:

As the opening capital figures are given, there's no need to prepare the statement of affairs as on 1st April 2012. We need to show the closing statement of affairs as follows:

Statement of Affairs as on 31-3-2013

Liabilities	Amount (₹)	Assets		Amount (₹)
Bank overdraft	15,000	Cash in hand		2,500
Creditors	10,200	Debtors	17,300	
Bills payable	3,500	Less: Bad debts	(300)	
Loan from Central		Less: Provision @ 10%	(1,700)	15,300
Bank	20,000			
Outstanding salaries	1,000	Bills receivables		4,000
Outstanding interest on loan	1,000	Stock	20,400	
		less: Overvalued	(400)	20,000
Combined Capital (balance)	101,100	Machinery		30,000
		Furniture	9,800	
		add: Undervalued	200	10,000
		Building		70,000
	1,51,800			1,51,800

Statement of profit or loss for the year ended 31.03.2013

Particulars	Amount (₹)
Combined Closing Capital as per statement of affairs as on 31-3-2013	1,01,100
Less: Opening Capital (Rani ₹ 50,000, Priti ₹ 30,000 and Deepa ₹ 20,000)	(100,000)
Increase or (decrease) in capital	1,100
Add: Drawings (Rani ₹ 4,500, Priti ₹ 3,500 & Deepa ₹ 6,900)	14,900
Less: Salary to Deepa (₹ 500*12)	(6,000)
Net Profit or loss for the year	**10,000**

Note & Verification

Share of profits is Rani ₹ 5,000, Priti ₹ 3,000 and Deepa ₹ 2,000.

	Rani	Priti	Deepa	Total
Original capital	50,000	30,000	20,000	100,000
Add : Share in profit	5,000	3,000	2,000	10,000
Add: Salary			6,000	6,000
Less: Drawings	(4,500)	(3,500)	(6,900)	(14,900)
Closing Capital	50,500	29,500	21,100	101,100

Illustration 57:

X,Y and Z were in partnership sharing profits and losses in the ratio of 3:2:1. They kept their books under Single Entry System.

Their statement of affairs as on 31.12.2012 was as follows:

Liabilities	Amount ₹	Assets	Amount ₹
Creditors	22,000	Cash at Bank	9,600
Capital A/c:		Debtors	14,400
X 18,000		Stock	26,000
Y 12,000		Plant & Machinery	5,760
Z 6,000		Furniture & Fixture	2,400
	36,000	Advance Payment	140
Current A/c:		Current A/c	
X 580		Z	680
Y 400			
	980		
	58,980		58,980

The partners drawing during the year 2013 were:

X - ₹ 5,600; Y – ₹ 4,000 and Z ₹ 2,600.

On 31.12.2013: Cash at Bank ₹ 12,800; Debtors ₹ 16,100; Stock ₹ 23,600; Advance Payment ₹ 100; Creditors ₹ 24,160.

Machinery to be depreciated at 10% p.a.; Furniture & Fixture at 7½% p.a. 5% interest to be allowed on capital.

Prepare a Statement of Profit and Loss for the year ended 31st December, 2013 and a Statement of Affairs as on that date.

Solution:

In the books of X, Y & Z
Statement of Affairs
for the year ended 31st December, 2013

Particulars	Amount ₹	Particulars	Particulars ₹
Creditors	24,160	Cash at Bank	12,800
Combined Capital		Debtors	16,100
(on 31.12.2013)	36,600	Stock	23,600
		Advance Payment	100
		Plant & Machinery	5,760
		Furniture & Fixture	2,400
	60,760		60,760

Statement of Profit & Loss

For the year ended 31st December, 2013

Particulars	**Amount ₹**	**Amount ₹**
Combined Capital (Closing)		36,600
Less: Opening Capital		36,000
Increase / (Decrease) in capital		600
Add: Drawings:		
X	5,600	
Y	4,000	
Z	2,600	
		12,200
Less: Current A/c (Opening)		12,800
X	580	
Y	400	980
Add: Current A/c (Opening)		11,820
Z		680
		12,500
Gross Profit		
Less: Depreciation on Plant & Machinery	576	
on Furniture & Fixture	180	756
		11,744
Net Profit before appropriation		
Less: Interest on Capital		
X	900	
Y	600	
Z	300	1,800
		9,944
Net Divisible Profit		
X – 3/6	4,972	
Y – 2/6	3,314	
Z – 1/6	1,658	9,944

Statement of Affairs
as at 31st December, 2013

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
Creditors		24,160	Cash at Bank		12,800
Current A/c:			Debtors		16,100
X –	580		Stock		23,600
Add: Interest on Capital	900		Advance Payment		100
Add: Net Profit	4,972		Plant & Machinery	5,760	
	6,452		Less: Depreciation	576	
Less: Drawings	5,600				5,184
		852	Furniture & Fixture	2,400	
Current A/c:			Less: Depreciation	180	
Y-	400				2,220
Add: Interest on Capital	600		Current A/c:		
Add: Net Profit	3,314		C-	680	
	4,314		Add: Drawings	2,600	
Less: Drawings	4,000			3,280	
		314	Less: Interest on Capital	300	
Capital A/c:				2,980	
X	18,000		Less: Net Profit	1,658	
Y	12,000				1,322
Z	6,000				
		36,000			
		61,326			61,326

5.5.5 Alternative method: Conversion of single entry to double entry:

It may be possible to prepare the P & L A/c and Balance Sheet for such organizations by converting the records into double entry method. In this method, various ledger accounts are prepared e.g. sales, purchases, debtors, creditors, Trading A/c, cash book. As full information is not available the balancing figure in each of these accounts needs to be correctly interpreted. For example, if we know opening & closing balances in Debtors' A/c and the cash received from debtors; then the balancing figure will obviously indicate sales figures. Also, if we know opening and closing balances of creditors & credit purchases figures; then the balancing figure will certainly mean cash paid to creditors.

Once these figures are calculated, it's easy to prepare the financial statements in regular formats.

Illustration 58:

Find out the collection from debtors from the following details	₹
Opening Debtors	34,000
Opening Bank Balance	8,000
Closing Debtors	46,000
Closing Bank Balance	14,000
Payments to Creditors	1,60,000
Credit Sales	2,37,000
Bills Receivable Encashed	18,000
Bills Payable Paid	12,000
Drawings	24,000
Expenses Paid	36,000
Discount Allowed	5,000

Solution:

Debtors Account

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Balance b/d	34,000	By, Bank (collection) A/c	2,25,000
To, Sales (credit)	2,37,000		
		By, Balance c/d	46,000
	2,71,000		2,71,000

Cash / Bank Account

Dr . **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Balance b/d	8,000	By, Creditors A/c	1,60,000
To, B/R encashed	18,000	By, Discount allowed A/c	5,000
To, Debtors (collection)	2,25,000	By, B/P paid A/c	12,000
		By, Drawings A/c	24,000
		By, Expenses A/c	36,000
		By, Balance c/d	14,000
	2,51,000		2,51,000

Illustration 59:

From the following particulars presented by Rama Brothers, who maintain their accounts under Single Entry System, calculate total purchase and total sales.

Particulars	Balance on	
	1.4.2012 ₹	31.3.2013 ₹
Debtors	28,000	24,000
Bills Receivable	14,000	15,000
Creditors	16,000	32,000
Bills Payable	8,000	15,000

Transaction during the year	Amount ₹
Cash Received from Debtors	2,00,000
Cash paid to creditors	1,60,000
Discount Allowed	1,000
Discount Received	2,000
Bad Debts	3,000
Returns Inwards	5,000
Return Outward	6,000
Bills Receivable dishonoured	4,000
Cash paid against Bills Payable	10,000
Cash Received against Bills Receivable	16,000
Cash Sales	60,000
Cash Purchase	40,000

Solution:

In the books of Rama Brothers

Bills Receivable Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	14,000	By Cash	16,000
,, Total Debtors c/d (bal. fig.)	21,000	,, Debtors (B/R Dishonours)	4,000
		,, Balance c/d	15,000
	35,000		35,000

Total Debtors Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	28,000	By Cash Received	2,00,000
,, B/R Dishonoured	4,000	,, Discount Allowed	1,000
,, Credit Sales (bal. fig.)	2,22,000	,, Dab Debts	3,000
		,, Returns Inward	5,000
		,, Bills Receivable A/c	21,000
		,, Balance c/d	24,000
	2,54,000		2,54,000

Bills Payable Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Cash	10,000	By Balance b/d	8,000
,, Balance c/d	15,000	,, Creditors A/c (bal. fig.)	17,000
	25,000		25,000

Total Creditors Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Cash Paid	1,60,000	By Balance b/d	16,000
,, Discount Received	2,000	,, Credit Purchase (bal. fig.)	2,01,000
,, Returns Outwards	6,000		
,, Bills Payable	17,000		
,, Balance c/d	32,000		
	2,17,000		2,17,000

Calculate of Total Sales

Particulars	Amount ₹
Total Sales:	
Cash Sales	60,000
Credit Sales	2,22,000
	2,82,000

Calculate Total Purchase

Particulars	Amount ₹
Total Purchase:	
Cash Purchase	40,000
Credit Purchase	2,01,000
	2,41,000

Illustration 60:

Mrs. Laxmi, a retail trader needs final accounts for the year ended 31-03-2013 for the purpose of taking a bank loan. However, she informs you that principle of double entry had not been followed. With following inputs, prepare a Profit & Loss A/c for the year ended 31-03-2013 and Balance sheet as on 31-03-2013. Details of receipts and payments:

(1) Cash deposited in bank ₹3,500

(2) Dividend on personal A/c deposited into bank ₹250

(3) Tuition fees of Laxmi's daughter paid by cheque ₹4,500

(4) Rent for the year by cheque ₹ 9,000

(5) Cash received from debtors ₹ 52,500

(6) Paid to creditors ₹ 40,025

(7) Salaries & wages paid in cash ₹ 9,000

(8) Transportation in cash ₹ 2,750

(9) Office electricity in cash ₹ 6,600

(10) Electricity (house) in cash ₹ 7,200

(11) General expenses in cash ₹ 890.

Opening and closing balances of assets & liabilities:

Particulars	31-3-2012	31-3-2013
Stock	42,500	22,500
Bank	55,500	20,500
Cash	10,850	10,500
Debtors	16,800	14,800
Creditors	15,600	22,800
Investments	15,000	15,000

She also informs you that she draws ₹6,000 from bank on monthly basis and some debtors deposit cheques directly in bank.

Solution:

Dr. **Stock Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	42,500	By Cost of sales (bal. fig)	90,135
To Purchases (credit)	47,225	By Balance c/d	22,500
To Cash (purchases)	22,910		
	1,12,635		1,12,635

Dr . **Bank Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	55,500	By Drawings (tuition fees)	4,500
To Cash A/c	3,500	By Rent	9,000
To Capital (dividend)	250	By Creditors	40,025
To Debtors (balancing figure)	86,775	By Drawings (@ ₹6,000 pm)	72,000
		By Balance c/d	20,500
	1,46,025		1,46,025

Dr. **Cash Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	10,850	By Bank	3,500
To Debtors	52,500	By Salaries & wages	9,000
		By Transportation	2,750
		By Electricity	6,600
		By Drawings (electricity)	7,200
		By General expenses	890
		By Purchases (balancing figure)	22,910
		By Balance c/d	10,500
	63,350		63,350

Dr. **Debtors Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	16,800	By Cash	52,500
To Sales (credit Sales) (balancing figure)	1,37,275	By Bank	86,775
		By Balance c/d	14,800
	1,54,075		1,54,075

Dr. **Creditors Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Bank	40,025	By Balance b/d	15,600
To Balance c/d	22,800	By Purchases (credit) (bal. fig.)	47,225
	62,825		62,825

Dr. **Mrs. Laxmi's capital Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Drawings (tuition fees)	4,500	By Balance b/d (bal. fig.)	1,25,050
To Drawings (electricity)	7,200	By Bank (dividend)	250
To Drawings (bank)	72,000		
To Balance c/d	41,600		
	1,25,300		1,25,300

Dr. **Trading Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening stock A/c	42,500	By Sales A/c	1,37,275
To Purchases A/c	70,135	By Closing Stock A/c	22,500
To Gross profit c/d	47,140		
	1,59,775		1,59,775

Dr. **Profit & Loss Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Rent	9,000		
To Salary & wages	9,000	By Gross Profit b/d	47,140
To Transportation	2,750		
To Electricity	6,600		
To General Expenses	890		
To Net Profit c/d	18,900		
	47,140		47,140

Balance sheet as on 31st March 2013

Particulars	Amount (₹)	Particulars	Amount (₹)
Creditors	22,800	Stock	22,500
Capital (balancing figure)	41,600	Bank	20,500
Net profit	18,900	Cash	10,500
		Debtors	14,800
		Investment	15,000
	83,300		83,300

Illustration 61:

Ms. Mythily who maintained books under single entry method approaches you with the following details. You are requested to prepare statement of affairs as on31-03-2013 and P & L A/c for the year ended 31-3-2013.

	31-3-2012	31-3-2013
Cash	1,500	8,500
Saving A/c with ICICI	2,000	10,000
Debtors	42,000	85,000
Advance received		15,000
Creditors	89,000	2,500
Advance paid		50,000
Building (depreciate 5%)	400,000	
Car (depreciate 20%)	358,000	
Computer (depreciate 60%)	70,000	

	₹
Credit sales during the year	10,95,000
Cash sales during the year	12,50,000
Credit purchases during the year	8,20,000

Details of cash expenses: Salary ₹ 48,000, Vehicle Expenses ₹ 18,000, Repairs & Maintenance ₹ 3,000

Details of expenses paid by cheque: Rent ₹ 60,000, Telephone ₹ 15,000, Electricity ₹ 9,000

Discount Allowed ₹ 250, Discount Received ₹ 550

Amount received from debtors was deposited into bank.

Advance was paid by cheque and advance received was also in the bank.

Drawings in cash ₹ 40,000.

Computation of drawings through bank and cash purchases during the year.

Solution:

Dr . ICICI Bank Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	2,000	By Telephone	15,000
To Cash (from customers)	10,51,750	By Rent	60,000
To Advance from Debtors	15,000	By Electricity	9,000
		By Drawings (balancing figure)	18,800
		By Advance to suppliers	50,000
		By Creditors	905,950
		By Balance c/d	10,000
	10,68,750		10,68,750

Dr. **Cash Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	1,500	By Salaries	48,000
To Sales	12,50,000	By Vehicle expenses	18,000
		By Repairs & Maintenance	3,000
		By Drawings	40,000
		By Cash Purchase (bal. fig.)	11,34,000
		By Balance c/d	8,500
	12,51,500		12,51,500

Dr. **Debtors Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	42,000	By Discount Allowed	250
To sales (credit Sales)	10,95,000	By Bank (bal. fig.)	10,51,750
		By Balance c/d	85,000
	11,37,000		11,37,000

Dr. **Creditors Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Bank (bal. fig.)	9,05,950	By Balance b/d	89,000
To Discount Received	550	By Purchases (credit)	8,20,000
To Balance c/d	2,500		
	9,09,000		9,09,000

Balance Sheet as at 31-03-2012

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital (Bal. Fig.)	7,84,500	Building	400,000
Creditors	89,000	Car	358,000
		Computer	70,000
		Debtors	42,000
		Cash	1,500
		Bank	2,000
	8,73,500		8,73,500

Dr. **Ms. Mythily's Capital Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Drawings (cash)	40,000	By Balance b/d	7,84,500
To Drawings (bank)	18,800		
To Balance c/d [bal. fig.]	7,25,700		
	7,84,500		7,84,500

Trading and Profit and Loss Account for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Purchases cash	11,34,000	By Sales credit	10,95,000
To Purchases credit	8,20,000	By Sales cash	12,50,000
To Salary	48,000	By Discount	550
To Vehicle expenses	18,000		
To Repairs & maintenance	3,000		
To Rent	60,000		
To Telephone	15,000		
To Electricity	9,000		
To Discount	250		
To Depreciation on building	20,000		
To Depreciation on car	71,600		
To Depreciation on computer	42,000		
To Net profit	104,700		
	23,45,550		23,45,550

Statement of Affairs as on 31st March 2013

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	2,500	Building (4,00,000-20,000)	3,80,000
Advance from debtors	15,000	Car (3,58,000-71,600)	2,86,400
Capital	7,25,700	Computers (70,000 - 42,000)	28,000
Net profit	1,04,700	ICICI Bank	10,000
		Cash	8,500
		Debtors	85,000
		Advance to suppliers	50,000
	8,47,900		**8,47,900**

APPLICATION OF ACCOUNTING RATIOS FOR PREPARATION OF ACCOUNTS UNDER SINGLE ENTRY SYSTEM

Computation of Average Collection Period

Illustration 62 :

Calculate the Average Collection Period from the following details by adopting 360 days an year:

Average Inventory	₹3,60,000	Gross Profit Ratio	10%
Debtors	₹2,30,000	Credit Sales to Total Sales	20%
Inventory Turnover Ratio	6 Times	1 Year	360 Days

Solution:

1. Cost of Goods Sold = Inventory Turnover Ratio X Avg. Inventory = 6× ₹ 3,60,000 = ₹21,60,000.
2. Total Sales = Cost of Goods Sold + Gross Profit of 10% on Sales
   = Cost of Goods Sold + (10/90 × Cost of Goods Sold)
   = ₹ 21,60,000 + 10/90 × ₹ 21,60,000) = ₹24,00,000
3. Credit Sales =20% of Total Sales = ₹4,80,000
4. Debtors Turnover Ratio =Credit Sales ÷ Average Debtors = 4,80,000 ÷ 2,30,000 = 2.09 times
5. Avg. Collection Period = 360 ÷ Debtors Turnover Ratio = 360 ÷ 2.09 = = 173 days. (approximately)

Computation of Return on Net Worth and Return on Capital Employed

Illustration 63:

The following data has been abstracted from the annual accounts a Company-

Particulars	₹ lakhs	Particulars	₹ lakhs
Share Capital: 20,000 Equity Shares of ₹10 each	200	Profit before Tax	140
General Reserve	150	Provision for Tax	84
Investment Allowance Reserve	50	Proposed Dividend	10
15% Long term loan.	300		

Calculate the following ratios – (1) Return on Capital Employed (ROCE) and (2) Return on Net Worth, (RONW).

Solution :

1. Computation of ROCE and RONW

Particulars	₹ lakhs
Profit Before Tax	140
Add : Interest on Long Term Loan at 15%	45
Profit Before Tax and Interest (PBIT) **(for RONW purposes)**	185
Less : Interest on Long Term Loan at 15%	(45)
Less : Provision for Tax	(84)
Profit After Tax (PAT) **(for ROCE purpose)**	56

2. Computation of Net Worth on Net Worth and Capital Employed (Amount in ₹ lakhs)

a. Net Worth = Share Cap. + Gen. Reserve +Invt. Allowance Reserve = 200+150+50	= 400
b. Capital Employed = Net Worth + Long term Borrowings = 400 + 300	= 700

3.Computation of Ratios

	Particulars		%
a. Return on Capital Employed	= (PBIT ÷ Capital Employed.)	= (185÷ 700) × 100	26.43%
b. Return on Net Worth	= (PAT ÷ Net Worth)	= (56÷ 400) × 100	14.00%

Computation of Debtors, Creditors and stock

Illustration 64:

Following are the ratios relating to the trading activities of an organization-

Debtors velocity	3 Months	Creditors Velocity	2 Months
Stock Velocity	6 Months	Gross Profit Ratio	20%

Gross Profit for the year ended 31st December was ₹5,00,000, Stock at the end of the year was ₹20,000 more than what it was at the beginning of the year. Bills Payable and Receivable were ₹36,667 and ₹60,000 respectively.

You are to ascertain the figures of (1) Sales; (2) Sundry Debtors; (3) Sundry Creditors and (4) Stock.

Solution:

1. Sales = Gross Profit ÷ Gross Profit Ratio = ₹5,00,000 ÷ 20% = ₹25,00,000
2. Year End Receivables = Sales X (Debtors Velocity ÷ 12 Months)
   = ₹25,00,000 X (3 Months ÷ 12 Months) = ₹6,25,000
3. Trade Debtors = Year End Receivables – Bills Receivable = ₹(6,25,000-60,000) = ₹5,65,000
4. Purchases = Cost of Sales + Increase in Stock
   = Sales – Gross profit + Increase in Stock
   = ₹(25,00,000 -5,00,000+ 20,000) = ₹20,20,000
5. Accounts Payables = Purchases X (Creditors Velocity ÷ 12 Months)
   = ₹ 20,20,000 X (2 Months ÷ 12 Months) = ₹3,36,667
6. Trade Creditors = Accounts Payables – Bills Payable = ₹(3,36,667 – 36,667) = ₹3,00,000
7. Average Stock = Cost of Goods Sold X (Stock Velocity ÷ 12 Months)
   = ₹20,00,000 X (6 Months ÷ 12 Months) = ₹10,00,000
8. Closing Stock = Average Stock = [(Opening Stock + Closing Stock)] ÷ 2
   Since Closing Stock is ₹20,000 more than Opening Stock,
   Opening Stock = Closing Stock Less 20,000. Substituting,
   10,00,000 =[(Closing Stock -20,000)+ Closing Stock] ÷ 2
   So, 20,00,000 = 2 X Closing Stock -20,000.
   2 × Closing Stock = 20,20,000; Hence, Closing Stock = ₹10,10,000

Computation of Ratios

Illustration 65:

From the following annual statements of a Company, calculate the following accounting ratios – (a) Gross Profit Ratio; (b) Current Ratio; (c) Liquidity Ratio; (d) Debt Equity Ratio and (e) Return on Investment Ratio.

Trading, Profit and Loss A/c for the year ended 31st December

Particulars		₹	Particulars	₹
To Materials Consumed			By Sales	85,000
Opening Stock	9,050		By Profit on sale of investment	600
Add: Purchases	54,525		By Interest on investments	300
Less: Closing Stock	(14,000)	49,575		
To Carriage Inwards		1,425		
To Office Expenses		15,000		
To Sales Expenses		3,000		
To Financial Expenses		1,500		
To Loss on Sale of Assets		400		
To Net Profit		15,000		
		85,900		85,900

Balance Sheet as at 31st December

Liabilities	₹	Assets	₹
Share Capital: 2,000 Equity Shares of ₹10 each fully paid	20,000	Fixed Assets:	
		— Buildings	15,000
Reserves	9,000	— Plant	8,000
Profit and Loss A/c	6,000	Current Assets:	
Bank Overdraft	3,000	— Stock in trade	14,000
Sundry Creditors:		— Debtors	7,000
— For Expenses	2,000	— Bills receivable	1,000
— For Others	8,000	— Bank balances	3,000
	48,000		48,000

Solution:

1.	Gross Profit	= Sales – (Materials Consumed + Carriage Inwards)	
		= ₹[85000 -(49,575+1,425)] =	₹34,000
2.	Gross Profit Ratio	= (Gross Profit ÷ Sales) × 100 = (₹34,000 ÷ ₹85,000) × 100	40%
3.	Current Assets	= Stock +Debtors +B/R +Bank = ₹(14,000+7,000+1,000+3,000)	₹25,000
4.	Current Liabilities	= Creditors (Others +Exps) +Bank OD = ₹(8,000 + 2,000 +3,000)	₹13,000
5.	Current Ratio	= Current Assets ÷ Current Liabilities = 25,000 ÷ 13,000	1.92 times
6.	Liquid Ratio	= Liquid Assets ÷ Liquid Liabilities = (11,000 ÷ 10,000)	1.10 times
		= (Current Assets – Stock) ÷ (Current Liab – Bank OD)	

7.	Debt Equity Ratio	= Long Term Debt / Equity There are no Long Term Debts. Therefore, D/E Ratio is NIL	NIL
8.	Return Investment	= Net Profit ÷ Capital Employed = ₹ (15,000 ÷35,000) × 100 =	42.86%

Balance Sheet and Ratio Analysis

Illustration 66:

Aditya is made an offer by the promoters of Himsagar Enterprises Ltd, to invest in the project of the Company by purchasing a substantial portion of the Share Capital. He is promised good returns by way of Dividends and Capital Appreciation. Aditya desires that you compute the following ratios for financial analysis – (a) Return on Investment Ratio; (b) Net Profit Ratio; (c) Stock Turnover Ratio; (d) Current Ratio and (e) Debt Equity Ratio.

The Income Tax rate may be presumed at 50%. The figures given to him are as under:

Particulars	₹ 000s	Particulars	₹ 000s
Sales	16,000	Share Capital	5,000
Raw Material Consumed	7,800	Reserves and Surplus	1,500
Consumables	800	Secured Term Loans	12,000
Direct Labour	750	Unsecured Term Loans	1,500
Other Direct Expenses	480	Trade Creditors	3,350
Administrative Expenses	1,200	Investments	400
Selling Expenses	260	Inventories	6,000
Interest	1,440	Receivables	3,700
Fixed Assets	14,000	Cash at Hand and Bank	100
Depreciation	700	Provisions	650
		Other Current Liabilities	200

Solution:

1.Profit and Loss Account of Himsagar Enterprises Ltd. for the year ended (in ₹000s)

Particulars		₹	₹
Sales			16,000
Less : Direct Costs:	— Raw Material Consumed	7,800	
	— Consumables	800	
	— Direct Labour	750	
	— Other Direct Expenses	480	(9,830)
Gross Profit			6,170
Less: Indirect Expenses	— Administrative Expenses	1,200	
	— Selling Expenses	260	
	— Depreciation	700	(2,160)
Profit before Interest and Tax			4,010
Less: Interest			(1,440)
Net Profit Before Tax			2,570
Less: Income tax at 50%			(1,285)
Net Profit After Tax			**1,285**

2. Balance Sheet Himsagar Enterprise Ltd. as at ...... (in ₹ 000s)

Liabilities		Amount ₹	Assets		Amount ₹
Share Capital		5,000	Fixed Assets		14,000
Reserves and Surplus		1,500	Investments		400
Secured Term Loans		12,000	Current Assets:		
Unsecured Term Loans		1,500	— Inventories	6,000	
Current Liabilities			— Receivables	3,700	
— Trade Creditors	3,350		— Cash and Bank	100	9,800
— Provisions	650				
— Other Current Liab	200	4,200			
		24,200			24,200

3. Computation of relevant Accounting Ratios (Amount in ₹ 000s)

1. Debt	= Total Long Term Borrowed Funds = ₹ (12,000 + 1,500)	=13,500
2. Equity	= Total Own Funds = Share Cap+ Reserves = ₹ (5,000 + 1,500)	= 6,500
3. Capital Employed	= Debt + Equity [5,000 + 1,500 + 12,000 + 1,500]	= 20,000
4. Return on Investment	= (PBIT ÷ Capital Employed) × 100 = ₹ (4,010 ÷ 20,000) × 100	= 20.05%
5. Net Profit Ratio	= (PBIT ÷ Sales) × 100 = ₹ (4,010 ÷16,000) × 100	= 25.06%
6. Stock Turnover Ratio	= Cost of Sales ÷ Closing Stock = ₹ (9,830 ÷ 6,000)	= 1.64 times
7. Current Ratio	= Current Assets ÷ Current Liabilities = ₹ (9,800 ÷ 4,200)	= 2.33 times
8. Debt Equity Ratio	= Debt ÷ Equity = ₹ (13,500 ÷ 6,500)	= 2.08 times

Note : NP Ratio may also be based on PAT.

Computation of Ratios from Financial Statements.

Illustration 67:

The Balance Sheet abstract of a Company for two years are given below. You are required to –

1. Calculate, for the two years Debt-Equity Ratio, Quick Ratio, and Working Capital Turnover Ratio; and
2. Sales Volume required to maintain the same Working Capital Turnover Ratio in last year.

Balance Sheet of a Company as at 31st December **(in ₹ lakhs)**

SOURCES OF FUNDS	This Year	Last Year	APPLICATION OF FUNDS	This Year	Last Year
Share Capital	10	10	Fixed Assets (Net)	30	30
Reserves and Surplus	30	10	Current Assets:		
Loan Funds	60	70	— Stocks	30	20
			— Debtors	30	30
			— Cash and Bank balances	10	20
			— Other Current Assets	30	10
			Total Current Assets	100	80
			Less: Current Liabilities	(30)	(20)
			Net Current Assets	70	60
	100	90		100	90

Sales for this year and last year were ₹270 Lakhs and ₹300 Lakhs respectively.

Solution: **(Amount in ₹ lakhs)**

Year ending 31st December	This Year	Last Year
1.Debt Equity Ratio = Debt ÷ Equity = Loan Funds ÷ (Share Capital + Reserves)	60 ÷ (30+10) = **1.5 times**	70 ÷ (10+10) = **3.5 times**
2.Quick Ratio = Quick Assets ÷ Quick Liabilities = (Debtors + Cash)÷ Quick Liabilities	(30+10) ÷ 30 = **1.33 times**	(30+20) ÷ 20 = **2.5 times**
3.Working Capital Turnover Ratio = Sales ÷ Working Capital = Sales ÷ Net Current Assets	270 ÷ 70 = **3.86 Times**	300 ÷ 60 = **5 Times**

4. Sales Volume in this year to maintain the last year Working Capital Turnover Ratio:

= Net Current Assets X Working Capital Turnover Ratio of last year

= ₹ 70 Lakhs X 5 = ₹ **350 Lakhs.**

Computation of Accounting ratios

Illustration 68:

The Balance Sheet of a accompany stood as follows as at the end and beginning of a financial year

(₹ lakhs)

Liabilities	End	Beginning	Assets	End	Beginning
Capital	250	250	Fixed Assets	400	300
Reserves	116	100	Less : Depreciation)	(140)	(100)
Loans	100	120		260	200
Creditors & Other current Liabilities	129	25			
			Investment	40	30
			Stock	120	100
			Debtors	70	50
			Cash/Bank	20	20
			Other Current Assets	25	25
			Miscellaneous Expenditure	60	70
	595	495		595	495

Additional Information: (a) Sales for the year = ₹600 lakhs; (b) PBIT = ₹150 lakhs; (c)Interest Paid = ₹24 lakhs; (d) Tax Provision = ₹60 lakhs ; (e) Proposed Dividend = ₹50 lakhs.

From the above, calculate for the year – (1) Return on Capital Employed; (2) Stock Turnover Ratio; (3) Return on Net Worth ; (4) Current Ratio and (5) Proprietary Ratio.

Solution: **(Amount in ₹ lakhs)**

1. Capital Employed	= Capital+ Reserves + Loans – Misc. Expenditure	
	Closing Capital Employed = (250+116+100-60) = 406	
	Opening Capital Employed = (250+100+120-70) = 400	
	Hence, Average Capital Employed = (406+400) ÷2	₹403 Lakhs
2. ROCE	= PBIT ÷ Average Capital Employed = (150 ÷ 403) × 100	37.22%
3. Average Stock	= (Opening Stock + Closing Stock) ÷2 = (120+100) ÷2	₹110 lakhs
4. Stock Turnover Ratio	= Sales ÷ Average Stock = 600÷110	5.45 times
5. Net Worth	= Capital Employed Less Long Term Loans	
	Closing Net Worth = (406-100) = 306	
	Opening Net Worth = (400-120) = 280	
	Hence, Average Net Worth = (306+280) ÷ 2	₹293 lakhs
6. Profit After Tax	= PBIT – Interest –Tax = 150-24-60 =	₹66 lakhs
7. Return on Net Worth	= (PAT ÷ Average Net Worth) × 100 = (66 ÷ 293) × 100	22.53%
8. Current Assets	= Stock 120+ Debtors 70 + Cash 20 + Others 25	₹235 lakhs
9. Current Liabilities	= given	₹129 lakhs
10. Current Ratio	= Current Assets ÷ Current Liabilities = 235 ÷129	1.82 times
11. Proprietary Ratio	= Proprietary Funds ÷ Total Tangible Assets	
	= Proprietary Funds / (Total Assets Less Misc. Expenditure)	0.57 times
	= 306÷(595-60)	

Performance Evaluation using Ratios

Illustration 69:

The following are the Financial Statements of Whole selling Company, for the last two years –

Profit and Loss Account **(in ₹ 000s)**

Year ending 31st December	Last Year		This Year	
Turnover - Credit Sales	2,200		2,640	
- Cash Sales	200		160	
	2,400		2,800	
Less: Cost of Sales	(1,872)		(2,212)	
Gross Profit		528		588
Less: Indirect Expenses				
Distribution Costs	278		300	
Administration Expenses	112	(390)	114	(414)
Operating Profit		138		174
Less: Interest Payable		-		(32)
Profit on Ordinary Activities before Tax		138		142

Balance Sheet as at the end of the last two years **(in ₹ 000s)**

Particulars	Last Year (₹)		This Year (₹)	
Tangible Fixed Assets		220		286
Current Assets:				
— Stocks	544		660	
— Debtors	384		644	
— Cash at Bank	8		110	
	936		1,414	
Less : Trade Creditors	(256)		(338)	
Net Current Assets		680		1,076
Total Capital Employed (Fixed Assets + Net Current Assets)		900		1,362
Less: Debentures and Loans		-		(320)
Shareholders' Funds		900		1,042

You may assume that:

- The range of products sold by the Company remained unchanged over the two years.
- The Company managed to acquire its products this year at the same prices as it acquired them last year.
- The effects of any inflationary aspects have been taken into account in the figures.

Ignore taxation and show all calculations to one decimal place. You are required, using the information above, to assess and comment briefly on the Company, from the point of view of—(a) Profitability and (b) Liquidity.

Solution :

1. Computation of Profitability related indicators (Amount in ₹ 000s)

(Express in Percentage)

Ratios	Last Year	This Year
1. Gross Profit Ratio = Gross Profit ÷ Turnover	= 528/2,400 = 22%	=588/2,800 =21%
2. Cost of Sales to Sales ratio = Cost of Sales ÷ Sales	= 1872/2,400 = 78%	=2212/2,800 = 79%
3.Net Profit Ratio = Net Profit ÷ Turnover	=138/2,400 = 5.8%	=142/2,800 = 5.1%
4.Distribution Costs to Sales = Distribution Cost ÷ Sales	= 278/2,400 = 11.6%	=300/2,800 = 10.7%
5. Administration Exp. to sales = Admn. Cost ÷ Sales	=112/2,400 = 4.7%	=114/2,800 = 4.1%
6. Interest Payable	-	₹32,000
7.Pre-Tax Profit ÷ Shareholders funds	= 138/900 = 15.3%	=142/1,042 = 13.6%

2. Analysis of Profitability Ratios

1. **Gross Profit Ratio**: There is a drop in the gross margin from 22% to 21% and also increase in the ratio of Cost of Sales to Turnover. This may be because of — (a) an increase in the cost of sales; or (b) a drop in the selling price. Since, the cost of purchase of materials has not changed, the cost of operation like labour has gone up or the sales price has been marginal lowered.
2. **Fall in Net Profit Ratio**: There is a marginal fall in Net Profit Margin which is due to a combination of factors like ----(a) Drop in the Gross Profit margin and (b) Incremental interest outflow due to raising of Loan Capital for expansion during the year.
3. **Reduction in ratio of other costs to Turnover**: The fall in Net Profit Margin has been curtailed due to the drop in the ratio of Distribution Costs and Administration Costs to Turnover.
4. **Increase in Sales**: The sales during the year has raised by 20%. This may be due to the expansion programme financed by the Loan Capital.
5. **Return on Shareholders Funds**: The Return on Shareholders Funds has dropped and due to the overall drop in the Profit Margin.

3. Computation of Liquidity related Ratios (Amount in ₹ 000s)

Ratios	Last Year	This Year
1. Current ratio = Current Assets ÷ Current Liabilities	936÷ 256 = **3.7 times**	1,414 ÷ 338 = **4.2 times**
2. Quick Ratio = Quick Assets ÷ Current Liabilities = (Debtors + Bank) ÷ Current Liabilities	392 ÷ 256 = **1.5 times**	754 ÷ 338 = **2.2 times**
3. Stock Turnover Ratio = Cost of Sales ÷ Closing Stock	1,872 ÷ 544 = **3.4 times**	2,212 ÷ 660 = **3.4 times**
4. Stock Holding Period = 365 ÷ Stock Turnover Ratio	365 ÷ 3.4 = **107 days**	365÷3.4 = **107 days**
5. Debtors Turnover Ratio = Credit Sales ÷ Closing Debtors	2,200 ÷ 384 = **5.7 times**	2,640 ÷ 644= **4.1 times**
6. Avg Credit Period = 365 ÷ Debtors Turnover Ratio	365 ÷ 5.7 = **64 days**	365 ÷ 4.1 = **89 days**
7. Cash at Bank	₹8,000	₹1,10,000
8. Gearing Ratio = Debt ÷ Equity	NIL	320 ÷ 1042 = **0.31**

4. Analysis of Liquidity Ratios

1. **Improvement in Current and Liquid Ratio**: Current Ratio and Quick Ratio have improved. Part of this is due to the additional loan raised during the year.
2. **Stock Turnover Ratio**: The Company has been steady in it sales as is reflected in the unchanged Stock Turnover Ratio.
3. **High Collection Period:** The time taken for collection of dues from Debtors has increased during the period from 64 days to 89 days. Debtors now take almost 25 more days to settle their accounts. This may be due to —(a) Poor Credit Control; and /or (b) Extension of more credit to stimulate Sales.
4. **Cash Balance**: The Cash Balance represents the idle funds as at the year end and they generate no return. Hence, they should be put to work to earn a return.

Performance Evaluation using Accounting Ratio

Illustration 70:

Following is the Balance Sheet of a Company for the two years — (in ₹)

Liabilities	Last year	This Year	Assets	Last Year	This Year
Equity Capital	8,00,000	8,00,000	Fixed Assets	5,00,000	15,00,000
Reserves & Surplus	2,00,000	1,00,000	Stock	8,00,000	3,00,000
12% Debentures	2,00,000	12,00,000	Debtors	12,00,000	20,00,000
Current Liabilities	14,00,000	18,00,000	Cash	1,00,000	1,00,000
Total	26,00,000	39,00,000	Total	26,00,000	39,00,000

The Trading Results for Year were as under:-

Particulars	Last Year	This Year
Sales	80,00,000	1,20,00,000
Less: Variable Expenses	(56,00,000)	(90,00,000)
Contribution	24,00,000	30,00,000
Less: Fixed Expenses	(22,00,000)	(22,00,000)
Fixed Expenses (Fresh Commitments)	-	(6,00,000)
Profit for Taxes and other appropriations	2,00,000	2,00,000

Comment on the Company's Performance for the year by calculating (a) Capitalization & Solvency, (b) Profitability, (c) Liquidity Ratios.

Solution:

1.Computation of Relevant Accounting Ratios

Ratios	Last Year	This Year
Capitalization & Solvency Ratios:		
1. Debt Equity Ratio = Debt ÷ Equity	= ₹ (2,00,000 ÷ 10,00,000)	= ₹ (12,00,000 ÷ 9,00,000)
	= 0.20 times	= 1.33 times
2. Debt to Capital Employed	= ₹ (2,00,000 ÷ 12,00,000)×100) = 17%	= ₹ (12,00,000 ÷ 21,00,000)×100 = 57%
3. Debt to Total Assets	= ₹ (2,00,000 ÷ 26,00,000)×100) = 8%	= ₹ (12,00,000 ÷ 39,00,000)×100 = 31%
4. Fixed Assets to Capital Employed	= ₹ (5,00,000 ÷ 12,00,000)×100 = 42%	= ₹ (15,00,000 ÷ 21,00,000)×100 = 71%

Profitability Ratios:	Last Year	This Year
1. Contribution Ratio (PV Ratio) 2. Net Profit Ratio 3. Return on NW = PAT ÷ Net Worth	= ₹ (24,00,000÷ 80,00,000)×100 = 30% = ₹ (2,00,000 ÷ 80,00,000)×100 =2.5% = ₹ (2,00,000 ÷ 10,00,000)×100 = 20%	= ₹ (30,00,000 ÷ 1,20,00,000)×100=25% = ₹ (2,00,000 ÷ 1,20,00,000)×100=1.7% = ₹ (2,00,000 ÷ 9,00,000)×100=22.22%
Liquidity Ratios		
1. Current Ratio = Current Assets ÷ Current Liabilities	= ₹ (21,00,000 ÷ 14,00,000)=1.5 times	= ₹ (24,00,000 ÷ 18,00,000)= 1.33 times
2. Quick Ratio = Quick Assets ÷ Current Liabilities i.e., (Current Assets – Stock) ÷ Current Liabilities	= ₹ (13,00,000 ÷ 14,00,000) = 0.93 times	= ₹ (21,00,000÷18,00,000)= 1.17 times
3. Stock Turnover = Sales ÷Clg Stock	= ₹ (80,00,000 ÷8,00,000) = 10 times	= (1,20,00,000 ÷ 3,00,000) = 40 times
4. Debtors Turnover = Sales ÷ Debtors	= ₹ (80,00,000 ÷ 12,00,000) = 6.67 times	= (1,20,00,000 ÷ 20,00,000) = 6 times
5. Debtors Credit Period = 12 Months ÷ Debtors Ratio	=12 Months ÷6.67 times = 1.8 Months	= 12 Months ÷ 6 Times = 2 Months

2. Evaluation of Company's performance

1. **Debt Equity Ratio**: The Company has large debts in relation to its equity. For every one rupee of the shareholders funds it has ₹1.33 as outside liability. This raises the risk level attributable to shareholders.
2. **Sourcing Funds for Fixed Assets**: Fixed assets are being financed from long-term sources. The Fixed Assets are only one third of the total assets while long-term funds are more than 50% of the total liabilities. Therefore, the Company's Capital Gearing is good.
3. **Profitability**: Contribution Ratio and Net Profit Ratio have decreased in comparison to the previous year. This is mainly because additional commitments during the year like additional interest on funds raised during the year by way of issue of Debentures. However, the ROI has gone up. This is because of disbursement of funds as dividend (inferred from reduction in balance in reserves) to the Equity Holders.
4. **Liquidity**: The liquidity position is fairly good for the Company, as evidenced by a healthy Current Ratio and Quick Ratio.
5. **Stock and Debtors**: Stockholding on the closing date is just sufficient to meet the sales of 10 days (3,00,000 / 1,20,00,000 X 365). This, coupled with the increase in sales during the year shows that the extension of credit period to debtors (from 1.8 Months to 2.0 Months) has increased the Sales.
6. **Variable and Fixed Costs**: In increasing its activity level, the company has incurred extra variable cost and its fixed expenditure commitments also have gone up. This fresh fixed cost commitment is highly risky as the company has to operate on higher scale to generate adequate contribution to meet its fixed expenditure commitments.
7. **Overall Comments**: the Company must- (a) Reduce Variable Expenses; (b) Operate in higher level to meet the increasing Fixed Expenditure Commitments; and (c) Maintain adequate Stocks to avoid stock outs.

Estimation of Working Capital Requirements using Ratios

Illustration 71:

Compute Working Capital Requirements of a Company from the following information:

Average Collection Period	60 days	Sales	₹20,00,000
Average Payment Period	75 days	Gross Profit	25%
Inventory Holding Period (on the basis of Cost of Goods Sold)	90 days	Credit Purchases	1/3 of Cost of Goods Sold
Cash & Bank Balances	2.5% of Sales	1 Year	360 days

The Company expects 50% Sales increment during the next year.

Solution:

1. Computation of Cost of Goods Sold

Particulars	₹
Sales	20,00,000
Add: Expected increment at 50% on Sales	10,00,000
Sales for the next year	30,00,000
Less: Gross profit at 25% on Sales	(7,50,000)
Cost of Goods Sold	**22,50,000**

Credit purchases = 1/3rd of ₹22,50,000 = ₹7,50,000

2. Computation of Working Capital Requirements

Particulars	₹
A. Current Assets	
Debtors= Sales X 60 Days ÷ 360 Days = ₹ 30,00,000 × 60/360	5,00,000
Inventory = Cost of Goods Sold X 90 Days ÷ 360 Days = ₹ 22,50,000 × 90 Days/360 Days	5,62,500
Cash and Bank Balances = 2.5% of Sales = ₹ 30,00,000 × 2.5%	75,000
Total Current Assets	**11,37,500**
B. Current Liabilities	
Creditors = Credit Purchases X 75 Days ÷ 360 Days = ₹ 7,50,000 × 75 Days ÷ 360 Days	(1,56,250)
C. Net Working Capital = (A-B)	**9,81,250**

Preparation of Balance Sheet using Accounting Ratios-

Illustration 72:

Using the following data, complete the Balance Sheet of the Company : (take 1 year = 365days)

Gross Profit	25% of Sales	Cost of Sales to Inventory	10 Times
Gross Profit	₹1,20,000	Average Collection Period	5 days
Shareholders Equity	₹20,000	Long Term Debt	?
Credit Sales to Total Sales	80%	Current Ratio	1.5 times
Total Turnover to Total Assets	4 Times	Sundry Creditors	₹60,000

The Balance Sheet of the Company is as follows-

Liabilities	₹	Assets	₹
Sundry Creditors		Cash	
Long-Term Debt		Sundry Debtors	
Share Capital		Inventory	
		Fixed Assets	

Solution:

1. Application of Ratios to find missing figures

1.	Sales	= Gross Profit ÷ Gross Profit Ratio = ₹1,20,000 ÷25% =	₹ 4,80,000
2.	COGS	=Sales – Gross Profit = ₹4,80,000 - ₹ 1,20,000 =	₹ 3,60,000
3.	Inventory	= COGS ÷ Inventory Turnover Ratio = ₹3,60,000 ÷ 10 =	₹ 36,000
4.	Total Assets	= Total Turnover ÷ Total Assets = 4 times (given). Hence,	
		₹4,80,000 ÷ Total Assets = 4 times; Hence, Total Assets as per B/S	₹ 1,20,000
5.	Current Assets	= Current Ratio = Current Assets ÷ Current Liabilities = 1.5 times (given)	
		Current Assets ÷ ₹60,000 = 1.5 times; Hence, Current Assets =	₹ 90,000
6.	Debtors	= Credit Sales X Collection Period in Days ÷ 365 Days	
		= Total Sales of ₹4,80,000 X 80% X 5 days ÷ 365 Days =	₹ 5,260
7.	Cash	= Current Assets – Stock in Trade – Debtors= ₹(90,000- 36,000 -5260)=	₹ 48,740

2.Balance Sheet of the Company as at..................

Liabilities	₹	Assets	₹
Sundry Creditors	60,000	Cash	48,740
Long-Term Debt (balancing figure)	40,000	Sundry Debtors	5,260
Share Capital	20,000	Inventory	36,000
		Fixed Assets(balancing figure)	30,000
	1,20,000		1,20,000

Financial Statements Preparation using Ratios

Illustration 73:

Complete the following Annual Financial Statements on the basis of ratios given below

Profit and Loss Account

Particulars	₹	Particulars	₹
To, Cost of Goods Sold To, Operating Expenses To, Earning Before Interest and Tax	6,00,000	By, Sales	20,00,000
To, Debenture Interest To, Income Tax To, Net Profit	10,000	By, Earnings before Interest and Tax	

Balance Sheet

Liabilities	₹	Assets	₹
Net Worth: Share Capital Reserve and Surplus 10% Debentures Sundry Creditors	60,000	Fixed Assets Current Assets: — Cash — Stock — Debtors	35,000

Other information:

Net Profit to Sales	5%	Inventory Turnover (based on Cost of Goods Sold)	15 times
Current Ratios	1.5	Share Capital to Reserves	4:1
Return on Net Worth	20%	Rate of Income tax	50%

Solution:

1. Application of Ratios to find missing figures

1.	Profit After Tax	= Sales × Net Profit Ratio = ₹ 20,00,000 X 5%	= ₹1,00,000
2.	Provision for Tax	= Since Income Tax Rate is 50%, Income Tax = 50% of PBIT; And PAT = balance 50%. Therefore, PAT and income Tax are equal. Hence, Income Tax = ₹1,00,000 (same as PAT)	₹1,00,000
3.	Debentures	= Interest on Debentures / Rate of Interest = ₹10,000/10% =	₹1,00,000
4.	EBIT	= Net Profit After Tax + Provision for Tax + Debenture Interest = ₹(1,00,000 + 1,00,000 + 10,000) =	₹2,10,000

5. Net Worth = Return/ Rate of Return on Net worth = ₹1,00,000/20% = ₹ 5,00,000
6. Share Capital = Net worth × 4/5 = ₹5,00,000 × 4/5 = ₹ 4,00,000
7. Reserves = Net Worth Less Share Capital = ₹5,00,000 - ₹4,00,000 = ₹ 1,00,000
8. Current Assets = Current liabilities × 1.5 = Trade Creditors ₹60,000 × 1.5 = ₹ 90,000
9. Closing Stock = Cost of Goods Sold / Inventory Turnover Ratio = ₹6,00,000/15 = ₹ 40,000

2.Profit and Loss Account

Particulars	₹	Particulars	₹
To, Cost of Goods Sold	6,00,000	By, Sales	20,00,000
To, Operating Expenses (balancing fig)	11,90,000		
To, Earnings before Interest and Tax	2,10,000		
	20,00,000		20,00,000
To, Debenture Interest	10,000	By, Earnings before Interest and Tax	2,10,000
To, Income Tax	1,00,000		
To, Net Profit	1,00,000		
	2,10,000		2,10,000

3.Balance Sheet

Liabilities	₹	₹	Assets	₹	₹
Net Worth:			Fixed Assets (bal. figure)		5,70,000
---- Share Capital:	4,00,000		Current Assets:		
----Reserve and Surplus	1,00,000	5,00,000	— Cash (bal . figure)	15,000	
10% Debentures		1,00,000	— Stock	40,000	
Sundry Creditors		60,000	— Debtors	35,000	90,000
		6,60,000			6,60,000

Preparation of Balance Sheet using Ratios

Illustration 74:

Based on the following information and Financial Ratios, prepare Balance Sheet the Company. Explain your workings and assumptions.

Current Ratio	2.5	Turnover Ratio to Net Fixed Assets	2
Liquidity Ratio	1.5	Average Debt Collection Period	2.4Mnths
Net Working Capital	₹6,00,000	Fixed Assets to Net Worth	0.80
Stock Turnover Ratio	5	Long Term Debt to Capital and Reserves	7/25
Ratio of Gross Profit to Sales	20%		

Solution:

1.Application of Ratios to find missing figures

1.	Current Liabilities	= Current Ratio = CA÷CL = 2.5. Hence, CA = 2.5 CL;	
		Also, Net Working Capital = CA-CL = 2.5CL-CL = 6,00,000	
		1.5CL= ₹ 6,00,000. Hence, Current Liabilities = 6,00,000 ÷ 1.5	= ₹ 4,00,000
2.	Current Assets	2.5 CL = 2.5 X ₹ 4,00,000	= ₹ 10,00,000
3.	Quick Assets	Quick Ratio = Quick Assets ÷ Current Liabilities = 1.5	
		Quick Assets = Current liabilities X 1.5 = ₹4,00,000 X 1.5	= ₹ 6,00,000
4.	Stock	Quick Assets = Current Assets Less Stock. Hence, Stock (2)-(3)	₹ 4,00,000
5.	COGS	Stock turnover = COGS ÷ Stock. Hence, COGS = ₹ 4,00,000 X 5	₹ 20,00,000
6.	Sales	Since GP = 20%, COGS =80% of Sales. So, Sales = ₹ 20,00,000 ÷ 80%	25,00,000
7.	Fixed Assets	Turnover ÷ Net Fixed Assets = 2(given). So, FA = ₹ 25,00,000÷ 2	₹ 12,50,000
8.	Debtors	Debt Collection Period = 2.4 Mths. So, Debtors= ₹ 25,00,000x2.4/12	₹ 5,00,000
9.	Net Worth	Fixed Assets ÷ Net Worth = 0.80. Hence, Net Worth = FA ÷ 0.80 =	₹ 15,62,500
10.	Long Term Debt	Long Term Debt ÷ Net Worth = 7/25	
		Hence, Long Term Debt = ₹15,62,500 × 7/25 =	₹ 4,37,500

2. Balance Sheet

Liabilities	₹	Assets	₹
Capital and Reserves	15,62,500	Fixed Assets: Cost less Depreciation	12,50,000
		Other Assets / Invts (balancing figure)	1,50,000
Long Term Debt	4,37,500		
Current Liabilities	4,00,000	Current Assets:	
		— Stock in Trade 4,00,000	
		— Sundry Debtors 5,00,000	
		— Cash (bal figure) 1,00,000	10,00,000
	24,00,000		24,00,000

Note: The difference in Balance Sheet is presumed as Investments

Preparation of Financial Statements using Ratios

Illustration 75:

From the following information of a Company, prepare its Trading, Profit & loss Account for the year ended 31st March and a summarized Balance Sheet as at that date:

Current Ratio	2.5	Sales	₹ 7,30,000
Quick ratio	1.3	Working Capital	₹ 1,20,000
Proprietary Ratio	0.6	Bank Overdraft	₹ 15,000
(Fixed Assets ÷ Proprietary Fund)		Share Capital	₹ 2,50,000
Gross Profit to Sales Ratio	10%	Closing Stock	10% more than Opening Stock
Debtors Velocity	40 days		
		Net Profit	10% of Proprietary Funds

Solution:

1. Application of Ratios for computing missing figures

1.	Current Liabilities	Current Ratio = Current Assets (CA) ÷ Current Liabilities (CL) = 2.5.	
		Hence, CA = 2.5CL;	
		Also, Net Working Capital = CA-CL = 2.5CL –CL = 1,20,000	
		1.5 CL = ₹ 1,20,000. Hence, Current Liabilities = ₹ 1,20,000 ÷ 1.5	₹ 80,000
2.	Current Assets	2.5CL = 2.5 X ₹ 80,000	₹ 2,00,000
3.	Closing Stock	Quick Assets (QA) ÷ Quick Liabilities (QL) = 1.3 times.	
		So, (CA-Stock) ÷ (CL-Bank OD) = 1.3	
		(2,00,000- Stock)÷ (80,000-15,000) = 1.3.	
		On substituting, Clg Stock	₹ 1,15,500
4.	Opening Stock	Clg Stock = 10% more than Opg Stk. So, Opg Stock	
		= ₹ 1,15,500÷ 110%	₹1,05,000
5.	Debtors	= Sales X 40/365 days = ₹ 7,30,000 X 40/365	₹ 80,000
6.	Gross Profit	= 10% of Sales = 10% X ₹ 7,30,000	₹ 73,000
7.	Proprietary Fund	= Given Fixed Assets ÷ Proprietary Fund = 0.6	
		Hence, Working Capital ÷ Proprietary Fund = 1-0.6 = 0.4	
		Since Working Capital = ₹ 1,20,000 , on substitution	
		Proprietary Fund	= ₹ 3,00,000
8.	Fixed Assets	= Proprietary Funds X Proprietary Ratio = ₹ 3,00,000 X 0.6 =	₹ 1,80,000
9.	Net profit	= 10% of Proprietary Fund = ₹ 3,00,000 X 10% =	₹ 30,000
10.	Reserves	Total Proprietary Fund = ₹ 3,00,000 of which Share Capital =	₹ 2,50,000
		Hence, Reserves, including P & L A/c Balance	₹50,000

2.Trading and Profit and Loss Account for the year

Particulars	₹	Particulars	₹
To, Opening Stock	1,05,000	By, Sales	7,30,000
To, Purchases (balancing figures)	6,67,500	By, Closing Stock	1,15,500
To, Gross Profit c/d	73,000		
	8,45,500		**8,45,500**
To Operating Expenses (balancing figure)	43,000	By Gross Profit b/d	73,000
To Net Profit for the year	30,000		
	73,000		**73,000**

3.Balance Sheet

Liabilities	₹	Assets	₹
Share Capital	2,50,000	Fixed Assets	1,80,000
Reserves and Surplus: Profit & Loss A/c	50,000	Current Assets	
Current Liabilities:		— Stock	1,15,500
— Bank Overdraft	15,000	— Debtors	80,000
— Other Current Liabilities (balancing figure)	65,000	— Cash & bank (balancing figure)	4,500
	3,80,000		**3,80,000**

Statement of Proprietary Fund from Ratios

Illustration 76:

Working Capital of a Company is ₹ 1,35,000 and Current Ratio is 2.5, Liquid Ratio is 1.5 and the Proprietary Ratio is 0.75. Bank Overdraft is ₹ 30,000. There are no Long Term Loan and Fictitious Assets. Reserves and Surplus amount to ₹ 90,000 and the Gearing Ratio (Equity Capital ÷ Preference Capital) is 2

From the above, you are required to ascertain:

(a) Current Assets (CA);	(e) Quick Liabilities (QL);
(b) Current Liabilities (CL);	(f) Quick Assets (QA);
(c) Net Block;	(g) Stock in Trade; and
(d) Proprietary Fund;	(h) Preference & Equity Capital

Also draw the Statement of Proprietary Fund

Solution:

1.Application of Ratios for computing missing figures

1.Current Liabilities	Current Ratio = CA ÷ CL = 2.5. Hence, CA = 2.5 CL;	
	Also, Net Working Capital = CA –CL = 2.5CL –CL = 1,35,000	
	1.5CL = ₹ 1,35,000. Hence, Current Liabilities = ₹ 1,35,000 ÷ 1.5	₹ 90,000
2.Current Assets	2.5CL = 2.5 X ₹ 90,000	₹ 2,25,000
3.Closing Stock	QA ÷ QL = 1.5 times . So, (CA- Stock) ÷ (CL – Bank OD) = 1.5	
	(₹ 2,25,000 – Stock)÷₹(90,000-30,000)=1.5 On substituting Clg Stock =	₹ 1,35,000
4. Fixed Assets	Proprietary Ratio = Proprietary Funds ÷ Total Assets i.e.,	
	(Fixed Assets + Net Wkg Capital) ÷ (Fixed Assets + Current Assets) =	0.75
	(Fixed Assets + ₹ 1,35,000) ÷ (Fixed Assets + ₹ 2,25,000) = 0.75	
	On substitution, Fixed Assets =	₹ 1,35,000
5.Proprietary Fund	Fixed Assets + Net Working Capital = ₹ (1,35,000 +1,35,000) =	₹ 2,70,000
6.Capital	Total Share Capital = Proprietary Funds – Reserves	
	= ₹ (2,70,000-90,000) =	₹1,80,000
	Since Equity ÷ Preference is 2 time; Equity = 1,80,000 X 1/3 =	₹60,000
	And Preference Capital = ₹ 1,80,000 X 2/3 =	₹ 1,20,000

2. Statement of Proprietary Funds

Particulars	₹	₹
Sources of Funds:		
Equity Capital		1,20,000
Preference Capital		60,000
Reserves and Surplus		90,000
		2,70,000

Application of Funds:			
Net Fixed Assets			1,35,000
Current Assets:			
— Stock		1,35,000	
— Other Current Assets		90,000	
		2,25,000	
Less: Current Liabilities			
— Bank Overdraft	30,000		
— Other Current Liabilities	60,000	90,000	1,35,000
			2,70,000

Preparation of Balance Sheet using Ratios

Illustration 77:

From the following information you are required to prepare a Balance Sheet

• Current Ratio: 1.75 • Liquid Ratio: 1.25 • Stock Turnover Ratio (Cost of Sales ÷ Closing Stock) : 9 • Gross Profit Ratio : 25% • Debt Collection Period: 1 ½ months	• Reserves and Surplus to Capital: 0.2 • Turnover to Fixed Assets: 1.2 • Capital Gearing Ratio: 6 • Fixed Assets to Net Worth: 1.25 • Sales for the year ₹ 12,00,000

Solution:

1. Application of Ratios for computing missing figure

1. Gross Profit	= Sales X Gross Profit Ratio = ₹ 12,00,000 X 25% =	₹ 3,00,000
2. COGS	= Sales – Gross Profit =₹ 12,00,000 - ₹ 3,00,000 =	₹ 9,00,000
3. Stock	= Stock Turnover = COGS ÷ Closing Stock = 9 times (Given)	
	Hence, ₹ 9,00,000 ÷ Stock = 9. Hence, Closing Stock	₹ 1,00,000
4. Current Liabilities	Current Ratio = CA÷ CL = 1.75. Hence, CA = 1.75 C.L	
	Also, Quick Ratio = (CA-Stock) ÷ CL = 1.25.	
	Substituting Stock and CA, we have, 1.75C.L – 1,00,000 = 1.25C.L	
	Hence, 0.5CL = 1,00,000. Therefore, Current Liabilities =	₹ 2,00,000
5. Current Assets	= CA = 1.75CL=1.75 X 2,00,000 =	₹ 3,50,000
6. Debtors	= Sales X 1.5 months / 12 months = 12,00,000 X 1.5/12	₹ 1,50,000
7. Fixed Assets	= Turnover ÷ FA = 1.2. Since Turnover (i.e Sales) = 12,00,000, F.A =	₹ 10,00,000
8. Net Worth	= Fixed Assets ÷ Net Worth = 1.25; Since FA = ₹ 10,00,000; Net Worth=	₹ 8,00,000
9. Capital	= Reserves and Surplus ÷ Capital = 0.2; Hence, R & S = 0.2 X Capital	
	Net Worth = R & S + Capital = 0.2 X Capital + Capital = ₹ 8,00,000.	
	1.2 Capital = ₹ 8,00,000. Hence, Capital = 8,00,000÷ 1.2	₹ 6,66,667
10. Reserves	= Net Worth – Capital = 8,00,000-6,66,667 =	₹ 1,33,333

2. Balance Sheet

Liabilities	₹	Assets	₹
Share Capital	6,66,667	Fixed Assets	10,00,000
Reserves	1,33,333	Current Assets	
Long Term Liabilities (balancing figures)	3,50,000	— Stock	1,00,000
		— Debtors	1,50,000
Current Liabilities	2,00,000	— Cash and Bank Balances (bal. figure)	1,00,000
	13,50,000		**13,50,000**

Preparation of Financial Statements using Ratios

Illustration 78:

From the following data, prepare the Financial Statements of the Company for the year ended on 31st March.

Gross Profit Ratio	40% on Sales	Net Profit Ratio	10% on Sales
Debtors Turnover Ratio	2 Months	Other Expenses(Administrative)	₹ 25 lakhs
Creditors Turnover Ratio	1.5 Months	Depreciation	₹ 5 lakhs
Inventory Turnover Ratio	2 Months	Debentures to Equity Share Capital	10%
Current Ratio	2.5 months		

Opening Stock was less than the Closing Stock by ₹4 lakhs. The ratio of Cash Sales to Credit Sales was 16:9. Depreciation was charged on Fixed Asset at 20%. Other Expenses include the payment of Interest on Debentures. No dividends were declared during the year. Ignore taxation.

Solution:

1. Application of Ratios for computing missing figure

1.Sales — Since GP Ratio and NP Ratio are 40% and 10% of Sales respectively,

Other Expenses debited to P & L Account = 40% -10% = 30% of Sales.

Since Other Expenses + Depreciation debited in P & L A/c =

(₹ 25+₹ 5) lakhs = ₹ 30 lakhs, Sales = 30 ÷ 30% = ₹100 lakhs

2.Gross Profit = 40% of Sales= ₹40 lakhs

3.Net Profit =10% of Sales = ₹10 lakhs

4.Credit Sales = Cash Sales to Credit Sales = 16:9

Hence Credit Sales = Total Sales X 9/25 = 100X 9/25 = ₹ 36 lakhs

5.Debtors = Credit Sales × 2 months /12 months = ₹ 36X 2/12 = ₹6 lakhs

6.Average Stock = COGS × 2 months ÷ 12 months = (Sales – GP) × 2/12 = 60X2/12 ₹10 lakhs

7.Closing Stock = Average Stock = (Opening Stock + Closing Stock) ÷ 2 = 10 lakhs.

Opening Stock = Closing Stock- 4 lakhs. On substituting.

(Closing Stock -4 + Closing Stock) ÷ 2 = 10; Hence, Closing Stock = ₹ 12 lakhs

Therefore Opening Stock = 12-4 = ₹8 lakhs

8. Purchases = COGS = Opening Stock + Purchases – Closing Stock.

Since COGS =Sales –GP = 100-40 = 60,

Opening and Closing Stocks are known, on substitution,

Purchases will be the bal. figure = ₹ 64 lakhs

9. Creditors = Credit Purchases X 1.5 months ÷ 12 months = 64 X 1.5/12 ₹ 8 lakhs

10. Current Assets : = Current Ratio = 2.5; CA ÷ CL = 2.5; Hence, CA = 2.5 CL.
Since CL = Creditors = ₹ 8 lakhs, on substitution, CA = 2.5 X 8 lakhs = ₹ 20 lakhs

11. Fixed Assets = Depreciation ÷Deprn Rate = ₹ 5 lakhs ÷ 20% = ₹ 25 lakhs

12. Net Block = Gross Block – Depreciation = ₹ 25 lakhs - ₹5lakhs = ₹ 20 lakhs

13. Cap.Employed = Fixed Assets + Net Working Capital = 20+(20-8) = ₹ 32 lakhs

14. Debentures = Capital Employed = Debt + Equity = Debenture + (Capital + R & S)
= ₹ 32lakhs, of which P&L = ₹ 10 lakhs. Hence, Debentures+ Share Capital
= ₹ 22 lakhs. Since Debentures to Share Capital = 10%,
Debentures = ₹ 22 × 10/110 = ₹ 2 lakhs

15. Share Capital = ₹ (22 – 2) = ₹ 20 lakhs

2. Trading and Profit and Loss Account for the year ended 31st March

Particulars	₹ in lakhs	Particulars	₹ in lakhs
To Opening Stock	8	By Sales	100
To Purchases	64	By Closing Stock	12
To Gross Profit c/d	40		
	112		**112**
To Depreciation	5	By Gross Profit b/d	40
To Other Expenses	25		
To Net Profit	10		
	40		**40**

3. Balance Sheet as on 31st March

Liabilities	₹ in lakhs	Assets	₹ in lakhs
Equity Share Capital	20	Fixed Assets (Net Block)	20
Profit and Loss Account	10	Current Assets:	
Debentures	2	Debtors	6
Creditors	8	Stock	12
		Cash — bal.figure	2
	40		**40**

Preparation of Financial Statements using Ratios

Illustration 79:

Given below is the Balance Sheet of a Company as at the beginning of a Financial year (1st April)

Liabilities	₹	Assets	₹	₹
Share Capital: Equity Shares	2,00,000	Fixed Assets : Cost	5,00,000	
14% Preference Shares	1,00,000	Less : Depreciation	1,60,000	3,40,000
General Reserve	40,000			
12% Debentures	60,000	Stock-in-Trade		60,000
Current Liabilities	1,00,000	Sundry Debtors		80,000
		Cash		20,000
	5,00,000			5,00,000

The following information is available

- Fixed Assets costing ₹1,00,000 to be installed on 1st April, would become operative on that date, payment is required to be made on 31st March (end of the financial year).
- The Fixed Assets Turnover Ratio would be 1.5 (on the basis of Cost of Fixed Assets)
- The Stock-Turnover Ratio would be 14.4 (on the basis of the Average of the Opening and Closing Stock).
- The break-up of Costs and Profit would be as follows: Materials -40% ; Labour-25%; Manufacturing OH-10%; Admin. and Selling OH – 10%; Depreciation – 5%; and Profit -10%; This Profit is subject to interest and Taxation at 50%.
- Debtors would be 1/9th of Sales while Creditors would be 1/5th of Materials Cost.
- Dividend at 10% would be paid on Equity Shares in March.
- ₹50,000, 12% Debentures have been issued on 1st April.

Prepare the Company's Balance Sheet as on 31st March (end of the financial year) and show the following resultant ratios- (a) Current Ratio; (b) Fixed Assets to Net Worth Ratio. Show workings.

Solution:

1. Application of Ratios for computing missing figures

1. Sales : Fixed Assets Turnover Ratio = Turnover ÷ Fixed Assets = 1.5 (given)

F.A = Opg Bal. + Additions = 5,00,000 + 1,00,000 = 6,00,000.

Hence, Sales = 6,00,000 X 1.5 = ₹ 9,00,000

2.P & L Account : Since breakup of Cost and Profits is given , P & L is prepared below:

Particulars				₹	₹
Sales					9,00,000
Less :	Expenses	Cost of Materials	(₹9,00,000 x 40%)	3,60,000	
		Labour	(₹9,00,000 x 25%)	2,25,000	
		Manufacturing Expenses	(₹9,00,000 x 10%)	90,000	
		Admin. and Selling Expenses	(₹9,00,000 x 10%)	90,000	
					(7,65,000)

Profit Before Depreciation , Interest and Tax Less: Depreciation (₹9,00,000 x 5%)		1,35,000 (45,000)
Profit Before Interest and Tax Less: Interest on Debentures [(₹60,000 + ₹50,000) x 12%]		90,000 (13,200)
Profit before Tax Less: Provision for Taxation at 50%		76,800 (38,400)
Profit After Tax Less: Preference Dividend for the year at 14% of ₹1,00,000		38,400 (14,000)
Balance Less: Equity Dividend at 10% of ₹2,00,000		24,400 (20,000)
Balance carried to Balance Sheet		4,400

3. Average Stock: Stock Turnover Ratio = Sales ÷ Average Stock = 14.4 times
(It is Assumed that Sales is taken instead of Cost of Goods Sold)
Hence, ₹9,00,000 ÷ Average Stock = 14.4. Hence, Average Stock = ₹62,500

4. Closing Stock : Average Stock = (Opening Stock + Closing Stock) ÷ 2
62,500 = (60,000+Closing Stock) ÷ 2. Hence, Closing Stock = ₹65,000

5. Debtors : 1/9th of Sales = 1/9 X ₹9,00,000 = ₹1,00,000

6. Creditors : 1/5th of Cost of Materials = 1/5 X ₹3,60,000 = ₹72,000

7. Cash & Bank : Statement showing the closing balance of cash as under

Inflows	₹	Outflows	₹
To Balance b/d - Opening balance.	20,000	By Increase in Current Assets:	
To Net Profit for the year	4,400	— Stock in Trade (65,000 - 60,000)	5,000
To Depreciation — Non Cash Item	45,000	— Trade Debtors (1,00,000-80,000)	20,000
To Debentures — proceeds of issue	50,000	By Decrease in Current Liabilities:	
To balance c/d (Overdraft Balance)	33,400	— Trade Creditors (1,00,000 -72,000)	28,000
(balancing figure)		By Asset Purchased	1,00,000
	1,53,000		**1,53,000**

2. Balance Sheet as at 31st March

Liabilities	₹	Assets	₹
Share Capital ; - Equity Share Capital	2,00,000	**Fixed Assets**:	
-14% Pref. Share Capital	1,00,000	Cost (5,00,000 + 1,00,000)	6,00,000
Reserve & Surplus:- General Reserve	40,000	**Less:** Depreciation (1,60,000 +45,000)	2,05,000
- P & L A/c	4,400	Net Block	3,95,000
Long Term Loan:			
12% Debentures (50,000 +60,000)	1,10,000	**Current Assets:**	
Current Liabilities: Trade Creditors	72,000	- Stock in Trade	65,000
Bank Overdraft	33,600	- Sundry Debtors	1,00,000
	5,60,000		**5,60,000**

Preparation of Financial Statements from Ratios

Illustration 80:

'X' manufacturers of Compact Discs and DVDs, commenced business on 1st April with a Paid Up capital of ₹5,00,000. On the same date it also obtained a Term Loan at 20% interest towards 100% of the Cost of a Special Machine from the State Financial Corporation. The loan is to be repaid over five years in equal installments excluding interest, the first installment being due on 31st March (end of the year).

For the first year ended 31st March, the Company's final accounts were prepared and stored in a Personal Computer. The Company had retained and transferred to Reserve a sum of ₹2,00,000 after proving for Taxes (Tax Rate 40%) and proposed a Dividend of 20%. The Company had invested the entire Reserve amount of ₹2,00,000 on 31st March in Government Securities. It had also paid first installment of the loan.

Unfortunately due to a computer virus, the data has been lost. However, the Chief Accountant is able to provide the following information.

Debt Service Coverage Ratio	2.5 Times	Debtors Turnover Ratio	2 Months
Interest Coverage Ratio	6 Times	Current Ratio	2
Creditors Turnover Ratio	1 Month	Gross Profit Ratio to Sales	33-1/3%
Stock Turnover Ratio (Based on Closing Stock)	5 Times	Selling and Admin Exps.	₹3,00,000

You are required to prepare the Profit and Loss Account and Balance Sheet of the Company.

Solution:

1. Application of Ratios to compute missing figures

1. Profit After Tax :	Retained Earnings + Proposed Dividend	
	= 2,00,000 + 20% X ₹ 5,00,000	₹ 3,00,000
2. Profit before tax :	Since Tax Rate = 40%, PAT = 60% (i.e. balance income).Hence,	
	Profit before Tax = PAT ÷ 60% = ₹3,00,000 ÷ 60% =	₹ 5,00,000
3. Interest on Loan :	Interest Coverage Ratio = PBIT ÷ Interest. Also, PBIT = PBT + Int.	
	Hence, (PBT + Interest) ÷ Interest = 6 times. On substitution of	
	PBT, we have, (₹ 5,00,000 + Interest)÷ Interest = 6. So, Interest =	₹ 1,00,000
4. PBIT :	PBT + Interest = ₹ 5,00,000 + ₹ 1,00,000 =	₹ 6,00,000
5. Loan Installment :	Loan Amount = Interest ÷ Rate of Interest = ₹ 1,00,000 ÷ 20% =	₹ 5,00,000
	Since it is repayable in 5 equal amts, installment p.a =	₹4,00,000
	So, Closing Balance of Loan = 5,00,000-1,00,000 = ₹ 4,00,000	
6. Depreciation :	DSCR = (PAT + Interest+ Depreciation) ÷ (Interest + installment)	
	(3,00,000 +1,00,000+ Depreciation) ÷ (1,00,000 + 1,00,000) = 2.5	
	On solving the above, we have Depreciation =	₹ 1,00,000
7. Gross Profit :	PBIT Add back Depreciation and Selling & Administration Exps.	
	6,00,000 + 1,00,000 +3,00,000 =	₹ 10,00,000
8. Sales	= GP ÷ GP ratio = ₹ 10,00,000 ÷33-1/3%.	₹ 30,00,000

9. COGS :	= Sales-Gross Profit = ₹30,00,000 - ₹ 10,00,000 =	₹ 20,00,000
10. Stock :	Stock Turnover Ratio (based on Closing Stock) = 5 times.	
	COGS ÷ Closing Stock = 5. Since COGS = ₹20,00,000, Clg Stk =	₹ 4,00,000
11. Purchases :	COGS = Opening Stock + Purchases – Closing Stock.	
	20,00,000 = Nil + Purchases – 4,00,000. Hence , Purchases =	₹ 24,00,000
	(Note: Company started business this year. Hence Opg Stock = Nil)	
12. Creditors :	Credit Purchases X 1/12 = ₹ 24,00,000 X 1/12 =	₹ 2,00,000
13. Debtors	Credit Sales X 2/12 = ₹ 30,00,000 X 2/12 =	₹ 5,00,000
14. Current Liabilities :	Creditors + Provision for tax + Proposed Dividend	
	= ₹ 2,00,000 + ₹ 2,00,000 + ₹ 1,00,000 =	₹ 5,00,000
15.Current Assets	Since Current Ratio =2, Current Assets = 2 X CL = 2 X ₹ 5,00,000	₹ 10,00,000
16.Cash & Bank :	Total Current Assets –Stock – Debtors	
	= ₹ 10,00,000 - ₹ 4,00,000 - ₹ 5,00,000 =	₹ 1,00,000
17. Total Liabilities :	Share Capital + Reserves + Loan balance + Current Liabilities	
	= 5,00,000 + 2,00,000 +4,00,000 + 5,00,000 =	₹ 16,00,000
18. Fixed Assets :	Total Assets = Total Liabilities = ₹ 16,00,000	
	FA (Net) + Investments + Current Assets = ₹ 16,00,000. Since	
	Investments = ₹ 2,00,000 and Current Assets = ₹ 10,00,000,	
	the balancing figure for Net Block of Fixed Assets =	₹ 4,00,000
19. Gross Block :	Net Block Add back Depreciation = ₹ 4,00,000 + ₹ 1,00,000 =	₹ 5,00,000

2. Profit and Loss A/c of 'X' Ltd for the year ended 31st March

Particulars	₹
Sales	30,00,000
Less: Cost of Goods Sold	(20,00,000)
Gross Profit	10,00,000
Less: Selling and Administration Expenses	(3,00,000)
Profit Before Depreciation, Interest and Tax	7,00,000
Less: Depreciation	(1,00,000)
Profit Before Interest and Tax	6,00,000
Less: Interest on Term Loans at 20%	(1,00,000)
Profit Before Tax	5,00,000
Less: Provision for Tax at 40%	(2,00,000)
Profit After Tax	3,00,000
Appropriations:	
— Proposed Dividend	1,00,000
— Transfer to Reserves	2,00,000

3. Balance Sheet of X Ltd. as at 31st March

Liabilities	₹	₹	Assets	₹	₹
Share Capital		5,00,000	**Fixed Assets:**		
Reserves and Surplus		2,00,000	Gross Block	5,00,000	
Secured Loans		4,00,000	Less : Depreciation	1,00,000	4,00,000
Current Liabilities:			**Investments** (Given)		2,00,000
— Sundry Creditors	2,00,000		**Current Assets**:		
— Provision for Tax	2,00,000		— Stock	4,00,000	
— Proposed Dividend	1,00,000	5,00,000	— Sundry Debtors	5,00,000	
			— Cash and Bank	1,00,000	10,00,000
		16,00,000			16,00,000

Financial Statements from various Ratios

Illustration 81:

Following is the abridged Balance Sheet of 'M' Ltd as at the beginning of a financial year –

Liabilities	₹	Assets		₹
Paid up Share Capital	5,00,000	Freehold Property		4,00,000
Profit and Loss A/c	85,000	Plant and Machinery	2,50,000	
Current Liabilities	2,00,000	Less: Depreciation	(75,000)	1,75,000
		Stocks		1,05,000
		Debtors		1,00,000
		Bank		5,000
	7,85,000			7,85,000

From the following information, you are required to prepare Profit and Loss A/c and Balance Sheet of the Company as at the end of the financial year.

- The composition of the total of the "Liabilities" Side of the Company's Balance Sheet as at the end of the year (the Paid-Up Share Capital remaining the same as at the beginning) was – Share Capital 50%; P& L A/c 15%; Debentures 10% and Creditors 25%.
- The Debentures Were issued on 1st April, interest (7% p.a) being paid on 30th September and 31st March.
- During the year, additional Plant and Machinery had been bought and a further ₹ 25,000 depreciation written off. Freehold Property remained unchanged. The total Fixed Assets then constituted 60% of Total Fixed and Current Assets.
- The Current Ratio was 1.6:1. The Quick Assets Ratio was 1:1.
- The Debtors (Four-Fifths of the Quick Assets) to Sales Ratio revealed a credit period of two months.
- Gross Profit was at the rate of 15% of Selling Price and Return on Net Worth as at the year-end was 10%.

Solution:

1. Application of Ratios to compute missing figures

1. Liabilities :	Share Capital + P & L A/c + 7% Debentures + Creditors	
	Since Share Capital=50% of Total Liabilities = ₹ 5,00,000, Total Liabilities= ₹ 10,00,000	
2. P&L A/c :	Closing Balance = 15% of Total Liabilities of ₹ 10,00,000 =	₹ 1,50,000
3. 7% Debentures :	10% of total Liabilities of ₹ 10,,00,000 =	₹ 1,00,000
4. Creditors :	25% of Total Liabilities of ₹ 10,00,000 =	₹ 2,50,000
5. Assets :	Total Assets = Total Liabilities =	₹10,00,000
6. Fixed Assets :	60% of Total Assets of ₹ 10,00,000 =	₹ 6,00,000
7. Current Assets :	40% of Total Assets of ₹ 10,00,000 =	₹ 4,00,000
	(Alternatively Current Assets can also be calculated using	
	Current Ratio = CA ÷ CL = 1.6 times. Since Creditors = CL= ₹ 2,50,000	
	Current Assets = 2,50,000 × 1.6 = ₹ 4,00,000)	
8. Plant & Machinery :	Net FA = ₹ 6,00,000 of which Freehold Property = ₹ 4,00,000.	
	Hence, Plant & Machinery (Net Block) = ₹ 2,00,000.	
	Accumulated Depreciation on Plant& Machinery = (₹ 75,000 +₹ 25,000)	
	= ₹ 1,00,000 . So Plant & Machinery (Gross Block) =	₹ 3,00,000
9. Stock :	Current Assets = 4,00,000. Quick Ratio = QA ÷ CL.	
	Hence, (CA-Stock) ÷ CL = 1; (4,00,000- Stock)÷ 2,50,000 = 1	
	On solving, we obtain Closing Stock =	₹ 1,50,000
10. Quick Assets :	Current Assets – Stock = ₹ 4,00,000 -₹ 1,50,000 =	₹ 2,50,000
11. Debtors:	4/5ths of Quick Assets = 4/5 X ₹ 2,50,000 =	₹ 2,00,000

12. Sales : Credit Period = 2months (given). Hence, Closing Debtors of ₹ 2,00,000 represent two months Sales.

Hence, Sales for the year =₹2,00,000 X 12/2 = ₹ 12,00,000

13. Gross Profit : 15% of Sales = 15% × ₹12,00,000 = ₹ 1,80,000

14. COGS : Sales- Gross Profit = ₹12,00,000 - ₹1,80,000 = ₹ 10,20,000

15. Purchases : COGS = Opening Stock + Purchases – Closing Stock.

10,20,000 = 1,05,000+ Purchases -1,50,000. On solving, Purchase = ₹ 10,65,000

16. Net Profit : 10% of Net Worth at the end of the year

= 10% of (Capital + P& L Bal)= 10% of (5,00,000+1,50,000) = ₹ 65,000

2. Profit and Loss A/c of M Ltd. for the Year ended 31st March

Particulars	₹	Particulars	₹
To Opening Stock	1,05,000	By Sales	12,00,000
To Purchases (balancing figure)	10,65,000	By Closing Stock	1,50,000
To Gross Profit c/d (15% x Sales)	1,80,000		
	13,50,000		13,50,000
To Expenses(balancing figure)	83,000	By Gross Profit b/d	1,80,000
To Debenture Interest (₹1,00,000 x 7%)	7,000		
To Depreciation	25,000		
To Net Profit	65,000		
	1,80,000		1,80,000

6. Balance Sheet of 'M' Ltd. as at 31st March

Liabilities	₹	Assets	₹	₹
Share Capital: Paid Up Capital (given)	5,00,000	**Fixed Assets:**		
Reserves and Surplus: Profit & Loss A/c	1,50,000	— Freehold Property		4,00,000
		— Plant and Machinery	3,00,000	
		Less: Depreciation	(1,00,000)	
Secured Loans:				2,00,000
— 7% Debentures	1,00,000			
Current Liabilities and Provisions:		Current Assets:		
Creditors	2,50,000	— Stock	1,50,000	
		— Debtors	2,00,000	
		— Bank (balancing figure)	50,000	4,00,000
	10,00,000			**10,00,000**

5.6 APPLICATION OF AS 3 – CASH FLOW STATEMENT

Introduction

Cash flow statement is additional information to user of financial statement. This statement exhibits the flow of incoming and outgoing cash and cash equivalent. It assesses the ability of the enterprise to generate cash and utilize cash. Cash Flow Statement is one of the tools for assessing the liquidity and solvency of the enterprise.

"The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others to (a) assess the enterprise's ability to generate positive future net cash flows; (b) assess the enterprise's ability to meet its obligations, its ability to pay dividends, and its needs for external financing; (c) assess the reasons for differences between net income and associated cash receipts and payments; and (d) assess the effects on an enterprise's financial position of both its cash and non-cash investing and financing transactions during the period." - SFAS 95 Statement of Cash Flows, Financial Accounting Standards Board, US

Cash

Generally, cash refers to cash in hand and cash at bank. But, for the purpose of preparation of Cash Flow Statement, the Council of the Institute of Chartered Accountants of India (ICAI) issued Accounting Standard - 3, where it is stated that 'cash' includes the following:

(i) Cash in hand;

(ii) Demand Deposits with Bank;

(iii) Cash equivalents.

Cash Equivalents, which are considered as a part of cash as per AS-3, are defined as 'short –term highly liquid investments that are readily converted into known amounts of cash and which are subject to an insignificant risk of changes in value.'

Therefore, as per AS-3 (Revised) ,as issued for the purpose of preparation and presentation of Cash Flow Statement, cash includes:

(i) Cash in Hand

(II) Cash at Bank; and

(iii) Short term Investment or Marketable Securities.

Cash Flow Statement

A cash flow statement is a statement which is prepared by acquiring Cash from different sources and the application of the same for different payments through the year. It is prepared from analysis of cash transactions, or it converts the financial transactions prepared under accrual basis to cash basis. In short we can say, Cash flow statement is a summarized statement showing sources of Cash Inflow and applications of cash outflows of an enterprise during a particular period of time.

Features:

The significant features are:

(i) Cash Flow Statement is very dynamic in character since it records the investment of cash from beginning of the period to the end of the period.

(ii) It is periodical statement as it covers a particular period.

(iii) This statement does not recognize matching principles.

Why Cash Flow Statement Is Prepared?

Cash Flow Statement is considered to be a summarized statement showing sources of Cash Inflows and application of cash outflows of an enterprise during a particular period of time. It is prepared on the basis of the published data as disclosed by the Financial Statement of two different financial periods. It is an essential tool for managerial decision-making. Cash Flow reports the management Net Cash Flow (i.e. cash inflow less cash outflow or vice versa) from each activity of the enterprise as well as of the overall business of the enterprise. The management of the enterprise gets a picture of movement of cash resources from the Cash Flow Statement and can assess the stronger and weaker area of movement of cash for different activities of the business for drawing up the future planning.

Importance of Cash flows

Cash flows are crucial to business decisions. Cash is invested in the business and the rationality of such investment is evaluated taking into account the future cash flows it is expected to generate. Economic value of an asset is derived on the basis of its ability to generate future cash flows. Economic value of an asset is given by the present value of future cash flows expected to be derived from the asset.

Profit is an accounting concept. Profit is derived on accrual assumption. Profit and cash flows from operational activities are not the same. Dividend decision is taken on the basis of profit, although it is to be paid in cash. Similarly, debt servicing capacity of a company is determined on the basis of cash flows from operations before interest. Plugging back of profit is a much talked about source of financing modernization, expansion and diversification. Unless retained profit is supported by cash, ploughing back is not possible. Thus cash flows analysis is an important basis for making several management decisions

Objectivity:

The main objectives of cash flow statement are:

(a) **Measurement of Cash:** Inflows of cash and outflows of cash can be measured annually which arise from operating activities, investing activities and financial activities.

(b) **Generating Inflow of Cash:** Timing and certainty of generating the inflow of cash can be known which directly helps the management to take financing decisions in future.

(c) **Classification of Activities:** All the activities are classified into operating activities , investing activities and financial activities which help a firm to analyze and interpret its various inflows and outflows of cash.

(d) **Periodic of future:** A cash flow statement, no doubt , forecast the future cash flows which helps the management to take various financing decisions since synchronization of cash is possible.

(e) **Assessing liquidity and solvency position:** Both the inflows and outflows of cash and cash equivalent can be known, and also be maintained as timing and certainty of cash generation is known i.e. it helps to assess the ability of a firm to generate cash.

Applicability of Cash Flow:

The following points are satisfied, the company need not prepare cash flow:

(i) The company's turnover (excluding other income) does not exceed 50 cores immediately preceding the accounting year.

(ii) Small Medium Size company need not prepare the cash flow.

(iii) If the equity debt securities are not listed in the stock exchange.

Preparation of Group Cash Flow Statement

The actual cash paid for the subsidiary is shown under the heading 'Acquisitions and Disposals'. It is possible that the purchase consideration will include other forms of payments such as the issue of shares or loan stock and there is no cash flow effect in these cases.

In exchange for the purchase consideration, the group acquires the individual net assets of the subsidiary and goodwill is recognized on acquisition.

The net assets in the closing consolidated Balance Sheet will include those of the newly acquired subsidiary. The preparation of the group cash flow statement must recognize that the movement from opening to closing positions is increased in party by the net assets of the new subsidiary and the amounts relating to that subsidiary are therefore excluded from the cash flow statement.

For example, additions to fixed assets are represented by purchases during the year plus fixed assets of the acquired subsidiary. This is broken down as follows:

Opening + cash purchases + fixed assets of – disposals - depreciation = closing

NBV for additions acquired subsidiary NBV

Only cash purchase for additions are included in the cash flow statement under 'inventive activities'

Presentation of Cash Flow :

Cash Flow Statement explains cash movements under three different heads, namely

- Cash flow from operating activities;
- Cash flow from investing activities;
- Cash flow from financing activities.

Sum of these three types of cash flow reflects net increase or decrease of cash and cash equivalents.

Operating activities are the principal revenue - producing activities of the enterprise and other activities that are not investing and financing. Operating activities include all transactions that are not defined as investing or financing. Operating activities generally involve producing and delivering goods and providing services.

Investment activities are the acquisition and disposal of long term assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Elements of operating cash flow

Given below are elements of operating cash flow:

- Cash receipts from sale of goods and rendering services.
- Cash receipts from royalty, fees, commissions and other revenue.
- Cash payments to suppliers for goods and services.
- Cash payments to and on behalf of employees.
- Cash receipts and cash payments by an insurance enterprise for premiums and claims, annuities and other policy benefits.
- Cash payments and refunds of income taxes unless these are specifically identified as cash flow from financing or investment.
- Cash receipts and payments relating to contracts held for dealing or trading purposes.
- Cash flow arising from dealing in securities when an enterprise holds securities for such purpose.

- Cash advances and loans made by financial institutions including all contracts held for trading purposes which may range from sale license, export-import quota, any other operating contract. This may not necessarily be a contract relating to derivative instruments.

Elements of cash flow from investment activities

Given below are eight elements of investment cash flow:

- Cash payments for acquisition of fixed assets including intangibles.
- Cash receipts from disposal of fixed assets.
- Cash payments to acquire shares, warrants or debt instruments of other enterprises and Interests in joint venture. This does not include an item covered in cash equivalents and items held for dealing or trading purposes.
- Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint venture. This does not include an item covered in cash equivalents and items held for dealing or trading purposes.
- Cash advances and loans made to third parties. This does not include loans and advances made by financial institutions as these fall under operating cash flow.
- Cash receipts from repayments of advances and loans made to third parties. This does not include.
- Cash payments for future, forward, option and swap contracts. This does not include contracts held for dealing or trading purposes or contracts which as classified as financing activities.

Elements of cash flow from financing activities

Given below are five elements illustrated cash flow from financing activities:

1.	Cash proceeds from issuing shares or other equity instruments.
2.	Cash payments to owners to acquire or redeem the enterprise's shares.
3.	Cash proceeds from issuing debentures, loans, notes, bonds, mortgages, and other short term and long term borrowings.
4.	Cash repayments of amounts borrowed.
5.	Cash payments by a lease for the reduction of the outstanding liability relating to a finance lease.

DIRECT METHOD:

Proforma of Cash Flow Statement as per AS-3

Cash flow Statement of ——————————
for the period ended ——————————

Particulars	₹	₹	₹
A. CASH FLOWS FROM OPERATING ACTIVITIES:			
Cash receipts from Customers		—	
Less: Cash paid to Suppliers and Employees		—	
Cash Generated from Operation		—	
Less: Income Tax Paid		—	
Cash Flows from Operation before Extraordinary Items		—	
Add: Proceeds from any Disaster Settlement		—	
Net cash flow from operating activities			—
B. CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from Sale of Fixed assets including Investments		—	
Less: Purchase of Fixed assets including Investments		—	
		—	
Add: Interest Received		—	
Dividends Received		—	
Net cash flow from Investing activities			—
C. CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of share capital		—	
Proceeds from Long-term Borrowings		—	
Less: Repayment of Long-term Borrowings including Redemption of Preference Shares		—	
		—	
Less: Interest Paid	—	—	
Dividend Paid	—	—	
Net cash flow from financing activity			—
Net Increase in cash and cash equivalents			—
Add: **Cash and Cash equivalents at the beginning of the period**			—
Cash and Cash equivalents at the end of the period			—

Notes:

(1) Figures of cash sales may be directly available from cash book. Then Cash collection can be derived taking Credit sales + Opening balance of debtors - closing balance of debtors.

(2) Similarly figures of cash purchases can also be obtained from cash books.

(3) Interest and dividend are investment cash inflow and, therefore, to be excluded.

(4) Interest expense is financing cash outflow.

(5) Tax provision is not cash expense, advance tax paid should be treated as tax cash outflow.

INDIRECT METHOD:

Proforma of cash flow Statement under Indirect method

cash flow Statement of ---------for the period ended-----------------

	₹	₹	₹
A. Cash Flows from Operating Activities:			
Net Profit for the Period before Taxation & Extraordinary Items		--	
Add: Adjustment for Non-current and Non-operating Items charged to Profit & Loss A/c:			
Depreciation	--		
Interest Paid	--		
Foreign Exchange Loss	--		
Loss on Sale of Fixed Assets & Investments	--	--	
Less: Adjustment for Non-current and Non-operating Items credited to Profit & Loss A/c:		--	
Interest Earned	--		
Dividend Earned	--		
Profit on Sale of Fixed Assets & Investments	--	--	
Operating Profit before Working Capital Changes		--	
Add: Increase in Operating Current Liabilities	--		
Decrease in Operating Current Assets	--		
		--	
Less: Increase in Operating Current Assets		--	
Decrease in Operating Current Liabilities		--	
Cash Generated from Operation	--	--	
Less: Income Tax Paid		--	
Add: Proceeds from any Disaster Settlement		--	
Net Cash Flow from Operating Activities		--	--
B. Cash Flows from Investing Activities:			
Proceeds from Sale of Fixed Assets including Investments		--	
Less: Purchase of Fixed Assets including Investments			
		--	
Add: Interest Received			
Dividend Received		--	--
Net Cash Flow from Investing Activities		--	
		--	
C. Cash Flows from Financing Activities:		--	
Proceeds from Issuance of Share Capital		--	--
Proceeds from Long-term Borrowings		--	
		--	
Less: Repayment of Long-term Borrowings including Redemption of Preference Shares			
Less: Interest Paid	--		
Dividend Paid	--		
Net Cash Flow from Financing Activities		--	--
Net increase in Cash & Cash Equivalents		--	--
Add: **Cash & Cash Equivalents at the beginning of the period**			
Cash & Cash Equivalents at the end of the period			--

Treatment of some Select Items

(a) **Foreign Currency Cash Flows:** Cash flows arising from transaction in a foreign currency should be recorded in an enterprise's reporting currency and by applying to the foreign currency amount, the exchange rate between the reporting currency and foreign currency at the date of cash flow. **Unrealized gains or losses** arising from changes in foreign exchange rates **are not Cash flows**.

(b) **Extraordinary items – classified disclosure:** Cash flows associated with extra ordinary items should be classified as arising from operating, investing, or financing activities as appropriate and separately disclosed.

(c) **Taxes on Income – Classified disclosure:** Cash flows arising from taxes on income should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

(d) **Investment in subsidiaries, Associates and Joint Venture:** When accounting for an investment in an associate or a subsidiary or a joint venture, an investor entity restricts in its cash flow reporting, transactions that lead to cash flows between itself and the investee / joint venture.

(e) **Hedging and Derivatives Contracts:** Cash flows arising from transactions which are in the nature of derivative or hedging contracts for an identifiable position, will have to be classified on the basis of the segment of activity to which the underlying contracts belong. Stated differently, when a contract is accounted for as hedge of an identifiable position , the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Illustration 82:

Calculate Cash Flows from Operating Activities from the following:

Particulars	₹	Particulars	₹
Cash Purchases	25,000	Rent Paid	4,000
Cash Paid to Suppliers	40,000	Trading Commission Received	2,500
Cash Sales	90,000	Income – Tax Refund Received	1,500
Cash received from Debtors	25,000	Trading Commission Paid	500
Salaries and Wages paid	5,000	Insurance proceeds from natural disaster	2,500
Manufacturing Expenses Paid	2,500		
Income tax Paid	4,000		
Office & Administration Expenses Paid	5,000		
Selling and Distribution Expenses	2,500		

Solution:

Cash Flow from Operating Activities

Particulars	₹	₹
Operating Receipts:		
Cash Sales	90,000	
Cash Received from Debtors	25,000	
Trading Commission Received	2,500	
		1,17,500

Less: Operating Expenses		
Cash Purchase	25,000	
Cash paid to Creditors	40,000	
Trading Commission Paid	500	
Salaries and Wages	5,000	
Manufacturing Expenses	2,500	
Office and Administration Expenses	5,000	
Selling and Distribution Expenses	2,500	80,500
		37,000
Less: Income Tax paid (4,000 – 1,500)		2,500
Cash flows before extra Ordinary Activities		**34,500**
Add: Insurance Proceeds for natural disaster		2,500
Net Cash flows from operating activities		**37,000**

Illustration 83:

From the following information relating to Y Ltd, calculated the cash Flow from Operating Activities:

Particulars	**Amount (₹)**
Operating Profit before changes in Operating Assets	57,500
Debtors (Decrease)	5,000
Stock (Increase)	2,000
Bills Payable (Decrease)	4,500
Creditors (Increase)	3,200
Cash at Bank(Increase)	20,000

Solution:

Statement showing calculation of Cash Flow from Operating Activities (Under Indirect Method) of Y Ltd. for the period..............

Particulars	₹	₹
Operating Profit before changes in operating Assets		57,500
Add: Increase in operating Assets : Creditors	3,200	
Decrease in Operating Current Assets: Debtors	5,000	8,200
		65,700
Less: Decrease in Operating Current Liabilities: Bills Payable	4,500	
Increase in Operating Current Assets: Stock	2,000	6,500
		59,200

Note : Since, the Net Profit is not given in the question, So, we calculated cashflow on the basis of Indirect Method.

Illustration 84:

From the following information, calculate the Net Cash Flow from the Operating Activities under indirect method for the year ended on 31st March, 2013:

Profit & Loss A/c for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	₹	Particulars	₹
To, Loss on Sale of Land	40,000	By, Gross Profit	8,20,000
To, Disc. On Issue of shares written off	10,000	By, Interest on Investment	15,000
To, Interest on Debentures	18,000	By, Dividend Received	18,000
To, Depreciation	1,20,000	By, Profit on sale of Plant	20,000
To, Goodwill written off	15,000	By, Rent Received	12,000
To, General Reserve	25,000	By, Refund of Tax	8,000
To, Tax Provision	30,000	By, Insurance claim received for Earthquake	90,000
To, Proposed Dividend	1,80,000	By, Commission Receivable	35,000
To, Interim Dividend	70,000		
To, Net Profit	5,10,000		
	10,18,000		**10,18,000**

Additional Information:

Particulars	**31st March, 2012**	**31st March, 2013**
Debtors	25,000	1,00,000
Creditors	15,000	50,000
Stock	1,40,000	1,00,000
Provision for Tax	50,000	60,000
Accrued Commission	15,000	30,000
Outstanding Wages	20,000	25,000
Prepaid Expenses	18,000	20,000

Solution:

Calculation of Net Cash Flow from Operating Activities (Under Indirect Method) of ………………….. for the year ended 31st March, 2013

Particulars	₹	₹
Net Profit for the year		5,10,000
Add: Adjustment for Non – Current and Non operating items debited to Profit & Loss A/c		
Loss on Sale of Land	40,000	
Discount on Issue of share	10,000	
Interest on Debentures	18,000	
Goodwill written off	15,000	
Depreciation	1,20,000	
General Reserve	25,000	
Tax provision	30,000	
Proposed Dividend	1,80,000	
Interim Dividend	70,000	
		5,08,000
		10,18,000
Less: Adjustment for Non- current and Non- operating items credited to Profit and Loss A/c:		
Interest on Investment	15,000	
Dividend Received	18,000	
Profit on Sale of Plant	20,000	
Rent Received	12,000	
Refund of Tax	8,000	
Insurance claim for Earthquake	90,000	1,63,000
Operating Profit before Working Capital Changes		8,55,000
Add: Increase in Operating Current Liabilities:		
Creditors	35,000	
Outstanding Wages	5,000	
Decrease in Operating Current Assets : Stock	40,000	
		80,000
		9,35,000
Less: Increase in Operating Current Assets		
Debtors	75,000	
Accrued Commission	15,000	
Prepaid Expenses	2,000	
Decrease in Operating Current Liabilities	Nil	92,000
Cash Generated from Operation		8,43,000

Less: Income Tax paid (see Working Notes)		20,000
Net Cash Flow operating Activities before Extraordinary item		8,23,000
Add: Extraordinary Income:		
Insurance Claim for Earthquake		90,000
Net Cash from Operating Activities		9,13,000

Working Notes:

Provision for tax Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To, Bank - Tax Paid for the year(B.f)	20,000	By, Balance b/f	50,000
To, Balance	60,000	By, Profit & Loss A/c- Tax Provided for the year	30,000
	80,000		80,000

Illustration 85:

From the following information, calculate the Net Cash Flow from Investing Activities:

Particulars	Opening ₹	Closing ₹
Machinery (at Cost)	4,00,000	4,20,000
Accumulated Depreciation	1,00,000	1,10,000
Patents	2,80,000	1,60,000

Additional information:

(i) During the year, a machine costing ₹40,000 with an accumulated depreciation of ₹ 24,000 was sold for ₹ 20,000.

(ii) Patents were written off to the extent of ₹ 40,000 and some patents were sold at a profit of ₹20,000.

Solution:

Calculation of Net Cash Flow from Investing Activities of ------------- for period…………………

	₹	₹
Inflows of cash:		
Proceeds Received from sale of Machinery	20,000	
Proceeds Received from sale of Patents[3]	1,00,000	
		1,20,000
Less: Outflows of cash:		
Purchase of Machinery[1]		60,000
Net Cash flow from Investing Activities		60,000

Working Notes:

1.

Dr. **Machinery (at cost) Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/f	4,00,000	By Provision for Depreciation A/c - Accumulated Depreciation on machine sold	24,000
To Profit & Loss A/c - Profit on Sale of Machinery[₹20,000 – (₹40,000 - ₹24,000)]	4,000	By Bank – Sale proceeds	20,000
To Bank – purchase (Bal. fig.)	60,000	By Balance c/f	4,20,000
	4,64,000		4,64,000

Dr. **Provision for Depreciation Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Machinery A/c - Accumulated Depreciation on machine sold & Transferred	24,000	By Balance b/f	1,00,000
To Balance c/f	1,10,000	By profit & Loss A/c – Depreciation for the year (Bal. fig.)	34,000
	1,34,000		1,34,000

Dr. **Patents Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/f	2,80,000	By Profit & Loss A/c – Written off	40,000
To Profit & Loss A/c – profit on sale of patents	20,000	By Bank – Sale proceeds of patents (Bal.fig)	1,00,000
		By Balance c/f	1,60,000
	3,00,000		3,00,000

Illustration 86:

From the following particulars, calculate the Cash flow from investing Activities of Miser Ltd. for the year 2013:

Particulars	Purchased ₹	Sold ₹
Investments	1,80,000	1,00,000
Goodwill	2,00,000	-
Machinery	4,40,000	1,50,000
Patents	-	1,00,000

Interest received on debentures held as investments - ₹ 16,000.

Dividend received on shares held as investments - ₹ 20,000.

A plot of land was purchased out of surplus funds for investment purchases and was let out for commercial use and the rent received was ₹ 80,000.

Solution:

Calculation of Net Cash Flow from the Investing Activities of Miser Ltd. for the year 2013

Particulars	₹	₹
Inflows of Cash:		
Sales Proceeds of investments	1,00,000	
Sales Proceeds of Machinery	1,50,000	
Sales Proceeds of patents	1,00,000	
Interest Received from investments	16,000	
Dividend from investments	20,000	
Rent Received from Land	80,000	4,66,000
Less: Outflows of Cash:		
Purchase of Investments	1,80,000	
Purchase of Goodwill	2,00,000	
Purchase of Machinery	4,40,000	8,20,000
Net Cash Flow from Investing Activities		(3,54,000)

Illustration 87:

From the following particulars, prepare a cash Flow Statement from investing Activities of Chalsa Ltd. for the year that ended 31 December 2013:

Dr. **Profit & Loss A/c for the year that ended 31 December 2013** **Cr.**

Particulars	₹	Particulars	₹
To opening Stock	5,500	By Sales	2,16,000
To Purchases	80,500	By Closing Stock	20,000
To Wages	16,000	By Loss of Stock	5,000
To Gross profit c/d	1,39,000		
	2,41,000		2,41,000
To Expenses	10,000	By Gross Profit b/d	1,39,000
To Depreciation	12,000	By Income from Investment (Tax Free)	6,000
To Bad Debt	1,000		
To Loss on Sale of plant (Sale value ₹23,000)	5,000		
To Loss of Stock less Insurance Claim (i.e., Net loss)	1,000		
To Deferred Expenses	1,000		
To Income Tax			
To Net Profit c/d	5,000		
	10,000		
	1,01,000		
	1,45,000		1,45,000
To Dividend	8,000		
To Reserve	23,000	By Balance b/d	30,000
To Balance c/d	1,00,000	By Net Profit b/d	1,01,000
	1,31,000		1,31,000

Balance Sheets as on

Liabilities	2012 ₹	2013 ₹	Assets	2012 ₹	2013 ₹
Share Capital	80,000	90,000	Fixed Assets	80,000	2,10,000
Reserve	50,000	73,000	Investment	68,500	30,000
Profit & Loss A/c	30,000	1,00,000	Stock in Trade	5,500	20,000
Creditors	30,000	20,000	Debtors	50,000	55,000
Liabilities for Expenses	8,000	10,000	Cash & Bank	3,500	1,500
Proposed Dividend	5,000	10,000	Prepaid Expenses	5,000	4,000
Provision for Taxation	15,000	20,000	Deferred Expenses	10,500	5,500
Advance Income from Investment	5,000	3,000			
	2,23,000	3,26,000		2,23,000	3,26,000

Solution:

Cash flow from the Investing activities of Chalsa Ltd for the year that ended 31 December 2013

Particulars	₹	₹
Cash Flows from Investing Activities:		
Proceeds Received from sale of plant	23,000	
Proceeds received from sale of Investment	38,500	
Income Received from Investment	4,000	(1,04,500)
	65,500	
Less: Purchase of Fixed Assets	1,70,000	
Net Cash Flow from Investing Activities		

Dr. Fixed Asset Account Cr.

Particulars	₹	Particulars	₹
To Balance b/f	80,000	By Profit & Loss A/c – Depreciation for the year	12,000
To Bank – Purchase of Fixed Assets (Bal.fig.)	1,70,000	By Profit & Loss A/c – Loss on sale of plant	5,000
		By Bank – Sale proceeds of plant	23,000
		By Balance c/f	2,10,000
	2,50,000		2,50,000

Dr. Income from Investments Account Cr.

Particulars	₹	Particulars	₹
To Profit & Loss A/c – Income receivable for the year	6,000	By Balance b/f (i.e., opening pre-received)	5,000
To Balance c/f (i.e., closing pre-received)	3,000	By Bank – Income Received during the year (Bal. fig.)	4,000
	9,000		9,000

Analysis of other Non-current Assets and Liabilities

Assets/Liabilities	Opening Balance ₹	Closing Balance ₹	Increase/ Decrease ₹	Analysis
Share Capital	80,000	90,000	(+) 10,000	New Issue of Shares
Investments	68,500	30,000	(-) 38,500	Sales of Investments

Illustration 88:

From the following Balance Sheets of 'X International', prepare a Cash Flow Statement from the investing activity for the year that ended 31 December 2013, as per As – 3:

Balance Sheets as on

Liabilities	31 December 2012 ₹ (in '000)	31 December 2013 ₹ (in '000)	Assets	31 December 2012 ₹ (in '000)	31 December 2013 ₹ (in '000)
Equity Share Capital	150	350	Goodwill	75	60
Redeemable Preference Share Capital	100	150	Fixed Assets	355	620
Debenture	150	100	Inventories	110	70
Long-term loan	100	50	Debtors	120	75
Reserves & Surplus	40	50	Bank	Nil	25
Bank Overdraft	60	-	Prepaid Expenses	30	20
Sundry Creditors	80	100	Miscellaneous Expenses	40	30
Proposed Dividend	30	60			
Provision for taxation	20	40			
	730	900		730	900

Additional information available on 31 December 2013:

(i) Accumulated Depreciation on Fixed Assets amounted to ₹ 1,60,000 and ₹ 1,85,000, as on 31 December 2012 and 31 December 2013, respectively; and a plant Costing ₹30,000 (25% depreciated) was sold for ₹ 50,000.

(ii) A land of ₹1,50,000 and stock of ₹ 40,000 were purchased for a consideration of ₹2,00,000, paid for in shares.

(ii) Dividend for 2012 was paid along with an interim Dividend of 5% on the opening Equity Capital.

(iv) Tax Liabilities for 2012 was settled at ₹ 28,000.

Solution:

Cash Flow Statement (under Indirect Method) of 'X International' for the year that ended on 31 December 2013

Particulars	₹ in ,000	₹ in ,000	₹ in ,000
Cash Flows from Investing Activities:			
Proceeds Received from sale of plant		50	
Less: Purchase of Fixed Assets		170	
Net Cash Flow from Investing Activities			(120.00)

Dr.	Fixed Asset Account		Cr.
Particulars	**₹ (in '000)**	**Particulars**	**₹ (in '000)**
To Balance b/f (355 + 160)	515.00	By Provision for Depreciation A/c – Accumulated Depreciation on plant sold	7.50
To Vendor Company A/c – Land purchased	150.00		
To Profit & Loss A/c – Profit on sale of plant [50,000 – (30,000 – 25%)]	27.50	By Bank – sale proceeds of plant	50.00
To Bank – fixed Assets purchased for Cash (Bal. fig.)	170.00	By Balance c/f (620 + 185)	805.00
	862.50		862.50

Illustration 89:

Following were the Balance Sheets of a company as on 31 December 2013 and 31 December 2012 **:**

Liabilities	2013 ₹ in ,000	2012 ₹ in ,000	Assets	2013 ₹ in ,000	2012 ₹ in ,000
Share Capital	1,500	1,250	Fixed Assets at cost	2,180	1,910
Reserves	3,410	1,380			
Long-term Loan	1,110	1,040	Less: Provision for Depreciation	1,450	1,060
Sunday Creditors	150	1,890		730	850
Interest payable	230	100			
Income Tax Payable	400	1,000	Long-term investments	2,500	2,500
			Inventories	900	1,950
			Sunday Debtors	1,700	1,200
			Short-term Investments	670	135
			Cash & Bank	200	25
			Income Receivable on Investments	100	-
	6,800	6,660		6,800	6,660

Statement of Profit & Loss A/c for the year that ended 31 December 2013

	₹ in '000	₹ in '000
Sales		30,650
Less: Cost of sales		
Materials Consume	19,000	
Wages & overheads	7,000	26,000
Gross Profit		4,650
Less: Depreciation on Fixed Assets	450	
Administrative & Selling Expenses	850	
Interest on Loan	400	
Loss on sale of long-term Investment	100	1,800
		2,850
Add: Income from Investment	500	
Insurance Claim Received from Earthquake Disaster settlement	180	
		680
Net profit before Tax		3,530
Less: Income Tax		300
Net profit after Tax		3,230

Additional Information

(i) Plant, having an Original Cost of ₹ 80,000 and accumulated Depreciation of ₹ 60,000, was sold in 2013 for ₹ 20,000.

(ii) Investment (long-term) further made during 2013 was ₹ 500(in lakhs).

(iii) An amount of ₹ 2,50,000 was raised from the long-term borrowing.

(iv) Income Tax of ₹ 3,00,000 as provided in the statement of profit & Loss A/c included ₹ 30,000 as Tax deducted at source on income from the Long-term investment.

Prepare a cash Flow Statement for the year that ended on 31 December 2013 separately under Direct Method and Indirect Method.

Solution:

Cash Flow From Investment Activity of a company for the year that ended 31st March, 2013

Particulars	₹ in '000	₹ in '000	₹ in '000
Cash Flows from Investing Activities:			
Sales Proceeds of Plant		20	
Sales Proceeds of long-term investments		400	
Income Received from Investments less TDS		370	
		790	
Less: Purchase of Fixed Assets	350		
Purchase of Investments	500		
		850	
Net Cash flow investing Activities			(60)

Working Notes:

Dr. Fixed Asset (at Cost) Account Cr.

Particulars	₹ in '000	Particulars	₹ in '000
To Balance b/f	1,910	By Provision for Depreciation A/c -Accumulated Depreciation on plant sold	60
To Bank – Purchase (Bal.fig.)	350	By Bank – sale proceeds of plant	20
		By Balance c/f	2,180
	2,260		2,260

Dr. Long-term Investment Account Cr.

Particulars	₹ in '000	Particulars	₹ in '000
To Balance b/f	2,500	By Bank – sale proceeds of investment (bal.fig.)	400
To Bank – Further investment made	500	By Profit & Loss A/c – Loss on sale of investment	100
		By Balance c/f	2,500
	3,000		3,000

Net income from Investment received in 2013	₹ in '000
Income Received from investment in 2007	400
Less: Tax Deducted from source (TDS)	30
Net income from investment	370

Illustration 90:

From the following particulars as furnished by Lava Ltd, calculate its net Cash flow from the Financing Activities for the year that ended 31 March 2013:

	31 March 2012 ₹	31 March 2013 ₹
Equity Share Capital	3,00,000	5,00,000
Preference Share Capital	2,00,000	2,00,000
Debentures	2,00,000	1,50,000
Long-term Loan	80,000	1,50,000
Proposed Dividend (Equity)	36,000	50,000
Outstanding Interest on Debentures	6,000	5,000

During the year 2012-13, the following events took place:

	₹
New Issue of preference Shares at 10% discount	1,00,000
New Issue of Debentures at 20% Discount	1,00,000
Repayment of Long-term Loan	50,000
Payment of Preference Dividend	20,000
Payment of Interest on long-term Loan	10,000
Interim Equity Dividend paid during the year in addition to Proposed Dividend	15,000
Interest on Debentures for the year	24,000
New Equity Shares were issued at 10% premium	

Solution:

Calculation of Net Cash Flow From the Financing Activities for the year that ended 31 March 2013

	₹	₹
Inflows of Cash:		
Proceeds Received from new issue of Equity Shares[1]	2,00,000	
Proceeds Received from new Issue of Preference Shares	90,000	
Proceeds Received from new Issue of Debentures	80,000	
Raising of long-term Loan[4]	1,20,000	
Premium Received on new Issue of Equity Shares (10% on ₹2,00,000)	20,000	
		5,10,000
Less: Outflows of Cash:		
Redemption of Preference shares	1,00,000	
Redemption of Debentures	1,50,000	
Payment of Long-term Loan	50,000	
Payment of preference Dividend	20,000	
Payment of Proposed Equity Dividend	36,000	
Payment of interim Equity Dividend	15,000	
Payment of interest on Debentures	25,000	
Payment of interest on Long-term Loan	10,000	4,06,000
Net Cash Flow from Financing Activities		1,04,000

Working Notes:

1.

Dr.	Equity Share Capital Account		Cr.
	₹		₹
To Balance c/f	5,00,000	By Balance b/f	3,00,000
		By Bank – New Issue of Shares (Bal. fig.)	2,00,000
	5,00,000		5,00,000

2.

Dr.	Preference Share Capital Account		Cr.
	₹		₹
To Bank – Redeemed (Bal. fig)	1,00,000	By Balance b/f	2,00,000
To Balance c/f	2,00,000	By Bank – proceeds received from new issue of shares	90,000
		By discount on Issue of Shares A/c	10,000
	3,00,000		3,00,000

3.

Dr.	Debentures Account		Cr.
	₹		₹
To Bank – Redeemed (Bal. fig)	1,50,000	By Balance b/f	2,00,000
		By Bank – proceeds received from new issue	80,000
To Balance c/f	1,50,000	By discount on Issue of Debentures	20,000
	3,00,000		3,00,000

4.

Dr.	Long-term Loan Account		Cr.
	₹		₹
To Bank – Repayment	50,000	By Balance b/f	80,000
		By Bank – Long-term Loan raised(Bal. fig.)	1,20,000
To Balance c/f	1,50,000		
	2,00,000		2,00,000

5.

Dr.	Interest on Debentures Account		Cr.
	₹		₹
To Bank – Interest paid during the year (Bal. fig)	25,000	By Balance b/f	6,000
		By Profit & Loss A/c – interest payable for the year	24,000
To Balance c/f	5,000		
	30,000		30,000

6.

Dr.	Proposed Equity Dividend Account		Cr.
	₹		₹
To Bank – Dividend proposed in 2006-07 & paid in 2007-08	36,000	By Balance b/f	36,000
To Balance c/f	50,000	By Profit & Loss Appropriation A/C – dividend proposed for 2007-08	50,000
	86,000		86,000

Illustration 91:

Calculation of Net Cash Flow from Financing Activities as per AS – 3

From the following information, as furnished by Arzoo Ltd, calculate its Net Cash Flow from the Financing Activities for the year that ended on 31 March 2013:

	31 March 2012 ₹	31 March 2013 ₹
Equity Share Capital	3,00,000	5,00,000
Preference Share Capital	2,00,000	1,00,000
Debentures	2,00,000	2,50,000

During the year 2012-13, debentures of ₹ 1,00,000 were redeemed for cash and debenture interest paid was ₹ 30,000. Preference Dividend paid was ₹ 20,000 and equity dividend paid was ₹ 40,000.

Solution:

Calculation of Net Cash flow from the financing activities of Arzoo Ltd.for the year that ended 31st March 2013

	₹	₹
Inflows of Cash:		
Proceeds Received from issue of Equity Shares	2,00,000	
Proceeds Received from Issue of Debentures	1,50,000	
		3,50,000
Less: Outflows of Cash:		
Redemption of Preference shares	1,00,000	
Redemption of Debentures	1,00,000	
Payment of Debentures' interest	30,000	
Payment of preference Dividend	20,000	
Payment of Equity Dividend	40,000	2,90,000
Net Cash Flow from Financing Activities		60,000

Working Notes:

1.

Dr.	Debentures Account		Cr.
	₹		₹
To Bank - Redeemed	1,00,000	By Balance b/f	2,00,000
		By Bank – New Issue (Bal. fig.)	1,50,000
To Balance c/f	2,50,000		
	3,50,000		3,50,000

2. Analysis of other Non-current Liabilities

Liabilities	Opening Balance ₹	Closing Balance ₹	Increase/ Decrease ₹	Analysis
Equity Share Capital	3,00,000	5,00,000	(+) 2,00,000	New Issue of Equity Shares
Preference Share Capital	2,00,000	1,00,000	(-) 1,00,000	Redemption of Preference Shares

Study Note - 6

PARTNERSHIP

This Study Note includes

6.1 Appropriation of Profits

6.2 Admission of Partner

6.3 Retirement of Partner

6.4 Death of Partner

6.5 Dissolution of a Partnership Firm

6.6 Insolvency of a Partner

6.7 Amalgamation of Firms and Conversion to a Company

6.8 Conversion or Sale of a Partnership Firm to a Company

6.1 APPROPRIATION OF PROFITS

According to section 4 of the Partnership Act, 1932 a Partnership is "the relation between persons who have agreed to share the profits of a business carried on by all or any one of them acting for all."

If we analyse the definition we find three basic element of a Partnership :

(1) It arises out of an agreement made by two or more persons;

(2) The agreement is made regarding sharing profits of a business;

(3) Such business is carried on by all or any one of them acting for all.

  (a) Partnership is the result of an agreement. It does not arise from status.

  (b) The agreement may be either verbal or in writing. There should be some terms and conditions binding the Partnership.

  (c) The existing law does not enforce that the terms of the Partnership must be in writing. If written, the agreement is known as Deed or Articles of Partnership.

  (d) For the formation of a Partnership more than one person is requires. For a banking business the maximum number of Partners is 10, in other businesses it is 20.

Partnership Deed

Mode of Appropriation : Among other details the deed contains the mode of appropriation of profits (or losses) specially regarding interest on partners capitals, salary or commission, etc. payable to partners and the profit-sharing ratio.

In the absence of deed the following guidelines should be followed :

1. Every Partner should share profits equally [Section 13 (b)].
2. No interest is to be allowed on Partners' capitals [Section 13 (c)].
3. No interest should be charged on the drawings of the Partners.
4. No salary is to be allowed to any partner.
5. Interest on advances made by partners should be provided @ 6% per annum. [Section 13(d)].
6. Every partner should be to have equal share in the property of the Partnership as per Section 14.

Some Important Considerations

Partners' Capitals

(a) Where the Partners decide and the agreement provides, the Capitals Accounts of the Partners remain unchanged over years. In that case the Capital Accounts show the original amounts invested by the Partners as capitals unless some change (like change in capital Ratio etc.) takes place. The Capitals are called Fixed Capitals.

Partners' Current Accounts are opened and used for recording subsequent trans actions between the Partner and the firm for salary/commission to Partners, Interest on Partners Capitals, their drawings and interests on drawings, share of profit/loss and interest on loans/advances given by Partners to the firm. Where Capitals are Fixed, Current Accounts serve as the appendix.

(b) Where there is no agreement to keep Capitals fixed over years, entries1 regarding Partners' drawings, Salary/Commission/Interest on Capital and share profit/loss are recorded through the Partners' Capital Accounts. As a result, the Capitals undergo changes from period to period and are called Fluctuating Capitals.

(c) If any Partner gives any amount as Loan or Advance to the firm separately, Partners Loan Accounts are opened and maintained. Interest on Loan may be transferred to Loan Account or to Current Account (if any).

(d) A separate Drawings Account may be maintained to record withdrawals made by the partners from the firm. On the closing date of a financial period, the balance of the Drawings Account is transferred to Capital Account or to Current Account (if capitals are fixed).

One must remember also that,

(i) A Capital represents a liability. The balances of fixed capitals should always be credit balances.

The balances of Current Accounts may be credit balances or debit balances (Where a partners' drawings exceed his share of profits/interests etc).

(ii) The balances of Fluctuating capital may be credit or debit balances.

(iii) Capitals of partners may not be as per their profit sharing ratio.

(iv) A partner may contribute his capitals in cash and also in the form of any other asset including goodwill. If he brings in any liability his Capital = Assets brought in – Liabilities brought in = Net Assets brought in.

Appropriation of Profits

Partners become entitled to receive Salary/Commission/Interests/Share of Profit, etc., and also to be charged with Interest on Drawings/Share of loss, etc. especially by virtue of their becoming partners. So at the time of preparing the final accounts of a partnership business, the net profit before making adjustments for the above items is found out. These adjustments are made through the Profit & Loss Appropriation Account. This Account may be separately opened or may be shown as the concluding part of the Profit & Loss Account itself. In any case it shows special entitlements of partners and distribution of profit or loss among them. But before going through illustrations, a student is advised to note the following:

(a) Interest on Capital: If the Partnership Deed says, provide it at the prescribed rate. If nothing is stated, do not provide it.

If Partnership Deed provides for charging full amount of interest irrespective of profit/loss, P/L Appr. A/c may show loss. Please remember that as per Section 13(c) of the Partnership Act, Interest on Capitals should be provided only up to the amount of available profits where such profits are inadequate to cover up the payment of full amount of interest on capital. Interest on Capital should be calculated on time basis. Dates of further capital investment or withdrawal of capitals should be given effect.

For interests on Capital, P/L Appr. A/c is debited and Partners' Capital or Current Accounts are credited.

(b) Interest on Drawings: Where the partners withdraw, money from the business in anticipation of profits and the Partnership Deed provides, Interest on Drawings is charged at a fixed rate (of percentage) from the date of drawings to the closing date of the financial period. Such interest is credited to P/L Appr. A/c and debited to Partners' Capital/Current Account. Latter we discuss detail about the Interest on Drawings.

(c) Interest on Loan: If the Partnership Deed clearly mentions it, provide interest on loan on time basis at the given rate. If the Deed does not mention it, provide interest at 6% p.a. Interest on loan is a general expense of a firm. The Partnership Act considers any payment to any partner, other than rent, as an appropriation of Profits. By implication the Income Tax Act also treats interest on partner's loan at par with Interest on Partner's Capital. So it should be debited to P/L Appr. A/c and credited to Partner's Current A/c (if any) or to Partner's Loan A/c.

(d) Partners Salaries & Commission: These are to be allowed only if the Deed specifically provides for these. These are paid to partners for special service rendered by them and are different from staff salaries or commission. These should be debited to P/L Appr. A/c and Credited to Partners' Capital or Current Accounts.

Fixed and Fluctuating Capital Method :

A. Fixed Capital Method

Under this method capital accounts of the partners will remain fixed year after year from the very beginning except for the introduction of additional capital contributed by the partners. In short, no entry,like interest on capital, interest on drawings, share of profits etc will appear in the capital account. Naturally, a separates current account is to be opened where all the adjustments, like interest on capital, interest on drawings, share of profits, partners' salaries and commissions, partners' drawings etc. will appear in this account along with the opening balance of current account (whether shows a debit or credit balances). The blance of current account will appear in the Balance Sheet.

The Interest on Capital Account and Current Account are under fixed capital method are represented as under :

Dr. **Capital Account** ***Cr.***

Particulars	X ₹	Y ₹	Particulars	X ₹	Y ₹
To Balance c/d	xxx	xxx	By Balance b/d	xxx	xxx
	xxx	xxx		xxx	xxx
			By Balance b/d	xxx	xxx

Dr. **Current Account** ***Cr.***

Particulars	X ₹	Y ₹	Particulars	X ₹	Y ₹
To Drawings	x x x	x x x	By Balance b/d	x x x	x x x
" Interest on Drawings	x x x	x x x	" Interest on Capital	x x x	x x x
" Balance c/d	x x x	x x x	" Interest on Loan	x x x	x x x
			" Salary	x x x	x x x
			" Commission	x x x	x x x
			" Share of P rofit	x x x	x x x
	x x x	x x x		x x x	x x x
			By Balance b/d	x x x	x x x

N.B :

The balance of current account may also show a debit balance. In that case, the same will appear in the asset side of the Balance Sheet.

B. Fluctuating Capital Method

Under this method, the capital account of the partners will fluctuate year after year. i.e., all the adjustments, viz, interest on capital, interest on drawings, partners' salaries and commission, share of profits, partners' drawings etc. will appear in this capital account together with the opening balance of capital accounts. The closing balance of the capital accounts will appear in the liabilities side of the Balance Sheet.

The proforma of capital accounts under fluctuating capital method is shown as under :

Dr. **Capital Account** ***Cr.***

Particulars	X ₹	Y ₹	Particulars	X ₹	Y ₹
To Drawings	xxx	xxx	By Balance b/d	xxx	xxx
" Interest on Drawings	xxx	xxx	" Interest on Capital	xxx	xxx
" Balance c/d	xxx	xxx	" Salaries	xxx	xxx
			" Commission	xxx	xxx
			" Share of Profit	xxx	xxx
	xxx	xxx		xxx	xxx
			By Balance b/d	xxx	xxx

Distinction between Fixed Capital Method and Fluctuating Capital Method

Fixed Capital method and Fluctuating Capital method in partnership accounts can be distinguished as follows:

Basis of Distinction	Fixed Capital Method	Fluctuating Capital Method
1. Change in Capital	The capital normally **remains unchanged** except under special circumstances.	The capital **fluctuates** quite frequently from period to period.
2. No. of Accounts maintained	**Two** accounts are maintained for each partner viz. (a) Fixed Capital Account, (b) Current Account.	Only **one** account (viz., Capital Account) is maintained for each year.
3. Adjustments for drawings etc.	All adjustments for drawings, interest on drawings, interest on capital, salary, share of profit/loss are made **in Current Account.**	All adjustments for drawings, interest on capital, salary, share of profit/ loss are made **in Capital Account.**
4. Can Capital Account show a negative balance?	Fixed Capital Account can **never show** a negative balance.	Fluctuating Capital Account **can show** a negative balance.

Illustration 1.

Prepare the Capital Accounts of the partners X and Y under (a) Fluctuating Capital Method and (b) Fixed Capital Method from the following particulars :

	X	Y
Capital A/c (on 1.4.2012)	50,000	30,000
Current A/c (on 1.4.2012)	5,000 (Cr.)	3,000 (Dr.)
Drawings	25,000	15,000
Partners' Salaries	10,000	10,000
Partners' Commission	8,000	—
Interest on partner's loan	—	3,000
Interest on Capital	5,000	3,000
Interest on Drawings	2,500	1,500
Share of Profit	12,000	12,000

Solution :

(a) **Under Fluctuating Capital Method**

Dr. **Capital Account** ***Cr.***

Particulars	X ₹	Y ₹	Particulars	X ₹	Y ₹
To Drawings	25,000	15,000	By Balance b/d	50,000	30,000
" Interest on Drawings	2,500	1,500	" Salaries	10,000	10,000
" Balance c/d	57,500	38,500	" Commission	8,000	—
			" Interest on Capital	5,000	3,000
			" Share of profit	12,000	12,000
	85,000	55,000		85,000	55,000
			By Balance b/d	57,500	38,500

(b) **Under Fixed Capital Method**

Dr. **Capital Account** ***Cr.***

Particulars	X ₹	Y ₹	Particulars	X ₹	Y ₹
To Balance c/d	50,000	30,000	By Balance b/d	50,000	30,000
	50,000	30,000		50,000	30,000
			By Balance b/d	50,000	30,000

Dr. **Current Account** **Cr.**

Particulars	X ₹	Y ₹	Particulars	X ₹	Y ₹
To Balance b/d	—	3,000	By Balance b/d	5,000	—
" Drawings	25,000	15,000	" Salaries	10,000	10,000
" Interest on Drawings	2,500	1,500	" Commission	8,000	—
" Balance c/d	12,500	8,500	" Interest on Capital	5,000	3,000
			" Interest on Loan	—	3,000
			" Share of Profit	12,000	12,000
	40,000	28,000		40,000	28,000
			By Balance b/d	12,500	8,500

Illustration 2.

A, B and C are partners sharing profits and loss as 2 : 2 : 1. They get interest on their Capitals at 5% p.a and are charged @ 6% p.a. on their Drawings.

A and B are paid salary @ ₹ 250 & ₹ 150 per month respectively. A would be paid 6% interest on his loan. A paid ₹ 25,000 as loan on 1st July, 2013. A, B and C withdrew ₹ 10,000, ₹ 8,000 and ₹ 6,000 respectively during 2013. C is entitled to a commission at 2% on total sales which amounted to ₹ 3,46,000 during the year. On 1st January, 2013 the capital balances of A, B and C were ₹ 1,00,000, ₹ 80,000 and ₹ 60,000 respectively. The net profit for the year is ₹ 1,00,000. Prepare the Profit & Loss Appropriation Account and the Capital Accounts of partners.

Solution :

Profit & Loss Appropriation Account for the year ended 31.12.2013

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Salary			By Profit & Loss (Net Profit)		1,00,000
A [250 × 12]	3,000		" Interest on Drawings :		
B [150 × 12]	1,800	4,800	@ 6% p.a. on an average of 6 months)		
" Commission – C [2% of ₹ 3,46,000]		6,920	A	300	
" Interest on Capital :			B	240	
A	5,000		C	180	720
B	4,000				
C	3,000	12,000			
" Interest on Loan – A		750			
" Share of profits :					
A [2/5]	30,500				
B [2/5]	30,500				
C [1/5]	15,250	76,250			
		1,00,720			1,00,720

Capital Accounts

Dr. *Cr.*

Date	Particulars	A ₹	B ₹	C ₹	Date	Particulars	A ₹	B ₹	C ₹
31.12.13	To Drawings	10,000	8,000	6,000	1.1.13	By Balance b/d	1,00,000	80,000	60,000
"	" Interest on Drawings	300	240	180	31.12.13	" Salary	3,000	1,800	-
"	" Balance c/d				"	" Commission	-	-	6,920
		1,28,200	1,08,060	78,990	"	" Interest on Capital	5,000	4,000	3,000
					"	" Share of Profit	30,500	30,500	15,250
		1,38,500	1,16,300	85,170			1,38,500	1,16,300	85,170

Illustration 3.

A and B are partners in a firm sharing profits and losses equally. On 1st April, 2012 the balance of their Capital Accounts were : A-₹ 50,000 and B-₹ 40,000. On that date the balances of their Current Accounts were : A-₹ 10,000 (credit) and B-₹ 3,000 (debit). Interest @ 5% p.a. is to be allowed on the balance of Capital Accounts as on 1.4.2012. B is to get annual salary of ₹ 3,000 which had not been withdrawn. Drawings of A and B during the year were ₹ 1,000 and ₹ 2,000 respectively. The profit for the year ended 31st March, 2013 before charging interest on capital but after charging B's salary was ₹ 70,000. It is decided to transfer 10% of divisible profit to a Reserve Account.

Prepare Profit & Loss Appropriation Account for the year ended 31st March, 2013 and show Capital and Current Accounts of the Partners for the year.

Points to be noted :

(i) Profit before charging interest on Capital and Salary to B = ₹ 70,000 + ₹ 3,000 = ₹ 73,000

(ii) Transfer to Reserve = 10% of Divisible Profits.

Solution :

Dr. **Profit & Loss Appropriation Account for the year ended 31.03.2013** *Cr.*

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Salary - B		3,000	By Profit & Loss (Net Profit before Charging Salary and Interest)		73,000
" Interest on Capitals :					
A	2,500				
B	2,000	4,500			
" Reserve [10% of 65,500]		6,550			
" Share of Profit					
A [1/2]	29,475				
B [1/2]	29,475	58,950			
		73,000			73,000

Capital Accounts

Dr. ***Cr.***

Date	Particulars	A ₹	B ₹	Date	Particulars	A ₹	B ₹
31.3.13	To Balance c/d	50,000	40,000	1.4.12	By Balance b/d	50,000	40,000

Current Accounts

Dr. ***Cr.***

Date	Particulars	A ₹	B ₹	Date	Particulars	A ₹	B ₹
1.4.12	To Balance b/d	-	3,000	1.4.12	By Balance b/d	10,000	-
31.3.13	" Drawings	1,000	2,000	31.3.13	" Interest on Capital	2,500	2,000
	" Balance c/d	40,975	29,475	"	" Salary	-	3,000
				"	" Share of Profit	29,475	29,475
		41,975	34,475			41,975	34,475

ACCOUNTING TREATMENT OF INTEREST ON CAPITAL

PROVISIONS RELATING TO INTEREST ON CAPITAL

Case	Provision
I. **If the Partnership Agreement is silent as to Interest on Capital.**	**I. No Interest on Capital will be allowed**
II. **If the Partnership Agreement Provides for Interest on capital but is silent as to the treatment of Interest as a charge or appropriation.**	**II.** Interest on Capital will be **allowed** only if there are **profits. [Sec 13(c)]** (a) **In case of Loss** – **No Interest on** Capital will be allowed. (b) **In case Profit Before interest is Equal to or more than the interest.** – **Full Interest** on capital will be **Allowed** (c) **In case Profit Before interest is less than the interest** – **Profit** will be distributed **in the ratio of interest on capital of** each partner.
III. **If the Partnership Agreement Provides for interest on capital as a charge (i.e. to be allowed whether there are profits or losses).**	III. Full Interest on capital will be allowed whether there are profits or losses.

Journal Entries

(a) **Adjusting Entry to adjust Interest on Capital**	
Interest on Capital A/c	Dr.
To Partner's Capital A/c (In case of Fluctuating Capitals)	
or	
To Partner's Current A/c (In case of Fixed Capitals)	
(b) **Closing Entry to close the Interest on Capital Account**	
Profit & Loss Appropriation A/c	Dr.
To Interest on capital A/c	

Example: X and Y are partners sharing the profits and losses in the ratio of 2:3 with capitals of ₹ 20,000 and ₹ 10,000 respectively. Show the distribution of profit/loss for the year 2012 -13 by preparing the relevant account in each of the following alternative cases-

Case (a) If the partnership deed is silent as to the Interest on Capital and the trading profits for the year are ₹ 1,500.

Case (b) If the partnership deed provides for Interest on Capital @ 6% p.a. and the trading losses for the year are ₹ 1,500.

Case (c) If the partnership deed provides for Interest on Capital @ 6% p.a and the trading profits for the year are ₹ 2,100.

Case (d) If the partnership deed provides for Interest on Capital @ 6% p.a. and the trading profits for the year are ₹ 1,500.

Case (e) If the partnership deed provides for Interest on Capital @ 6% p.a. even if it involves the firm in loss and the trading profits for the year are ₹ 1,500.

Case (a)

PROFIT AND LOSS APPROPRIATION ACCOUNT

For the year ended on 31st March, 2013

Dr. ***Cr.***

Particulars	₹	Particulars	₹
To Profit transferred to:		By Profit & Loss A/c	1,500
X	600	(Profit for the year)	
Y	900		
	1,500		1,500

Case (b)

***PROFIT AND LOSS ACCOUNT**

For the year ended on 31st March, 2013

Dr. ***Cr.***

Particulars	₹	Particulars		₹
To Losses for the year	1,500	By Loss transferred to:		
		X	600	
		Y	900	1,500
	1,500			1,500

*'Profit & Loss Appropriation A/c should not be prepared because there is nothing to appropriate.

Case (c)

PROFIT AND LOSS APPROPRIATION ACCOUNT

For the year ended on 31st March , 2013

Dr. ***Cr.***

Particulars		₹	Particulars	₹
To Interest on Capital:			By Profit & Loss A/c	2,100
X	1,200		(Profit for the year)	
Y	600	1,800		
To Profit transferred to:				
X	120			
Y	180	300		
		2,100		**2,100**

Case (d)

PROFIT AND LOSS APPROPRIATION ACCOUNT

For the year ended on 31st March, 2013

Dr. ***Cr.***

Particulars		₹	Particulars	₹
To Interest on capital:			By Profit & Loss A/c	1,500
X	1,000		(Profit for the year)	
Y	500	1,500		
		1,500		**1,500**

Note: Since the amount of available profits is less than the total amount of interest on capital, the available profits have been distributed in the ratio of interest claims of X and Y i.e. ₹ 1,200: ₹ 600.

Case (e)

***PROFIT AND LOSS ACCOUNT**

For the year ended on 31st March, 2013

Dr. ***Cr.***

Particulars		₹	Particulars		₹
To Interest on capital:			By Profits before Interest		1,500
			By Loss transferred to:		
X	1,200		X	120	
Y	600	1,800	Y	180	300
		1,800			1,800

*Profit & Loss Appropriation Account should not be prepared since all the charges against the profits are shown in Profit & Loss Account and all appropriations out of profits are shown in Profit & Loss Appropriation Account.

Calculation of Interest on Drawings

1. If the date of drawings is mentioned, then calculate interest according to the time.
2. If the date of drawings is not mentioned, then calculate interest on the average of the time period. i.e. if the accounting period is for one-year, then interest for 6 months, and so on.
3. If unequal amounts are drawn at irregular intervals :

Illustration 4

Accounting Period : January – December. Interest @ 12% p.a

Month	Amount Drawn (₹)	Period (In Months)	Product (Amount × Period)
February	10,000	11	1,10,000
May	5,000	8	40,000
September	15,000	4	60,000
November	10,000	2	20,000
December	20,000	1	20,000
			2,50,000

Interest = Product × Rate of Interest × 1/12

= 2,50,000 × 12/100 X 1/12 = 2,500

4. If equal amounts are drawn at a fixed date every month, throughout the accounting period :
   (a) Drawn at the beginning of every month
   (b) Drawn at the middle of every month
   (c) Drawn at the end of every month

   Interest = Amount Drawn p.m × Rate of Interest × Time

Again, the Accounting Period may be for 12 months; 6 months; 3 months or etc.

"How to calculate the time?"

If the Accounting Period is for 12 months : (January – December)

	Beginning of the month			Middle of the month			End of the month		
	One-Year	6-months	3-months	One-year	6-months	3-months	One-Year	6-months	3-months
January	12	6	3	11.5	5.5	2.5	11	5	2
February	11	5	2	10.5	4.5	1.5	10	4	1
March	10	4	1	9.5	3.5	0.5	9	3	0
April	9	3	6	8.5	2.5	4.5	8	2	3
May	8	2		7.5	1.5		7	1	
June	7	1		6.5	0.5		6	0	
July	6	21		5.5	18		5	15	
August	5			4.5			4		
September	4			3.5			3		
October	3			2.5			2		
November	2			1.5			1		
December	1			0.5			0		
	78			72			66		

Time Period :

Accounting Period	At the Beginning	At the Middle	At the End
12 months	78/12	72/12	66/12
6 months	21/12	18/12	15/12
3 months	6/12	4.5/12	3/12

Note : It is a general tendency to learn the time period of 6.5, 6 & 5.5, irrespective of understanding the rationale behind on such.

Refer to the 1st Row (where the amount is drawn at the beginning of every month and throughout the year), we find 78/12 = 6.5, 72/12 = 6 & 66/12 = 5.5.

The rationale is Rate of interest being mentioned as per annum. But, if the rate of interest is mentioned per month basis, then interest shall be calculated by considering the time period for 78 months, 72 months & so on.

Illustration 5

Amount Drawn p.m. ₹ 1000. Rate of Interest @ 12% p.a. If drawn at the begining of every month.

Account Period	**Interest**
12 months	= 1,000 x 12/100 X 78/12 = 780
6 months	= 1,000 x 12/100 X 72/12 = 720
3 months	= 1,000 x 12/100 X 66/12 = 660

If drawn at the middle of every month.

Account Period	Interest
12 months	= 1,000 × 12/100 X 21/12 = 210
6 months	= 1,000 × 12/100 X 18/12 = 180
3 months	= 1,000 × 12/100 X 15/12 = 150

If drawn at the end of every month.

Account Period	Interest
12 months	= 1,000 × 12/100 × 6/12 = 60
6 months	= 1,000 × 12/100 × 4.5/12 = 45
3 months	= 1,000 × 12/100 × 3/12 = 30

Illustration 6

Rani, Rini and Rina are three partners in a firm. According to partnership deed, the partners are entitled to draw ₹ 800 per month. On 1st day of every month Rani, Rini and Rina drew ₹ 700 ₹ 600 and ₹ 500 respectively. Profit during the year 2013 was ₹ 85,500 out of which ₹ 30,000 was transferred to General Reserve. Rini and Rina are entitled to received salary of ₹ 3,000 and ₹ 4,500 p.a. respectively and Rani is entitled to received commission at 10% of net distributable profit after charging such commission. On 1st January, 2013 the balance of their Capital Accounts were ₹ 50,000 ₹ 40,000 and ₹ 35,000 respectively. Interest on Capital provided at 8% p.a.

You are required to show Profit & Loss Appropriation Account for the year ended 31st December, 2013 and Capital Accounts of Partners in the book of the firm.

Points to be noted :

1. A partner was allowed to draw ₹ 800 per deed in this case, none of the Partners draw more than that.
2. Interest on Drawings should be calculated as 1st month's drawings for 12 months, for second month's drawings for 11 months and so on.

Alternatively, 6.5 month interest is to be calculated on total drawings of each partners. (See theoretical discussion regarding interest on drawings.)

Rani's total drawings = 700 × 12 = ₹ 8,400; Interest on Drawings = $700 \times \frac{10}{100} \times \frac{78}{12}$ = ₹ 455

Rini's total drawings = 600 × 12 = ₹ 7,200; Interest on Drawings = $600 \times \frac{10}{100} \times \frac{78}{12}$ = ₹ 390

Rina's total drawings = 500 × 12 = ₹ 6,000; Interest on Drawings = $500 \times \frac{10}{100} \times \frac{78}{12}$ = ₹ 325

Solution :

Dr. **Profit & Loss Appropriation Account for the year ended 31.12.2013** **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To General Reserve		30,000	By Profit & Loss (Net Profit)		85,500
			Interest on Drawings :		
" Salary - Rini	3,000		Rani	455	
Rina	4,500	7,500	Rini	390	
" Interest on Capital (at 8%)			Rina	325	1,170
Rani	4,000				
Rini	3,200				
Rina	2,800	10,000			
" Commission-Rani-(Note)		3,561			
" Share of Profit					
Rani [1/3]	11,870				
Rini [1/3]	11,870				
Rina [1/3]	11,869	35,609			
		86,670			86,670

Capital Accounts

Dr. **Cr.**

Date	Particulars	Rani ₹	Rini ₹	Rina ₹	Date	Particulars	Rani ₹	Rini ₹	Rina ₹
2013					2013				
01.01	To Drawings	8,400	7,200	6,000	31.12	By Balance b/d	50,000	40,000	35,000
31.12	" Interest on Drawings	455	390	325		" Interest on Capital	4,000	3,200	2800
						" Salary	-	3,000	4,500
	" Balance c/d	60,576	50,480	47,844		" Commission	3,561	-	-
						" Share of Profit	11,870	11,870	11,869
		69,431	58,070	54,169			69,431	58,070	54,169

Working Notes :

Particulars	₹
Net Profit before Commission [86,670 – 30,000 – 7,500 – 10,000]	39,170
Less : Rina's Commission = 10/110 of 39,170 (approx)	3,561
Share of Profit	35,609

Illustration 7

Calculation of Interest on Drawings made uniformly at the end of each quarter.

On January 1, 2013, Amethyst and Emerald commenced business as partners introducing capitals of ₹ 20,000 and ₹ 30,000 to their respective accounts. The partnership deed, provided inter alia that :

(i) Profit/Losses shall be shared in the ratio of 2 : 3 as between Amethyst and Enerald.

(ii) Partners shall be entitled to interest on Capital at the commencement of each year at 6 % p.a.; and

(iii) Interest on Drawings shall be charged at 8 % p.a.

During the year ended 31.12.2013 the firm made a profit of ₹ 19,280 before adjustment of interest on Capital and drawings. The Partners withdrew during the year ₹ 3,000 each at the end of every quarter commencing from 31.3.2013.

You are required to prepare a Profit Loss Appropriation Account and show the entries therein for distribution of Profit.

Show also the Capital Account of the partners for the year.

Points to be noted :

Each Partner drew ₹ 3,000 at the end of each quarter or ₹ 12,000 during the year. But interest on drawings for each of them should be :

(a) On 3,000 draw at the end of 1st Quarter – Interest for 9 months = 3,000 × 8/100 × 9/12 = ₹180

(b) On 3,000 draw at the end of 2nd Quarter – Interest for 6 months = 3,000 × 8/100 × 6/12 = ₹120

(c) On 3,000 draw at the end of 3rd Quarter – Interest for 3 months = 3,000 × 8/100 × 3/12 = ₹60

(d) On 3,000 draw at the end of 4th Quarter – No interest

* Total Interest on Drawings for each partner = ₹ 180 + ₹ 120 + ₹ 60 = ₹ 360.

Solution :

Dr. **Profit & Loss Appropriation Account for the year ended 31.12.2012** ***Cr.***

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Interest on Capital : (at 6% p.a)			By Profit & Loss (Net Profit)		19,280
– Amethyst	1,200		" Interest on Drawings:		
– Emerald	1,800	3,000	– Amethyst	360	
" Share of Profit			– Emerald	360	720
– Amethyst [2/5]	6,800				
– Emerald [3/5]	10,200	17,000			
		20,000			20,000

Dr. **Capital Accounts** ***Cr.***

Date	Particulars	Amount ₹	Amount ₹	Date	Particulars	Amount ₹	Amount ₹
31.12.13	To Drawings	12,000	12,000	1.1.13	By Bank (Capital Introduced)	20,000	30,000
	" Intrest on Drawings	360	360	31.12.13	" Interest on Capital	1,200	1,800
	" Balance c/d	15,640	29,640		" Share of Profit	6,800	10,200
		28,000	42,000			28,000	42,000

Illustration 8.

Azu and Biju are partners firm contributing ₹ 25,000 and ₹ 20,000 respectively as capitals and sharing profit as Azu 3/5 th and Biju 2/5 th. Interest on Capitals is to be allowed at 10% per annum. The net profit for year ended 31st March, 2013 amounts to ₹ 3,600 before making any allowance for interest. Show the appropriation of profit.

Solution :

Particulars	**Azu (₹)**	**Biju (₹)**	**Total (₹)**
Interest on Capital @ 10% p.a.	2,500	2,000	4,500
The profit are ₹ 3,600.			

Unless specifically agreed upon, interest on capitals should be allowed only up to ₹ 3,600 and should be shared in Capital Ratio [25,000 : 20,000 or 5 : 4]

Azu's share = 5/9 × ₹ 3,600 = ₹ 2,000; Biju's share = 4/9 × ₹ 3,600 = ₹ 1,600

If the partners have agreed upon provision for interest on capital irrespective of profits, the distribution should be :

Dr. **Profit & Loss Appropriation Account for the year ended 31.03.2013** ***Cr.***

Particulars	**Amount** ₹	**Amount** ₹	**Particulars**	**Amount** ₹	**Amount** ₹
To Interest on Capital :			By Profit & Loss (Net Profit)		3,600
Azu			" Share of Loss :		
Biju	2,500		" Azu [3/5]		
	2,000	4,500	" Biju [2/5]	540	
				360	900
		4,500			4,500

Illustration 9.

Sharing of profit on Effective Capital Ratio.

Sachin, Sanat and Sohali Started a partnership firm on 1.1.2013. Sachin introduced ₹ 10,000 on 1.1.2013 and further introduced ₹ 5,000 on 1.7.13 Sanat introduced ₹ 20,000 at first on 1.1.13 but withdrew ₹ 8,000 from the business on 31.7.13. Sohali introduced ₹ 12,000 at the beginning on 1.1.13, increased it by ₹ 4,000 on 1.6.13 and reduced it to ₹ 10,000 on 1.11.13.

During the year 2013 they made a net profit of ₹ 56,100. The partners decided to provide interest on their capitals at 12% p.a. and to divide the balance of profit in their effective capital contribution ratio.

Prepare the Profit & Loss Appropriation Account for the year ended 31.12.13.

Solution :

(a) Calculation of effective capital contribution :

		Product (₹)
Sachin :	₹ 10,000 for 6 months (1.1.to 1.7)	60,000
	₹ 15,000 for 6 months (1.7.to 31.12)	90,000
		1,50,000
Sanat :	₹ 20,000 for 7 months (1.1.to 31.7)	1,40,000
	₹ (20,000 – 8,000) for 5 months (1.8.to 31.12)	60,000
		2,00,000
Sohali :	₹ 12,000 for 5 months (1.1.to 1.6)	60,000
	₹ (12,000 + 4,000) for 5 months (1.6.to 1.11)	80,000
	₹ 10,000 for 2 months (1.11.to 31.12)	20,000
		1,60,000

• Profit Sharing Ratio = Effective Capital Ratio = 15 : 20 : 16

(b) Interest on Capitals = Product × Interest on Capital × 1/12

Sachin = 1,50,000 × 12/100 × 1/12 = 1,500;

Sanat = 2,00,000 × 12/100 × 1/12 = 2,000;

Sohali = 1,60,000 × 12/100 × 1/12 = 1,600

Dr. **Profit & Loss Appropriation Account for the year ended 31.12.2013** ***Cr.***

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Interest on Capital :			By Profit & Loss		56,100
– Sachin	1,500		(Net Profit)		
– Sanat	2,000				
– Sohali	1,600	5,100			
To Share of Profit :					
– Sachin [15/51]	15,000				
– Sanat [20/51]	20,000				
– Sohali [16/51]	16,000	51,000			
		56,100			56,100

B. PAST ADJUSTMENTS

Errors committed in making appropriations of profit or in measuring revenues or profits in any earlier year may be located by a partnership firm in a subsequent year. Such errors may result from wrong valuation of inventory, incorrect distribution of profit, errors of misposting or principles, etc. Their adjustments should be made with retrospective effect from the date of initiation of errors. The adjustment is usually made with the help of adjustment entries made through the partner's Capital Accounts. A 'Prior Period Adjustment Account' or 'Profit & Loss Adjustment Account' may be used to accommodate the adjustments and

the balance of this account may be transferred either to this Profit & Loss Account of the current year or to the partners capital accounts.

Also there may be situations involving personal payment of salary by one partner to another, omission to charge Interests, etc.

Interest on Capitals omitted to be charged.

Illustration 10.

A, B, C and D are partners sharing profit and losses in the rate of 4 : 3 : 3 : 2. Their respective capitals on 31st March, 2013 were ₹ 3,000 ₹ 4,500 ₹ 6,000 and ₹ 4,500. After closing and finalizing the accounts it was found that interest on capital @ 6% per annum was omitted. Instead of altering the signed accounts it was decided to pass a single adjusting entry on 1st April, 2013 crediting or debiting the respective partners' accounts. Show the Journal Entry.

Solution :

Statement showing Rectification of Profits

Partner	Interest on Capital @ 6% p.a. not provided ₹	Amount Wrongly distributed in PSR ₹	(Excess)/Deficit ₹	Adjust ₹
A	180	360	(180)	Debit
B	270	270	-	-
C	360	270	90	Credit
D	270	180	90	Credit
	1,080	1,080		-

Journal

Date	Particulars	L.F	Dr. Amount ₹	Cr. Amount ₹
1.4.13	A's Current A/c Dr.		180	
	To C's Current A/c			90
	To D's Current A/c			90
	[Interest on Capital not provided @ 6% p.a. now rectified]			

Illustration 11.

The Capital Accounts of Adhar and Bhudhar stood at ₹ 40,000 and ₹ 30,000 respectively after the necessary adjustment in respect of the drawings and the net profit for the year ended 31st December, 2013. It was subsequently ascertained that 5% p.a. interest on Capitals and drawings was not taken into account in arriving at the net profit. The drawings of the partners had been: Adhar ₹ 1,200 at the end of each quarter and Bhudhar ₹ 1,800 at the end of each half year.

The profit for the year as adjusted amounted to ₹ 20,000. The partners share profit in the proportion of Adhar 3/5 and Bhudhar 2/5.

You are required to pass journal entries and show the adjusted capital accounts of the partners.

Solution : Working Notes :

(i) Interest Drawings

Particulars	Adhar ₹	Bhudhar ₹
On 1,200 drawn at the end of 1st quarter [1,200 × 5/100 × 9/12]	45	
On 1,200 drawn at the end of 2nd quarter [1,200 × 5/100 × 6/12]	30	
On 1,200 drawn at the end of 3rd quarter [1,200 × 5/100 × 3/12]	15	
On 1,200 drawn at the end of last quarter	Nil	
	90	
On 1,800 drawn at the end of 1st half year [1,800 × 5/100 × 6/12]		45
On 1,800 drawn at the end of 2nd half year		Nil
		45

(ii) Statement showing Rectification of Profits

Particulars	Adhar ₹	Bhudhar ₹
(A) Capital as on 31.12.13	40,000	30,000
Add : Drawings	4,800	3,600
Less : Share of Profits already Credited	12,000	8,000
Capital as on 1.1.13	32,800	25,600
Add : Interest on Capital @ 5%	1,640	1,280
Less : Interest on Drawings	90	45
Add : Share of Profits = 17,215 [20,000 – 1,640 – 1,280 + 90 + 45]	10,329	6,886
Less : Drawings	4,800	3,600
(B) Adjusted Capital as on 31.12.13	39,879	30,121
Difference of Capital [A – B]	121 (Excess)	121 (Deficit)

Solution :

Adjustment Entry :

Journal

Date	Particulars	L.F.	*Dr.* Amount ₹	*Cr.* Amount ₹
1.1.2014	Adhar's Capital Account *Dr.*		121	
	To Bhudhar's Capitals Account			121
	[Adjustment made for Interests on Capital and on Drawings not provided and the net amount wrongly shared as Profits]			

Capital Accounts

Dr. | *Cr.*

Date	Particulars	Adhar ₹	Bhudhar ₹	Date	Particulars	Adhar ₹	Bhudhar ₹
1.1.13	To Bhudhar's Capitals	121	—	1.1.13	By Balance b/f	40,000	30,000
	" Balance c/f	39,879	30,121		" Adhar's Capital	—	121
		40,000	30,121			40,000	30,121

Adjustment for wrong distribution of Profits.

Illustration 12.

Dr. **Profit & Loss Appropriation Account for the year ended 31st March 2013** *Cr.*

Particulars	Amount ₹	Particulars	Amount ₹
To Interest on Capital :		By Net Profit	40,000
– Dhruva 8% of ₹ 40,000	3,200	" Interest on Drawings	
– Rohini 8% of ₹ 30,000	2,400	(calculated on average of 6	
" Salary – Dhruva	4,800	months)	
" Share of Profit :		– Dhruva 6% of ₹ 8,000	240
Dhruva [1/2]	15,010	– Rohini 6% of ₹ 6,000	180
Rohini [1/2]	15,010		
	40,420		40,420

The entries were duly passed in the books but the following discrepancies were subsequently discovered :

(i) Interest on capital should have been allowed at 6% p.a. and that on drawings should have been charged at 8% p.a.

(ii) Dhruva was not entitled to get any salary but Rohini was to get a monthly salary of ₹ 250.

(iii) Profits should have been shared in opening capital ratio.

You are required to redistribute the profits correctly.

Solution :

Calculation of Net Amounts already Credited to each Partner's Capital

Particulars	Dhruva (₹)	Rohini (₹)
Amounts Credited : Interest on Capital	3,200	2,400
Salary	4,800	—
Share of Profit	15,010	15,010
	23,010	17,410
Less : Amount debited – Interest on drawings	240	180
	22,770	17,230

Dr. **Profit & Loss Appropriation Account for the year ended 31.12.2013** *Cr.*

Particulars	Amount ₹	Amount ₹	Particulars ₹	Amount ₹	Amount
To Interest on Capital			By Dhruva'a Capital		22,770
Dhruva [6% of 40,000]	2,400		(Amount written back)		
Rohini [6% of 30,000]	1,800	4,200	" Rohini's Capitals		17,230
" Salary –			(Amount written back)		
Rohini [250 × 12]		3,000	" Interest on Drawings :		
			[@ 8% p.a. on		
" Share of Profit :			average 6 months]		
Dhruva [4/7]			Dhruva		
Rohini [3/7]	19,063		Rohini	320	
	14,297	33,360		240	560
		40,560			40,560

C. GUARANTEED PARTNERSHIP

In a Partnership, there may be special agreement by virtue of which a Partner may get the guarantee of earning a minimum amount of profit.

This guarantee may be given by one partner in particular or by the firm. It is given generally to encourage a junior partner or any sincere clerk of the business inducted to the benefits of Partnership.

(a) Guarantee given by one Partner :

(i) The appropriation of profit should be made in the general course by applying the existing profit sharing ratio.

(ii) The minimum amount guaranteed is to be decided.

(iii) In case the guaranteed amount (ii) is more, the excess should be deducted from the share of profit of the Partner given guarantee and calculated under (i) above.

The same amount should be added with the original share of profit of the Partner to whom the guarantee has been given.

Illustration 13.

X and Y are Partners sharing profit as 5:3. Z is the clerk of their business getting a salary of ₹ 500 p.m. and a commission of 5% of the net profit after deducting his salary and commission. Now, X guarantee that Z be made a Partners with 1/10th share of profit and nothing else. If the annual profits is ₹ 1,32,000. Show the appropriation.

Steps :

(i) General Application of Profit Z's Share as clerk :	₹
Salary 500 × 12	6,000
Commission 5/105 of [1,32,000 – 6,000]	6,000
	12,000

Balance of profit 1,20,000 Shared as : X = 5/8 × 1,20,000 = ₹ 75,000;

Y = 3/8 × 1,20,000 = ₹ 45,000

(ii) Minimum guaranteed share of Z = 1/10th of ₹ 1,32,000 = ₹ 13,200

(ii) Shortfall = ₹ 13,200 – ₹ 12,000 = ₹ 1,200 to be deducted from share and added with Z's share.

Final appropriation should be –

	₹
X : ₹ 75,000 – ₹ 1200	73,800
Y :	45,000
Z : ₹ 12,000 + ₹ 1200	13,200
	1,32,000

X's Capital / Current A/c	Dr.	1,200	
To Z's Capital / Current A/c			1,200
(Being Guaranteed share of profits provided			

(b) Guarantee given by firm :

(i) The share of profit of the guaranteed Partner is to be calculated according to the profit – sharing ratio.

(ii) His minimum guaranteed amount is ascertained.

(iii) The higher of (i) and (ii) is given or credited to him.

(iv) The remaining profits are shared among the remaining Partners in their remaining ratio.

If the minimum guaranteed amount is more, the shortfall may be agreed to be in a ratio specially agreed upon.

Illustration 14.

The profit sharing ratio among X, Y and Z is 3: 2: 1. Z is guaranteed a minimum profit of ₹ 84,000 p.a. Annual profit are ₹ 4,20,000. Show the distribution.

Steps :

(i) Normal Distribution :	
X : 3/6 of ₹ 4,20,000	2,10,000
Y : 2/6 of ₹ 4,20,000	1,40,000
Z : 1/6 of ₹ 4,20,000	70,000
(ii) Z's guaranteed share is ₹ 84,000	
(iii) Z's share should be ₹ 84,000 (higher than ₹ 70,000)	
(iv) X's share [4,20,000 – 84,000] × 3/5	2,01,600
Y's share [4,20,000 – 84,000] × 2/5	1,34,400
Z's share	84,000
	4,20,000

X's Capital / Current A/c	Dr.	8,400		[= 2,10,000 - 2,01,600]
Y's Capital / A/c	Dr.	5600		[= 1,40,000 - 1,34,400]
To Z's Capital / Current A/c			14,000	[= 70,000 - 84,000]

Illustration 15.

Cross Guarantee

Susmita and Aishwarya were partners of a Beauty Parlour sharing profit and Losses as 3 : 2 Manpereet who had been running a similar business as a beauty consultant requested Susmita and Aishwarya to form a new partnership to which all of them agreed on the conditions that :

1. They would share the profits and losses 3 : 2 : 1.
2. Susmita and Aisharwya guranteed to the effect that Manpreet's share of profit would not be lower than ₹ 22,500 per annum.
3. Manpreet guaranteed that gross fees earned by her for partnership business shall be at least equal to her average gross fees of the preceding three years when she was doing business on her own. Her average gross fees were ₹ 37,500.

The profit of the new partnership for the first accounting year ended on 31st March, 2013 was ₹ 1,12,500 and the gross fees earned by Manpreet for the firm were ₹ 24,000.

Show the distribution of the above profit in a Profit & Loss Appropriation Account for the year ended 31st March, 2013.

Solution:

In the Books of
Susmita, Aisharwya & Manpreet
Profit & Loss Appropriation Account for the year ended 31.03.2013

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Partnerships' Capital A/cs :			By Profit & Loss A/c		1,12,500
(Share of Profit) [Note 2]			(Net Profit)		
Susmita	62,100		" Manpreet's Capital A/c		13,500
Aisharwya	41,400		[Note 1]		
Manpreet	22,500	1,26,000			
		1,26,000			1,26,000

Note :

1. Manpreet's shortfall in gross fees earned by her for the partnership = ₹ 37,500 – ₹ 24,000 = ₹ 13,500. This amount is to be paid by her out of her Capital Account.

   Manpreet's Capital A/c Dr. 13,500

   To Profit & Loss Appropriation A/c 13,500

2. Manpreet's share of actual profit =1/6 of ₹ 1,26,000 = ₹ 21,000. As amount guaranteed to her is ₹22,500.

   - Deficit = ₹ 1,500 to be shared by Susmita and Aishwarya as 3 : 2.
   - Final Distribution of Profit should be :

   Susmita = 3/6 of 1,26,000 – 3/5 of 1,500 = 63,000 – 900 = ₹ 62, 100;

   Aishwarya = 2/6 of 1,26,000 – 2/5 of 1,500 = 42,000 – 600 = ₹ 41,400;

   Manpreet = 1/6 of 1,26,000 + 1,500 = 21,000 + 1,500 = ₹ 22,500.

Susmita's Capiital A/c	Dr.	900	
Aishwarya's Capital A/c	Dr.	600	
To Manpreet's Capital A/c			1,500

Illustration 16.

Anju and Manju are in partnership sharing profits and losses in 7 : 3. As a mark of appreciation of the services of their senior officer Sreenjoy, they took him into partnership of January 1, 2013 giving him 1/10th share of profits only. The mutual ratio between Anju and Manju remains unalloted.
Before becoming a partner, Sreenjoy was getting a salary of ₹ 4,000 per month and a commission of 5% on the profits after charging his salary and commission.

It was also agreed that any excess over his former remuneration to which Sreenjoy as a partner becomes entitled is to be provided out of Anju's share of profit.

The net profit for the year ended Dec 31, 2013, amounted to ₹ 19,80,000. Prepare the Profit and Loss Appropriation Account for the year ended Dec 31, 2013 showing the distribution of the net profits amongst the partners.

Solution :

In the book of the firm
Profit and Loss Appropriation Account
for the year ended 31st December, 2013

Dr. *Cr.*

Particulars		Amount ₹	Particulars	Amount ₹
To Share Profits :			By Profit & Loss A/c	
Anju	12,30,000		— Net Profit	19,80,000
Manju	5,52,000			
Sreenjoy	1,98,000	19,80,000		
		19,80,000		19,80,000

Workings :

Sreenjoy as a partner	₹	₹
Profit @ 1/10 ₹19,80,000		= 1,98,000
Less : Received as on officer ₹ 4,000 × 12 =	48,000	
Commission		
@ 5/105 × (19,80,000 – 48,000)	92,000	1,40,000
		58,000

Sreenjoy as a officer	₹
Profits (₹ 19,80,000 – ₹ 1,40,000)	18,40,000
Anju's share ₹ 18,40,000 × (7/10)	12,88,000
Manju's share ₹ 18,40,000 x (3/10)	5,52,000

Thus, when Sreenjoy becomes a partners, share of profits will be :

	₹
Anju (₹ 12,88,000 – ₹ 58,000)	12,30,000
Manju	5,52,000
Sreenjoy	1,98,000
	19,80,000

Illustration 17.

Guarantee with Retrospective effect

Kalyani and Ranu commenced business on 1st July, 2010 as partners with capitals of ₹ 1,80,000 and ₹ 1,20,000 respectively. The capitals would remain fixed and carry interest at 10% p.a. Profit and losses were to be shared in proportion to their capitals.

They appointed Anita as their Manager on 1st July, 2010 at a salary of ₹ 9,600 per annum plus a bonus of 5% of the net profits after charging such bonus and interest as a partner from the commencement of the business. She had to deposit ₹ 80,000 as security, carrying an interest @ 12%p.a. It was agreed that she would be associated as a partner w.e.f her date of joining as a manager and be entitled to one-fifth share of the profits and her security deposit would be treated as her capital carrying interest @ 10% p.a. It was further agreed that this new arrangement should not result in Anita's share for any of these years being less than what she had already received under the original agreement and terms of her appointment.

The profits before charging Anita's bonus and interest on Capital of the partners or giving effect to the new arrangement were – (a) for the year 2010-11 — ₹ 60,000; (b) for the year 2011-12 — ₹ 1,20,000; (c) for the year 2012-13 — ₹ 1,60,000.

Show by a single journal entry to give effect to the new arrangement with explanatory computation.

Points to be noted :

1. As a Manager, Anita received (a) bonus @ 5% on Net Profits after charging such bonus and interest on capital at 10% p.a. to Kalyani and Ranu (b) Salary ₹ 9,600 p.a. (c) Interest on security deposit at 12% p.a.
2. As a Partner Anita is entitled to (a) Interest on Capital at 10% p.a. (b) 1/5th of profit after providing interest on capital at 10% p.a. to all partners including herself.
3. If total dues of Anita under (2) above is more than that under (1) above, she should get the difference. But if such dues under (1) above is more, she would not refund the excess already received.

Solution :

Workings : (1) – Calculation of Anita's Dues as Manager

Particulars	2010-11 ₹	2011-12 ₹	2012-13 ₹
Salary	9,600	9,600	9,600
Interest on Security Deposit : 12% of 80,000	9,600	9,600	9,600
Bonus 5/105 of profit after charging interest on capitals of Kalyani and Ranu			
2010-11 = 5/105 of (60,000 – 10% of 3,00,000)	1,429		
2011-12 = 5/105 of (1,20,000 – 10% of 3,00,000)		4,286	
2012-13 = 5/105 of (1,60,000 – 10% of 3,00,000)			6,190
	20,629	23,486	25,390

(2) Calculation of Distributable profit under the new arrangement

Particulars	2010-11 ₹	2011-12 ₹	2012-13 ₹
Net profits given (after charging interest on security deposit and Anita's salary but before charging interest on capitals)	60,000	1,20,000	1,60,000
Add : Anita's Salary and Interest on Deposit no more payable [9,600 + 9,600]	19,200	19,200	19,200
	79,200	1,39,200	1,79,200
Less : Interest on Capitals to all partners @ 10% of [1,80,000 + 1,20,000 + 80,000]	38,000	38,000	38,000
Distributable Profits	41,200	1,01,200	1,41,200
Anita's Share of Profit = 1/5th of Distributable Profit	8,240	20,240	28,240

(3) Difference in Payments to Anita

Particulars	2010-11 ₹	2011-12 ₹	2012-13 ₹
A. Anita's Dues as Partner :			
Interest on Capital @ 10% of 80,000	8,000	8,000	8,000
Share of Profit [as per workings 2]	8,240	20,240	28,240
	16,240	28,240	36,240
B. Anita's Dues as manager [as per workings 1]			
Difference Payable to Anita	20,629	23,486	25,390
	-	4,754	10,850
Total			15,604

Journal

Date	Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
	Kalyani's Current A/c [3/5 of 15,604]	Dr.		9,362	
	Ranu's Current A/c [2/5 of 15,604]	Dr.		6,242	
	To Anita's Current A/c				15,604
	[Adjustments made through Partners' Current A/cs to the to new arrangement regarding profits]				

As capitals remained fixed and interest was calculated every year on these fixed capitals, the necessary adjustment has been made through current accounts.

Illustration 18.

Adjustments without alteration of book values

R, S and T are partners of a firm, sharing profits and losses as 5 : 3 : 2. Their Balance Sheet as on 31st March, 2012 stood as follows :

Liabilities	Amount ₹	Assets		Amount ₹
Sundry Creditors	25,000	Cash at bank		10,000
General Reserve	20,000	Sundry Debtors	22,000	
S Loan Account	15,000	*Less* : Reserve for Bad Debts	2,000	
Capital Account :		Furniture		20,000
R S T	25,000	Machinery		10,000
	10,000	Stock		35,000
	5,000			25,000
	1,00,000			100,000

From 1st April, 2012 the partners decided to change their profit sharing ratio as 2 : 1 : 2 in place of their previous ratio 5 : 3 : 2 and the following adjustments were agreed upon :

(1) The Reserve for Bad Debts was to be raised to 10%;

(2) Furniture was to be appreciated by ₹ 5,200. They did not want to alter the book values of the assets and reserve but recorded the change by passing one single journal entry.

The profit for the year ended 31st March, 2013 showed a net profit of ₹ 22,900.

You are required :

1. To show the single journal entry adjusting the partners' capital on 1st April, 2012, and
2. To prepare the Profits and Loss Account for the year ended 31st March, 2013 after taking into account the following : (i) Interest on Capital at 5% p.a.; (ii) Interest on S's loan and (iii) Transfer 25% of the divisible profit to Reserve Fund after charging interest on Capital & Loan.

Solution :

Working Notes :

1. Calculation of Net Effect of the adjustments

Particulars	₹
Profit due to increase of Value of Furniture	5,200
General Reserve	20,000
	25,200
Less : Additional Reserve for Bad Debts (Provision) [10% of (₹ 22,000 – ₹ 2000)]	200
Profit	25,000

2. Adjustment of Capital as on 01.04.12

Particulars	R ₹	S ₹	T ₹
Profit ₹ 25,000 shared in old ratio 5:3:2	12,500	7,500	5,000
Reversal of Profis of ₹ 25,000 in 2:1:2, whichever earlier shared in 5:3:2. ₹ 25,000 shared in new ratio 2:1:2	(10,000)	(5,000)	(10,000)
Net Effect	2,500	2,500	(5,000)
Capitals as on 31.03.12	25,000	10,000	5,000
Adjusted Capital on 1.4.12	27,500	12,500	—

Books of R, S & T
Journal Entry

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
1.4.12	T's Capital A/c *Dr.* To, R's Capital To, S's Capital (Adjustment made due to change in profit sharing ratio)		5,000	 2,500 2,500

Dr. **Profit & Loss Account for the year ended 31st March, 2013** **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars ₹	Amount ₹	Amount
To Interest on Capital :			By Profit & Loss A/c		22,900
R - [5% of 27,500]	1,375		(Net Profit)		
S - [5% of 12,500]	625	2,000			
" Interest on S's loan					
[6% of 15,000]		900			
" Reserve Fund					
[25/125×(22,900–2,900)]		4,000			
" Shares of Profit :					
R [2/5]	6,400				
S [1/5]	3,200				
T [2/5]	6,400	16,000			
		22,900			22,900

Illustration 19.

Adjustment of Profits – A typical problem

Agni and Bani started a partnership on April 1, 2010 with respective capital contributions of ₹ 60,000 and ₹ 20,000. On 31.03.2012 they prepared the following Trial Balance for their business :

Particulars	***Dr.*** (₹)	***Cr.*** (₹)
Stock	46,000	-
Machinery	46,500	-
Debtors and Creditors	58,000	12,000
Provision for Depreciation		9,500
Cash and Bank	21,000	-
Capitals :		
Agni	-	1,04,750
Bani	-	45,250
	1,71,500	1,71,500

The transactions recorded in the Capital Accounts during these two years were interest on capital at 10% p.a. on initial investments and allocation of incomes. On 31.03.12 it was further discovered that total drawings of ₹ 21,000 by Agni and ₹ 15,000 by Bani had been wrongly treated as business expenses.

The Partnership Accounts were to be correctly adjusted.

On 1.4.2012 Agni and Bani offered partnership to Clara and Dela on the following terms:

1. The new partners should introduce capitals as Clara ₹ 50,000 and Dela ₹ 40,000.
2. All partners would be entitled to interest on opening balance of the new partnership @ 10% p.a.
3. Agni and Bani are to receive salaries for their special services @ ₹ 10,000 p.a. and ₹ 6,000 p.a.
4. The minimum dues of Clara and Dela would be ₹ 10,000 p.a. and 12,000 p.a. respectively (inclusive of their interest on capital)
5. Profits after charging Partners' salaries and interests on capitals would be shared as 3 : 3 : 2 : 2 among Agni, Bani, Clara and Dela.

You are required to show : (1) Correct Capital balance of Agni and Bani on 31.03.12 (2) the net income that must be earned by the new firm during the year ended 31st March 2013 so that Agni and Bani receive equal shares of Profit and Agni receives an aggregate of ₹ 30,000 inclusive of interest on Capital, Salary and Share of Profit.

Solution :

Notes :

1. Profits already credited

Particulars	Agni ₹	Bani ₹
Opening Capitals	60,000	20,000
Add: Interest on Capital for 2 years @ 10% p.a. on original capitals	12,000	4,000
Add: Profits Credited (Balance in figure)		
Closing Balance	32,750	21,250
Therefore Total Profit Credited = 32,750 + 21,250 = ₹ 54,000		
	1,04,750	45,250

Therefore rectified Profit = Profits Credited + drawings treated as an expense

= 54,000 + 21,000 + 15,000 = 90,000

2. Sharing Profits

Particulars	Agni ₹	Bani ₹
Correct Profit equally divided [90,000 as 1 : 1]	45,000	45,000
Profits wrongly credited	32,750	21,250
Adjustment Required	12,250	23,750

Statement showing correction of Capitals of Agni and Bani on 31.03.12
And correction of Profits upto that date

Correction of Capital Balance	Agni ₹	Bani ₹
Balance as per Trial Balance on 31.3.12	1,04,750	45,250
Less : Drawing	21,000	15,000
	83,750	30,250
Add : Adjustment for Profit [Note 2]	12,250	23,750
Adjusted Capitals on 31.3.12	96,000	54,000

Statement Showing Calculation of Minimum Income to be earned during the year ended 31.3.13

Particulars	Amount ₹	Amount ₹
Minimum Amount Payable to :		
Agni : Interest on Capital [10% of 96,000]	9,600	
Salary	10,000	
Share of Profit [Balancing amount to make total dues ₹30,000]	10,400	30,000
Bani : Interest on Capital [10% of 54,000]		
Salary	5,400	
Share of Profit [Equal share with Agni]	6,000	
	10,400	21,800
Clara : Interest on Capital [10% of 50,000]		
Share of Profit [Balancing Amount to make total ₹ 10,000]	5,000	
	5,000	10,000
Dela : Interest on Capital [10% of 40,000]		
Share of Profit [Balancing Amount to make total ₹ 12,000]	4,000	
	8,000	12,000
Total Profits Required to be earned		73,800

6.2 ADMISSION OF A PARTNER

Partners of a continuing business may, by common consent, decide to admit a new partner for additional capital, technical skill or managerial efficiency. At the time of such admission, the usual adjustments required are : (1) Adjustment regarding Profit Sharing Ratio; (2) Adjustment regarding Valuation of Assets and Liabilities; (3) Adjustment regarding Goodwill; (4) Adjustments regarding accumulated Profits or Losses and (5) Adjustment regarding Capital Contribution of New partner and Capitals of existing partners.

1. ***Adjustment regarding Profit Sharing Ratio :*** The new partner becomes entitled to a share of future profits which is sacrificed by the existing (old) partners in his favour. The sacrifice may be made by one or all of the existing partners. **The new profit sharing ratio has to be found out.**

   It should be noted that :

(a) The new profit sharing ratio may be agreed upon by the partners. [It may be given and we need not calculate it]

(b) The mutual profit sharing ratio among the existing partners may remain unaltered after giving away the new partner's share.

Example : X and Y were partners sharing profit/losses as 3 : 2. They admit as a new partner giving him 1/5th share of future profits. What should be the new profit sharing ratio?

Solution : Z's share = 1/5 Balance = 1 – 1/5 = 4/5

X's share = 4/5 x 3/5 = 12/25; Y's share = 4/5x2/5 = 8/25; Z's share = 1/5 = 5/25. The new profit sharing ratio = 12 : 8 : 5.

(c) The mutual profit sharing ratio among existing partners may be changed by agreement.

Example: P and Q were partners sharing profits/losses as 4 : 3. R is admitted as a new partner for 1/5 th share. P and Q decide to share the balance of profits equally.

Solution : R's share = 1/5 Balance = 1 – 1/5 = 4/5.

P's share = 4/5 × 1/2 = 4/10; Q's share = 4/5 × 1/2 = 4/10; R's share = 1/5 = 2/10. New Ratio = 4 : 4 : 2 or 2 : 2 : 1.

(d) If the sacrifice made individually by the existing partners is given then New Ratio should be calculated by deducting the sacrifice from the old ratio.

Example : A, B & C were partners sharing profits/loses as 3 : 2: 1. They admitted D as a new partner giving him 1/6th share of future profits. D acquired 3/24 th share from A and 1/24 share from B. Calculate the new Profit Sharing Ratio.

Solution : New Ratio = Old Ratio – Sacrifice Ratio

A = 3/6 – 3/24 = 12/24 – 3/24 = 9/24; B = 2/6-1/24 = 8/24 – 1/24 = 7/24; C = 1/6 – Nil = 4/24 – Nil = 4/24; D=3/24 + 1/24=4/24 The new ratio = 9 : 7 : 4 : 4.

Thus regarding Profit Sharing Ratio we can sum up as follows :

1. **Old Ratio** = Profit Sharing Ratio of existing Partners (before admission of new partner)

   = Given or Equal (If not mentioned)

2. **New Ratio** = Future Profit Sharing Ratio among all partners (including new partner, after his admission)

   = Given ***or*** = Old Ratio – Sacrificing Ratio made by each of existing partners.

3. **Sacrificing ratio** = Share of an existing partner under Old Ratio – his Share under new ratio.

But unless otherwise mentioned the mutual profit sharing Ratio between the existing partners will remain unaltered. In that case Sacrifice Ratio = Old Ratio.

It will be evident from subsequent discussions that proper use of the above ratios will be required for solving problems regarding Admission of a new partner.

2. ***Adjustment Regarding Valuation of Assets and Liabilities*** : The Book values of assets as shown in the Balance Sheet may not reflect their current realizable values. Similarly the liabilities included in the Balance Sheet may not exhibit their actual position. Whenever a change takes place in a partnership business in the form of admission or retirement or death of a partner or due to change in profit sharing ratio, revaluation of assets or liabilities become necessary.

The effect of Revaluation are given in two ways : (a) **by incorporation the changes of the Balance Sheet Values** and (b) **without changing the Balance Sheet values.**

(a) By Incorporating Changes in the Balance sheet values

Prepare : Revaluation Account

(i) For decrease in the value of assets, increase in the value of liabilities, provision for unrecorded liabilities:

Revaluation A/c Dr

To Assets A/c (with the decrease in value)

To Liabilities A/c (with the increase in value)

(ii) For increase in the value of assets, decrease in the value of liabilities, unrecorded assets

Assets A/c Dr (with the increase in value)

Liabilities A/c Dr (with the decrease in value)

To Revaluation A/c

(iii) For profit on revaluation :

Revaluation A/c Dr

To old partners capital A/c (in their old profit sharing ratio) [For loss on revaluation, the reverse entry should be made]

Proforma :

Revaluation Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Assets (Decrease)	x x x	By Assets (Increase)	x x x
To Liabilities (Increase)	x x x	By Liabilities (Decrease)	x x x
To Partners Capital A/c	x x x	By Partners Capital A/c	x x x
(Share of Revaluation Profit)		(Share of Revaluation loss)	
	x x x		x x x

(b) Without changing the Balance sheet Values

Prepare : Memorandum Revaluation Account

(i) Record increase/decrease in the value of assets and liabilities as discussed.

(ii) Share the profit or loss on Revaluation amongst the old partners in their old profit sharing Ratio.

(iii) Reverse the increase/decrease in the value of assets and liabilities.

(iv) After reversal, calculate profit or loss.

(v) Share the profit/loss, after reversal amongst all the partners (including the new partner) in their new profit sharing ratio.

Memorandum Revaluation Account

Dr. *Cr.*

Particulars	₹	Particulars	₹
To Assets (Decrease) To Liabilities (Increase) To Partners Capital A/c (Share of Revaluation Profit) [Old Partners in old Profit sharing Ratio]	x x x x x x x x	By Assets (Increase) By Libilities (Decrease) By Partners Capital A/c (Share of Revaluation loss) [Old Partners in their Old profit sharing ratio]	x x x x x x
	xxx		xxx
To Reversal of Items b/d To Partners Capital A/c (Revaluation Profit amount all partners in new profit sharing Ratio)	x x x x	By Revarsal of Items b/d By Partners capital A/c (Revaluation loss amought all partners in their new Profit sharing (Ratio)	x x x x
	xxx		xxx

3. Adjustment regarding Goodwill : It is being separately discussed later.

Adjustment Regarding Goodwill

Goodwill is an invisible force that helps a business to earn more than the normal return on investment enjoyed by similar businesses. It is the sum total of the reputation and other favourable attributes built up by a business. Goodwill results into larger number of customers, higher turnover and more profits for a business. The additional profits earned by the business or its "super profits" indicate that it has goodwill. Thus goodwill is a real but intangible asset.

When the amount paid for the purchase of a business is in excess of its net assets, such excess payment is treated as "Goodwill at Cost" or "Purchased Goodwill".

Where there is no purchase or sale but a change of constitution takes place like admission of a new partner etc., the value of goodwill may be recognised as "Inherent/Potential" Goodwill. Accounting Treatment of Goodwill as Read with the Relevant Accounting Standard issued by the ICAI.

(A) Accounting Standard 10 (AS—10) to related is 'Accounting for Fixed Assets'.

(B) Paragraph 16 of this standard stipulates that "Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is excess of the value of the net assets of the business taken over the excess is to be termed as 'goodwill'."

Illustration 20.

X and Y were partners sharing profits as 4 : 3. Z joined as a new partner. The new profit sharing ratio between X, Y and Z was agreed to be 7 : 5 : 3. The Goodwill of the firm was valued at ₹ 84,000. But Z could not pay any premium for goodwill.

Solution :

Step 1 : Calculate Z's premium : 3/15 of ₹ 84,000 = ₹ 16,800

Step 2 : Calculate sacrifices made by X and Y : X = (4/7-7/15) = 11/105

Y =3/7-5/15 = 10/105 Sacrifice Ratio : 11:10.

Z's Capital A/c Dr.	16,800	
To X's Capital A/c		8,800
To Y's Capital A/c		8,000

Treatment of Goodwill (At the time of Admission of a New Partner)

Sl. No	Case	Journal Entry	Ratio used	Remarks
1.	New Partner pays Premium for Goodwill.	Cash/Bank...... *Dr.* To Old Partners Capital (Premium money)	Sacrifice Ratio	(1) If mutual ratio between old partners do not change sacrifice ratio = Old Ratio (2) If Goodwill stands at or is raised to full value, no premium should be paid.
2.	If the premium or its part is immediately withdrawn by old partners	Old Partners Capital...... *Dr.* To Bank (Amount withdrawn)	As withdrawn	
3.	New Partner pays Premium although Goodwill appears in the Books at full value	Either Old Partners Capital ...... *Dr.* To Goodwill (written off) Cash/Bank....... *Dr.* To New Partner's Capital [Premium Money treated as part of new partner's capital]	Old Ratio	Write off Goodwill if it is already existing in the Books.
4.	New Partner pays privately for premium for Goodwill to old partners	No Entry		Not a transaction of the business.
5.	New Partner cannot pay the Premium temporarily, but a loan account is opened.	Loan to New Partner....... *Dr.* To Old Partners Capital A/c	Sacrifice Ratio	OR old ratio if the mutual ratio between old partners do not change.

6.	New Partner is unable to pay the Premium (a) A Goodwill Account is raised at its full value (b) A Goodwill Account is raised and written off	Goodwill A/c ……. *Dr.* To Old Partners Capital A/c [Full Value] (i) Goodwill A/c.... *Dr.* To Old Partners Capitals (Raised) (ii) All Partners Capital A/c.. *Dr.* (including new partner) To Goodwill (Written off)	Old Ratio Old Ratio New Ratio	'Full value may be given or may have to be calculated. For example, the new partner for his 2/5th the share failed to pay premium ₹ 5,000. Full value = (5000 × 5)/2 = ₹ 12,500 As a result No GOODWILL ACCOUNT will appear in the Balance Sheet
7.	New Partner is unable to pay the Premium and an adjustment is to be made through the Capital A/c.	New Partner's Capital *Dr.* To Old Partners Capitals [Premium Money]	Sacrifice Ratio	Or, old ratio if the mutual ratio between old Partners remain unchanged.
8.	New partner pays only a portion of the Premium but cannot pay the remaining portion: (a) For Portion Paid (b) For unpaid Portion	(a) Cash/Bank *Dr.* To Old Partners Capitals [Portion Paid] (b) Goodwill *Dr.* To Old Partners Capital [Goodwill for unpaidportion]	Sacrifice Ratio Old Ratio	Or, old ratio 'Goodwill is valued on the basis ofunpaid Premium. For example, the newpartner for his 2/5th share paid ₹ 12,000 out of ₹ 20,000 Premium. Unpaid Premium for 2/5th share = ₹ 8,000. Value of Goodwill = (8,000 × 5)/2 = ₹ 20,000
9.	If Goodwill Account already appears in the Books and Goodwill is to be raised at its full value (a) If Book value is lower than full value (b) If Book value is more than full value	(a) Goodwill *Dr.* To Old Partners Capital A/c [Full value—Book Value] (b) Old Partners Capital *Dr.* To Goodwill [Book value — Full Value]	Old Ratio Old Ratio	

Valuation of Inherent or Non-Purchased Goodwill

Serial No.	Name of the Method	Description of the method	Other Consideration
1.	**Average Profits Methods**	Under this method - **Value of Goodwill = Agreed Number of Years (Purchase) × Average Maintainable Profits** **Average Maintainable/Profit** Average Annual Profits — 00 [Simple average or may be weighted average considering the trend of profits] Less: "Exceptional/Casual Income — 00 Add: Abnormal Loss — 00 00 Add: Capital Expenditure wrongly charged against profits — 00 00 Less: Provision for Taxation (As may be required) — 00 Adjusted Maintainable Profits — 000 ("Adjustments for undercharged or overcharged Depreciation or under or over valuation of stocks to be made, if required)	(i) If profits are fluctuating, simple average is taken. If profits show an increasing trend, weights may be used. If profits constantly decrease, the lowest of the profits after adjustments may be considered. (ii) Exceptional Income or Expense of any particular year, should better be adjusted against the profit of that year. (iii) More weightage is usually given to later years.
2.	**Super Profits Method**	**Super Profit = Future maintainable profits – Normal Return on Capital Employed** **Goodwill = Super Profit × No. of years** **Steps to be followed** **Steps (a) Calculation of Capital employed OR Average Capital Employed** Sundry Assets — 00 **Excluding:** (i) Goodwill But including Goodwill at Cost Paid for (ii) Non-trading assets and (iii) Fictitious Assets Less: (i) Current Liabilities & Provisions — - 00 (ii) Contingent & Probable Liabilities — - 00 (Trading) **Capital Employed** — 00 Less: ½ of Current years trading profits after taxation (if the profits remain undistributed) — - 00 **Average Capital Employed** — 000 **Step (b) Average Annual Adjusted Profits (Maintainable)** — **00** Same as shown under Method 1. But debenture interest, if any, should be added back with Profits before making provision for taxation **Step (c) Calculate Normal Return on Capital Employed or Average Capital Employed** [Say at 10% or 12%, etc. — as may be given or assumed] **Step(d) Deduct Normal Return (c) from Average Maintainable Profits (b).** The difference is called **Annual Super Profit** **Step (e) Goodwill = Annual Super Profit × No. of Years for which the Super Profit can be maintained.** [Usually expressed as...years purchase of super profit]	(i) Calculation of Average capital Employed **cannot be made if current years' profits** are not separately given. (ii) Trading Profits exclude any non trading income like Interest on Non-trading investments. (iii) Adjustments against profits including provision for managerial remuneration, should be made. [iv) If there is any change in the value of any fixed asset on revaluation, that does not affect Annual Trading Profit. But adjustment for over charged or undercharged depreciation may be required to adjust the profits. (v) If there is any decrease in the value of any Current Asset like bad debts or reduction of stock and that has not been adjusted, the adjustment should be made for finding out correct Trading Profit of the current year. (vi) For calculating capital employed, proposed dividend need not be deducted. [Please see valuation of shares']

3.	**Capitalization of Profits Methods** **(A) Profits**	Under the method follow these steps – (a) Calculate Annual Maintainable Profit as shown above. (b) Calculate normal Capital Employed capitalizing the above profit by applying the normal rate of return. $\text{Normal Capital Employed} = \frac{\text{Maintainable Profit}}{\text{Normal Rate of Return}} \times 100$ (c) Calculate actual Capital Employed (d) Goodwill = Normal Capital Employed – Actual capital Employed.	Here also the profits should be adjusted considering necessary adjustments for managerial remunerations, change of depreciation, etc.
	(B) Capitalization of Super Profits	(a) Calculate Super profit as said under Method 2. (b) $\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100$	
4.	**Annuity Method**	It is a derivative of super profit concept. If super profit is expected to be earned uniformly over a number of years, Goodwill is computed with the help of Annuity Table. Calculate Super Profit as discussed before **Goodwill=Annual Super ProfitxPresent Value of Annuity of ₹1.** If Interest rate for calculating annuity table is given, the following formula may be applied — $V = \frac{a}{i}\left[1-(1+i)^{-n}\right]$ OR $= \frac{a}{i}\left[1-\frac{1}{(1+i)^n}\right]$ V = Value of Goodwill n = No. of years a = Annual Super Profit i = rate of interest	Here also similar principles as said before should be followed for calculating — Capital Employed or Average Capital Employed, Annual Average Profits and Annual Super Profits.

Illustration 21.

X and Y are partners having Capitals of ₹ 80,000 and ₹ 20,000 respectively and a profit sharing ratio of 4 : 1. Z is admitted for 1/5 th share in the profits of the firm and he pays ₹ 30,000 as Capital. Find out the value of the Goodwill.

Solution:

Total Capital of the firm 30,000 × 5/1 =		₹ 1,50,000 [Taking Z's Capital as base]
Less : Combined Adjusted Capital		
80,000 + 20,000 + 30,000	=	₹ 1,30,000
Hidden Goodwill	=	₹ 20,000

Illustration Regarding Valuation of Goodwill

Valuation of Goodwill for a non corporate assessee

Illustration 22.

From the following information, calculate the value of goodwill by super profit method.

(i) Average Capital employed in the business ₹ 7,00,000.

(ii) Net trading profit of the firm for the past three years ₹ 1,47,600; ₹ 1,48,100 and ₹ 1,52,500.

(iii) Rate of Interest expected from capital having regard to the risk involved —18%.

(iv) Fair remuneration to the partners for their services 12,000 per annum.

(v) Sundry Assets (excluding goodwill) of the firm ₹ 7,54,762.

(vi) Sundry Liabilities ₹ 31,329.

(vii) Goodwill valued at 2 years' purchase

Solution:

Years	Profits Given ₹	Adjusted Profits after Considering Remunerations ₹
1st	1,47,600	1,35,600
2nd	1,48,100	1,36,100
3rd	1,52,500	1,40,500
Total Profits	4,48,200	4,12,200

	₹
Average Adjusted Annual Profits (4,12,200/3)	1,37,400
Less : Normal Return on Capital @ 18% of ₹ 7,00,000	1,26,000
Super Profits	11,400

Therefore Goodwill = Super profit × year of Purchase = 11,400 × 2 = 22,800.

Illustration 23.

The new partner cannot pay premium and a Goodwill Account is raised.

A and B are partners sharing profits and losses as 3 : 2. They admit C as a partner who is unable to bring Goodwill premium in cash but pays ₹ 10,000 as capital. A Goodwill Account is raised in the hooks of the firm which is valued at two years' purchase of the last three years average profits. The profits for the last 3 years were ₹ 5.000; ₹ 4,000 and ₹ 4,500. The Profit sharing ratio among the partners has been agreed to be 5 : 2 : 2. The partners decide to write-off Goodwill after C's admission.

Solution:

Points to be noted

1.	Valuation of Goodwill Average Annual Profits of last 3 years = (₹ 5,000 + 4000 + 4500)/3 = ₹ 4500
2.	Goodwill = ₹ 4,500 × 2 = ₹ 9,000
3.	Goodwill to be raised = New Value – Book Value = ₹ 9,000 – Nil = ₹ 9,000. It is to be raised in Old Ratio and written off in new ratio. So sacrifice ratio is not required.

Journal Entries Dr. Cr.

Date	Particulars	L.F.	Amount ₹	Amount ₹
	Goodwill A/c Dr.		9,000	
	To A's Capital A/c			5,400
	To B's Capital A/c			3,600
	(Goodwill Account raised and credited to old partners in old ratio 3 : 2)			
	Bank A/c Dr.		10,000	
	To C's Capital A/c			10,000
	(Capital introduced by new partner on admission)			
	A's Capital A/c Dr.		5,000	
	B's Capital A/c Dr.		2,000	
	C's Capital A/c Dr.		2,000	
	To Goodwill A/c			9,000

Illustration 24.

New partner pays premium for Goodwill but Goodwill Account is appearing at the Balance Sheet at full value.

Gargi and Khana were partners sharing profits and losses as 5 : 3. They agreed to admit Lilabati as a new partner on payment of ₹ 9,000 as premium for Goodwill. The new profit sharing ratio was agreed as 3 : 2 : 1. The Goodwill Account appearing in the books amounted to ₹ 54,000. Pass the necessary Journal Entries.

Solution:

Points to be noted

Lilabati brought in ₹ 9,000 as his share of premium for googwill for 1/6 in there.

Therefore, Full value of Goodwill = 9,000 × 6/1 = 54,000

There is neither overvaluation nor undervaluation.

Calculation of Sacrifice	Gargi	Khana	Lilabati
Old Ratio	$\frac{5}{8}$	$\frac{3}{8}$	—
New Ratio	$\frac{3}{6}$ 5/8 - 3/6 = (30 - 24)/48 = 6/48 (Sacrifice)	$\frac{2}{6}$ 3/8 - 2/6 = (18 - 16)/48 = 2/48 (Sacrifice)	$\frac{1}{6}$ Nil -1/6 = (0 - 8)/48 = 8/48 (Gain)

Journal Entries

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
	Gargi's Capital A/c *Dr.* Khana's Capital A/c *Dr.* To Goodwill A/c (Goodwill Account written back between the old partners in old ratio)		33,750 20,250	 54,000
	Bank A/c *Dr.* To Gargi's Capital A/c To Khana's Capital A/c (Premium for Goodwill brought in by new partner and shared by old partners in their sacrifice ratio 3 : 1)		9,000	 6,750 2,250

Illustration 25.

Premium for Goodwill paid privately

P and Q are partners sharing profits as 3:2. They admit R as a new partner for 1/4th share. The Goodwill Account appears in the books at its full value ₹ 20,000. R is to pay proportionate amount as premium and he pays it privately to P and Q.

Show the Journal Entries.

Solution:

Points to be noted

1. For private payment of premium, no entry is required in the books of the partnership.
2. The new partner is paying premium although a Goodwill Account is appearing in the books at full value. So the Goodwill Account should be written back between the old partners in old ratio.

Journal *Dr.* *Cr.*

Date	Particulars	L.F.	Amount ₹	Amount ₹
	P's Capital A/c *Dr.*		12,000	
	Q's Capital A/c *Dr.*		8,000	
	To Goodwill A/c			20,000
	(Goodwill Account written back between the old partners in old ratio 3 : 2)			

Illustration 26.

Premium for Goodwill in "true sense"

Jatin and Lalit are partners sharing profit as 3 : 2. Malik is admitted as a new partner for 1/5th share on payment of ₹ 20,000 as capital and ₹ 5,000 as premium for Goodwill. A Goodwill Account appearing in the books at ₹ 20,000 is decided to be left undisturbed.

Show the Journal Entries.

Solution:

Points to be noted

1. Premium for 1/5th share = ₹ 5,000 (It may be called premium in popular sense) Goodwill should be taken as ₹ 25,000

   But Goodwill appearing in Books and to be maintained = ₹ 20,000.

   Undervaluation of Goodwill = ₹ 5,000.

   Premium in 'true sense" should be 1/5th of ₹ 5,000 = ₹ 1,000 (to be shared by old partners) The excess premium paid ₹ 4,000 should be credited to Malik himself.
2. Premium should be shared in old ratio which is the same as sacrifice ratio as mutual ratio between Jatin and Lalit has not changed.

Journal *Dr.* *Cr.*

Date	Particulars	L.F.	Amount ₹	Amount ₹
	Bank A/c *Dr.*		25,000	
	To Jatin's Capital [3/5 of 1000]			600
	To Lalit's Capital [2/5 of 1000]			400
	To Malik's Capital [20,000 + 4,000]			24,000
	[True Premium shared by Jatin and Lalit in sacrifice ratio 3:2 and the balance of contribution made by Malik transferred to his capital]			

Illustration 27.

Where the new partner pays premium for goodwill and also brings his own goodwill to the business.

Amal and Bimal are partners sharing profits in the ratio of 2 : 3. Charu is admitted as a partner on 1st January, 2013 and he pays into the firm cash ₹ 9,000 out of which ₹ 3,000 is premium on his admission to a quarter share, the raitio between Amal and Bimal to be 1 : 2.

Charu also brings into the business his own Goodwill to be run as a separate unit and the Goodwill is agreed at ₹ 4,800.

Show the entries required to give effect to the above arrangements (for both the units separately).

Solution:

Points to be noted

1. For the First unit, ₹ 3,000 paid as premium should be shared by Amal and Bimal in their sacrifice ratio. We should calculate the new ratio and the sacrifice ratio.
2. For the 2nd unit, an adjustment should be made for Charu's own goodwill to be credited to his capital and debited to Amal and Bimal in remaining ratio 2 : 3, excluding Charu's share.

Working Notes :

1. Calculation of New Profit Sharing Ratio

Charu's share = 1/4 ; Balance left = 1 – 1/4 = 3/4. Amal's new share = 3/4 × 1/3 = 1/4;

Bimal's new share = 3/4 × 2/3 = 2/4 and Charu's new share = 1/4.

New Ratio = 1:2:1 Sacrifice Ratio = 3 : 2. [= Old Ratio - New Ratio]

Journal Entries *Dr.* *Cr.*

Date	Particulars	L.F.	Amount ₹	Amount ₹
1.1.13	Bank A/c *Dr.*		6,000	
	To Charu's Capital A/c			
	[Amount invested as capital contribution by Charu]			6,000
1.1.13	Bank A/c *Dr.*		3,000	
	To Amal's Capital A/c [3/5]			1,800
	To Bimal's Capital A/c [2/5]			1,200
	[Premium paid by Chanu and credited to Amal and Bimal in their sacrifice ratio 3: 2]			
1.1.13	Amal's Capital A/c [2/10 of ₹ 4,800] *Dr.*		960	
	Bimal's Capital A/c [3/10 of ₹ 4,800] *Dr.*		1,440	
	To Charu's Capital A/c			2,400
	[Adjustment made for Charu's own Goodwill brought into the business]			

4. Regarding Accumulated Profits/Losses or Reserve & Surplus

It is needless to state that if there is any accumulated profits or losses or other surpluses, the same should be transferred to old partner's Capital or Current Account as per old profit sharing ratio before the admission of new partner :

Entries

(a) **For transferring accumulated profits**

Profit & Loss A/c (Cr.) Dr.

General Reserve A/c Dr. (as per old profit sharing ratio)

Any other Surpluses A/c Dr.

To Old Partner's Capital A/c

(b) **For transferring accumulated losses**

Old Partner's Capital A/c Dr.

To Accumulated Losses A/c

Illustration 28.

X, Y and Z were in partnership sharing profits and losses in the ratio 3 : 2 : 1. Their Balance Sheet stood as under:

Balance Sheet
as at 1.4.2012

Liabilities		₹	Assets	₹
Capital			Fixed Assets	80,000
X	40,000		Machinery Replacement	15,000
Y	30,000		Investment:	
Z	20,000	90,000	Investment (MV ₹ 7,000)	10,000
General Reserve		12,000	Current Asset	33,000
Machinery Replacement Fund		16,000		
Investment Fluctuation Fund		15,000		
Current Liabilities		5,000		
		1,38,000		1,38,000

Show the entries for accumulated profits/reserves assuming that Mr. T is admitted as partner for 1/5th share.

Solution:

In the books of.........
Journal

Date	Particulars		L.F.	Debit ₹	Credit ₹
	General Reserve A/c	Dr.		12,000	
	Investment Fluctuation Fund A/c	Dr.		12,000	
	(₹ 15,000 – ₹ 3,000)				
	To X - Capital A/c				12,000
	To Y - Capital A/c				8,000
	To Z - Capital A/c				4,000
	(Accumulated profits are distributed in 3 : 2 : 1)				

5. Regarding Adjustment of Capital

When a new partner is admitted, the total amount of capital is determined on the basis of new partners' capital and his profit sharing ratio. On the basis of new profit sharing ratio old partners' capital is to be ascertained. Thereafter, existing capital (after considering all adjustments) is to be compared with the capital so ascertained on the basis of new profit sharing ratio, and excess if any, is to be withdrawn by the partner concerned and deficit, if any, is to be brought in by the concerned partner. Sometimes, the excess or deficit, is to be adjusted against the current account of the partners.

Illustration 29.

A and B are partner in a firm sharing profit and losses in the ratio of 4 : 1. Their Balance Sheet as on 31st March 2013 stood as follows :

Liabilities		₹	Assets	₹
Capital A/c			Furniture	20,000
A	25,000		Stock	40,000
B	65,000	90,000	Bills Receivable	10,000
Reserve		20,000	Debtors	30,000
Creditors		25,000	Cash at Bank	40,000
Bills Payable		5,000		
		1,40,000		1,40,000

They agreed to take C as a partner with effect from 1st April 2013 on the following terms :

(a) A, B and C will share profit and losses in the ratio of 5 : 3 : 2.

(b) C will bring ₹ 20,000 as premium for goodwill and ₹ 30,000 as capital.

(c) Half of the Reserve is to be withdrawn by the partners.

(d) The asset will be revalued as follows : Furniture ₹ 30,000; Stock ₹ 39,500; Debtors ₹ 28,500.

(e) A creditor of ₹ 12,000 has agreed to forgo his claim by ₹ 2,000.

(f) After making the above adjustments, the capital accounts of A and B should be adjusted on the basis of C's capital, by bringing cash or withdrawing cash as the case may be.

Show Revaluation Account, Partners' Capital Account and the Balance Sheet of the new firm :

Solution :

In the books of A, B and C

Dr. **Revaluation Account** *Cr.*

Particulars		Amount ₹	Particulars	Amount ₹
To Stock A/c		500	By Furniture A/c	10,000
To Prov. for Bad Debts A/c		1,500	By Creditors A/c	2,000
To Profit on Revaluation:				
A	8,000			
B	2,000	10,000		
		12,000		12,000

Dr. **Capital Account** **Cr.**

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To A's Capital A/c	—	10,000	—	By Balance b/d	25,000	65,000	—
To Bank A/c	8,000	2,000	—	By Bank	—	—	30,000
To Bank A/c (bal. fig.	—	14,000	—	By Revaluation — Profit	8,000	2,000	—
To Balance c/d	75,000	45,000	30,000	By Reserve	16,000	4,000	—
				By Goodwill	20,000	—	—
				By Capital A/c	10,000	—	—
				By Bank (bal. fig.)	4,000	—	—
	83,000	71,000	30,000		83,000	71,000	30,000

Balance Sheet
as at 1st April, 2013

Liabilities	Amount ₹	Amount ₹	*Assets*	Amount ₹	Amount ₹
Capital A/c :			Furniture		30,000
A	75,000		Stock		39,500
B	45,000		Debtors	30,000	
C	30,000	1,50,000	Less : R/B/Debts	1,500	28,500
Creditors (25,000–2,000)		23,000	Bills Receivable		10,000
Bills Payable		5,000	Cash at Bank (₹40,000 + ₹50,000 - ₹10,000 + ₹4,000 - ₹14,000)		70,000
		1,78,000			1,78,000

Workings :

1. **Sharing of Goodwill**

Sacrificing Ratio :

A = 4/5 - 5/10 = (8 - 5)/10 = 3/10 (Sacrifice)

B = 1/5 - 3/10 = (2 - 3)/10 = 1/10 (Gains)

C = 2/10 (Gains)

∴ Entire goodwill to be credited to A's Capital Account. B will have to pay A for goodwill

= ₹ 20,000 × 10/2 x 1/10

= ₹ 10,000.

2. **Adjustment of Capital**

C brings for 2/10 ₹ 30,000

∴ A will have to bring for 5/10 = ₹ 30,000 x 5/10 x 10/2 = ₹ 75,000

And B should bring for 3/10 = ₹ 30,000 x 3/10 x 10/2 = ₹ 45,000

Illustration 30.

Special Points : (a) Journal Entries; (b) Portion of Premium for Goodwill and Reserve withdrawn; (c) Discount received on payment of creditor.

Brick, Sand and Cement were partners in a firm sharing profits and losses in the ratio of 3:2:1 respectively.

Following is their Balance Sheet as on 31st December, 2012.

Liabilities	₹	₹	Assets	₹
Capital Accounts :			Land & Buildings	50,000
Brick	30,000		Furniture	15,000
Sand	20,000		Stock	20,000
Cement	10,000	60,000	Bill Receivable	5,000
			Debtors	7,500
Reserve		29,800	Cash in hand and at Bank	2,500
Creditors		6,200		
Bills Payable		4,000		
		1,00,000		1,00,000

Lime is to be admitted as a partner with effect from 1st January, 2013 on the following terms

(a) Lime will bring in ₹ 15,000 as Capital and ₹ 12,000 as premium for goodwill. Half of the premium will be withdrawn by the partners.

(b) Lime will be entitled to : 1/6th share in the profits of the firm.

(c) The assets will be revalued as follows Land and Building— ₹ 56,000; Furniture — ₹ 12.000; Stock— ₹ 16,000; Debtors — ₹ 7,000

(d) The claim of a creditor for ₹ 2,300 is paid at ₹ 2,000.

(e) Half of the Reserve is to be withdrawn by the partners.

Record the Journal entries (including cash transactions) in the books of the firm and show the opening Balance Sheet of the new firm.

Solution :

Books of Brick, Sand, Cement and Lime
Journal Entries

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
01.01.13	Bank A/c *Dr.* To Lime's Capital A/c [Being amount contributed by lime on admission as a new partner]		15,000	 15,000
"	Bank A/c *Dr.* To Brick's Capital A/c [3/6] To Sand's Capital A/c [2/6] To Cement's Capital A/c [1/6] [Being premium for goodwill brought in by new partner and credited to old partners Capitals in their sacrifice ratio 3:2:1]		12,000	 6,000 4,000 2,000
"	Land and Buildings A/c *Dr.* To Revaluation A/c [Being value of Land & Buildings appreciated on revaluation]		6,000	 6,000
"	Revaluation A/c *Dr.* To Furniture A/c To Stock A/c To Provision for Bad Debts A/c [Being values of assets decreased on revaluation]		7,500	 3,000 4,000 500
"	Creditors A/c *Dr.* To Bank A/c To Revaluation A/c [Being creditors claim discharged at a discount]		2,300	 2,000 300
"	Brick's Capital A/c *Dr.* Sand's Capital A/c *Dr.* Cement's Capital A/c *Dr.* To Revaluation A/c [Loss on revaluation debited to' old partners in old ratio 3 : 2 :1]		600 400 200	 1,200
"	Reserve A/c *Dr.* To Brick's Capital A/c To Sand's Capital A/c To Cement's Capital A/c [Reserve A/c closed and credited to old partners in old ratio 3 : 2 :1]		29,800	 14,900 9,933 4,967
"	Brick's Capital A/c *Dr.* Sand's Capital A/c *Dr.* Cement's Capital A/c *Dr.* To Bank A/c [Half of the Reserve withdrawn by old partners]		7,450 4,967 2,483	 14,900

"	Brick's Capital A/c *Dr.* Sand's Capital A/c *Dr.* Cement's Capital A/c *Dr.* To Bank A/c [Half of the premium money withdrawn by old partners]		3,000 2,000 1,000	6,000

Balance Sheet as on 1.1.2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital Accounts : [Note3]			Land & Buildings		56,000
Brick	39,850				
Sand	26,566		Furniture		12,000
Cement	13,284		Stock		16,000
Lime	15,000		Debtors		
Creditors [6,200 – 2,300]		94,700	*Less* : Provision for Bad	7,500	
Bills Payable		3,900	Debts	5 0 0	7,000
		4,000	Bill Receivable		
			Cash in hand and at		5,000
			Bank [Note 2]		6,600
		1,02,600			1,02,600

Working Notes :

1. It is assumed that after giving 1/6th share of profits to Lime, the balance will be shared by old partners in old ratio 3 : 2 : 1. So, Sacrifice Ratio = Old Ratio = 3 : 2 : 1.

2. Cash and Bank	₹
As per last Balance Sheet	2,500
Add: Lime's Capital Contribution and Premium (net)	27,000
	29,500
Less: Paid to creditors	2,000
Less: Portion of Reserve withdrawn	14,900
Less: Share of premium withdrawn	6,000
	6,600

3. Capital	**Brick**	**Sand**	**Cement**	**Lime**
Balances	30,000	20,000	10,000	—
Add: Capital brought in	—	—	—	15,000
Add: Share of Premium for Goodwill	6,000	4,000	2,000	—
Add: Share of Reserves	14,900	9,933	4,967	—
Less: Share of Reserves withdrawn	7,450	4,967	2,483	—
Less: Share of Premium for goodwill withdrawn	3,000	2,000	1,000	—
Less: Loss on Revaluation	600	400	200	—
	39,850	26,566	13,284	15,000

Illustration 31.

Arun and Anand were partners sharing profits in the ratio of 3:2. Their position as on 31st March, 2013 was as under :

Liabilities	₹	Assets	₹
Arun's Capital	12,000	Land and Buildings	8,000
Anand's Capital	10,000	Plant and Machinery	10,000
General Reserve	12,000	Sundry Debtors	11,000
Workmen's Compensation Fund	4,000	Stock	12,000
Sundry Creditors	12,000	Cash at Bank	9,000
	50,000		50,000

They decided to admit Ashok for a 20% profit on the following terms : (a) The liability on Workmen's Compensation Fund is to be determined at ₹ 2,000; (b) Ashok to bring in ₹ 3,000 as premium out of his share of ₹ 3,600. He is also to bring in ₹ 20,000 as his capital; (c) General Reserve is to be maintained at its original value; (d) ₹ 2,000 out of creditors to be paid at 5% discount.

Pass the necessary journal entries to give effect to the above arrangement; to show the capital accounts and prepare the Balance Sheet of the new firm.

Points to be noted

1. Ashok pays premium ₹ 3,000. This should be shared by Arun and Anand in their sacrifice ratio, which is eventually the old ratio 3 : 2. For the unpaid Premium [₹ 3,600 — ₹ 3,000 = ₹ 600]. Goodwill Account to be raised at ₹ 3,000 × 1/5 = 600. This is to be credited to old partners in old ratio 3 : 2.
2. For General Reserve to be maintained, the following adjustment will be required.

Particulars	Arun ₹	Anand ₹	Ashok ₹
Credited in Old Ratio between old partners (12,000 as 3 : 2)	7,200 (Cr.)	4,800 (Cr.)	
Debited in New Ratio (12 : 8 : 5)	5,760 (Dr.)	3,840 (Dr.)	2,400 (Dr.)
Net Effect	1,440 (Cr)	960 (Cr.)	2,400 (Dr.)

Solution:

Arun, Anand and Ashok

Journal Entries

Date	Particulars		L.F.	*Dr.* Amount ₹	*Cr.* Amount ₹
31.3.13	Workmen's Compensation Fund A/c [₹ 4,000 — ₹ 2,000] To Revaluation A/c (Value of liability reduced)	Dr.		2,000	2000
31.3.13	Bank A/c To Ashok's Capital A/c (Amount contributed as capital by incoming partner)	Dr.		20,000	20,000

	Bank A/c Dr. To Arun's Capital A/c To Anand's Capital A/c (Premium for Goodwill paid by incoming partner and shared by existing partners in their sacrificing ratio 3 : 2)		3,000	 1,800 1,200
	Goodwill A/c Dr. To Arun's Capital A/c To Anand's Capital A/c (Goodwill A/c raised and credited to existing partners in old ratio 3 : 2)		3,000	 1,800 1,200
	Arun Capital A/c Dr. Anand Capital A/c Dr. Ashok Capital A/c Dr. To Goodwill A/c (Being the Goodwill written off)		1,440 960 600	 3,000
	Creditors A/c Dr. To Bank A/c (actual payment at 95%) To Revaluation A/c (A creditor paid off and the discount received credited to revaluation A/c)		2,000	 1,900 100
	Revaluation A/c Dr. To Arun's Capital A/c To Anand's Capital A/c (Being Revaluation profit credited to old partners in the ratio 3 : 2)		2,100	 1,260 840

Dr. **Capital Accounts** **Cr.**

Date 2013	Particulars	Arun ₹	Anand ₹	Ashok ₹	Date 2013	Particulars	Arun ₹	Anand ₹	Ashok ₹
31.3.	To General Res	5,760	3,840	2,400	31.3.	By Balance b/d	12,000	10,000	-
	,, Goodwill A/c	1,440	960	600		,, Bank A/c			20,000
						,, Bank A/c (Premium)	1,800	1,200	-
	" Balance c/d	16,860	13,240	17,000		,, Goodwill A/c	1,800	1,200	
						,, General Res A/c	7,200	4,800	-
						,, Revaluation A/c	1,260	840	-
		24,060	18,040	20,000			24,060	18,040	20,000
					1.4.	By Balance b/d	16,860	13,240	17,000

Balance Sheet as on 01.04.2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital Accounts':			Land and Buildings		8,000
Arun	16,860		Plant and Machinery		10,000
Anand	13,240		Stock		12,000
Ashok	17,000	47,100	Debtors		11,000
General Reserve		12,000	Cash at Bank		30,100
Workmen's Compensation Fund		2,000	[9,000 + 20,000 + 3,000 - 1,900]		
Sundry Creditors		10,000			
		71,100			71,100

Illustration 32.

No alteration of book values of assets and liabilities

Baisakhi and Srabani are partners sharing profits and losses in proportion to their capitals. Their Balance Sheet as on 31st March, 2013 is given below :

Liabilities	₹	Assets	₹
Creditors	15,000	Freehold Premises	10,000
General Reserve	2,100	Machinery	3,500
Capitals :		Furniture	1,750
Baisakhi	20,000	Office Equipments	550
Srabani	15,000	Stock	14,100
		Bill Receivable	3,060
		Debtors	17,500
		Bank	1,590
		Cash	50
	52,100		52,100

On 1st April, 2013 they admit Poushali on the following conditions :

(i) Poushali should bring in ₹ 10,000 as capital and to pay ₹ 3,500 for goodwill as she will get 1/4th share in profits.

(ii) A provision of 2% to be raised against debtors, stock to be reduced by 5%, Freehold Premises to be revalued at ₹ 12,650, Machinery at ₹ 2,800, Furniture at ₹ 1,540 and Office equipments at ₹ 495.

(iii) Partners agreed that the values of assets and liabilities should remain unaltered.

Show the necessary accounts and prepare the opening Balance Sheet of the new firm.

Points to be noted

1. The Partners have decided not to alter the book values of the assets and liabilities. The effects of revaluation may be ascertained by preparing a Memorandum Revaluation Account as follows.

(a) Calculation of Profit/Loss on Revaluation.

Memorandum Revaluation Account

Dr. Particulars	Amount ₹	Particulars		Amount ₹ *Cr.*
To Provision for bad debts (@ 2% of 17,500)	350	By Freehold Premises		2,650
To Stock	705			
To Machinery	700			
To Furniture	210			
To Office Equipments	55			
To Partners Capital A/c's				
Baisakhi : (4/7)	360			
Srabani : (3/7)	270			
	2,650			2,650
To Reversal of Items b/d	2,650	By Reversal of Items b/d		2,020
		By Partners Capital A/c (In New Ratio) [Loss on Revaluation]		
		Baisakhi	270	
		Sarbani	203	
		Poushali	157	630
	2,650			2,650

(b) As General Reserve is to remain unaltered, similar adjustment will be required to be shared among old partners in old ratio and then written back among all partner's in new ratio.

2. Calculation of net effects on Capital Accounts. New Profit Sharing Ratio : 12 : 9 : 7

Solution :

Capital Accounts

Dr. Date	Particulars	Baisakhi Amount ₹	Srabani Amount ₹	Poushli Amount ₹	Date	Particulars	Baisakhi Amount ₹	Srabani Amount ₹	Poushali Amount ₹ *Cr.*
31.3.13	To General Reserve	900	675	525	1.4.12	By Balance b/d	20000	15000	-
	To M. Rev. A./c	270	203	157		By General Reserve	1,200	900	-
					31.3.13	By Bank A/c	-	-	10000
						By M. Rev. A/c	360	270	-
						By Bank A/c (Premium) at 4:3.	2000	1500	-
	To Balance c/d	22,390	16,792	9,318					
		23,560	17,670	10,000			23,560	17,670	10,000

Balance Sheet as at 1.4.2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹
Capitals:			Freehold Premises	10,000
Baisakhi	22,390		Machinery	3,500
Srabani	16,792		Furniture	1,750
Poushali	9,318		Office Equipments	550
		48,500	Stock	14,100
General Reserve		2,100	Bill Receivable	3,060
			Debtors	17,500
Sundry Creditors		15,000	Bank	
			[1,590 + 10,000 + 3,500]	15,090
			Cash	50
		65,600		65,600

Illustration 33.

K and L are two partners sharing profits and losses in the ratio of 5:3. Their Balance Sheet as at 30th June, 2013 is a follows :

Liabilities	₹	₹	Assets	₹	₹
Creditors		30,000	Furniture		40,000
Reserve		14,000	Patent		10,000
Capital Account :			Debtors	44,000	
K			*Less* : Reserve for Bad Debts	5,000	39,000
L	40,000		Stock		20,000
	50,000	90,000	Cash in hand		25,000
		1,34,000			1,34,000

On 1st July, 2013, they take M into partnership. M brings ₹ 25,000 as his capital and brings ₹ 3,600 as his share of goodwill. The new profit sharing ratio of K, L and M is 2:4:1. Patent is written off from the books and a reserve for Bad Debt is created at 5%. Reserve appears in the books of new firm at its original figure.

Show the necessary Journal entries to carry out the above transactions and prepare a Balance

Sheet of the new firm as at 1st July, 2013.

In the books of K. L. M.

Journal

Date	Particulars		L.F.	Debit ₹	Credit ₹
2013 July 1	Bank A/c	Dr.		28,600	
	To M's Capital A/c				25,000
	To Goodiwll A/c				3,600
	(Cash to be brought in by M As capital)				
	Goodwill A/c	Dr.		3,600*	
	To K's Capital A/c				3,600
	(Value of goodwill credited to K's Capital only)				
	Reserve A/c	Dr.		14,000	
	To K's Capital A/c				8,750
	To L's Capital A/c				5,250
	(Reserve credited to old partners capital accounts in 5:3)				
	K : Capital A/c	Dr.		4,000	
	L : Capital A/c	Dr.		8,000	
	M : Capital A/c	Dr.		2,000	
	To Reserve A/c				14,000
	(Reserve shown at its original value)				
	Revaluation A/c	Dr.		10,000	
	To Patents A/c				10,000
	(Patent eliminated from the book)				
	Reserve for Bad Debts A/c	Dr.		2,800	
	To Revaluation A/c				2,800
	(Excess provision written back)				
	K's Capital A/c	Dr.		4,500	
	L's Capital A/c	Dr.		2,700	
	To Revaluation A/c				7,200
	(Loss on revaluation transferred)				

Capital Account

Dr. *Cr.*

Particulars	K ₹	L ₹	M ₹	Particulars	K ₹	L ₹	M ₹
To Reserve A/c	4,000	8,000	2,000	By Balance b/d	40,000	50,000	—
" Revaluation A/c	4,500	2,700	—	" Goodwill A/c	3,600	—	—
— Loss				" Reserve A/c	8,750	5,250	—
" K's Capital A/c	—	4,950	—	" L's Capital A/c	4,950**	—	—
" Balance c/d	48,800	39,600	23,000	" Bank	—	—	25,000
	56,850	55,250	25,000		57,300	55,250	25,000

Balance Sheet as on July 1, 2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capitals:			Furniture		40,000
K	48,800		Debtors	44,000	
L	39,600		Less : R/B/Debts	2,200	41,800
M	23,000	1,11,400	Stock		20,000
Reserve		14,000	Cash & Bank		
Creditors		30,000	(25,000 + 28,600)		53,600
		1,55,400			1,55,400

**Goodwill should be credited to the sacrificing ratio which is computed as under :

K = 5/8 - 2/7 = (35 - 16)/56 = 19/56 (Sacrifice)

L = 3/8 - 4/7 = (21 - 32)/56 = 11/56 (Gains)

M = 1/7 (Gains) = 8/56

∴ Entire goodwill should be credited to K's Capital only.

Since L is gaining 11/56 from K, he must have to pay in proportionate amount to K as under, i.e., if M brings for 8/56 ₹ 3,600, L should pay for 11/56 ₹ 4,950 (i.e. ₹ 3,600 x 11/56 x 56/8)

Illustration 34.

Red and White are partners in a firm sharing profits and losses is the ratio of 3:2. On 1st July 2013 the positions of the firm as follows :

Liabilities	₹	₹	Assets	₹
Capital Accounts :			Building	50,000
Red			Machinery	2,50,000
White	1,50,000		Furniture	40,000
	98,000		Stock	60,000
		2,48,000	Debtors	90,000
General Reserve		84,000	Cash	12,000
Sundry Creditors		1,70,000		
		5,02,000		5,02,000

Blue joined the firm as a partner from this date and the following terms and conditions were agreed upon :

(a) Red, White and Blue will share the future profits of the firm in the ratio 5:3:2, respectively.

(b) Blue would first pay ₹ 10,000 as his share of Goodwill and this sum is to be retained in the business.

(c) The value of Machinery is to be increased by ₹ 20,000 and stock is to be written down by 10%.

(d) Blue would introduce such an amount of Capital in Cash which should be proportionate to the combined Capital accounts of Red and White after making all adjustments.

It was decided that the Capital Accounts of Red and White would be adjusted on the basis of Blue's Capital by opening Current Accounts.

Show the Capital Accounts of the partners and the Balance Sheet of the firm after Blue's admission.

Solution :

Capital Account

Dr. ***Cr.***

Particulars	Red ₹	White ₹	Blue ₹	Particulars	Red ₹	White ₹	Blue ₹
To Current A/c	—	8,700	—	By Balance b/d	1,50,000	98,000	—
" Balance c/d	2,22,500	1,33,500	89,000	" General Reserve	50,400	33,600	—
				" Goodwill	5,000	5,000	—
				" Revaluation — Profit	8,400	5,600*	—
				" Bank	2,13,800	1,42,200	—
				" Current A/c	—	—	89,000
					8,700	—	—
	2,22,500	1,423,200	89,000		2,22,500	1,423,200	89,000

Balance Sheet

as at 1st July, 2013

Liabilities	₹	₹	***Assets***	₹
Capital A/c :			Building	50,000
Red	2,22,500		Machinery (2,50,000 + 20,000)	2,70,000
White	1,33,500		Furniture	40,000
Blue	89,000	4,45,000	Stock (60,000 – 6,000)	54,000
			Debtors	90,000
Sundry Creditors		1,70,000	Cash (12,000+10,000+89,000)	1,11,000
Current A/c (Red)		8,700	Current A/c (White)	8,700
		6,23,700		6,23,700

* Profit on Revaluations = (₹ 20,000 Increased Value of Machinery – ₹ 6,000 (Stock decreased)
= ₹ 14,000 in 3:2.

Workings:

1. **Capital introduced by Blue**

1/4 th of the combined adjusted capital of Red & White i.e. ₹ 3,56,000 (₹ 2,13,800 + ₹ 1,42,200) × 1/4 = ₹ 89,000.

2. Now, capital account of Red & While will be in proportion of Blue

Red = ₹ 3,56,000 × 5/8 = ₹ 2,22,500 – ₹ 2,13,800 = ₹ 8,700

White = ₹ 3,56,000 × 3/8 = ₹ 1,33,500 – ₹ 1,42,200 = (–) ₹ 8,700

— to be transferred to Current Accounts.

Illustration 35.

Quick and Slow are partners in a firm sharing profits and losses in the ratio of 3 : 2. The Balance Sheet of the firm as on 31st March, 2013 was as under :

Liabilities		₹	Assets	₹
Capital Accounts			Furniture & Fixtures	60,000
Quick	1,20,000		Office Equipments	30,000
Slow	77,000	1,97,000	Motor Car	75,000
			Stock	50,000
General Reserve		30,000	Sundry Debtors	90,000
Sundry Creditors		96,000	Cash at Bank	18,000
		3,23,000		3,23,000

Smooth was admitted as a new with effect from 1st April, 2013 and it was agreed that he would bring some private furniture worth ₹ 10,000 and private stock costing ₹ 8,000 and in addition contribute ₹ 50,000 cash towards capital.

He would also bring proportionate share of goodwill which is to be valued at two year' purchase of the average profits of the last three years.

The profits of the last three years were :

	₹
2012-13	52,000
2011-12	32,000
2010-11	28,000

However, on a checking of the past records, it was noticed that on 1.4.2011 a new furniture costing ₹8,000 was purchased but wrongly debited to revenue, and in 2012-13 a purchase invoice for ₹ 4,000 dated 25.3.2013 has been omitted in the books. The firm charges depreciation on Furniture @ 10% p.a.

Your calculation of goodwill is to be made on the basis of correct profits.

On revaluation value of Stock is to be reduced by 5% and Motor car is worth ₹ 85,000. Smooth duly paid the required amount for goodwill and cash towards capital.

It was decided that the future profits of the firm would be shared as Quick — 50%, Slow — 30% and Smooth — 20%.

Assuming the above — mentioned arrangements were duly carried out, show the Capital

Accounts of the partners and the Balance Sheet of the firm after Smooth's admission.

Solution :

Capital Account

Dr. *Cr.*

Particulars	Quick ₹	Slow ₹	Smooth ₹	Particulars	Quick ₹	Slow ₹	Smooth ₹
To Balance c/d	1,51,620	1,00,624	68,000	By Balance b/d	1,20,000	77,000	—
				" General Reserve	18,000	12,000	—
				" Revaluation A/c			
				— Profit	4,500	3,000	—
				" Goodwill A/c	7,632	7,632	—
				(a sacrificing ratio is 1 : 1)			
				" Furniture	—	—	10,000
				" Stock	—	—	8,000
				" Bank	—	—	50,000
				" Advertisement			
				(for Profit)	1,488	992	—
	1,51,620	1,00,624	68,000		1,51,620	1,00,624	68,000

Balance Sheet
as at April 1, 2013

Liabilities	₹	₹	***Assets***	₹	₹
Capital Accounts :			Furniture & Fittings	60,000	
Quick	1,51,620		*Add* : Brought in by Smooth	10,000	
Slow	1,00,624			70,000	
Smooth	68,000	3,20,244		6,480	76,480
			Add : For Rectification		
Sundry Creditors		1,00,000			
(₹ 96,000+ ₹ 4,000)			Office Equipment		30,000
			Motor car		85,000
			Stock	50,000	
			Add : Brought in by Smooth	8,000	
				58,000	
			Less : Revaluation	2,500	55,500
			Sundry Debtors		90,000
			Bank (18,000+50,000+15,264)		83,264
		4,20,244			4,20,244

Working :

1. **Calculation of goodwill**

Year	Profit ₹	Adjustment	Corect Profit ₹
2010-11	28,000	—	28,000
2011-12	32,000	Add: 8,000 (New furniture) Less: 800 (Depreciation)	39,200
2012-13	52,000	Less: 4,000 (purchase omitted) Less: 720 (Depreciation on new furniture) For 2nd years	47,280
		Total	1,14,480

∴ Value of goodwill ₹ 1,14,480 ÷ 3 = ₹ 38,160 × 2 = ₹ 76,320

Smooth should bring ₹ 76,320 × 20% = ₹ 15,264.

2. **Adjusted Profit**

   Furniture and Fixture A/c Dr. 6,480 (8,000 – 800 – 720)

To	Creditors	4,000
"	Quick's Capital A/c	1,488
"	Slow's Capital A/c	992

3. **Profit on revaluations**

   Motor Car – Stock = ₹ 10,000 – ₹ 2,500 = ₹ 7,500

Illustration 36.

A and B are partners in a firm sharing profits and losses in the ratio 3 : 2. Their Balance Sheet as on 31.12.2012 stood as follows :

Liabilities	₹	₹	Assets	₹	₹
Sundry Creditors		20,000	Goodwill		12,000
Capital Account			Cash in hand		15,000
A			Sundry Debtors		
B	12,000		*Less* : Reserve for Bad Debts	21,000	
	30,000			1,000	20,000
					10,750
		42,000	Stock-in-trade		250
			Fixture & Fittings		4,000
			Profit and Loss Account		
		62,000			62,000

On 1.1.2013 they admit C as a partner on the following terms :

(a) The new profit sharing ratio of A, B and C becomes 5 :3 : 2.

(b) Agreed value of Goodwill is ₹ 20,000 and C brings the necessary premium for Goodwill in cash, half of which is retained in the business. Book value of Goodwill should remain undisturbed.

(c) The Reserve for bad debts is to be raised to 10% of Sundry Debtors.

(d) Stock-in-trade is to be revalued at ₹ 12,000 but the effect is not be shown in the books.

(e) Fixture & Fittings are to be reduced to ₹ 150.

(f) C should bring further sum in cash in order to make his capital equal to 1/5 th of the combined adjusted capital of A and B.

Show the necessary journal entries and the Capital Accounts of the partners and also prepare the Balance Sheet of the new firm as at 1.1.2013.

Solution.

In the books of A, B and C
Journal

Date	Particulars		L.F.	Debit ₹	Credit ₹
2013 Jan. 1					
	Bank A/c	Dr.		9,420	
	To C's Capital A/c				7,280
	To Goodwill A/c				1,600
	(Goodwill and capital to be brought in by C in cash)				
	Goodwill A/c	Dr.		1,600	
	To A's Capital A/c				800
	To B's Capital A/c				800
	(Goodwill to be credited to A and B's capital account in sacrificing ratio)				
	A's Capital A/c	Dr.		400	
	B's Capital A/c	Dr.		400	
	To Bank A/c				800
	(Half of the goodwill to be distributed)				
	A's Capital A/c	Dr.		2,400	
	B's Capital A/c	Dr.		1,600	
	To Profit and Loss A/c				4,000
	(Debit balance of P&L A/c transferred to A and B's capital in 3 : 2)				
	Profit and Loss Adjustment A/c	Dr.		1,200	
	To Reserve for Bad Debts A/c				1,100
	To Fixture and Fitting A/c				100
	(Value of assets is reduced on revaluation before C's admission)				
	A's Capital A/c	Dr.		720	
	B's Capital A/c	Dr.		480	
	To Profit and Loss Adjustment A/c				1,200
	(Loss on revaluation transferred to A and B's capital in 3 : 2)				
	C's Capital A/c	Dr.		250	
	To A's Capital A/c				125
	To B's Capital A/c				125
	(Effect of stock on revaluation adjusted on C's admission)				

Capital Account

Dr. *Cr.*

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To Profit and Loss				By Balance b/d	12,000	30,000	—
— Loss	2,400	1,600	—	" Bank	—	—	7,820
" Profit and Loss				" Goodwill	800	800	—
Adj. A/c — Loss				" C's Capital	125	125	—
" A's Capital	720	480	—				
" B's Capital	—	—	125				
" Bank	—	—	125				
(Withdraw of goodwill)	400	400	—				
" Balance c/d							
	9,405	28,445	7,570				
	12,925	30,925	7,820		12,925	30,925	7,820

Balance Sheet
as at 1st January, 2013

Liabilities	₹	₹	*Assets*	₹	₹
Capital :			Goodwill		12,000
A	9,405		Cash (₹ 15,000 + ₹ 9,420		
B	28,445		– ₹ 800)		23,620
C	7,570	45,420	Sundry Debtors		
			Less : Prov. for Bad Debts	21,000	
Sundry Creditors		20,000		2,100	18,900
			Stock		10,750
			Furniture and Fixtures		150
			(₹ 250 – ₹ 100)		
		65,420			65,420

Working :

1. **Goodwill to be brought in by C :**

	₹
Agreed value of goodwill	20,000
Less : as per Balance Sheet	12,000
Under valuation	8,000

∴ C is to bring ₹ 8,000 x 1/5 = 1,600

Sacrificing ratio :

A 3/5 - 5/10 = (6-5)/10 = 1/10 (Sacrifices)

B 2/5 - 3/10 = (4-3)/10 = 1/10 (Sacrifices)

C 1/10 + 1/10 = 2/10 (gains)

∴ Goodwill to be shared between A and B equally i.e. (1 : 1)

2. **Adjustments for increased value of Stock**

Since the increased value of stock is not to be shown in the books, the effect of the same will be:

Increased value of stock ₹ 1,250 (₹ 12,000 – ₹ 10,750)

	Credit ₹	Debit ₹	Net Effect ₹
A	750 $\left(\frac{2}{5}\right)$	625 $\left(\frac{5}{10}\right)$	125 (Cr.)
B	500 $\left(\frac{2}{5}\right)$	375 $\left(\frac{3}{10}\right)$	125 (Cr.)
A	—	250 $\left(\frac{2}{10}\right)$	250 (Dr.)

3. **Capital to be brought in By C**

Existing capital of A and B		42,000
Less: P & L A/c (Dr.)	4,000	
Loss on Revaluation	1,200	5,200
		36,800
Add: Premium brought in by		
C 1,600 x ½	800	
Stock revalued	250	1,050
		37,850

∴ C is to bring: ₹ 37,850 × $\frac{1}{5}$ = ₹ 7,570 + ₹ 250 (for stock) = ₹ 7,820.

Illustration 37.

X and Y were trading in partnership sharing profits and losses in the ratio of 7 : 5. On 1.1.2013, they admitted Z into partnership on the following terms :

Z was to have 1/6 th share which he purchased 1/8 th from X and 1/24 th from Y paying ₹ 20,000 for that share of Goodwill. Z also brought ₹ 25,000 as his capital into the firm. It was further agreed that Machinery should be reduced by 10% and that Investments should be reduced to their market value of ₹ 8,000.

The Balance Sheet of the old firm at 31.12.2012, was as follows :

Liabilities		₹	Assets	₹
Creditors		16,000	Machinery	20,000
Capital Accounts :			Furniture	4,000
X			Investment at cost	12,000
Y	25,000		Stock	10,000
	25,000	50,000	Debtors	6,000
			Cash at Bank	14,000
		66,000		66,000

Interest on drawing is to be ignored but interest on capitals is to be allowed at 5% p.a. The profits of the new firm for the year ended 31.12.2012 amounted to ₹ 52,450 before charging interest on capitals. Drawings of the partners during the year were : X ₹ 16,325, Y ₹ 13,875 and Z ₹ 3,250.

You are required to show the capital account and prepare the Balance Sheet as at 31.12.2013.

Solution :

In the books of X, Y and Z

Dr. Capital Accounts Cr.

Particulars	X ₹	Y ₹	Z ₹	Particulars	X ₹	Y ₹	Z ₹
To Revaluation A/c — Loss	3,500	2,500	—	By Balance b/d	25,000	25,000	—
" Balance c/d	36,500	27,500	25,000	" Bank — Premium	15,000	5,000	—
				" Bank	—	—	25,000
	40,000	30,000	25,000		40,000	30,000	25,000
To Drawings A/c	16,325	13,875	3,250	By Balance b/d	36,500	27,500	25,000
" Balance c/d	44,000	33,000	31,000	" Interest on Capital	1,825	1,375	1,250
				" Share of Profit	22,000	18,000	8,000
	60,325	46,875	34,250		60,325	46,875	34,250
				By Balance b/d	44,000	33,000	31,000

Balance Sheet
as at 31st December, 2013

Liabilities	₹	₹	***Assets***	₹
Capital—			Machinery (20,000 – 2,000)	18,000
X	44,000		Furniture	4,000
Y	33,000		Investment (12,000 – 4,000)	8,000
Z	31,000	1,08,000	Stock	10,000
Creditors		16,000	Debtors	6,000
			Cash at bank	78,000
		1,24,000		1,24,000

Working :

1.

Dr. **Revaluation Account** ***Cr.***

Particulars	Amount (₹)	Particulars		Amount (₹)
To Machinery	2,000	By Capital A/c		
" Investments	4,000	— Loss on Revaluation		
		X	3,500	
		Y	2,500	6,000
	6,000			6,000

2. Goodwill should be distributed as per sacrificing ratio i.e.,

   1/8 : 1/24 or 3:1.

   X's share = ₹ 20,000 x 3/4 = ₹ 15,000

   Y's share = ₹ 20,000 x 1/4 = ₹ 5,000

3. Since there is interest on capital, it is better to forward this balance of capital account and thereafter interest on capital should be charged.

Dr. **Profit and Loss Appropriation Account** ***Cr.***

Particulars		Amount (₹)	Particulars	Amount (₹)
To Interest on Capital			By P & L A/c	
X	1,825		— Net Profit	52,450
Y	1,375			
Z	1,250	4,450		
" Share of Profit				
X 11/24	22,000			
Y 9/24	18,000			
Z 4/24	8,000	48,000		
		52,450		52,450

4.

Dr. **Bank Account** ***Cr.***

Particulars	Amount (₹)	Particulars		Amount (₹)
To Balance b/d	14,000	By Drawings		
" Goodwill	20,000	X	16,325	
" Z's Capital	25,000	Y	13,875	
" Profit		Z	3,250	33,450
— (i.e. increase in cash)	52,450	" Balance c/d		78,000
	1,11,450			1,11,450

6.3 RETIREMENT OF A PARTNER

Introduction

A Partner may leave the firm by taking retirement. Normally the retirement takes place by consent of all the partners and / or by other mode of communication by the intended partner to all other partners.

In case of retirement, for paying off the retiring partner(s) some adjustment are required to be done in the books of accounts.

Steps for Adjustments / Books of Accounts :

Following steps to be taken and books of accounts to be prepared to calculate the due of retiring partner.

(1) Revaluation of Assets and liabilities.

This is required for giving the share of net assets of the firm. Treatments are:

Profit or loss on revaluation to be transferred to all the partners in old Profit Sharing ratio.

If the remaining partners decide not to alter the book value of assets or liabilities then the profit or loss on revaluation as distributed earlier should be reversed through remaining partner's capital account in new profit sharing ratio. We shall have to prepare Memorandum Revaluation Account.

(2) Undistributed profit or loss.

Any undistributed profit or loss including reserve is to be transferred in old profit sharing ratio.

Journal entries :

In case of undistributed profit or reserves:

Profit & Loss A/c Dr.

Reserve A/c Dr.

To Old Partners Capital A/c (In old P.S.R)

In case of undistributed Loss

Old Partners Capital A/c Dr.

To Profit & Loss A/c

(3) Adjustment regarding goodwill:

At the time of retirement the retiring partner is also eligible for share of goodwill of the firm. This can be made in the following ways :

(a) Raising of goodwill : (If goodwill is already existing in the Balance sheet the difference shall be raised)

Goodwill A/c Dr.

(Value of goodwill – existing goodwill in the balance sheet)

To All Partners Capital A/c (Old P.S.R)

(b) Goodwill raised and written off :

(i) Raise goodwill as discussed above.

(ii) Write off goodwill

Existing partners Capital A/c Dr.

To Goodwill A/c

Settlement of Dues to the Retiring Partner :

The retiring partner becomes entitled to get back his dues from the firm which consists of the following :

(i) Balance of his capital and current account at the time of retirement.

(ii) Share of goodwill, undistributed profit or loss, reserves and profit or loss on revaluation of assets and liabilities.

(iii) Salary, commission, interest on capital, if any and all other dues till the date of retirement.

(iv) Any adjustment in drawings and interest thereon.

Payment of dues.

(i) Payment at a time. Subject to availability of the fund, the payment may be made at a time. Journal entry :

Retiring Partner's Capital A/c Dr.
To Bank A/c

(ii) If part payment be made by giving assets :

Retiring Partner's Capital A/c Dr.
To Assets A/c

(iii) If the dues are transferred to Loan account.

Retiring Partner's Capital A/c Dr.
To Retiring partners' Loan A/c

(iv) If the existing partners bring in cash for making payment :

Bank/Cash A/c Dr.
To Existing Partners' Capital A/c

(v) For interest due on Retiring Partners Loan A/c

Interest on Retiring Partner's Loan A/c Dr.
To Retiring Partner's Loan account.

Illustration 38.

The Balance Sheet of Baichung, Tausif and Vijayan who shared profits and losses in the ratio 3:3:2 respectively was as follows on 31st December, 2013 :

Capitals :			Machinery	31,600
Baichung	24,000		Furniture	6,400
Tausif	10,000		Stock	8,500
Vijayan	8,000	42,000	Debtors	4,300
Reserve		4,800	Cash at Bank	4,700
Creditors		8,700		
		55,500		55,500

Baichung retired from the business on 1st January, 2013. Revaluation of assets were made as : Machinery ₹ 34,000, Furniture ₹ 5,000, Stock ₹ 9,600, Debtors ₹ 4,000 and Goodwill ₹ 10,000.

Baichung was paid ₹ 4,225 immediately and the balance was transferred to a Loan Account for payment in 4 equal half-yearly installments together with interest @ 6% p.a.

Show the necessary accounts, the Balance Sheet of the firm immediately after Baichung's retirement and his Loan Account till finally paid off.

Solution:

Books of Baichung, Tausif and Vijayan

Revaluation Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Amount ₹	Date	Particulars	Amount ₹	Amount ₹
1.1.13	To Furniture A/c		1,400	1.1.13	By Machinery A/c		2,400
	To Provision On Debtors A/c		300		By Stock A/c		1,100
	To Capital A/c: (Profit on Revaluation)						
	Baichung [3/8]	675					
	Tausif [3/8]	675					
	Vijayan [2/8]	450	1,800				
			3,500				3,500

Dr. **Capital Account** ***Cr.***

Date	Particulars	Baichung ₹	Tausif ₹	Vijayan ₹	Date	Particulars	Baichung ₹	Tausif ₹	Vijayan ₹
1.1.13	To Bank A/c	4,225			1.1.13	By Balance b/d	24,000	10,000	8,000
	To 6% Loan A/c	26,000				By Reserve [3:3:2]	1,800	1,800	1,200
	(Balance transferred)	–				By Revaluation A/c	675	675	450
	To Balance c/d		16,225	12,150		" Goodwill	3,750	3,750	2,500
		30,225	16,225	12,150			30,225	16,225	12,150

Tausif and Vijayan
Balance Sheet as at 1.1.13

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capitals :			Goodwill		10,000
Tausif	16,225		Machinery		34,000
Vijayan	12,150		Furniture		5,000
		28,375	Stock		9,600
Baichung's 6% Loan		26,000	Debtors		
Sundry Creditors		8,700	*Less* : Provision	4,300	
				300	4,000
			Cash at Bank [4,700–4,225]		475
		63,075			63,075

Baichung's Loan 6% Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.13	To Bank A/c [1/4 of 26,000+780]	7,280	1.1.13	By Baichung's Capital A/c	26,000
			30.6.13	By Interest [6% of 26,000 for 6 months]	780
31.12.13	To Bank A/c [1/4 of 26,000+585]	7,085		By Interest A/c of [6% of (26,000 – 6,500) for 6 months]	585
	To Balance c/d	13,000			
		27,365			27,365
			1.1.14	By Balance b/d	13,000
30.6.14	To Bank A/c [6500+390]	6,890	31.06.14	By Interest A/c [6% of 13,000 for 6 months]	390
31.12.14	To Bank A/c [6,500+195]	6,695	31.12.14	By Interest A/c [6% of 6,500 for 6 months]	195
		13,585			13,585

Illustration 39.

On 31st March, 2013 the Balance Sheet of M/s. Ram, Hari and Mohan sharing profits & losses as 2:3:2, stood as follows :

Liabilities		Amount ₹	Assets	Amount ₹
Capital Accounts :			Land & Building	10,00,000
Ram	10,00,000		Machinery	17,00,000
Hari	15,00,000		Closing Stock	5,00,000
Mohan	10,00,000	35,00,000	Sundry Debtors	6,00,000
Sundry Creditors		5,00,000	Cash & Bank Balance	2,00,000
		40,00,000		40,00,000

On 31st March, 2013 Hari decided to retire from the firm and the remaining partners decided to carry on. It was agreed to revalue the Assets and Liabilities on that date on the following basis : (1) Land & Buildings be appreciated by 30%; (2) Machinery be depreciated by 20%; (3) Closing Stock to be revalued at ₹ 4,50,000; (4) Provision for bad debts be made at 5%; (5) Old credit balances of Sundry Creditors ₹ 50,000 be written back; (6) Joint Life Policy of the partners surrendered and cash obtained ₹ 3,50,000; (7) Goodwill of the old firm be valued at ₹ 6,30,000 and Hari's Share of the Goodwill adjusted in the accounts of Ram and Mohan who share the profits and losses as 3 : 2. No goodwill being raised; (8) The total capital of the firm is to be the same as before retirement, Individual capitals be in their profit sharing ratio; (9) Amount due to Hari is to be settled on the following basis : 50% on retirement and the balance 50% within one year.

Prepare Revaluation Account, Capital Accounts of Partners, Cash Account and Balance Sheet as on 1.4.2013 of M/s Ram & Mohan.

Solution:

In the Books of M/s. Ram, Hari & Mohan
Revaluation Account

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Machinery A/c		3,40,000	By Land & Buildings A/c		3,00,000
To Stock A/c		50,000	By Sundry Creditors		50,000
To Provision for Bad Debts		30,000	By Partners Capital A/cs:		
			Ram [2/7]	20,000	
			Hari [3/7]	30,000	
			Mohan [2/7]	20,000	70,000
		4,20,000			4,20,000

[Treatment of Joint Life Policy - Surrender value]

For proceeds from Joint Life Policy

Bank A/c	Dr.	3,50,000	
To Joint Life Policy A/c			3,50,000

For sharing the proceeds of Joint Life Policy

Joint Life Policy A/c	Dr.	3,50,000	
To Ram's Capital A/c (2/7)			1,00,000
To Hari's Capital A/c (3/7)			1,50,000
To Mohan's Capital A/c (2/7)			1,00,000

Adjustment of Hari's share of goodwill

Hari's share of goodwill = 3/7 × 6,30,000 = 2,70,000

Goodwill A/c	Dr.	6,30,000	
To Ram Capital A/c			1,80,000
To Hari Capital A/c			2,70,000
To Mohan Capital A/c			1,80,000
(Being the goodwill is raised)			
Ram Capial A/c	Dr.	3,78,000	
Mohan Capital A/c	Dr.	2,52,000	
To Goodwill A/c			6,30,000
(Being the goodwill is written off)			

Or

Ram Capial A/c	Dr.	1,98,000	(In gaining
Mohan Capital A/c	Dr.	72,000	ratio)
To Hari A/c			2,70,000
(Being the Hari's share of goodwill is adjusted)			

Partner's Capital Account

Dr. *Cr.*

Date 2013	Particulars	Ram ₹	Hari ₹	Mohan ₹	Date 2013	Particulars	Ram ₹	Hari ₹	Mohan ₹
31.3	To Hari's Capital A/c	1,98,000	—	72,000	31.3	By Balance b/d	10,00,000	15,00,000	10,00,000
	To Revaluation A/c	20,000	30,000	20,000		By Bank A/c (Joint Life Policy as 2:3:2)	1,00,000	1,50,000	1,00,000
	To Cash /Bank A/c [50%]	—	9,45,000	—					
	To Loan A/c	—	9,45,000	—		By Ram's & Mohan's Capital (G/will shared)	—	2,70,000	—
	To Balance c/d (Note)	21,00,000	—	14,00,000					
						By Cash/Bank A/c (Bal. figure)	12,18,000	—	3,92,000
		23,18,000	19,20,000	14,92,000			23,18,000	19,20,000	14,92,000

Total Capital of the new firm = Total capital of the old firm (given)

= ₹ 35,00,000

Therefore Ram's Capital = 3/5 × 35,00,000 = ₹ 21,00,000

Mohan's Capital = 2/5 × 35,00,000 = ₹ 14,00,000

Cash/Bank

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.3.13	To Balance b/d	2,00,000	31.3.13	By Hari's Capital A/c	9,45,000
	To (Joint Life Policy A/c	3,50,000		By Balance c/d	12,15,000
	To Ram's Capital A/c	12,18,000			
	To Mohan Capital A/c	3,92,000			
		21,60,000			21,60,000

Balance Sheet as on 1.4.2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital Accounts :			Land & Building		13,00,000
Ram		21,00,000	Machinery		13,60,000
Mohan		14,00,000	Stock		4,50,000
Sundry Creditors		4,50,000	Sundry Debtors	6,00,000	
Hari's Loan		9,45,000	*Less* : Provision for Bad Debts	30,000	5,70,000
			Cash and Bank		12,15,000
		48,95,000			48,95,000

Working Notes :

1. Calculation of Gaining Ratio [New Ratio – Old Ratio]

   Ram = 3/5 – 2/7 = 11/35; Mohan = 2/5 – 2/7 = 4/35 So, Gaining Ratio = 11:4

Illustration 40.

A, B and C were in partnership sharing profits in the proportion of 5:4:3. The Balance Sheet of the firm as on 31st March, 2013 was as under :

Liabilities	Amount ₹	Assets	Amount ₹
Capital Accounts :		Goodwill	40,000
A	1,35,930	Fixtures	8,200
B	95,120	Stock	1,57,300
C	61,170	Sundry Debtors	93,500
Sundry Creditors	41,690	Cash	34,910
	3,33,910		3,33,910

A had been suffering from ill-health and gave notice that he wished to retire. An agreement was, therefore entered into as on 31st March, 2013, the terms of which were as follows:

(i) The Profit & Loss Account for the year ended 31st March, 2013, which showed a net profit of ₹ 48,000 was to be reopened. B was to be credited with ₹ 4,000 as bonus, in consideration of the extra work which had devolved upon him during the year. The profit sharing ratio was to be revised as from 1st April, 2012 to 3:4:4.

(ii) Goodwill was to be valued at two years' purchase of the average profits of the preceding five years. The Fixtures were to be revalued by an independent valuer. A provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book values.

(iii) The valuations arising out of the above agreement were Goodwill ₹ 56,800 and Fixture ₹ 10,980.

(iv) B and C agreed, as between themselves, to continue the business, sharing profits in the ratio of 3:2 and decided to eliminate Goodwill from the Balance Sheet, to retain the Fixtures on the books at revised value, and to increase the provision for doubtful debts to 6%.

You are required to submit the Journal Entries necessary to give effect to the above arrangement and to draw up the Capital Accounts of the partners after carrying out all adjustment entries as stated above.

Solution :

Books of the Firm A, B & C
Journal Entries

Date	Particulars		Dr. Amount ₹	Cr. Amount ₹
31.3.13	A's Capital A/c [5/12 of ₹ 48,000]	Dr.	20,000	
	B's Capital A/c [4/12 of ₹ 48,000]	Dr.	16,000	
	C's Capital A/c [3/12 of ₹ 48,000]	Dr.	12,000	
	To Profit & Loss Adjustment A/c			48,000
	[Profits of ₹ 48,000 already shared by A, B & C as 5 : 4 : 3 written back]			
	Profit & Loss Adjustment A/c	Dr.	4,000	
	To B's Capital A/c			4,000
	[B Credited with bonus of ₹ 4,000 for his extra work]			
	Profit & Loss Adjustment A/c	Dr.	44,000	
	To A's Capital A/c [3/11 of ₹ 44,000]			12,000
	To B's Capital A/c [4/11 of ₹ 44,000]			16,000
	To C's Capital A/c [4/11 of ₹ 44,000]			16,000
	[The remaining profits re-distributed as 3 : 4 : 4]			
	Goodwill A/c	Dr.	16,800	
	Fixtures A/c	Dr.	2,780	
	To Profit & Loss Adjustment A/c			19,580
	[Values of assets increased on revaluation]			
	Profit & Loss Adjustment A/c	Dr.	1,870	
	To Provision for doubtful debts A/c			1,870
	[Provision created @ 2% on Debtors]			
	Profit & Loss Adjustment A/c	Dr.	17,710	
	To A's Capital A/c [3/11]			4,830
	To B's Capital A/c [4/11]			6,440
	To C's Capital A/c [4/11]			6,440
	[Profit on Revaluation shared among all partners as 3 : 4 : 4]			
	A's Capital A/c	Dr.	1,32,760	
	To A's Loan A/c			1,32,760
	[Transfer of A's dues to his Loan A/c]			
	B's Capital A/c [3/5]	Dr.	36,324	
	C's Capital A/c [2/5]	Dr.	24,216	
	To Goodwill A/c			56,800
	To Provision for doubtful debts A/c			3,740
	[Goodwill Account written off and provision on debtors increased by 4% further on ₹ 93,500]			

Dr. **Capital Accounts** *Cr.*

Date 2013	Particulars	A ₹	B ₹	C ₹	Date 2013	Particulars	A ₹	B ₹	C ₹
31.3	To Profit & Loss Adjustment A/c	20,000	16,000	12,000	31.3	By Balance b/d	1,35,930	95,120	61,170
	To Loan A/c (Balance Transferred)	1,32,760	-	-		By Profit & Loss Adjustment A/c (Bonus)	-	4,000	-
	To Goodwill & Provision for Doubtful Debts	-	36,324	24,216		By Profit & Loss Adjustment A/c	12,000	16,000	16,000
	To Balance c/d	-	69,236	47,394		By Profit & Loss Adjustment A/c	4,830	6,440	6,440
		1,52,760	1,21,560	83,610			1,52,760	1,21,560	83,610

Illustration 41.

Sona, Mona and Dona were partners sharing profits in the proportions of 1/2, 1/3 and 1/6 respectively. Their Balance Sheet as on 31st March, 2013 was as under :

Liabilities		Amount ₹	Assets		Amount ₹
Sundry Creditors		24,000	Cash		2,500
Reserve		12,000	Debtors	16,000	
			Less : Provision	500	15,500
Capitals :			Stock		25,000
Sona	35,000		Motor Vans		8,000
Mona	30,000		Plant		35,000
Dona	30,000	95,000	Buildings		45,000
		1,31,000			1,31,000

Mona retired on that date subject to the following adjustments : (a) The Goodwill of the firm be valued at ₹ 18,000; (b) Plant and Motor Vans be depreciated by 10% and 15% respectively; (c) Stock and Buildings be appreciated by 20% and 10% respectively; (d) Provision for Doubtful Debts be fixed at ₹ 2,450; (e) Liability for damages be provided at ₹ 450; (f) The new profit sharing ratio between Sona and Dona be 3/5 and 2/5 respectively.

Pass the necessary Journal entries and prepare the Capital Accounts and the Balance Sheet assuming that no alteration of book values of assets and liabilities is to be made.

Solution:

Note :

1. As book values are not to be altered, there should be Memorandum Revaluation Account
2. The share of Reserve of the retiring partner should be credited to her account and debited to continuing partners in their gaining ratio.
3. Calculation of Gaining Ratio

   Gain by Sona = New Ratio – Old Ratio = $3/5 - 1/2 = \frac{6-5}{10} = 1/10$ or 3/30;

   Gain by Dona $2/5 - 1/6 = \frac{12-5}{30} = 7/30$, So Gaining Ratio = 3 : 7.

   So, Gaining Ratio = 3 : 7.

4.

Dr. **Memorandum Revaluation Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Liab. for Damages	450	By Stock	
" Plant	3,500	" Building	5,000
" Motor Van	1,200		4,500
" Prov. for D/Debts	1,950		
" Partners Capital A/c (3:2:1) Sona - 1200, Mona - 800, Dona - 400	2,400		
	9,500		9,500
To Reversal of Items b/d		By Reversal of Items b/d	
Stock	5,000	Liab. for Damage	450
Building	4,500	Plant	3,500
		Motor van	1,200
		Prov. for D / Debts	1,950
		By Partner's Capital A/c (3:2) Sona - 1,440, Dona - 960	2,400
	9,500		9,500

Sona, Mona and Dona
Journal Entries

Date	Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
31.3.13	Sona's Capital A/c [3/10]	Dr.		1,200	
	Dona's Capital A/c [7/10]	Dr.		2,800	
	To Mona's Capital A/c				4,000
	[Mona's share of Reserve credited to her capital on her retirement and debited to continuing partners capitals in gaining ratio 3 : 7]				
	Sona's Capital A/c	Dr.		1,800	
	Dona's Capital A/c	Dr.		4,200	
	To Mona's Capital A/c				6,000
	[Retiring Partner's share of Goodwill borne by continuing partners]				
	Mona's Capital A/c	Dr.		40,800	
	To Mona's Loan A/c				40,800
	[Balance due to the retiring partner transferred to her loan account]				
	Sona's Capital A/c (1,200 – 1,440)	Dr.		240	
	Dona's Capital A/c (400 – 960)	Dr.		560	
	To Mona's Capital A/c				800
	[Net effect of Memorandum Revaluation passed through Capital Accounts]				

Capital Account

Dr. *Cr.*

Date 2008	Particulars	Sona ₹	Mona ₹	Dona ₹	Date 2008	Particulars	Sona ₹	Mona ₹	Dona ₹
31.3	To Mona's Capital A/c	1,200	—	2,800	31.3	By Balance b/d	35,000	30000	30,000
	To Mem. Rev. A/c	1,440	—	960		By Sona & Dona's Capital A/c	—	4,000	—
	To Mona's Capital A/c	1,800	—	4,200					
	To Mona's Loan A/c (transfer)	—	40,800	—		By Mem. Rev. A/c	1,200	800	400
	To Balance c/d	31,760	—	22,400		By Sona & Dona's Capital A/c	—	6,000	—
		36,200	40,800	30,400			36,200	40,800	30,400

Sona and Dona
Balance Sheet as on 31st March, 2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Sundry Creditors		24,000	Cash		2,500
Reserve		12,000	Debtors	16,000	
Mona's Loan A/c		40,800	*Less :* Provision	500	15,500
Capital A/c :			Stock		25,000
Sona	31,760		Motor Vans		8,000
Dona	22,440	54,200	Plant		35,000
			Buildings		45,000
		1,31,000			1,31,000

Illustration 42.

On 1.1.2010, A and B started a firm of Cost Accountants sharing profits and losses equally. Each of the partners contributed ₹ 2,000 towards his capital of the firm and was allowed to draw ₹ 400 p.m. in anticipation of profits. On 1.1.2011, they admitted C as a third partners with equal share and he contributed ₹ 3,000 towards his capital and a further sum of ₹ 2,000 towards premium for goodwill. He too was entitled to draw ₹ 400 p.m. From 1.1.2012, A got a part-time job of cost consultant elsewhere and considering that he would be unable to devote his full time towards the business of the firm agreed to leave half of his share in the profits to be apportioned equally between B and C and his drawings was reduced to ₹ 200 p.m. for 1st January, 2012. On 1.1.2013, B got a full time job and in consequence A had to leave his part-time job and to devote full time in the firm. It was arranged that B will remain only a quarter of his earlier share in the firm and would be drawing nothing from 1.1.2013. A and C would be drawing @ ₹ 600 p.m. instead. The interest surrendered by B would be apportioned equally by A and C. On 31st Dec. 2013, B decided to retire altogether from the firm.

You are required to ascertain the amount due to B by the firm from the following particulars :

(a) Profits earned by the firm : 2010 — ₹ 17,000; 2011 — ₹ 18,000
2012 — ₹ 24,000; 2013 — ₹ 28,896

(b) B's share of goodwill is to be taken at two years' purchase of the average of his share of profit of the previous two years.

(c) The partners have drawn exactly what they could draw under the agreement.

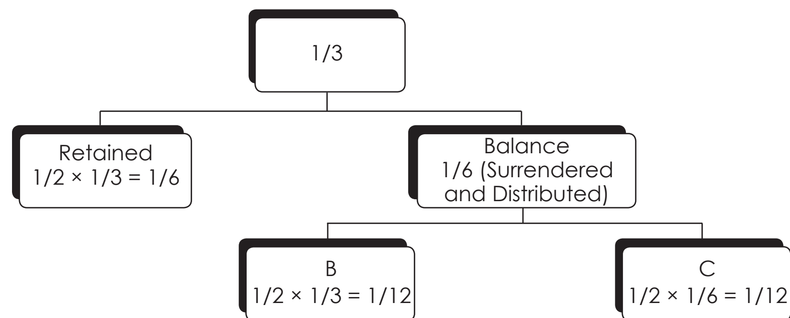
Solution :

Workings:

1. Profit Sharing Ratios among the Partners in different accounting years.

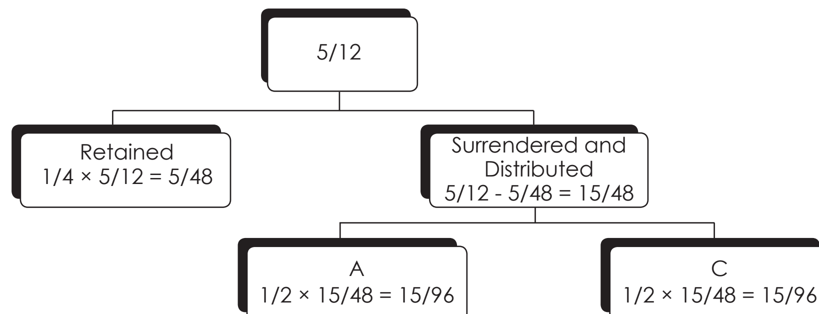
Year	A	B	C
2010	$\frac{1}{2}$	$\frac{1}{2}$	—
2011	$\frac{1}{3}$	$\frac{1}{3}$	$\frac{1}{3}$
2012	$\frac{1}{3}-(\frac{1}{2}\text{ of }\frac{1}{3})=\frac{1}{6}$	$\frac{1}{3}+\frac{1}{2}\text{ of }\frac{1}{6}=\frac{5}{12}$	$\frac{1}{3}+\frac{1}{2}\text{ of }\frac{1}{6}=\frac{5}{12}$
2013	$\frac{1}{6}+\frac{1}{2}\text{ of }\frac{15}{48}=\frac{31}{96}$	$\frac{1}{4}\text{ of }\frac{5}{12}=\frac{5}{48}$ **Share of profit surrendered** $\frac{3}{4}\text{ of }\frac{5}{12}=\frac{15}{48}$	$\frac{5}{12}+\frac{1}{2}\text{ of }\frac{15}{48}=\frac{55}{96}$
2013	$\frac{1}{6}+\frac{1}{2}\text{ of }\frac{15}{48}=\frac{31}{96}$	$\frac{1}{4}\text{ of }\frac{5}{12}=\frac{5}{48}$ Share of profit surrendered $\frac{3}{4}\text{ of }\frac{5}{12}=\frac{15}{48}$	$\frac{5}{12}+\frac{1}{2}\text{ of }\frac{15}{48}=\frac{55}{96}$

A's Share of profit :



∵ B's & C's profit sharing ratio for 2012 = $\frac{1}{3}+\frac{1}{12}=\frac{4+1}{12}+\frac{5}{12}$

B's Share of Profit :



A's profit sharing ratio for 2013 $= \frac{1}{6} + \frac{15}{96} = \frac{31}{96}$

C's profit sharing ratio for 2012 $= \frac{5}{12} + \frac{15}{96} = \frac{55}{96}$

2. Goodwill

B retires on 31.12.13 and for the purpose of calculating goodwill 'previous two years' should be taken 2012 and 2011. Thus, the value of goodwill will be:

B's Share of Annual Profits of the previous two years: 2012 = $\frac{5}{12}$ of 24,000 = ₹ 10,000

2011 = $\frac{1}{3}$ of 18,000 = ₹ 6,000

₹ 16,000

Average of this 16,000 = $\frac{16,000}{2}$ = ₹ 8,000; Two years purchase of the above amount = 2 × ₹ 8,000 = ₹16,000.

B's Capital Account

Dr. ***Cr.***

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.12.10	To Cash (Drawings)	4,800	1.1.10	By Cash — (Contribution)	2,000
	" Balance c/d	5,700	31.12.10	" Profit and Loss A/c — (Share of Profit) (₹ 17,000 x 1/2)	8,500
		10,500			10,500
31.12.10	To Cash — Drawings	4,800	1.1.10	By Balance b/d	5,700
	" Balance c/d	7,900	31.12.10	" Goodwill — Share of Premium (₹ 2,000 x 1/2)	1,000
				" Profit and Loss A/c — Share of Profit (₹ 18,000 ×1/3)	6,000
		12,700			12,700
31.12.11	To Cash — Drawings	4,800		By Balance b/d	7,900
	" Balance c/d	13,100	1.1.11	" Profit and Loss A/c — Share of Profit	
			31.12.11	(₹ 24,000 x 5/12)	10,000
		17,900			17,900
31.12.12	To B's Loan A/c — amount transferred	32,110	1.1.12	By Balance b/d	13,100
			31.12.12	" Profit and Loss A/c — (Share of Profit) (₹ 28,896 x 5/48)	3,010
				" Goodwill	16,000
		32,110			32,110

Rights to Share of Profits after Retirement

According to Sec. 37 of the Indian Partnership Act, "where any member of a firm has died or otherwise ceased to be a partner and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary. The outgoing partners or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or interest @ 6% p.a. on the amount of his share in the property of the firm."

In short, if any partners retires from a firm and if the final and if the final settlement of accounts is not made (i.e. if he is not paid in full) and if the continuing partner carry on the business after his retirement, the outgoing partner or his legal representatives is entitled to get share of profits or 6% p.a. of his share of property of the firm.

Under the circumstances, the share of profit of the outgoing partner should be ascertained as under:

(a) Computes the average profits of the last year at first.

(b) Ascertain the amount of profit on proportionate basis.

$$\text{i.e. Average profit} \times \frac{\text{Period after retirement}}{12}$$

(c) On the basis of computed figure of (b), ascertain retiring partners' share.

The Share of Profit so ascertained should be transfoerred to Profit & Loss suspense Account by passing the following entry:

Profit & Loss Suspense A/c Dr.

To Retiring Partners Capital A/c

Illustration 43.

Apte, Gupte and Sathe are partners in a firm in profit sharing ratio as 4 : 3 : 3. Their Balance Sheet as at 31.12.2012 was as follows :

Liabilities	₹	₹	Assets	₹	₹
Sundry Creditors		60,000	Cash in hand		32,000
Reserve		10,000	Debtors	70,000	
Capital Accounts :			Less : Prov. for Bad Debts	2,000	68,000
Apte	40,000		Stock		50,000
Gupte	30,000		Furniture		20,000
Sathe	60,000	1,30,000	Machinery		30,000
		2,00,000			2,00,000

Gupte retires on 30.9.2013 and Apte and Sathe carry on the business in their old ratio. On retirement, the following provisions apply :

(a) Goodwill is to be valued at two years' purchase of average profit for last three completed years and the period up to the date of retirement but no goodwill account is to be raised.

(b) Value of Stock is to be increased by ₹ 7,000 and Furniture is to be reduced to ₹ 7,000. Provision for bad debts is not needed.

(c) Retiring partner's share is to be purchased by the existing partners in their profit-sharing ratio, payment to be made privately.

Profit for the last three years are as follows :

Year ending		₹
"	31.12.2010	36,000
"	31.12.2011	21,000
"	31.12.2012	28,000

Profit up to the date of retirement is estimated at ₹ 20,000. Show the journal entries to give effect to the above arrangements and prepare the Balance Sheet of the new firm following the retirement of Gupte.

Solution :

Gupte's share of goodwill to be calculated as under

		₹
Average profit : Year ending	31.12.2010	36,000
" "	31.12.2011	21,000
" "	31.12.2012	28,000
And, Profit upto the date of retirement (30.9.13)		20,000
	For 3 ¾ years =	1,05,000

So, Value of goodwill = ₹ 1,05,000 × 4/15 ×2
= ₹ 56,000.

And, Gupte's share of goodwill ₹ 56,000 × 3/10 = ₹ 16,800.

In the books of the firm
Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Apte's Capital A/c Dr.		9,600	
	Sathe's Capital A/c Dr.		7,200	
	To Gupte's Capital A/c			16,800
	(Adjustment made for goodwill on Gupte's retirement against Apte and Sathe's accounts in 4:3)			
	Reserve A/c Dr.		10,000	
	To Apte's Capital A/c			4,000
	To Gupte's Capital A/c			3,000
	To Sathe's Capital A/c			3,000
	(Reserve credited to partners' capital accounts on Gupte's retirement)			
	Stock A/c Dr.		7,000	
	Provision for Bad Debts A/c Dr.		2,000	
	To Revaluation A/c			9,000
	(Value of stock increased and provision for bad debts to be written back on gupte's retirement)			
	Revaluation A/c Dr.		13,000	
	To Furniture A/c			13,000
	(Value of Furniture reduced on Gupte's retirement)			

	Particulars		Dr. (₹)	Cr. (₹)
	Apte's Capital A/c Dr. Gupte's Capital A/c Dr. Sathe's Capital A/c Dr. To Revaluation A/c (Loss on revaluation to be transferred to partners capital accounts in 4:3:3)		1,600 1,200 1,200	4,000
	Profit and Loss Suspense A/c Dr. To Gupte's Capital A/c (Gupte's share of profit up to the date of retirement transferred to his capital accounts.)		6,000	6,000
	Gupte's Capital A/c Dr. To Apte's Capital A/c To Sathe's Capital A/c (Gupte's share acquired by Apte and Sathe in the profit-sharing ratio, payment to be made privately.)		54,600	31,200 23,400

Capital Account

Dr. ***Cr.***

Particulars	Apte ₹	Gupte ₹	Sathe ₹	Particulars	Apte ₹	Gupte ₹	Sathe ₹
To Gupte's Capital	9,600	—	7,200	By Balance b/d	40,000	30,000	60,000
" Revaluation	1,600	1,200	1,200	" Apte's Capital	—	9,600	—
" Apte's Capital	—	31,200	—	" Sathe's Capital	—	7,200	—
" Sathe's Capital	—	23,400	—	" Reserve	4,000	3,000	3,000
" Balance c/d	64,000	—	78,000	" P & L Suspenses	—	6,000	—
				" Gupte's Capital	31,200	—	26,400
	75,200	55,800	86,400		75,200	55,800	86,400
				By Balance b/d	64,000	—	78,000

Balance Sheet
as at 1st July, 2013

Liabilities	₹	₹	Assets	₹	₹
Capital A/c:			Machinery		30,000
Apte	64,000		Furniture		7,000
Sathe	78,000	1,42,000	Stock		57,000
			Debtors		70,000
Creditors		60,000	Cash in hand		32,000
			Profit and Loss Suspense A/c		6,000
		2,02,000			2,02,000

Note :

Gupte's share of profit upto the date of his retirement has been credited to him against P & L Suspense Account. At the end of the year the same amount is transferred to P & L Appropriation Account. But if the profit-sharing ratio changes, the whole amount of such profit should be credited to all Partners Capital Account.

Illustration 44.

P, Q & R were equal partners. R retired on 31st March, 2013. The Balance Sheet of the firm as on 31st December, 2012 was as follows :

Liabilities		Amount ₹	Assets	Amount ₹
Capitals :			Goodwill	18,900
P	30,000		Buildings	40,000
Q	20,000		Investments (at Cost)	5,000
R	20,000	70,000	Stock	10,000
			Debtors	10,000
			Cash at Bank	10,000
Investment Fluctuation Fund		1,200		
Provision for Bad Debts		800		
General Reserve		4,000		
Trade Creditors		17,900		
		93,900		93,900

On 31.3.13 the following adjustments were considered : (a) Buildings were appreciated by ₹ 18,000; Book Debts were considered good; Investments were considered worth ₹ 4,700 and Stock was valued at ₹ 9,400; (b) Goodwill was considered equivalent to the average annual profits of the last three years; (c) R's share of Profit up to the date of his retirement was calculated on the basis of the average annual profits of the preceding three years which were ₹ 8,000; ₹ 9,000 and ₹ 10,000.

Show the Journal Entries and prepare the Balance Sheet immediately after R's retirement.

Solution:

Working notes :

1. **Valuation of Goodwill :** Average Annual Profits = $\frac{8,000 + 9,000 + 10,000}{3}$ = ₹ 9,000 Decrease in value of Goodwill = ₹ 18,900 – ₹ 9,000 = ₹ 9,900

   This shall be shared amongst all the Partners' in their old ratio.

2. R retired on 31st March, 2013, that is, after 3 months from the date of the last year ending. Estimated Profits for 3 months = 3/12 of 9,000 = ₹ 2,250. The retiring partner should be credited with 1/3rd of 2,250 = ₹ 750.

   Either the continuing Partners' Capital accounts should be debited in their Gaining Ratio OR Profit and Loss Suspense Account may be debited.

3. Investment at cost was shown at ₹ 5,000. Now It is valued at ₹ 4,700. Loss on Revaluation is ₹300.

   The fluctuation fund in excess of ₹ 300 (that is ₹ 1,200 - ₹ 300 = 900) should be transferred to Revaluation Account.

In the books of P, Q & R
Journal Entries

Date	Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
31.3.13	P's Capital A/c	Dr.		3,300	
	Q's Capital A/c	Dr.		3,300	
	R's Capital A/c	Dr.		3,300	
	To Goodwill A/c				
	[Value of Goodwill written down and partners capitals debited in old ratio 1 : 1: 1]				9,900
	Profit & Loss Suspense A/c	Dr.		750	
	To R's Capital A/c				75
	[Adjustment made for retiring partner's estimated share of profit]				
	Buildings A/c	Dr.		18,000	
	Provision for Bad Debts A/c	Dr.		800	
	Investment Fluctuation Fund A/c [1,200 - 300]	Dr.		900	
	To Revaluation A/c				
	[Adjustment made for revaluation of assets and liabilities]				19,700
	Revaluation A/c	Dr.		600	
	To Stock A/c				600
	[Value of stock reduced on revaluation]				
	Revaluation A/c	Dr.		19,100	
	To P's Capital A/c				6,366
	To Q's Capital A/c				6,367
	To R's Capital A/c				6,367
	[Profit on Revaluation shared by all partners equally]				
	General Reserve A/c	Dr.		4,000	
	To P's Capital A/c				1,334
	To Q's Capital A/c				1,333
	To R's Capital A/c				1,333
	[Undistributed Reserve shared equally by all partners]				
	R's Capital A/c	Dr.		25,150	
	To R's Loan A/c				25,150
	[Dues to the retiring partner transferred to Loan A/c]				

Partners Capital Accounts

Dr. **Cr.**

Particulars	P ₹	Q ₹	R ₹	Particulars	P ₹	Q ₹	R ₹
To Goodwill A/c - Written off	3,300	3,300	3,300	By Balance b/d	30,000	20,000	20,000
" R's Loan A/c (Transfer)	-	-	25,150	" P & L Suspense A/c	-	-	750
				" Revaluation A/c (Sh. of Profit)	6,366	6,367	6,367
				" General Reserve	1,334	1,333	1,333
To Balance c/d	34,400	24,400	-				
	37,700	27,700	28,450		37,700	27,700	28,450

P and Q
Balance Sheet as at 31st March, 2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital :			Goodwill		9,000
P	34,400		Buildings	40,000	
Q	24,400	58,800	*Add*: Appreciation	18,000	58,000
			Investment at Cost		5,000
R's Loan A/c		25,150	Stock		9,400
Investment Fluctuation Fund		300	Debtors		10,000
			Cash at Bank		10,000
Trade Creditors		17,900	P & L Suspense A/c		750
		1,02,150			1,02,150

Illustration 45.

X, Y and Z were partners sharing profits & losses as 4 : 3 : 1. On 1.4.2012 their capitals were ₹ 15,000, ₹15,000 and ₹ 10,000 respectively. The Partnership Deed contained :

1. Interest on Capital would be provided @ 10% p.a.
2. In case of retirement, the goodwill would be valued at 2 years purchase of the average distributable profits of the preceding 5 years.
3. The Profit of the retiring partner to the date of retirement would be estimated on the basis of the average distributable profit of the last 3 years; and
4. The firm would effect a Joint Life Policy for ₹ 30,000 whose premium would be charged as business expense.

X retired from the firm on 1.10.12. The surrender value of the policy as on that date was ascertained as ₹ 8,000. Drawings of the partners upto that date were X ₹ 3,000; Y ₹ 2,000 and Z ₹ 1,000. The annual net profits after charging interest on capital and joint life policy premia were : 2007-08 – ₹ 8,000; 2008-09 ₹ 8,800; 2009-10- ₹ 7,200; 2010-11- ₹ 9,500; 2011-12 ₹ 10,000.

X's final claims regarding revenue accounts were met out of the assets of the business and the rest was paid out of cash brought in by Y and Z in such proportions as to set their capital balances equated to their shares of profits. Show the Partners Capital Accounts.

Solution:

Working Notes :

1. Calculation for Goodwill

Average Annual Profits for last 5 years = (8,000 + 8,800 + 7,200 + 9,500 + 10,000)/5 = ₹ 8,700

Goodwill = 2 × 8,700 = 17,400

2. Profits upto the date of retirement & share of profits :

Average Annual Profits of last 3 years = (7,200 + 9,500 + 10,000)/3 = ₹ 8,900

Therefore, Proportionate share of profits in between (01.04.12 - 01.10.12) = 8,900 × 6/12 × 4/8 = 2,225

3. Share of Joint Life Policy at surrender value = 4/8 × 8000 = ₹ 4,000

4. Total claim of X on Retirement

Amount Payable to Mr. X

Particulars	₹
Capital (as on 1.4.12)	15,000
Add: Share of Goodwill (4/8 x 17,400)	8,700
Add: Interest on Capital (15,000 x 10/100 x 6/12)	750
Add: Proportionate share of profits (Note 2)	2,225
Add: Share of Surrender Value of Joint Life Policy (Note 3)	4,000
	30,675
Less : Drawings	3,000
	27,675

Note :

(1) Interest on Capital, proportionate share of profits are adjusted through Profit & Loss Suspense A/c as follows :

		Dr.	Cr.
P & L Suspense A/c	Dr.	2,975	
To X 's Capital A/c (2,225 + 750)			2,975
(Being interest on capital & proportionate share of profits provided)			

(2) Adjustment of X's share of Goodwill

		Dr.	Cr.
Y's Capital A/c	Dr.	6,525	
Z's Capital A/c	Dr.	2,175	
To X's Capital A/c			8,700
(Being X's Share of Goodwill adjusted against existing partners in their Gaining ratio (3 : 1)			

(3) Proportionate capital of Y & Z

Balance of Y's Capital (15,000 – 6,525 – 2,000)	=	6,475
Balance of Z's Capital (10,000 – 2,175 – 1,000)	=	6,825
(+) Cash Paid to X	=	27,675
		40,975

Therefore Y's Capital = 3/4 × 40,000 = 30,731
Z's Capital = 1/4 × 40,975 = 10,244

Y & Z Balance sheet as at 1.10.12 (after retirement)

Capital	₹	₹	Assets	₹	₹
Y :	30,731		Sundry Assets		38,000
Z :	10,244	40,975	P & L Susp. A/c		2,975
		40,975			40,975

Balance sheet (Before retirement)

Capital	₹	₹	Assets	₹	₹
X	15,000		Sundry Assets		34,000
Y	15,000		Advance to Partners		6,000
Z	10,000	40,000			
		40,000			40,000

Capital Account

Dr. *Cr.*

Date 2012	Particulars	X ₹	Y ₹	Z ₹	Date 2012	Particulars	X ₹	Y ₹	Z ₹
1.10	To X Capital A/c	-	6,525	2,175	1 . 4	By Balance b/d	15,000	15,000	10,000
	To Drawings	3,000	2,000	1,000		By Y and Z's Capital A/c	8,700	-	-
	To Cash (Bal. Paid off)	27,675	-	-					
	To Balance c/d	-	30,731	10,244		By P & L Susp. A/c	7 5 0	-	-
						By Cash A/c (brought in)	-	24,256	3,419
						By JLP A/c	4,000	-	-
		30,675	39,256	13,419			30,675	39,256	13,419

Illustration 46.

M, J and P were partners sharing profits/losses in the ratio of M 40%, J 35% and P 25%. The draft Balance Sheet of the partnership as on 31st December, 2012 was as follows :

Liabilities		Amount ₹	Assets		Amount ₹
Sundry Creditors		30,000	Cash in hand and at Bank		67,000
Bills payable		8,000	Stock		42,000
Loan from J		30,000	Sundry Debtors	34,000	
Current Accounts :			*Less* : Provision	6,000	28,000
M	12,000				
J	8,000		Plant & Machinery	80,000	
P	6,000		Less: Dep.	28,000	52,000
Capital Accounts:			Premises (at cost)		75,000
M	90,000	26,000			
J	50,000				
P	30,000	1,70,000			
		2,64,000			2,64,000

J retired on 31.12.12. M and P continued in partnership sharing profit/losses in the ratio of M 60% and P 40%.

50% of J's loan was repaid on 1.1.2013 and it was agreed that out of the amount then remaining due to him a sum of ₹ 80,000 should remain as loan to partnership and the balance to be carried forward as ordinary trading liability. The following adjustments were agreed to be made to the above-mentioned Balance Sheet:

1. ₹ 10,000 should be written off from the premises, which was acquired two years back on lease for a term of 15 years.
2. Plant & Machinery was revalued at ₹ 58,000;
3. Provision for Doubtful Debts to be increased by ₹ 1,200;
4. ₹ 4,000 to be written off stock;
5. ₹ 5,000 due to creditors for expenses had been omitted from the books of accounts;
6. Provide ₹ 1,200 for professional charges in connection with the revaluation.

As per the deed of partnership, in the event of retirement of a partner, goodwill was to be valued at an amount equal to one year's purchase of the average profits of the preceding 3 years on the date of retirement. Before determining the said average profits, a notional amount of ₹ 80,000 should be charged for remuneration of partners. The necessary profits (before charging such remuneration) for the years ending on 31st December, 2010, 2011 and 2012 were ₹ 1,44,000, ₹ 1,68,000 and ₹ 1,88,200 (as per draft accounts) respectively.

It was agreed that, for the purpose of valuing goodwill, the amount of profit for the year 2012 be recomputed after charging the loss on revaluation in respect of premises and stock, the unprovided expenses (except professional expenses) and increase in the provision for doubtful debts. The continuing partners decided to eliminate goodwill account from their books.

Prepare the Revaluation Account; Capital Accounts (merging current accounts therein); J's Account showing balance due to him, and Balance Sheet of M and P as at 1st January, 2013.

Solution :

In the books of M, J & P

Dr. **Revaluation Account** ***Cr.***

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Premises A/c		10,000	By Machinery A/c		6,000
To Provision for Bad Debts A/c		1,200	[58,000 – 52,000]		
To Creditors for Expenses A/c		5,000	By Capital A/cs :		
To Stock A/c		4,000	(Loss on Revaluation)		
To Outstanding Professional Charges A/c		1,200	M [8/20]	6,160	
			J [7/30]	5,390	
			P [5/20]	3,850	15,400
		21,400			21,400

Gaining Ratio = New Ratio - Old ratio

M = 60/100 – 40/100 = 20/100

P = 40/100 – 25/100 = 15/100

∴ Gaining Ratio = 4 : 3

Capital Accounts

Dr. ***Cr.***

Particulars	M ₹	J ₹	P ₹	Particulars	M ₹	J ₹	P ₹
To Revaluation A/c	6,160	5,390	3,850	By Balance b/d	90,000	50,000	30,000
To J's Capital A/c	16,000	—	12,000	By Current A/c	12,000	8,000	6,000
To J's loan A/c (Bal. Transferred)		80,610		By M and P's Cap. A/c [Note]	—	28,000	—
To Balance c/d	79,840	—	— 20,150				
	1,02,000	86,000	36,000		1,02,000	86,000	36,000

J's Loan Account

Dr. ***Cr.***

Particulars	Amount ₹	Particulars	Amount ₹
To Bank A/c [50% of 30,000]	15,000	By Balance b/d	30,000
To J's A/c (Bal. Fig treated as ord. Liability)	15,610	By J's Capital A/c	80,610
To Balance c/d	80,000		
	1,10,610		1,10,610

Balance Sheet as on 1.1.2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Sundry Creditors		45,610	Cash in hand and at Bank		52,000
[30,000 + J's A/c 15,610]			[67,000 – 15,000		
Bills Payable			Stock		
Creditors for Expenses		8,000	Sundry Debtors	34,000	38,000
O/S professional charges		5,000	*Less* : Provision for Debts	7,200	26,800
Loan from J		1,200	Plant & Machinery		58,000
Capital Accounts :		80,000	Premises [75,000 – 10,000]		65,000
M	79,840				
P	20,150	99,990			
		2,39,800			2,39,800

Working Notes :

Adjustment of Profit & Valuation of Goodwill

Particulars	₹	₹
Total Profits for the last 3 years [1,44,000 + 1,68,000 + 1,88,200]		5,00,200
Less : (1) Notional Remuneration for 3 years [80,000 × 3]	2,40,000	
(2) Premises w/off	10,000	
(3) Creditors for Expenses	5,000	
(4) Provision on Debtors	1,200	
(5) Stock written off	4,000	2,60,200
Adjusted Profits for last 3 years		2,40,000

Goodwill = Average of Adjusted Profits = 1/3 of 2,40,000 = ₹ 80,000

Goodwill A/c	Dr.	80,000	
To M's A/c			32,000
To J's A/c			28,000
To P's A/c			20,000
M's A/c	Dr.	48,000	
P's A/c	Dr.	32,000	
To Goodwill A/c			80,000

Or,

M's A/c	Dr.	16,000		
P's A/c	Dr.	12,000		
To J's A/c			28,000	(In Gaining Ratio 4 : 3)

Illustration 47.

Compass, Cone and Circle are in partnership sharing profits and losses in the ratio of 3 : 2 : 1. The Balance Sheet of the firm as on 31st December, 2012 was as follows :

Liabilities	₹	₹	Assets	₹	₹
Capital accounts :			Machinery (at Cost)	50,000	
Compass	40,000		*Less* : Provision for Dep.	8,000	42,000
Cone	60,000				
Circle	20,000				
			Furniture		1,000
Reserve		1,20,000			
Sundry Creditors		30,000	Sundry Debtors	80,000	
		60,000	*Less* : Prov. for Doubtful Debts	3,000	77,000
			Stocks		50,000
			Cash at Bank		40,000
		2,10,000			2,10,000

On 31st Mardh 2013 Conre retired and Compass an Circle continued in partnership, sharing profits and losses in the ratio of 3 : 2. It was agreed that adjustments were to be made in the Balance Sheet as on 31st March, 2013, in respect of the following :

(a) The Machinery was to be revalued at ₹ 45,000; (b) The Stock was to be reduced by 2%; (c) The Furniture was to be reduced to ₹ 600; (d) The Provision for Doubtful Debts would be ₹ 4,000; (e) A provision of ₹ 300 was to be made for Outstanding Expenses.

The Partnership agreement provided that on the retirement of a partner, goodwill was to be valued at ₹ 24,000 and Cone's share of the same was to be adjusted into the accounts of Compass and Circle. The profit up to the date of retirement was estimated at ₹ 18,000.

Cone was to be paid off in full, Compass and Circle were to bring such an amount in cash so as to make their capital in proportion to the new profit sharing ratio. Subject to the condition that a cash balance of ₹ 20,000 was to be maintained as working capital.

Pass the necessary journal entire to give effect to the above arrangements and prepare the partners' Capital Accounts on 31st March, 2013.

Solution:

In the books of Compass, Cone and Circle
Journal

Date	Particulars		L.F.	Debit ₹	Credit ₹
31.3.2013	Reserve A/c	Dr.		30,000	
	To Compass's Capital A/c				15,000
	To Cone's Capital A/c				10,000
	To Circle's Capital A/c				5,000
	(Reserve transferred to the capital accounts of the partners in 3 : 2 : 1)				
	Machinery A/c	Dr.		3,000	
	To Revaluation A/c				3,000
	(Value of the machinery increased on Cone's retirement)				
	Revaluation A/c	Dr.		2,700	
	To Stock A/c				1,000
	To Furniture A/c				400
	To Provision for Bad Debts A/c				1,000
	To Outstanding Expenses A/c				300
	(Value of the assets reduced on Cone's retirement)				
	Revaluation A/c	Dr.		300	
	To Compass's Capital A/c				150
	To Cone's Capital A/c				100
	To Circle's Capital A/c				50
	(Profit on revaluation transferred to the capital accounts of the partners)				
	Compass's Capital A/c	Dr.		2,400	
	Circle's Capital A/c	Dr.		5,600	
	To Cone's Capital A/c				8,000
	(Cone's share of goodwill to be adjusted against remaining partner's capital accounts in the gaining ratio of 3 : 7)				
	Profit and Loss Suspense A/c	Dr.		18,000	
	To Compass's Capital A/c				9,000
	To Cone's Capital A/c				6,000
	To Circle's Capital A/c				3,000
	(Estimated profit transferred to the capital accounts of the partners)				

	Cone's Capital A/c Dr. To Bank A/c (Payment is made to Cone on his retirement)		84,100	84,100
	Bank A/c Dr. To Compass's Capital A/c To Circle's Capital A/c (Cash to be brought in by Compass and Circle as per agreement)		46,100	16,430 29,670

Dr. **Capital Account** *Cr.*

Particulars	Compass ₹	Cone ₹	Circle ₹	Particulars	Compass ₹	Cone ₹	Circle ₹
To Cone's Capital	2,400	—	5,600	By Balance b/d	40,000	60,000	20,000
" Bank (bal. fig.)	—	84,100	—	" Reserve	15,000	10,000	5,000
" Balance c/d	78,180	—	52,120	" Revaluation — Profit	150	100	50
				" Share of Profit	9,000	6,000	3,000
				" Compass's Capital	—	2,400	—
				" Circle's Capital	—	5,600	—
				" Bank (bal. fig.)	16,430	—	29,670
	80,580	84,100	57,720		80,580	84,100	57,720
				By Balance b/d	78,180	—	52,120

Working Notes :

1. Total value of goodwill ₹ 24,000

∴ Cone's share of goodwill = 24,000 × 2/6 = 8,000 to be adjusted against Compass's and Circle capital in 3 : 7.

Computation of ratio :

Compass = 3/5 - 3/6 = 3/30 (gain)

Circle = 2/5 - 1/6 = 7/30 (gain)

2. **Bank Account**

Dr. *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	40,000	By Cone's Capital	84,100
" Profit — increase in Cash	18,000	" Balance c/d (to be maintained)	20,000
" Compass and Circle's Capital (balance figure)	46,100		
	1,04,100		1,04,100

3. **Total adjusted capitals of Compass and Circle :**

	₹
Compass's Capital (40,000 + 15,000 + 150 + 9,000 – 2,400)	61,750
Circle's Capital :	
(20,000 + 5,000 + 50 + 3,000 – 5,600)	22,450
Add : Total Cash to be brought in	46,100
Combined adjusted capitals	1,30,300

∴ Compass's Cap. = 1,30,300 x 3/5 = 78,180

Circle's Cap. = 1,30,300 x 2/5 = 52,120

ADMISSION – CUM - RETIREMENT

We have separately explained the treatment of admission of partner and the retirement of a partner. Now, we are going to highlight the combined changes effect of simultaneous admission and retirement. It should be remembered that no separate treatment is practically needed i.e. same principles for admission and retirement are followed but only two sets of transactions are incorporated simultaneously.

Illustration 48.

X, Y, & Z were equal partners. Their Balance Sheet as on 31.12.12 was as follows :

Liabilities			Assets	
Partners' Capital			Land & Freehold Property	1,00,000
X	1,00,000		Plant & Machinery	2,00,000
Y	1,00,000		Furniture & Equipment	50,000
Z	2,00,000		Stock in-trade	1,00,000
Partner's Current A/c :		4,00,000	Sundry Debtors	1,00,000
X	50,000		Balance with Bankers	1,50,000
Y	75,000			
Z	25,000	1,50,000		
Sundry Creditors		1,50,000		
		7,00,000		7,00,000

On 1.1.13 X retired and it was agreed that he should be paid all his dues in full on that date. For this purpose, goodwill was to be calculated on the basis of 3 years purchase of past 3 years profits which amounted to ₹ 1,00,000, ₹ 1,40,000 and ₹ 1,20,000 respectively.

In order to meet his obligation, a bank loan was arranged on 1.1.13 for ₹ 2,00,000 pledging the fixed assets as security.

Further, to compensate a loyal manager Q, it was agreed between Y and Z that Q should be admitted as a partner, who should bring in, over and above a capital of ₹ 1,00,000, his share of Goodwill in cash to serve as working capital. Y and Z agreed to forego 1/3rd of their individual share of profits to Q.

Prepare the opening Balance Sheet of the firm as on 1.1.13.

Solution :

Working Notes :

(1) Valuation of Goodwill

Average Annual Profits = $\frac{1,00,000 + 1,40,000 + 1,20,000}{3}$ = ₹ 1,20,000

∴ Goodwill = 3 × 1,20,000 = ₹ 3,60,000

Premium to be paid by Q = 1/3 of 3,60,000 = ₹ 1,20,000 and to be shared by Y and Z equally. Similarity X should be provided ₹ 1,20,000 by Y and Z equally.

(2) Journal Entries

	Particulars		Dr.	Cr.
(a)	Y's Current A/c	Dr.	60,000	
	Z's Current A/c	Dr.	60,000	
	To X's Current A/c			1,20,000
	(Being X's share of goodwill adjusted against existing partners Y & Z in their gaining ratio 1:1)			
(b)	Cash A/c	Dr.	1,00,000	
	To Q's Capital A/c			1,00,000
	(Being Capital contributed by C)			
(c)	Cash A/c	Dr.	1,20,000	
	To Y's Current A/c			60,000
	To Z's Current A/c			60,000
	(Being Q's share of premium for goodwill share between Y & Z in their sacrificing ratio)			
(d)	Bank A/c	Dr.	2,00,000	
	To Bank Loan A/c			2,00,000
	(Being loan taken from Bank against hypothecation of fixed assets)			

(3)

Dr. **Partner Capital Accounts** ***Cr.***

Particulars	X	Y	Z	Q	Particulars	X	Y	Z	Q
To Cash A/c (Final settlement)	2,70,000	-	-	-	By Balance b/d	1,00,000	1,00,000	2,00,000	-
To Balance c/d	-	1,00,000	2,00,000	1,00,000	" X's Current A/c (Transfer)	1,70,000	-	-	-
					" Cash A/c (Capital introduced)	-	-	-	1,00,000
	2,70,000	1,00,000	2,00,000	1,00,000		2,70,000	1,00,000	2,00,000	1,00,000

(4) Partners Current Account

Dr. Particulars	X	Y	Z	Particulars	X	Y	Cr. Z
To X's Capital A/c (Tran)	1,70,000	-	-	By Balance b/d	50,000	75,000	25,000
				" Y's Current A/c	60,000	-	-
To X's Current A/c	-	60,000	60,000	" Z's Current A/c	60,000	-	-
To Balance c/d	-	75,000	25,000	" Cash A/c	-	60,000	60,000
	1,70,000	1,35,000	85,000		1,70,000	1,35,000	85,000

(5)

Dr. Balance with Bankers Account Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	1,50,000	By X's Capital A/c	2,70,000
To Bank Loan A/c	2,00,000		
To Cash A/c (Premium for goodwill)	1,20,000		
To Q's capital A/c	1,00,000	By Balance c/d	3,00,000
	5,70,000		5,70,000

Balance Sheet as at 1.1.13

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Partners' Capital A/cs :			Land and Freehold		1,00,000
Y	1,00,000		Property		
Z	2,00,000		Plant & Machinery		2,00,000
Q	1,00,000	4,00,000	Furniture & Equipment		50,000
			Stock		1,00,000
Partner's Current A/cs :			Debtors		1,00,000
Y	75,000		Cash at Bank (W5)		3,00,000
Z	25,000	1,00,000			
Bank loan (Secured)		2,00,000			
Sundry Creditors		1,50,000			
		8,50,000			8,50,000

Illustration 49.

Khana and Lilavati started practicing as Chartered Accountants since 1965 sharing profits as equal partners. They admitted Gargi in 1970 from which time they have all been equal partners. The accounts were maintained on cash basis without regard to debtors and work-in-progress at the time of Gargi's admission. She paid Khana and Lilabati privately in respect of debtors and work-in-progress.

On 31st December, 2013 Khana and Lilavati retired from the partnership and Maitrayee, their paid assistant, became an equal partner with Gargi. Upon the elevation of Maitrayee as partner, Arundhati was engaged on a salary of ₹ 24,500 per annum to take over the place, so long held by Maitrayee who was paid ₹ 15,000, ₹ 17,500 and ₹ 20,000 respectively as salary for the last three financial years. It

was agreed that Maitrayee would effectively replace Khana and Lilavati. The Profits of the last three years as shown by partnership accounts were ₹ 85,000 ₹ 87,000 and ₹ 92,000 respectively. The fees received in each of the past three years have been about ₹ 6,00,000 accruing evenly throughout the year.It is agreed that goodwill based on one year's purchase of the average of the past 3 years profits, as adjusted, should be shown in the books in lieu of the present book value of ₹ 60,000. On 31st December, 2013, the Capital Accounts of Khana, Lilavati and Gargi stood at ₹ 40,000 each without any adjustment suggested above. Maitrayee was to pay adequate cash to make her capital equivalent to that of Gargi and this amount was to be withdrawn equally by Khana and Lilavati, any balance due to them should be transferred to their loan accounts.

As the financial adviser to the partnership you are requested to opine on inter-partner payments required regarding debtors and work-in-progress. You come to know that normally a job takes 6 months from start to finish, at the end of which the client concerned is billed and payment is received.

Show :

1. The Capital Accounts of Khana, Lilavati, Gargi and Maitrayee showing the Goodwill adjustments; and
2. Prepare a statement showing your recommendations concerning inter-partner payments in respect of debtors and work-in-progress.

Solution :

Working Notes :

1. Adjustment for Goodwill

Particulars	**2011** ₹	**2012** ₹	**2013** ₹
Annual Profits as per accounts	85,000	87,000	92,000
Add : Salary of Maitrayee	15,000	17,500	20,000
	1,00,000	1,04,500	1,12,000
Less : Salary of Arundhati	24,500	24,500	24,500
	75,500	80,500	87,500
Value of Goodwill [75,500 + 80,000 + 87,000]/3			81,000
Less : The present value of Goodwill			60,000
Increase in the value of goodwill			21,000

2. **Debtors & Work-in-Progress**

Average time taken to complete a job = 6 months

Fees Receivable in a year = ₹ 6,00,000

Fees Receivable in 6 months = ₹ 3,00,000

Here it has been said that jobs accrue evenly throughout the year. So Debtors & work-in- Progress should be equal to three months work. Its value should be ₹ 1,50,000.

Dr. **Partners Capital Accounts** ***Cr.***

Particulars	Khana ₹	Lilavati ₹	Gargi ₹	Maitrayee ₹	Particulars ₹	Khana ₹	Lilavati ₹	Gargi ₹	Maitrayee ₹
					By Balance b/d	40,000	40,000	40,000	-
To Cash A/c	23,500	23,500	-	-	By Goodwill A/c	7,000	7,000	7,000	
To Loan A/c	23,500	23,500	-	-	[21,000 as 1:1:1]				-
To Balance c/d	-	-	47,000	47,000	By Cash A/c	-	-	-	47,000
	47,000	47,000	47,000	47,000		47,000	47,000	47,000	47,000

2nd Part : Recommendations **Re : Inter-Partner Payments for Debtors & Work-in-Progress**

Particulars	Khana ₹	Lilavati ₹	Gargi ₹	Maitrayee ₹
Average value ₹ 1,50,000 credited to Khana, Lilavati and Gargi as 1:1:1	50,000 (Cr.)	50,000 (Cr.)	50,000 (Cr.)	-
Average value now debited equally to Gargi & Maitrayee as 1:1	-	-	75,000 (Dr.)	75,000 (Dr.)
	50,000 (Cr.)	50,000 (Cr.)	25,000 (Dr.)	75,000 (Dr.)

Illustration 50.

P, Q and R were partners sharing Profits & Losses as 2 : 3 : 5. P retired on 31.3.13 and X joined as a new partner on the same date, the new profit sharing ratio between Q, R and X being 2 : 3 : 1. The Balance Sheet of P, Q & R on 31.3.2013 was as follows :

Liabilities			Assets	
Sundry Creditors		50,000	Cash in hand	2,000
Loan from X		50,000	Cash at Bank	93,000
General Reserve		40,000	Sundry Debtors	30,000
Capitals :			Stock	20,000
P	10,000		Machinery	30,000
Q	15,000		Buildings	10,000
R	20,000	45,000		
		1,85,000		1,85,000

X was admitted on the following terms :

(1) Machinery was to be depreciated by ₹ 3,000 (2) Buildings were revalued at ₹ 30,000 (3) Stock was to be written off by ₹ 5,000 (4) Provision of 5% was made against doubtful debts (5) General Reserve would be apportioned among the partners (6) The firm's Goodwill was to be valued at two years purchase of the average profits of the last three years (7) The amount due to P was retained in the business as a loan but X's Capital contribution should be 1/5th of the combined adjusted capitals of Q and R. His capital would be transferred from his Loan Account, (8) the Goodwill would be wiped off from the books after X's admission. (9) Partners decided not to alter the book values of assets & liabilities after admission.

The profits/losses during the last 3 years had been 31.3.11 ₹ 20,000 (Profit) 31.3.12 ₹ 15,000 (loss) and 31.3.13 ₹ 40,000 (Profit).

Show the necessary Accounts and Balance Sheet of the firm.

Solution:

Working Notes :

1. **Valuation of Goodwill**

Profits for years ended :	31.3.11	₹ 20,000
	31.3.12	₹ (15,000)
	31.3.13	₹ 40,000
		₹ 45,000

So, Average Annual Profits = 45,000/3 = ₹ 15,000. Goodwill = 2 x ₹ 15,000 = ₹ 30,000

For Goodwill raised :

Goodwill A/c	Dr.	30,000	
To P			6,000
To Q			9,000
To R			15,000

For Goodwill written off :

Q	Dr.	10,000	
R	Dr.	15,000	
X	Dr.	5,000	
To Goodwill			30,000

Dr. **Memorandum Revaluation Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Machinery	3,000	By Building	20,000
" Stock	5,000		
" Prov. for doubtful Debts	1,500		
" P/Capital A/c (Share of Rev. Profit) P – 2,100 Q – 3,150 R – 5,250	10,500		
	20,000		20,000
To Reversal of Items b/d Building		By Reversal of Items b/d	
		Machinery	3,000
		Stock	5,000
		Provision for D/Debts	1,500
		By P/Capital A/c (Share of Rev. Profit) Q – 3,500 R – 5,250 X – 1,750	10,500
	20,000		20,000

Partners Capital Accounts

Dr. *Cr.*

	P ₹	Q ₹	R ₹	S ₹		P ₹	Q ₹	R ₹	S ₹
To Mem. Rev A/c - Sh. of loss	-	3,500	5,250	1,750	By Balance b/d	10,000	15,000	20,000	-
To Goodwill written off	-	10,000	15,000	5,000	By General Reserve	8,000	12,000	20,000	-
To P's loss A/c (transfer)	26,100				By Memorandum Revaluation A/c (Sh. of profit)	2,100	3,150	5,250	-
	-				By Goodwill raised	6,000	9,000	15,000	-
To Balance c/d		25,650	40,000	13,130	By Loan from X A/c (Transfer)	-	-	-	19,880
	26,100	39,150	60,250	19,880		26,100	39,150	60,250	19,880

Capital Balance of X = 1/5 of (25,650 + 40,000) = 1/5 × 65,650 = 13,130

Therefore from X's loan A/c : Loan from X A/c Dr. 19,880

To X's Capital A/c 19,880

Q, R & X

Balance sheet as at 31.3.13

Liabilities		Amount ₹	Assets	Amount ₹
S/Creditors		50,000	Building	10,000
Loan for X		30,120	Machinery	30,000
Loan from P		26,100	Stock	20,000
Capitals :			Debtors	30,000
Q :	25,650		Cash in hand	2,000
R :	40,000		Cash at Bank	93,000
X :	13,130	78,780		
		1,85,000		1,85,000

Illustration 51.

Shukla, Grewal, Jain and Narang were partners sharing profits and losses as 4 : 3 : 2 : 1. Their Balance Sheet as on 31.03.13 was as follows :

Liabilities		Amount ₹	Assets	Amount ₹
Capital :			Goodwiill	9,000
Shukla	7,000		Stock Debtors	2,000
Grewal	6,500		Cash	11,000
Jain	5,000		Profit and Loss (Dr. Balance) A/c	5,000
Narang	4,000	22,500		3,000
Sundry Creditors		7,500		
		30,000		30,000

On that date Grewal retired and the amount due to him was paid privately by the other partners in their profit sharing ratio. Chakraborty was then admitted as a new partner. The latter paid ₹ 5,000 as capital and ₹ 3,200 as his share of goodwill, his share being 1/5th of the future profits. Shukla, Jain and Narang resolved to share the remaining profits as 3 : 3 : 2. It was also decided that the capitals of Shukla, Jain, Narang and Chakraborty should be made proportionate to their new profit sharing ratio and for this they should bring in or withdraw cash, as necessary.

Show necessary Journal Entries to give effect the above transactions.

Solution:

1. The undistributed loss should be shared by Shukla, Grewal, Jain and Narang (the old partners) in old ratio 4 : 3 : 2 : 1.
2. Grewal retired and the amount due to him was paid privately by the other Partners, Shukla, Jain, Narang in their profit sharing ratio.

3.

(a) For 1/5th share Chakraborty's premium is ₹ 3,200.
Full value of Goodwill = 3,200 × 5/1 = 16,000

(b) Write off Goodwill as per B/S

Shukla's Capital A/c	Dr.	5,143	
Jain's Capital A/c	Dr.	2,571	
Narang's Capital A/c	Dr.	1,286	
To Goodwill A/c			9,000
(Goodwill written off in 4 : 2 : 1)			

Jain & Narang shall also pay to Shukla the only sacrificing partner, in their gaining ratio.
Jain's share = 1/70 × 16,000 = 229
Narang's = 4/70 × 16,000 = 914

Jain's Capital A/c	Dr.	229	
Narang's Capital A/c	Dr.	914	
Cash A/c	Dr.	3,200	
To Shukla's Capital A/c			4,343

(c) New Profit Sharing Ratio
Chakraborty's Share = 1/5
Balance left = 1- 1/5 = 4/5 to be shared in 3:3:2
Shukla's Share = 4/5 × 3/8 = 3/10;
Narang's Share = 4/5 × 2/8 = 2/10;
Jain's Share = 4/5 × 3/8 = 3/10
New Ratio = 3/10 : 3/10 : 2/10 : 2/10 = 3 : 3 : 2 : 2

(d) Sacrifice/Gains = Old Ratio – New Ratio

	Shukla ₹	**Jain** ₹	**Narang** ₹	**Ckakraborty** ₹
Old Ratio [S : J : N = 4 : 2: 1]	4/7	2/7	1/7	-
New Ratio [S : J : N : C]	3/10	3/10	2/10	2/10
Differences	19/70 (Sacrifice)	1/70 (Gain)	4/70 (Gain)	14/70 (Gain)

4. Adjustment of Capital Balances

Particulars	Shukla ₹	Jain ₹	Narang ₹	Chakraborty ₹
Capital as per last Balance Sheet	7,000	5,000	4,000	5,000
Add: Grewal's Capital acquired against private Payment (6,500 – 900) in 4:2:1	3,200	1,600	800	-
Adjustment for goodwill				
- Write off Goodwill as per B/s	(5,143)	(2,571)	(1,286)	-
- Adjustment for goodwill	4,343	(229)	(914)	-
- Share of loss	(1,200)	(600)	(300)	-
Adjusted Capitals	8,200	3,200	2,300	5,000
Therefore, Capital in Profit Sharing Ratio (3:3:2:2)	5,610	5,610	3,740	3,740
	2,590 Excess	2,410 Deficit	1,440 Deficit	1,260 Excess

Journal Entries Dr. Cr.

Date	Particulars	L. F.	Amount ₹	Amount ₹
	Shukla's Capital A/c Dr.		1,200	
	Grewal's Capital A/c Dr.		900	
	Jain's Capital A/c Dr.		600	
	Narang's Capital A/c Dr.		300	
	To Profit & Loss A/c			3,000
	[Unshared loss written off in old ratio 4 : 3 : 2 : 1]			
	Grewal's Capital A/c Dr.		5,600	
	To Shukla's Capital A/c			3,200
	To Jain's Capital A/c			1,600
	To Narang's Capital A/c			800
	[Retiring partners credited to continuing partners in their remaining profit sharing ratio 4 : 2 : 1 on their private payments to the retiring partner]			
	Cash A/c Dr.		5,000	
	To Chakraborti's Capital A/c			5,000
	[Cash brought in by the incoming partner as capital]			
	Shukla's Capital A/c Dr.		2,590	
	Chakraborti's Capital A/c Dr.		1,260	
	To Cash A/c			3,850
	[Out of premium paid by the incoming partner, true premium credited to Shukla for his sole sacrifice, the balance being credited to Chakrabarti himself]			
	Cash A/c Dr.		3,850	
	To Jain's Capital A/c			2,410
	To Narang's Capital A/c			1,440
	[Additional Cash invested to make capitals proportionate to new profit sharing ratio]			

Shukla, Jain, Narang & Chakraborty

Balance Sheet as at 1.4.2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital A/cs :			Stock		2,000
Shukla	5,610		Debtors		11,000
Jain	5,610		Cash [5,000 + 5,000 +		13,200
Narang	3,740		3,200 + 3,850 – 3,850]		
Chakraborty	3,740	18,700			
Creditors		7,500			
		26,200			26,200

Illustration 52.

X,Y and Z are partners sharing profits and losses in the proportion to 3:2:2, respectively. The Balance Sheet of the firm as on 01.01.2013 was as follows:

Liabilities		Amount (₹)	Assets	Amount (₹)
Capital Accounts;			Plant and Machinery	72,000
X	1,00,000		Furniture	28,000
Y	80,000		Stock	1,12,000
Z	70,000	2,50,000	Sundry Debtors	96,000
Bank overdraft		20,000	Cash at Bank	18,000
Sundry Creditors		56,000		
		3,26,000		3,26,000

X retired on 01.01.2013 on which date R is admitted as new partner. For the purpose of adjusting the rights as between on partners' goodwill to be valued at ₹ 84,000 and Sundry Debtors and Stock to be reduced by ₹ 16,000 and to ₹ 1,00,000 respectively. X is to receive ₹ 44,000 in cash on the date of retirement and the balance due to him is to remain as loan at 8% p.a. Repayment of loan to be made at the end of each year by annual installments representing 25% of the future profit before charging interest on loan.

R is to bring in ₹ 1,00,000 in cash as his capital on the date of admission. The new partners are to share profits and losses equally after paying the interest on X's Loan.

The net profit for the year ended 31st December 2013, is ₹ 64,000 before taking into account the installment payable to X.

You are required to show:

(a) Profit and Loss Appropriation Account for the year ended 31st December,2012.

(b) Capital Accounts of the new partners; and

(c) X's Loan Account as on 31st Dec, 2013.

Solution:

In the books of X, Y, Z and R
Revaluation Account

Dr. Cr.

Particulars		Amount (₹)	Particulars	Amount (₹)
To, Provision for Bad Debts		16,000	By, Goodwill	84,000
,, Stock		12,000		
,, Share of Profit:				
- X 3/7	24,000			
- Y 2/7	16,000			
- Z 2/7	16,000	56,000		
		84,000		84,000

Capital Account

Dr. Cr.

Particulars	X (₹)	Y (₹)	Z (₹)	Particulars	X (₹)	Y (₹)	Z (₹)
To, Bank – Repayment	44,000	-	-	By, Balance c/d	1,00,000	80,000	70,000
,, X's Loan A/c	80,000	-	-	,, Revaluation A/c			
,, Balance c/d	-	96,000	86,000	- Profit	24,000	16,000	16,000
	1,24,000	96,000	86,000		1,24,000	96,000	86,000

Profit and Loss Appropriation Account

for the year ended 31.12.2013

Dr. Cr.

Particulars		Amount (₹)	Particulars	Amount (₹)
To, Loan Redemption Fund A/c (25% of ₹ 64,000)		16,000	By, Profit and Loss A/c	
,, Share of Profit:			- Net Profit	64,000
- Y (1/3)	16,000			
- Z (1/3)	16,000			
- R (1/3)	16,000	48,000		
		64,000		64,000

Capital Account

Dr. Cr.

Date	Particulars	Y (₹)	Z (₹)	R (₹)	Date	Particulars	Y (₹)	Z (₹)	R (₹)
31.12.12	To, Balance c/d	1,12,000	1,02,000	1,16,000	1.1.12	By, Balance c/d	96,000	86,000	-
						,, Bank A/c	-	-	1,00,000
					31.12.12	,, Share of profit	16,000	16,000	16,000
		1,12,000	1,02,000	1,16,000			1,12,000	1,02,000	1,16,000
						By, Balance b/d	1,12,000	1,02,000	1,16,000

X's Loan Account (8%)

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2012	To Bank A/c	16,000	2012	By X's Capital A/c	80,000
Dec. 31	To Balance c/d	70,400	Jan. 1	" Interest [80,000 × 8%]	6,400
		86,400			86,400
				By balance c/d	70,400

Illustration 53.

Gita and Mita are equal partners. Gita , by agreement, retires and Lata joins the firm on the basis of one third share of profits on 01.04.2013. The balances of the books as on 31st March 2013 were:

Particulars	Dr. ₹	Cr. ₹
Good will	10,000	
Fixed Assets at Cost	1,20,000	
Current Assets:		
Stock	60,000	
Debtors	40,000	
Bank Balance	8,000	
Creditors		20,000
Provision for Depreciation		12,000
Capital Accounts:		
Gita		1,04,000
Mita		1,02,000
	2,38,000	2,38,000

Goodwill and Fixed Assets valued at ₹ 30,000 and ₹ 1,40,000 respectively and it was agreed to be written up accordingly before admission of Lata as partner. Sufficient money is to be introduced so as to enable Gita to be paid off and leave ₹ 5,000 cash at Bank; Mita and Lata are to provide such sum as to make their Capitals proportionate to their share of profit. Assuming the agreement was carried out, show the journal entries required and prepare the Balance Sheet after admission of Lata.

All working should form part of your answer.

Solution:

I .Capital of the new firm

Particulars	Amount ₹
Good will	30,000
Fixed Asset	1,40,000
Stock	60,000
Debtors	40,000
Cash at Bank	5,000
	2,75,000
Less: Creditors	20,000
	2,55,000

Mita = ₹ 2,55,00 x 2/3 = ₹ 1,70, 000

Lata = ₹ 2,55,000 x 1/3= ₹ 85,000

II.. Amount to be brought in by Mita

Particulars	Amount ₹	Amount ₹
Capital to be maintained		1,70,000
Less: Opening balance	1,02,000	
Profit on Revaluation	26,000	
		1,28,000
To be brought in by Mita		42,000

3. Revaluation Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Capital A/c		By Goodwill A/c	20,000
,, Profit on Revaluation		,, Fixed Assets A/c	20,000
Gita 26,000		,, Prov. For Depreciation A/c.	12,000
Mita 26,000	52,000		
	52,000		52,000

Bank Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	8,000	By Gita's capital A/C	1,30,000
To Mita's capital 42,000		,, Balance c/d	5,000
Lata's Capital 85,000	1,27,000		
	1,35,000		1,35,000

Journal

Date	Particulars		L.F.	Debit ₹	Credit ₹
1.4.13	Goodwill A/c	Dr.		20,000	
	Fixed Asset A/c	Dr.		20,000	
	Prov. for Depreciation A/c	Dr.		12,000	
	To Revaluation A/c				52,000
	(Increased value of assets transferred to Revaluation A/c).				
	Revaluation A/c	Dr.		52,000	
	To Gita' s Capital A/c				26,000
	,, Mita's Capital A/c				26,000
	(Profit on revaluation transferred).				
	Gita's Capital A/c	Dr.		1,30,000	
	To Bank A/c				1,30,000
	(Amount paid to Gita)				
	Bank A/c	Dr.		1,27,000	
	To Mita's Capital A/c				42,000
	,, Lata's Capital A/c				85,000
	(Additional cash to be brought in to make their capital in proportion).				

Balance Sheet
as at April 1, 2013

Liabilities	Amount ₹	Assets	Amount ₹
Capital:		Goodwill	30,000
Mita	1,70,000	Fixed Assets	1,40,000
Lata	85,000	Stock	60,000
Creditor	20,000	Debtors	40,000
		Cash at Bank	5,000
	2,75,000		2,75,000

6.4 DEATH OF PARTNER

If a partner dies, the partnership is usually dissolved. But if the surviving partners desire so, they may purchase the share of the deceased partner and carry on the business. In that case they have to decide (1) the total amount payable to the legal representative or executor of the deceased partner and (2) the mode of such payment.

Total Amount Payable includes:

(i) The deceased partner's Capital and / Current Accounts last Balance.

(ii) His share of undistributed profit/loss.

(iii) His share of revaluation profit/loss

(iv) His share of goodwill.

(v) His share of Joint Life Policy, if any and

(vi) His share of profit/loss made by the firm between the last year ending and the date of his death.

The accounting procedure involved is similar to that followed in case of retirement of a partner. The mode of payment depends on the agreement between the partners. It may be :

(i) **Lump Sum Payment :** If the firm has sufficient funds, the total amount payable on account of the deceased partner is transferred to his Representative's Account (or Executor). Such Representative's Account is debited and Bank Account is credited on payment of the dues.

(ii) **Instalment Payment/Loan Payment :** The firm may not have enough funds to make prompt payment. In such a case, the total amount payable is transferred to a loan account in the name of the legal representative or executor. The loan is paid off gradually by installments after considering interest on unpaid balance. The word "Loan" may or may not be appended with the Account. But its gradual payment will definitely resemble the payment of loan.

Joint Life Policy and its Treatment

The partners of a firm may have a Joint Life Policy covering the lives of all the partners. It helps to realize money from the Insurance company in case of death of a partner. The dues of the deceased partner can be paid off without affecting the working capital of the firm.

The policy matures when a partner dies. The money realized from the Insurance Company is distributed among all the partners, including the deceased partner. The accounting entries made are stated below:

1. **If Premium paid is treated as a revenue expense of the firm :** The Premium is charged to Profit & loss Account which reduces the divisible profits. The amount paid by the Insurance Company in case of death of a partner or on surrender of the Policy is shared by all the partners (including the deceased partner) in their profit sharing ratio.

1. If premium paid is treated as an expense

Journal Entries :

(a) Premium Paid

Joint Life Insurance Premium A/c Dr.

To Bank A/c (amount of the Premium)

(b) For charging premium as expense

P & L A/c Dr.

To J.L.P. Premium A/c

(c) Amount Realised from Insurance Company

Bank A/c Dr.

To Joint life Policies A/c (in profit sharing ratio)

(d) For sharing the surplus of Joint Life Policy

Joint Life Policy A/c Dr.

To All partners Capital A/c

2. If premium is treated as a capital expenditure (Joint Life Policy Method) :

Here the premium is debited to Life Policy Account. At the end of the accounting period, the book value of the Life Policy [Opening Balance of Joint Life Policy + Current year's premium] is adjusted to its surrender value [amount receivable in case the Policy is surrendered before maturity]. Under this method the Policy appears on the Asset side at its surrender value.

Journal Entries :

(a) Premium Paid

Joint Life Policy A/c Dr.

To Bank A/c (amount of Premium)

(b) At the end of the year :

Profit & Loss A/c Dr.

To Joint Life Policy

(Difference between Book value and surrender value).

(c) Policy Money Realised

Bank A/c Dr.

To Joint Life Policy A/c (amount received)

(d) Transfer of Credit Balance of Joint Life Policy A/c

Joint Life Policy A/c Dr.

To All Partners Capital A/c's (in their profit sharing ratio)

3. Joint Life Policy Reserve Method

Journal Entries :

(a) Premium Paid

Joint Life Policy A/c Dr.

To Bank Ac/ (amount of premium)

(b) At the end of the year :

Joint life Policy Reserve A/c Dr.

To Joint Life Policy A/c

(Excess of surrender value over book value)

(c) Transferring from J.L.P. Reserve to P&L A/c

Profit & Loss A/c Dr.

To Joint Life Policy Reserve A/c

Adjusting the difference between premium paid and the increase in surrender value

(d) Recording the receipt of Policy money

Bank A/c Dr.

To Joint Life Policy A/c

(e) Transferring the balance of the Reserve A/c

Joint Life Policy Reserve A/c Dr.

To Joint Life Policy A/c

(f) Distributing the Life Policy among partners

Joint Life Policy A/c Dr.

To All Partners Capital A/cs (Old ratio)

Illustration 54.

X, Y and Z are partners sharing profits and losses in the ratio of 2 : 1 : 1. They took out a joint life policy of ₹ 1,20,000 on 1.1.2009, for the purpose of providing fund for repayment of their share of capital and goodwill in the event of death. The annual premium of ₹ 5,000 was payable on 1st February every year and last premium was paid on 1st February, 2012. Y died on 10th March, 2012 and policy money was received on 30th April 2012. The surrender value of the policy as on 31st December each year were : 2009 - Nil; 2010- ₹ 1,000; 2011- ₹ 1,600.

Show the necessary accounts and Balance Sheet assuming :

(i) that the insurance premium is charged every year to the Profit and Loss Account of the firm as business expenses;

(ii) that the insurance premium is debited to Joint Life Policy Account but an adjustment is made through the Profit and Loss Account each year to bring the policy to its surrender value; and

(iii) that a sum equal to the annual insurance premium is charged to Profit and Loss Appropriation Account each year and credited to Joint Life Policy Reserve Account through which the adjustment is made to bring the policy to its surrender value.

Solution :

Under Method (i) When premium paid is treated as an expense

In the book of X, Y and Z

Joint Life Policy Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2009 Feb, 1	To, Bank A/c (premium paid)	5,000	2009 Mar, 31	By, Profit and Loss A/c	5,000
		5,000			**5,000**
2010 Feb, 1	To, Bank A/c (premium paid)	5,000	2010 Mar, 31	By, Profit and Loss A/c	5,000
		5,000			**5,000**
2011 Feb, 1	To, Bank A/c (premium paid)	5,000	2011 Mar, 31	By, Profit and Loss A/c	5,000
		5,000			**5,000**
2012 Feb,1	To, Bank A/c (premium paid)	5,000	2012 Mar,31	By, Profit and Loss A/c	5,000
		5,000			**5,000**
2012 Apr,30	To, Partners' Capital - X 60,000 - Y 30,000 - Z 30,000	1,20,000	2012 Apr,30	By, Bank A/c (Insurance money recd)	1,20,000
		1,20,000			**1,20,000**

Under Method (ii) When premium paid is treated as an assets

Dr. **Joint Life Policy Account** *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2009 Feb. 1	To Bank A/c — Premium paid	5,000	2009 Dec. 31	By Profit and Loss A/c By Balance c/d	5,000 Nil
		5,000			5,000
2010 Feb. 1	To Balance b/d To Bank A/c — Premium paid	Nil 5,000	2010 Dec. 31	By Profit & Loss A/c " Balance c/d	4,000 1,000
		5,000			5,000
2011 Jan. 1 Feb. 1	To Balance b/d To Bank A/c — Premium paid	1,000 5,000	2011 Dec. 31	By Profit & Loss A/c " Balance c/d	4,400 1,600
		6,000			6,000
2012 Jan. 1 Feb. 1 April 30	To Balance b/d " Bank A/c — Premium paid " Capital A/c — Transferred X (2/4) 56,700 Y (1/4) 28,350 Z (1/4) 28,350	1,600 5,000 1,13,400	2012 April 30	By Bank A/c — Policy money received	1,20,000
		1,20,000			1,20,000

Under Method (iii) J.L.P. Reserve account is maintained

Joint Life Policy

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2009 Feb. 1	To Bank A/c — Premium paid	5,000	2009 Dec,31	By, Joint Life policy Reserve A/c	5,000
		5,000			**5,000**
2010 Feb, 1	To Bank A/c — Premium paid	5,000	2010 Dec,31 ,,	By, Joint Life policy Reserve A/c By, Balanced c/d (SV)	4,000 1,000
		5,000			**5,000**
2011 Jan, 1 Feb, 1	To, Balance b/d To, Bank A/c — Premium paid	1,000 5,000	2011 Dec,31 ,,	By, Joint Life policy Reserve A/c By, Balanced c/d (SV)	4,400 1,600
		6,000			**6,000**

2012			2012		
Jan, 1	To, Balance b/d	1,600	Dec,31	By, Bank A/c (Insurance money recd)	1,20,000
Feb, 1	To, Bank A/c — Premium paid	5,000			
Apr,30	To, Joint Life Policy Reserve	1,13,400			
		1,20,000			**1,20,000**

Joint Life Policy Reserve Account

Dr. **Cr.**

Date	**Particulars**	**Amount (₹)**	**Date**	**Particulars**	**Amount (₹)**
2009			2009		
Dec,31	To Joint Life Policy A/c	5,000	Dec,31	By, Profit and Loss A/c	5,000
Dec,31	To, Balance c/d	Nil			
		5,000			**5,000**
2010			2010		
Dec,31	To Joint Life Policy A/c	4,000	Jan,1	To, Balance b/d	Nil
Dec,31	To, Balanced c/d (SV)	1,000	Dec,31	By, Profit and Loss A/c	5,000
		5,000			**5,000**
2011			2011		
Dec,31	To Joint Life Policy A/c	4,400	Jan,1	To, Balance b/d	1,000
Dec,31	To, Balanced c/d (SV)	1,600	Dec,31	By, Profit and Loss A/c	5,000
		6,000			**6,000**
2012			2012		
Apr,30	To, Partners' Capital - X 57,500 - Y 28,750 - Z 28,750	1,15,000	Jan,1 Dec,31	To, Balance b/d By, Joint Life policy A/c	1,600 1,13,400
		1,15000			**1,15,000**

Illustration 55.

The following was the Balance Sheet of A, B and C who shared profits in the ratio of 1 : 2 : 2 as on 31st December, 2012.

Sundry Creditors	10,000	Goodwill	15,000
Capital A/c :		Debtors	10,000
A 10,000		Machinery	20,000
B 20,000		Buildings	30,000
C 20,000	50,000	Stock	10,000
General Reserve	5,000	Cash at Bank	5,000
Investment Fluctuation Fund	3,000	Investments	10,000
Bad Debts Reserve	2,000		
Bank Loan	30,000		
	1,00,000		1,00,000

C died on 31st March, 2013. His account is to be settled under the following terms :

Goodwill is to be calculated at the rate of 2 years purchase on the basis of the average of 5 years profit or loss. Profit for January to March' 13 is to be calculated proportionately on the average profit of 3 years. The profits were : 2008 ₹ 3,000, 2009 ₹ 7,000, 2010 ₹ 10,000, 2011 ₹ 14,000, 2012 loss ₹ 12,000. During 2012 a Moped costing ₹ 4,000 was purchased and debited to Travelling Expenses Account on which depreciation is to be calculated @ 25%. Other values agreed on assets are : Stock ₹ 12,000, Building ₹35,000, Machinery ₹ 25,000 and Investments ₹ 8,000. Debtors are considered good.

Prepare new Balance Sheet of the firm, necessary Journal entries and Ledger Accounts of the Partners.

Solution:

Working Notes :

1. **Adjusted profit for 2012**

Loss			(12,000)
Add : Cost of Moped			
Wrongly treated as Travelling Expense		4,000	
Less : Depreciation not charged on Moped @25%			
on ₹ 4,000	(1,000)		
Adjusted Loss	(9,000)		

2. **Valuation of Goodwill**

Total Profit/Loss for the last 5 years = 3,000 + 7,000 + 10,000 + 14,000 – 9,000 = ₹ 25,000

Average Profit = ₹ 25,000/5 = ₹ 5,000; Goodwill = 2 × ₹ 5,000 = ₹ 10,000

But Goodwill is appearing at Balance Sheet at ₹ 15,000. Over valuation of Goodwill ₹ 5,000 should be written off among A, B & C as 1 : 2 : 2.

The balance of Goodwill between A & B in the ratio 1 : 2

3. Share of Profit of Deceased Partner till his date of death

Average Profit of the last 3 years [2010, 2011 & 2012] = (10,000 + 14,000 – 9,000)/3 = ₹ 5,000

Estimated Profit for 3 months [Jan to March, '13] = ₹ 5,000 × 3/12 = ₹ 1,250

C's share of profit = ₹ 1,250 × 2/5 = ₹ 500

Solution :

Books of A, B & C

Journal Entries

Date	Particulars	L. F.	Dr. Amount ₹	Cr. Amount ₹
	Stock A/c Dr.		2,000	
	Buildings A/c Dr.		5,000	
	Machinery A/c Dr.		5,000	
	Moped A/c [4,000 – Depr. 1,000] Dr.		3,000	
	To Revaluation A/c			15,000
	[Values of assets increased on revaluation]			
	General Reserve A/c Dr.		5,000	
	Investment Fluctuation Fund A/c Dr.		3,000	
	Bad Debts Reserve A/c Dr.		2,000	
	To A's Capital A/c			2,000
	To B's Capital A/c			4,000
	To C's Capital A/c			4,000
	[Transfer of Reserves etc. to Partners Capitals in 1 : 2 : 2]			
	Revaluation A/c Dr.		2,000	
	To Investment A/c			2,000
	[Value of investments reduced]			
	Revaluation A/c Dr.		13,000	
	To A's Capital A/c			2,600
	To B's Capital A/c			5,200
	To C's Capital A/c			5,200
	(Being profit on revaluation shared in 1 : 2 : 2)			
	A's Capital A/c Dr.		1,000	
	B's Capital A/c Dr.		2,000	
	C's Capital A/c Dr.		2,000	
	To Goodwill A/c			5,000
	[Value of Goodwill reduced]			
	Profit & Loss Suspense A/c Dr.		500	
	To C's Capital A/c			500
	[Estimated share of Profit till his date of death transferred to the decreased partner's Capital]			
	C's Capital A/c Dr.		27,700	
	To C's Executors A/c			27,700
	[Total dues to the deceased partner transferred to his Executor's A/c]			

Dr.						Capital Accounts			Cr.
Date 2011	**Particulars**	**A ₹**	**B ₹**	**C ₹**	**Date 2011**	**Particulars**	**A ₹**	**B ₹**	**C ₹**
31.3	To Goodwill A/c	1,000	2,000	2,000	31.3	By Balance b/d	10,000	20,000	20,000
	To Goodwill A/c	3,333	6,667	-		" Revaluation A/c	2,600	5,200	5,200
	To C's Executors A/c (Balance transferred)			27,700		" Sundry Reserves A/c	2,000	4,000	4,000
	To Balance c/d	10,267	20,533	-		" P & L Suspense A/c	-	-	500
		14,600	29,200	29,700			14,600	29,200	29,700

A and B
Balance Sheet as at 31.3.2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital A/cs :			Buildings		35,000
A	10,267		Machinery		25,000
B	20,533	30,800	Moped		3,000
C's Executor's A/c		27,700	(cost less depreciation)		
Bank Loan		30,000	Investments		8,000
Sundry Creditors		10,000	Stock		12,000
			Debtors		10,000
			Bank		5,000
			Profit & Loss Suspense A/c (Dr.)		500
		98,500			98,500

Illustration 56.

A and B entered into partnership on 1.1.2010 agreeing to share profits and losses as 2 : 1. On that date they introduced capital : A ₹ 90,000 and B ₹ 30,000. They effected a policy of Insurance for ₹ 30,000 of their joint lives. The net profits before charging interests on capitals as at the beginning of each year at 6% per annum and on drawings averaged at 4% per annum were as follows :

Year	Net Profits ₹	A's Drawings ₹	B's Drawings ₹
2010	34,800	10,000	5,000
2011	37,600	12,000	7,000
2012	38,000	14,000	7,500

The annual insurance premium ₹ 3,000 was being charged to Profit & Loss Account as a business expense.

A died on 31st March, 2013. According to the terms of the Partnership Deed, the deceased partner's executors became entitled to receive his share of capital as it stood on 31st December, 2012 plus his share of profits for the three months calculated upon the previous year's rate of profit and share of goodwill which was calculated as 2/3rds of the previous three years profits after adjusting for interest on capital and drawings but without deducting the premium paid on Joint Life Policy.

Show the amounts payable to the Executors of A.

Solution:

Working Notes :

1. Adjustment of Profits

Particulars	2010 ₹	2011 ₹	2012 ₹
Profits before adjusting interests	34,800	37,600	38,000
Add : Interest on Drawings @ 4% p.a.	600	760	860
[4% of total drawings of A & B for every year]			
	35,400	38,360	38,860
Less : Interest on Capital [see working Note 2 below]	7,200	8,388	9,504
Profits after adjustments	28,200	29,972	29,356
A's Share [2/3]	18,800	19,981	19,571
B's Share [1/3]	9,400	9,991	9,785

2. Adjustment of Capitals

Particulars	Total ₹	A ₹	B ₹
Capital on 1.1.2010	1,20,000	90,000	30,000
Add : Interest on Capital @ 6% p.a.	7,200	5,400	1,800
Add : Share of Profits [Note 1]	28,200	18,800	9,400
Less : Drawings	15,000	10,000	5,000
Less : Interest on Drawings @ 4%	600	400	200
Capital on 1.1.11	1,39,800	1,03,800	36,000
Add : Interest on Capital @ 6% p.a.	8,388	6,228	2,160
Add : Share of Profits [Note 1]	29,972	19,981	9,991
Less : Drawings	19,000	12,000	7,000
Less : Interest on Drawings	760	480	280
Capitals on 1.1.12	1,58,400	1,17,529	40,871
Add : Interest on Capital @ 6% p.a.	9,504	7,052	2,452
Add : Share of Profits [Note 1]	29,356	19,571	9,785
Less : Drawings	21,500	14,000	7,500
Less : Interest on Drawings @ 4%	860	560	300
Capital as on 1.1.13	1,74,900	1,29,592	45,308

3. **Valuation of Goodwill**

Total Profits after adjustments for Interest [Note 1]

Particulars	₹	₹
2010	28,200	
2011	29,972	
2012	29,356	87,528
Added Back : Insurance Premium for 3 years [3 × 3,000]		9,000
		96,528

Average Annual Profits before charging insurance premium = 96,528/3 = 32,176

Goodwill = 32,176 × 2 = 64,352; A's share = 2/3 × 64,352 = ₹ 42,901

4. Profits between 1.1.13 and 31.3.13

Profits for 2012 after interest = ₹ 29,356

Average Profits for 3 months = 29,356 × 3/12 = 7,339, A's share = 2/3 × 7,339 = ₹ 4,893

Dr. **Executor of A's Account** ***Cr.***

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.3.13	To Balance c/d	1,99,930	31.3.13	By A's Capital A/c	1,29,592
				By P & L Suspense A/c	
				Interest on Capital	1,944
				[1,29,000 × 6% × 3/12]	4,893
				Share of Profits	42,901
				By Goodwill	20,000
				By Joint Life Policy A/c	
		1,99,330			1,99,330

Illustration 57.

Peter, Paul and Prince were partners sharing profit and losses in the ratio 2 : 1 : 1. It was provided in the partnership deed that in the event of retirement/death of a partner he/his legal representatives would be paid :

(i) The balance in the Capital Account.

(ii) His share of Goodwill of the firm valued at two years purchase of normal average profits (after charging interest on fixed capital) for the last three years to 31st December preceding the retirement or death.

(iii) His share of profits from the beginning of the accounting year to the date of retirement or death, which shall be taken on proportionate basis of profits of the previous year as increased by 25%.

(iv) Interest on Fixed Capital at 10% p.a. though payable to the partners, but not payable in the year of death or retirement.

(v) All the assets are to be revalued on the date of retirement or death and the profit and loss be debited/credited to the Capital Accounts in the profit sharing ratio.

Peter died on 30th September, 2013. The books of Account are closed on calendar year basis from 1st January to 31st December.

The balance in the Fixed Capital Accounts as on 1st January, 2013 were Peter – ₹ 10,000; Paul – ₹50,000 and Prince – ₹ 50,000. The balance in the Current Accounts as on 1st January, 2013 were Peter– ₹ 20,000; Paul – ₹10,000 and Prince – ₹7,000, Drawings of Peter till 30th September, 2012 were ₹10,000.

The Profits of the firm before charging interest on capital for the calendar years 2010, 2011 and 2012 were ₹ 1,00,000; ₹ 1,20,000 and ₹ 1,50,000 respectively. The profits include the following abnormal items of credit :

	2010	2011	2012
Profit on Sale of Assets	₹ 5,000	₹ 7,000	₹ 10,000
Insurance claim received	₹ 3,000	—	₹ 12,000

The firm has taken out a Joint Life Policy for ₹ 1,00,000. Besides the partners had severally insured their lives for ₹ 50,000 each, the premium in respect thereof being charged to the Profit and Loss Account.

The surrender value of the Policies were 30% of the face value. On 30th June, 2013 the firm received notice from the insurance company that the insurance premium in respect of a fire policy had been undercharged to the extent of ₹ 6,000 in the year 2012 and the firm has to pay immediately. The revaluation of the assets indicate an upward revision in value of assets to the extent of ₹ 20,000. Prepare an account showing the amount due to Peter's legal representatives as on 30th September, 2013 along with necessary working.

Solution:

Working Notes :

1. **Peter's share of Profit on Revaluation**

Profit on Revaluation = Upward revision in values of assets = ₹ 20,000.

Peter's share = $\frac{2}{4}$ of 20,000 = ₹**10,000** (to be transferred to Capital A/c as said in the problem)

2. **Peter's share of Profits between 1.1.2013 and 30.09. 2013 (date of his death)**

	₹	₹
Profits (as reported) for 2012		1,50,000
Less: (a) Interest on capital @ 10% p.a. to the surviving partners		
[Not to Peter in the year of his death] @ 10% of 10,000	1,000	
(b) Undercharged insurance premium	6,000	7,000
		1,43,000
Add: 25% increase on 1,43,000		35,750
Expected Annual Profits for 2013		1,78,750

∴ Profits up to 30.09.13 = $\frac{9}{12}$ of 1,78,750 = ₹ 1,34,062 (approx) ∴ Peter's Share = $\frac{2}{4}$ of 1,34,062 = 67,031

3. **Peter's Share of Life Policy**

	₹
Value of Joint Life Policy taken by the firm	1,00,000
Value of Peter's own Life Policy [Matured]	50,000
Surrender values of Life Policies of other two partners [2 x 30% of ₹ 50,000]	30,000
Total Value	1,80,000

Peter's Share = $\frac{2}{4}$ of 1,80,000 = ₹ 90,000

4. **Undercharged Insurance Premium =** ₹ 6,000; to be borne by Peter = $\frac{2}{4}$ of 6,000 = ₹ 3,000

5. **Valuation of Goodwill and Peter's share thereof**

	2010 ₹	2011 ₹	2012 ₹
Reported Profits	1,00,000	1,20,000	1,50,000
Less: (a) Interest on capital 10% of ₹ 20,000	- 2,000	- 2,000	- 2,000
(b) Abnormal credit for Profit on sale of assets	- 5,000	- 7,000	- 10,000
(c) Abnormal credit for insurance claim received	- 3,000	—	- 12,000
(d) Undercharged insurance			- 6,000
	90,000	1,11,000	1,20,000

∴ Average Profits = $\frac{1}{3}$ of (90,000 + 1,11,000 + 1,20,000) = ₹ 1,07,000

Goodwill = 2 x ₹ 1,07,000 = ₹ 2,14,000; Peter's share thereof = $\frac{2}{4}$ of ₹ 2,14,000 = ₹ 1,07,000.

6.

Peter's Current Account

Dr. *Cr.*

Date	Particulars	₹	Date	Particulars	₹
30.9.13	To Drawings	10,000	1.1.13	By Balance b/f	20,000
	" Insurance (Note 4)	3,000	30.9.13	" Goodwill [Note 5]	1,07,000
	" Legal Representative's A/c	2,71,031		" Life Policy [Note3]	90,000
	(Balance transferred)			" Share of Profit [Note 2]	67,031
		2,84,031			2,84,031

Peter's Capital Account

Dr. *Cr.*

Date	Particulars	₹	Date	Particulars	₹
30.9.13	To Balance c/f	20,000	30.9.13	By Balance b/d	10,000
				" Profit on Revaluation A/c	10,000
		20,000			20,000

Peter's Legal Representative Account

Dr. *Cr.*

Date	Particulars	₹	Date	Particulars	₹
30.9.13	To Balance c/f	2,91,031	30.9.13	By Peter's Capital A/c	20,000
				" Peter's Current A/c	2,71,031
		2,91,031			2,91,031

Illustration 58.

Firm ABC consisted of 3 partners, A, B and C sharing profits and losses in the ratio 5 : 3 : 2, respectively. The partner A died on February 20, 2013, Profit and Loss Account for the period up to date of death and Balance Sheet as on that date were prepared. The Balance Sheet as on that date was as below :

Balance Sheet

Liabilities	₹	₹	Assets	₹
Capital Accounts :			Goodwill	6,000
A	12,000		Machinery	35,000
B	16,000		Furniture	6,000
C	12,000		Stock	9,000
		40,000	Debtors	15,000
Loan from A		5,000	Bank	3,000
General Reserve		7,000		
Creditors		22,000		
		74,000		74,000

In addition to the assets shown above, the firm had 3 life policies in the name of each partner, for insured value of ₹ 20,000 each, the premium of which were charged to Profit and Loss Account.

According to the partnership deed, on death of partner, the assets and liabilities are to be revalued by a valuer. There valued figures were :

(1) Goodwill ₹ 21,000; Machinery ₹ 45,000; Debtors are subject to a provision for doubtful debts at 10% and Furniture at ₹ 7,000.

(2) Provision for taxation to be created for ₹ 1,500.

(3) Death-claim for policy in the name of A will be realised in full and the surrender values of the other 2 policies were ₹ 7,500 each.

The business will be continued by B and C, henceforth sharing profits and losses equally. The net balance due to A is transferred to a Loan Account, which will be paid off later.

Show Capital Account, Revaluation Account and the new Balance Sheet of the firm.

Solution :

In the books of A, B and C

Dr. **Revaluation Account** **Cr.**

Particulars	₹	₹	Particulars	₹
To Reserve for Bad Debts		1,500	By Goodwill	15,000
" Provision for Taxation		1,500	" Machinery	10,000
" Profit on Revaluation :			" Furniture	1,000
A 5/10	11,500			
B 3/10	6,900			
C 2/10	4,600			
		23,000		
		26,000		26,000

Dr. **Capital Account** Cr.

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To Loan from A's estate	49,500	—	—	By Balance b/d	12,000	16,000	12,000
" Balance c/d	—	35,500	25,000	" Revaluation A/c — Profit	11,500	6,900	4,600
				" General Reserve	3,500	2,100	1,400
				" Insurance Claim A/c			
				" Loan	17,500	10,500	7,000
				By Balance b/d	5,000	—	—
	49,500	35,500	25,000		49,500	35,500	25,000
					—	35,500	25,000

Dr. **Insurance Claim Account** Cr.

Particulars ₹	₹	Particulars	₹
To Capital Accounts : (5:3:2)		By Bank :	
A 17,500		Claim of A's policy	20,000
B 10,500		Surrender of B and C's Policy	15,000
C 7,000	35,000	(7,500 × 2)	
	35,000		35,000

Balance Sheet

as at ....

Liabilities	₹	₹	Assets	₹	₹
Capital Accounts :			Goodwill		21,000
B	35,500		Machinery		45,000
C	25,000	60,500	Furniture		7,000
			Stock		9,000
Loan from A's Estate		49,500	Debtors	15,000	
Creditors		22,000	Less : Reserve for Bad Debts	1,500	13,500
Provision for Taxation		1,500	Bank (3,000 + 35,000)		38,000
		1,33,500			1,33,500

Illustration 59.

Ravindra Singh, Sundaram and Telewani were partners sharing profits and losses in the proportion of 1/2, 1/3 and 1/6 respectively. Telewani expired on 31st May, 2013.

Partnership agreement provided that :

(a) Interest on fixed capital to be allowed at 12% p.a.

(b) Telewani to be credited with salary of ₹ 18,000 p.a.

(c) On the death of any of the partners, his heir will receive in addition to balance in the fixed, capital and current account :

(i) Salary and interest on capital.

(ii) Share of proportionate profit from last Balance Sheet to the date of death based on annual average profits of last 3 years (after interest on capital and salary to partner).

(iii) Share of goodwill calculated at twice the average profits of last 3 years (before interest on capital and salary to partner).

(iv) Share of profit on joint assurance policy.

Following further information is available :

(A) Fixed capitals on 31.3.2013 : ₹

	₹
Ravindra Singh	3,00,000
Sundaram	2,00,000
Telewani	1,00,000

B) Current Accounts (credit) on 31.3.2013 : ₹

	₹
Ravindra Singh	50,000
Sundaram	10,000
Telewani	20,000

(C) Joint Life Policy 1,00,000

(D) There is no change in capital and current accounts since 31.3.2013

(E) Joint Life Policy realised ₹ 1,50,000 (on 15.6.2013 amount due to Telewani paid on receipt of policy amount).

(F) Profits (before interest and salary) were : ₹

	₹
2012-13	1,24,000
2011-12	1,20,000
2010-2011	80,000
2009-2010	1,30,000

(G) The Firm closes its books on 31st March, Ravindra Singh and Sundaram decided to continue the firm and raise goodwill.

Show the following accounts in the books of the firm relating to the above transactions :

(a) Current Accounts of Partners,

(b) Profit & Loss Adjustment A/c, and

(c) Heir of Telewani's Loan A/c.

Solution :

Workings :

Valuation of goodwill and Telewani's share thereon :

		₹
Profit for	2012-13	1,24,000
	2011-12	1,20,000
	2010-11	80,000
		3,24,000

$\therefore$ Average profit = $\frac{₹\ 3,24,000}{3}$ = ₹ 1,08,000.

And, value of goodwill = ₹ 1,08,000 × 2 = ₹ 2,16,000.

Telewani's share of goodwill = ₹ 2,16,000 x 1/6 = 36,000.

The entry for the purpose will be :

Ravindra's Current A/c	Dr.	21,600	
Sundaram's Current A/c	Dr.	14,400	
To Telewani's Current A/c			36,000

Calculation of profit to be credited to Telewani's Current Account

Average profit (from the above) ₹ 1,08,000

$\therefore$ Propoortionate profits for 2 months = ₹ 1,08,000 × 2/12 = ₹18,000

Now,

		₹
Proportionate profit for 2 months (before charging interest on Capital and Salary)		18,000
Less : Interest on Capital		
	₹	
Ravinder	6,000(3,00,000 X 12/100 X 2/12)	
Sundaram	4,000(2,00,000 X 12/100 X 2/12)	
Telewani	2,000(1,00,000 X 12/100 X 2/12)	
	12,000	
Partner's Salary : Telewani 1,500 x 2 =	3,000	
		15,000
		3,000

Telewani's share = ₹ 3,000 x 1/6 = ₹ 500.

Dr. Profit and Loss Adjustment Account Cr.

Particulars	₹	₹	Particulars	₹
To Current Accounts :			By Joint Life Policy Profit	50,000
Ravinder	25,000		(1,50,000 – 1,00,000)	
Sudaram	16,667			
Telewani	8,333	50,000		
		50,000		50,000
To Telewani's Current A/c			By Balance c/d	15,500
Profit	500			
Salary	3,000			
Interest	2,000	5,500		
To Ravinder's Current A/c Interest		6,000		
To Sundaram's Current A/c Interest		4,000		
		15,500		15,500

Dr. Current Account Cr.

Particulars	Ravinder ₹	Sundaram ₹	Telewani ₹	Particulars	Ravinder ₹	Sundaram ₹	Telewani ₹
To Telewani Current A/c	21,600	14,400	—	By Balance b/d	50,000	10,000	20,000
" Executor of Telewani's Loan A/c	—	—	69,833	" P & L Adj. A/c (J.L.P.)	25,000	16,667	8,333
" Balance c/d	59,400	16,267	—	" Ravinder's Current A/c	—	—	21,600
				" Sundaram's Current A/c	—	—	14,400
				" P & L Adj. A/c			
				Profit	—	—	500
				Salary	—	—	3,000
				Interest	6,000	4,000	2,000
	81,000	30,667	69,833		81,000	30,667	69,833

Dr. Executor of Telewani's Loan Account Cr.

Particulars	₹	Particulars	₹
To Bank A/c	1,69,833	By Telewani's Capital A/c	1,00,000
		" Telewani's Current A/c	69,833
	1,69,833		1,69,833

6.5 DISSOLUTION OF A PARTNERSHIP FIRM

Whenever a reconstitution takes place within a Partnership in the form of admission, retirement or death of a Partner, the existing partnership is dissolved. The Partnership firm, may however, continue, if the remaining partners desire so.

But if the partnership firm is discontinued for any reason, that is called Dissolution of the firm. Dissolution of Firm – when does it take place [in accordance with the Indian Partnership Act of 1932]

1. By Mutual consent of all the partners or in accordance with a contract made by them [Section 40]

2. By Notice – given in writing, by any partner to all other partners if the Partnership is at will [Section 43].

3. On the happening of any one of the following events : [Section 42] : (i) expiry of the term, where the Partnership was constituted for a fixed term; (ii) completion of the adventure for which the firm was constituted; (iii) Death of a partner, (iv) Adjudication of a Partner as insolvent.

4. Compulsory Dissolution [Section 41]

   (i) Where all the partners or all but one are adjudged insolvent.

   (ii) If any event occurs making it unlawful for the business of the firm to be carried on.

5. Dissolution by Court: According to Section 44 of the Indian Partnership Act the court, at the suit of a partner, may dissolve a firm on any one of the grounds namely –

   (i) insanity of a partner;

   (ii) permanent incapability of a partner to do his duties;

   (iii) if a partner is guilty of misconduct that might affect prejudicially the carrying on of the business;

   (iv) If a partner willfully or persistently commits breach of agreement;

   (v) If a partner transfers all his shares to a third party or has allowed his share to be charged under the Provisions of Rule 49 of order XXI of the First Schedule to the Code of Civil Procedure, 1908;

   (vi) If the court considers that the business cannot be carried on except at loss;

   (vii) On any other ground on which the court considers the dissolution as just and equitable.

Settlement of Accounts on Dissolution

According to Section 48 of the Indian Partnership Act the following rules should be observed for settlement of Accounts after dissolution, subject to agreement by partners :

(a) **Regarding Losses :** "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". [Section 48(1)]

(b) **Regarding Assets :** "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 each partner ratably what is due to him from the firm for advances as distinguished from capital;

(iii) In paying to each partner ratably what is due to him as capital; and

(iv) The residue, if any, shall be divided among the partners in the proportions in which they are entitled to share profits." [Section 48(2)]

Accounting Entries Regarding Dissolution

The two separate aspects of Dissolution for which accounting entries have to be made are:

[A] Realization of Assets and Payment of liabilities and [B] Settlement of the dues of the Partners,

[A] Realization of Assets and Payment of liabilities

(i) Prepare Realisation Account

(ii) Trausfer all assets (except cash, bank & fictitious assets) and liabilities at book values to Realisation Account.

Journal Entries

Item/Purpose	Entry	Special Points to be noted
1. Transfer of book values of assets as recorded in the Balance Sheet	Realization A/c .... Dr. To Sundry Assets [Book value] (including goodwill if any, shown in the Balance Sheet) Realization A/c .... Dr. To Debtors A/c Provision for Bad Debts A/c .... Dr. To Realization A/c.	(a) Cash or Bank A/c are not to be credited unless the firm, as a whole, is sold out as a going concern. (b) Debit balance of any Cap. A/c etc. or Debit balance of P/L A/c not to be transferred to Realization A/c. (c) If there is any Provision for bad Debts, debit Realization A/c and credit Debtors A/c with gross figure. Then debit Provision A/c and credit Realization A/c. Same treatment for Provision for Depreciation.
2. Realization/Sale of above assets	Cash/Bank A/c (amt. realized) .. Dr. OR Partners Cap. A/c .... Dr. (agreed value at which a partner takes over an asset/assets) To Realization A/c.	
3. Shares etc. received as purchase consideration	in exchange of the firm's assets. Shares A/c.................................... Dr. To Realization A/c. (agreed value)	

4. Closing the External liabilities	External Liabilities A/c .... Dr. (such as creditors, outstanding expenses, Bank Loan etc.) To Realization A/c. (book value)	(a) Alternatively – this entry may be passed (combining 4,5 & 6) Liability A/c ……. Dr. To Bank A/c (actual amt. paid) OR, To Partners Cap. A/c (agreed value) To Realization A/c (Discount, if any received on payment/ discharge) (b) Where assets and liabilities are taken over by another business on making some lump sum payment, separate entries for realization of assets and / payment of liabilities need not be made.
5. External liabilities paid off	Realization A/c. .... Dr. To Cash/Bank A/c (actual amt. paid)	
6. External liabilities taken over by any partner	Realization A/c. .... Dr. To Particular Partner's Cap. A/c (agreed value)	
7. Unrecorded asset sold or taken over by any partner	Cash / Bank A/c .... Dr. Partners Capital A/c .... Dr. To Realisation A/c	
8. If any unrecorded liability is paid.	Realization A/c .... Dr. To Cash/Bank A/c (actual amt.)	
9. If shares etc. received and shown in (3) above are sold out or transferred to partners.	Cash/Bank A/c .... Dr. OR, Partners Cap. A/c .... Dr. [excluding insolvent partner] To shares A/c	For sale, there may be profit or loss on sale which is transferred to Realization A/c.
10. Payment of Expenses of Realization.	Realization A/c .... Dr. To Cash/Bank A/c (if paid by the firm) OR To Partners Cap. A/c (if paid by any partner)	If a partner bears such expenses personally in pursuance of a separate agreement – NO ENTRY is required.
11. Balance of Realization Account representing Profit or Loss on Realization.	Realization A/c. .... Dr. To Partners Cap. A/c (Profit shared in Profit Sharing Ratio) OR, Partner's Cap. A/c .... Dr. To Realization A/c. (Loss shared in Profit Sharing Ratio)	

[B] Settlement of Partners Dues – through Capital Accounts

Item/Purpose	Entry	Special Points to be noted
1. Prepare Capital Accounts with balance as per Balance Sheet before the dissolution.	By Balance b/d (Cr. balance) To Balance b/d (Dr. balance)	
2. Transfer of Current A/c, if any.	Partner's Current A/c … Dr. To Partner's Cap. A/c. (Credit Balance) OR Partner's Capital A/c … Dr. To Partner's Current A/c (Debit balance)	
3. Undistributed Profit, Reserve, Joint Life Policy Reserve, Investment Fluctuation Fund, Contingency Reserve etc. transfer.	Profit & Loss (Cr.) A/c… Dr. OR, Any Reserve A/c …….. Dr. To Partner's Capital A/cs [Profit sharing ratio]	
4. Undistributed Loss, Fictitious/Unrealizable Assets etc. transfer.	Partners Capital A/c… Dr. To Profit & Loss (Dr.) A/c OR, To Fictitious Assets A/c (Profit Sharing Ratio)	Example of unrealizable Asset- Advertisement Suspense A/c
5. Any loan taken from any partner	Partner's Loan A/c …. Dr. To Cash/Bank A/c	U/s 48 Repayment of loan should enjoy priority over repayment of capital.
6. Any loan given to any partner	Cash/Bank A/c…..Dr. To Partner's Loan A/c OR Partner's Capital A/c ..... Dr. To Partner's Loan A/c	If such amount is realized. Adjustment of loan against Capital
7. If any Partner's Capital A/c shows a debit balance (after balancing)	Cash/Bank A/c…..Dr. To Particulars Partner's Capital A/c [Cash brought in to make up the shortfall]	If the deficient partner is insolvent, treatment will be different- Vide – Insolvency of Partner.
8. Payment of credit balance (after final balancing)	Particulars Partner's Cap. A/c Dr. To Cash/Bank A/c	Same as above

Illustration 60.

Cloud, Storm and Rain were partners in a firm sharing profits and losses in the ratio of 5:3:2. Due to difference in opinion, they decided to dissolve the partnership with effect from 1st April, 2013 on which date the firm's position was as under:

Liabilities	Amount ₹	Assets	Amount ₹
Capital Accounts:		Plant and Machinery	80,000
Cloud	60,000	Furniture & Fixtures	45,000
Storm	40,000	Motor car	25,000
Rain	30,000	Stock in Trade	30,000
Current Accounts:		Sundry Debtors	71,000
Cloud	8,000	Cash at bank	14,000
Storm	10,000	Current Account:	
Sundry Creditors	1,20,000	Rain	3,000
	2,68,000		2,68,000

The following information is given:

(i) Plant costing ₹ 40,000 was taken over by Cloud at an agreed valuation of ₹ 45,000 and the remaining machineries realised ₹ 50,000.

(ii) Furniture & fixture realised ₹ 40,000.

(iii) Motor car was taken over by storm for ₹ 30,000.

(iv) Sundry Debtors included a Bad Debt for ₹ 1,200 and the rest portion was realised subject to a cash discount of 10%.

(v) Stock worth ₹ 5,000 was taken over by rain for ₹ 5,200 and the rest realised at 20% above their book value.

(vi) A creditor for ₹ 2,000 was untraceable and other creditors accepted payment allowing 15% discount.

Realisation expenses amounted to ₹ 5,000.

You are required to show the Realisation Accounts and the Capital Accounts of the partners on dissolution showing final payment to them.

Solution:

In the Books of Cloud, Storm & rain
Realisation Account

Dr. Cr.

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Plant & Machinery		80,000	By Sundry Creditors		1,20,000
,, Furniture & Fixtures		45,000	,, Cloud's A/c — plants		45,000
,, Motor car		25,000	taken over		
,, Stock in trade		30,000	,, Storm's A/c —		30,000
,, Sundry debtors:		71,000	Motor car taken over		
Bank Payments:			,, Rain's A/c —		5,200
Sundry Creditors 85%	1,00,300		Stock taken over		
of (1,20,000 – 2,000)			,, Bank (assets realised);		
,, Realisation Expenses	5,000	1,05,300	Machinery	50,000	
			Furniture & Fixtures	40,000	
,, Profit on Realisation:			Debtors –	62,820	
Cloud (5/10)	13,360		90% of (71,000 – 1,200)		
Storm (3/10)	8016		Stock 120% of		
Rain (2/10)	5,344	26,720	(30,000 – 5,000)	30,000	1,82,820
		3,83,020			3,83,020

Capital Account

Dr. Cr.

Particulars	Cloud (₹)	Storm (₹)	Rain (₹)	Particulars	Cloud (₹)	Storm (₹)	Rain (₹)
To Current A/c	-	-	3,000	By Balance b/d	60,000	40,000	30,000
" Realisation A/c				" Current A/c	8,000	10,000	-
– Plant taken	45,000	-	-	" Realisation A/c			
over				– Profit	13,360	8,016	5,344
" Realisation A/c							
– Motor car	-	30,000	-				
taken over							
" Realisation A/c							
– Stock taken	-	-	5,200				
over							
" Bank							
– Final Payment	36,360	28,016	27,144				
	81,360	58,016	35,344		81,360	58,016	35,344

Illustration 61.

The following is the Balance Sheet of S and R as on 31.12.2013

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Sundry Creditors	76,000	Cash at bank	23,000
Loan from Lalita (Wife of S)	20,000	Stock –in trade	12,000
		Sundry Debtors 40,000	
Loan from R	30,000	Less: Provisions 2,000	38,000
Reserve Fund	10,000		8,000
Capital:		Furniture	56,000
S	20,000	Plant	20,000
R	16,000	Investments	15,000
	1,72,000	Profit and Loss A/c	1,72,000

The firm was dissolve on 31.12.2013 and the following was the result:

(i) S took over investment at an agreed value of ₹ 16,000 and agreed to pay off the loan to Lalita (wife of S).

(ii) The assets realised as under: Stock ₹ 10,000; debtors ₹ 37,000; Furniture ₹ 9,000 and plant ₹ 50,000. The expenses of realization was ₹ 2,200.

(iii) The Sundry Creditors were paid off less 2½% discount. S and R shared profits and losses in the ratio of 3:2. Show Realisation Account, Bank Account and the Capital Accounts of the partners.

Solution:

In the books of S and R

Realisation Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Sundry Assets:		By Provision for bad debts	2,000
Stock 12,000		,, Sundry Creditors (Discount)	1,900
Debtors 40,000		,, Bank:	
Furniture 8,000		Stock 10,000	
Plant 56,000		Debtors 37,000	
Investments 20,000	1,36,000	Furniture 9,000	
		Plant 50,000	1,06,000
,, Bank – Expenses	2,200		
		,, Capital Account:	16,000
		S (Investments taken)	
		,, Loss on Realisation:	
		S (3/5) 7,380	
		R (2/5) 4,920	12,300
	1,38,200		1,38,200

Capital Account

Dr. Particulars	S ₹	R ₹	Particulars	S ₹	R ₹ Cr.
To Profit and Loss A/c Loss (3:2)	9,000	6,000	By Balance b/d	20,000	16,000
			,, Reserve Fund (3:2)	6,000	4,000
,, Realisation A/c Investment taken over	16,000	-	,, Loan from Lalita	20,000	-
,, Realisation A/c Loss	7,380	4920	,, Loan from R	-	30,000
,, Bank A/c (Final payment)	13,620	39,080			
	46,000	50,000		46,000	50,000

Bank Account

Dr. Particulars	Amount ₹	Particulars	Amount ₹ Cr.
To Balance b/d	23,000	By Sundry Creditors A/c	74,100
,, Realisation A/c		,, Realisation – Expenses	2,200
Assets realised	1,06,000	,, Capital Accounts:	
		S 13,620	
		R 39,080	
			52,700
	1,29,000		1,29,000

Sundry Creditors Account

Dr. Particulars	Amount ₹	Particulars	Amount ₹ Cr.
To Bank A/c	74,100	By Balance b/d	76,000
,, Realisation (Discount) A/c	1,900		
	76,000		76,000

Illustration 62.

A, B and C sharing profits in 3 : 1 : 1 agree upon dissolution. They each decide to take over certain assets and liabilities and continue business separately.

Balance Sheet

as on date of dissolution

Liabilities		Amount ₹	Assets		Amount ₹
Creditors		6,000	Cash at Bank		3,200
Loan		1,500	Sundry Assets		17,000
Capitals:			Debtors	24,200	
A	27,500		Less: Bad Debts Provision	1,200	
B	10,000				23,000
C	7,000	44,500	Stock		7800
			Furnitures		1,000
		52,000			52,000

It is agreed as follows:

(1) Goodwill is to be ignored.

(2) A is to take over all the Fixtures at ₹ 800; Debtors amounting to ₹ 20,000 at ₹ 17, 200. The creditors of ₹ 6,000 to be assumed by A at the figure.

(3) B is to take over all the stocks at ₹ 7,000 and certain of the sundry assets at ₹ 7,200 (being book value less 10%)

(4) C is take over the remaining sundry assets at 90% of book values less ₹ 100 allowances and assume responsibility for the discharge of the loan, together with accruing interest of ₹ 30 which has not been recorded in the books of the firm.

(5) The expenses of dissolution were ₹ 270. The remaining debtors were sold to a debt collecting agency for 50% of book values.

Prepare Realisation Account, partners' Capital Accounts and Bank Account.

Solution:

In the books of A, B and C
Realisation Account

Dr. **Cr.**

Particulars		Amount ₹	Particulars		Amount ₹
To Sundry Assets:			By Provision for bad debts		1,200
			Capital Account A :		
Sundry Assets	17,000		Fixtures	800	
Debtors	24,200		Debtors	17,200	
Stock	7,800				18,000
Fixtures	1,000		B: Stock	7,000	
		50,000	Sundry Assets	7,200	
					14,200
,, Bank – Expenses		270	C: Sundry Assets		8,000
,, Capital Account			By Bank: Collection from Debtors		2,100
C- Interest on loan		30	By Loss on realization:		
			A (3/5)	4,080	
			B (1/5)	1,360	
			C (1/5)	1,360	
					6,800
		50,300			50,300

Capital Account

Dr. **Cr.**

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To Dissolution	18,000	14,200	8,000	By Balance b/d	27,500	10,000	7,000
Assets taken				,, Creditors	6,000	-	-
,, Dissolution A/c	4,080	1,360	1,360	,, Loan(with interest)	-	-	1,530
Loss				,, Bank			
,, Bank —				Final receipts	-	5,560	830
Final payment	11,420	-	-				
	33,500	15,560	9,360		33,500	15,560	9,360

Bank Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	3,200	By Dissolution Account	
,, Dissolution A/c		Expenses	270
Collection from Debtors	2,100	,, Capital Account:	
,, Capital Accounts:		A	11,420
B 5,560			
C 830	6,390		
	11,690		11,690

Working Notes: ₹

1. Realization of Sundry Assets:

	₹
Sundry Assets (Book Value)	17,000
Less: Taken by B [7,200 x (100/90)]	8,000
Remaining at book value	9,000

Taken by C: 90% of Book value

i.e. (9,000 x (90/100) = 8,100 – 100 for allowance = 8,000

2. Collection from Debtors:

	₹
Debtors (Book Value)	24,200
Less: Taken by (Book value)	20,000
	4,200

Remaining at 50% i.e., ₹ 2100

Illustration 63.

X, Y and Z sharing profits & Losses in the ratio of 2 : 2: 1 agreed upon dissolution of their partnership on 31st December, 2012 on which date their Balance Sheet was as under :

Liabilities		Amount ₹	Assets		Amount ₹
Capital :			Fixed Assets		50,000
X		40,000	Joint Life Policy (at surrender Value)		10,000
Y		30,000			
Reserve Fund		10,000			
Joint Life Policy Fund		10,000	Debtors	10,000	
Creditors	19,000		Less : Provision for Bad Debts	500	
Less: Prov	500				
Salary Outstanding		18,500			9,500
		2,000	Stock at Invoice Price	10,000	
			Less: Price loading	2,000	
					8,000
			Investments	8,000	
			Less: Fluctuation Fund	500	
					7,500
			Capital Account –Z		2,000
			Bank		23,500
		1,10,500			1,10,500

Investments were taken over by X at ₹ 6,000, creditors of ₹ 10,000 were taken over by Y who has agreed to settle account with them at ₹ 9,900. Remaining creditors were paid ₹ 7,500. Joint Life Policy was surrendered and Fixed Assets realized ₹ 70,000, Stock and Debtors realized ₹ 7,000 and ₹ 9,000 respectively. One customer, whose account was written off as bad, now paid ₹ 800 which is not included in ₹ 9,000 mentioned above. There was an unrecorded asset estimated at ₹ 3,000, half of which as handed over to an unrecorded liability of ₹ 5,000 in settlement of claim of ₹ 2,500 and the remaining half was sold in the market which realized ₹ 1,300.

Y took over the responsibility of completing the dissolution and he is granted a salary of ₹ 400 per month. Actual expenses amounted to ₹ 1,100. Dissolution was completed and final payments were made on 30th April, 2013.

You are required to prepare the Realization Account, Capital Account and Bank Account.

Solution :

Dr. **Realization Account** **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Fixed Assets A/c		50,000	By Provision on Debtors A/c		500
To Joint Life Policy A/c		10,000	By Provision on Stock A/c		2,000
To Debtors A/c		10,000	By Investment Fluctuation		
To Stock (at I. P.)		10,000	Fund A/c		500
To Investments A/c		8,000	By Joint Life Policy Fund A/c		10,000
To Pro. for Disc. on Creditors A/c		500	By Creditors A/c		19,000
			By Outstanding Salary A/c		2,000
To Y's Capital A/c		10,000	By X' Capital A/c		6,000
[Creditors taken			(Investments taken over)		
over- see Note]			By Bank A/c :		
To Bank A/c :			Joint Life Policy	10,000	
Creditors paid off	7,500		Fixed Assets	70,000	
Unrecorded liability	2,500		Stock	7,000	
paid [1/2 × 5,000]			Debtors	9,800	
Outstanding Salary	2,000		Unrecorded Assets (Sold)	1,300	
Outstanding Expense	1,100	13,100	Bad Debt Recovered	800	98,100
To Y's Cap. A/c		1,600			
[Salary 400 × 4]					
To Partner's Capital A/c					
(Profit on Realization)					
X [2/5]	9,960				
Y [2/5]	9,960				
Z [1/5]	4,980	24,900			
		1,38,100			1,38,100

Dr. **Bank Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/f	23,500	By Realization A/c	
To Realization A/c		Creditors	7,500
Joint Life Policy	10,000	Unrecorded Liability	2,500
Fixed Assets	70,000	Outstanding Salary	2,000
Stock	7,000	Expenses	1,100
Debtors	9,800	By X's Capital A/c	47,960
Unrecorded Assets	1,300	By Y's Capital A/c	55,560
		By Z's Capital A/c	4,980
	1,21,600		1,21,600

Dr. **Partners Capital Account** **Cr.**

Date 2013	Particulars	X ₹	Y ₹	Z ₹	Date 20123	Particulars	X ₹	Y ₹	Z ₹
1 . 1	To Balance b/d	-	-	2,000	1 . 1	By Balance b/d	40,000	30,000	-
30.4	To Realization A/c	6,000	-	-	30.4	By Reserve Fund [2:2:1]	4,000	4,000	2,000
	To Bank A/c (Balance withdrawn)	47,960	55,560	4,980		By Realization A/c (Profit)	9,960	9,960	4,980
						By Realization A/c (Creditors)	-	10,000	-
						By Realization A/c (Salary)	-	1,600	-
		53,960	55,560	6,980			53,960	55,560	6,980

Note :

1. Unrecorded Asset and unrecorded liability were not recorded. Any part of such asset utilized to discharge any part of such liability and discount received there on have been ignored.

   But unrecorded asset realized (debts previously written off now recovered) has been recorded. Similarly unrecorded asset sold has been recorded.

2. Y took over creditors of ₹10,000. This has been recorded. How he settles such liability is his personal matter. The discount on payment does not benefit the firm.

Special considerations for a retiring partner and the estate of a deceased partner in relation to debts contracted by the partnership firm:

(a) debts due on the date of retirement/death: the retiring partner and the estate of the deceased partner is liable for the whole of the debts due by the firm at the date of retirement or death, to the extent of their share.

(b) debts incurred after retirement: where the notice of retirement is not published in accordance with law, the retiring partner is liable for debts contracted after retirement.

(c) deceased/ insolvent partner: the estate of a deceased or bankrupt partner will not be liable for debts contracted by the firm after the death or bankruptcy.

Applicability of Section 37 of the Partnership Act:

In case of retirement, the retiring partner or in case of death, the executor of the deceased partner, if the dues are not settled, then such retired partner or the executor is entitled to the following :

Maximum of :

Interest @ 6% p.a. on the amount due to them(i.e. if the amount is unsettled, like, rate of interest on loan to be allowed to the retired partner or the executor is not mentioned)

Or

The share of profit earned for the amount due to the partner

Conditions :

(a) The surviving partners/continuing partners continue to carry on the business of the firm.

(b) The business is carried on without any final settlement of accounts between the continuing partners and the outgoing partners or his estate.

(c) There is no contract to the contrary of the options contained in Section 37 i.e. share in the profits or interest @ 6% p.a. on the unsettled capital.

Example : Unsettled capital of C ₹ 52,000 (Date of retirement : 30.9.12, financial year 2012-13). Net Profit earned by the firm after C's retirement ₹ 25,000. Capitals of A: ₹ 57,000 and B: ₹ 76,000)

C is entitled to the maximum of the following :

(i) Interest on unsettled capital = ₹ 52,000 × 6% × 6 months = ₹ 1,560

(ii) Profit earned out of unsettled capital = Profit × Retired or Deceased Partner's unsettled

Dues/ Total Capital of the firm (including the amount due to the retired or deceased partner)

= ₹ (25,000 × 52,000)/(₹ 52,000 + 57,000 + 76,000) = ₹ 7,027.

6.6 INSOLVENCY OF A PARTNER

If a partner becomes insolvent and fails to pay his debit balance of Capital A/c either wholly or in part, the unrecoverable portion is a loss to be borne by the solvent partners. The question now arises is that, in what ratio they will share this loss. Prior to the decision in the leading case of Garner vs. Murray this loss was borne by the solvent partners in the profit sharing ratio just like ordinary losses.

Decision in Garner vs. Murray Case

Justice Joyee held in the case of Garner vs. Murray that the loss arising due to the insolvency of a partner must be distinguished from an ordinary loss (including realization loss). Unless otherwise agreed, the decision in Garner vs. Murray requires –

(i) That the solvent partners should bring in cash equal to their respective shares of the loss on realization;

(ii) That the solvent partners should bear the loss arising due to the insolvency of a partner in the ratio of their Last Agreed Capitals.

In case of fixed capital system, capitals as per last Balance Sheet represent last agreed capitals. In case of fluctuating capital system, however, all necessary adjustments in respect of reserved, unappropriated profits or losses (but not realization profit or loss), Drawings A/c., undisclosed liabilities and assets etc. must be made to get last agreed capitals. A partner who has nil or negative balance in his capital account before dissolution does not contribute anything to the loss arising as a result of insolvency of a partner.

Criticism of the decision of Garner vs. Murray

The following criticism may be advocated against the decisions laid down in Garner vs. Murray principle:

(i) If any solvent partner has a debit balance in capital account, he must not bear the deficiency of the insolvent partner;

(ii) This principle does not apply if there are only two partners;

(iii) In spite of having a credit balance in capital account the solvent partner must bring cash equal to the amount of loss on reasilation which is immaterial and useless; and

(iv) If any solvent partner who possess more private asset but contributes less capital, he will naturally, as per Garner vs. Murray decision, bear less amount of deficiency of the insolvent partner than the other solvent partner who possess less private assets but contributes more capital to the firm. This is not justified.

Applicability in India

According to sub section (ii) of Sec 48(b) of the Indian Partnership Act, if a partner becomes insolvent or otherwise incapable of paying his share of the contribution, the solvent partners must share ratably the available assets (including their own contribution to the capital deficiency). That is to say, the available assets will be distributed in proportion to their capitals.

Thus, under the Indian Partnership Act also the solvent partners are required to make good their share of the realization loss (i.e., capital deficiency). The total cash available after making good the solvent partners' share of capital deficiency shall be shared by the solvent partners in proportion to their capitals. As a result of this the ultimate debit balance of the insolvent partner's Capital A/c. is borne by the solvent partners in capital ratio.

The provision of the Indian Partnership Act in this respect are, thus, similar to the rules laid down by the decision in Garner vs. Murray.

When there is a specific provision in the Partnership Deed as to how the deficiency of an insolvent partner is to be borne by the solvent partners, such provision must be followed, because the provision of the Act will apply only when there is no specific agreement.

Illustration 64.

A, B and C are in partnership sharing profit and losses equally and agreed to dissolve the firm on 30.06.2012. On that date their Balance Sheet stood as follows:

Balance Sheet
as at 30th June, 2013

Liabilities	Amount ₹	Asset	Amount ₹
Capital A/c		Sundry Asset	50,000
A 34,000		Profit & Loss A/c	12,000
B 24,000	58,000	Capital A/c	
Creditors	12,000	C	8,000
	70,000		70,000

The assets are realised at 50% of the book value. Realization expenses amounted to ₹ 5,000. C became insolvent and received ₹ 2,000 from his estates.

Close the book of the firm under (i) Fixed Capital Method and (ii) Fluctuating Capital Method applying Garner Vs. Murray principles.

Solution:

In the books of A, B & C

Dr. **Realization Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Sundry Asset A/c	50,000	By Bank A/c	
`` Bank A/c		Amount Realised	25,000
Expense	5,000	`` Capital A/c	
		Loss on Realization	
		A 10,000	
		B 10,000	
		C 10,000	30,000
	55,000		55,000

Working:

(a) Under Fixed Capital Method

Deficiency of the insolvent partner Mr. C must be borne by the solvent partner A and B as per their last agreed capital given in the Balance Sheet i.e., 17:12.

(b) Under Fluctuating Capital Method

Deficiency of the insolvent partner Mr. C must be borne by the solvent partners A & B as the following adjusted capital which will be considered as the last agreed capital i.e., after adjusting the debit balance of Profit and Loss Account.

Particulars	A ₹	B ₹
Capital as per Balance Sheet	34,000	24,000
Less: Debit balance of P&L A/c (equally)	(-) 4,000	(-) 4,000
	30,000	20,000

∴ Ratio = 3:2

(a) Capital Account under Fixed Capital Method

Dr. **Capital Account** **Cr.**

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To Balance b/d	---	---	8,000	By Balance b/d	34,000	24,000	---
`` Realisation A/c				`` Bank A/c	---	---	2,000
Loss	10,000	10,000	10,000	`` Bank A/c	10,000	10,000	---
`` Profit & Loss A/c				`` A's Capital	---	---	11,724
Loss	4,000	4,000	4,000	`` B's Capital	---	---	8,276
`` C's Capital A/c	11,724	8,276	---				
`` Bank A/c	18,276	11,724	---				
(bal. fig.)							
	44,000	34,000	22,000		44,000	34,000	22,000

Dr. **Bank Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	25,000	By Realisation A/c	
`` Capital A/c		Expenses	5,000
A 10,000		`` Creditors	12,000
B 10,000		`` Capital A/c	
C 2,000		A	18,276
	22,000	B	11,724
	47,000		47,000

(b) Under Fluctuating Capital Method

Dr. **Capital Account** **Cr.**

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To Balance b/d	---	---	8,000	By Balance b/d	34,000	24,000	---
`` Realisation A/c				`` Bank A/c	10,000	10,000	---
Loss	10,000	10,000	10,000	`` Bank A/c	---	---	2,000
`` Profit & Loss A/c				`` A's Capital	---	---	12,000
Loss	4,000	4,000	4,000	`` B's Capital	---	---	8,000
`` C's Capital A/c	12,000	8,000	---				
`` Bank A/c	18,000	12,000	---				
(bal. fig.)							
	44,000	34,000	22,000		44,000	34,000	22,000

Dr. **Bank Account** **Cr.**

Particulars	₹	Particulars	₹
To Realisation A/c	25,000	By Realisation A/c	
Assets realized		Expenses	5,000
`` Capital A/c		`` Creditors	12,000
A	10,000	`` Capital A/c	
B	10,000	A	18,000
C	2,000	B	12,000
	47,000		47,000

Illustration 65.

Kay, Ell, Emm and Enn are partners in a firm sharing profits and losses in the ratio 4 : 1 : 2 : 3. The following is their Balance Sheet as at 31st March 2013.

Balance Sheet

Liabilities	₹	₹	Assets	₹	₹
Sundry Creditors		30,000	Cash at Bank		14,000
Capital A/c			Sundry Debtors	35,000	
Kay	70,000		Less: Provision for Bad		
Enn	30,000	1,00,000	Debts	5,000	30,000
			Other Assets		51,000
			Capital A/c		
			Ell		
			Emm	20,000	
				15,000	35,000
		1,30,000			1,30,000

On 31st March, 2013, the firm was dissolved. The partnership agreement provides that the deficiency on an insolvent partner will be borne by the solvent partners in the ratio of capitals as they stand just before dissolution.

The following arrangements are agreed upon:

(a) Kay is to take over 60% of book debts at 70% and Enn is to take over the balance at 75%. Further, they are to be allowed ₹ 2,100 and ₹ 1,100, respectively, to cover future losses.

(b) Enn is to realized other assets and to pay-off the creditors. He is to receive 5% gross commission on the amounts finally payable to other partners but to bear expenses of realization. He reports the result of realization as follows:

Other assets realize a loss of 2% on net collection and pays off the creditors at a discount of 30%. Realization expenses amount to ₹ 3,000.

Enn is declared insolvent and a dividend of 20% in a rupee is realized from his estate.

Prepare Bank Account, Realisation Account, Capital Account and Deficiency Account.

Solution :

In the books of Kay, Ell, Emm & Enn

Realization Account

Dr. **Cr.**

Particulars		₹	Particulars		₹
	₹			₹	
To Sundry Asset :	35,000		By Provision for Bad Debts		5,000
Other Assets	51,000	86,000	`` Creditors		9,000
			`` Bank – Other assets realized		50,000
			`` Capital Accounts:		
`` Capital A/c			Kay	14,700	
Kay	2,100		Enn	10,500	
Enn	1,100	3,200			25,200
		89,200			89,200

Dr. **Capital Account** **Cr.**

Particulars	KAY ₹	ELL ₹	EMM ₹	ENN ₹	Particulars	KAY ₹	ELL ₹	EMM ₹	ENN ₹
To Balance b/d	---	20,000	15,000	---	By Balance b/d				
`` Realisation					`` Realisation	70,000	---	---	30,000
Debtors taken	14,700	---	---	10,500	Future loss				
``DeficiencyA/c	11,200	---	---	4,800	`` Bank	2,100	---	---	1,100
`` Capital A/c Enn	2,200	---	---	---	`` Deficiency	---	4,000	---	---
`` Bank A/c	44,000	---	---	18,000	`` Capital A/c	---	16,000	---	---
— Final payment					(Kay)	---	---	---	2,200
					`` Bank	---	---	15,000	---
	72,100	20,000	15,000	33,300		72,100	20,000	15,000	33,300

Bank Account

Dr. Cr.

Particulars	Amount ₹	Particulars	Amount ₹
₹		₹	
To Balance b/d	14,000	By Creditors	21,000
`` Realisation – Assets realized	50,000	`` Capital Accounts:	
`` Capital A/c		Kay 44,000	
Ell 4,000		Enn 18,000	
Emm 15,000	19,000		62,000
	83,000		83,000

Deficiency Account

Dr. Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To Capital A/c		By Capital Accounts:	
Ell	16,000	Kay (7/10)	11,200
		Enn (3/10)	4,800
	16,000		16,000

Creditors Account

Dr. Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To Bank - Payment	21,000	By Balance b/d	30,000
`` Realisation (Discount @ 30%)	9,000		
	30,000		30,000

Working Notes:

(i) There will be no entry for the realization expense.

(ii) Sundry Debtors taken over:

Kay-60% of ₹ 35,000 i.e., 21,000 at 70% which is ₹ 14,700

Enn-40% of ₹ 35,000 i.e., 14,000 at 75% which is ₹ 10,500.

(iii) Net Collection of Sundry Assets:

	₹
Sundry Assets	51,000
Less: Loss (51,000 x 2/102)	1,000
	50,000

(iv) Commission payable of Enn:

Gross amount payable to Key ₹ 46,200. So, Commission ₹ 46,200 x 5/105 = ₹ 2,200

(v) Since Emm has got a debt balance in capital account, he will not take part in deficiency account although he is solvent.

IF ALL THE PARTNERS ARE INSOLVEN

Since all partners are insolvent, creditors cannot expect to be paid in full. In such a case Sundry Creditors should not be transferred to Realization Account. Cash in hand together with the amount realized on sale of assets and surplus from private estate of partners, if any, less expenses will be applied in making payment to the creditors. The balance of Creditors Account represents the deficiency to be borne by them which to be transferred to a Deficiency Account. The balance of Capital Accounts should also to be transferred to the Deficiency Account to close the books. Alternatively, the deficiency to be borne by the Creditors may be directly adjusted in between Creditors Account and Capital Accounts.

The following entries required to be passed :

(i) To pay-off the creditors

Creditors A/c	Dr.	(Total Creditors)
To Bank A/c		(Amount paid)
To Deficiency A/c		(Amount unpaid)

(ii) When deficiency is transferred

Deficiency A/c	Dr.
To Partners' Capital A/c	

Illustration 66.

Balance Sheet as at 30.10.13

Liabilities	Amount ₹	Asset	Amount ₹
Capitals		Fixed Assets	1,00,000
P	5,000		
Q	3,000		
R	2,000	Cash	10,000
Bank Loan	60,000		
Sundry Creditors	40,000		
	1,10,000		**1,10,000**

All the partners were declared insolvent. Profit sharing ratio : 5 : 3 : 2. Assets realized ₹60,000. Prepare necessary ledger accounts to close the books of the firm.

Solution :

Dr. Realisation Account Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To Fixed Assets	1,00,000	By Cash A/c (realisation)	60,000
		By Partners Capital A/cs	
		(loss on realisation)	
		P: 20,000	
		Q: 12,000	
		R: 8,000	40,000
	1,00,000		**1,00,000**

Dr. Partners Capital Acounts Cr.

Particulars	P	Q	R	Particulars	P	Q	R
				By Balance b/d	5,000	3,000	2,000
				By Deficiency A/c	15,000	9,000	6,000
To Realization A/c	20,000	12,000	8,000				
	20,000	**12,000**	**8,000**		**20,000**	**12,000**	**8,000**

Dr. Deficiency Account Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To Partners Capital A/cs :			
P	15,000	By Bank Loan A/c	18,000
Q	9,000	By Creditors	12,000
R	6,000		
	30,000		**30,000**

Dr. Bank Loan Account Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To Deficiency A/c	18,000	By Balance b/d	60,000
To Cash A/c	42,000		
	60,000		**60,000**

Dr. **Creditors Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Deficiency A/c	12,000	By Balance b/d	40,000
To Cash A/c	28,000		
	40,000		**40,000**

Dr. **Cash Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	10,000	By Bank Loan A/c	42,000
To Realisation A/c	60,000	By Creditors A/c	28,000
	70,000		**70,000**

Note :

The total deficiency of the partners i.e. the firm is ₹30,000. This is shared between the external liabilities in the ratio of their amount outstanding ₹60,000 : ₹40,000 = 3 : 2

Bank Loan A/c	Dr.	18,000	
Creditors A/c	Dr.	12,000	
To Deficiency A/c			30,000

Return of Premium to a partner on dissolution before expiry of term :

Conditions :

(i) A partner was admitted in the partnership firm for a fixed term period,

(ii) Such partner had paid a premium for goodwill at the time of admission.

(iii) The partnership firm has dissolved.

Exceptions : The partner will not be entitled to any claim under any of the following conditions :

(i) the firm is dissolved due to death of a partner

(ii) the dissolution is due to the misconduct of the partner claiming refund

(iii) dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

Amount of Refund: the amount to be repaid will be determined having regard to the terms upon which the admission was made and to the length of the period agreed upon and the period that has expired.

Liability of other partners: the amount of refund payable shall be borne by the other partners in their profit sharing ratio.

Ilustration 67.

X was admitted into partnership for 5 years, for which he paid a premium of ₹1,20,000. After 39 months, the partnership firm was dissolved due to misconduct of Mr.Z , another partner of the firm. Y, being the third partner. Profit Sharing Ratio : Y : Z : X = 5 : 3 : 2.

Solution.

X is entitled to claim the refund of premium paid at the time of admission, since the admission was for a fixed term period and the firm is getting dissolved due to a misconduct of Mr.Z, another partner of the firm.

The amount of refund is

= (Total Premium Paid × Unexpired term of the partnership)/Total term of the partnership

= 1,20,000 × 21/60 = ₹42,000

This shall be shared by the other partners Y and Z in their profit sharing ratio 3 : 2.

Y's Capital A/c	Dr.	25,200	
Z's Capital A/c	Dr.	16,800	
To X's Capital A/c			42,000
(Being premium paid during admission now refunded to X after adjusting capitals of other partners)			

PIECEMEAL DISTRIBUTION

Till now the discussion was based on the implicit assumption that all assets were realized and settlement was done on the same date. In fact, on the dissolution of a partnership, assets are sometimes realized gradually over a period of time. In such a case it may be agreed that different parties are to be paid in order of preference as and when assets are realized without unnecessarily waiting for the final realization of all the assets.

The order of the payment will be as follows :

(i) Realisation expenses

(ii) For provision for expenses that are to be made

(iii) Preferential creditors (say, Income Tax or any payment made to the Government)

(iv) Secured creditors – upto the amount realized from the disposal of assets by which they are secured and for the balance, if any, to be paid to unsecured creditors

(v) Unsecured creditors – in proportion to the amount of debts, if more than one creditor

(vi) Partners' loan – if there is more than one partner – in that case, in proportion to the amount of loan

(vii) Partners' capital – the order of payment may be made by any one of the following two methods:

 (a) Surplus Capital Method/ Proportionate Capital Method/ Highest Relative Capital Method

 (b) Maximum Possible Loss Method

Surplus Capital Method/ Proportionate Capital Method/ Highest Relative Capital Method

Under this method, actual capital of the partners on the date of dissolution is compared with their proportionate capital (determined on the basis of minimum capital per unit of profit) to determine surplus capital of the partners. Surplus capital is paid first and any balance left thereafter is distributed in the profit sharing ratio. This ensures that final balances of partners show their share of realisation profit/ loss and thus, no settlement need to be dome at that point of time.

Illustration 68.

Capitals (as on the date of dissolution) :

P = ₹ 55,000; Q = ₹ 37,500; R = ₹ 31,500; Profit-Sharing Ratio = 5 : 3 : 2.

Statement showing the Highest Relative Capital or Absolute Surplus :

Particulars	P	Q	R
1. Actual Capital	55,000	37,500	31,500
2. Profit Sharing Ratio (PSR)	5	3	2
3. Actual Capital ÷ PSR = Proportionate Capital	11,000	12,500	15,750
4. Consider the smallest of proportionate capital as per (3) as base capital ×PSR [i.e. 11,000 × PSR]	55,000	33,000	22,000
5. Surplus Capital [(1) — (4)]	—	4,500	9,500
6. PSR	—	3	2
7. Surplus Capital (as per 5) ÷ PSR	—	1,500	4,750
8. Consider the smallest of Proportionate capital as per (7)	—	4,500	3,000
9. Absolute surplus [5 - 8]	—	—	6,500

This means that R will be paid ₹ 6,500 to clear off his Absolute Surplus Capital.

Illustration 69.

Capitals : X = ₹ 15,000 ; Y = ₹ 18,000 ; Z = ₹ 9,000

Profit Sharing Ratio = 2 : 2 : 1

Statement showing the Highest Relative Capital

Particulars	X	Y	Z
1. Actual Capital	15,000	18,000	9,000
2. PSR	2	2	1
3. Actual Capital ÷ PSR = Prop. Capital	7,500	9,000	9,000
4. Consider the smallest of Proportionate	15,000	15,000	7,500
Capital as Base × PSR [i.e. 7,500×PSR]			
5. Surplus Capital [1—4]	NIL	3,000	1,500

Since the Surplus Capitals for Y & Z are in their profit-sharing ratio, no further steps are required.

Illustration 70.

Partners M, N and P have called upon you to assist them in winding up the affairs of their partnership on 30th June, 2013. Their Balance Sheet as on that date is given below :

Liabilities	Amount ₹	Assets	Amount ₹
Sundry Creditors	17,000	Cash at Bank	6,500
Capital		Sundry Debtors	22,000
Accounts : M	67,000	Stock in trade	13,500
N	45,000	Plant and Equipment	99,000
P	31,500	Loan : M	12,000
		Loan : N	7,500
	1,60,500		1,60,500

(a) The partners share profits and losses in the ratio of 5 : 3 : 2.

(b) Cash is distributed to the partners at the end of each month.

(c) A summary of liquidation transaction are as follows :

July :

₹ 16,000 — collected from Debtors; balance is irrecoverable.

₹ 10,000 — received from sale of entire stock.

₹ 1,000 — liquidation expenses paid.

₹ 8,000 — cash retained in the business at the end of the month.

August :

₹ 1,500 — liquidation expenses paid; as part of the payment of his capital, P accepted an equipment for ₹ 10,000 (book value ₹ 4,000).

₹ 2,500 — cash retained in the business at the end of the month.

September :

₹ 75,000 — received on sale of remaining plant and equipment.

₹ 1,000 — liquidation expenses paid. No cash is retained in the business.

Required : Prepare a Schedule of cash payments as on 30th September, showing how the cash was distributed.

Solution :

Statement showing the Distribution of Cash (According to Proportionate Capital Method)

Particulars	Creditors	Capital		
	₹	M ₹	N ₹	P ₹
A. Balance Due	17,000	55,000	37,500	31,500
B. Amount distributed as on 31st July	17,000	—	—	6,500
C. Balance Due (A – B)	—	55,000	37,500	25,000
D. Cash paid to 'N' and Equipment given to P on 31st August.		—	4,000	10,000
E. Balance due (C – D)		55,000	33,500	15,000
F. Amount paid to partners on 30th September		41,500	25,400	9,600
G. Loss on Realisation (Unpaid Balance) [E – F]		13,500	8,100	5,400

Working Notes :

(i) Statement showing the Calculation of Highest Relative Capital

Particulars	M	N	P
A Balance of Capital Accounts	67,000	45,000	31,500
B Less : Loan	12,000	7,500	—
C Actual Capital (A – B)	55,000	37,500	31,500
D Profit sharing ratio	5	3	2
E Actual Capital ÷ Profit sharing ratio	11,000	12,500	15,750
F Proportionate Capitals taking M's Capital as Base Capital	55,000	33,000	22,000
G Excess of Actual Capitals over Proportionate Capitals (C - F)		4,500	9,500
H Profit Sharing Ratio	—	3	2
I Surplus Capital ÷ Profit Sharing Ratio	—	1,500	4,750
J Revised Proportionate Capitaltaking N's Capital as Base Capital	—	4,500	3,000
K Excess of Surplus Capital over Revised Proportionate Capitals (G - J)	—	—	6,500

Scheme of distribution of available cash : First instalment up to ₹ 6,500 will be paid to P. Next instalment up to ₹ 7,500 will be distribution between N and P in the ratio of 3 : 2. Balance realisation will be distributed among M, N and P in the ratio of 5 : 3 : 2.

(ii) Statement showing the Calculation of Cash Available for Distribution

Particulars	July ₹	August ₹	September ₹
A Opening Balance	6,500	8,000	2,500
B Add : Net amount realised (Gross amount — Expenses)	25,000	(1,500)	74,000
C Less : Closing Balance	8,000	2,500	—
D Amount available for distribution (A + B – C)	23,500	4,000	76,500

(iii) Statement showing the Manner of Distribution of amount available in August and September

Particulars	July ₹	August ₹	September ₹
First ₹ 7,500	—	4,500	3,000
Balance ₹ 83,000	41,500	24,900	16,600
(Cash and Equipment)	41,500	29,400	19,600
Less : Actual Distribution in August	—	4,000	10,000
Manner of Distribution in September	41,500	25,400	9,600

Illustration 71.

The firm of Blue Collars presented you with the following Balance Sheet drawn as on 31st March 2013 :

Liabilities		Amount ₹	Assets		Amount ₹
Sundry Creditors		37,000	Cash in hand		3,000
Capital Accounts :			Sundry Debtors		34,000
L	40,000		Stock in trade		39,000
K	30,000		Plant and Machinery		51,000
J	27,000	97,000	Current Accounts :		
			K	4,000	
			J	3,000	7,000
		1,34,000			**1,34,000**

Partners shared profits and losses in the ratio of 4 : 3 : 3. Due to difference among the partners, it was decided to wind up the firm, realise the assets and distribute cash among the partners at the end of each month.

The following realisations were made :

(i) May — ₹ 15,000 from debtors and ₹ 20,000 by sale of stock. Expenses on realisation were ₹ 500.

(ii) June — Balance of debtors realised ₹ 10,000. Balance of stock fetched ₹ 24,000.

(iii) August — Part of machinery was sold for ₹ 18,000. Expenses incidental to sale were ₹ 600.

(iv) September — Part of machinery valued in the books at ₹ 5,000 was taken by K, in part discharge at an agreed value of ₹ 10,000. Balance of machinery was sold for ₹ 30,000 (net).

Partners decided to keep a minimum cash balance of ₹ 2,000 in the first 3 months and ₹ 1,000 thereafter.

Required : Show how the amounts due to partners will be settled.

Solution :

(i) Statement showing the Distribution of Cash

(According to Proportionate Capital Method)

Particulars	Creditors ₹	Capital		
		L ₹	K ₹	J ₹
A Amount due	37,000	40,000	26,000	24,000
B Amount distribution as on 31st May	35,500	—	—	—
C Balance Due (A - B)	1,500	40,000	26,000	24,000
D Amount Distributed as on 30th June				
First ₹ 1,500	1,500			
Next ₹ 5,333	—	5,333	—	—
Next ₹ 4,667	—	2,667	2,000	—
Balance ₹ 22,500	—	9,000	6,750	6,750
E Balance due (C - D)		23,000	17,250	17,250
F Amount Distributed as on 31st August		7,360	5,520	5,520
G Balance Due (E - F)		15,640	11,730	11,730
H *Add* : Profit on realisation (₹ 41,000 – ₹ 39,100)		760	570	570
I Amount Distributed (including Machinery taken by K) as on 30th September. * Includes value of Machinery ₹ 10,000 and Cash ₹ 2,300		16,400	12,300*	12,300

Working Notes :

(i) Assumption : As the firm is dissolved due to difference among the partners, all partners are presumed to be solvent and the problem has been worked out on the basis of the highest relative capital.

(ii) Statement showing the Calculation of Highest Relative Capitals

Particulars	L ₹	K ₹	J ₹
A Actual Capitals	40,000	26,000	24,000
B Profit sharing ratio	4	3	3
C Actual Capitals ÷ Profit ratio	10,000	8,667	8,000
D Proportionate Capitals taking J's Capital as Base Capital	32,000	24,000	24,000
E Surplus Capital of L and K (A - D)	8,000	2,000	—
F Profit sharing ratio	4	3	_
G Surplus Capital ÷ Profit sharing ratio	2,000	667	_
H Revised Proportionate Capital of L and J	2,667	2,000	—
I Revised Surplus Capital of L (E - H)	5,333	—	—

While distributing surplus among partners, 1st instalment up to ₹ 5,333 will be paid to L, next instalment up to ₹ 4,667 will be distributed between L and K in the ratio of 4 : 3 and the Balance among L, K and J in the ratio of 4 : 3 : 3.

(iii) Statement showing the Calculation of Cash available each month

Particulars	May ₹	June ₹	August ₹	September ₹
A Opening Balance	3,000	2,000	2,000	1,000
B Add : Amount realised Less Expenses	34,500	34,000	17,400	30,000
C Less : Closing blance	2,000	2,000	1,000	—
D Total Cash available for Distribution (A+B–C)	35,500	34,000	18,400	31,000

Dr. **(iv) Realisation Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Sundry Debtors	34,000	By Sundry Creditors	37,000
To Stock in trade	39,000	By Cash/Bank	1,17,000
To Plant and Machinery	51,000	By L (Assets taken over)	10,000
To Cash/Bank :			
Creditors	37,000		
Expenses	1,100		
To Profit transferred to Capital A/c	1,900		
	1,64,000		1,64,000

Illustration 72.

A partnership firm was dissolved on 30th June, 2013. Its Balance Sheet on the date of dissolution was as follows :

Liabilities	Amount ₹	Assets	Amount ₹
Capitals :		Cash	5,400
Atrik	38,000	Sundry Assets	94,600
Mohit	24,000		
Rupa	18,000		
Loan A/c — Mohit	5,000		
Sundry Creditors	15,000		
	1,00,000		**1,00,000**

The assets were realised in instalments and the payments were made on the proportionate capital basis. Creditors were paid ₹ 14,500 in full settlement of their account. Expenses of realisation were estimated to be ₹ 2,700 but actual amount spent on this account was ₹ 2,000. This amount was paid on 15th September. Draw up a Memorandum of distribution of Cash, which was realised as follows :

On 5th July ₹ 12,600

On 30th August ₹ 30,000

On 15th September ₹ 40,000

The partners shared profits and losses in the ratio of 2 : 2 : 1. Give working notes.

Solution :

Statement Showing the Distribution of Cash

(According to Proportionate Capital Method)

	Particulars	Creditors ₹	Mohit's Loan ₹	Atrik ₹	Mohit ₹	Rupa ₹
A	Balance Due	15,000	5,000	38,000	24,000	18,000
B	Cash paid (₹ 5,400 – ₹ 2,700)	2,700	—	—	—	—
C	Balance unpaid (A - B)	12,300	5,000	38,000	24,000	18,000
D	1st installment of ₹ 12,600	11,800	8 0 0	—	—	—
E	Balance unpaid (C - D)	5 0 0	4,200	38,000	24,000	18,000
F	Less : Written-off	5 0 0				
G	2nd installment of ₹ 30,000		4,200	16,320	2,320	7,160
H	Balance unpaid (E-F-G)			21,680	21,680	10,840
I	3rd installment (₹ 40,000 + ₹ 700)			16,280	16,280	8,140
J	Unpaid Balance					
	(H-I) = Loss on Realisation			5,400	5,400	2,700

Working Notes :

(i) Statement showing the Calculation of Highest Relative Capitals

	Particulars	Atrik ₹	Mohit ₹	Rupa ₹
A	Actual Capitals	38,000	24,000	18,000
B	Profit-sharing ratio	2	2	1
C	Actual Capitals ÷ Profit Sharing Ratio	19,000	12,000	18,000
D	Proportionate Capitals taking Mohit's Capital as Base Capital	24,000	24,000	12,000
E	Surplus Capital [A-D]	14,000	Nil	6,000
F	Surplus Capital ÷ Profit Sharing Ratio	7,000	—	6,000
G	Revised Proportionate capitals taking Rupa's Capital as the basis	12,000	—	6,000
H	Revised Surplus Capital (E - G)	2,000	—	—

(ii) Distribution of Second Instalment of ₹ 30,000

Particulars	Mohit's Loan	Atrik	Mohit	Rupa
First ₹ 4,200	4,200	—	—	—
Next ₹ 2,000 (Absolute Surplus)		2,000	—	—
Next ₹ 18,000 (Balance of Surplus)		12,000	—	6,000
Balance ₹ 5,800 (2 : 2 : 1)		2,320	2,320	1,160
Total 30,000	4,200	16,320	2,320	7,160

Illustration 73.

East, South and North are in partnership sharing profits and losses in the ratio 3 : 2 : 1 respectively. They decide to dissolve the business on 31st July, 2013 on which date their Balance Sheet was as follows :

Liabilities	Amount ₹	Assets	Amount ₹
Capital Accounts :		Land and Buildings	30,810
East	38,700	Motor car	5,160
South	10,680	Investment	1,080
North	11,100	Stock	19,530
Loan account : North	3,000	Debtors	11,280
Creditors	10,320	Cash	5,940
	73,800		**73,800**

The assets were realised piecemeal as follows and it was agreed that cash should be distributed as and when realised :

			₹
14th	August		10,380
20th	September		27,900
16th	October		3,600
		North took over investment as follows at a value of:-	
15th	November		1,260
18th	November		19,200

Dissolution expenses were originally provided for an estimated amount of ₹ 2,700, but actual amount spent on 25th October was ₹ 1,920. The creditors were settled for ₹ 10,080.

Required : Prepare a statement showing distribution of cash amongst the partners, according to Proportionate Capital Method.

Solution :

Statement Showing the Distribution of Cash
(According to Proportionate Capital Method)

Particualr	Creditors ₹	Loan ₹	East ₹	South ₹	North ₹
A Balance Due	10,320	3,000	38,700	10,680	11,100
B Paid to Creditors					
[₹ 5,940 – ₹ 2,700]	3,240	—	—	—	—
C Balance Due (A - B)	7,080	3,000	38,700	10,680	11,100
D Amount paid on 14th August	6,840	3,000	540		
	240	—	38,160	10,680	11,100
E Less : Written off	(240)	—	—	—	—
F Balances Due (D - E)			38,160	10,680	11,100
G Amount paid on 20th September					
(i) First 4,860 (i.e. ₹ 5,400 – ₹ 540)			4,860	—	—
(ii) Balance ₹ 23,040			33,300	10,680	11,100
H Balance Due (F - G)			17,280	—	5,760
I Amount paid on 16th October			16,020	10,680	5,340
J Balance Due (H-I)			1,800	1,200	600
K Amount paid on 25th October			14,220	9,480	4,740
(being excess over estimated expenses ₹ 780)			390	260	130
L Balance due (J - K)			13,830	9,220	4,610
M Cash brought in by North			630	420	210
N Balance Due (L-M)			13,200	8,800	4,400
O Amount paid on 18th November			9,600	6,400	3,200
P Balance unpaid (N-O)			3,600	2,400	1,200

Working Note :

Statement Showing the Calculation of Highest Relative Capitals

	Particulars	East ₹	South ₹	North ₹
A	Actual Capitals	38,700	10,680	11,100
B	Profit Sharing Ratio	3	2	1
C	Actual Capital ÷ Profit Sharing Ratio	12,900	5,340	11,100
D	Proportionate capitals taking South's Capital as Base Capital (being the smallest) × PSR	16,020	10,680	5,340
E	Surplus capital (i.e. Excess of Actual Capitals over proportionate capital) [A-D]	22,680	—	5,760
F	Profit Sharing Ratio	3	—	1
G	Surplus Capital ÷ Profit Sharing Ratio	7,560	—	5,760
H	Revised Proportionate Capitals taking North's Capital as Base Capital	17,280	—	5,760
I	Revised Surplus Capital [E-H]	5,400	—	—
J	Distribution Sequence			
	First ₹ 5,400 [To East]	5,400	—	—
	Next ₹ 23,040 [To East & North in the ratio of 3 : 1]	17,280	—	5,760
	Balance ₹ 19,200 [To East, South & North in the ratio of 3 : 2 : 1]	9,600	6,400	3,200

Illustration 74.

The firm of M/s LMS was dissolved on 31.3.2013, at which date its Balance Sheet stood as follows :

Liabilities	Amount ₹	Assets	Amount ₹
Creditors	2,00,000	Fixed Assets	45,00,000
Bank Loan	5,00,000	Cash and Bank	2,00,000
L's Loan	10,00,000		
Capitals :			
L	15,00,000		
M	10,00,000		
S	5,00,000		
	47,00,000		**47,00,000**

Partners share profits equally. A firm of Chartered Accounts is retained to realise the assets and distributed the cash after discharge of liabilities. Their fees which are to include all expenses is fixed at ₹ 1,00,000. No loss is expected on realisation since fixed assets include valuable land and building.

Realisations are : 1st ₹ 5,00,000, 2nd ₹ 15,00,000, 3rd ₹ 15,00,000, 4th ₹ 30,00,000, 5th ₹ 30,00,000.

The Chartered Accountant firm decided to pay off the partners in 'Higher Relative Capital Method'. You are required to prepare a statement showing distribution of cash with necessary workings.

Solution :

Statement showing the Distribution towards Firm's Outside Debts' and Partner's Loan

Particulars	Ratio	Total ₹	Creditors ₹	Bank Loan ₹	L's Loan ₹
A Balance Due		17,00,000	2,00,000	5,00,000	10,00,000
B Less : Amount paid out of its instalment	2 : 5	6,00,000	1,71,429	4,28,571	—
C Balance Due (A-B)		11,000,000	28,571	71,429	10,00,000
D Less : Amount paid out of 2nd installment					
First ₹ 1,00,000	2 : 5	1,00,000	28,571	71,429	—
Next ₹ 10,00,000	0 : 0 : 1	10,00,000	—	—	10,00,000
E Balance Due (C-D)		Nil	Nil	Nil	Nil

Statement showing the Distribution of Cash among Partners (According to Proportionate Capital Method)

Particular	Ratio	Total ₹	L ₹	M ₹	S ₹
A Balance Due		30,00,000	15,00,000	10,00,000	5,00,000
B Less : Amount paid out of 2nd instalment	1 : 0 : 0	4,00,000	4,00,000	—	—
C Balance Due (A-B)		26,00,000	11,00,000	10,00,000	5,00,000
D Less : Amount paid out of 3rd Instalment					
First ₹ 1,00,000	1 : 1 : 0	1,00,000	1,00,000	—	—
Next ₹ 10,00,000	1 : 1 : 1	10,00,000	5,00,000	5,00,000	—
Balance ₹ 4,00,000		4,00,000	1,33,334	1,33,333	1,33,333
E Balance Due (C-D)		11,00,000	3,66,666	3,66,666	3,66,667
F Less: Amount paid out of 4th Instalment	1 : 1 : 1	30,00,000	10,00,000	10,00,000	10,00,000
G Balance Due (F - G)		(19,00,000)	(6,33,334)	(6,33,334)	(6,33,334)
H Less: Amount paid out of 5th Instalment	1 : 1 : 1	30,00,000	10,00,000	10,00,000	10,00,000
I Balance Due (G - H)		(49,00,000)	(16,33,334)	(16,33,334)	(16,33,334)
– Realisation profit					
		Nil	Nil	Nil	Nil

Working Notes :

(i) Statement showing the computation of Highest Relative Capital

	Particulars	L ₹	M ₹	S ₹
A	Actual Capitals	15,00,000	10,00,000	5,00,000
B	Profit Sharing Ratio	1	1	1
C	Actual Capital ÷ Profit Sharing Ratio	15,00,000	10,00,000	5,00,000
D	Proportionate Capital taking			
	S's Capital as Base Capital × PSR	5,00,000	5,00,000	5,00,000
E	Surplus Capital (A - D)	10,00,000	5,00,000	—
F	Profit Sharing Ratio	1	1	—
G	Surplus Capital ÷ Profit Sharing Ratio	10,00,000	5,00,000	—
H	Revised Proportional Capital taking			
	M's Capital as Base Capital	5,00,000	5,00,000	—
I	Revised Surplus Capital (E - G)	5,00,000	—	—

(ii) Scheme of Distribution : First ₹ 5,00,000 will be paid to L, next ₹ 10,00,000 will be distributed between L and M in their profit sharing (i.e. 1 : 1) and the balance will be distributed among L, M and S in their profit sharing ratio (i.e. 1 : 1 : 1).

(iii) It has been assumed that the amounts of realisation given in the question pertain to realisation of fixed assets.

(iv) Calculation of amount available for distribution at the time of first realisation of fixed asset

= Cash & Bank Balance + 1st Realisation – Liquidator's remuneration

= ₹ 2,00,000 + ₹ 5,00,000 – ₹ 1,00,000 = ₹ 6,00,000.

MAXIMUM LOSS METHOD :

Steps

(1) Prepare a statement showing distribution of cash

(2) Pay off the external Liabilities

(3) After all the payment is made for the external liabilities, the partners will be paid off.

Total Due of Partners	xxx
Less : Net/Balance of Realisation	(x)
Maximum Loss	xxx

(4) The maximum loss shall be shared amongst the partners in their profit sharing ratio, as if, there will be no further realisation.

(5) If any of the partner capitals, after step (4) is negative, that partner shall be treated like an insolvent partner.

(6) The deficiency of the insolvent partner as per step (5) shall be shared by the other solvent partners (i.e. those partners who has positive capital balances) in their capital contribution ratio as per Garner vs. Murray Rule.

(7) Repeat the steps (3) to (6) till final realisation.

PROBLEMS ON MAXIMUM LOSS METHOD

Illustration 75.

The following is the Balance Sheet of X, Y and Z, who were sharing in the ratio 5 : 3 : 2, on 31st December, 2012 when they decided to dissolve the partnership.

Liabilities	Amount ₹	Assets	Amount ₹
X's Capital	55,000	Cash	20,000
Y's Capital	37,500	Other assets	13,04,000
Z's Capital	31,500		
Y's Loan	2,00,000		
Creditors	10,00,000		
	13,24,000		**13,24,000**

Note : There was a bill for ₹ 4,000 due on 1.4.2013 under discount.

Other assets realised as under :

1st January : ₹ 8,85,000, 1st February : ₹ 3,00,000 ; 1st March : ₹ 8,000; 1st April : ₹ 5,000; 1st May : ₹ 10,000. The expenses of realisation were expected to be ₹ 5,000, but ultimately amounted to ₹ 4,000 only and were paid on 1st May. The acceptor of the bill under discount met the bill on the due date.

Required : Prepare a statement showing the monthly distribution of cash according to Maximum Loss Method.

Solution:

Statement showing the Distribution towards Firm's Outside debts' & Partners' Loan

	Particulars	Creditors ₹	Y's Loan ₹
A	Amount Due	10,00,000	2,00,000
B	Amount paid on 1st Jan. (₹ 20,000 + ₹ 8,85,000 – ₹ 5,000)	9,00,000	—
C	Balance Due (A - B)	1,00,000	2,00,000
D	Amount paid on 1st February	1,00,000	2,00,000
E	Balance Due (C - D)	Nil	Nil

Statement showing the Distribution of Cash

(According to Maximum Loss Method)

Particulars	Total ₹	X ₹	Y ₹	Z ₹
(i) Distribution of ₹ 4,000				
A. Amount due as on 1st March	1,24,000	55,000	37,500	31,500
Less : Max. Possible Loss if the remaining nothing (₹ 1,24,000 – ₹ 4,000) in the ratio of 5 : 3 : 2	1,20,000	60,000	36,000	24,000
Note : Cash available = ₹ 8,000 – ₹ 4,000 (Reserved for discounted B/R) = ₹ 4,000				
Adjustment of X's Deficiency between Y and Z in their Capital ratio i.e. 375 : 315	—	5,000	(2,717)	(2,283)
	—	—	(1,217)	5,217
Adjustment of Y's Deficiency (charged to Z)	—	—	1,217	(1,217)
B. Cash paid as on 1st March	4,000	—	—	4,000
(ii) Distribution of ₹ 9,000 (including amount kept reserved for B/R no longer required)		—		
C. Balance due (A-B)	1,20,000	55,000	37,500	27,500
Less : Max. Possible Loss (₹ 1,20,000 – ₹9,000)	1,11,000	55,500	33,300	22,200
Note : Cash available = ₹ 5,000 + ₹ 4,000 = ₹ 9,000		(500)	4,200	5,300
Adjustment of X's Deficiency between Y and Z in their Capital ratio i.e. 375 : 315	—	500	(272)	(228)
D. Cash paid as on 1st April	9,000	—	3,928	5,072
(iii) Distribution of ₹ 11,000				
E. Balance due (C-D)	1,11,000	55,000	33,572	22,428
Less : Max. Possible Loss (₹ 1,11,000 – ₹ 11,000)	1,00,000	50,000	30,000	20,000
F. Cash paid as on 1st May	11,000	5,000	3,572	2,428
G. Unpaid Balance (E - F)	1,00,000	50,000	30,000	20,000

Illustration 76.

The following is the Balance Sheet of P, Q and R on 31st August, 2012 when they decided to dissolve the partnership. They share profits in the ratio of 2 : 2 : 1.

Liabilities	Amount ₹	Assets	Amount ₹
Creditors	2,000	Sundry Assets	48,500
P's Loan	5,000	Cash	500
P's Capital	15,000		
Q's Capital	18,000		
R's Capial	9,000		
	49,000		**49,000**

The assets realised the following sums in instalments.

I— ₹ 1,000, II— ₹ 3,000, III— ₹ 3,900, IV— ₹ 6,000, V— ₹ 20,000.

The expenses of realisation were expected to be ₹ 500 but ultimately amounted to ₹ 400 only.

Required : Show, how at each stage, the cash received should be distributed among partners according to Maximum Loss Method.

Solution :

Statement showing the Realisation and Distribution of Cash

Installments	Realisation ₹	Creditors ₹	Partners' Loans ₹	Partners' Capital ₹
(I) (After taking into account cash and amount set aside for expenses)	1,000	1,000		
(II)	3,000	1,000	2,000	
(III)	3,900		3,000	900
(IV)	6,000	—	—	6,000
(V) (including saving in expenses)	20,100	—	—	20,100
	34,000	**2,000**	**5,000**	**27,000**

Statement showing the Distribution of Cash among partners

(According to Maximum Loss Method)

Particulars	Total ₹	P ₹	Q ₹	R ₹
(i) Distribution of ₹ 900				
A. Balance Due	42,000	15,000	18,000	9,000
B. Less : Max. Possible loss, if the remaining assets prove to be worthless				
(₹ 42,000 – ₹ 900) in the ratio (2 : 2 : 1)	41,100	16,440	16,440	8,220
C. Deficiency of P's Capital charged to Q and R in the ratio of their Capitals i.e., 18,000 : 9,000 (Garner vs. Murray)	—	1,440	(960)	(480)
D. Amount paid	900	—	600	300
(ii) Distribution of ₹ 6,000				
E. Balance after payment (A -D)	41,100	15,000	17,400	8,700
F. Less : Max. Possible loss				
(₹ 41,100 – ₹ 6,000)	35,100	14,040	14,040	7,020
G. Amount paid	6,000	960	3,360	1,680
(iii) Distribution of ₹ 20,100				
H. Balance after payment (E - G)	35,100	14,040	14,040	7,020
I. Less : Max. Possible loss				
(₹ 35,100 – ₹ 20,100)	15,000	6,000	6,000	3,000
J. Amount paid	20,100	8,040	8,040	4,020
K. Unpaid balance (H - J)	15,000	6,000	6,000	3,000

Illustration 77.

Rahul, Roshan and Rohan were in partnership sharing profits and losses in the ratio of 3 : 2 : 1 respectively. The partnership was dissolved on 30th June, 2013 when the position was as follows :

Liabilities	Amount ₹	Assets	Amount ₹
Capitals :		Cash in hand	28,000
Rahul	1,40,000	Sundry Debtors	2,94,000
Roshan	70,000	Stock in trade	1,12,000
Rohan	14,000		
Creditors	2,10,000		
	4,34,000		**4,34,000**

There was bill for ₹ 10,000, due on 30th November, 2013, under discount. It was agreed that the net realisations should be distributed in their due order (at end of each month) but as safely as possible. The realisations and expenses were as under :

Date	Stock and Debtors ₹	Expenses ₹
31st July	84,000	7,000
31st August	1,26,000	5,400
30th September	70,000	4,900
31st October	77,000	3,500
30th November	35,500	3,500

The Stock was completely disposed off and amounts due from debtors were realised, the balance being irrecoverable. The acceptor of the bill under discount met the billl on the due date. Prepare a Statement showing the piecemeal distribution of cash according to Maximum Loss Method.

Solution :

Statement showing the Distribution of Cash

(According to Maximum Loss Method)

Particulars	Creditors ₹	Rahul ₹	Roshan ₹	Rohan ₹
A Balance Due	2,10,000	1,40,000	70,000	14,000
B Cash on hand on 30th June paid to creditors	28,000	—	—	—
C Balance outstanding (A – B)	1,82,000	1,40,000	70,000	14,000
D Cash paid on 31st July	77,000	—	—	—
E Balance outstanding (C – D)	1,05,000	1,40,000	70,000	14,000
F ₹ 1,05,000 paid to creditors on 31st August	1,05,000	—	—	—
G Balance outstanding (E – F)	—	1,40,000	70,000	14,000
Balance available for distribution (₹1,20,600 – ₹ 1,05,000 – ₹ 10,000) = ₹ 5,600				
Less : Maximum loss (₹ 2,24,000 – ₹ 5,600) in ratio of 3 : 2 : 1		(1,09,200)	(72,800)	(36,400)
Balance		30,800	(2,800)	(22,400)
Deficiency of Roshan and Rohan's capital charged to Rahul		(25,200)	2,800	22,400
H Cash paid on 31st August		5,600	—	—
I Balance outstanding (G – H)		1,34,400	70,000	14,000
Less : Maximum Loss (₹ 2,18,400 – ₹ 65,100)		(76,650)	(51,100)	(25,550)
Balance		57,750	18,900	(11,550)
Deficiency of Rohan's capital charged to Rahul and Roshan (2 : 1)		(7,700)	(3,850)	11,550
J Cash paid on 30th September		50,050	15,050	—
K Balance outstanding (I – J)		84,350	54,950	14,000
Less : Maximum loss (₹ 1,53,300 – ₹ 73,500)		(39,900)	(26,600)	(13,300)
L Cash paid on 31st October		44,450	28,350	700
M Balance outstanding (K – L)		39,900	26,600	13,300
Less : Maximum loss (₹ 79,800 – ₹42,000*)		(18,900)	(12,600)	(6,300)
N Cash paid on 30th November		21,000	14,000	7,000
O Unpaid Balance (M – N)		18,900	12,600	6,300

***Note :** Cash available on 30th November = (₹ 35,500 – ₹ 3,500) + ₹ 10,000 (Reserved for Discounted B/R, now no longer required) = ₹ 42,000.

Illustration 78.

E, F and G were partners in a firm, sharing profits and losses in the ratio of 3 : 2 : 1, respectively. Due to extreme competition, it was decided to dissolve the partnership on 31st December, 2013. The Balance Sheet on that date was as follows :

Liabilities		Amount ₹	Assets	Amount ₹
Capitals Accounts :			Machinery	1,54,000
E	1,13,100		Furniture and Fittings	25,800
F	35,400		Investments	5,400
G	31,500	1,80,000	Stock	97,700
Current Accounts :			Debtors	56,400
E	26,400		Bank	29,700
G	6,000	32,400	Current Account : F	18,000
Reserves		1,08,000		
Loan Account : G		15,000		
Creditors		51,600		
		3,87,000		**3,87,000**

The realisation of assets is spread over the next few months as follows :

February, Debtors, ₹ 51,900; March : Machinery, ₹ 1,39,500; April, Furniture, etc. ₹ 18,000; May : G agreed to take over Investments at ₹ 6,300; June, Stock, ₹ 96,000.

Dissolution expenses, originally provided, were ₹ 13,500, but actually amounted to ₹ 9,600 and were paid on 30th April. The partners decided that after creditors were settled for ₹ 50,400, all cash received should be distributed at the end of each month in the most equitable manner.

Required : Prepare a statement of actual cash distribution as is received following "Maximum Loss basis".

Solution :

Statement showing the Distribution of Cash (According to Maximum Loss Method)

	Particular	Creditors	G's Loan	Capital Accounts			
				E	F	G	Total
		₹	₹	₹	₹	₹	₹
A	Balance due [Creditors net of discount]	51,600	15,000	1,93,500	53,400	55,500	3,02,400
B	Paid to Creditors and G	50,400	15,000	—	—	—	—
C	Balance due (A - B) Max. Possible Loss if remaining assets fetch nothing (₹ 3,02,400 – ₹ 2,700)	—	—	1,93,500	53,400	55,500	3,02,400
	in the ratio of 3 : 2 : 1			1,49,850	99,900	49,950	2,99,700
	Adjustment of F's Deficiency between			43,650	(46,500)	5,550	
	E and G in the ratio of their fixed capitals i.e. 1,13,100 : 31,500			(36,370)	46,500	(10,130)	
	Balance Adjustment of G's Deficiency			7,280	—	(4,580)	
	(charged to E)			(4,580)		4,580	
D	Cash paid to E on 28th Feb.			2,700	—	—	2,700
E	Balance due (C - D)			1,90,800	53,400	55,500	2,99,700
	Possible Max. Loss (₹ 2,99,700 – ₹ 1,39,500)			80,100	53,400	26,700	1,60,200
F	Cash paid on 31st Mar.			1,10,700	—	28,800	1,39,500
G	Balance Due (E - F)			80,100	53,400	26,700	1,60,200
	Possible Max. Loss (₹1,60,200 – ₹21,900)			69,150	46,100	23,050	1,38,300
H	Cash paid on 30th April			10,950	7,300	3,650	21,900
I	Balance Due (G - H)			69,150	46,100	23,050	1,38,300
J	Maximum Loss (₹1,38,300 – ₹ 6,300)			66,000	44,000	22,000	1,32,000
K	Cash brought in by G			3,150	2,100	1,050	(6,300)
L	Balance Due (I + K)			66,000	44,000	22,000	1,32,000
	Possible Max. Loss (₹ 1,32,000 – ₹ 96,000)			18,000	12,000	6,000	36,000
M	Cash paid on 30th June			48,000	32,000	16,000	96,000
N	Unpaid Balance (L – N)			18,000	12,000	6,000	36,000

Working Note :

Statement showing the Calculation of Cash Available for Distribution

Particular	February ₹	March ₹	April ₹	May ₹	June ₹
A Opening Balance	29,700	—	—	—	—
B Add : Net Amount realised	51,900	1,39,500	18,000	—	96,000
C Less : Provision for Expenses	13,500	—	—	—	—
D Add : Provision no longer required	—	—	3,900	—	—
E Cash available for distribution (A + B – C + D)	68,100	1,39,500	21,900	—	96,000

Illustration 79.

Ajay, Rama, Adesh and Sharad were partners in a firm. The capital of the firm consisted of ₹ 40,000 contributed originally in the proportion of 4 : 3 : 2 : 1. The profits and losses were shared in the same proportion. The firm was dissolved on 31st March, 2013. The Balance Sheet as on that date was as under :

Liabilities	Amount ₹	Assets	Amount ₹
Capitals :		Cash	6,000
Ajay	20,000	Debtors	50,000
Rama	14,000	Stock	19,000
Adesh	10,500		
Sharad	2,500		
Loans :			
Ajay	5,000		
Adesh	8,000		
Creditors	15,000		
	75,000		**75,000**

It was decided on 15th April that the net realisations should be distributed on the first of each month in the appropriate order. The realisation and expenses at the end of each month were as under :

Particulars	Debtors ₹	Stock ₹	Expenses ₹
April	15,000	7,000	500
May	8,500	5,000	1,000
June	11,000	Nil	250
July	5,500	4,000	150
August	7,000	2,500	100

The Stock was completely disposed off. It was further agreed that Rama should take over the remaining debts for ₹ 2,500.

Required : Show how the cash was distributed according to Maximum Loss Method.

Solution :

Statement showing the Distribution of Cash
(According to Maximum loss method)

Particulars	Creditors ₹	Ajay's Loan ₹	Adesh's Loan ₹	Ajay ₹	Rama ₹	Adesh ₹	Sharad ₹
A Balance Due	15,000	5,000	8,000	20,000	14,000	10,500	2,500
B Cash balance							
₹ 6,000 paid to creditors	6,000	—	—	—	—	—	—
C Balances Due (A-B)	9,000	5,000	8,000	20,000	14,000	10,500	2,500
D Paid to Creditors & Ajay & Adesh	9,000	4,808	7,692	—	—	—	—
E Balance unpaid (C - D)		192	308	20,000	14,000	10,500	2,500
F First ₹ 500 out of Net Collection to Ajay & Adesh Loan		192	308	—	—	—	—
G Balance Unpaid				20,000	14,000	10,500	2,500
Max. Loss distributd [₹ 47,000 – ₹12,000]				(14,000)	(10,500)	(7,000)	(3,500)
Sharad's deficiency charged to other Partners				(450)	(315)	(235)	1,000
H Amount paid on 1st June				5,550	3,185	3,265	Nil
I Balance unpaid [G - H]				14,450	10,815	7,235	2,500
Max Loss distributed [₹35,000 – ₹ 10,750]				(9,700)	(7,275)	(4,850)	(2,425)
J Amount paid on 1st July				4,750	3,540	2,385	75
K Balance Unpaid (I - J)				9,700	7,275	4,850	2,425
Max. Loss distributed [₹ 24,250 – ₹ 9,350]				(5,960)	(4,470)	(2,980)	(1,490)
L Amount paid on 1st August				3,740	2,805	1,870	935
M Balances unpaid [K - L]				5,960	4,470	2,980	1,490
N Max Loss distributed [₹ 14,900 – ₹ 9,400 – ₹ 2,500]				(1,200)	(900)	(600)	(300)
O Balances payable				4,760	3,570	2,380	1,190
P Cash paid on 1st Sept.				(4,760)	(1,070)	(2,380)	(1,190)
Q Book debts taken over on 1st Sept.				—	(2,500)	—	—
R Balances unpaid being los on realisation [M - P - Q]				1,200	900	600	300

Illustration 80.

Given below is the Balance Sheet of Alpha, Beta and Cappa as on 31st March, 2013 on which date they dissolved their partnership. They shared profits and losses in the ratio 3 : 4 : 3. They decided to distribute amount as and when feasible and to appoint Cappa for the purpose who was to get as his remuneration 1% of the value of the assets realised other than cash at Bank and 10% of the amount distributed to the partners :

Liabilities	Amount ₹	Assets	Amount ₹
Capitals :		Cash at Bank	275
Alpha	7,500	Sundry assets	53,725
Beta	15,000		
Cappa	15,000		
Sundry Creditors	16,500		
	54,000		54,000

Assets realised as under :

First Installment ₹ 16,250, Second Installment ₹ 12,750, Third Installment ₹ 10,000, Last Installment ₹ 7,500.

Required : Prepare a statement showing distribution of cash according to Maximum Loss Method.

Solution :

Statement showing the Distribution of Cash
(According to Maximum Loss Method)

Installment Number	Particulars		Sundry Creditors ₹	Alpha's Capital ₹	Beta's Capital ₹	Cappa's Capital ₹
(1)	A. Balance Due					
	Bank Balance	275	16,500	7,500	15,000	15,000
	Sales Proceeds of assets	16,250				
		16,525				
	Paid to creditors	16,500	16,500	—	—	—
	B. Balance Carried forward	25	Nil	7,500	15,000	15,000
	Sale proceeds of assets	12,750				
		12,775				
	Commission to C (i)	1,425				
	Balance available	11,350				
(2)	Maximum loss allocated ₹ 26,150					
	(i.e. ₹ 37,500 – ₹ 11,350)			(7,845)	(10,460)	(7,845)
	Deficiency of Alpha's Capital allocated to Beta and Cappa in Capital Ratio			345	(173)	(173)
	C. Amount paid			—	4,367	6,983

(3)	D. Balance Unpaid [B - C]			7,500	10,633	8,018
	Sale proceeds of assets	10,000				
	Less : Cappa's commission (ii)	1,000				
	Balance available	9,000				
	Maximum loss allocated			5,145	6,860	5,145
	₹ 17,150 (i.e. ₹ 26,150 – ₹ 9,000)					
	E. Amount paid			2,355	3,773	2,873
Last	F. Balance unpaid [D - E]			5,145	6,860	5,145
	Sale Proceeds of assets	7,500				
	Less : Cappa's Commission (iii)	750				
	Balance available	6,750				
	Maximum loss allocated			3,120	4,160	3,120
	G. Amounts Paid			2,025	2,700	2,025
	H. Unpaid Balance [F - G]			3,120	4,160	3,120

Working Note :

Calculation of Commission payable to Cappa		₹
(i) Commission on the sale of assets @ 1% on 1st and 2nd installments		290
1/11th of amount available for distribution to partners [1/11× ₹ 12,485]		1,135
	Total	1,425
(ii) Commission on sale of assets 1% on ₹ 10,000		100
1/11 of amount available for distribution, [i.e., 1/11× ₹ 9,900]		900
	Total	1,000
(iii) Commission on sale of assets 1% on ₹ 7,500		75
1/11 of amount available for distribution [i.e., 1/11 × ₹ 7,425]		675
	Total	750

Grand Total of Commission payable to Cappa ₹ 3,175

(iv) Commission is not paid Cappa during the first installment due to insufficiency of cash. Hence the small balance available is carried forward.

6.7 AMALGAMATION OF FIRMS AND CONVERSION TO A COMPANY

Introduction

As defined earlier, a Partnership firm is formed with two or more persons. But it can also be formed in any of the following ways.

(A) When two or more sole proprietors forms new partnership firm;

(B) When one existing partnership firm absorbs a sole proprietorship;

(C) When one existing partnership firm absorbs another partnership firm;

(D) When two or more partnership firms form new partnership firm.

The amalgamation is used to be done to avoid competition amongst them and to maximize the profit of the firm/firms.

Accounting entries under different situation are in below:

(A) When two or more sole proprietors form a new partnership firm

When two or more sole proprietorship businesses amalgamate to form a new partnership firm, the existing sets of books will be closed and a new set of books of accounts to be opened, recording all assets, liabilities and transactions of the partnership.

Steps to be taken for the existing books.

Step 1 : Prepare the Balance Sheet of the business on the date of dissolution.

Step 2 : Open a Realisation Account and transfer all assets and liabilities, except cash in hand and cash at bank, at their book values.

However, cash in hand and cash at bank are transferred to Realisation Account only when they are taken over by the new firm.

Step 3 : All undistributed reserves or profits or losses (appearing in the balance sheet) are to be transferred to Partners' Capital Accounts.

Step 4 : Calculate Purchase Consideration on the basis of terms and conditions agreed upon by the parties. Generally, purchase consideration is calculated on the basis of agreed value of assets and liabilities taken over by the new firm. The purchase consideration is calculated as under:

Agreed values of assets taken over	xxxx
Less: Agreed values of liabilities assumed	(xxx)
Purchase consideration	xxxx

Step 5 : Credit Realisation Account by the amount of Purchase Consideration.

Step 6 : If there are any unrecorded assets or liabilities, they are to be recorded.

Step 7 : The Profit or loss on relisation (balancing figure of Realisation Account) to be transferred to the Capital Account of the proprietor.

Step 8 : To ensure that all the accounts of the Sole Proprietor’s business are closed.

Accounting Entries in the Books of Amalgamating Sole Proprietors :

1. For transferring sundry assets to Realisation Account
   Realisation A/c Dr.
   To Sundry Assets A/c [Individually]
   (Assets transferred to Realisation Account at their book values except Cash and Bank i.e. if not taken over by the new firm)

2. For transferring sundry liabilities to Realisation Account
   Liabilities A/c Dr.
   To Realisation A/c [Individually]
   (Liabilities transferred to Realisation Account at their book values)

3. For the amount of purchase consideration
   New Firm A/c Dr.
   To Realisation A/c
   (Purchase consideration due from the new firm)

4. For assets taken over by the proprietor
   Capital A/c Dr.
   To Realisation A/c
   (Assets taken over by the proprietor)

5. For realisation of assets not taken over by the new firm
   Bank A/c Dr.
   To Realisation A/c
   (Realisation of assets not taken over by the new firm)

6. For recording of unrecorded assets
   Assets A/c Dr.
   To Capital A/c
   (Unrecorded assets are recorded)

7. For realisation of unrecorded assets
   Bank A/c Dr.
   To Assets A/c
   (Realisation of unrecorded assets)
   (Note: If unrecorded assets are taken over by the new firm, it is also transferred to Realisation Account along with other assets.)

8. For payment of liabilities not taken over
   Realisation A/c Dr.
   To Bank A/c
   (Payment of liabilities not taken overby the new firm)

9. For recording of unrecorded liabilities
   Capital A/c Dr.
   To Liabilities A/c
   (Being the unrecorded liabilities are recorded)

10. For payment of unrecorded liabilities
    Liabilities A/c Dr.
        To Bank A/c
    (Payment of unrecorded liabilities)
    (**Note :** If unrecorded liabilities are taken over by the new firm, it is also transferred to Realisation Account along with other liabilities.)

11. For liabilities taken over by the proprietor
    Realisation A/c Dr.
        To Capital A/c
    (Being liabilities assumed by the proprietor)

12. For realisation expenses
    Realisation A/c Dr.
        To Bank A/c
    (Realisation expenses paid)

13. For profit on realisation
    Realisation A/c Dr.
        To Capital A/c
    (Profit on realisation transferred to Capital Account)

14. For loss on realisation
    Capital A/c Dr.
        To Realisation A/c
    (Loss on realisation transferred to Capital Account)

15. For accumulated profits / reserves
    Reserves A/c Dr.
    Profit and Loss A/c Dr.
        To Capital A/c
    (Undrawn profits transferred to Capital Account)

16. For accumulated losses
    Capital A/c Dr.
        To Profit and Loss A/c (if any)
    (Accumulated losses transferred to Capital A/c))

17. For settlement of purchase consideration by the New firm
    Capital in New Firm A/c Dr.
        To New Firm A/c
    (Settlement of purchase consideration)

18. For final adjustment
    Capital A/c Dr.
        To Capital in New Firm A/c
        To Bank A/c (if any)
    (Final adjustment to close the books of account)

Accounting Entries in the Books of the New Firm

The new firm records all the assets and liabilities at the values it has decided to take over. If the purchase consideration payable is, more than the net assets (assets minus liabilities) acquired, it represents goodwill. Conversely, if the purchase consideration payable is less than the net assets acquired, it represents capital reserve.

1. If the net acquired assets is equal to purchase consideration.

Assets A/c	Dr.	[Acquired value]
To Liabilities A/c		[Assumed value]
To Partners' Capital A/c		[Purchase consideration]

2. If the net acquired asset is more than the purchase consideration:

Assets A/c	Dr.	[Acquired value]
To Liabilities A/c		[Assumed value]
To Partners' Capital A/c		[Purchase consideration]
To Capital Reserve A/c		[Purchase consideration - net assets]

3. If the net acquired asset is less than the amount of purchase consideration, it represents goodwill.

Assets A/c	Dr.	[Acquired value]
Goodwill A/c	Dr.	[Purchase consideration - net assets]
To Liabilities A/c		[Assumed value]
To Partners' Capital A/c		[Purchase consideration]

Illustration 81.

A and B carry on independent business and their position on 31.03.2013 are reflected in the Balance Sheet given below :

Liabilities	A ₹	B ₹	Assets	A ₹	B ₹
Sundry creditors for purchases	1,10,000	47,000	Stock-in-trade	1,70,000	98,000
Sundry creditors for expenses	750	2,000	Sundry Debtors	89,000	37,000
Bills payable	12,500	-	Cash at bank	13,000	7,500
Capital A/c	1,53,000	95,500	Cash in hand	987	234
			Furniture and Fixtures	2,750	1,766
			Investments	513	—
	2,76,250	1,44,500		2,76,250	1,44,500

Both of them want to form a partnership firm from 1.4.2013 in the style of AB & Co. on the following terms:

(a) The capital of the partnership firm would be ₹ 3,00,000 and to be contributed by them in the ratio of 2:1.

(b) The assets of the individual businesses would be evaluated by C at which values, the firm will take them over and the value would be adjusted against the contribution due by A and B.

(c) C gave his valuation report as follows :

Assets of A : Stock-in trade to be written-down by 15% and a portion of the sundry debtors amounting to ₹9,000 estimated unrealisable; furniture and fixtures to be valued at ₹2,000 and investments to be taken at market value of ₹1,000.

Assets of B : Stocks to be written-up by 10% and sundry debtors to be admitted at 85% of their value; rest of the assets to be assumed at their book values.

(d) The firm is not to consider any creditors other than the dues on account of purchases made.

You are required to pass necessary Journal entries in the books of A and B. Also prepare the opening Balance Sheet of the firm as on 1.4.2013.

Solution :

In the books of A

Journal

Date	Particulars		Dr. Amount ₹	Cr. Amount ₹
2013 Apr.1	Realisation A/c	Dr.	2,76,250	
	To Stock-in-trade A/c			1,70,000
	To Sundry Debtors A/c			89,000
	To Cash at bank A/c			13,000
	To Cash in hand A/c			987
	To Furniture & Fixture A/c			2,750
	To Investments A/c			513
	(Transfer of different Assers to Realisation A/c)			
	Creditors for Goods A/c	Dr.	1,10,000	
	Creditors for Expenses A/c	Dr.	750	
	Bills Payable A/c	Dr.	12,500	
	To Realisation A/c			1,23,250
	(Transfer of different liabilities to Realisation A/c)			
	AB & Co. A/c (Note 1)	Dr.	1,18,987	
	To Realisation A/c			1,18,987
	(Purchase consideration due)			
	Capital A/c	Dr.	34,013	
	To Realisation A/c			34,013
	(Realisation loss transferred to Capital A/c)			
	Capital in AB & Co. A/c	Dr.	1,18,987	
	To AB & Co. A/c			1,18,987
	(Settlement of purchase consideration)			
	Capital A/c	Dr.	1,18,987	
	To Capital in AB & Co. A/c			1,18,987
	(Final adjustment to close the books of account)			

In the books of B

Journal

Date	Particulars		Dr. Amount ₹	Cr. Amount ₹
2013 Apr. 1	Realisation A/c	Dr.	1,44,500	
	To Stock-in-trade A/c			98,000
	To Sundry Debtors A/c			37,000
	To Cash at bank A/c			7,500
	To Cash in hand A/c			234
	To Furniture & Fixture A/c			1,766
	(Transfer of different Assers to Realisation A/c)			
	Creditors for Goods A/c	Dr.	47,000	
	Creditors for Expenses A/c	Dr.	2,000	
	To Realisation A/c			49,000
	(Transfer of different liabilities to Realisation A/c)			
	AB & Co. A/c	Dr.	1,01,750	
	To Realisation A/c			1,01,750
	(Purchase consideration due)			
	Realisation A/c	Dr.	6,250	
	To Capital A/c			6,250
	(Realisation Profit transferred to Capital A/c)			
	Capital in AB & Co. A/c	Dr.	1,01,750	
	To AB & Co. A/c			1,01,750
	(Settlement of purchase consideration)			
	Capital A/c	Dr.	1,01,750	
	To Capital in AB & Co. A/c			1,01,750
	(Final adjustment to close the books of account)			

Balance Sheet of AB & Co. as on 01.04.2013

Liabilities	Amount ₹	Assets	Amount ₹
Capital Accounts :		Furniture & Fittings	3,766
A	2,00,000	Investments	1,000
B	1,00,000	Stock-in-trade	2,52,300
Sundry creditors for	1,57,000	Sundry Debtors	1,11,450
purchases	12,500	Cash at bank	99,763
Bills payable		(13,000 + 7,500 + 81,013 - 1,750)	
		Cash in hand (987 + 234)	1,221
	4,69,500		4,69,500

Working :

(1) Calculation of purchase consideration :

Particulars	A (₹)	B (₹)
Furniture	2,000	1,776
Investments	1,000	-
Stock-in-trade	1,44,500	1,07,800
Sundry Debtors	80,000	31,450
Cash at bank	13,000	7,500
Cash in hand	987	234
	2,41,487	1,48,750
Less : Sundry creditors for purchases	1,10,000	47,000
Bills payable (Assumed arising out of credit purchases)	12,500	-
Net assets taken over by the AB & Co.	1,18,987	1,01,750
Capital as per agreement	2,00,000	1,00,000
Less: Net assets taken over	1,18,987 (+)	1,01,750 (-)
Cash to be introduced (+) / withdrawn (-)	81,013	1,750

(B) When an existing partnership firm absorbs a sole proprietorship

When a sole proprietorship is taken over by an existing firm, the original business of the sole proprietor is dissolved and compensated by a share of the partnership firm which is acquiring it. In this case, assets and liabilities of the sole proprietorship business are taken over by the partnership firm at agreed values. **The procedures for closing the books of account of the sole proprietorship are same as explained earlier**.

However, the following points are to be noted:

(i) The assets and liabilities of the sole proprietorship taken over by the existing firm, are added with the existing assets and liabilities of the firm.

(ii) The capital of the new partner (the sole proprietorship) is equal to the purchase consideration agreed upon.

(iii) Calculation and treatment for goodwill and Capital reserve are same as explained in situation (A).

(iv) Before amalgamation, all the assets and liabilities of the firm may be revalued. Any profit or loss on revaluation is transferred to the Partners' Capital Accounts in the old profit-sharing ratio.

(v) Goodwill of the firm is to be adjusted by crediting the Partners' Capital Accounts in their old profit-sharing ratio.

(vi) Balance of reserve and surplus of the firm is also to be credited to partners' Capital Accounts in the old profit-sharing ratio.

Illustration 82.

Following are the Balance Sheets of partners X and Y (sharing profits and losses in the ratio of their capital) and the sole proprietor Z as on 31.03.2013 :

Liabilities	Partners X & Y	Sole Proprietor Z	Assets	Partners X & Y	Sole Proprietor Z
Capital X	15,000	-	Goodwill	-	2,000
Y	5,000	-	Building	25,000	-
Z	-	10,000	Stock	10,000	15,000
Creditors	26,000	13,000	Bills receivable	5,000	5,000
Loan	-	5,000	Debtors	4,000	6,000
			Cash in Hand	2,000	-
	46,000	28,000		46,000	28,000

The partners decided to admit Z as a partner and Z agreed to amalgamate his business with that of the partnership on the following terms :

1. The new profit-sharing ratio among X, Y, and Z will be in the ratio of their capitals.
2. The building is to be appreciated by ₹ 15,000 and provision @ 5 % is to be created on debtors.
3. The goodwill of the partnership is valued at ₹ 10,000 and of the sole proprietor at ₹ 1,500; both are to be recorded in the books.
4. Stock is to be taken at ₹ 9,200 and ₹ 16,800, respectively of the firm and the sole proprietor.

Prepare ledger accounts to close the books of Z, to make necessary Journal entries in the books of the firm and prepare the Balance Sheet of the re-constituted partnership.

Solution :

Working Note : Calculation of purchase consideration

Assets taken over :	₹	₹
Goodwill	1,500	
Stock	16,800	
Bills receivable	5,000	
Debtors	6,000	29,300
Less: Liabillties taken over:		
Creditors	13,000	
Loan	5,000	
Provision for bad debts	300	18,300
Purchase consideration		11,000

In the books of Z

Realisation Account

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Goodwill A/c	2,000		By Creditors A/c	13,000
	To Stock A/c	15,000		By Loan A/c	5,000
	To Bills receivable A/c	5,000		By Partners X & Y A/c	11,000
	To Debtors A/c	6,000			
	To Capital A/c - Profit	1,000			
		29,000			29,000

Capital Account

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Partners X & Y A/c	11,000		By Balance b/d	10,000
				By Realisation A/c	1,000
		11,000			11,000

Partners X & Y Account

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Realisation A/c	11,000		By Capital A/c	11,000
		11,000			11,000

In the Books of X & Y
Journals

Date	Particulars	L.F	Dr. Amount ₹	Cr. Amount ₹
	Building A/c Dr.		15,000	
	To Revaluation A/c			15,000
	(Increase in the Value of Building)			
	Revaluation A/c Dr.		1,000	
	To Stock A/c			800
	To Provision for Bad Debt A/c			200
	(Decrease in the value of assets)			
	Revaluation A/c Dr.		14,000	
	To X Capital A/c			10,500
	To Y Capital A/c			3,500
	(Profit on revaluation transferred)			

	Goodwill A/c Dr. To X Capital A/c To Y Capital A/c (Goodwill raised in the books)		10,000	 7,500 2,500
	Goodwill A/c Dr. Stock A/c Dr. Bills Receivable A/c Dr. Debtors A/c Dr. To Loan A/c To Creditors A/c To Provision for Bad Debt A/c To Z Capital A/c (Assets and liabilities taken over)		1,500 16,800 5,000 6,000	 5,000 13,000 300 11,000

Balance Sheet of X, Y & Z (after absorption) as at 01.04.13

Liabilities	Amount ₹	Assets	Amount ₹	Amount ₹
Capital Account		Goodwill		11,500
- X	33,000	Building		40,000
- Y	11,000	Stock		26,000
- Z	11,000	Bills Receivable		10,000
Loan	5,000	Debtors	10,000	
Crditors	39,000	Less: Provision	500	9,500
		Cash in hand		2,000
	99,000			99,000

(C) When one firm takes over another firm

In this case, the procedures for closing of books are same as earlier. The assets of the absorbed firm added with the firm who absorbed the firm.

The treatment for capital reserve and goodwill are same as before.

Illustration 83.

Following is the Balance sheet of AB & Co. and CD & Co. as on 31.03.2013.

Liabilities	AB (₹)	CD (₹)	Assets	AB (₹)	CD (₹)
Bank Loan	10,000	-	Stock-in-trade	32,000	24,000
Bills Payable	30,000	40,000	Sundry Debtors	18,000	30,000
Capital A	60,000	-	Machinery	60,000	20,000
Capital B	30,000	-	Cash in hand	12,000	2,000
Capital C		36,000	Furniture	8,000	6,000
Capital D		24,000	Investments	-	18,000
	130,000	100,000		130,000	100,000

AB & Co. absorbed CD & Co. on 01.04.2013 on the following terms:

(a) that the value of the goodwill of CD & Co. would be ₹ 12,000;

(b) that the investments of CD & Co. to be sold out for ₹ 24,000 and the realised cash will be introduced in the acquiring business;

(c) that the stock of CD & Co. to be reduced to ₹ 22,000;

(d) that the machinery of CD & Co. will be increased by 40%;

(e) that the Furniture of CD & Co. will be reduced by 10%.

It was further agreed that for AB & Co., following are the adjustments to be made :

(i) Assets are to be revalued as follows :

Goodwill- ₹ 16,000; Stock - ₹ 40,000; Machinery - ₹ 84,000; Furniture - ₹ 7,200;

(ii) Bank loan to be repaid

Show necessary Ledger Accounts to close the books of CD & Co. and to prepare necessary Journal entry and Balance Sheet of AB & Co. after absorption.

Solution :

Workings :

Calculation of purchase consideration

Assets taken over :	₹
Machinery	28,000
Furniture	5,400
Stock	22,000
Debtors	30,000
Cash (₹ 24,000 + ₹ 2,000)	26,000
Goodwill	12,000
	1,23,400
Less : **Liability taken over**	
– Bills payable	40,000
Purchase consideration	**83,400**

In the books of CD & Co.

Dr. **Realisation Account** **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Stock-in-trade	24,000		By Bills Payable A/c	40,000
	" Sundry Debtors	30,000		By AB & Co A/c	83,400
	" Machinery	20,000			
	" Cash in hand	26,000			
	" Furniture				
	To Partners' Capital A/cs:	6,000			
	C - 8,700				
	D - 8,700				
		17,400			
		123,400			123,400

Dr. **Cash Account** Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Balance b/d	2,000		By Realisation A/c	26,000
	To Investments A/c	24,000			
		26000			26,000

Dr. **Partners' Capital Accounts** Cr.

Date	Particulars	C ₹	D ₹	Date	Particulars	C ₹	D ₹
	To Capital in AB & co A/c	47,700	35,700		By Balance b/d	36,000	24,000
					By Profit on Sale of Investment A/c	3,000	3,000
					By Realisation A/c	8,700	8,700
		47,700	35,700			47,700	35,700

In the books of AB & Co.

Dr. **Partners' Capital Accounts** Cr.

Date	Particulars	A ₹	B ₹	Date	Particulars	A ₹	B ₹
	To Balance c/d	83,600	53,600		By Balance b/d	60,000	30,000
					By Goodwill A/c	8,000	8,000
					By Revaluation A/c	15,600	15,600
		83,600	53,600			83,600	53,600

Balance Sheet as on 01.04.2013

Liabilities	Amount ₹	Assets	Amount ₹
Capital Accounts		Goodwill	28,000
A B C D	83,600	Machinery	1,12,000
	53,600	Furniture	12,600
Bills payable	47,700	Stock	62,000
	35,700	Debtors	48,000
	70,000	Cash (26,000 + 12,000 – 10,000)	28,000
	2,90,600		2,90,600

Journal

Date	Particulars		L.F	Dr. Amount ₹	Cr. Amount ₹
1.4.13	Bank Loan A/c	Dr.		10,000	
	To Cash A/c				10,000
	(Being the bank loan repaid)				
	Goodwill A/c	Dr.		16,000	
	To A's Capital A/c				8,000
	To B's Capital A/c				8,000
	(Being the goodwill raised)				
	Stock A/c	Dr.		8,000	
	Machinery A/c	Dr.		24,000	
	To Revaluation A/c				32,000
	(Being increase in the value of assets)				
	Revaluation A/c	Dr.		800	
	To Furniture A/c				800
	(Being the decrease in the value of furniture)				
	Revaluation A/c	Dr.		31,200	
	To A's Capital A/c				15,600
	To B's Capital A/c				15,600
	(Being the profit on revaluation transferred to Partners' Capital A/cs in the profit-sharing ratio)				
	Goodwill A/c	Dr.		12,000	
	Machinery A/c	Dr.		28,000	
	Furniture A/c	Dr.		5,400	
	Stock A/c	Dr.		22,000	
	Debtors A/c	Dr.		30,000	
	Cash A/c	Dr.		26,000	
	To Bills Payable A/c				
	To C 's Capital A/c				40,000
	To D's Capital A/c				47,700
	(Being the introduction of capital by C & D)				35,700

(D) When two or more partnership firms form a new partnership firm

When two or more partnership firms amalgamate to form a new partnership firm, the books of account of the old firm is to be closed. In the books of each old firm, a Realisation Account to be opened. The accounting entries of the amalgamating firm is same as before as they were absorbed.

Illustration 84.

Two partnership firms, carrying on business under the style of R & Co. (Partners A & B) and W & Co. (Partners C & D) respectively, decided to amalgamate into RW & Co. with effect from 1st April 2013. The respective Balance Sheets of both the firms as on 31st March, 2013 are in below :

Liabilities	R (₹)	W (₹)	Assets	R (₹)	W (₹)
Capital B	19,000	-	Goodwill	-	5,000
Capital C	-	10,000	Machinery	10,000	-
Capital D	-	2,000	Stock-in-trade	20,000	5,000
Bank Loan	15,000	-	Sundry Debtors	10,000	10,000
Creditors	10,000	9,500	Cash in hand	-	1,500
			Capital - A	4,000	-
	44,000	21,500		44,000	21,500

Profit sharing ratios are : A & B = 1:2; C & D = 1:1. Agreed terms are :

1. All fixed assets are to be devalued by 20%.
2. All stock in trade is to be appreciated by 50%.
3. R & Co. owes ₹5,000 to W & Co. as on 31st March 2013. This is settled at ₹2,000. Goodwill is to be ignored for the purpose of amalgamation.
4. The fixed capital accounts in the new firm (RW & Co.) are to be : Mr A ₹2,000; Mr. B ₹3,000; Mr C ₹1,000 and D ₹4,000.
5. Mr. B takes over bank overdraft of R & Co. and contributed to Mr. A the amount of money to be brought in by Mr. A to make up his capital contribution.
6. Mr C is paid off in cash from W & Co. and Mr. D brings in sufficient cash to make up his required capital contribution.

Pass necessary Journal entries to close the books of both the firms as on 31st March 2013.

Solution :

Calculation of Purchase Consideration

Assets taken over :		**R & Co.**	**W & Co.**
Plant & Machinery		8,000	-
Stock-in-trade		30,000	7,500
Sundry Debtors [(* After adjustment of ₹ 3,000		10,000	*7,000
(₹ 5,000 – 2,000)]	(A)	48,000	14,500
Liability taken over:			
Sundry Creditors [(* ₹ (10,000 – 3000)]	(B)	*7,000	9,500
Purchase consideration	(A-B)	41,000	5,000

In the books of R & Co.
Journals

Date	Particulars		L.F	Dr. Amount ₹	Cr. Amount ₹
31.3.13	Realisation A/c	Dr.		40,000	
	To Plant and Machinery A/c				10,000
	To Stock-in-trade A/c				20,000
	To Sundry Debtors A/c				10,000
	(Different assets transferred)				
	Sundry Creditors A/c	Dr.		10,000	
	To Realisation A/c				10,000
	(Sundry creditors transferred to Realisation Account)				
	Bank Loan A/c	Dr.		15,000	
	To B Capital A/c				15,000
	(Bank overdraft taken over by B)				
	RW & Co. A/c	Dr.		41,000	
	To Realisation A/c				41,000
	(Purchase consideration due)				
	Realisation A/c	Dr.		11,000	
	To A Capital A/c				3,667
	To B Capital A/c				7,333
	(Profit on realisation transferred to partners capital in the ratio of 1:2)				
	B Capital A/c	Dr.		2,333	
	To A Capital A/c				2,333
	(Deficit in A's capital made good by B)				
	A Capital A/c	Dr.		2,000	
	B Capital A/c (3,000 + 36,000)	Dr.		39,000	
	To RW & Co. A/c				41,000
	(Capital accounts of the partners closed by transfer to RW & Co.)				
	Alternatively Shows:				
	A Capital A/c	Dr.		2,000	
	B Capital A/c	Dr.		3,000	
	Loan from B A/c	Dr.		36,000	
	To RW & Co. A/c				41,000

Note : It should be noted that the credit balance in B's capital account is ₹ 39,000. His agreed capital in RW & Co is ₹ 3,000 only. Since there is no liquid assets in R & Co. from which B can be repaid, the excess amount of ₹ 36,000 should be taken over by RW & Co. as loan from B.

In the books of W & Co.

Journals

Date	Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
31.3.13					
	Realisalion A/c	Dr.		20,000	
	To Goodwill A/c				5,000
	To Stock-in-trade A/c				5,000
	To Sundry Debtors A/c				10,000
	(Different Assets transferred)				
	Sundry Creditors A/c	Dr.		9,500	
	To Realisation A/c				9,500
	(Sundry creditors transferred)				
	RW & Co. A/c	Dr.		5,000	
	To Realisation A/c				5,000
	(Purchase consideration due)				
	C's Capital A/c	Dr.		2,750	
	D's Capital A/c	Dr.		2,750	
	To Realisation A/c				5,500
	(Loss on realisation transferred to Capital Account equally)				
	Cash A/c	Dr.		4,750	
	To D's Capital A/c				4,750
	(Being the necessary amount brought in by D to make up his required capital contribution)				
	C's Capital A/c	Dr.		7,250	
	D's Capital A/c	Dr.		4,000	
	To RW & Co. A/c				5,000
	To Cash A/c				6,250
	(Capital accounts of the partners closed by transfer to RW & Co. and balance paid by cash)				
	Alternatively Shows:				
	C's Capital A/c	Dr.		6,250	
	To Cash A/c				6,250
	(Being the C's Capital is paid off)				
	C's Capital A/c	Dr.		1,000	
	D's Capital A/c	Dr.		4,000	
	To RW & Co. A/c				5,000
	(Being the Partner's Capital transferred to RW & Co.)				

Realization Account

Dr. ***Cr.***

Particulars	R & Co. ₹	W & Co. ₹	Particulars	R & Co. ₹	W & Co. ₹
To Goodwill	-	5,000	By Creditors	10,000	9,500
" Machinery	10,000	-	By RW & Co.	41,000	5,000
" Stock-in-trade	20,000	5,000	By C's Capital		2,750
" Sundry Debtors	10,000	10,000	By D's Capital		2,750
" Cash in hand	-				
" A's Capital	3,667				
" B's Capital	7,333				
	51,000	20,000		51,000	20,000

Partners' Capital Accounts of R & Co.

Dr. ***Cr.***

Date	Particulars	A (₹)	B (₹)	Date	Particulars	A (₹)	B (₹)
2013	To Balance b/d	4,000	—	2013	By Balance b/d	—	19,000
Mar 13	`` A Capital A/c	—	2,333	Mar 31	`` Realisation A/c (Profit)	3,667	7,333
	`` Loan A/c	—	36,000		`` Bank overdraft A/c	—	15,000
	`` R W & Co. A/c	2,000	3,000		`` B's Capital A/c	2,333	—
		6,000	41,333			6,000	41,333

Partners' Capital Accounts of W & Co.

Dr. ***Cr.***

Date	Particulars	C (₹)	D (₹)	Date	Particulars	C (₹)	D (₹)
2013	To Realisation A/c (Loss)	2,750	2,750	2013	By Balance b/d	10,000	2,000
Mar 31	`` Cash A/c	6,250	—	Mar 31	`` Cash A/c	—	4,750
	`` R W & Co. A/c	1,000	4,000				
		10,000	6,750			10,000	6,750

Illustration 85.

M/s AB & Co., having A and B as equal partners, decided to amalgamate with M/s CD & Co., having C and D as equal partners on the following terms and conditions :

1. The new firm XY and Co. to pay ₹ 12,000 to each firm for Goodwill.

2. The new firm to take over investments at 90% of the value, land at ₹ 66,800, premises at ₹ 53,000, machinery at ₹ 9,000 and only the trade liabilities of both the firms and the debtors at book value. Typewriters, worth ₹ 800, belonging to CD & Co., not appearing in the Balance Sheet. That is not taken over by the new firm.

4. Bills payable pertaining to trade transactions only.

5. All the four partners in the new firm to bring in ₹ 1,60,000 as capital in equal shares.

The following were the Balance Sheets of both the firms on the date of amalgamation :

Liabilities	AB & Co. ₹	CD & Co. ₹	Assets	AB & Co. ₹	CD & Co. ₹
Trade creditors	20,000	10,000	Cash	15,000	12,000
Bills payable	5,000	-	Investments	10,000	8,000
Bank overdraft	2,000	10,000	Debtors 10,000		
A's Loan	6,000	-	*Less* : Provision 1,000	9,000	4,000
Capitals :			Furniture	12,000	6,000
A	35,000	-	Premises	30,000	-
B	22,000	-	Land	-	50,000
D	-	36,000	Machinery	15,000	15,000
General Reserve	-	20,000	Goodwill	9,000	9,000
Investment	8,000	3,000			
Fluctuation Fund	2,000	1,000			
	1,00,000	80,000		1,00,000	80,000

Assuming immediate discharge of bank overdraft, pass necessary Journal entries to close the books *of* A B & Co. Also pass Journal entries in the books of XY & Co. and prepare the Balance Sheet of the firm.

Solution :

In the books of AB & Company
Journal

Date	Particulars		L.F	Dr. Amount ₹	Cr. Amount ₹
	Bank Overdraft A/c	Dr.		2,000	
	To Cash A/c				2,000
	(Payment of overdraft)				
	Realisation A/c	Dr.		99,000	
	To Cash A/c				13,000
	To Investments A/c				10,000
	To Debtors A/c				10,000
	To Furniture A/c				12,000
	To Premises A/c				30,000
	To Machinery A/c				15,000
	To Goodwill A/c				9,000
	(Transfer of different assets)				
	Provision for Bad Debts A/c	Dr.		1,000	
	Trade Creditors A/c	Dr.		20,000	
	Bills Payable A/c	Dr.		5,000	
	To Realisation A/c				26,000
	(Transfer of different Liabilities)				
	M/s XY & Co. A/c	Dr.		80,000	
	To Realisation A/c				80,000
	(Purchase consideration due)				
	A Capital A/c	Dr.		6,000	
	B Capital A/c	Dr.		6,000	
	To Realisation A/c				12,000
	(Furniture taken over by the partners)				
	General Reserve A/c	Dr.		8,000	
	Investment Fluctuation Fund A/c	Dr.		2,000	
	To A Capital A/c				5,000
	To B Capital A/c				5,000
	(Reserve and surplus distributed)				
	Realisation A/c	Dr.		19,000	
	To A Capital A/c				9,500
	To B Capital A/c				9,500
	(Profit on realisation transferred)				
	A's Loan A/c	Dr.		6,000	
	To A Capital A/c				6,000
	(A's loan transferred to his Capital A/c)				

	Cash A/c Dr. To B Capital A/c (Cash brought in by B)		9,500	 9,500
	Capital in M/s XY & Co. A/c Dr. To M/s XY & Co. A/c (Settlement of purchase consideration)		80,000	 80,000
	A Capital A/c Dr. To Capital in XY & Co. A/c To Cash A/c (Final adjustment to close the books)		49,500	 40,000 9,500
	B's Capital A/c Dr. To B's Cap. In XY & Co. A/c (Final adjustment to close the books)		40,000	 40,000

In the Books of XY & Co.
Journals

Date	Particulars	L.F	Dr. Amount (₹)	Cr. Amount (₹)
	Goodwill A/c Dr. Cash A/c Dr. Investments A/c Dr. Debtors A/c Dr. Premises A/c Dr. Machinery A/c Dr. To Provision for Bad Debts A/c To Trade Creditors A/c To Bills Payable A/c To A's Capital A/c To B's Capital A/c (Assets and liabilities taken over from AB & Co.)		12,000 13,000 9,000 10,000 53,000 9,000	 1,000 20,000 5,000 40,000 40,000
	Goodwill A/c Dr. Investments A/c Dr. Debtors A/c Dr. Land A/c Dr. To Trade Creditors A/c To C's Capital A/c To D's Capital A/c (Assets and liabilities taken over from CD & Co.)		12,000 7,200 4,000 66,800	 10,000 40,000 40,000

Balance Sheet as on .....

Liabilities	Amount ₹	Assets	Amount ₹
Partners' Capitals :		Goodwill	24,000
A	40,000	Land	66,800
B	40,000	Premises	53,000
C	40,000	Machinery	9,000
D	40,000	Investments	16,200
Creditors	30,000	Debtors	13,000
Bills Payable	5,000	Cash	13,000
	1,95,000		1,95,000

Working Notes:

(1) Calculation of Purchase Consideration

Assets taken over:		**A & Co. (₹)**	**C & Co. (₹)**
Cash (See Note below)		13,000	—
Investments		9,000	7,200
Debtors		9,000	4,000
Premises		53,000	—
Machinery		9,000	—
Land		—	66,800
Goodwill		12,000	12,000
	(A)	1,05,000	90,000
Liabilities taken over:			
Trade Creditors		20,000	10,000
Bills Payable		5,000	—
	(B)	25,000	10,000
Purchase Consideration	(A – B)	80,000	80,000

Note: Total capital of the new firm should be ₹ 1,60,000. Combined capital of A and B will be ₹ 80,000 and that of C and D will be ₹ 80,000. Net assets (other than cash) taken over by the new firm are as follows:

Assets taken over:		**A & Co. (₹)**	**C & Co. (₹)**
Investments		9,000	7,200
Debtors		9,000	4,000
Premises		53,000	—
Machinery		9,000	—
Land		—	66,800
Goodwill		12,000	12,000
	(A)	92,000	90,000
Liabilities taken over:			
Trade Creditors		20,000	10,000
Bills Payable		5,000	—
	(B)	25,000	10,000
Net Assets Taken over	(A – B)	67,000	80,000

It should be noted that A & Co.'s net assets (other than cash) comes to ₹67,000 whereas required capital of A and B should be ₹80,000. Therefore, the cash of A & Co. ₹13,000 is also to be taken over to make the capital of A and B equal to ₹80,000.

But in case of C & Co., the net assets comes to ₹80,000 and the required capital of C and D also ₹80,000. Therefore, the cash of C & Co. will not be taken over by the new firm.

(2) Realisation Account

Dr. **Cr.**

Date	Particulars	A & Co. (₹)	C & Co. (₹)	Date	Particulars	A & Co. (₹)	C & Co. (₹)
	To Cash A/c	13,000	—		By Prov. for Bad Debts A/c	1,000	—
	To Investments A/c	10,000	8,000		By Trade Creditors A/c	20,000	10,000
	To Debtors A/c	10,000	4,000		By Bills Payable A/c	5,000	—
	To Furnitures A/c	12,000	6,000		By M/s AC & Co. A/c	80,000	80,000
	To Premises/Land A/c	30,000	50,000		By A Capital A/c (Note 6)	6,000	—
	To Office Equipment A/c	—	800		By B Capital A/c (Note 6)	6,000	—
	To Machinery A/c	15,000	—		By C Capital A/c (Note 7)	—	3,400
	To Goodwill A/c	9,000	—		By D Capital A/c (Note 7)	—	3,400
	To A Capital A/c (Profit)	9,500	—				
	To B Capital A/c (Profit)	9,500	—				
	To C Capital A/c (Profit)	—	14,000				
	To D Capital A/c (Profit)	—	14,000				
		1,18,000	96,800			1,18,000	96,800

(3) Partners' Capital Account

Dr. **Cr.**

Date	Particulars	A (₹)	B (₹)	Date	Particulars	A (₹)	B (₹)
	To Realisation A/c (Note 6)	6,000	6,000		By Balance b/d	35,000	22,000
	To Capital in AC & Co. A/c	40,000	40,000		By General Reserve A/c	4,000	4,000
	To Cash A/c (final settlement)	9,500	—		By Inv. Fluctuation Fund A/c	1,000	1,000
					By A's Loan A/c	6,000	—
					By Realisation A/c (Profit)	9,500	9,500
					By Cash A/c (final settlement)	—	9,500
		55,500	46,000			55,500	46,000

(4) Partners' Capital Account

Dr. **Cr.**

Date	Particulars	C (₹)	D (₹)	Date	Particulars	C (₹)	D (₹)
	To Realisation A/c (Note 7)	3,400	3,400		By Balance b/d	36,000	20,000
	To Capital in AC & Co. A/c	40,000	40,000		By General Reserve A/c	1,500	1,500
	To Cash A/c (final settlement)	9,000	—		By Inv. Fluctuation Fund A/c	500	500
					By Office Equipment A/c	400	400
					By Realisation A/c (Profit)	14,000	14,000
					By Cash A/c (Final settlement)	—	7,000
		52,400	43,400			52,400	43,400

(5) Cash Book of C & Co.

Dr. **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
	To Balance b/d	12,000		By Bank Overdraft A/c	10,000
	To D Capital A/c	7,000		By C Capital A/c	9,000
		19,000			19,000

(6) Furniture has not been taken over by the new firm. It has been distributed between the partners equally.

(7) Furniture and Typewriters has not been taken over by the new firm. It has been distributed between the partners equally.

6.8 CONVERSION OR SALE OF A PARTNERSHIP FIRM TO A COMPANY

For various reasons, an existing partnership may sell its entire business to an existing Joint Stock Company. It can also convert itself into a Joint Stock Company. The former case is the absorption of a partnership firm by a Joint Stock Company but the latter case is the flotation of a new company to take over the business of the partnership.

In either of the above cases, the existing partnership firm is dissolved and all the books of account are closed. Broadly, the procedure of liquidation of the partnership business is same as what has already been explained in "Amalgamation of Partnership"

Some important points :

(1) The Purchase Consideration is satisfied by the Company either in the form of cash or shares or debentures or a combination of two or more of these. The shares may be equity or preference shares. The shares may be issued at par, at a premium or at a discount. For the partnership, the issue price is relevant which may form a part of the purchase consideration.

(2) In the absence of any agreement, share received from purchasing company should be distributed among the partners in the same ratio as profits and losses are shared.

Accounting Entries in the books of selling firms.

1. For transferring different assets to Realisation Account

   Realisation A/c Dr. [Individually]

   To Sundry Assets A/c

   (Assets transferred to Realisation Account at their book values)

2. For transferring different liabilities to Realisation Account

   Liabilities A/c Dr. [Individually]

   To Realisation A/c

   (Liabilities transferred to Realisation Account at their book values)

3. For purchase consideration due

   Purchasing Co. A/c Dr

   To Realisation A/c

   (Purchase consideration due from the new firm)

4. For assets taken over by the proprietor

   Capital A/c Dr

   To Realisation A/c

   (Assets taken over by the proprietor)

5. For realisation of assets not taken over by the Company

   Bank A/c Dr.

   To Realisation A/c

   (Realisation of assets not taken over by the new firm)

6. For recording unrecorded assets

   Assets A/c Dr

   To Capital A/c

   (Unrecorded assets recorded)

7. For realisation of unrecorded assets

   Bank A/c Dr

   To Assets A/c

8. For payment of liabilities not taken over

   Realisation A/c Dr

   To Bank A/c

   (Payment of liabilities not taken over by the new firm)

9. For recording unrecorded liabilities

   Capital A/c Dr

   To Liabilities A/c

   (Being the unrecorded liabilities recorded)

10. For payment of unrecorded liabilities

    Liabilities A/c Dr

    To Bank A/c

    (Payment of unrecorded liabilities)

(**Note:** If unrecorded liabilities are taken over by the Company, it is also transferred to Realisation Account along with other liabilities.)

11. For liabilities taken over by the proprietor

    Realisation A/c Dr

    To Capital A/c

    (Being liabilities assumed by the proprietor)

12. For realisation expenses

    Realisation A/c Dr.

    To Bank A/c

    (Realisation expenses paid)

13. For profit on realisation

    Realisation A/c Dr

    To Capital A/c

    (Profit on realisation transferred to Capital Account)

14. For loss on realisation

    Capital A/c Dr

    To Realisation A/c

    (Loss on realisation transferred to Capital Account)

15. For accumulated profits / reserves

    Reserves A/c Dr

    Profit and Loss A/c Dr

    To Capital A/c

    (Undrawn profits transferred to Capital Account)

16. For Loss : Reverse entry of 15.

17. For transferring partners' current accounts (Credit balances) to capital accounts

    Partners' Current A/cs Dr.

    To Partners' Capital A/cs

    If there is a debit balance in current account, the reverse entry shall be recorded.

18. For Settlement of purchase consideration by the company

    Shares in Purchasing Co. Dr.

    Debentures in Purchasing Co. Dr.

    Cash A/c Dr.

    To Purchasing Co. A/c

19. For final adjustment

    Partners' Capital A/cs Dr.

    To Shares in Purchasing Co. A/c

    To Debenture in Purchasing Co. A/c

    To Cash A/c

Accounting Entries in the books of the Purchasing Company

The purchasing company will record all the assets and liabilities at agreed values. Calculation of Goodwill and Capital Reserve same as explained earlier.

1. For assets and liabilities taken over:

(When net assets taken over is less than the Purchase consideration)

Assets *A/c*	Dr.	(Agreed Value)
Goodwill *A/c*	Dr.	(Balancing figure)
To Liabilities *A/c*		(Agreed Value)
To Firm A/c		(Purchase Consideration)

(Being different assets and liabilities taken over)

(When net assets taken over is more than the Purchase consideration)

Assets A/c	Dr.	(Agreed Value)
To Liabilities A/c		(Agreed Value)
To Firm A/c		(Purchase Consideration)
To Capital Reserve A/c		(Balancing Figure)
(Being different assets and liabilities taken over)		

2. For discharge of Purchase Consideration:

Firm A/c	Dr	(Purchase Consideration)
To Share Capital A/c		(Face value of shares issued)
To Securities Premium A/c		(if any)
To Debentures A/c		
To Bank A/c		

Illustration 86.

X and Y were in partnership in XY & Co. sharing profits in the proportions 3:2. On 31st March 2013, they accepted an offer from P. Ltd. to acquire at that date their fixed assets and stock at an agreed price of ₹ 7,20,000. Debtors, creditors and bank overdraft would be collected and discharged by the partnership firm.

The purchase consideration of ₹ 7,20,000 consisted of cash ₹ 3,60,000, debentures in P Ltd. (at par) ₹ 1,80,000 and 12,000 Equity Shares of ₹ 10 each in P. Ltd. X will be employed in P. Ltd. but, since Y was retiring X agreed to allow him ₹ 30,000 in compensation, to be adjusted through their Capital Accounts. Y was to receive 1,800 shares in P. Ltd. and the balance due to him in cash. The Balance Sheet of the firm as on 31.03.2013 is in below :

Liabilities	Amount ₹	Assets	Amount ₹
X's Capital Account	1,20,000	Fixed Assets	4,80,000
Loan from X	2,10,000	Stock	45,000
Bank overdraft	1,50,000	Debtors	75,000
Creditors	1,80,000	Y's Capital Account	60,000
	6,60,000		6,60,000

The sale of the assets to P. Ltd. took place as agreed; the debtors realised ₹ 60,000 and creditors were settled for ₹ 1,71,000. The firm then ceased business. You are required to pass necessary Journal entries and show: (a) Realisation Account (b) Bank Account (c) Partners' Capital Accounts.

In the books of XY & Co.
Journals

Date	Particulars		L.F	Dr. Amount ₹	Cr. Amount ₹
31.3.13	Realisalion A/c	Dr.		6,00,000	
	To Fixed Assets A/c				4,80,000
	To Stock-in-trade A/c				45,000
	To Sundry Debtors A/c				75,000
	(Different Assets transferred)				
	Creditors A/c	Dr.		1,80,000	
	To Realisation A/c				1,80,000
	(Sundry creditors transferred)				
	P. Ltd A/c	Dr.		7,20,000	
	To Realisation A/c				7,20,000
	(Purchase consideration due)				
	Bank A/c	Dr.		3,60,000	
	Debentures in P Ltd.	Dr.		1,80,000	
	Shares in P Ltd.	Dr.		1,80,000	
	To P. Ltd A/c				7,20,000
	(Purchase consideration Received)				
	Bank A/c	Dr.		60,000	
	To Realisation A/c				60,000
	(Debtors realized)				
	Realisation A/c	Dr.		1,71,000	
	To Bank A/c				1,71,000
	(Payment to Creditors)				
	Realisation A/c	Dr.		1,89,000	
	To X Capital A/c				1,13,400
	To Y Capital A/c				75,600
	(Profit on realisation transferred to Capital Account)				
	Loan from X	Dr.		2,10,000	
	To X Capital				2,10,000
	(Loan Balance transferred)				
	X Capital A/c	Dr.		30,000	
	To Y Capital A/c				30,000
	(Adjustment for compensation)				
	X Capital A/c	Dr.		4,13,400	
	To Share in P Ltd				1,53,000
	To Debenture in P Ltd.				1,80,000
	To Bank A/c				80,400
	(Final settlement of accounts of X)				
	Y Capital A/c	Dr.		45,600	
	To Shares in P Ltd.				27,000
	To Bank				18,600
	(Fianal settlement of accounts of Y)				

Dr. **Realisation Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Fixed Assets A/c	4,80,000	By Creditors A/c	1,80,000
To Stock A/c	45,000	By Bank A/c (Debtors realised)	60,000
To Debtors A/c	75,000	By P Ltd A/c (Purch. Consid.)	
To Bank A/c (creditors payment)	1,71,000	Bank	3,60,000
To X's Capital A/c (profit)	1,13,400	Debentures in P Ltd	1,80,000
To Y's Capital A/c (profit)	75,600	Shares in P Ltd.	1,80,000
	9,60,000		9,60,000

Bank Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Realisation A/c (Debtors realised)	60,000	By Balance b/d	1,50,000
To S Ltd. A/c (Purchase Consideration)	3,60,000	By Realisation A/c (Crs payment)	1,71,000
		By Capital A/c - X	80,400
		By Capital A/c - Y	18,600
	4,20,000		4,20,000

Partners' Capital Accounts

Dr. **Cr.**

Dt.	Particulars	X	Y	Dt.	Particulars	X	Y
	To Balance b/d	-	60,000		By Balance b/d	1,20,000	-
	To Y Capital A/c	30,000			By Loan from X	2,10,000	-
	To Shares in P Ltd	1,53,000	27,000		By Realisation A/c (profit)	1,13,400	75,600
	To Debentures in P Ltd A/c	1,80,000	-		By X 's Capital A/c	-	30,000
	To Bank A/c (final payment)	80,400	18,600				
		4,43,400	1,05,600			4,43,400	1,05,600

Note :

Value of equity shares		₹
Total Purchase consideration		7,20,000
Discharged:		
In Cash	3,60,000	
By Debentures	1,80,000	5,40,000
Balance by 12,000 Equity shares of ₹ 10 per each		1,80,000

So the cost of each equity share be ₹ 1,80,000/12,000 = ₹ 15 per share.

Thus in the books of P Ltd. Security premium will be ₹ 12,000 × 5 = ₹ 60,000

Illustration 87.

A and B were carrying on business sharing profits and losses equally. The Firm's Balance Sheet as at 31.03.2013 was as below :

Liabilities		Amount ₹	Assets		Amount ₹
Creditors		60,000	Stock		60,000
Bank Loan		35,000	Machinery		1,50,000
Capital A/c :			Debtors		70,000
A	1,40,000		Joint life Policy		9,000
B	1,30,000	2,70,000	Leasehold Premises		34,000
			Profit & loss A/c (Dr)		26,000
			Drawings Accounts		
			A	10,000	
			B	6,000	16,000
		3,65,000			3,65,000

The business was carried on till 30.9.2013. The partners withdrew half the amount of profits made during the period of six months after charging depreciation at 10% p.a. on machinery and after writing off 10% p.a. on leasehold premises. In the half-year, sundry creditors were reduced by ₹ 10,000 and bank overdraft by ₹ 15,000.

On 30.9.2013, stock was valued at ₹ 75,000 and Debtors at ₹ 60,000; the Joint Life Policy had been surrendered for ₹ 9,000 before that date and other items remained the same as at 31.03.2013.

On 30.9.2013, the firm sold the business to a Prix Limited Company. The value of goodwill was fixed at ₹1,00,000 and the rest of the assets were valued on the basis of the Balance Sheet as at 30.9.2013.

The Company paid the purchase consideration in Equity Shares of ₹ 10 each. You are required to prepare :

(a) Balance Sheet of the firm as at 30.9.2013;

(b) The Realisation Account;

(c) Partners' Capital Accounts showing the final settlement between them.

Solution :

Workings:

(1) Ascertainment of profit for the 6 months ended 30th September, 2013

Closing Assets:	₹	₹
Stock		75,000
Debtors		60,000
Machinery less depreciation		1,42,500
Leasehold premises less written off		32,300
		3,09,800
Less : **Closing liabilities :**		
Creditors	50,000	70,000
Bank Loan	20,000	
Closing Net Assets		2,39,800
Less Opening combined capital:		
A - ₹ (1,40,000 -13,000 -10,000)	1,17,000	
B - ₹ (1,30,000 -13,000 - 6,000)	1,11,000	2,28,000
Profit before adjustment of drawings		11,800
Add : Combined drawings during the 6 months (equal to profit)		11,800
Profit for 6 months		23,600

(2) Ascertainment of Purchase Consideration

Closing net asset (as above) ₹ 2,39,800 + Goodwill ₹ 1,00,000 = ₹ 3,39,800.

Balance Sheet as on 30.09.2013

Liabilities	Amount ₹	Assets	Amount ₹
A's Capital Account	1,22,900	Machinery	1,42,500
B's Capital Account	1,16,900	Leasehold premises	32,300
Sundry Creditors	50,000	Stock	75,000
Bank overdraft	20,000	Sundry Debtors	60,000
	3,09,800		3,09,800

Realisation Account

Dr. *Cr.*

Particulars	₹	Particulars	₹
To Machinery A/c	1,42,500	By Creditors A/c	50,000
To Leasehold Premises A/c	32,300	By Bank Loan A/c	20,000
To Stock A/c	75,000	By Prix Ltd A/c (purchase consideration)	3,39,800
To Debtors A/c	60,000		
To A Capital A/c	50,000		
To B Capital A/c	50,000		
	4,09,800		4,09,800

Capital Accounts

Dr. ***Cr.***

Date	Particulars	A	B	Date	Particulars	A	B
1.4.13	To Profit & Loss A/c	13,000	13,000	1.4.13	By Balance b/d	1,40,000	1,30,000
	To Drawings A/c To	10,000	6,000	30.9.13	By P/L Appro A/c	11,800	11,800
	Drawings A/c To Bal	5,900	5,900		(6 months' Profit)		
30.9.13	c/d	1,22,900	1,16,900			1,51,800	1,41,800
		1,51,800	1,41,800				
						1,22,900	
				30.9.13	By Bal b/d	50,000	1,16,900
30.9.13	To Shares in Prix. Ltd	1,72,900	1,66,900		By Realisation A/c		50,000
		1,72,900	1,66,900			1,72,900	1,66,900

Study Note - 7

ROYALTY AND HIRE PURCHASE

This Study Note includes

7.1 Royalty Accounting

7.2 Hire Purchase and Installment Purchase Systems

7.1. ROYALTY ACCOUNTING

7.1.1 Introduction

The owner of an asset (e.g. mines, quarries, patent, copyright, etc), as a business arrangement, may allow other party (lessee, licencee, publisher, etc) the right to use that asset against some consideration. Such consideration is calculated with reference to the quantity produced or sold. This payment to the owner by the user of the asset is termed as **Royalty**.

We can therefore say that the royalty is the amount of consideration paid by a party to the owner of the asset in return for the right to use that asset.
For example, when a publisher publishes a book, he makes a payment to the author which is based on the number of copies sold known as royalty.

The following are some of cases where one party paid to another in the form of Royalty:
1. where the owner of a mine allows another the right to extract minerals from land;
2. where right such as patents or copyrights are licensed in favour of another;
3. where an author, artist or designer gives exclusive rights to another to copy the work.

Common terms Used in Connection with Accounting for Royalty :

1. Minimum Rent / Dead Rent

A contract is entered into between the landlord and the lessee for payment of royalty, usually calculated upon the quantum of production or sale at a certain stipulated rate.

So, if there is little or no production or sale, the landlord would receive little or no royalty at all, thus affects the monetary interest of the landlord as well as the lessee. It is normally not acceptable to the owner, since sale or production mostly depends on the capacity of the person to whom the rights have been given. To avoid such a situation, the landlord and the lessee agreed upon a minimum periodical amount that the landlord will receive from the lessee, even if the actual royalty as calculated on the basis of actual production or sale is less than such minimum amount.

This assured and mutually agreed periodical minimum amount is known as **"Minimum Rent".**

Example: Suppose royalty per ton of production is ₹ 10 and the minimum (annual) rent is ₹ 4,00,000. Now, the actual production is 35,000 tons, then actual royalty would become ₹ 3,50,000. In this case the minimum rent of ₹ 4,00,000 will have to be paid by the lessee. On the other hand, if the actual production is 46,000 tons, then the actual royalty would become ₹ 4,60,000. In this case ₹ 4,60,000 will have to be paid by the lessee.

Thus, as there is a stipulation for minimum rent, then either the minimum rent or the actual royalty whichever is more shall have to be paid by the lessee.

The minimum rent is also called dead rent, certain rent, fixed rent, etc.

2. Short workings/Redeemable Dead Rent

Short workings is the amount by which the minimum rent exceeds the actual royalty. It is the difference between Actual Rent and Minimum Rent.

In the above example, the short workings is ₹ 50,000 (₹ 4,00,000 – ₹ 3,50,000). Where there is short workings in any period the lessee is liable to pay the minimum rent and, in effect, short workings becomes the part of the minimum rent and not represented by the use of rights.

The question of short workings will arise only when there is a stipulation for minimum rent in the agreement.

3. Excess working

It refers to the amount by which the actual royalty exceeds the minimum rent. In the above example, the excess workings is ₹ 60,000 (₹ 4,60,000 – ₹ 4,00,000) if the production is 46,000 tons.

4. Ground Rent/Surface Rent

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

5. Recoupment of Short workings

Generally the royalty agreement contains a provision for carrying forward of short workings with a view to adjust it in the future. In the subsequent years, such shortworking is adjusted against the surplus royalty. This process of adjustment is called recoupment of short workings. The right of recoupment of short workings enables the lessee to recover the excess payment, made in the earlier years to meet the condition of payment of minimum rent. A time is usually agreed upon the number of years for which such short workings can be recouped. This time limit for recoupment of short workings may be fixed or fluctuating. If the short workings cannot be recouped within the specified time, they lapse and are charged to Profit and Loss Account in the year when that specified time limit for recoupment ends.

(i) Fixed right :

When the lessee can recoup shortworkings within a certain period from the date of the lease it is known as fixed right. For example, short workings can be recouped within three years from the date of the lease. So, after three years from the date of the lease the short workings cannot be recouped.

(ii) Fluctuating right :

In this type of agreement, lessee can recoup short workings of any year during the next following year(s). For example, shortworkings can be recouped in the year subsequent to the year of short workings.

6. Strike and Lockout, etc :

If agreement so provides, the minimum rent may be proportionately reduced in the event of strike and/ or lockout. So special entry is required for the same except the adjustment of minimum rent for that particular year.

Accounting Entries in the Books of the Lessee/Licencee/Publisher etc.

1. Where a minimum rent exists with right to recoup short workings

(a) Where the actual royalty is less than the minimum rent

(i)	Royalties (payable) Account	Dr.	[Actual royalties for the period]
	Short workings Account	Dr.	[Minimum rent - Actual royalties]
	To Landlord Account		[Minimum rent]

(ii) Landlord Account Dr. [Minimum rent]
To Bank Account [Net amount paid]
To Income Tax Payable Account [Tax deducted at source]

(iii) Manufacturing / Profit & Loss Account Dr. [Transfer]
To Royalties (payable) Account [Actual royalties for the period]

If the user is a manufacturer and royalties are calculated on the basis of production, the actual royalties are debited to Manufacturing Account. Where royalties are calculated on the basis of sales, they are debited to Profit and Loss Account.

In case of a limited company, which does not prepare Manufacturing Account separately, the actual royalties are debited to Profit and Loss Account and they are shown in production or manufacturing section of the Profit and Loss Account.

Treatment of Short workings

As per agreed terms, short workings can be recouped in the year when the actual royalty is more than the Minimum rent. Any short workings, which cannot be recouped within the specified period becomes irrecoverable and it should be charged to Profit and Loss Account in the year in which the period ends.

However, the recoupable short workings should be carried forward and they are shown in the Balance Sheet as a Current Asset.

The relationship between Minimum rent, Actual Royalty and Royalty payable are in below :
Minimum rent = Actual Royalty + Short workings.

(b) Where the actual royalty is more than the minimum rent :

(i) Royalties (payable) Account Dr.
To Landlord Account
[Actual royalties for the period]

(ii) Landlord Account Dr.
To Short workings Account
(Short workings, if any, recouped)

(iii) Landlord Account Dr.
To Bank Account
To Income Tax Payable Account

(iv) Profit & Loss Account Dr.
To Short workings Account
(Short workings, which can not be recouped)

(v) Manufacturing / Profit & Loss Account Dr.
To Royalties (payable) Account

Important Points to note :

1. When the royalty agreement does not contain a clause for minimum rent, the question of short workings and its recoupment does not arise.
2. The landlord is always entitled to get either the minimum rent or the actual royalty whichever is higher subject to any adjustment for short workings recouped.

Illustration 1

The Bihar Coal Co. Ltd. holds a lease of coal mines for a period of twelve years, commencing from 1st April 2006. According to the lease, the company is to pay ₹ 7.50 as royalty per ton with a minimum rent of ₹ 150,000 per year. Short workings can, however, be recovered out of the royalty in excess of the minimum rent of the next two years only. For the year of a strike the minimum rent is to be reduced to 60%. The output in tons for the 6 years ending 31st March, 2012 is as under : 2006-07 :10,000; 2007-08 :12,000; 2008-09:25,000; 2009-10: 20,000; 2010-11: 50,000; and 2011-12: 15,000 (strike). Write up the necessary Ledger Accounts in the books of Bihar Coal Co. Ltd.

Solution :

In the books of Bihar Coal Co. Ltd.

Statement showing Royalty Payable

Fig in (₹)

Year	Output (Tons)	Actual Royalties	Min. Rent	Excess Short Workings	Shortworkings				Amount
					Occurred	Recouped	Written off or lapsed	C/F	Payable
2006-07	10,000	75,000	150,000	0	75,000	0	0	75,000	150,000
2007-08	12,000	90,000	150,000	0	60,000	0	0	135,000	150,000
2008-09	25,000	187,500	150,000	37,500	0	37,500	37,500	60,000	150,000
2009-10	20,000	150,000	150,000	0	0	0	60,000	0	150,000
2010-11	50,000	375,000	150,000	225,000	0	0	0	0	375,000
2011-12	15,000	112,500	90,000	22,500	0	0	0	0	112,500

Dr. **Royalties Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.07	To Landlord A/c	75,000	31.03.07	By Profit & Loss A/c	75,000
31.03.08	To Landlord A/c	90,000	31.03.08	By Profit & Loss A/c	90,000
31.03.09	To Landlord A/c	187,500	31.03.09	By Profit & Loss A/c	187,500
31.03.10	To Landlord A/c	150,000	31.03.10	By Profit & Loss A/c	150,000
31.03.11	To Landlord A/c	375,000	31.03.11	By Profit & Loss A/c	375,000
31.03.12	To Landlord A/c	112,500	31.03.12	By Profit & Loss A/c	112,500

Dr. **Landlord Account** Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.07	To Bank A/c	150,000	31.03.07	By Royalties A/c	75,000
				By Short workings A/c	75,000
		150,000			150,000
31.03.08	To Bank A/c	150,000	31.03.08	By Royalties A/c	90,000
				By Short workings A/c	60,000
		150,000			150,000
31.03.09	To Bank A/c	150,000	31.03.09	By Royalties A/c	187,500
	To Short workings A/c	37,500			
		187,500			187,500
31.03.10	To Bank A/c	150,000	31.03.10	By Royalties A/c	150,000
		150,000			150,000
31.03.11	To Bank A/c	375,000	31.03.11	By Royalties A/c	375,000
		375,000			375,000
31.03.12	To Bank A/c	112,500	31.03.12	By Royalties A/c	112,500
		112,500			112,500

Dr. **Short workings Account** Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.07	To Landlord A/c	75,000	31.03.07	By Balance c/d	75,000
		75,000			75,000
1.4.07	To Balance b/d	75,000	31.03.08	By Balance c/d	135,000
31.03.08	To Landlord A/c	60,000			
		135,000			135,000
1.4.08	To Balance b/d	135,000	31.03.09	By Landlord A/c	37,500
				By Profit & Loss A/c	37,500
				By Balance c/d	60,000
		135,000			135,000
1.4.09	To Balance b/d	60,000	31.03.10	By Profit & Loss A/c	60,000
		60,000			60,000

Illustration 2

A. Ltd. obtain from B.S. Ltd. a lease of some coal-bearing land, the terms being a royalty of ₹ 15 per ton of coal raised subject to a minimum rent of ₹ 75,000 p.a. with a right of recoupment of short-working over the first four years of the lease. From the following details, show (i) Short-working Account, (ii) Royalty Account and (iii) B.S. Ltd. Account in the books of A. Ltd.

Year	Sales (Tons) ₹	Closing Stock (Tons) ₹
2009	2,000	300
2010	3,500	400
2011	4,800	600
2012	5,600	500
2013	8,000	800

Solution:

Workings:

[Coal raised i.e., Production = Sales + Closing Stock – Opening Stock.]

Year	Sales	+	Closing Stock	-	Opening Stock	=	Net Production
2009	2,000	+	300	-	Nil	=	2,300
2010	3,500	+	400	-	300	=	3,600
2011	4,800	+	600	-	400	=	5,000
2012	5,600	+	500	-	600	=	5,500
2013	8,000	+	800	-	500	=	8,300

In the books of A. Ltd.

Memorandum Royalty Statement

Year	Quantity	Rate ₹	Royalty ₹	Minimum Rent ₹	Short working ₹	Recoupment ₹	Short working carried forward ₹	Short working Transferred to P&L A/c or lapsed ₹	Payment to Landlord ₹
2009	2,300	15	34,500	75,000	40,500	---	40,500	---	75,000
2010	3,600	15	54,000	75,000	21,000	---	61,500	---	75,000
2011	5,000	15	75,000	75,000	---	---	61,500	---	75,000
2012	5,500	15	82,500	75,000	---	7,500	---	54,000	75,000
2013	8,300	15	1,24,500	75,000	---	---	---	---	1,24,500

Dr. **B. S. Ltd. (Landlord) Account** Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2009	To Bank A/c	75,000	2009	By Royalty A/c	34,500
				" Short-working A/c	40,500
		75,000			75,000
2010	To Bank A/c	75,000	2010	By Royalty A/c	54,000
				" Short-working A/c	21,000
		75,000			75,000
2011	To Bank A/c	75,000	2011	By Royalty A/c	75,000
		75,000			75,000
2012	To Bank A/c	75,000	2012	By Royalty A/c	82,500
	To Short-Working A/c	7,500			
		82,500			82,500
2013	To Bank A/c	1,24,500	2013	By Royalty A/c	1,24,500
		1,24,500			1,24,500

Dr. **Short-Working Account** Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2009	To B. S. Ltd. A/c (Landlord)	40,500	2009	By Balance c/d	40,500
		40,500			40,500
2010	To Balance b/d	40,500	2010	By Balance c/d	61,500
	" B. S. Ltd. A/c (Landlord)	21,000			
		61,500			61,500
2011	To Balance b/d	61,500	2011	By Balance c/d	61,500
		61,500			61,500
2012	To Balance b/d	61,500	2012	By B. S Ltd. (Landlord) A/c	7,500
				" Profit and Loss A/c	54,000
		61,500			61,500

Dr. **Royalty Account** **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2009	To B. S. Ltd. A/c	34,500	2009	By Profit & Loss A/c	34,500
2010	To B. S. Ltd. A/c	54,000	2010	By Profit & Loss A/c	54,000
2011	To B. S. Ltd. A/c	75,000	2011	By Profit & Loss A/c	75,000
2012	To B. S. Ltd. A/c	82,500	2012	By Profit & Loss A/c	82,500
2013	To B. S. Ltd. A/c	1,24,500	2013	By Profit & Loss A/c	1,24,500

Accounting Entries in the Books of the Landlord / Lessor

1. Where a minimum rent exists with right to recoup short workings

(a) Where the actual royalty is less than the minimum rent :

(i) Lessee Account Dr. [Minimum rent]
 To Royalty Receivable Account [Actual Royalties for the period]
 To Royalty Suspense Account/ [Short fall in Royalties]
 Or Shortworkings Allowable A/c

(ii) Bank Account Dr. [Net amount paid]
 Tax Deducted at source Dr. [Tax deducted at source]
 To Lessee Account [Minimum rent]

(iii) Royalties Receivable Account Dr.
 To Profit & Loss Account [Transfer]

(b) Where the actual royalty is more than the minimum rent :

(ii) Royalty Suspense Account/ Dr.
 Or Short workings Allowable A/c
 To Lessee Account [Recoupment of Short workings, if any]

(iii) Bank Account Dr. [Net amount paid]
 Tax Deducted at source Dr. [Tax deducted at source]
 To Lessee Account

(iv) Royalties (Receivable) Account Dr.
 To Profit & Loss Account [Transfer]

(v) Royalty Suspense Account/ Dr.
 Or Short workings Allowable A/c
 To Profit and Loss Account [Short workings, which can not be recouped]

Illustration 3

For the same figures as given in illustration 1, prepare necessary accounts in the books of Landlord.

Solution :

In the books of Landlord

Dr. **Royalty Receivable Account** *Cr.*

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.07	To Profit & Loss A/c	75,000	31.03.07	By Bihar Coal Co.Ltd	75,000
31.03.08	To Profit & Loss A/c	90,000	31.03.08	By Bihar Coal Co. Ltd	90,000
31.03.09	To Profit & Loss A/c	1,87,500	31.03.09	By Bihar Coal Co. Ltd	1,87,500
31.03.10	To Profit & Loss A/c	1,50,000	31.03.10	By Bihar Coal Co. Ltd	1,50,000
31.03.11	To Profit & Loss A/c	3,75,000	31.03.11	By Bihar Coal Co. Ltd	3,75,000
31.03.12	To Profit & Loss A/c	1,12,500	31.03.12	By Bihar Coal Co. Ltd	1,12,500

Dr. **Bihar Coal Co. Ltd. (Lessee) Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.07	To Royalties Receivable A/c	75,000	31.03.07	By Bank A/c	150,000
	To Shortworkings Susp.A/c	75,000			
		150,000			150,000
31.03.08	To Royalties Receivable A/c	90,000	31.03.08	By Bank A/c	150,000
	To Shortworkings Susp.A/c	60,000			
		150,000			150,000
31.03.09	To Royalties Receivable A/c	187,500	31.03.09	By Bank A/c	150,000
				By Shortworkings Susp. A/c	37,500
		1,87,500			1,87,500
31.03.10	To Royalties Receivable A/c	150,000	31.03.10	By Bank A/c	150,000
		150,000			150,000
31.03.11	To Royalties Receivable A/c	375,000	31.03.11	By Bank A/c	375,000
		375,000			375,000
31.03.12	To Royalties Receivable A/c	112,500	31.03.12	By Bank A/c	112,500
		112,500			112,500

Dr. Shortworkings Suspense Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.07	To Balance c/d	75,000	31.03.07	By Bihar Coal Co. Ltd	75,000
			1.4.07	By Balance b/d	75,000
31.03.08	To Balance c/d	1,35,000	31.03.08	By Bihar Coal Co. Ltd	60,000
		1,35,000			1,35,000
31.03.09	To Bihar Coal Co. Ltd	37,000	1.4.08	By Balance b/d	135,000
	To Profit & Loss A/c	37,500			
	To Balance c/d	60,000			
		1,35,500			1,35,500
31.03.10	To Profit & Loss A/c	60,000	1.04.09	By Balance b/d	60,000
		60,000			60,000

Illustration 4

The following information has been obtained from the books of a lesee relating to the years 2008-09 to 2011-12 :

Payments to Landlord (after tax deducted @ 20% at Source) :

	2008-09	₹ 12,000
	2009-10	₹ 12,000
	2010-11	₹ 12,000
	2011-12	₹ 19,200
Short-working recovered :	2009-10	₹ 2,500
	2010-11	₹ 1,000
Short-working written-off :	2010-11	₹ 500

Balance of Short-working Account forward on April 1, 2008 ₹800 (which are in 2008-09). According to the terms of agreement short-working is recoverable within the next two years following the year in which short-working arises.

You are required to show the necessary accounts in the books of the lessee for the four years ended 31st March 2012.

Solution :

Before preparing the ledger accounts we are to find out some missing information :

1. The recoupment which was made in 2009-10 for ₹ 2,500 is inclusive of ₹ 800 of 2007-08 and the balance ₹ 1,700 for 2008-09.

   Again, the short-working which was recovered and written-off ₹ 1,000 and ₹ 500 (i.e., ₹1,500), respectively, in 2010-11 are also for the year 2008-09. So, the total short-working for 2008-09 amounted to ₹ 3,200 (i.e., ₹ 1,700 + ₹ 1,500).

2. Rate of taxes @ 20% on gross i.e., 25% (i.e., $\frac{20}{80} = \frac{1}{4}$) on net amount paid.

3. Actual Payment = Annual Royalty + Short-working – Recoupment.

Thus, actual royalty is calculated as under :

	2008-09 ₹	2009-10 ₹	2010-11 ₹	2011-12 ₹
Payment to landlord (after tax)	12,000	12,000	12,000	19,200
Add : Back Tax Deducted at Source @ ¼ th	3,000	3,000	3,000	4,800
Payment to landlord (before Tax)	15,000	15,000	15,000	24,000
Less : Short-working	3,200	—	—	—
Add : Recoupment	—	2,500	1,000	—
	11,800	17,500	16,000	24,000

In the Books of Lessee

Dr. **Royalty Account** ***Cr.***

Date	Particulars	Amount	Date	Particulars	Amount
2009 March, 31	To Landlord A/c	11,800	2009 March, 31	By P/L A/c	11,800
2010 March, 31	To Landlord A/c	17,500	2010 March, 31	By P/L A/c	17,500
2011 March, 31	To Landlord A/c	16,000	2011 March, 31	By P/L A/c	16,000
2012 March, 31	To Landlord A/c	24,000	2012 March, 31	By P/L A/c	24,000

Dr. **Landlord Account** ***Cr.***

Date	Particulars	Amount	Date	Particulars	Amount
2009	To Bank A/c	12,000	2009	By Royalty A/c	11,800
March, 31	To Income Tax Payable A/c	3,000	March, 31	By Shortworkings A/c	3,200
		15,000			15,000
2010	To Bank A/c	12,000	2010	By Royalty A/c	17,500
March, 31	To Income Tax Payable A/c	3,000	March, 31		
	To Short workings A/c (Recoupment)	2,500			
		17,500			17,500

2011	To Bank A/c	12,000	2011	By Royalty A/c	16,000
March, 31	To Income Tax Payable A/c	3,000	March, 31		
	To Short workings A/c(Recoupment)	1,000			
		16,000			16,000
2012	To Bank A/c	19,200	2012	By Royalty A/c	24,000
March, 31	To Income Tax Payable A/c	4,800	March, 31		
		24,000			24,000

Dr. **Shortworking Account** ***Cr.***

Date	Particulars	Amount	Date	Particulars	Amount
2009	To Balance b/f	800	2009	By Balance c/d	4,000
March, 31	To Landlord A/c	3,200	March, 31		
		4,000			4,000
2010	To Balance b/d	4,000	2010	By Landlord A/c	2,500
March, 31			March, 31	By Balance c/d	1,500
		4,000			4,000
2011	To Balance b/d	1,500	2011	By Landlord A/c	1,000
March, 31			March, 31	By P/L c/d	500
		1,500			1,500

Illustration 5.

A fire occurred in the office premises of lessee in the evening of 31.3.2012 destroying most of the books and records. From the documents saved, the following information is gathered:

Short-working recovered :

2009-10 ₹ 4,000 (towards short-workings which arose in 2006-07)

2010-11 ₹ 8,000 (including ₹ 1,000 for short-working 2007-08)

2011-12 ₹ 2,000

Short-working lapsed :

2008-09 ₹ 3,000

2009-10 ₹ 3,600

2011-12 ₹ 2,000

A sum of ₹ 50,000 was paid to the landlord in 2008-09. The agreement of Royalty contains a clause of Minimum Rent payable for fixed amount and recoupment of short-workings within 3 years following the year in which Short-workings arise.

Information as regards payments to landlord subsequent to the year 2008-09 is not readily available.

Show the Short – working Account and the Royalty Account in the books of lessee.

Solution:

Working Notes:

Analysis of payments

Year	Minimum Rent ₹	Royalty ₹	Actual Payment ₹	Shortworking ₹			
				Occurred	Recouped	Lapsed	Carried Forward
2007-08	-	-	-	-	-	-	11,600
2008-09	50,000	39,000	50,000	11,000	-	3,000	19,600**(C)**
2009-10	50,000	54,000	50,000	-	4,000	3,600	12,000**(B)**
2010-11	50,000	58,000	50,000	-	8,000	-	4,000**(A)**
2011-12	50,000	52,000	50,000	-	2,000	2,000	-

Analysis of Royalty Payable:

		₹	₹
Royalty in 2008-09	Minimum Rent – Shortworking	50,000 - 11,000	39,000
Royalty in 2009-10	Minimum Rent + Recoupment	50,000 + 4,000	54,000
Royalty in 2010-11	Minimum Rent + Recoupment	50,000 + 8,000	58,000
Royalty in 2011-12	Minimum Rent + Recoupment	50,000 + 2,000	52,000

Explanation of the above mentioned Analysis:

(i) 2008-09 ₹50,000 was paid but there was no recoupment. ∴ ₹50,000 was the payment for Minimum Rent. This has been posted in the minimum rent column, every year.

(ii) In 2011-12 Shortworking recouped + Shortworking lapsed = ₹2,000 + ₹2,000 = ₹4,000. This has been posted as the amount carried forward in 2010-11. **(A)**

(iii) In 2010-11 ₹8,000 has been recouped. So, the closing balance of its preceding year 2009-10 was = ₹(4,000+8,000)=₹12,000. **(B)**

(iv) In 2009-10 Shortworkings adjusted = amount recouped + amount lapsed =₹(4,000+3,600)=₹7,600. In its preceding year 2008-09, the closing balance was ₹(12,000+7,600) =₹19,600. **(C)**

(v) No Shortworking occurred in 2009-10, 2010-11,2011-12. ∴All Shortworkings occurred in 2008-09 or before.

(vi) Shortworking can be recovered within next 3 years.

∴ Total Shortworking adjusted in 2011-12 ₹4,000 must be related to 2008-09.

Again out of ₹8,000 recouped in 2010-11. ₹1,000 is related to 2007-08.

∴ Balance ₹7,000 was related to 2008-09.

∴ Total Shortworking of 2008-09 = ₹4,000 + ₹7,000 = ₹11,000.

(vii) Opening Balance of Short working in 2007-08 = Closing balance + Amount recouped + Amount Lapsed – Amount of Shortworking occurred i.e.₹(19,600+3,000-11,000)=₹11,600

In the books of ….

Dr. **Royalty Account** *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2008-09	To, Landlord A/c	39,000	2008-09	By, Profit and Loss A/c	39,000
		39,000			39,000
2009-10	To, Landlord A/c	54,000	2009-10	By, Profit and Loss A/c	54,000
		54,000			54,000
2010-11	To, Landlord A/c	58,000	2010-11	By, Profit and Loss A/c	58,000
		58,000			58,000
2011-12	To, Landlord A/c	52,000	2011-12	BY, Profit and Loss A/	52,000
		52,000			52,000

Dr. **Shortworkings Account** *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2008-09	To, Balance b/d	11,600	2008-09	By, Profit and Loss A/c	3,000
	To, Landlord A/c	11,000		By, Balance c/d	19,600
		22,600			22,600
2009-10	To, Balance b/d	19,600	2009-10	By, Landlord A/c	4,000
				By, Profit and Loss A/c	3,600
				By, Balance c/d	12,000
		19,600			19,600
2010-11	To, Balance b/d	12,000	2010-11	By, Landlord A/c	8,000
				By, Balance c/d	4,000
		12,000			12,000
2011-12	To, Balance b/d	4,000	2011-12	By, Landlord A/c	2,000
				By, Profit and Loss A/c	2,000
		4,000			4,000

SUB-LEASE

In some cases the lessee transfers a part to its right of lease to an another party to complete the work under lease with terms and condition as agreed between himself and that party.

In these cases, there are three parties, viz. landlord, lessee and sub-lessee. So far accounting entries are concerned, the status of lessee with the sub-lessee is like a landlord.

Accounting Entries

(a) **In the books of Landlord.**

Same as before. Payment to landlord will depend on the total production /sell made by lessee as well as sub-lessee.

(b) **In the books of the Lessee.**

In this book both royalty payable and receivable account to be opened since he has two status. He has to maintain,if any, both Short - workings and Royalty Suspense Account.

(c) **In the books of sub-lessee.**

In this case the entry will be from the view point of lessee in normal cases as explained earlier.

Illustration 6

On 1.4.2008 Mayami got a mining lease and from that date a part of the mine was sub-leased to Pathan. The terms of payment and the production of 5 years are as below.

Particulars	**Lessee**	**Sub-Lessee**
Royalty (₹/Tonne)	2.00	3.00
Dead Rent per anum (₹)	15,000	10,000
Short working recoverable (Years)	3	2
Production (Year ended....31.3.)		
2009	1,000	1,000
2010	3,000	2,000
2011	12,000	5,000
2012	9,000	2,000 (strike)
2013	5,000	12,000

In case of strike, royalty earned will discharge all liabilities for the year only.
Show ledger accounts in the books of Mayami.

Solution :

In the Books of Mayami
Statement showing Royalties Payable

Fig in (₹)

Year	Output (Tons)	Actual Royalties	Min. Rent	Excess Short Workings	Shortworkings Occurred	Shortworkings Recouped	Shortworkings Written off	Shortworkings C/F	Amount Payable
2009	2,000	4,000	15,000	0	11,000	0	0	11,000	15,000
2010	5,000	10,000	15,000	0	5,000	0	0	16,000	15,000
2011	17,000	34,000	15,000	19,000	0	16,000	0	0	18,000
2012	11,000	22,000	15,000	7,000	0	0	0	0	22,000
2013	17,000	34,000	15,000	19,000	0	0	0	0	34,000

Statement showing Royalties Receivable

Fig in (₹)

Year	Output (Tons)	Actual Royalties	Min. Rent	Excess Short Workings	Shortworkings				Amount Payable
					Occurred	Recouped	Written off	C/F	
2009	1,000	3,000	10,000	0	7,000	0	0	7,000	10,000
2010	2,000	6,000	10,000	0	4,000	0	0	11,000	10,000
2011	5,000	15,000	10,000	5,000	0	5,000	2,000	4,000	10,000
2012	2,000	6,000	6,000	0	0	0	4,000	0	6,000
2013	12,000	36,000	10,000	26,000	0	0	0	0	36,000

Dr. **Shortworkings Account** ***Cr.***

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.09	To Landlord A/c	11,000	31.03.09	By Balance c/d	11,000
		11,000			11,000
01.04.09	To Balance b/d	11,000	31.03.10	By Balance c/d	16,000
31.03.10	To Landlord A/c	5,000			
		16,000			16,000
01.04.10	To Balance b/d	16,000	31.03.11	By Royalty Payable A/c (recouped)	16,000
		16,000			16,000

Dr. **Shortworkings Suspense Account** ***Cr.***

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.09	To Balance c/d	7,000	31.03.09	By Pathan A/c	7,000
		7,000			7,000
31.03.10	To Balance c/d	11,000	01.04.09	By Balance b/d	7,000
			31.03.10	By Pathan A/c	4,000
		11,000			11,000
31.03.11	To Royalty Receivable A/c	5,000	01.04.10	By Balance b/d	11,000
	To P& L A/c	2,000			
	To Balance c/d	4,000			
		11,000			11,000
31.03.12	To P &L A/c	4,000	01.4.11	By Balance b/d	4,000
		4,000			4,000

Dr **Royalty Receivable Account** *Cr.*

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.09	To Royalties Payable A/c (1,000 × 2)	2,000	31.03.09	By Pathan A/c (1,000 × 3)	3,000
	To Profit & Loss A/c	1,000			
		3,000			3,000
31.03.10	To Royalties Payable A/c (2,000 × 2)	4,000	31.03.10	By Pathan A/c (2,000 × 3)	6,000
	To Profit & Loss A/c	2,000			
		6,000			6,000
31.03.11	To Royalties Payable A/c (5,000 × 2)	10,000	31.03.11	By Shortworkings Suspence A/c	5,000
	To Profit & Loss A/c	5,000		By Pathan A/c (5,000 × 2)	10,000
		15,000			15,000
31.03.12	To Royalties Payable A/c (2,000 × 2)	4,000	31.03.12	By Pathan A/c (2,000 × 3)	6,000
	To Profit & Loss A/c	2,000			6,000
		6,000	31.03.13	By Pathan A/c (12,000 × 3)	36,000
31.03.13	To Royalties Payable A/c (12,000 × 2)	24,000			
	To Profit & Loss A/c	12,000			
		36,000			36,000

Dr. **Royalty Payable Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.09	To Landlord A/c (2000*2)	4,000	31.03.09	By Royalty Receivable A/c (1000*2)	2,000
				By Profit & Loss A/c	2,000
		4,000			4,000
31.03.10	To Landlord A/c (5000*2)	10,000	31.03.10	By Royalty Receivable A/c (2000*2)	4,000
				By Profit & Loss A/c	6,000
		10,000			10,000
31.03.11	To Shortworkings A/c	16,000	31.03.11	By Royalty Receivable A/c (5000*2)	10,000
	To Landlord A/c (17000*2)	18,000		By Profit & Loss A/c	24,000
		34,000			34,000
31.03.12	To Landlord A/c (11000*2)	22,000	31.03.12	By Royalty Receivable A/c (2000*2)	4,000
				By Profit & Loss A/c	18,000
		22,000			22,000
31.03.13	To Landlord A/c (17000*2)	34,000	31.03.13	By Royalty Receivable A/c (12000*2)	24,000
				By Profit & Loss A/c	10,000
		34,000			34,000

Note :

1. Royalty to be paid to Landlord on total production including the production from sub-lessee.
2. Royalties receivable from sub lease to be adjusted against the payable amount to the extent of royalty payable to Landlord.

Dr. **Pathan's Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.09	To Royalties Receivable A/c	3,000	31.03.09	By Bank A/c	10,000
	To Shortworkings Susp. A/c	7,000			
		10,000			10,000
31.03.10	To Royalties Receivable A/c	6,000	31.03.10	By Bank A/c	10,000
	To Shortworkings Susp. A/c	4,000			
		10,000			10,000
31.03.11	To Royalties Receivable A/c	10,000	31.03.11	By Bank A/c	10,000
		10,000			10,000
31.03.12	To Royalties Receivable A/c	6,000	31.03.12	By Bank A/c	6,000
		6,000			6,000
31.03.13	To Royalties Receivable A/c	36,000	31.03.13	By Bank A/c	36,000
		36,000			36,000

Dr. **Landlord Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.09	To Bank A/c	15,000	31.03.09	By Royalties A/c	4,000
				By Shortworkings A/c	11,000
		15,000			15,000
31.03.10	To Bank A/c	15,000	31.03.10	By Royalties A/c	10,000
				By Shortworkings A/c	5,000
		15,000			15,000
31.03.11	To Bank A/c	18,000	31.03.11	By Royalties A/c	34,000
	To Shortworkings A/c	16,000			
		34,000			15,000
31.03.12	To Bank A/c	22,000	31.03.12	By Royalties A/c	22,000
		22,000			22,000
31.03.13	To Bank A/c	34,000	31.03.13	By Royalties A/c	34,000
		34,000			34,000

7.2. HIRE-PURCHASE AND INSTALLMENT PURCHASE SYSTEMS

HIRE-PURCHASE SYSTEM Introduction :

It is not always possible by a purchaser to meet up the higher demand for goods due to immediate cash payment. To meet this demand the concept of Hire Purchase is very popular in the market.

Under this system the purchaser **(Hirer)** pays the entire amount in staggered way viz. monthly, quarterly or yearly with some interest. Under this system the goods are sold with the following conditions:

Possession of goods is delivered to a hirer but the title to the goods (Ownership) are transferred only when the agreed sum (Hire Purchase price) is paid by the hirer.

Such hirer has a right to terminate the agreement at any time before the property so passes. That means he has the option to return the goods in which case he need not pay installments falling due thereafter. However, the hirer cannot recover the sums already paid as such sums legally represent hire charges of the goods in question.

The hire-purchaser, during that period of possession of goods, cannot damage, destroy, pledge or sell such goods. He is supposed to take all such care of goods as a prudent person does in his own goods.

In case of Installment Sale, it is not only the possession of goods but also the *ownership* in goods is transferred to the buyer immediately at the time of agreement.

Further, in installment system if the buyer stops the payment of dues, then he does not have the right of seizing his goods. The differences between installment sale and hire-purchase are as below:

Particulars	Hire Purchase	Installment Sale
Ownership	Stipulates the time at which the ownership passes to the buyer. It is usually on the payment of last installment.	Ownership passes at the time of sale.
Default in making payment	Seller can repossess the goods. In that case the installment so far paid is treated to be Hiring charges.	Seller does not have any other right except the right of suing the buyer for the non-payment of price.
Right of sale or other wise	No right to sale or otherwise transfer the goods since the legal position of the hirer is bailee.	Right to sale or otherwise transfer the goods.
Loss or damages to the goods.	Any loss occurring to goods has to be borne by the seller if the buyer takes reasonable care.	Any loss occurring to goods has to be borne by the buyer.

SITUATION – I : WHEN RATE OF INTEREST, TOTAL CASH PRICE AND IN STALLMENTS ARE GIVEN

Illustration 7

X purchases a car on hire-purchase system on 1.1.11. The total cash price of the car is ₹4,50,000 payable ₹90,000 down and three installments of ₹1,70,000, ₹1,50,000 and ₹1,08,460 payable at the end of first, second and third year respectively. Interest is charged at 10% p.a.

You are required to calculate interest paid by the buyer to the seller each year.

Solution: Following table is useful for calculating interest paid with each installment :

Analysis of Instalments

Year	Opening Balance of Cash Price ₹	Installments ₹	Payment towards Principal/Cash Price ₹	Payment towards Interest ₹	Closing Balance of Cash Price ₹
01.01.11	4,50,000	90,000	90,000	-	3,60,000
31.12.11	3,60,000	1,70,000	1,34,000	36,000	2,26,000
31.12.12	2,26,000	1,50,000	1,27,400	22,600	98,600
31.12.13	98,600	1,08,460	98,600	9,860	-

SITUATION – II : WHEN RATE OF INTEREST AND INSTALLMENTS ARE GIVEN BUT TOTAL CASH PRICE IS NOT GIVEN.

Illustration 8

X purchased a T.V on hire-purchase system. As per terms he is required to pay ₹ 3000 down, ₹4000 at the end of first year, ₹ 3000 at the end of second year, and ₹ 5000 at end of third year. Interest is charged at 12% p.a.

You are required to calculate total cash price of T.V and interest paid with each installment.

Solution :

Calculation of Cash Price	Installment ₹	Analysis of Instalments: Interest ₹	Analysis of Instalments: Cash Price ₹
3rd Instalment	5,000		
(-) Interest (12/112 × 5,000)	536	536	4,464
Balance of Cash Price	4,464		
(+) 2nd Instalment	3,000		
	7,464		
(-) Interest (12/112 × 7,464)	800	800	2,200
Balance of Cash Price	6,664		
(+) 1st Instalment	4,000		
	10,664		
(-) Interest (12/112 × 10,664)	1,143	1,143	2,857
Balance of Cash Price	9,521		
(+) Down Payment	3,000	-	3,000
Total Cash Price	12,521	2,479	12,521

SITUATION – III : WHEN ONLY INSTALLMENTS ARE GIVEN, BUT CASH PRICE AND RATE OF INTEREST ARE NOT GIVEN.

Illustration 9

X & Co. purchased a Motor car on April 1, 2009 on hire-purchase paying ₹ 60,000 cash down and balance in four annual installments of ₹ 55,000, ₹ 50,000, ₹ 45000 and ₹ 40,000 each Installment comprising equal amount of cash price at the end of each accounting period. You are required to calculate total cash price and amount of interest in each Installment.

Solution : Hire-purchase Price

Down Payment	60,000
1st installment	55,000
2nd installment	50,000
3rd installment	45,000
4th installment	40,000
Total	2,50,000

As each installment comprises equal amount of cash price the differences in installment amounts are due to interest amount only. Assuming X is the amount of Cash Price in each installment and I is the amount of interest.

Thus for the installments, starting from last installment, we have the following equations:

(i) $X + I = 40,000$

(ii) $X + 2I = 45,000$

(iii) $X + 3I = 50,000$

(iv) $X + 4I = 55,000$

Subtracting any preceding equation from the following equation we get I = ₹ 5,000 and by substituting the value of I in any equation we get X = ₹ 35,000.

The hire-purchase price is divided into cash price and interest parts as under :

Particulars	Cash Price ₹	Interest ₹	Installment ₹
Down Payment	60,000	-	60,000
First installment	35,000	20,000	55,000
Second installment	35,000	15,000	50,000
Third installment	35,000	10,000	45,000
Fourth installment	35,000	5,000	40,000
Total	2,00,000	50,000	250,000
Total Cash Price	2,00,000		
Hire Purchase Price	2,50,000		
Total Interest	50,000		

SITUATION – IV : WHEN REFERENCE TO ANNUITY TABLE RATE OF INTEREST ANDINSTALLMENTS ARE GIVEN BUT TOTAL CASH PRICE IS NOT GIVEN.

In such questions the reference to annuity table gives the present value of the annuity for a number of years at a certain rate of interest. This present worth is equal to total cash price. Therefore, with the help of annuity tables the total cash price of the total installments given can be calculated and then question can be solved by the first method.

Illustration 10

On 1.1.2010 X purchase a plant from Y on hire purchase system. The hire purchase rate was settled at ₹60,000, payable as to ₹ 15,000 on 1.1.2010 and ₹ 15,000 at the end of three successive year. Interest was charged @5% p.a. The asset was to be depreciated in the books of the purchaser at 10% p.a. on Reducing Balance Method. Given the present value of an annuity of Re. 1 p.a. @5% interest is ₹2.7232.

Ascertain the cash price.

Solution :

Amount of Interest	Present value
₹ 1	₹ 2.7232
₹ 15,000	$\frac{₹\,15,000 \times 2.7232}{1}$ = ₹ 40,848

∴ Cash Price = ₹ 40,848 + ₹ 15,000 (down) = ₹ 55,848.

ACCOUNTING TREATMENT

Accounting treatment in the books of buyer is presented in below :

In the Books of the Hire-Purchaser

The following methods are followed:

(1) Cash Price Method

(2) Interest Suspense Method

(3) Asset Accrual Method

Cash Price Method:

	Particulars		Debit (₹)	Credit (₹)
1.	Hire Purchase A/c	Dr.	xxxx	
	To, Hire Vendor A/c [Cash price]			xxxx
2.	Hire Vendor A/c	Dr.	xxxx	
	To, Bank A/c [Down payment]			xxxx
3.	Interest A/c	Dr.	xxxx	
	To, Hire Vendor A/c			xxxx
4.	Hire Vendor A/c	Dr.	xxxx	
	To, Bank A/c [Instalment amount]			xxxx
5.	P/L A/c	Dr.	xxxx	
	To, Interest A/c			xxxx
	To, Depreciation A/c			xxxx

Interest Suspense Method:

	Particulars		Debit (₹)	Credit (₹)
1.	Hire Purchase Asset A/c [Cash Price]	Dr.	xxxx	
	Interest Suspense A/c [Total Interest]	Dr.	xxxx	
	To, Hire Vendor A/c [H.P price]			xxxx
2.	Hire Vendor A/c	Dr.	xxxx	
	To, Bank A/c [Down payment]			xxxx
3.	Interest A/c	Dr.	xxxx	
	To, Interest Suspense A/c			xxxx
4.	Hire Vendor A/c	Dr.	xxxx	
	To, Bank A/c [Instalment amount]			xxxx
5.	P/L A/c	Dr.	xxxx	
	To, Interest A/c			xxxx
	To, Depreciation A/c			xxxx

Asset Accrual Method:

	Particulars		Debit (₹)	Credit (₹)
1.	Hire Purchase Asset A/c [Down payment]	Dr.	xxxx	
	To, Hire Vendor A/c			xxxx
2.	Hire Vendor A/c	Dr.	xxxx	
	To, Bank A/c			xxxx
3.	Hire Purchase Asset A/c [Instalment less Interest]	Dr.	xxxx	
	Interest A/c	Dr.	xxxx	
	To, Hire Vendor A/c			xxxx
4.	Hire Vendor A/c	Dr.	xxxx	
	To, Bank A/c			xxxx
5.	P/L A/c	Dr.	xxxx	
	To, Interest A/c			xxxx
	To, Depreciation A/c			xxxx

Illustration 11

On 1.1.2009 Mr. X took delivery from Mr. Y of 5 machines on a hire purchase system. ₹ 4,000 being paid on delivery and the balance in five installments of ₹ 6,000 each, payable annually on 31st December. The vendor company charges 5% interest p.a. on yearly balances. The cash price of 5 machines was ₹ 30,000. Show the entries (without narration) Assets Account, Mr. Y Account for 5 years assuming that the purchaser charges depreciation @20% on straight line method under (a) Asset Accrual Method and (b) under Sales Method.

Solution:

Computation of Interest

	₹	₹
Hire-purchase price		
Down payment	4,000	
Interest ₹ 6,000 x 5 =	30,000	34,000
Less: Cash Price		30,000
∴ **Interest**		**4,000**

Analysis of Payments of Vendors

Year	Opening Balance of Cash Price ₹	Towards Principal ₹	Towards Interest ₹	Installment ₹	Closing balance of Cash Price ₹
01.01.2009	30,000	4,000	---	---	26,000
31.12.2009	26,000	4,700	1,300	6,000	21,300
31.12.2010	21,300	4,935	1,065	6,000	16,365
31.12.2011	16,365	5,182	818	6,000	11,183
31.12.2012	11,183	5,441	559	6,000	5,742
31.12.2013	5,742	5,742	258 (bal. fig.)	6,000	NIL
			4,000		

(A) Large Items

(a) Under Asset Accrual Method

In the Books of Mr. X

Journal (without narrations)

Date	Particulars		L/F	Dr. Amount ₹	Cr. Amount ₹
2009	Assets A/c.	Dr.		4,000	
Jan. 1.	To Mr. Y A/c.				4,000
	Mr. Y A/c.	Dr.		4,000	
	To Bank A/c.				4,000
Dec. 31.	Assets A/c.	Dr.		4,700	
	Interest A/c.	Dr.		1,300	
	To Mr. Y A/c.				6,000
	Mr. Y A/c.	Dr.		6,000	
	To Bank A/c.				6,000
	Depreciation A/c.	Dr.		6,000	
	To Assets A/c.				6,000
	Profit & Loss A/c.	Dr.		7,300	
	To Interest A/c.				1,300
	To Depreciation A/c.				6,000
2010	Assets A/c.	Dr.		4,935	
Dec. 31.	Interest A/c.	Dr.		1,065	
	To Mr. Y A/c.				6,000
	Mr. Y A/c.	Dr.		6,000	
	To Bank A/c.				6,000
	Depreciation A/c.	Dr.		6,000	
	To Assets A/c.				6,000
	Profit & Loss A/c.	Dr.		7,065	
	To Interest A/c.				1,065
	To Depreciation A/c.				6,000
2011	Assets A/c.	Dr.		5,182	
Dec. 31.	Interest A/c.	Dr.		818	
	To Mr. Y A/c.				6,000
	Mr. Y A/c.	Dr.		6,000	
	To Bank A/c.				6,000
	Depreciation A/c.	Dr.		6,000	
	To Assets A/c.				6,000
	Profit & Loss A/c.	Dr.		6,818	
	To Interest A/c.				818
	To Depreciation A/c.				6,000

2012 Dec. 31.	Assets A/c. Dr.			5,441	
	Interest A/c. Dr.			559	
	To Mr. Y A/c.				6,000
	Mr. Y A/c. Dr.			6,000	
	To Bank A/c.				6,000
	Depreciation A/c. Dr.			6,000	
	To Assets A/c.				6,000
	Profit & Loss A/c. Dr.			6,559	
	To Interest A/c.				559
	To Depreciation A/c.				6,000
2013 Dec. 31.	Assets A/c. Dr.			5,742	
	Interest A/c. Dr.			258	
	To Mr. Y A/c.				6,000
	Mr. Y A/c. Dr.			6,000	
	To Bank A/c.				6,000
	Depreciation A/c. Dr.			6,000	
	To Assets A/c.				6,000
	Profit & Loss A/c. Dr.			6,258	
	To Interest A/c.				258
	To Depreciation A/c.				6,000

Dr. **Asset Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2009			2009		
Jan. 1.	To Mr. Y A/c.	4,000	Dec.31.	By Depreciation A/c.	6,000
Dec. 31.	`` Mr. Y A/c.	4,700		`` Balance c/d.	2,700
		8,700			8,700
2010			2010		
Jan. 1.	To Balance b/d.	2,700	Dec.31.	By Depreciation A/c.	6,000
Dec. 31.	`` Mr. Y A/c.	4,935		`` Balance c/d.	1,635
		7,635			7,635
2011			2011		
Jan. 1.	To Balance b/d.	1,635	Dec.31.	By Depreciation A/c.	6,000
	`` Mr. Y A/c.	5,182		`` Balance c/d.	817
		6,817			6,817
2012			2012		
Jan. 1.	To Balance b/d.	817	Dec.31.	By Depreciation A/c.	6,000
Dec. 31.	`` Mr. Y A/c.	5,441		`` Balance c/d.	258
		6,258			6,258
2013			2013		
Jan. 1.	To Balance b/d.	258	Dec.31.	By Depreciation A/c.	6,000
Dec. 31.	`` Mr. Y A/c.	5,742			
		6,000			6,000

Dr. **Mr. Y Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2009			2009		
Jan. 1.	To Bank A/c.	4,000	Jan. 1.	By Asset A/c.	4,000
Dec. 31.	`` Bank A/c.	6,000	Dec.31.	`` Asset A/c.	4,700
				Interest A/c.	1,300
		10,000			10,000
2010			2010		
Dec. 31.	To Bank A/c.	6,000	Dec.31.	By Asset A/c.	4,935
				Interest A/c.	1,065
		6,000			6,000
2011			2011		
Dec. 31.	To Bank A/c.	6,000	Dec.31.	By Asset A/c.	5,182
				Interest A/c.	818
		6,000			6,000
2012			2012		
Dec. 31.	To Bank A/c.	6,000	Dec.31.	By Asset A/c.	5,441
				Interest A/c.	559
		6,000			6,000
2013			2013		
Dec. 31.	To Bank A/c.	6,000	Dec.31.	By Asset A/c.	5,742
				Interest A/c.	258
		6,000			6,000

(b) Under Sales Method

In the Books of Mr. X

Journal (without narrations) ***Dr.*** ***Cr.***

Date	Particulars		L/F	Amount ₹	Amount ₹
2009	Assets A/c.	Dr.		30,000	
Jan. 1.	To Mr. Y A/c.				30,000
	Mr. Y A/c.	Dr.		4,000	
	To Bank A/c.				4,000
Dec. 31.	Interest A/c.	Dr.		1,300	
	To Mr. Y A/c.				1,300
	Mr. Y A/c.	Dr.		6,000	
	To Bank A/c.				6,000
	Depreciation A/c.	Dr.		6,000	
	To Assets A/c.				6,000
	Profit & Loss A/c.	Dr.		7,300	
	To Interest A/c.				1,300
	To Depreciation A/c.				6,000

2010 Dec. 31.	Interest A/c. Dr. To Mr. Y A/c.		1,065	 1,065
	Mr. Y A/c. Dr. To Bank A/c.		6,000	 6,000
	Depreciation A/c. Dr. To Assets A/c.		6,000	 6,000
	Profit & Loss A/c. Dr. To Interest A/c. To Depreciation A/c.		7,065	 1,065 6,000
2011 Dec. 31.	Interest A/c. Dr. To Mr. Y A/c.		818	 818
	Mr. Y A/c. Dr. To Bank A/c.		6,000	 6,000
	Depreciation A/c. Dr. To Assets A/c.		6,000	 6,000
	Profit & Loss A/c. Dr. To Interest A/c. To Depreciation A/c.		6,818	 818 6,000
2012 Dec. 31.	Interest A/c. Dr. To Mr. Y A/c.		559	 559
	Mr. Y A/c. Dr. To Bank A/c.		6,000	 6,000
	Depreciation A/c. Dr. To Assets A/c.		6,000	 6,000
	Profit & Loss A/c. Dr. To Interest A/c. To Depreciation A/c.		6,559	 559 6,000
2013 Dec. 31.	Interest A/c. Dr. To Mr. Y A/c.		258	 258
	Mr. Y A/c. Dr. To Bank A/c.		6,000	 6,000
	Depreciation A/c. Dr. To Assets A/c.		6,000	 6,000
	Profit & Loss A/c. Dr. To Interest A/c. To Depreciation A/c.		6,258	 258 6,000

Dr. **Asset Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2009			2009		
Jan. 1.	To Mr. Y A/c.	30,000	Dec. 31.	By Depreciation A/c.	6,000
				`` Balance c/d.	24,000
		30,000			30,000
2010			2010		
Jan. 1.	To Balance b/d.	24,000	Dec. 31.	By Depreciation A/c.	6,000
				`` Balance c/d.	18,000
		24,000			24,000
2011			2011		
Jan. 1.	To Balance b/d.	18,000	Dec. 31.	By Depreciation A/c.	6,000
				`` Balance c/d.	12,000
		18,000			18,000
2012			2012		
Jan. 1.	To Balance b/d.	12,000	Dec. 31.	By Depreciation A/c.	6,000
				`` Balance c/d.	6,000
		12,000			12,000
2013			2012		
Jan. 1.	To Balance b/d.		Dec. 31.	By Depreciation A/c.	6,000
		6,000			
		6,000			6,000

DEFAULT AND REPOSSESSION

Note:

It has been observed that Hire Purchase Trading Account (Debtors) method and Stock and Debtors method of ascertaining profit or loss on sale of goods of small value under hire purchase system based on the simplified approach are not fully compliant with AS 19 "Leases" since loading amount contains both profit as well as interest element.

As both companies and other than companies are involved in Hire Purchase Trading it is necessary to prepare the company accounts in compliance with Accounting Standards as per Companies Act, 2013.

Accordingly it is proposed to follow the methods other than Hire Purchase Trading Account (Debtors) Method and Stock and Debtors Method in case of Companies.

Meaning of Sales Method

Sales method follows a practical approach and practically (of course not technically) treats the hire purchaser as owner of the asset. Under this method, the asset is recorded at full cash price on the basis of 'substance over form'. This method is more appropriate since the intention all along is to buy the asset.

Journal Entries

The various accounting entries in the books of the hire purchaser and hire vendor are shown below:

Case	In the Books of Hire Purchaser	In the Books of Hire Vendor
1. On transfer of Possession	Asset A/c Dr. To Hire Vendor's A/c	Hire Purchaser's A/c Dr. To H.P. Sales A/c
2. On making Down Payment	Hire Vendor's A/c Dr. To Bank A/c	Bank A/c Dr. To Hire Purchaser's A/c
3. On making Interest due on unpaid balance	Interest A/c Dr. To Hire Vendor's A/c	Hire Purchaser's A/c Dr. To Interest A/c
4. On making payment of Instalment	Hire Vendor's A/c Dr. To Bank A/c	Bank A/c Dr. To Hire Purchaser's A/c
5. On providing Depreciation	Depreciation A/c Dr. To Asset A/c	No Entry
6. On closure of Depreciation A/c	Profit & Loss A/c Dr. To Depreciation A/c	No Entry
7. On closure of Interest A/c	Profit & Loss A/c Dr. To Interest A/c	Interest A/c Dr. To Profit & Loss A/c

Disclosure in Balance Sheet

At the end of each accounting period the balances of relevant accounts appear in the Balance Sheet as shown below:

Disclosure in Balance Sheet

Balance Sheet of Hire Purchaser				Balance Sheet of Hire Vendor			
Liabilities	**₹**	**Assets**	**₹**	**Liabilities**	**₹**	**Assets**	**₹**
		Fixed Assets:				Current Assets:	
		Asset (at full cash price)	xxx			Hire Purchase Debtors	xxx
		Less: Depreciation till date	xxx				
		Less: Balance in Hire Vendor's Account	xxx				
			xxx				**xxx**

Illustration 12

On 01.01.2011 A purchased five Machines each costing ₹ 1,58,500 each from B Payment was to be made 20% down and the remainder in four equal annual instalments commencing from 31.12.2011 with interest at 10% p.a. A writes off depreciation @20% on the diminishing balance.

Give the necessary journal entries and ledger accounts in the books of A and B under Sales Method. Also show how the relevant of items will appear in the Balance Sheet.

Solution:

Journal

Journal A	Journal B	Dr. (₹)	Cr.(₹)
01.01.2011			
(a) Machines A/c Dr.	(a) A A/c Dr.	7,92,500	
To B A/c	To HP Sales A/c		7,92,500
(b) B A/c Dr.	(b) Bank A/c Dr.	1,58,500	
To Bank A/c	To A A/c		1,58,500
31.12.2011			
(c) Interest A/c Dr.	(c) A A/c Dr.	63,400	
To B A/c	To Interest A/c		63,400
(d) B A/c Dr.	(d) Bank A/c Dr.	2,21,900	
To Bank A/c	To A A/c		2,21,900
(e) Depreciation A/c Dr.	(e) No Entry	1,58,500	
To Machines A/c			1,58,500
(f) Profit & Loss A/c Dr.	(f) No Entry	1,58,500	
To Depreciation A/c			1,58,500
(g) Profit & Loss A/c Dr.	(g) Interest A/c Dr.	63,400	
To Interest A/c	To Profit & Loss A/c		63,400
31.12.2012			
(a) Interest A/c Dr.	(b) A A/c Dr.	47,550	
To B A/c	To Interest A/c		47,550
(b) B A/c Dr.	(b) Bank A/c Dr.	2,06,050	
To Bank A/c	To A A/c		2,06,050
(c) Depreciation A/c Dr.	(c) No Entry	1,26,800	
To Machines A/c			1,26,800
(d) Profit & Loss A/c Dr.	(d) No Entry	1,26,800	
To Depreciation A/c			1,26,800
(e) Profit & Loss A/c Dr.	(e) Interest A/c Dr.	47,550	
To Interest A/c	To Profit & Loss A/c		47,550
31.12.2013			
(a) Interest A/c Dr.	(c) A A/c Dr.	31,700	
To B A/c	To Interest A/c		31,700
(b) B A/c Dr.	(b) Bank A/c Dr.	1,90,200	
To Bank A/c	To A A/c		1,90,200
(c) Depreciation A/c Dr.	(c) No Entry	1,01,440	
To Machines A/c			1,01,440
(d) Profit & Loss A/c Dr.	(d) No Entry	1,01,440	
To Depreciation A/c			1,01,440

(e) Profit & Loss A/c Dr.	(e) Interest A/c Dr.	31,700	
To Interest A/c	To Profit & Loss A/c		31,700
31.12.2014			
(a) Interest A/c Dr.	(d) A A/c Dr.	15,850	
To B A/c	To Interest A/c		15,850
(b) B A/c Dr.	(b) Bank A/c Dr.	1,74,350	
To Bank A/c	To A A/c		1,74,350
(c) Depreciation A/c Dr.	(c) No Entry	81,152	
To Machines A/c			81,152
(d) Profit & Loss A/c Dr.	(d) No Entry	81,152	
To Depreciation A/c			81,152
(e) Profit & Loss A/c Dr.	(e) Interest A/c Dr.	15,850	
To Interest A/c	To Profit & Loss A/c		15,850

Dr. **Machines Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To B A/c	7,92,500	31.12.11	By Depreciation A/c	1,58,500
				By Balance c/d	6,34,000
		7,92,500			**7,92,500**
01.01.12	To Balance b/d	6,34,500	31.12.12	By Depreciation A/c	1,26,800
				By Balance c/d	5,07,200
		6,34,500			**6,34,500**
01.01.13	To Balance b/d	5,07,200	31.12.13	By Depreciation A/c	1,01,440
				By Balance c/d	4,05,760
		5,07,200			**5,07,200**
01.01.14	To Balance b/d	4,05,760	31.12.14	By Depreciation A/c	81,152
				By Balance c/d	3,24,608
		4,05,760			**4,05,760**

Dr. **B's Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To Bank A/c [Down Payment]	1,58,500	01.01.11	By Machines A/c	7,92,500
31.12.11	To Bank A/c [₹1,58,500 + ₹63,400]	2,21,900	31.12.11	By Interest A/c [(₹7,92,500 - ₹1,58,500)×10/100]	63,400
	To Balance c/d	4,75,500			
		8,55,900			**8,55,900**
31.12.12	To Bank A/c [₹1,58,500 + ₹47,550]	2,06,050	01.01.12	By Balance b/d	4,75,500
	To Balance c/d	3,17,000	31.12.12	By Interest A/c [₹4,75,500 × 10/100]	47,550
		5,23,050			**5,23,050**
31.12.13	To Bank A/c [₹1,58,500 + ₹31,700]	1,90,200	01.01.13	By Balance b/d	3,17,000
	To Balance c/d	1,58,500	31.12.13	By Interest A/c [₹ 3,17,000 × 10/100]	31,700
		3,48,700			**3,48,700**
31.12.14	To Bank A/c [₹1,58,500 + ₹15,850]	1,74,350	01.01.14	By Balance b/d	1,58,500
			31.12.14	By Interest A/c [₹1,58,500 × 10/100]	15,850
		1,74,350			**1,74,350**

An Extract of Balance Sheet of A

Liabilities	1st yr	2nd yr	3rd yr	4th yr	Assets	1st yr (₹)	2nd yr (₹)	3rd yr (₹)	4th yr (₹)
					Fixed Assets:				
					Machines	7,92,500	7,92,500	7,92,500	7,92,500
					Less: Depreciation till date	1,58,500	2,85,300	3,86,740	4,67,892
					Less: Balance due To B	4,75,500	3,17,000	1,58,500	-
						1,58,500	**1,90,200**	**2,47,260**	**3,24,608**

Ledger Accounts in the books of B

Dr. **A's Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To Sales A/c	7,92,500	01.01.11	By Bank A/c [Down payment]	1,58,500
31.12.11	To Interest A/c	63,400	31.12.11	By Bank A/c	2,21,900
				By Balance c/d	4,75,500
		8,55,900			**8,55,900**
01.01.12	To Balance b/d	4,75,500	31.12.12	By Bank A/c	2,06,050
31.12.12	To Interest A/c	47,550	31.12.12	By Balance c/d	3,17,000
		5,23,050			**5,23,050**
01.01.13	To Balance b/d	3,17,000	31.12.13	By Bank A/c	1,90,200
31.12.13	To Interest A/c	31,700		By Balance c/d	1,58,500
		3,48,700			**3,48,700**
01.01.14	To Balance b/d	1,58,500	31.12.14	By Bank A/c	1,74,350
31.12.14	To Interest A/c	15,850			
		1,74,350			**1,74,350**

An Extract of Balance Sheet of B

Liabilities	1st yr	2nd yr	3rd yr	4th yr	Assets	1st yr (₹)	2nd yr (₹)	3rd yr (₹)	4th yr (₹)
					Current Assets:				
					Hire Purchase Debtors – A	4,75,500	3,17,000	1,58,500	-

Default and Repossession

If a hire purchaser fails to pay any instalment on the stipulated date, the hire purchaser is said to be at default. In case of default by the hire purchaser, the hire vendor may repossess the goods. Repossession means taking back the possession of goods by the hire vendor. Subject to agreement, the repossession may be either complete or partial.

Meaning of Complete or Full Repossession

In case of complete or full repossession the hire vendor takes back the possession of all the goods.

Journal Entries under Complete or Full Repossession

All Entries till the date of default are passed in the usual manner. The additional Entries are as follows:

Books of Hire Purchaser	Books of Hire Vendor
1. For Closing Hire Vendor's Account Hire Vendor's A/c Dr. To Asset A/c **Note:** This entry is passed with the amount due to the hire-vendor.	**1. On Repossession of goods** Goods Repossessed A/c Dr. To Hire Purchaser's A/c **Note:** This entry is passed with the revalued amount of goods repossessed.

2. For Closing Asset Account	**2. For amount spent on reconditioning of Goods Repossessed**
(i) If the Book Value of the Asset exceeds the amount due to Hire-Vendor	Goods Repossessed A/c Dr.
Profit & Loss A/c Dr.	To Cash A/c/Bank A/c
To Asset A/c	**3. For sale of Goods Repossessed**
(ii) If the amount due to Hire-Vendor exceeds the Book Value of the Asset	Cash A/c/Bank A/c /Debtors A/c Dr.
Asset A/c Dr.	To Goods Repossessed A/c
To Profit & Loss A/c	**4. For loss on sale of Goods Repossessed**
	Profit & Loss A/c Dr.
	To Goods Repossessed A/c
	Note: In case of profit, a reverse entry will be passed.

Illustration 13

On 1.1.2011, A purchased 5 Machines from B. Payment was to be made—20% down and the balance in four annual instalments of ₹2,80,000, ₹ 2,60,000, ₹ 2,40,000 and ₹ 2,20,000 commencing from 31.12.2011. The vendor charged interest @ 10% p.a. A, writes off depreciation @ 20% p.a. on the original cost.

On A's failure to pay the instalment due on 31.12.2012, B repossessed all the machines on 01.01.2013 and valued them on the basis of 40% p.a. depreciation on W.D.V. basis. B after incurring ₹6,000 on repairs sold the machines for ₹2,66,000 on 30th June 2013. Prepare the relevant accounts in the books of A and B.

Solution:

Computation of Cash Price and Periodic Interest

A Instalment Number	B Closing Balance after the Payment of Instalment	C Instalment Amount	D = B + C Closing Balance before the payment of Instalment	E = D × R/(100 + R) Interest D × 10/110	F = D-E Opening Balance
IV	—	2,20,000	2,20,000	20,000	2,00,000
III	2,00,000	2,40,000	4,40,000	40,000	4,00,000
II	4,00,000	2,60,000	6,60,000	60,000	6,00,000
I	6,00,000	2,80,000	8,80,000	80,000	8,00,000

Let the cash price be 'X

X = ₹ 8,00,000 + 20% of X (i.e. down payment) 0.8X = ₹ 8,00,000

X = ₹ 8,00,000/0.8 = ₹10,00,000

Ledger Accounts in the book of A

Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To B's A/c	10,00,000	31.12.11	By Depreciation A/c	2,00,000
				By Balance c/d	8,00,000
		10,00,000			**10,00,000**
01.01.12	To Balance b/d	8,00,000	31.12.12	By Depreciation A/c	2,00,000
				By Balance c/d	6,00,000

		8,00,000			**8,00,000**
01.01.13	To Balance b/d	6,00,000	01.01.13	By B's A/c	6,60,000
	To P&L A/c (Profit)	60,000			
		6,60,000			**6,60,000**

Dr. **B's Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To Bank A/c (Down payment)	2,00,000	01.01.11	By Machinery A/c	10,00,000
31.12.11	To Bank A/c [₹2,00,000 + ₹80,000]	2,80,000	31.12.11	By Interest A/c [(₹10,00,000 - ₹2,00,000) × 10/100]	80,000
	To Balance c/d	6,00,000			
		10,80,000			**10,80,000**
31.12.12	To Balance c/d	6,60,000	01.01.12	By Balance b/d	6,00,000
				By Interest A/c (₹6,00,000 × 10/100)]	60,000
01.01.13	To Machinery A/c	6,60,000	01.01.13	By Balance b/d	6,60,000

Ledger Accounts in the books of B

Dr. **A's Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To H.P. Sales A/c	10,00,000	01.01.11	By Bank A/c (Down Payment)	2,00,000
31.12.11	To Interest A/c [(₹10,00,000 - ₹2,00,000) × 10/100]	80,000	31.12.11	By Bank A/c (₹2,00,000 + ₹80,000)	2,80,000
				By Balance c/d	6,00,000
		10,80,000			**10,80,000**
01.01.12	To Balance b/d	6,00,000	31.12.12	By Balance c/d	6,60,000
31.12.12	To Interest A/c [₹6,00,000 × 10/100]	60,000			
		6,60,000			**6,60,000**
01.01.13	To Balance b/d	6,60,000	01.01.13	By H.P. Goods Repossessed A/c	3,60,000
				By Profit & Loss A/c	3,00,000
		6,60,000			**6,60,000**

Dr. **H.P. Goods Repossessed Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.13	To A's A/c	3,60,000	30.06.13	By Bank A/c	2,66,000
	To Bank A/c	6,000		By P&L A/c	1,00,000
		3,66,000			**3,66,000**

Partial Repossession

In case of partial repossession, the hire vendor takes back the possession of a part of the goods.

Practical Steps under Partial Repossession

Step1: Calculate Book value of Goods Repossessed

A. Cost

B. Less: Depreciation upto date of repossession

C. Book value of Goods Repossessed

Step 2: Calculate Agreed Value of Goods Repossessed

Step 3: Loss on default = Book Value – Agreed Value

Journal Entries Under Partial Repossession

Entries till the date of default are passed in the usual manner. The additional Entries are as follows:

Books of Hire Purchaser	Books of Hire Vendor
1. For transfer of the agreed value of Goods Repossessed Hire Vendor's A/c Dr. To Asset A/c	**1. On Repossession of Goods at agreed value** H.P. Goods Repossessed A/c Dr. To Hire Purchaser's A/c
2. For Transfer of Loss on default Profit & Loss A/c Dr. To Asset A/c Note: In case of profit on default, the reverse entry will be passed	2,3,4—Same entries as in case of complete repossession.

Illustration 14

On 1.1.2011, A purchased 5 Machines from B. Payment was to be made—20% down and the balance in four annual instalments of ₹2,80,000, ₹ 2,60,000, ₹ 2,40,000 and ₹ 2,20,000 commencing from 31.12.2011. The vendor charged interest @ 10% p.a. A, writes off depreciation @ 20% p.a. on the original cost.

On A's failure to pay the instalment due on 31.12.2012, after negotiations on 01.01.2013 B agreed to leave two machines with A adjusting the value of the other three machines against the amount due. The machines being valued at cost less 40% p.a. depreciation on W.D.V basis, B after spending ₹6000 on repairs of each of such machines sold @ ₹70,000 on 30th June 2013. Prepare the relevant accounts in the books of A and B.

Solution:

A Instalment Number	B Closing Balance after the payment of Instalment	C Instalment Amount	D= B+C Closing Balance before the payment of Instalment	E = D × R/(100 +R) Interest D × 10/110	F = D-E Opening Balance
IV	-	2,20,000	2,20,000	20,000	2,00,000
III	2,00,000	2,40,000	4,40,000	40,000	4,00,000
II	4,00,000	2,60,000	6,60,000	60,000	6,00,000
I	6,00,000	2,80,000	8,80,000	80,000	8,00,000

Let the cash price be 'X'

X= ₹8,00,000 +20% of X (i.e. down payment)

0.8X = ₹8,00,000

X = ₹8,00,000/0.8 = ₹10,00,000

Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To B A/c	10,00,000	31.12.11	By Depreciation A/c	2,00,000
				By Balance c/d	8,00,000
		10,00,000			**10,00,000**
01.01.12	To Balance b/d	8,00,000	31.12.12	By Depreciation A/c	2,00,000
				By Balance c/d	6,00,000
		8,00,000			**8,00,000**
01.01.13	To Balance b/d	6,00,000	01.01.13	By B A/c	2,16,000
				By P&L A/c [loss on default]	1,44,000
				By Depreciation A/c	80,000
				By Balance c/d	1,60,000
		6,00,000			**6,00,000**

Dr. **B's Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To Bank A/c (Down payment)	2,00,000	01.01.11	By Machinery A/c	10,00,000
31.12.11	To Bank A/c [₹2,00,000 + ₹80,000] To Balance c/d	2,80,000 6,00,000	31.12.11	By Interest A/c [(₹10,00,000 - ₹2,00,000) × 10/100]	80,000
		10,80,000			**10,80,000**
31.12.12	To Balance c/d	6,60,000	01.01.12	By Balance b/d	6,00,000
			31.12.12	By Interest A/c [(₹6,00,000 × 10/100)]	60,000
01.01.13	To Machinery A/c	6,60,000	01.01.13	By Balance b/d	6,60,000

Working Notes

1. **Calculation of Book value of Goods Repossessed**

A. Cost [₹2,00,000 × 3]	₹6,00,000
B. Less: Depreciation for 2 years [₹6,00,000 × 20% × 2]	₹2,40,000
	₹3,60,000

2. **Calculation of Agreed value of Goods Repossessed**

A. Cost [₹2,00,000 × 3]	₹6,00,000
B. Less: Depreciation for 1st Year [40% of ₹6,00,000]	₹2,40,000
C. Book Value in the beginning of 2nd year	₹3,60,000
D. Less: Depreciation for 2nd year [40% of ₹3,60,000]	₹1,44,000
E. Book Value at the end of 2nd Year	₹2,16,000

2. Loss on Default = Book Value – Agreed Value = ₹3,60,000 - ₹2,16,000 = ₹1,44,000

Dr. **A's Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To H.P. Sales A/c	10,00,000	01.01.11	By Bank A/c (Down payment)	2,00,000
31.12.11	To Interest A/c [(₹10,00,000 - ₹2,00,000)× 10/100]	80,000	31.12.11	By Bank A/c [₹2,00,000 +₹80,000]	2,80,000
				By Balance c/d	6,00,000
		10,80,000			**10,80,000**
01.01.12	To Balance b/d	6,00,000	31.12.12	By Balance c/d	6,60,000
31.12.12	To Interest A/c [₹6,00,000 × 10/100]	60,000			
		6,60,000			**6,60,000**
01.01.13	To Balance b/d	6,60,000	01.01.13	By H.P. Goods Repossessed A/c	2,16,000
				By Balance c/d	4,44,000
		6,60,000			**6,60,000**

Dr. **H.P. Goods Repossessed Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.13	To A's A/c	2,16,000	30.06.13	By Bank A/c	2,10,000
	To Bank A/c (Repairs) [₹6,000 ×3]	18,000		By P&L A/c (Loss)	24,000
		2,34,000			**2,34,000**

Illustration 15

A Transport purchased from Kolkata Motors 3 Tempos costing ₹50,000 each on the hire purchase system on 1.1.2011. Payment was to be made ₹30,000 down and the remainder in 3 equal annual instalments payable on 31.12.2011, 31.12.2012 and 31.12.2013 together with interest @ 9%. p.a. A Transport writes off depreciation at the rate of 20% p.a. on the diminishing balance. It paid the instalment due at the end of the first year i.e. 31.12.2011 but could not pay the next on 31.12.2012. Kolkata Motors agreed to leave one Tempo with the purchaser on 31.12.2012 adjusting the value of the other 2 Tempos against the amount due on 31.12.2012. The Tempos were valued on the basis of 30% depreciation annually on W.D.V. basis.

Required: Show the necessary accounts in the books of A Transport for the year 2011, 2012,2013.

Solution:

Dr. **Tempos Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To Kolkata Motors' A/c (₹50,000 × 3)	1,50,000	31.12.11	By Depreciation A/c (20% on ₹1,50,000)	30,000
				By Balance c/d	1,20,000
		1,50,000			**1,50,000**
01.01.12	To Balance b/d	1,20,000	31.12.12	By Depreciation A/c	24,000
			31.12.12	By Kolkata Motors' A/c (Value of 2 tempos taken away)	49,000
			31.12.12	By P&L A/c (Loss on Default)	15,000
			31.12.12	By Balance c/d (value of one tempo left)	32,000
		1,20,000			**1,20,000**
01.01.13	To Balance b/d	32,000	31.12.13	By Depreciation A/c	6,400
			31.12.13	By Balance c/d	25,600
		32,000			**32,000**

Dr. **Kolkata Motor's Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.11	To Bank A/c (Down Payment)	30,000	01.01.11	By Tempos A/c (₹50,000 ×3)	1,50,000
31.12.11	To Bank A/c	50,800	31.12.11	By Interest A/c (9% on ₹1,20,000)	10,800
31.12.11	To Balance c/d	80,000			
		1,60,800			**1,60,800**
31.12.12	To Tempos A/c	49,000	01.01.12	By Balance b/d	80,000
31.12.12	To Balance c/d	38,200	31.12.12	By Interest A/c (9% on ₹80,000)	7,200
		87,200			**87,200**
31.12.13	To Bank A/c	41,638	01.01.13	By Balance b/d	38,200
			31.12.13	By Interest A/c (9% on ₹38,200)	3,438
		41,638			**41,638**

Working Notes:

1. Value of a tempo left with the buyer = ₹50,000 × 80/100 × 80/100 = ₹32,000
2. Value of Tempos taken away by the seller = ₹50,000 × 2 × 70/100 × 70/100 = ₹49,000
3. Loss on Tempos taken away = Book Value – Agreed Value

   = [2 × ₹50,000 × 80/100 × 80/100] - ₹49,000 = ₹15,000.

Illustration 16

On 1 January 2012, A purchased from B a plant valued at ₹7,45,000; payment to be made by four semi-annual instalments of ₹2,10,000 each; interest being charged at 5% per half year. A paid the first instalment on 1st July 2012 but failed to pay the next. B repossessed the plant on 4 January 2013.On 5 January 2013, after negotitation, A was allowed to retain the plant of which the original cash price was ₹3,90,000 and he was to bear the loss on the remainder which was taken over by B on that date for ₹3,75,000. B waived the interest after 31st December 2012.Another agreement was signed for payment of the balance amount.

Show by ledger accounts the necessary records in the books of A charging depreciation at 10% per annum half yearly on the written down value.

Solution:

Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.2012	To B's A/c	7,45,000	30.06.2012	By Depreciation A/c By Balance c/d	37,250 7,07,750
		7,45,000			**7,45,000**
01.07.2012	To Balance b/d	7,07,750	31.12.2012	By Depreciation A/c By Balance c/d	35,388 6,72,362
		7,07,750			**7,07,750**
01.01.2013	To Balance b/d To Profit & Loss A/c (Balancing Figure) [3,75,000-3,20,387]	6,72,362 54,613	05.01.2013	By B's A/c By Balance c/d	3,75,000 3,51,975
		7,26,975			**7,26,975**

Dr. **B's Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
30.6.2012	To balance c/d	7,82,250	01.01.2012	By Plant on Hire Purchase A/c	7,45,000
			30.06.2012	By Interest A/c [₹7,45,000 × 5%]	37,250
		7,82,250			**7,82,250**
01.07.2012	To Bank A/c	2,10,000	01.07.2012	By Balance b/d	7,82,250
31.12.2012	To Balance c/d	6,00,863	31.12.2012	By Interest A/c [₹5,72,250 × 5%]	28,613
		8,10,863			**8,10,863**
05.01.2013	To Machinery A/c	3,75,000	01.01.2013	By Balance b/d	6,00,863
	To Balance c/d	2,25,863			
		6,00,863			**6,00,863**

Working Note: Calculation of Book Value of Plant Repossessed and Retained

	Repossessed (₹)	Retained (₹)
A. Cash Price of the Plant	3,55,000	3,90,000
B. Less: Depreciation @10% for 6 months	(17,750)	(19,500)
C. Book Value	3,37,250	3,70,500
D. Less: Depreciation @10% for 6 months	(16,863)	(18,525)
E. Book Value	3,20,387	3,51,975

Illustration 17

Z sold 3 Machinery for a total cash sale price of ₹6,00,000 on hire purchase basis to X on 01.01.2011. The terms of agreement provided for 30% as cash down and the balance of the cash price in three equal instalments together with interest at 10% per annum compounded annually. The instalments were payable as per the following schedule:

1st instalment on 31.12.2012; 2nd instalment on 31.12.2013 and 3rd instalment on 31.12.2014.X paid the 1st instalment on time but failed to pay thereafter. On his failure to pay the second instalment, Z repossessed two machineries and valued them at 50% of the cash price. X charges 10% p.a. depreciation on straight line method.

Prepare necessary ledger accounts in the books of X for 2011-2013.

Solution:

Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.2011	To Z's A/c	6,00,000	31.12.2011	By Depreciation A/c	60,000
				By Balance c/d	5,40,000
		6,00,000			**6,00,000**
01.01.2012	To Balance b/d	5,40,000	31.12.2012	By Depreciation A/c	60,000
				By Balance c/d	4,80,000
		5,40,000			**5,40,000**
01.01.2013	To Balance b/d	4,80,000	31.12.2013	By Depreciation A/c	60,000
				By Z's A/c	2,00,000
				By Profit and Loss A/c (balancing figure)	80,000
				By Balance c/d	1,40,000
		4,80,000			**4,80,000**

Dr. **Z's Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.2011	To Bank A/c	1,80,000	31.12.2011	By Machinery A/c	6,00,000
31.12.2011	To Balance c/d	4,62,000		By Interest A/c [10% on (₹6,00,000 - ₹1,80,000)]	42,000
		6,42,000			**6,42,000**
31.12.2012	To Bank A/c (1,40,000 + 42,000 + 46,200) To Balance c/d	2,28,200 2,80,000	01.01.2012 31.12.2012	By Balance c/d By Interest A/c [10% on ₹4,62,000]	4,62,000 46,200
		5,08,200			**5,08,200**
31.12.2013	To Machinery A/c To Balance c/d	2,00,000 1,08,000	01.01.2013 31.12.2013	By Balance b/d By Interest A/c	2,80,000 28,000
		3,08,000			**3,08,000**

Working Notes:

1. Book value of machine left and repossessed

	1 left	2 repossessed
A. Costs	2,00,000	4,00,000
B. Less: Depreciation for 3 years @10%	(60,000)	(1,20,000)
	1,40,000	2,80,000

2. Agreed Value of 2 Machinery Repossessed = Cash Price – 50% of cash price

= ₹(4,00,000 – 2,00,000) = ₹2,00,000

3. Loss on Default = Agreed Value – Book Value

= ₹(2,00,000 - 2,80,000) = ₹80,000

Illustration 18

X purchased a truck for ₹ 2,80,000, payment to be made ₹ 91,000 down and 3 installments of ₹ 76,000 each at the end of each year. Rate of interest is charged at 10% p.a. Buyer depreciates assets at 15% p.a. on written down value method.

Because of financial difficulties, X, after having paid down payment and first installment to the end of 1st year could not pay second installment and seller took possession of the truck. Seller, after spending ₹ 9,200 on repairs of the asset sold for ₹ 150,000. Show the relevant accounts in the books of the purchaser & the vendor.

Solution:

Particulars	Total Cash Price ₹	Installment Paid @ 10% Int ₹	Interest Paid ₹	Paid towards Cash Price (Installment-Interest) ₹
	280,000			
Down Payment	91,000	91,000	0	91,000
	189,000			
End of 1st year	57,100	76,000	18,900	57,100
	131,900			
End of 2nd Year	62,810	76,000	13,190	62,810
	69,090			
End of 3rd Year	69,090	76,000	6,910	69,090
Total	0	3,19,000	39,000	2,80,000

In the Books of X

Dr. **Car Account** *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1st Year	To Vendor A/c	2,80,000		By Depreciation A/c	42,000
				By Bal c/d	2,38,000
		2,80,000			2,80,000
2nd Year	To Bal b/d	2,38,000		By Depreciation A/c	35,700
				By Vendors A/c	1,45,090
				By P/L A/c (Bal. figure)	57,210
		2,38,000			2,38,000

Dr. **Vendors Account** **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1st Year	To Bank (Down Payment)	91,000		By Car (Cash Price) A/c	2,80,000
	To Bank (Installment)	76,000		By Interest A/c	18,900
	To Bal c/d	1,31,900			
		2,98,900			2,98,900
2nd Year	To Asset A/c (Default- Assets taken over	1,45,090		By Balance b/d	1,31,900
				" Interest A/c	13,190
		1,45,090			1,45,090

In the Books of Vendor

Dr. **X Account** **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1st Year	To Hire Purchase Sales A/c	2,80,000		By Bank (Down) A/c	91,000
				By Bank (Installment) A/c	76,000
	To Interest A/c	18,900		By Balance c/d	1,31,900
		2,98,900			2,98,900
2nd Year	To Balance b/d	1,31,900		By Goods Repossessed A/c	1,45,090
	To Interest A/c	13,190			
		1,45,090			1,45,090

Dr. **Goods Repossessed Account** **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To X A/c (Purchaser) A/c	1,45,090		By Bank (Sales) A/c	1,50,000
	To Bank (Repairing Charge) A/c	9,200		By P/L A/c (Bal Figure)	4,290
		1,54,290			1,54,290

Illustration 19

Z Associates purchased seven trucks on hire purchase on 1st July, 2012. The cash purchase price of each truck was ₹ 1,00,000. The company has to pay 20% of the cash purchase price at the time of delivery and the balance in five half yearly instalment starting from 31st December, 2012 with interest at 5% per annum at half yearly rates. On the Company's failure to pay the instalment due on 30th June 2013, it was agreed that the Company would return 3 trucks to the vender and the remaining four would be retained. The vendor agreed to allow him a credit for the amount paid against these 3 trucks less 25%. Show the relevant Accounts in the books of the purchaser and vendor assuming the books are closed in June every year and depreciation @ 20% p.a. is charged on Trucks. Vendor after spending ₹2,000 on repairs sold away all the three trucks for ₹ 80,000.

Solution :

In Books of Hire-Purchaser

Dr. **Trucks Account** ***Cr.***

Date	Particulars	₹	Date	Particulars	₹
01.07.12	To Hire Vendor's A/c (Cost of Trucks @ ₹ 1,00,000 each)	7,00,000	30.06.13	By Depreciation A/c	1,40,000
				By Hire Vendor's A/c (Value of 3 Trucks returned to Vendor)	81,000
				By P & L A/c (Loss on surrender)	1,59,000
				By Balance c/d [4/7 of (₹7,00,000 - ₹1,40,000)	3,20,000
		7,00,000			7,00,000

Dr. **Hire Vendor's Account** ***Cr.***

Date	Particulars	₹	Date	Particulars	₹
01.07.12	To Bank A/c (7,00,000 × 20/100)	1,40,000	01.07.12	By Trucks A/c	7,00,000
			31.12.12	By Interest A/c [5,60,000 × 2.5%]	14,000
31.12.12	To Bank A/c [(20% of 5,60,000 +14,000]	1,26,000	30.06.13	By Interest A/c [4,48,000 × 2.5%]	11,200
30.06.13	To Trucks A/c (Value of Trucks surrendered)	81,000			
30.06.13	To Balance c/d	3,78,200			
		7,25,200			7,25,200

Rate of interest is [5% ÷ 2] = 2.5% for half year.

Working Notes :

		₹
(i)	Credit allowed by Vendor against 3 trucks	
	Total amount of principal paid against 7 trucks (₹ 1,40,000 + ₹ 1,12,000)	2,52,000
	Total amount of principal paid against 3 trucks (₹ 2,52,000 × 3/7)	1,08,000
	Credit allowed by Vendor (₹ 1,08,000 – 25% of ₹ 1,08,000)	81,000
(ii)	Loss on surrender of 3 trucks	
	Book value of 3 turcks surrendered [(₹ 1,00,000 × 3) less 20% of ₹3,00,000]	2,40,000
	Less : Credit allowed by Vendor against these 3 Trucks	81,000
	Loss on surrender of 3 Trucks	1,59,000

In Books of Hire Vendor

Dr. **Z Associates Account** *Cr.*

Date	Particulars	₹	Date	Particulars	₹
01.07.12	To H.P. Sales A/c	7,00,000	01.07.12	By Bank A/c	1,40,000
31.12.12	To Interest A/c	14,000	31.12.12	By Bank A/c	1,26,000
30.06.13	To Interest A/c	11,200	30.06.13	By Goods Repossessed A/c	81,000
			30.06.13	By Balance c/d	3,78,200
		7,25,200			7,25,200

Dr. **Goods Repossessed Account** *Cr.*

Date	Particulars	₹	Date	Particulars	₹
30.6.13	To Banerjee & Co.	81,000	30.6.13	By Bank A/c (Sales)	80,000
30.6.13	To Cash A/c (expenses)	2,000	30.6.13	By Profit & Loss A/c (Loss on Sale)	3,000
		83,000			83,000

Illustration 20

HT Associates purchased three electric motors costing ₹ 10,000 each from KM Associates on 1st January, 2010 on the hire purchase system. The terms were : Payment on delivery ₹ 2,500 for each motor and balance of the principal amount by 3 equal instalments plus interest at 15% per annum to be paid at the end of each year. HT Associates writes off 25% depreciation each year on the diminishing balance method. HT Associates failed to pay the last instalment. KM Associates repossessed two motors adjusting values against the amount due. The repossession was done on 1st January, 2013 on the basis of 40% depreciation on the diminishing balance method. You are required to: (a) Write up the ledger accounts in the books of HT Associates showing the above transactions upto 1.1.2013, and (b) Show the disclosure of the balance arising from the above in the Balance Sheet of HT Associates as on 31st December 2012.

Solution :

In the Books of HT Associates

Motor Account

Dr. | | | | | Cr.

Date	Particulars	₹	Date	Particulars	₹
01.01.10	To KM Associates A/c	30,000	31.12.10	By Depreciation A/c By Balance c/d	7,500 22,500
		30,000			30,000
01.01.11	To Balance b/d	22,500	31.12.11	By Depreciation A/c By Balance c/d	5,625 16,875
		22,500			22,500
01.01.12	To Balance b/d	16,875	31.12.12	By Depreciation A/c By Balance c/d	4,218 12,657
		16,875			16,875
01.01.13	To Balance b/d	12,657	01.01.13	By KM Associates A/c By Profit & Loss A/c By Balance c/d (1/3 of ₹ 12,657)	4,320 4,118 4,219
		12,657			12,657

KM Associates Account

Dr. | | | | | Cr.

Date	Particulars	₹	Date	Particulars	₹
01.01.10 31.12.10	To Bank A/c To Bank (₹ 7,500 + ₹ 3,375) To Balance c/d	7,500 10,875 15,000	01.01.10 31.12.10	By Motor A/c By Interest (15% on ₹ 22,500)	30,000 3,375
		33,375			33,375
31.12.11	To Bank A/c To Bank c/d	9,750 7,500	01.01.11 31.12.11	By Balance b/d By Interest (15% on ₹ 15,000)	15,000 2,250
		17,250			17,250
31.12.12	To Balance c/d	8,625	01.01.12	By Balance b/d	7,500 1,125
		8,625	31.12.12	By Interest (15% on ₹ 7,500)	8,625
01.01.13	To Motor A/c To Balance c/d	4,320 4,305	01.01.12	By Balance b/d	8,625
		8,625			8,625

Working Notes :

(i) Agreed Value of two motors repossessed on 01.01.2013 at 40% depreciation

	2010	2011	2012
	₹	₹	₹
Cost/WDV in the beginning	20000	12,000	7,200
Less: Depreciation for the year@ 40%	8,000	4,800	2,880
Book Value	12,000	7,200	4,320

(ii) Loss on surrender of two motors

	₹
Written down value of 3 motors as on 01.01.2013	12,657
Less: Value of one truck retained (₹ 12,657 × 1/3)	4,219
Written down value of repossessed motors	8,438
Less: Agreed value of repossessed motors	4,320
Loss on surrender of two motors	**4,118**

Illustration 21

On 1.1.2010, B & Brothers bought 5 computers from Chirag Computers on hire-purchase. The cash price of each computer was ₹ 20,000. It was agreed ₹ 30,000 each at the end of each year. The Vendor charges interest @ 10% p.a. The buyer depreciates computers at 20% p.a. on the diminishing balance method.

B & Brothers paid cash down of ₹ 5,000 each and two instalments but failed to pay the last instalment. Consequently, the Computer Traders repossessed three sets, leaving two sets with the buyer and adjusting the value of 3 sets against the amount due. The sets repossessed were valued on the basis of 30% depreciation p.a. on the written down value. The sets repossessed were sold by the Chirag Computers for ₹ 30,000 after necessary rapairs amounting to ₹ 5,000 on 30th June 2013.

Required : Open the necessary ledger account in the books of both the parties.

Solution :

In the Books of B & Brothers

Dr. **Computers Account** *Cr.*

Date	Particulars	₹	Date	Particulars	₹
01.01.10	To Chirag Computers A/c	1,00,000	31.12.10	By Depreciation A/c By Balance c/d	20,000 80,000
		1,00,000			1,00,000
01.01.11	To Balance b/d	80,000	31.12.11	By Depreciation A/c By Balance c/d	16,000 64,000
		80,000			80,000
31.12.12	To Balance b/d	64,000	31.12.12	By Depreciation A/c By Chirag Computers (computers surrendered) By P & L A/c - Loss on surrender By Balance c/d	12,800 20,580 10,140 20,480
		64,000			64,000

Dr. **Chirag Computers Account** *Cr.*

Date	Particulars	₹	Date	Particulars	₹
01.01.10	To Cash A/c	25,000	01.01.10	By Computers A/c	1,00,000
31.12.10	To Cash A/c	30,000	31.12.10	By Interest A/c	
	To Balance c/d	52,500		[(₹ 1,00,000 –	7,500
		1,07,500		₹ 25,000) × 10%]	1,07,500
		30,000			52,500
31.12.11	To Cash	27,750	01.01.11	By Balance b/d	5,250
	To Balance c/d		31.12.11	By Interest A/c	
		57,750		[52,500 × 10%]	57,750
		20,580			27,750
31.12.12	To Computers A/c	9,420	01.01.12	By Balance b/d	2,250
	(surrendered)		31.12.12	By Interest A/c	
	To Balance c/d	30,000			30,000

Working Notes :

(i) Total Interest = Hire Purchase Price – Cash Price

= [₹ 25,000 + (₹ 30,000 × 3)] – (₹ 20,000 × 5)

= ₹ 1,15,000 – ₹ 1,00,000 = ₹ 15,000

(ii) Interest for 3rd year = ₹ 15,000 – ₹ 7,500 – ₹ 5,250 = ₹ 2,250

(iii) Agreed Value of 3 Computers Repossessed on the basis of depreciation @ 30% p.a.

	₹
Cost (Cash Price) of 3 Computers	60,000
Less : Depreciation @ 30% p.a. for 3 years [₹ 18,000 + ₹ 12,600 + ₹ 8,820]	39,420
	20,580

(iv) Book Value of 3 Computers Repossessed on the basis of depreciation @ 20% p.a

Cost (Cash Price) of 3 Computers	60,000
Less : Depreciation @ 20% WDV for 3 years [₹ 12,000 + ₹ 9,600 + ₹ 7,680]	29,280
	30,720

(v) Loss on Surrender = Book value – Agreed Value = ₹ 30,720 – ₹ 20,580 = ₹ 10,140

In the Books of Chirag Computers

Dr. **B & Brothers Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.10	To H.P. Sales A/c	1,00,000	01.01.10	By Cash A/c	25,000
31.12.10	To Interest A/c	7,500	31.12.10	By Cash A/c	30,000
				By Balance c/d	52,500
		1,07,500			1,07,500
01.01.11	To Balance b/d	52,500	31.12.11	By Cash A/c	30,000
31.12.11	To Interest A/c	5,250	31.12.11	By Balance c/d	27,750
		57,750			57,750
01.01.12	To Balance b/d	27,750	31.12.12	By Goods Repossessed A/c	20,580
31.12.12	To Interest A/c	2,250		By Balance c/d	9,420
		30,000			30,000

Dr. **Goods Repossessed Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
30.06.13	To B & Brothers A/c	20,580	30.06.13	By Cash A/c (sales)	30,000
30.06.13	To Cash A/c (Repairs)	5,000			
30.06.13	To Profit & Loss A/c (Profit)	4,420			
		30,000			30,000

Items of Small Value-Hire-Purchase Trading Account

For items of 'B' category, *i.e.*. of small value such as cycles, radios, fans etc. sold on hire-purchase system it would be impractical for the seller to calculate the interest involved in each installment (as discussed earlier). It involves huge amount of clerical work. It is impossible to distinguish the gross profit and interest for each and every contract. Therefore on grounds of expediency no distinction is made between one contract and another on the one hand and the gross profit element and interest on the other. It is the combined figure of gross profit and interest for all contracts that is apportioned for each accounting period on an appropriate basis.

(a) **Book-keeping procedures:** Maintain a subsidiary book and record therein the name of article, selling price of article, number of installments to be paid etc. provide many small columns for recording the receipt of installments as and when received.

(b) At the end of the financial year, collect the following statistics from the subsidiary records;

(i) Cost price of total goods paid to various customers during the year;

(ii) Total cash received from customers;

(iii) Total installments due but not paid by customers. This happens only when there is delay on the part of customers to make payments; and

(iv) Cost price of unpaid and *not* due installments; because at the end of the year, there are always some customers from whom installments do not become due. The cost price calculated from the amount of installments unpaid and not due, gives us the cost price of the goods in the hands of the customers. This item is known as 'Stock out on hire purchase system at cost price'. The value of this item can be ascertained in three ways provided the gross profit margin is uniform.

Accounting procedure for preparing Hire-Purchase Trading Account

There are two ways in which the Hire-Purchase Trading Account may be prepared and both methods produce the same profit figures and same value of "stock out on hire at cost" for Balance Sheet purposes. The methods are (1) Stock on Hire Method and (2) Provision for stock or Provision for Unrealized Profit method. (H.P.Adjustment)

1. Stock on Hire Method

Under this method the following accounting entries are made resulting in the preparation of Hire- Purchase Trading Account and the ascertainment of the Profit.

Transaction	DR	CR
(1) Goods sold on hire-purchase at Hire-purchase selling price	Hire-Purchase Debtors	Hire-Purchase Sales
(2) (i) Deposits and installments received from customers. (ii) -do- (Total)	Bank Hire-Purchase Sales	Hire-Purchase Debtors (Individual A/c) Hire-Purchase Trading A/c
(3) Cost price of goods sold on hire-purchase	Hire-Purchase Trading	Purchases/ Trading
(4) (i) Installment due and unpaid (ii) -do- (Total)	Installment Due Hire-Purchase Sales	Hire- Purchase Debtors Hire-Purchase Trading A/c
(5) Hire-purchase Trading profit	Hire-Purchase Trading	General Profit and Loss

Notes :

(1) The balance in the Hire-purchase Debtors Account represents amount not due and not paid on hire-purchase contracts.

(2) The balance in the Hire-purchase Sales amount will be equal to Hire-purchase Debtors. The nature of the balances is however, opposite. Therefore, these balances need not be shown in the balance sheet.

2. Provision for Unrealized Profit Method

Under this method provision is made for the unrealized profit included in hire-purchase debtors not yet due to reduce them to the cost basis. Because of this the method is named as "Provision for unrealized profit method"

The accounting entries are :

Transaction	DR	CR
(1) Goods sold on hire-purchase at hire-purchase selling price	Hire-Purchase Debtors	Hire-Purchase Sales
(2) Deposits and installments received from customers.	Bank	Hire-Purchase Debtors
(3) Installment due and unpaid.	Installment Due	Hire- Purchase Debtors
(4) Balance in hire-purchase sales	Hire-Purchase Sales	Hire-Purchase Trading
(5) Cost price of goods sold on hire-purchase.	Hire-Purchase Trading	Purchases/Trading
(6) Provision for unrealized profit.	Hire-Purchase Trading	H.P. Adjustment A/c
(7) Hire-Purchase Trading profit	Hire-Purchase Trading	General Profit and Loss

Notes :

(1) Formula for Provision for unrealized profit is:-

Installments not yet due / (Total Hire - purchase sales) × Total profit

(2) In the Balance Sheet balance of Hire-purchase debtors (not yet due) *minus* the provision for unrealized profit is shown under 'Current Assets'.

3. Debtors System

Hire-Purchase Trading Account prepared under this system is similar to branch account prepared under the debtors system. Just as branch account gives the profit made by the branch, Hire-Purchase Trading Account also discloses the profit made through hire sales of items of small value. The logic of preparing the H.P. Trading account and the Journal entries made are similar to the preparation of branch account under the debtors system.

Meaning of some of the terms used in this system.

(a) *Hire Purchase Debtors: (Installments due and unpaid)* : These are installments due in the accounting period, but not paid by the buyers of goods.

(b) *Hire-Purchase Stock:* This represents instalments from buyers are not due. These installments are payable in subsequent accounting period. This can be valued at selling or cost price . Other names to this item are 'Stock out on Hire', 'Stock with Customers' and 'Installments not due'.

(c) *Shop Stock account:* This represents the cost of goods with the Hire Vendor which have not yet been sold to Hire Purchasers.

(d) *Purchases:* This item represents the cost of goods purchased during the accounting period.

(e) *Installments paid:* This represents installments received during the accounting period and may relate to current or earlier periods.

The Accounting entries under this method are :

Transaction	DR	CR
(1) Cost price of goods sold on hire-purchase	Hire-Purchase Trading	Goods sold on H.P
(2) Installments received from customers	Bank	Hire-Purchase Trading
(3) Installment due and unpaid (at cost)	H.P. Debtors A/c	Hire-Purchase Trading
(4) Goods with customers on hire at close	Hire-Purchase Stock	Hire-Purchase Trading
(5) Hire-purchase Trading profit	Hire-Purchase Trading	General Profit and Loss

Repossessed Goods

The seller can repossess the goods *from* the buyer defaulting to make payments due under the contract. The seller is not bound to return any deposits and installments received in respect of such goods. Such goods are usually repaired or reconditioned and then sold. There are two ways of dealing with such repossessed goods. First, they can be dealt with in the framework of HP Trading Account. Secondly the figures relating to such repossessed goods can be segregated and shown separately so that HP Trading Account shows the normal gross profit.

First *Method*:

Under this method the installments due in respect of such repossessed goods are transferred to general profit and loss account, the entry being

General Profit and Loss Account Dr.

To Installments Due Account

This entry is made at Hire-purchase price and represents abnormal loss written off to profit and loss account. Goods repossessed are valued at cost or market price whichever is less and are included in the stock and shown on the credit side of HP Trading Account, the entry being:

Goods Repossessed Account Dr.
To Hire-Purchase Trading Account

4. Stock and Debtors System

Under this system the following accounts are to be opened:

(1) Hire-purchase Stock Account.
(2) Shop Stock Account.
(3) Goods on Hire Purchase Account.
(4) Hire-purchase Adjustment Account.

And the treatments are like below.

Transaction	DR	CR
1. Cost price of goods available for hire-purchase sale.	Shop Stock	Purchase
2. Goods sold on hire Purchase during the year	(a) Hire-purchase Stock (b) Goods sold on hire Purchase	(a) Shop Stock (b) H. P. Adjustment
3. Installment Due During the year	Hire-Purchase debtors	Hire-Purchase Stock
4. Installments Received in Cash	Bank	Hire Purchase Debtors
5. Loading on un-matured Installments	Hire Purchase Adjustment	Stock Reserve
6. Unpaid Installments of Repossessed Goods	Repossessed Goods	Hire Purchase Debtors
7. Balance of Hire Purchase Adjustment	Hire Purchase Adjustment	Profit and Loss

Illustration 22

S Traders has a hire purchase department. Goods are sold on hire purchase at cost plus 50%. The following information is provided for the year ending on 31st March 2013.

	01.04.2012	31.03.2013
Stock out with Hire Purchase Customers (₹)	9,000	?
Stock at shop (₹)	18,000	20,000
Instalment Due (Customers still Paying) (₹)	5,000	9,000

Required : Prepare Hire Purchase Trading Account in each of the following alternative cases:

Case (a) If Cash received from hire purchasers amounted to ₹ 60,000 and Goods purchased during the year amounted to ₹ 60,000.

Case (b) If Cash received from hire purchasers amounted to ₹ 60,000 and Goods purchased during the year amounted to ₹ 60,000. Goods repossessed (Instalments due ₹ 2000) valued at ₹ 500 which have not been included in the Stock at shop at the end.

Case (c) If Cash received from hire purchasers amounted to ₹ 60,000 and Goods purchased during the year amounted to ₹ 60,000. Goods repossessed (Instalments unpaid ₹ 2,000 of which ₹ 1,400 were overdue) valued at ₹ 500 which have not been included in the Stock at shop at the end.

Solution :

Case (a)

Dr. **Hire Purchase Trading Account** *Cr.*

Particulars	₹	Particulars	₹
To Opening Balances:		By Hire Purchase Stock Reserve	
Hire Purchase Stock	9,000	[₹ 9,000 × 50/150]	3,000
Hire Purchase Debtors	5,000	By Bank A/c	60,000
To Goods Sold on Hire Purchase	87,000	By Goods Sold on Hire Purchase A/c [₹ 87,000 × 50/150]	29,000
To Hire Purchase Stock Reserve A/c [₹ 32,000 × 50/150]	10,667	By Closing Balances :	
To Profit t/f to General		Hire Purchase Stock	32,000
P & L A/c	21,333	Hire Purchase Debtors	9,000
	1,33,000		1,33,000

Working Notes :

Dr. **(i) Shop Stock Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	18,000	By Goods Sold on Hire Purchase A/c	58,000
To Purchases	60,000	By Balance c/d	20,000
	78,000		78,000

Dr. **(ii) Goods Sold on Hire Purchase Account** *Cr.*

Particulars	₹	Particulars	₹
To Shop Stock A/c	58,000	By Hire Purchase Trading A/c	87,000
To Hire Purchase Trading A/c	29,000		
	87,000		87,000

Dr. **(iii) Memorandum Hire Purchase Stock Account** *Cr.*

Particulars	₹	Particulars	₹
To, balance b/d	9,000	By, Hire Purchase Debtors A/c	64,000
To, Goods Sold on Hire Purchase A/c	87,000	By, Balance c/d (bal.fig)	32,000
	96,000		96,000

Dr. **(iv) Memorandum Hire Purchase Debtors Account** *Cr.*

Particulars	₹	Particulars	₹
To, Balance b/d	5,000	By, Bank A/c	60,000
To, Hire Purchase Stock A/c(bal.fig)	64,000	By, Balance c/d	9,000
	69,000		69,000

Case (b)

Dr. **Hire Purchase Trading Account** *Cr.*

Particulars	₹	Particulars	₹
To Opening Balances :		By Hire Purchase Stock Reserve	
Hire Purchase Stock	9,000	[₹ 9,000 × 50/150] By	3,000
Hire Purchase Debtors	5,000	By Bank A/c	60,000
To Goods Sold on Hire Purchase	87,000	By Goods Sold on Hire Purchase A/c	29,000
To Hire Purchase Stock Reserve A/c	10,000	[₹ 87,000 × 50/150]	
[₹ 30,000 × 50/150]		By Goods Repossessed A/c	500
To Profit t/f to General	20,500	[At Revalued Figure]	
P & L A/c		By Closing Balances :	
		Hire Purchase Stock	30,000
		Hire Purchase Debtors	9,000
	1,31,500		1,31,500

Working Notes :

Dr. **(i) Shop Stock Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	18,000	By Goods Sold on Hire Purchase A/c	58,000
To Purchases	60,000	By Balance c/d	20,000
		[Excluding Goods Repossessed]	
	78,000		78,000

Dr. **(ii) Goods Sold on Hire Purchase Account** *Cr.*

Particulars	₹	Particulars	₹
To Stop Stock A/c	58,000	By Hire Purchase Trading A/c	87,000
To Hire Purchase Trading A/c	29,000		
	87,000		87,000

Dr. **(iii) Memorandum Hire Purchase Stock Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	9,000	By Hire Purchase Debtors A/c	66,000
To Goods Sold on Hire Purchase	87,000	By Balance c/d (bal. fig.)	30,000
	96,000		96,000

Dr. **(iv) Memorandum Hire Purchase Debtors Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	5,000	By Bank A/c	60,000
To Hire Purchase Stock A/c	66,000	By Goods Repossessed A/c	2,000
		By Balance c/d	9,000
	71,000		71,000

Case (c)

Dr. **Hire Purchase Trading Account** *Cr.*

Particulars	₹	Particulars	₹
To Opening Balances:		By Hire Purchase Stock Reserve	3,000
Hire Purchase Stock	9,000	[₹ 9,000 × 50/150]	
Hire Purchase Debtors	5,000	By Bank A/c	60,000
To Goods Sold on Hire Purchase	87,000	By Goods Sold on Hire Purchase A/c	29,000
To Hire Purchase Stock Reserve A/c	10,000	[₹ 87,000 × 50/150]	
[₹ 30,000 × 50/150]		By Goods Repossessed A/c	500
To Profit t/f to General	20,500	[At Revalued figure]	
P & L A/c		By Closing Balances :	
		Hire Purchase Stock	30,000
		Hire Purchase Debtors	9,000
	1,31,500		1,31,500

Working Notes :

Dr. **(i) Shop Stock Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	18,000	By Goods Sold on Hire Purchase A/c	58,000
To Purchases	60,000	By Balance c/d	20,000
		[Excluding Goods Repossessed]	
	78,000		78,000

Dr. **(ii) Goods Sold on Hire Purchase Account** *Cr.*

Particulars	₹	Particulars	₹
To Shop Stock A/c	58,000	By Hire Purchase Trading A/c	87,000
To Hire Purchase Trading A/c	29,000		
	87,000		87,000

Dr. **(iii) Memorandum Hire Purchase Stock Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	9,000	By Hire Purchase Debtors A/c	65,400
To Goods Sold on Hire Purchase	87,000	By Goods Repossessed A/c	600
		By Balance c/d	30,000
	96,000		96,000

Dr. **(iv) Memorandum Hire Purchase Debtors Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	5,000	By Bank A/c	60,000
To Hire Purchase Stock A/c	65,400	By Goods Repossessed A/c	1,400
		By Balance c/d	9,000
	70,400		70,400

Illustration 23

Mr. Gulab sells goods on hire purchase basis. He fixes hire purchase price at 33 1/3% profit on invoice price of the goods. The following are the fugures relating to his hire purchase business for the year ending on 31st March 2013 :

	01.04.2012	31.03.2013
	₹	₹
Hire Purchase Stock	60,000	?
Hire Purchase Debtors	1,500	?
Shop Stock	50,000	75,000

Goods purchased during the year ₹ 3,27,000, Cash received from customers during the year ₹4,62,000. Total amount of installments that fell due during the year ₹ 4,63,500.

One customer to whom goods had been sold for ₹ 6,000 paid only 5 instalments of ₹ 500 each. On his failure to pay the monthly instalment of ₹ 500 each on 4th March 2013, the goods were repossessed on 27th March 2013 after due legal notice.

Required : Prepare the Hire Purchase Trading Account.

Solution :

Dr. **Hire Purchase Trading Account** *Cr.*

Particulars	₹	Particulars	₹
To Opening Balances:		By Hire Purchase Stock Reserve	20,000
Hire Purchase Stock	60,000	[60,000×50/150]	
Hire Purchase Debtors	1,500	By Bank A/c	4,62,000
To Goods Sold on Hire Purchase	4,53,000	By Goods Sold on Hire Purchase A/c	1,51,000
To Hire Purchase Stock Reserve A/c	15,500	[4,53,000×50/150]	
[46,500 × 50/150]		By Goods Repossessed A/c [At Revalued Figure]	2,333
To Profit t/f to General P & L A/c	1,54,333	By Closing Balances :	
		Hire Purchase Stock	46,500
		Hire Purchase Debtors	2,500
	6,84,333		6,84,333

Working Notes :

Dr. **(i) Shop Stock Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	50,000	By Goods Sold on Hire Purchase A/c	3,02,000
To Purchases	3,27,000	By Balance c/d [Excluding Goods Repossessed]	75,000
	3,77,000		3,77,000

Dr. **(ii) Goods Sold on Hire Purchase Account** *Cr.*

Particulars	₹	Particulars	₹
To Shop Stock A/c	3,02,000	By Hire Purchase Trading A/c	4,53,000
To Hire Purchase Trading A/c	1,51,000		
	4,53,000		4,53,000

Dr. **(iii) Memorandum Hire Purchase Stock Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	60,000	By Hire Purchase Debtors A/c	4,63,500
To Goods Sold on Hire Purchase	4,53,000	By Goods Repossessed A/c	3,000
		By Balance c/d	46,500
	5,13,000		5,13,000

Dr. **(iv) Memorandum Hire Purchase Debtors Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	1,500	By Bank A/c	4,62,000
To Hire Purchase Stock A/c	4,63,500	By Goods Repossessed A/c	500
		By Balance c/d	2,500
	4,65,000		4,65,000

Working Note :

Calculation of the value of Goods Repossessed

$$= \frac{\text{Cost Price}}{\text{H. P. Price}} \times \text{Unpaid Amount (whether due or not)}$$

$$= \frac{4,000}{6,000} \times 3,500 = ₹\ 2,333.$$

Illustration 24

Goods amounting to ₹ 6,23,988 at hire purchase price were sold on hire purchase system. The hire-vendor normally sells goods at retail price showing a gross profit of 30% on that price. But when goods are sold on hire-purchase, he adds 5 per cent to retail price to cover additional risk. During the year goods costing ₹42,000 were repossessed for non-receipt of any payment on them. These goods were valued at cost on 31 March. Cash received from customers amounted to ₹2,52,000.

Required : Prepare Hire Purchse Trading Account for the year ending on 31st March, 2013, so that profits to be taken into account is such proportion of the profits as installments due bear to the total goods sold on hire-purchase.

Solution :

Dr. **Hire Purchase Trading Account** Cr.

Particulars	₹	Particulars	₹
To Opening Balances: Hire Purchase Stock	–	By Bank A/c	2,52,000
Hire Purchase Debtors	–	By Goods Sold on Hire Purchase A/c [₹ 6,23,988 × 35/105]	2,07,996
To Goods Sold on Hire Purchase	6,23,988	By Goods Repossessed A/c	42,000
To Hire Purchase Stock Reserve A/c [₹ 3,08,988 × 35/105]	1,02,996	By Closing Balances :	
		Hire Purchase Stock	3,08,988
To Profit t/f to General P & L A/c	84,000	Hire Purchase Debtors	–
	8,10,984		8,10,984

Working Notes:

Dr. **(i) Memorandum Hire Purchase Stock Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	–	By Hire Purchase Debtors A/c	3,15,000
To Goods Sold on Hire Purchase	6,23,988	By Balance c/d	3,08,988
	6,23,988		6,23,988

Dr. **(ii) Memorandum Hire Purchase Debtors Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	–	By Bank A/c	2,52,000
To Hire Purchase Stock A/c	3,15,000	By Goods Repossessed A/c [₹ 42,000 × 105/70]	63,000
		By Balance c/d	–
	3,15,000		3,15,000

Note : Retail Price of the goods = 100 + 5 = 105. So, Loading is calculated as 35/105.

Illustration 25

Considering the same information as given in Illustrtion 22, prepare Shop Stock Account, Goods Sold on Hire Purchase Account, Hire Purchase Stock Account, Hire Purchase Debtors Account, Hire Purchase Adjustment Account.

Case(a)

Dr. **(i) Shop Stock Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	18,000	By Goods Sold on Hire Purchase A/c	58,000
To Purchases	60,000	By Balance c/d	20,000
	78,000		78,000

Dr. **(ii) Good Sold on Hire Purchase Account** Cr.

Particulars	₹	Particulars	₹
To Shop Stock A/c	58,000	By Hire Purchase Stock A/c	87,000
To Hire Purchase Adjustment A/c	29,000		
	87,000		87,000

Dr. **(iii) Hire Purchase Stock Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	9,000	By Hire Purchase Debtors A/c	64,000
To Goods Sold on Hire Purchase A/c	87,000	By Balance c/d (bal. fig.)	32,000
	96,000		96,000

Dr. **(iv) Hire Purchase Debtors Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	5,000	By Bank A/c	60,000
To Hire Purchase Stock A/c	64,000	By Balance c/d	9,000
	69,000		69,000

Dr. **(v) Hire Purchase Adjustment Account** Cr.

Particulars	₹	Particulars	₹
To Hire Purchase Stock Reserve A/c [32,000 × 50/150]	10,667	By Hire Purchase Stock Reserve A/c [9,000 × 50/150]	3,000
To Profit t/f to Profit & Loss A/c	21,333	By Goods Sold Hire Purchase A/c [87,000 × 50/150]	29,000
	32,000		32,000

Case (b)

Dr. **(i) Shop Stock Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	18,000	By Goods Sold on Hire Purchase A/c	58,000
To Purchases (bal. fig.)	60,000	By Balance c/d [Excluding Goods Repossessed]	20,000
	78,000		78,000

Dr. **(ii) Good Sold on Hire Purchase Account** Cr.

Particulars	₹	Particulars	₹
To Shop Stock A/c	58,000	By Hire Purchase Stock A/c	87,000
To Hire Purchase Adjustment A/c	29,000		
	87,000		87,000

Dr. **(iii) Hire Purchase Stock Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	9,000	By Hire Purchase Debtors A/c	66,000
To Goods Sold on Hire Purchase A/c	87,000	By Balance c/d (bal. fig.)	30,000
	96,000		96,000

Dr. **(iv) Hire Purchase Debtors Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	5,000	By Bank A/c	60,000
To Hire Purchase Stock A/c	66,000	By Goods Repossessed A/c	2,000
		By Balance c/d	9,000
	71,000		71,000

Dr. **(v) Hire Purchase Adjustment Account** Cr.

Particulars	₹	Particulars	₹
To Hire Purchase Stock Reserve A/c [30,000 × 50/150]	10,000	By Hire Purchase Stock Reserve A/c [9,000 × 50/150]	3,000
To Goods on Repossessed A/c [Loss on Repossession] [2,000 – 500]	1,500	By Goods Sold on Hire Purchase A/c [87,000 × 50/150]	29,000
To Profit t/f to Profit & Loss A/c	20,500		
	32,000		32,000

Case (c)

Dr. **(i) Shop Stock Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	18,000	By Good Sold on Hire Purchase A/c (bal. fig.)	58,000
To Purchases	60,000	By Balance c/d [excluding goods repossessed]	20,000
	78,000		78,000

Dr. **(ii) Good Sold on Hire Purchase Account** Cr.

Particulars	₹	Particulars	₹
To Shop Stock A/c	58,000	By Hire Purchase Stock A/c	87,000
To Hire Purchase Adjustment A/c	29,000		
	87,000		87,000

Dr. **(iii) Hire Purchase Stock Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	9,000	By Hire Purchase Debtors A/c	65,400
To Goods Sold on Hire Purchase A/c	87,000	By Goods Repossessed A/c	600
		By Balance c/d (b.f.)	30,000
	96,000		96,000

Dr. **(iv) Hire Purchase Debtors Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	5,000	By Bank A/c	60,000
To Hire Purchase Stock A/c	65,400	By Goods Repossessed A/c	1,400
		By Balance c/d	9,000
	70,400		70,400

Dr. **(v) Hire Purchase Adjustment Account** Cr.

Particulars	₹	Particulars	₹
To Hire Purchase Stock Reserve A/c [30,000 × 50/150]	10,000	By Hire Purchase Stock Reserve A/c [9,000 × 50/150]	3,000
To Goods on Repossessed A/c [Loss on Repossession] [2,000 - 500]	1,500	By Goods Sold on Hire Purchase A/c [87,000 × 50/150]	29,000
To Profit t/f to Profit & Loss A/c	20,500		
	32,000		32,000

Illustration 26

Capital Electronics sold a colour TV set to X on hire purchase system on 1.1.2013 for ₹ 18,400. *X* paid ₹ 4,000 on the same date to receive the delivery of the TV set and agreed to pay the balance in 12 equal monthly installments, each instalment becoming due on the last date of each month. *X* paid six instalments in time but failed to pay other installments. In September 2013 (before the monthly instalment has become due) the seller repossessed the TV set. The repossessed set was valued at ₹ 7,000.

Required : Show the necessary ledger accounts (on the basis of Stock and Debtors system) in the books of Capital Electronics.

Solution :

In the books of Capital Electronics

Dr. **(i) Hire Purchase Stock Account** ***Cr.***

Particulars	₹	Particulars	₹
To Balance b/d	–	By Hire Purchase Debtors A/c	13,600
To Goods Sold on H. P. A/c	18,400	By Goods Repossessed A/c (1200×4) (Instalment not yet due)	4,800
		By Balance c/d	–
	18,400		18,400

Dr. **(ii) Hire Purchase Debtors Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	–	By Cash A/c/Bank A/c [4000 + (1,200 × 6)]	11,200
To Hire Purchase Stock A/c	13,600	By Goods Repossessed A/c (1,200 × 2) (Instalment due but not paid)	2,400
		By Balance c/d	–
	13,600		13,600

Dr. **(iii) Goods Repossessed Account** *Cr.*

Particulars	₹	Particulars	₹
To Hire Purchase Stock a/c	4,800	By Hire Purchase Adjustment A/c	200
To Hire Purchase Debtors A/c	2,400	By Balance c/d	7,000
	7,200		7,200

Dr. **(iv) Hire Purchase Adjustment Account(extracts)** *Cr.*

Particulars	₹	Particulars	₹
To Goods Repossessed A/c	200		

Illustration 27

Trans Enterprise records transactions relating to its hire purchase business on Stock & Debtors System, It sold to Rasheed a Handicam (Cost ₹ 27,000) for which Rasheed was required to pay in all ₹ 36,000 in the form of 12 monthly installments of ₹ 3,000 each. Rasheed paid four instalments in time but thereafter stopped paying installments. Trans Enterprise after the seventh instalment, had

also become due (but before the eight installment had fallden due) repossessed the tape recorder. Trans Enterprise spent ₹ 6,000 on reconditioning of the tape recorder and sold the same for ₹ 30,000.

Required : Give the necessary journal entries relating to Goods repossessed and prepare the Goods Repossessed Account.

Case (a) If the repossessed tape recorder was valued at ₹ 19,500.

Case (b) If no other information is given.

Solution :

Case (a)

Journal

Particulars		Dr. (₹)	Cr. (₹)
Goods Repossessed A/c	Dr.	24,000	
To Hire Purchase Stock A/c			15,000
To HIre Purchase Debtors A/c			9,000
(Being 5 instalments not yet due credited to H.P. Stock A/c, 3 instalments due but not paid, credited to Hire Purchase Debtors A/c)			
Hire Purchase Adjustment A/c	Dr.	4,500	
To Goods Repossessed A/c			4,500
Being the repossessed goods valued at ₹ 19,500 and thus, the difference (i.e. ₹ 19,500 – ₹ 24,000) being debited to Hire Purchase Adjustment Account)			
Goods Repossessed A/c	Dr.	6,000	
To Bank A/c			6,000
(Being the reconditioning charges paid)			
Bank A/c	Dr.	30,000	
To Goods Repossessed A/c			30,000
(Being the repossessed goods sold)			
Goods Repossessed A/c	Dr.	4,500	
To Hire Purchase Adjustment A/c			4,500
(Being the profit on sale of repossessed goods transferred)			

Dr. **Goods Repossessed Account** *Cr.*

Particulars	₹	Particulars	₹
To Hire Purchase Stock A/c	15,000	By Hire Purchse Adjustment A/c	4,500
To Hire Purchased Debtors A/c	9,000	By Balance c/d	19,500
	24,000		24,000
To Balance b/d	19,500	By Bank A/c (Sale proceeds)	30,000
To Bank A/c (Expenses)	6,000		
To Hire Purchase Adjustment A/c	4,500		
	30,000		30,000

Case (b)

Journal

Particulars		Dr. (₹)	Cr. (₹)
Goods Repossessed A/c	Dr.	24,000	
To Hire Purchase Stock A/c			15,000
To Hire Purchase Debtors A/c			9,000
(Being 5 instalments not yet due credited to H.P. Stock A/c, 3 instalments due but not paid, credited to Hire Purchase Debtors A/c)			
Hire Purchase Adjustment A/c	Dr.	6,000	
To Godds Repossessed A/c			6,000
(Being the repossessed goods valued at theoretical cost of ₹ 6,000 and thus, the difference (i.e. ₹ 18,000 – ₹ 24,000) being debited to Hire Purchase Adjustment Account) [*Refer Note*]			
Goods Repossessed A/c	Dr.	6,000	
To Bank A/c			6,000
(Being the reconditioning charges paid)			
Bank A/c	Dr.	30,000	
To Goods Repossessed A/c			30,000
(Being the repossessed goods sold)			
Goods Repossessed A/c	Dr.	6,000	
To Hire Purchased Adjustment A/c			6,000
(Being the profit on sale of repossessed goods t/f)			

Working Note : Calculation of the Value of goods repossessed

$$\text{Value of goods reposessed} = \frac{\text{Cost Price}}{\text{H.P. Price}} \times \text{Unpaid amount (whether due or not)}$$

$$= \frac{₹\ 27{,}000}{₹\ 36{,}000} \times ₹\ 24{,}000 = ₹\ 18{,}000$$

Dr. **Goods Repossessed Account** *Cr.*

Particulars	₹	Particulars	₹
To Hire Purchase Stock A/c	15,000	By Hire Purchse Adjustment A/c	6,000
To Hire Purchased Debtors A/c	9,000	By Balance c/d	18,000
	24,000		24,000
To Balance b/d	18,000	By Bank A/c (Sale proceeds)	30,000
To Bank A/c (Expenses)	6,000		
To Hire Purchase Adjustment A/c	6,000		
	30,000		30,000

Illustration 28

The hire purchases department of Zapak Traders provides you the following information for the year ending on 30th September 2013 :

Purchase cost per unit	₹ 3,000
Cash sales price per unit	₹ 4,000
Cash down payment per unit	₹ 400
Monthly payment per unit	₹ 350
Number of instalments per unit	12
Number of units sold on hire purchase basis	120
Number of instalments collected	420
Nuber of instalments due but not yet collected	58

Required : Calculate the following :

(a) Number of instalments fallen due during the year, (b) Number of instalments not yet due on 30.9.2012, (c) Amount of instalment not yet due, (d) Amount of installment due but not yet collected, (e) Amount fallen due during the year, (f) Cash collected during the year, (g) Hire Purchase price per unit, (h) Total hire purchase price of units sold, (i) Total cost price of units sold on hire purchase, (j) % of profit margin on H.P. Sales, (k) Profit included in total hire purchases price, (l) Profit included in the amount of instalments not yet due, (m) Gross Profit.

Also Prepare Hire Purchase Stock Account, Hire Purchases Debtors Account and Hire Purchase Adjustment Acount.

Solution :

Step 1 Preparation of the Analysis of No. of Instalments

Total No. of Instalments = No. of Units sold × Total No. of Instalments Payable

= 120 × 12 = 1440

Again, Total No. of Instalments = Instalment Due + Instalments not Due

Where, **Instalments Due** = Instalments Received + Instalments not received = 420 + 58 = 478

Instalments Not Due = Total No of Instalments – Instalments Due

= 1440 – 478 = 962 (Balancing Figure)

Step 2 Preparation of the Analysis of Total Hire Purchase Price

Total Hire Purchase Price = No. of Units sold × H.P. Selling price per unit

= 120 × 4,600 = ₹ 5,52,000

Again, **Total Hire Purchase Price** = **Down Payment received** + **Instalments Receivable**

Down Payment Received = No. of units sold × Down Payment per unit

= 120 × ₹ 400 = ₹ 48,000

Instalments Receivable = 1,440 × ₹ 350 = ₹ 5,04,000

Again, **Instalments Receivable=Instalments Due +Instalments not Due**

Where, **Instalments Due** = 478 × ₹ 350 = ₹ 1,67,300

Instalments Not Due = 962 × ₹ 350 = ₹ 3,36,700

Again, **Instalments Due** = **Instalments due & received** + **Instalments due but not received**

Where, Instalments due & received = 420 × ₹ 350 = ₹ 1,47,000

Instalments due but not received = 58 × ₹ 350 = ₹ 20,300

Let us answer the given questions on the basis of above :

(a) Number of Instalments fallen due = 478

(b) Number of Instalments not yet due = 962

(c) Amount of Instalments not yet due = ₹ 3,36,700

(d) Amount of Instalments due but not yet collected = ₹ 20,300

(e) Total Amount fallen due = Down Payment + Instalments due
= ₹ 48,000 + ₹ 1,67,300 = ₹ 2,15,300

(f) Total Cash Collected = Down Payment + Instalments due and received
= ₹ 48,000 + ₹ 1,47,000 = ₹ 1,95,000

(g) Hire Purchase Price per unit = Down Payment/Unit + Amount of Instalment/Unit
= ₹ 400 + (₹ 350 × 12) = ₹ 4,600

(h) Total Hire Purchase Price = ₹ 5,52,000

(i) Total Cost Price of Units sold on H.P. = No. of Units sold Cost per unit
= 120 × ₹ 3,000 = ₹ 3,60,000

(j) % of Profit Margin on H.P. Sales = [{(H. P. Price – Cost Price)/H. P. Price} × (100)]
= [{(4,600 – 3,000) / 4,600} × (100)]
= 34.78%

(k) Profit included in total Hire Purchase Price = [{(4,600 – 3,000)/4,600} × (5,52,000)] = ₹ 1,92,000

(l) Profit included in the Total Amount of Instalments not yet due
= [{(4,600 – 3,000)/4,600} × (3,36,700)]
= 1,17,113

(m) Gross Profit on Hire Purchase Sales = % of Profit Margin × Total Amount fallen due
= [{(4,600 – 3,000)/4,600} × (2,15,300)]
= 74,887

Dr. **(i) Hire Purchase Stock Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	–	By Hire Purchase Debtors A/c	2,15,300
To Goods Sold on Hire Purchase A/c	5,52,000	By Balance c/d	3,36,700
	5,52,000		5,52,000

Dr. **(ii) Hire Purchase Debtors Account** *Cr.*

Particulars	₹	Particulars	₹
To Balance b/d	–	By Bank A/c	1,95,000
To Hire Purchase Stock A/c	2,15,300	By Balance c/d	20,300
	2,15,300		2,15,300

Dr. **(iii) Hire Purchase Adjustment Account** *Cr.*

Particulars	₹	Particulars	₹
To Hire Purchase Stock Reserve A/c [3,36,700 × 1,600/4,600]	1,17,113	By Goods Sold on Hire Purchase A/c [5,52,000 × 1,600/4,600]	1,92,000
To Profit t/f to Profit & Loss A/c	74,887		
	1,92,000		1,92,000

Study Note - 8

BRANCH AND DEPARTMENTAL ACCOUNTS

This Study Note includes

8.1 Branch Accounts

8.2 Departmental Accounts

8.1 BRANCH ACCOUNTS INCLUDING FOREIGN BRANCH

A Branch is a subordinate division of an office.

Section 2(9) of the Companies Act, 1956 defines a Branch Office as-

[Section 2(14) of the Companies Act, 2013]

- Any establishment described as a Branch by the Company

  Any establishment carrying on either the same or substantially the same activity as that carried on by the Head Office of the Company; any establishment engaged in any production, processing or manufacturing but does not include any establishment specified in the Central Government's Order u/s 8. [Companies Act, 1956]

Classification of Branches :

A. Inland Branches:

(i) Dependent Branches : branches in respect of which the whole of the accounting records are kept at Head Office only.

(ii) Independent Branches : branches which maintain independent accounting records.

B. Foreign Branches : branches which are located in a foreign country(i.e. in a country other than in which the company is incorporated and registered)

Dependent Branches

Branch Accounts can be maintained at the Head Office, particularly when the business policies and administration of the Branch are wholly controlled by the Head office.

The Branch prepares the periodic returns based on which the accounting records are maintained at the Head Office.

Methods of Accounting :

(i) Final Accounts Method;

(ii) Debtors Method and

(iii) Stock and Debtors Method.

FINAL ACCOUNTS METHOD

Final Accounts Method

Under this method, the profit or loss of the branch is ascertained by preparing the Branch Trading and Profit and Loss Account in place of Branch Account.

(a) At cost price

Branch Trading and Profit & Loss Account

Dr. **Cr.**

Particulars		Amount ₹	Particulars	Amount ₹
To Opening Stock at Branch (at Cost)		×××	By Sales made at Branch	
To Goods sent from Head Office	×××		(net of returns)	
Less : Goods returned to H.O	×××	×××	— Cash	×××
To Purchases (made directly by Branch, if any)		×××	— Credit	×××
To Direct Expenses at Branch (if any)		×××	By Closing Stock at Branch (at Cost)	×××
To Gross proft c/d		×××		
		×××		**×××**
To Various expenses incurred at Branch (including Bad Debts if any)		×××	By Gross profit b/d	×××
To General P&L Account (Net Profit transferred)		×××		
		×××		**×××**

Illustration 1.

From the following particulars prepare Branch Trading and Profit and Loss Account in the books of Head Office:

The Delhi stores invoiced goods to its Patna Branch at cost which sells both for cash and credit. Cash received by the branch is remitted to H.O. Branch expense are paid direct from the H.O. except petty expense which are met by the branch.

Particulars	Amount ₹	Particulars	Amount ₹
Opening Balance:		Rates & Taxes	3,000
Stock	5,000	Salary & Wages	6,000
Debtors	20,000	Petty expense by the branch	1,000
Petty Cash	1,000	Pilferage of goods	1,000
Goods from H.O.	50,000	Closing Balance:	
Cash Sales	30,000	Stock	8,000
Credit Sales	40,000	Debtors	25,000
Sales Return	4,000	Petty Cash	800
Bad Debts	1,000		
Discount Allowed	1,000		
Goods returned to H.O.	5,000		

Solution:

In the books of H.O.
Branch Trading and Profit and Loss Account
for the year ended……………

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Opening Stock		5,000	By Sales:		
,, Goods sent to Branch	50,000		Cash Sales		30,000
Less: Returns	5,000	45,000	Credit Sales	40,000	
			Less: Return	4,000	36,000
			,, Closing Stock	8,000	
,, Gross Profit c/d		25,000	Add: Pilferage of Stock	1,000	9,000
		75,000			**75,000**
To Pilferage of Stock		1,000	By Gross Profit b/d		25,000
,, Bad Debt		1,000			
,, Discount Allowed		1,000			
,, Rates & Taxes		3,000			
,, Salaries & wages		6,000			
,, Petty Expense		1,000			
,, General P & L A/c Net Profit transferred		12,000			
		25,000			**25,000**

(b) At Invoice Price

If goods are invoiced above cost, the loading (i,e, profit element) on Opening Stock, Goods Sent from Head office (net of returns) and Closing Stock are **reversed**, to ascertain the true profits.

Illustration 2.

X Ltd. has its H.O. in Delhi and a branch in Mumbai. H.O. supplied goods to its branch at cost plus $33\frac{1}{3}\%$. From the particulars given below prepare a Branch Trading Account in the books of H.O.

Particulars	Amount ₹	Particulars	Amount ₹
Opening Stock (I.P.)	40,000	Sales:	
Goods sent to Branch (I.P.)	2,50,000	Cash	1,00,000
Return to H.O. (I.P.)	10,000	Credit	3,00,000
		Discount allowed to customers	10,000
		Closing Stock (I.P.)	60,000

It is estimated that 2% of the goods received are lost through natural wastage.

Solution:

In the books of H.O.
Trading Account
for the year ended……………

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Opening Stock	40,000		By Sales:		
Less: Loading	10,000	30,000	Cash	1,00,000	
			Credit	3,00,000	4,00,000
,, Goods sent to Branch	2,50,000		,, Closing Stock	60,000	
Less: Returns to H.O.	10,000		Less : Loading	15,000	45,000
	2,40,000		($\frac{1}{4}$× 60,000)		
Less: Loading ($\frac{1}{4}$× 2,40,000)	60,000	1,80,000			
[$\frac{1}{3}$ on CP = $\frac{1}{4}$ on SP]					
,, Gross Profit c/d		2,35,000			
		4,45,000			**4,45,000**

Note:

1. Discount allowed to customer will appear in Branch Profit & Loss Account.
2. Loss through natural wastage is a normal loss and as such, the same should be charged against branch gross profit. So, no adjustment is required.

Illustration 3.

Y Ltd. with its H.O. in Delhi invoiced goods to its branch at Patna at 20% less than the catalogue price which is cost plus 50%, with instruction that cash sales were to be made at invoice price and credit sales at catalogue price less discount at 15% on prompt payment.

From the following particulars, prepare the Branch Trading and Profit and Loss Account for the year ended 31st March 2013 in H.O. books so as to show the actual profit and loss for the branch for the year.

Particulars	Amount ₹	Particulars	Amount ₹
Stock on 1.4.2012 (Invoice Price)	12,000	Discount allowed to Debtors	13,365
Debtors (,,)	10,000	Expense	6,000
Goods received from H.O. (I.P.)	1,32,000	Remittance to H.O.	1,20,000
Cash sales	46,000	Debtors (31.03.2013)	11,000
Credit Sales	1,00,000	Cash in hand (31.03.2013)	5,635
Cash received from Debtors	85,635	Stock on 31.03.2013 (Invoice Price)	15,000

It was further reported that a part of stock at the branch was lost by fire (not covered by insurance) during the year whose value is to be ascertained and provisions should be made for discount to be allowed to Debtors as on 31.03.2013 on the basis of years trend of prompt payment.

Solution:

In the books of H.O.
Branch Trading & Profit and Loss Account
for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Opening Stock (₹12,000 x $\frac{100}{120}$)		10,000	By Sales:		
			Cash	46,000	
			Credit	1,00,000	1,46,000
,, Goods sent to Branch (₹1,32,000 x $\frac{100}{120}$)		1,10,000	,, Closing Stock (₹15,000 x $\frac{100}{120}$)	12,500	
,, Gross Profit c/d		41,000	Add: Stock Destroyed (Bal. fig.)	2,500	15,000
		1,61,000			**1,61,000**
,, Branch Expense		6,000	By Gross Profit b/d		41,000
,, Discount Allowed		13,365			
,, Stock Destroyed by fire [₹ 3,000 – 500]		2,500			
,, Provision for Discount		1,337			
,, General Profit & Loss A/c (Net Profit Transferred)		17,798			
		41,000			**41,000**

Working:

1. Cost price ₹100; Catalogue Price = ₹100 + 50% = ₹150; Invoice Price (Cat. Price – 20%) = ₹150 – ₹30 = ₹120

Cost price	Catalogue Price	Invoice Price (Cat. Price – 20%)
₹100	= ₹100 + 50%	= ₹150 – ₹30
	= ₹150	= ₹120

2. Stock Destroyed by fire

Particulars	Amount ₹	Amount ₹
Opening Stock (I.P.)		12,000
Add: Goods Sent (I.P.)		1,32,000
		1,44,000
Less: Cash Sales	46,000	
Invoice value of goods sold on credit (₹1,00,000 x$\frac{120}{150}$) 80,000	80,000	
Closing Stock (I.P.)	15,000	1,41,000
Stock Destroyed by fire		3,000

3. Provision for Discount on Debtors

   Prompt payment by Debtors ₹89,100 (i.e., ₹13,365 x $\frac{100}{15}$)

Out of ₹1,10,000 (i.e., 1,00,000 + 10,000), Portion of prompt payment $\frac{89,100}{1,10,000} \times 100 = 81\%$

∴ for closing debtors of ₹11,000 prompt payment to be made for ₹8,910 i.e. (₹11,000 × 81%)

So, Provision for Discount will be ₹8,910 x $\frac{15}{100}$ = ₹ 1,337

Wholesale and Retail profit at Branch

A branch may be operated both under the retail profit basis as well as under wholesale profit basis. For instance, the cost price of a product is ₹100, the retail price is ₹160, and the wholesale price is ₹150. Now, under retail profit basis there will be a profit of ₹60 (i.e., ₹160 - ₹100) earned by the branch. But if it is sold under wholesale basis, the amount of profit will be ₹50. Usually, it is the usual practice to debit branch with wholesale profit basis to know the usual profit made by a branch. For this purpose, H.O. Trading account will be credited with goods sent to branch at wholesale price. At the same time, closing stock at branch should be valued as per wholesale price basis. For this, H.O. should make proper reserve on closing stock at branch. The entry will be

Profit & Loss A/c .... Dr. (Wholesale price - Cost price.)

  To Stock Reserve A/c

Illustration 4.

X Ltd. has a retail branch at Puri. Goods are sold at 60% profit on cost. The wholesale price is cost plus 40%. Goods are invoiced from Delhi H.O. to branch at Puri at Wholesale price. From the following particulars ascertain the profit made at H.O. and branch for the year ended 31st March 2013.

Particulars	H.O. ₹	Branch ₹
Stock on 01.04.2012	7,00,000	---
Purchase	42,00,000	---
Goods sent to Branch (at invoice price)	15,12,000	---
Sales	42,84,000	14,40,000
Stock on 31.03.2013	16,80,000	2,52,000
Expenses	80,000	40,000

Sales at H.O. are made only on wholesale basis and that at branch only to customers. Stock at H.O. is valued at invoice price.

Solution:

In the books of H.O.

Puri Branch Trading Account

for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	H.O. ₹	Branch ₹	Particulars	H.O. ₹	Branch ₹
To Opening Stock (I.P.)	7,00,000	---	By Sales	42,84,000	14,40,000
,, Goods sent to Branch (I.P.)	---	15,12,000	,, Goods sent to Branch (I.P.)	15,12,000	---
,, Purchase	42,00,000	---			
,, Gross Profit c/d	25,76,000	1,80,000	,, Closing Stock	16,80,000	2,52,000
	74,76,000	16,92,000		74,76,000	16,92,000
To Expenses	80,000	40,000	By Gross Profit b/d	25,76,000	1,80,000
,, Closing Stock Reserve on Branch Stock: (₹2,52,000 x $\frac{40}{140}$)	72,000	---	By Opening Stock Reserve	2,00,000	-
On H.O. Stock: (₹16,80,000 x $\frac{40}{140}$)	4,80,000	---	Provision for unrealized profit (₹7,00,000 x $\frac{40}{140}$)		
,, General P&L A/c (Net profit Transferred)	21,44,000	1,40,000			
	27,76,000	1,80,000		27,76,000	1,80,000

Working:

Let Cost price ₹100; Wholesale Price = ₹100 + ₹40 = ₹140; Invoice price ₹140; Selling Price at H.O. ₹140.

Selling price at Branch ₹100 + ₹60 = ₹160.

As goods are sent to branch at wholesale price i.e., ₹140, branch stock should be valued at the same price.

Wholesale profit on opening stock of H.O. = ₹7,00,000 x $\frac{40}{140}$ = ₹2,00,000

on Closing stock of H.O. = ₹16,80,000 x $\frac{40}{140}$ = ₹4,80,000

on Closing stock of Branch = ₹2,52,000 x $\frac{40}{140}$ = ₹72,000.

DEBTORS METHOD :

This method is usually adopted when the branch is of small size. Under this method, the head office maintains separate Branch Account for each branch. Its purpose is to ascertain profit or loss made by each branch.

Journal Entries under Debtors Method:

Situation	Journal
1. To record Opening Balances of Branch Assets	Branch A/c Dr. To Branch Assets (Individually)
2. To record Opening Balances of Branch Liabilities	Branch Liabilities (Individually) Dr. To Branch A/c
3. When goods are supplied by the Head Office/ another Branch to Branch	Branch A/c Dr. To Goods sent to Branch A/c
4. When goods are returned by the Branch / Branch Customers directly to the Head Office	Goods Sent to Branch A/c Dr. To Branch A/c
5. When goods are supplied by the Branch to another Branch as per instructions of Head office	Goods Sent to Branch A/c Dr. To Branch A/c
6. When goods are supplied by the Head office but not received by the Branch head	Goods-in Transit A/c Dr. To Branch A/c
7. When the Head Office meets the branch expenses or sends cash to the Branch for meeting expenses	Branch A/c Dr. To Cash/Bank A/c
8. When remittances are received by the Head Office from the Branch/ Branch Customers	Cash/Bank A/c Dr. To Branch A/c
9. When remittances are sent by the Branch but not received by the Head office	Cash in-transit A/c Dr. To Branch A/c
10. When the balance in Goods sent to Branch Account is transferred	Goods sent to Branch A/c Dr. To Purchases A/c (in case of Trading concerns) or, To Trading A/c (in case of manufacturing concerns)
11. To record the closing balances of Branch Assets	Branch Assets A/c (Individually) Dr. To Branch A/c
12. To record the closing balances of Branch Liabilities	Branch A/c Dr. To Branch Liabilities (Individually)
13. To record Profit or Loss (i) If credit side exceeds the debit side (ii) If debit side exceeds the credit side	Branch A/c Dr. To General Profit & Loss A/c General Profit & Loss A/c Dr. To Branch A/c

Format of Branch Account

A format of Branch Account is given below:

BRANCH ACCOUNT

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d:		By Balance b/d:	
Stock	XXX	Creditors	XXX
Debtors	XXX	Outstanding Expenses	XXX
Petty Cash	XXX	By Bank (remittances to H.O.):	
Fixed Assets	XXX	by Branch	XXX
Prepaid Expenses	XXX	by Branch Debtors directly to H.O.	XXX
To Goods sent to Branch A/c:		By Goods Sent to Branch A/c:	
Goods sent by H.O.	XXX	Returned by Branch	XXX
Goods sent by other Branches	XXX	Returned by Branch debtors directly to H.O.	XXX
To Bank (Remittances by H.O.)	XXX	Sent to other Branches	XXX
To Balance c/d:		By Balance c/d:	
Creditors	XXX	Stock-in-hand	XXX
Outstanding Expenses	XXX	Stock-in-transit	XXX
*To Net Profit t/f to General P&LA/c	XXX	Cash in-transit	XXX
		Debtors	XXX
		Petty Cash	XXX
		Fixed Assets	XXX
		Prepaid Expenses	XXX
		*By Net Loss t/f to General P&LA/c	XXX
	XXX		XXX

*Only one figure shall appear.

- The following **transactions do not appear in the Branch Account:**

  (a) Expenses incurred by Branch out of cash, since either reduced cash balance at the end is decreased or the liability at the end is increased.

  (b) Purchase of Goods/Fixed Assets by Branch, since book value of Goods/Fixed assets at the end is increased and either the amount of remittances is reduced or the Creditors at the end are increased.

  (c) Sale of Goods/Fixed Assets by Branch since book value of Goods/Fixed assets at the end is decreased and either the amount of remittances is increased or the Debtors at the end are increased.

  (d) Bad debts, discount allowed, sales returns by customers to branch, cash received by Branch from Branch Debtors, etc., since the debtors at the end appear at the adjusted figure.

(e) Depreciation and Profit/Loss on sale of fixed assets since fixed assets at the end appear at the adjusted figure.

(d) Abnormal Losses since stock at the end appears at the adjusted figure.

- When the branch is not authorised to keep any sum out of collections, expenses incurred by Branch out of petty cash maintained may be dealt with as under:

  (a) In case the petty cash is maintained on Imprest System, the expenses met by the branch are to be shown in the same manner as the branch expenses met by the Head Office. In such a case, petty cash balance at the end appears at the same amount at which it appears in the beginning.

  (b) In case the petty cash is not maintained on Imprest System, the expenses met by branch are automatically charged to the Branch Account since the petty cash at the end appears at the adjusted figure.

- When goods are returned either by Branch Debtors to the H.O. directly or are sent by one branch to another branch, the entry will be same as in the case of goods returned by the Branch to the H.O.
- In case any insurance claim is admitted and paid to the Branch, either the Bank balance at the end will increase or the remittances to H.O., will increase. In case, the insurance claim is admitted but not paid, the insurance company will appear as a debtor at the end.
- To ascertain any missing figure, relating to Stock and /or Debtors, Memorandum Branch Stock Account & Memorandum Branch Debtors Account has to be prepared.

Illustration 5.

From the following information, prepare Mumbai Branch Account in the books of head office for the year ending on 31st March 2013:

Particulars	₹	Particulars	₹
Opening Stock (at cost)	3,56,000	Closing Stock (at cost)	3,76,800
Opening Debtors	28,000	Closing Debtors	1,93,000
Opening Petty Cash	500	Closing Petty Cash	240
Furniture (in the beginning)	12,000	Furniture at the end	?
Opening Creditors	12,000	Closing Creditors	12,000
Goods sent to Branch (at cost)	10,45,000	Cheques sent to Branch	
Goods returned by Branch to	17,200	for Expenses	99,740
H.O. (at Cost)	13,800	Cash received from Debtors	12,78,000
Goods returned by Customers to Branch		Cash Sales	64,000

Depreciate the furniture @ 10% p.a.

Solution:

In the books of H.O

Dr. **Mumbai Branch Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d:		By Balance b/d: (Creditors)	12,000
Stock	3,56,000	By Bank A/c (remittance from Branch)	
Debtors	28,000	Cash sales 64,000	
Petty Cash	500	Collection from Debtors 12,78,000	13,42,000
Furniture	12,000	By Goods sent to Branch A/c	
To Goods sent to Branch A/c		(Returns)	17,200
(at Cost)	10,45,000	By Balance c/d:	
To Bank A/c (Remittance to Branch)	99,740	Stock	3,76,800
To Balance c/d (Creditors)	12,000	Debtors	1,93,000
To Net Profit t/f to General P&L A/c	3,98,800	Petty Cash	240
		Furniture (₹12,000 - ₹1,200)	10,800
	19,52,040		**19,52,040**

Illustration 6.

VIRAT Bros, Mumbai have a branch at Surat. They send goods at cost to their branch at Surat. However, direct purchases are also made by the branch for which payments are made at head office. All the daily collections are transferred from the branch to the head office. From the following prepare Surat branch account in the books of head office:

Particulars	₹	Particulars	₹
Opening Balances:			
Imprest Cash	200	Bad Debts	100
Sundry Debtors	2,500	Discount to Customers	200
Stock: Transferred from H.O.	2,400	Remittances to H.O.	
Direct Purchases	1,600	(received by H.O.)	16,500
Cash Sales	4,500	Remittances to H.O.	
Credit Sales	13,000	(not received by H.O. so far)	500
Direct Purchases	4,500	Branch Exp. Directly paid by H.O.	3,000
Returns from Customers	300	Closing Balances:	
Goods sent to branch from H.O.	6,000	Stock: Direct Purchases	1,000
Transfer from H.O. for Petty		Transfer from H.O.	1,500
Cash Expenses	400	Debtors	?
Imprest Cash	?		

Solution:

In the books of H.O.

Dr. **Surat Branch Account** **Cr.**

Particulars	₹	Particulars		₹
To Opening Balances	4,000	By Bank—Remittances rec. from the branch		
Stock	2,500	Cash Sales	4,500	
Debtors	200	Cash from Debtors	12,000	
Imprest Cash	6,000	Cash from Drs in transit	500	17,000
To Goods sent to Branch A/c	4,500	By Closing Balances:		
To Creditors (Direct purchases)	3,000	By Stock: Transfer from H.O.		1,500
To Bank (Sundry expenses)	400	: Direct purchases		1,000
To Bank (Petty Cash expenses)		By Sundry Debtors		2,400
To Net Profit transferred to General Profit & Loss A/c	1,500	By Imprest Cash		200
	22,100			22,100

Working Notes:

(i) Collection from debtors = Total Remittances - Cash Sales

= (₹ 16,500 + ₹ 500) - ₹ 4,500 = ₹ 12,500

(ii) **Sundry Debtors Accounts**

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	2,500	By Branch Stock (Return)	300
To Credit Sales	13,000	By Discount	200
		By Bad Debts	100
		By Cash/Bank (Collection)	12,500
		By Balance c/d	2,400
	15,500		15,500

(iii) It is assumed that petty cash expenses of the branch for the year were ₹ 400.

Illustration 7.

From the following information, prepare Delhi Branch Account in the books of head office for the year ending on 31st March 2013:

Particulars	₹	Particulars	₹
Opening Stock (at cost)	17,80,000	Discount allowed to Customers	5,000
Opening Debtors	1,40,000	Bad Debts written off	10,000
Opening Petty Cash	2,500	Credit sales	72,94,000
Furniture (in the beginning)	60,000	Cash Sales	3,20,000
Opening Creditors	60,000	Petty Expenses paid by Branch	80,000
Goods sent to Branch (at Cost)	52,20,000	Cheques sent to Branch for expenses:	
Goods returned by Branch to H.O (at cost)	78,000		
Goods returned by Customers to Branch	57,000	Salaries	3,00,000
Cash received by Branch from its		Rent and Insurance	1,20,000
Customers	61,10,000	Petty Cash	78,700

Goods are sold to customers at cost plus 50%. Depreciate the furniture @ 10% p.a.

Solution:

Delhi Branch Account in the books of H.O.

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d:		By Balance b/d: creditors	60,000
Stock	17,80,000	By Bank A/c (Remittance from Branch)	64,30,000
Debtors	1,40,000	By Goods sent to Branch A/c	
Petty Cash	2,500	(return by branch)	78,000
Furniture	60,000	By Balance c/d:	
To Goods sent to Branch A/c	52,20,000	Stock	18,84,000
To Bank A/c (Remittance by H.O.)	4,98,700	Debtors	12,52,000
To Balance c/d (creditors)	60,000	Petty Cash	1,200
To Net Profit t/f to General P&L A/c	19,98,000	Furniture (₹ 60,000 – ₹ 6,000)	54,000
	97,59,200		97,59,200

Working Notes:

(i) Dr. **Memorandum Branch Debtors Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	1,40,000	By Returns to Branch	57,000
To Credit Sales	72,94,000	By Discount allowed	5,000
		By Bad Debts	10,000
		By Cash received by Branch	61,10,000
		By Balance c/d	12,52,000
	74,34,000		74,34,000

(ii) Dr. **Memorandum Branch Stock Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	17,80,000	By Goods sent to Branch A/c (Return)	78,000
To Goods sent to Branch A/c	52,20,000	By Cost of Goods sold	50,38,000
		[(3,20,000+72,94,000 - 57,000) x100/150]	
		By Balance c/d	18,84,000
	70,00,000		70,00,000

(iii) Dr. **Memorandum Branch Petty Cash Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	2,500	By Petty Expenses A/c	80,000
To Remittance from H.O.	78,700	By Balance c/d	1,200
	81,200		81,200

(iv) Dr. **Memorandum Branch Cash Account** Cr.

Particulars	₹	Particulars	₹
To Cash Sales	3,20,000	By Salaries	3,00,000
To Remittance by H.O.	4,98,700	By Rent & Insurance	1,20,000
To Debtors (Collection)	61,10,000	By Petty Cash	78,700
		By Remittance to H.O.	64,30,000
	69,28,700		69,28,700

Accounting Treatment of Goods Returned and Cash Remitted by Branch Customers directly to Head Office

Item	Treatment in Branch A/c	Treatment in Memorandum Branch Debtors A/c
1. Goods returned by Branch customers directly to H.O.	Treat like goods returned by Branch to H.O. and thus, show the Cost/ Invoice price (as the case may be) of these goods on credit side of Branch Account.	Show the selling price of these goods on credit side of Branch Debtors Account.
2. Cash remitted by Branch customers directly to H.O.	Treat like cash remitted by branch to H.O. and thus, show on the credit side of Branch Account.	Show on the credit side of Branch Debtors Account.

Illustration 8.

Taking the same information as given in Illustration 3 along with the following information, prepare the Delhi Branch Account:

(i) Goods returned by Branch Customers directly to H.O. ₹ 12,000

(ii) Cash remitted by Branch Customers directly to H.O. ₹ 2,80,000

Solution:

Delhi Branch Account
Dr. **In the Books of H.O.** Cr.

Particulars	₹	Particulars	₹
To Balance b/d:		By Balance b/d: (creditors)	60,000
Stock	17,80,000	By Bank A/c (Remittance from Branch)	
Debtors	1,40,000	Remittance by Branch	64,30,000
Petty cash	2,500	**Direct Remittance by Branch**	
Furniture	60,000	**customers**	**2,80,000**
To Goods sent to Branch A/c	52,20,000	By Goods sent to Branch A/c:	
To Bank A/c (Remittance by H.O.)	4,98,700	Return by Branch	78,000
To Balance c/d: (creditors)	60,000	**Direct Return by Branch**	
To Net Profit t/f to General P&LA/c	19,94,000	**customers [12,000 x 100/150]**	**8,000**
		By Balance c/d:	
		Stock	18,84,000
		Debtors	9,60,000
		Petty Cash	1,200
		By Furniture (₹ 60,000 – ₹ 6,000)	54,000
	97,55,200		97,55,200

Working Notes:

(i) Dr. Memorandum Branch Debtors Account Cr.

Particulars	₹	Particulars	₹
To Balance c/d	1,40,000	By Returns to Branch	57,000
To Credit Sales	72,94,000	**By Returns to H.O.**	**12,000**
		By Discount allowed	5,000
		By Bad Debts	10,000
		By Cash remitted to H.O.	**2,80,000**
		By Cash remitted to Branch	61,10,000
		By Balance c/d	96,0000
	74,34,000		74,34,000

(ii) Dr. Memorandum Branch Stock Account Cr.

Particulars	₹	Particulars	₹
To Balance b/d	17,80,000	By Goods sent to Branch A/c:	
To Goods Sent to Branch A/c	52,20,000	— Return by Branch	78,000
		— Direct Return by Branch	8,000
		Customers [₹ 12,000 x 100/150]	
		By Cost of Net Goods Sold [(3,20,000+72,94,000-57,000-12,000) x100/150]	50,30,000
		By Balance c/d	18,84,000
	70,00,000		70,00,000

(iii) & (iv) Memorandum Branch Petty Cash Account and Memorandum Branch Cash Account - Refer to Working Note [(iii) & (iv) of Illustration 7].

Accounting Treatment of Goods Sent to Another Branch and Goods received from Another Branch

Item	Treatment in Branch A/c	Treatment in Memorandum Branch Stock A/c
1. Goods sent to another branch	Treat like goods returned to H.O. and thus, show on the credit side of Branch Account.	Treat like goods returned to H.O. and thus, show on the credit side of Branch Stock Account.
2. Goods received from another branch.	Treat like goods received from H.O. and thus, show on the debit side of Branch Account.	Treat like goods received from H.O. and thus, show on the debit side of Branch Stock Account.

Accounting Treatment of Normal Loss, Abnormal Loss, Insurance Claim and Agreed Allowance/Trade Discount

Item	Treatment in Branch A/c	Treatment in Memorandum Branch Stock A/c
1. Normal loss	Normal loss does not appear in the Branch Account since the Closing Stock appears at the adjusted figure.	Cost/Invoice price (as the case may be) of normal loss appears on the credit side of Branch Stock Account in order to reduce the figure of Closing Stock.
2. Abnormal loss	Abnormal loss does not appear in the Branch Account since the Closing Stock appears at the adjusted figure.	Cost/Invoice price (as the case may be) of abnormal loss appears on the credit side of Branch Stock Account in order to reduce the figure of Closing Stock.
3. Insurance claim (a)Admitted and received	Shown on the credit side of Branch Account by way of Increased Closing either Cash/Bank Balance or remittance to H.O.	No Treatment
(b)Admitted but not yet received	Shown Insurance Co. as a debtor at the end on the credit side of Branch Account.	No Treatment
4. Agreed allowance/ Trade discount	Agreed Allowance/Trade Discount does not appear in the Branch Account since the closing debtors appear at the adjusted figure.	Cost/Invoice Price (as the case may be) of Agreed Allowance/ Trade Discount appears on the credit side of Branch Stock Account.

Illustration 9.

Prepare a Branch account in the books of Head Office from the following particulars for the year ended 31st March, 2013 assuming that H.O. sold goods at cost price 25%.

Particulars	Amount ₹	Particulars	Amount ₹
Stock on 1.4.2012 (I.P.)	12,500	Bad Debts	2,000
Debtors (,,)	5,000	Allowances to customers	1,000
Purchase (,,)	1,000	Returns Inwards	1,000
Goods sent to branch (I.P.)	40,000	Charges sent to Bank:	
Goods return to H.O. (I.P.)	5,000	Rates & Taxes	3,000
Cash Sales	12,000	Salaries	8,000
Cash received from Debtors	30,000	Misc. Exps.	1,000
		Stock on 31.03.2013 (I.P.)	15,000
		Debtors (,,)	4,000
		Petty Cash (,,)	1,000

Solution:

In the books of H.O.

Branch Account

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Balance b/d			By Stock Reserve (Loading)		2,500
Stock	12,500		,, Bank A/c:		
Debtors	5,000		Cash Sales	12,000	
Petty Cash	1,000	18,500	,, Cash Received from Debtors	30,000	42,000
,, Goods sent to branch		40,000	,, Goods sent to branch		5,000
,, Bank A/c:			(Return to H.O.)		
Rates & Taxes	3,000		,, Goods sent to branch		8,000
Salaries	8,000		(Loading)		
Misc. Expenses	1,000	12,000	By Balance c/d		
			Stock	15,000	
,, Goods sent to Branch		1,000	Debtors	4,000	
(Loading on returns)			Petty Cash	1,000	20,000
,, Closing Stock Reserve		3,000			
(₹ 15,000 x $\frac{1}{5}$)					
,, General Profit & Loss A/c		3,000			
		77,500			77,500

Note: Here, loading is $\frac{25}{125} = \frac{1}{5}$ of invoice price. Hence, loading on opening stock will be ₹12,500 x $\frac{1}{5}$ = ₹2,500 and so on.

Preparation of Branch Stock Account

Branch Stock Account may be prepared in two ways viz. (a) Single Column and (b) Double Column.

(a) Single Column

Under this method Branch Stock Account is prepared on the basis of invoice price of goods and this account will be equal in both sides. If it does not agree, it will be adjusted with the amount of surplus (if credit side is greater) and shortage (if debit side is greater) of stock.

(b) Double Column

Under this method, there will be two columns-one column is made for recording invoice price and the other for recording cost price. The invoice price column should be equal in both sides, if it does not, the above techniques i.e., surplus of stock or shortage of stock, must be followed.

Incase of cost price column, the cost price of all transaction should be recorded except the selling price and the difference in cost price column will show either Gross Profit (if credit side is greater) or Gross loss (if debit side is greater). This method is particularly applicable when it is desired to know the Gross Profit from Branch Stock Account.

Illustration 10.

Salt Lake Ltd. Kolkata invoice goods to its branch at Delhi at a profit of 25% on cost. Prepare Branch Stock Account under (i) Single Column and (ii) Double Column from the following particulars:

Particulars	Amount ₹	Particulars	Amount ₹
Opening Stock (Invoice Price)	20,000	Normal Loss (Invoice Price)	1,000
Goods sent to Branch (,,)	1,20,000	Pilferage of Stock (,,)	2,000
Goods return to H.O. (,,)	5,000	Cash Sales	97,000
Goods lost in transit (,,)	5,000	Closing Stock (,,)	30,000

Solution:

(i) Under Single Column

In the books of H.O.
Delhi Branch Stock Account

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	20,000	By Branch Cash A/c	
,, Goods sent to branch	1,20,000	Cash Sales	97,000
		,, Goods sent to branch (Return)	5,000
		,, Loss-in-transit	5,000
		,, Normal Loss	1,000
		,, Pilferage of Stock	2,000
		By Balance c/d	30,000
	1,40,000		1,40,000

(ii) Under Double Column

In the books of H.O.

Delhi Branch Stock Account

Dr. **Cr.**

Particulars	Invoice Price ₹	Cost Price ₹	Particulars	Invoice Price ₹	Cost Price ₹
To Balance b/d	20,000	16,000	By Branch Cash A/c		
,, Goods sent to branch	1,20,000	96,000	Cash Sales	97,000	97,000
			,, Goods sent to branch	5,000	4,000
,, Gross Profit	---	19,400	(Return)		
			,, Loss – in- transit	5,000	4,000
			,, Normal Loss	1,000	800
			,, Pilferage of Stock	2,000	1,600
			,, Balance c/d	30,000	24,000
	1,40,000	1,31,400		1,40,000	1,31,400

STOCK AND DEBTORS METHOD

When there are large number of transactions, this method is particularly maintained by the H.O. to make efficient control over the branches. Under this method, we are to open (a) Branch Stock Account (at invoice price); (b) Branch Debtors Account; (c) Branch Adjustment Account (for recording loading for goods and for ascertaining gross profit) (d) Branch Profit and Loss Account (for ascertaining branch net profit) (e) Goods Sent to Branch Account. In addition to above, there are certain accounts which may also be opened; viz (a) Branch Expense Account; (b) Branch Cash Account; (c) Branch Fixed Asset Account (d) Abnormal Loss / Lost-in-Transit Account etc.

Under this method, the most important account is the Branch Adjustment Account which helps to ascertain Gross Profit. It takes only the loading on Opening Stock, Closing Stock, Goods Sent to Branch, Goods Returned by Branch, any abnormal loss, Surpluse of stock etc.

Apparent Profit and Apparent Loss

An unusual increase or decrease in the value of stock arises at Branch Stock Account due to inaccurate prediction of the expected selling price of the goods which are invoiced by the H.O. Usually H.O. sent goods after charging certain percentage of profit. But in reality, the said goods are sold either at a higher or at a lower price rather than the price fixed by the H.O. for which Branch Stock Account shows either a surplus of stock which is known here as Apparent Profit or a Shortage of stock which is known as Apparent Loss. The said apparent profit or loss should be recorded as under.

(a) For Apparent Profit

Branch Stock A/c …………………….. Dr.

To Apparent Profit A/c

Apparent Profit A/c …………………….. Dr.

To Branch (Stock) Adjustment A/c

(b) In case of Apparent Loss, the entry will be reversed

Stock and Debtors Method : (for dependent branches)

1. **Ledger Accounts :** The following accounts are maintained by the Head office under the Stock and Debtors System–

(a) Branch Stock Account (or Branch Trading A/c) — to ascertain Gross Profit

(b) Branch Profit and Loss Account — to ascertain Net profit

(c) Branch Debtors Account — to record Receivables/Credit Sales, if any.

(d) Branch Expenses Account — to record expenses incurred at Branch

(e) Branch Cash Account — to control Branch Cash position / remittances

(f) Branch Adjustment Account — to reverse Loading i. e. unrealised profits, if any.

(g) Goods sent to Branch Account — t o record goods sent/returned

(h) Branch Assets Account — to record Assets at Branch, if any.

2. Journal Entries :

No	***Transaction***	***Journal Entry***
(a)	Goods sent to Branch by HO	Branch Stock Account (total Value of goods) Dr. To Goods sent to Branch (at Cost) To Branch Adjustment A/c (loading, if any)
(b)	Goods returned by Branch to HO	Goods sent to Branch Account (at Cost) Dr. Branch Adjustment A/c (loading, if any) Dr. To Branch Stock A/c (total value of goods)
(c)	Assets provided by HO to Branch either by way of fresh purchase or by way of transfer from HO	Branch Assets Account Dr. To (Main) Cash Account/Vendor Account [or] To (HO) Assets Account (in case of transfer)
(d)	Cash sent to Branch for expenses	Branch Cash Accout Dr. To (Main) Cash Account
(e)	Cash Sales at the Branch	Branch Cash Account Dr. To Branch Stock Account
(f)	Credit Sales at the Branch	Branch Debtors Account Dr. To Branch Stock Account
(g)	Collection from Branch Debtors	Branch Cash Account Dr. To Branch Debtors Account
(h)	Sales Returns at the Branch	Branch Stock Account Dr. To Branch Debtors Account
(i)	Discounts / Bad Debts etc.	Branch Expenses Account Dr. To Branch Debtors Account
(j)	Various expenses incurred at Branch	Branch Expenses Account Dr. To Branch Cash Account
(k)	Branch Expenses directly met by HO	Branch Expenses Account Dr. To (Main) Cash Account
(l)	Remittances made by Branch to Head Office	(Main) Cash Account Dr. To Branch Cash Account
(m)	Goods Lost in Transit/Stolen etc.	Goods Lost in Transit A/c (at cost) Dr. Branch Adjustment (loading if any) Dr. To Branch Stock Account (total value of goods)
	At the End of the Year : Closing Entries	
(n)	Recording Closing Stock at Branch	Closing Stock at Branch Account (incl. Loading) Dr. To Branch Stock Account
(o)	Excess of Sale Price over Invoice Price	Branch Stock Account Dr. To Branch Adjustment Account

(p)	Recording Unrealised Profit on Closing Stock i.e. Stock Reserve (after this entry, the Branch Adjustment Account will show Gross Profit)	Branch Adjustment Account Dr. To Stock Reserve (closing) **Note :** Stock Reserve on Opening Stock is credited to Branch Adjustment A/c.
(q)	Recording Gross Profit at Branch	Branch Adjustment Account Dr. To Branch P & L Account
(r)	Depreciation on Branch Assets, (if any)	Branch Expenses Account Dr. To Branch Assets Account
(s)	Transfer of Branch Expenses	Branch P & L Account Dr. To Branch Expenses Account
(t)	Recording Net Profit at Branch	Branch P & L Account Dr. To General P & L Account

Illustration 11.

ESSKAY Ltd. of Kolkata invoices goods to its Branch at Mumbai at cost plus $33\frac{1}{3}$%. From the following particulars prepare the Branch Stock Account and the Branch Stock Adjustment Account as they would appear in the books of H.O.

Particulars	Amount ₹
Stock at commencement at Branch (at invoice price)	75,000
Stock at close at branch (at invoice price)	60,000
Goods sent to Branch during the year at invoice price (include goods invoiced at ₹ 10,000 to Branch on 31.03.2013 but not received by the Branch before close of the year.)	5,00,000
Return of goods to H.O. (invoice price)	25,000
Cash sales at Branch	4,50,000
Credit sales at Branch	25,000
Invoice value of goods pilfered	5,000
Normal loss at branch due to wastage and deterioration of Stock (invoice value)	7,500
ESSKAY Ltd. closes its books on 31.03.2013.	

Solution :

In the books of ESSKAY Ltd. (H.O.)
Mumbai Branch Stock Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Balance b/d	75,000		By Goods sent to Mumbai Branch A/c – Goods returned	25,000
	,, Goods sent to Branch A/c	5,00,000		,, Branch Cash A/c – Cash Sales	4,50,000
	,, Mumbai Branch Stock Adjustment A/c – Apparent Profit (bal. fig.)	7,500		,, Branch Debtors A/c – Credit Sales	25,000
				,, Pilferage A/c –	5,000
				Mumbai Branch Stock Adjustment: ,, Normal Loss	7,500
				,, Goods-in-Transit A/c	10,000
				,, Balance c/d	60,000
		5,82,500			5,82,500

Dr. **Mumbai Branch Stock Adjustment Account** **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Goods sent to Branch A/c Load on goods returned (25,000 x $\frac{1}{4}$)	6,250		By Balance b/d Load on Opening Stock (₹ 75,000 x $\frac{1}{4}$)	18,750
	,, Mumbai Branch Stock A/c Cash Sales			,, Goods sent to Branch A/c Load on goods sent (₹ 5,00,000 x $\frac{1}{4}$)	1,25,000
	,, Pilferage (5,000 x $\frac{1}{4}$)	1,250		,, Mumbai Branch Stock A/c Apparent profit	7,500
	Normal Loss	7,500			
	,, Goods-in-Transit A/c Loading (₹ 10,000 x $\frac{1}{4}$)	2,500			
	,, Branch Profit and Loss A/c Gross Profit transferred (bal. fig.)	1,18,750			
	,, Balance c/d (₹ 60,000 x $\frac{1}{4}$)	15,000			
		1,51,250			1,51,250

Notes: 1. Goods sent by H.O. to Branch which was not received by the Branch is to be treated as Goods-in-Transit.

2. Since normal loss is given, pilferage of stock (which is 1% of goods sent) is treated as abnormal loss.

Illustration 12.

Multichained Stores Ltd. Delhi, has its branches at Lucknow and Chennai. It charges goods to its Branches at cost plus 25%. Following information is available of the transactions of the Lucknow Branch for the year ended on 31st March 2013:

Particulars	Amount ₹
Balances on 01.04.2012	
Stock (at invoice price)	30,000
Debtors	10,000
Petty Cash	50
Transactions during 2012-13 (Lucknow Branch):	
Goods send to Lucknow Branch (at invoice price)	3,25,000
Goods returned to Head Office (at invoice price)	10,000
Cash Sales	1,00,000
Credit Sales	1,75,000
Goods pilfered (at invoice price)	2,000
Goods lost by fire (at invoice price)	5,000
Insurance Co. paid to H.O. for loss by fire at Lucknow	3,000
Cash sent for petty expenses	34,000
Bad debts at Branch	500
Goods transferred to Chennai Branch under H.O. advice	15,000
Insurance charges paid by H.O.	500
Goods returned by Debtors	500
Balance on 31.03.2013	
Petty Cash	230
Debtors	14,000

Goods worth ₹15,000 (including above) sent by Lucknow Branch to Chennai Branch was in-transit on 31.03.2013.

Show the following accounts in the books of Multichained Stores Ltd.: (a) Lucknow Branch Stock Account; (b) Lucknow Branch Debtors Account; (c) Lucknow Branch Adjustment Account; (d) Lucknow Branch Profit & Loss Account, and (e) Stock Reserve Account.

Solution:

In the books of H.O.

Lucknow Branch Stock Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2012 Apr.1	To Balance b/d	30,000	2013 Mar.31	By Branch Cash A/c – Cash Sales 1,00,000	
				,, Branch Debtors	
2013 Mar. 31	,, Goods sent to Branch A/c	3,25,000		Credit Sales 1,75,000	2,75,000
	,, Branch Debtors A/c (Returns Inward)	500		,, Goods Sent to Branch A/c Returned from Branch	10,000
				,, Pilferage A/c	2,000
				,, Lost by Fire A/c	5,000
				,, Chennai Branch A/c Goods transferred but in-transit	15,000
				,, Balance c/d	48,500
		3,55,500			3,55,500

Lucknow Branch Debtors Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2012 Apr.1	To Balance b/d	10,000	2013 Mar.31	By Branch P&L A/c – Bad Debts	500
2013 Mar. 31	,, Branch Stock A/c – Credit Sales	1,75,000		,, Branch Stock Returns Inward	500
				,, Branch Cash A/c Collection from Customers (bal. fig.)	1,70,000
				,, Balance c/d	14,000
		1,85,000			1,85,000

Lucknow Branch Stock Adjustment Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013	To Goods sent to Branch A/c		2013	By Balance b/d	
Mar. 31	Load on goods returned	2,000	Mar. 31	Load on Opening Stock	
	(10,000 x $\frac{1}{5}$)			(₹ 30,000 x $\frac{1}{5}$)	6,000
	Branch Stock A/c			,, Goods sent to Branch A/c Loading	
	,, Pilferage A/c			(₹ 3,25,000 x $\frac{1}{5}$)	65,000
	(Loading) (₹ 2,000 x $\frac{1}{5}$)	400			
	,, Lost by fire	1,000			
	(Loading) (₹ 5,000 x $\frac{1}{5}$)				
	,, Chennai Branch A/c	3,000			
	(Loading) (₹ 15,000 x $\frac{1}{5}$)				
	,, Branch Profit and Loss A/c				
	Gross Profit transferred	54,900			
	(bal. fig.)				
	,, Balance c/d				
	Load on Closing Stock	9,700			
	(₹ 48,500 x $\frac{1}{5}$)				
		71,000			71,000

Branch Profit and Loss Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013	To Branch Debtors A/c		2013	By Branch Stock	
Mar. 31	Bad Debts	500	Mar.31	Adjustment A/c –	
	,, Insurance	500		Gross Profit	54,900
	,, Pilferage (at cost)	1,600			
	,, Stock Lost by Fire	1,000			
	,, Petty Expenses	33,820			
	,, General P&L A/c – Branch Profit transferred	17,480			
		54,900			54,900

Stock Reserve Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.03.13	To Stock Adjustment A/c		01.04.12	By Balance b/d	6,000
	– Transfer	6,000	31.03.13	,, Branch Stock	
				Adjustment A/c	9,700
	,, Balance c/d	9,700			
		15,700			15,700

Workings:

The following two accounts should also be opened:

Stock Lost by Fire Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.03.13	To Lucknow Branch Stock A/c	5,000	31.03.13	By Branch Stock Adjustment A/c	1,000
				,, Bank – Insurance claim	3,000
				,, Branch P&L A/c (bal. fig.)	1,000
		5,000			5,000

Petty Cash Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
01.04.12	To Balance b/d	50	31.03.13	By Branch P&L A/c –	
31.03.13				Expenses (bal. fig.)	33,820
	,, Cash - General	34,000		,, Balance c/d	230
		34,050			34,050

Illustration 13.

X Ltd. has two Branches in Cochin and Bangalore. During the year ended 31.03.2013, goods have been invoiced to the Cochin Branch at 20% above cost and to the Bangalore Branch at 25% above cost. The Branches do not maintain complete books of account but the following figures are available for the year ended on 31.03.2013.

Particulars	Cochin ₹	Bangalore ₹
Opening Stock at invoice price	10,000	10,000
Goods Sent to Branch at cost	50,000	40,000
Amount remitted by Branch	80,000	80,000
Amount remitted by H.O.	15,000	15,000
Goods returned by Branch at invoice price	3,000	---
Cash as on 1.4.2012	2,000	1,000
Cash on 31.3.2013	1,000	500
Goods returned by customers at Branch at selling price	5,000	4,000
Expenses at Branch in cash	5,000	3,000

All sales at the Branches are for Cash. During the year Cochin Branch purchased Fixed Assets worth ₹4,000 and this amount is included in the figure of Branch expenses. Cochin Branch transferred to the Bangalore Branch Stock costing ₹5,000 during the year. The Bangalore Branch remitted ₹2,000 to Cochin Branch also during the year. There was a Closing Stock of ₹24,000 valued at invoice price at the Cochin Branch. There was no Closing Stock at the Bangalore Branch. The Branch Stock Adjustment Account in the Head Office books showed the following position as on 1st April 2012.

For Cochin	₹2,500 (Cr.)
For Bangalore	₹2,000 (Cr.)

Prepare Branch Stock Account, Branch Stock Adjustment Account, Branch Cash Account and Branch Profit and Loss Account in the Head Office books ignoring depreciation.

Solution:

In the books of X Ltd.

Branch Stock Account

Dr. **Cr.**

Particulars	Cochin ₹	Bangalore ₹	Particulars	Cochin ₹	Bangalore ₹
To Balance b/d	10,000	10,000	By Branch Cash A/c	76,000	73,500
,, Goods sent to			Cash Sales		
Branch (I.P.)	60,000	50,000	,, Goods Sent to Branch A/c – (Return)		
,, Branch Debtors (Returns)				3,000	---
	5,000	4,000	,, Bangalore A/c transferred	6,000	---
,, Cochin A/c – Transfer			(5,000 + 20%)		
(5,000 + 25%)	---	6,250	,, Balance c/d	24,000	---
,, Branch Stock					
Adjustment A/c					
Apparent Profit over Invoice Price (bal. fig.)	34,000	3,250			
	1,09,000	73,500		1,09,000	73,500

Branch Adjustment Account

Dr. **Cr.**

Particulars	Cochin ₹	Bangalore ₹	Particulars	Cochin ₹	Bangalore ₹
To Goods sent to Branch A/c – Load on Returns	500	---	By Balance b/d Load on Opening Stock	2,500	2,000
,, Bangalore Branch A/c – Load on Transfer	1,000	---	,, Goods Sent to Branch A/c Loading (60,000 x $\frac{1}{6}$)	10,000	---
,, Branch P&L A/c – Gross profit transferred	41,000	16,500	Loading (50,000 x $\frac{1}{5}$)	---	10,000
,, Balance c/d	4,000	---	,, Cochin-Branch A/c Load on transfer		1,250
			,, Branch Stock A/c Apparent Profit	34,000	3,250
	46,500	16,500		46,500	16,500

Branch Cash Account

Dr. **Cr.**

Particulars	Cochin ₹	Bangalore ₹	Particulars	Cochin ₹	Bangalore ₹
To Balance b/d	2,000	1,000	By Bank A/c – Remittance	80,000	80,000
To Bank			,, Branch Stock A/c (Return)	5,000	4,000
– Remittance	15,000	15,000	,, Branch Expenses A/c	5,000	3,000
,, H.O.	2,000	---	,, Fixed Assets A/c	4,000	---
Bangalore Branch			,, H.O. A/c (Cochin Br.)	---	2,000
,, Branch Stock			'' Balance c/d	1,000	500
– Cash Sales (bal. fig.)	76,000	73,500			
	95,000	89,500		95,000	89,500

Branch Profit & Loss Account

Dr. **Cr.**

Particulars	Cochin ₹	Bangalore ₹	Particulars	Cochin ₹	Bangalore ₹
To Branch Expense	5,000	3,000	By Branch Adjustment A/c	41,000	16,500
,, General P&L A/c Net Profit transferred	36,000	13,500	Gross Profit		
	41,000	16,500		41,000	16,500

Illustration 14.

Swapna Ltd has two branches, at Mumbai and at Delhi. Goods are invoiced to Branches at cost plus 50%. Goods are transferred by/to another branch at its cost. Following information is available of the transactions of Mumbai for the year ended on 31st March 2013.

		₹
(a)	Opening Stock at its cost	26,700
(b)	Goods sent to Branch (including goods invoiced at ₹ 1,500 to Branch on 31st March but not received by Branch before closing)	78,300
(c)	Goods received from Delhi Branch	600
(d)	Goods transferred to Delhi Branch	5,100
(e)	Goods returned by Branch to H.O.	1,170
(f)	Goods returned by Credit Customers to Branch	570
(g)	Goods returned by Credit Customers directly to H.O.	120
(h)	Agreed allowance to Customers off the selling price (already taken into account while invoicing)	100
(i)	Normal loss due to wastage and deterioration of stock (at cost)	150
(j)	Loss-in transit (at invoice price) ₹ 660 against which a sum of ₹ 400 was recovered from the Insurance Company in full settlement of the claim.	
(k)	Cash Sales ₹ 3,200 and Credit Sales	72,940
(l)	Branch Expenses (including Insurance charges)	5,000
(m)	Bad Debts ₹ 100 and Discount allowed to Customers	50

Prepare Branch Stock Account, Branch Adjustment Account and Branch Profit and Loss Account in each of the following alternative cases :

Case I. If the Closing Stock at Branch at its cost as per physical verification amounted to ₹20,000.

Case II. If the Closing Stock at Branch at its cost as per physical verification amounted to ₹22,700.

Solution : Case I

Dr. **(i) Branch Stock Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d.	26,700	By Goods Sent to Branch A/c (Returns to H.O.)	1,170
To Goods Sent to Branch A/c	78,300	By Goods Sent to Branch A/c (Transfer to Delhi Branch)	5,100
To Branch Debtors A/c (Returns to Branch)	570	By Branch Cash A/c (Cash Sales)	3,200
To Goods Sent to Branch A/c (Transfer from Delhi Branch)	600	By Branch Debtors A/c (Credit Sales)	72,940
		By Branch Adjustment A/c (Load on Loss-in-transit)	220
		By Branch Profit and Loss A/c (Cost of Loss-in-transit)	440
		By Branch Adjustment A/c (Normal Loss)	150
		By Branch Adjustment A/c (Agreed Allowance Allowed)	100
		By Branch Adjustment A/c (Load on Shortage)	450
		By Branch Profit/Loss A/c (Cost of shortage)	900
		By Balance c/d : In hand	20,000
		In transit	1,500
	1,06,170		1,06,170

Dr. **Mumbai Branch Adjustment Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Branch Stock A/c (Load on loss-transit)	220	By Stock Reserve A/c (Load on Op. Stock)	8,900
To Branch Stock A/c (Normal loss)	150	By Goods Sent to Branch A/c (Load on Net Goods Sent) (78,300 + 600 – 1,170 – 5,100 – 120) × (50/150)	24,170
To Branch Stock A/c (Agreed Allowance)	100		
To Branch Stock A/c (Load on Shortage)	450		
To Stock Reserve A/c (Load on Closing Stock)	7,167		
To Gross Profit t/f to Branch Profit and Loss A/c	24,983		
	33,070		33,070

Dr. **Mumbai Branch Profit and Loss Account** *Cr.*

Particulars	Amount ₹	Particulars	Amount ₹
To Branch Expense A/c	5,000	By Branch Adjustment A/c (Gross Profit)	24,983
To Branch Stock A/c (Cost of loss-in-transit)	440	By Bank A/c (Claim)	400
To Branch Stock A/c (Cost of shortage)	900		
To Bad Debts	100		
To Discount allowed	50		
To Net Profit t/f to General P and L A/c.	18,893		
	25,383		25,383

Unless otherwise specifically stated, shortage arising in Branch Stock is presumed to have occurred due to abnormal factors like theft and thus the load portion is debited to Branch Adjustment Account and the cost portion is debited to Branch Profit & Loss Account.

Case II

Dr. **Mumbai Branch Stock Account** *Cr.*

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d	26,700	By Goods Sent to Branch (Return to H.O.)	1,170
To Goods Sent to Branch A/c	78,300	By Goods sent to Branch A/c (Transter to Delhi Branch)	5,100
To Branch Debtors A/c (Returns to Branch)	570	By Branch Cash A/c (cash Sales)	3,200
To Goods sent to Branch A/c (Transfer from Delhi Branch)	600	By Branch Debtors A/c (Credit Sales)	72,940
To Branch Adjustment A/c (Surplus being Excess of Selling Price over invoice Price) (Balancing figure)	1,350	By Branch Adjustment A/c (Load on Loss-in-transit)	220
		By Branch Profit and Loss A/c (Cost of Loss-in-transit)	440
		By Branch Adjustment A/c (Normal Loss)	150
		By Branch Adjustment A/c (Agreed Allowance Allowed)	100
		By Balance c/d:	
		In hand	22,700
		In transit	1,500
	1,07,520		1,07,520

Dr. **Mumbai Branch Adjustment Account** *Cr.*

Particulars	Amount ₹	Particulars	Amount ₹
To Branch Stock A/c (Load on loss-in-transit)	220	By Stock Reserve A/c (Load on Op. Stock)	8,900
To Branch Stock A/c (Normal Loss)	150	By Goods Sent to Branch A/c (Load on Net Goods Sent) (₹ 78,300 + 600 – 1,170 – ₹ 5,100 – 120) × 50/150)	24,170
To Branch Stock A/c (Agreed Allowance)	100		
To Stock Reserve A/c (Load On Cl. Stock)	8,067	By Branch Stock A/c (Surplus)	1,350
To Gross Profit t/f to Branch P and L A/c.	25,883		
	34,420		34,420

Dr. **Mumbai Branch Profit & Loss Account** *Cr.*

Particulars	Amount ₹	Particulars	Amount ₹
To Branch Expenses A/c	5,000	By Branch Adjustment A/c (Gross Profit)	25,883
To Branch Stock A/c (Cost of loss-in-transit)	440	By Bank A/c (Claim)	400
To Bad Debts	100		
To Discount Allowed	50		
To Net Profit t/f to General P and L A/c	20,693		
	26,283		26,283

Unless otherwise stated, surplus arising in Branch Stock is presumed to have occurred due to excess of selling price over invoice price and thus the entire amount is credited to Branch Adjustment Account.

INDEPENDENT BRANCH

When there are voluminous transactions in a Branch, they prepare the accounts independently. They purchase and sell goods independently and also sell the goods which are sent by H.O.. As the branches are owned by H.O., the profit or loss so made by the branch is enjoyed by H.O. These branches prepare a Trial Balance, Trading and Profit and Loss Account and a Balance Sheet at the end of the year. As such, they maintain a Head Office Account and on contrary H.O. maintains a Branch Account. All sorts of transactions, e.g., remittance of cash, transfer of goods etc. are to be passed through these accounts.

Needless to say that where H.O. receives the accounts from the branches, it incorporates profit of the branches as –

Branch A/c……………………….. Dr.

To Profit & Loss A/c

Sometimes, the balance of branch account in H.O. books and H.O. accounts in branch books do not agree. If that be so, the same must be adjusted accordingly i.e., Goods-in-Transit or Cash-in-Transit etc. At last the Branch Balance Sheet is amalgamated with H.O. Balance Sheet by eliminating inter-branch/H.O. transaction as per the respective heads of assets and liabilities.

INDEPENDENT BRANCHES

Accounting Steps :

S No.	Transaction	HO Books	Branch Books
1.	Goods sent by H.O. to Branch	Branch A/c Dr. To Goods Sent to Branch A/c	Goods Recd. from H.O. A/c. Dr. To H.O. A/c
2.	Goods returned by Branch to H.O.	Goods Sent to Branch A/c Dr. To Branch A/c	HO A/c. Dr. To Goods Recd. From H. O. A/c
3.	Branch Expenses incurred at Branch Office	—	Expenses A/c Dr. To Cash / Bank A/c
4.	Branch expenses paid for by the Head Office	Branch A/c Dr. To Cash/Bank A/c	Expenses A/c. Dr. To H.O. A/c
5.	Purchases made from parties other than H.O. by Branch	—	Purchases A/c Dr. To Bank/ Creditors A/c
6.	Sales effected by the Branch		Cash/Debtors A/c Dr. To Sales A/c
7.	Collection from Debtors received directly by the H.O.	Cash/Bank A/c Dr. To Branch A/c	H.O. A/c Dr. To Sundry Debtors A/c
8.	Payment by H.O. for Purchase made by the Branch	Branch A/c Dr. To Bank A/c	Purchases/Creditors A/c Dr. To H.O. A/c
9.	Purchase of Asset by Branch	—	Sundry Assets A/c Dr. To Bank/Liability
10.	Asset account maintained at H.O. and asset purchased by Branch	Branch Asset A/c Dr. To Branch A/c	H.O. A/c Dr. To Bank/Creditors A/c
11.	Depreciation when asset account is maintained by H.O.	Branch A/c Dr To Branch Asset A/c	Depreciation A/c Dr. To H.O. A/c
12.	Remittance of Funds by H.O. to Branch	Branch A/c Dr. To Bank A/c	Bank A/c Dr. To H.O. A/c
13.	Remittance of Funds to H.O. by Branch	Bank A/c Dr. To Branch A/c	Ho A/c Dr. To Bank A/c
14.	Transfer of Goods between different branches	Recipient Branch A/c Dr. To Supplying Branch A/c	(i) Supplying Branch A/c Dr. To Goods recd. from H.O. A/c (ii) Goods recd. from H.O. A/c Dr. To H.O. A/c
15.	Charging the Branch service charges by H.O.	Branch (Expenses) A/c Dr. To Service Charges A/c	Expense A/c Dr. To H.O. A/c
16.	Cash-in-transit	Cash-in-transit A/c. Dr. To Branch A/c.	Cash-in-transit A/c. Dr. To H.O. A/c.
17.	Goods-in-transit	Goods-in-transit A/c. Dr. To Branch A/c.	Goods-in-transit A/c. Dr. To H.O. A/c.

Illurstration 15.

Journalise the following transactions in the books of Head Office. Delhi Branch and Agra Branch :

(a) Goods worth ₹ 50,000 are supplied by Delhi Branch to Agra Branch under the instructions of Head Office.

(b) Delhi Branch draws a bill receivable for ₹ 40,000 on Agra Branch which sends its acceptance.

(c) Delhi Branch received ₹ 10,000 from Agra Branch.

(d) Goods worth ₹ 20,000 were returned by a customer of Agra Branch to Delhi Branch.

(e) Agra Branch collected ₹ 20,000 from a customer of Delhi Branch.

Solution :

Journal of Head Office

Particulars		L.F.	*Dr.* Amount ₹	*Cr.* Amount ₹
(a) Agra Branch A/c	Dr.		50,000	
To Delhi Branch A/c				50,000
(Being the goods supplied by Delhi Branch to Agra Branch)				
(b) Delhi Branch A/c	Dr.		40,000	
To Agra Branch A/c				40,000
(Being a B/R drawn by Delhi upon Agra Branch)				
(c) Delhi Branch A/c	Dr.		10,000	
To Agra Branch A/c				10,000
(Being Cash sent by Agra Branch to Delhi Branch)				
(d) Delhi Branch A/c	Dr.		20,000	
To Agra Branch A/c				20,000
(Being the goods returned by customer of Agra Branch to Delhi Branch)				
(e) Agra Branch A/c	Dr.		20,000	
To Delhi Branch A/c				20,000
(Being the Cash collected by Agra Branch from a customer of Delhi Branch				

Journal of Delhi Branch

Particulars	L.F.	*Dr.* Amount ₹	Cr. Amount ₹
(a) H.O. A/c Dr. To Goods sent to Branch A/c (Being the goods supplied to Agra Branch)		50,000	50,000
(b) Bills Receivable A/c Dr. To H.O. A/c (Being the acceptance of a B/R received from Agra Branch)		40,000	40,000
(c) Cash A/c Dr. To H.O. A/c (Being the cash received from Agra Branch)		10,000	10,000
(d) Goods Sent to Branch A/c Dr. To H.O. A/c (Being the goods received from a customer of Agra Branch)		20,000	20,000
(e) H.O. A/c Dr. To Debtors A/c (Being the cash collected by Agra Branch from our customer)		20,000	20,000

Journal of Agra Branch

Particulars	L.F.	*Dr.* Amount ₹	Cr. Amount ₹
(a) Goods sent to Branch A/c Dr. To H.O. A/c (Being the goods received from Delhi Branch)		50,000	50,000
(b) H.O. A/c Dr. To Bill Payable A/c (Being a B/P accepted for Delhi Branch)		40,000	40,000
(c) H.O. A/c Dr. To Cash A/c (Being cash paid to Delhi Branch)		10,000	10,000
(d) H.O. A/c Dr. To Debtors A/c (Being the goods returned by customer of Delhi Branch)		20,000	20,000
(e) Cash A/c Dr. To H.O. A/c (Being the Cash received from a customer of Delhi Branch)		20,000	20,000

Ilustration 16.

A Delhi head office passes one entry at the end of each month to adjust the position arising out of inter- branch transactions during the month. From the following inter-branch transactions in March 2013, make the entries in the books of Delhi Head office.

(a) Kolkata Branch :

(i) Received goods from Patna branch ₹ 9,000 and Ahmedabad branch ₹ 6,000.

(ii) Sent goods to Ahmedabad branch ₹ 15,000 and Patna branch ₹ 12,000.

(iii) Sent acceptances to Patna branch ₹ 6,000 and Ahmedabad branch ₹ 3,000.

(b) Kanpur branch [apart from (a) above] :

(i) Sent goods to Ahmedabad branch ₹ 9,000.

(ii) Recived B/R from Ahmedabad branch ₹ 9,000.

(iii) Recived cash from Ahmedabad branch ₹ 5,000.

Solution :

Journal of Head Office

Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
Kanpur Branch A/c	Dr.		5,000	
Patna Branch A/c	Dr.		9,000	
Ahmedabad Branch A/c	Dr.		7,000	
To Kolkata Branch A/c				21,000

Statement of Inter-branch Transactions

Particulars	Kolkata		Kanpur		Patna		Ahmedabad	
	Dr. ₹	Cr. ₹	Dr. ₹	Cr. ₹	Dr. ₹	Cr. ₹	Dr. ₹	Cr ₹
Goods Received	15,000	–	–	–	–	9,000	–	6,000
Goods Sent	–	27,000	–	–	12,000	–	15,000	–
Acceptance	–	9,000	–	–	6,000	–	3,000	–
Goods Sent	–	–	–	9,000	–	–	9,000	–
B/R Received	–	–	9,000	–	–	–	–	9,000
Cash	–	–	5,000	–	–	–	–	5,000
	15,000	36,000	14,000	9,000	18,000	9,000	27,000	20,000
	21,000	–	–	5,000	–	9,000	–	7,000
Balance	36,000	36,000	14,000	14,000	18,000	18,000	27,000	27,000

Illustration 17.

Journalise the following transactions in the books of the Head Office.

(a) Goods returned by Thane Branch on 28th March, worth ₹10,000 to its Head Office not received by the head office upto 31st March.

(b) Goods worth ₹ 20,000 sent by the Head Office to its Coimbatore Branch on 29th March, were received on 3rd April following.

(c) ₹ 50,000 remitted by Coimbatore Branch to Head Office on 28th March was received on 4th April.

Solution :

Journal of Head Office

Particulars		L.F.	*Dr.* Amount ₹	*Cr.* Amount ₹
(a) Goods-in-transit A/c	Dr.		10,000	
To Thane Branch A/c				10,000
(Being the goods returned by Thane Branch not yet received)				
(b) Goods-in-transit A/c	Dr.		20,000	
To Coimbatore Branch A/c				20,000
(Being the goods sent to Coimbatore Branch not yet received by Branch)				
(c) Cash-in-transit A/c	Dr.		50,000	
To Coimbatore Branch A/c				50,000
(Being the Cash sent by Coimbatore Branch not yet received)				

Incorporation of Branch Trial Balance in Head Office Books.

While discussing independent branch in the previous paragraphs it has been stated that branch prepares its own trial balance and the same is sent to the H.O. for incorporation. Naturally, after receiving the trial balance from branch H.O. incorporates with its own accounts the same to prepare and ascertain the net result of the concern. There are two methods for incorporating branch trial balance in H.O. Book.

It can be prepared in two ways :

(a) First Method

All revenue items are passed through Branch Trading and Profit & Loss Account and Profit or Loss so made (in the Profit and Loss Account) together with assets and liabilities are passed through Branch Account for the purpose of preparing consolidated Balance Sheet in the Books of H.O.

Incorporation Entries

(a) For all revenue expenses related to Trading A/c
Branch Trading A/c Dr.
To Branch A/c

i.e. Opening stock, Purchase, Return Inwards, Wages and other items appearing in the debit side.

(b) For all revenue incomes related to Trading A/c
Branch A/c Dr.
To Branch Trading A/c

i.e. Sales, Closin g Stock and Return Outwards and other items that appear in the credit side.

(c) For gross profit of the Branch
Branch Trading A/c Dr.
To Branch P&L A/c

In case of gross loss, the entry will be reversed.

(d) For all revenue expenses related to P&L A/c — i.e. items that appear in the debit side of the P & L Account.

Branch P & L A/c Dr.

To Branch (All Revenue Expenses) A/c

(e) For all revenue incomes related to P & L A/c — i.e. items that appear in the credit side of the P & L Account.

Branch (All Revenue Incomes) A/c Dr.

To Branch P&L A/c

(f) For net profit of the Branch

Branch P&L A/c Dr.

To General P&L A/c

In case of net loss, the entry will be reversed.

(g) For branch assets.

Branch Assets A/c Dr.

To Branch A/c

(h) For branch liabilities.

Branch A/c Dr.

To Branch Liabilties A/c

(b) Second Method / Abridged Method

This method is applicable only when net profit or net loss is given instead of detailed information about all revenue expense and income. Under this method, only net profit/net loss will be transferred to Branch Account. Branch Assets and Branch Liabilities will not appear in branch account and this branch account will show a balance. The same must be equal to the difference between assets and liabilities, i.e., in other words, net worth of the business.

Illustration 18.

Salt Lake Corporation presented the following trial balance on 31.03.2013 to the H.O. at New Delhi.

Particulars	Debit Amount ₹	Particulars	Credit Amount ₹
Delhi H.O.	6,480	Sales	76,000
Stock 1.4.2012	12,000	Goods supplied to H.O.	12,000
Purchase	35,600	Creditors	3,700
Goods Return From H.O.	18,000		
Salaries	3,000		
Debtors	7,400		
Rent	1,920		
Misc. Expense	940		
Furniture	2,800		
Cash and Bank	3,560		
	91,700		91,700

Additional Information:

The branch account on H.O. books on 31.03.2013 stood at ₹ 920 (Debit).

On 31.03.2013, the, H.O. forwarded goods to the value of ₹5,000 to the branch which are received on 3rd July.

A cash remittance of ₹2,400 by branch on 29th March 2013, was received by the H.O. on 2nd April 2013.

Closing Stock was valued at ₹5,400

Show the incorporation entries in the books of H.O. showing separate Branch Trading and Branch Profit and Loss Account, and Prepare Branch Account and Branch Balance Sheet also in H.O. books.

(a) First Method

In the Books of H.O.

Journal *Dr.* **Cr.**

Date	Particulars	L/F	Amount ₹	Amount ₹
31.03.13	Branch Trading A/c Dr. To Branch A/c (Items of Br. Trading incorporated) ₹ 12,000 + ₹ 35,600 + ₹ 18,000)		65,600	 65,600
	Branch A/c Dr. To Branch Trading A/c (Items of Br. Trading incorporated i.e., ₹ 76,000 + ₹ 12,000 + ₹ 5,400)		93,400	 93,400
	Branch Trading A/c Dr. To Branch Profit & Loss A/c (Gross Profit transferred) [₹ 93,400 – ₹ 65,600]		27,800	 27,800
	Branch Profit and Loss A/c Dr. To Branch A/c (Item of Branch Profit & Loss incorporated i.e., ₹ 3,000 + ₹ 1,920 + ₹ 940)		5,860	 5,860
	Branch Profit and Loss A/c Dr. To General Profit & Loss A/c (Net Profit Transferred) [₹ 27,800 – ₹ 5,860]		21,940	 21,940
	Goods-in-Transit A/c Dr. To Branch A/c (Goods-in-Transit adjusted)		5,000	 5,000
	Remittance (Cash)-in-Transit A/c Dr. To Branch A/c (Remittance-in-Transit adjusted)		2,400	 2,400
	Branch Asset A/c Dr. To Branch A/c (Branch Asset incorporated) [₹ 2,800 + ₹ 5,400 + ₹ 7,400 + ₹ 3,560]		19,160	 19,160
	Branch A/c Dr. To Branch Liabilities A/c (Branch liabilities incorporated)		3,700	 3,700

Dr. Branch Trading and Profit and Loss Account Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, Branch A/c			By, Branch A/c		
Stock	12,000		Sales	76,000	
Purchase	35,600		Goods supplied to H.O.	12,000	
Goods from H.O.	18,000	65,600	Closing Stock	5,400	93,400
To, Branch Profit and Loss A/c (Gross Profit transferred)		27,800			
		93,400			**93,400**
To, Branch A/c			By, Branch Trading A/c - Gross Profit		27,800
Salaries	3,000				
Rent	1,920				
Office Expenses	940	5,860			
To, General Profit and Loss A/c (Net Profit transferred)		21,940			
		27,800			**27,800**

Branch Account

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars		Amount ₹
01.04.12	To Balance b/d	920	31.03.13	By Branch Trading A/c		65,600
				,, Branch P&L A/c		5,860
31.03.13	,, Branch Trading A/c	93,400		,, Goods-in-Transit A/c		5,000
	,, Branch Liabilities A/c			,, Remittance-in-Transit A/c		2,400
	Creditors	3,700		,, Branch Assets A/c		
				Furniture	2,800	
				Stock	5,400	
				Debtors	7,400	
				Cash	3,560	19,160
		98,020				98,020

Branch Balance Sheet
as at 31st March, 2013

Liabilities		Amount ₹	Assets	Amount ₹
H.O. A/c			Furniture	2,800
Opening balance (Dr.)	6,480		Stock	5,400
Less: Net Profit	21,940	15,460	Debtors	7.400
Creditors		3,700	Cash at Bank	3,560
		19,160		19,460

(b) Second Method/Abridged Method

Branch Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
01.04.12	To Balance b/d	920	31.03.13	By Goods-in-Transit A/c	5,000
				,, Remittance-in-Transit A/c	2,400
31.03.13	,, Branch P&L A/c Net Profit	21,940		,, Balance c/d	15,460*
		22,860			22,860

* **Note:** This is the difference between Branch Assets and Branch Liabilities (₹19,160 – ₹3,700) = ₹15,460.

Closing of Branch Books

Branch closes its accounts at the end of the financial year by passing the following entries:

In this situation Accounts can be prepared by two methods.

Method – 1

All revenue items are passed through H.O. Account.

Journal entries

(a) For all revenue expenses that appear in the debit side of Branch Trading A/c

H.O. A/c	Dr.	
To Opening Stock A/c		Actual amount
,, Purchase A/c		
,, Goods Received from H.O. A/c		
,, All revenue expenses		

(b) For all revenue incomes that appear in the credit side of Branch Trading A/c

Sales A/c	Dr.	Actual amount
Closing Stock A/c	Dr.	
All revenue incomes A/c	Dr.	
To H.O. A/c		

(c) For all Branch Assets:

H.O. A/c	Dr.	Actual amount
To Branch Assets A/c		

(d) For all Branch Liabilities:

Branch Liabilities A/c	Dr.	Actual amount
To H.O. A/c		

Method - 2

In this case, net profit or net loss is transferred to Head Office Account. But treatment of branch assets and branch liabilities will remain the same.

(a) For Net Profit:

Profit & Loss A/c	Dr.	}	with the amount of net profit
To H.O. A/c			

(b) For Net Loss:

H.O. A/c	Dr.	}	with the amount of net loss
To Profit & Loss A/c			

Illustration 19.

A Chennai Head Office has an independent Branch at Ahmedabad. From the following particulars, give journal entries to close the books of the Ahmedabad Branch. Show also the Chennai Head Office account in the branch books.

Ahmedabad Branch

Trial Balance as at 31st December, 2013

Liabilities	Amount ₹	Assets	Amount ₹
Stock on 1st January	8,200	Creditors	2,700
Purchases	12,800	Sales	34,950
Wages	6,550	Head Office	14,000
Manufacturing Expenses	3,400	Discount	150
Rent	1,700	Purchase Returns	300
Salaries	5,500		
Debtors	4,000		
General Expenses	2,000		
Goods received from H.O.	7,200		
Cash at Bank	750		
	52,100		52,100

(a) Closing Stock at Branch ₹ 14,350.

(b) The branch fixed assets maintained at H.O. books were: Machinery ₹ 25,000, Furniture ₹ 1,000 Depreciations are to be allowed at 10% on Machinery and 15% on Furniture.

(c) Rent due ₹ 150.

(d) A remittance of ₹ 4,000 made by the Branch on 29th Dec. 2013 was received by Head Office on 4th January, 2014.

Solution:

(i) As per Method 1

In the books of Branch
Journal

Date	Particulars	L/F	*Dr.* Amount ₹	*Cr.* Amount ₹
31.12.13	Depreciation A/c Dr.		2,650	
	To Head Office A/c			2,650
	(Depreciation on fixed assets maintained in head office books @ 10% on Machinery and 15% on Furniture)			
	Rent A/c Dr.		150	
	To Outstanding Rent A/c			150
	(Rent Outstanding)			
	Cash-in-Transit A/c Dr.		4,000	
	To Head Office A/c			4,000
	(Cash remitted to H.O. but not received within 31st December)			
	Head Office A/c Dr.		50,150	
	To Opening Stock			8,200
	,, Purchases			12,800
	,, Wages			6,550
	,, Manufacturing Expenses			3,400
	,, Rent (1,700 + 150)			1,850
	,, Salaries			5,500
	,, General Expenses			2,000
	,, Goods received from H.O.			7,200
	,, Depreciation			2,650
	(Above items transferred to H.O. A/c)			
	Discount A/c Dr.		150	
	Sales A/c Dr.		34,950	
	Purchase Returns A/c Dr.		300	
	Closing Stock A/c Dr.		14,350	
	To Head Office A/c			49,750
	(Above items transferred to H.O. A/c)			
	Head Office A/c Dr.		23,100	
	To Closing Stock A/c			14,350
	,, Debtors A/c			4,000
	,, Bank A/c			750
	,, Cash-in-Transit A/c			4,000
	(Assets transferred to H.O. A/c)			
	Creditors A/c Dr.		2,700	
	Outstanding Rent A/c Dr.		150	
	To Head Office A/c			2,850
	(Liabilities transferred to H.O. A/c)			

Dr. Head Office Account Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.12.13	To Sundries- (debit balance of Revenue items)	50,150	31.12.12	By Balance b/d	14,000
	,, Sundry Assets	23,100		,, Depreciation A/c	2,650
				,, Cash-in-Transit A/c	4,000
				,, Sundries –Credit Balance of Revenue items	49,750
				,, Sundry Liabilities	2,850
		73,250			73,250

(ii) As per Method 2

In the books of Branch

Journal

Date	Particulars	L/F	Dr. Amount ₹	Cr. Amount ₹
2013 Dec. 31.	Depreciation A/c Dr.		2,650	
	To Head Office A/c			2,650
	(Depreciation on fixed assets @ 10% Monthly and @ 15% or Furniture in H.O. Books.)			
	Rent A/c Dr.		150	
	To Outstanding Rent A/c			150
	(Rent Outstanding)			
	Cash-in-Transit A/c Dr.		4,000	
	To Head Office A/c			4,000
	(Cash remitted to H.O. but in transit)			
	Head Office A/c Dr.		400	
	To Profit & Loss A/c			400
	(Net Loss Transferred.) [₹50,150 – 49,750]			
	Head Office A/c Dr.		23,100	
	To Closing Stock			14,350
	,, Debtors			4,000
	,, Cash at Bank			750
	,, Cash-in-Transit			4,000
	(Asset transferred to H.O. A/c)			
	Creditors A/c Dr.		2,700	
	Outstanding Rent A/c Dr.		150	
	To Head Office A/c			2,850
	(Various Liabilities transferred to H.O. A/c)			

Head Office Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.12.13	To Profit & Loss A/c	400	31.12.13	By Balance b/d	14,000
	Net Loss			,, Depreciation A/c	2,650
	,, Closing Stock A/c	14,350		,, Cash-in-Transit A/c	4,000
	,, Debtors A/c	4,000		,, Credit A/c	2,700
	,, Cash at Bank	750		,, Outstanding Rent	150
	,, Cash-in-Transit A/c	4,000			
		23,500			23,500

Illustration 20.

A merchant of Kolkata opens a new branch in Mathura, which trades independently of the Head Office. The transactions of the Branch for the year ended 31.3.2013 are as under :

Particulars	Amount ₹	Amount ₹
Goods supplied by Head Office		20,00,000
Purchases from outsiders :		
— Credit		
— Cash	15,55,000	
Sales :	3,00,000	18,55,000
— Credit		
— Cash	25,05,000	
	4,60,000	29,65,000
Cash received from Customers		30,45,000
Trade Creditors Paid		14,25,000
Expenses paid by Branch		8,95,000
Furniture purchased by Branch on credit		3,50,000
Cash received from Head Office initially		4,00,000
Remittances to Head Office		11,00,000

Prepare the Trading and Profit and Loss Account, Balance Sheet, Head Office Account in the books of Branch :

1. The account of the Branch Fixed Assets are maintained in the Head Office books.
2. Write off depreciation on furniture at 5 percent per annum for full year.
3. A remmittance of ₹ 2,00,000 from the Branch to the Head Office is in transit.
4. The Branch value its closing stock at ₹ 12,00,000.

Solution :

IN BRANCH BOOKS

1. Trading and Profit and Loss Account for year ended 31.3.2013

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Goods Supplied by HO		20,00,000	By Sales :		
To Purchase			— Credit	25,05,000	
— Credit	15,55,000		— Cash	4,60,000	29,65,000
— Cash	3,00,000	18,55,000			
To Gross Profit c/d		3,10,000	By Closing Stock		12,00,000
		41,65,000			**41,65,000**
To Expenses		8,95,000	By Gross Profit b/d		3,10,000
To Depreciation on Furniture		17,500	By HO — Transfer of net loss		6,02,500
		9,12,500			**9,12,500**

2.

Dr. **Branch Cash Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Head Office (initial Receipt)	4,00,000	By Cash Purchases	3,00,000
To Cash Sales	4,60,000	By Trade Creditors	14,25,000
To Trade Debtors	30,45,000	By Expenses	8,95,000
		By Head Office A/c — Remittance	11,00,000
		By Balance c/d	1,85,000
	39,05,000		**39,05,000**

3.

Dr. **Head Office Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Creditors for Furniture	3,50,000	By Cash (Initial Receipt)	4,00,000
To Cash (remittance)	11,00,000	By Goods received from HO A/c	20,00,000
To Profit & Loss A/c (Loss for the Year)	6,02,500	By Depreciation on Furniture	17,500
		By Cash in Transit	2,00,000
To Balance c/d — balancing	**5,65,000**		
	26,17,500		**26,17,500**

4. Balance Sheet as on 31.3.2013

Liabilities	Amount ₹	Assets	Amount ₹
Sundry Trade Creditors (₹ 15,55,000 – ₹ 14,25,000)	1,30,000	Closing Stock	12,00,000
Creditors for Furniture	3,50,000	Cash in Transit	2,00,000
Advances from Trade Debtors (₹ 30,45,000 – ₹ 25,05,000)	5,40,000	Cash in Hand (As per Cash Book)	1,85,000
Head Office A/c	5,65,000		
	15,85,000		**15,85,000**

Illustration 21.

The Head Office of Z Ltd. and its Branch keep their own books prepare own Profit and Loss Account. The following are the balances appearing in the two sets of the books as on 31.3.2013 after ascertainment of profits and after making all adjustments except those referred to below :

Particulars	Head Office		Branch Office	
	Dr. (₹)	Cr. (₹)	Dr. (₹)	Cr. (₹)
Capital	—	1,00,000	—	—
Fixed Assets	36,000	—	16,000	—
Stock	34,200	—	10,740	—
Debtors & Creditors	7,820	3,960	4,840	1,920
Cash	10,740	—	1,420	—
Profit & Loss	—	14,660	—	3,060
Branch Account	29,860	—	—	—
Head Office Account	—	—	—	28,020
Total	1,18,620	1,18,620	33,000	33,000

Prepare the Balance Sheet of the business as on 31.3.2013 and the journal entries necessary (in both sets of books) to record the adjustments dealing with the following :

1. On 31.3.2013, the branch had sent a cheque for ₹ 1,000 to the head office, not received by them nor credited to the branch till next month.
2. Goods valued at ₹ 440 had been forwarded by the head office to the branch and invoiced on 30.3.2013, but were not received by the branch nor dealt with in their books till next month.
3. It was agreed that the branch should be charged with ₹ 300 for Administration Services, rendered by the Head Office during the year.
4. Stock stolen in transit from the Head Office to the Branch and charged to the Branch by the Head Office but not credited to the Head Office in the Branch Books as the Manager declined to admit any liability, ₹ 400 (not covered by insurance).
5. Depreciation of Branch Assets, of which accounts are maintained by the Head Office, not provided for ₹ 250.
6. The balance of Profits shown by the Branch is to be transferred to HO Books.

Solution :

1. **Balance Sheet of Z Ltd. as at 31.03.2013**

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital	1,00,000		**Fixed Assets :**		
Add : Net Profit of :			—Head Office		
—Head Office	14,560		—Branch	36,000	
—Branch	2,510	1,17,070	**Less :** Depreciation	16,000	
				(250)	51,750
Creditors :			**Stock :**		
—Head Office	3,960		—Head Office	34,200	
—Branch	1,920	5,880	—Branch	10,740	
			—Goods in Transit	440	45,380
			Debtors :		
			—Head Office	7,820	
			—Branch	4,840	12,660
			Creditors:		
			—Head Office	10,740	
			—Branch	1,420	
			—In Transit	1,000	13,160
		1,22,950			**1,22,950**

2. **Journal Entries in the books of Head Office** Dr. Cr.

Sl. No.	Particulars		Amt. (₹)	Amt. (₹)
1	Goods in Transit A/c	Dr.	440	
	To Branch A/c			440
	(Being the goods invoiced on 30.3.2013 not yet received by the branch as on the Balance Sheet date)			
2	Branch A/c	Dr.	300	
	To Profit & Loss A/c			300
	(Being amount of Administrative Services rendered by the HO to the Branch)			
3	Profit & Losss A/c	Dr.	400	
	To Branch A/c			400
	(Being the amount of uninsurd stock stolen on way to Branch)			
4	Branch A/c	Dr.	250	
	To Branch Fixed Assets			250
	(Being depreciation on Branch Fixed Assets for which accounts are maintained in the Head Office books)			
5	Branch Profit & Loss A/c	Dr.	2,510	
	To Profit & Loss A/c			2,510
	(Being Profit shown by the Branch Profit & Loss Account transferred to (General) Profit & Loss Account)			

3.

Dr. **Head Office Profit and Loss Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Branch — Uninsured Stock stolen	4 0 0	By Balance b/d	14,660
To Profit — Transferred	14,560	By Branch Administration Expenses	300
	14,960		**14,960**

4. Journal Entries in the books of Branch Office

S. No.	Particulars		Dr. Amt. (₹)	Cr. Amt. (₹)
1	Cash in Transit A/c	Dr.	1,000	
	To Head Office A/c			1,000
	(Being cash sent on 31.3.2013 not yet received by the HO)			
2	Profit & Loss A/c	Dr.	300	
	To Head Office A/c			300
	(Being administrative services rendered by the Head Office)			
3	Profit & Loss A/c	Dr.	250	
	To Head Office A/c			250
	(Being depreciation on Branch Fixed Assets for which accounts are maintained in the Head Office books)			
4	Profit & Loss Account	Dr.	2,510	
	To Head Office A/c			2,510
	(Being profit transferred to Head Office Account)			

5.

Dr. **Branch Profit and Loss Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To HO A/c – Administrative Services	300	By Balance b/d	3,060
To HO A/c – Depn. on Branch Assets	250		
To Profit – Transferred to HO Account	2,510		
	3,060		3,060

Illustration 22

Puskar Enterprise has its H.O. in Ranchi and a branch in Imphal. The following Trial Balance has been extracted from the books of accounts as at 31st March, 2013:

Particulars	Head Office		Branch Office	
	Dr.	Cr.	Dr.	Cr.
	₹	₹	₹	₹
Capital	---	16,50,000	---	---
Debtors	3,00,000	---	1,80,000	---
Creditors	---	1,50,000	---	---
Purchases	27,42,000	---	---	---
Sales	---	25,50,000	---	13,11,000
Goods sent to Branch at I.P.	---	11,40,000	11,25,000	---
Fixed Assets (Net)	10,50,000	---	2,00,000	---
Stock (1.4.2012)	24,000	---	60,000	---
Stock Adjustment (Unrealised Profit)	---	12,000	---	---
H.O./Branch Current A/c	5,25,000	---	---	3,60,000
Administrative & Selling Expenses	8,41,500	---	74,500	---
Cash and Bank	46,500	---	39,000	---
Provision for Bad Debts	---	27,000	---	7,500
	55,29,000	55,29,000	16,78,500	16,78,500

Other relevant information:

(1) All goods are purchased by the H.O. Goods are sent to branch at cost plus 25%.

(2) Stock 31.3.2013 are valued at:

H.O. ₹ 36,000

Branch ₹ 45,000 (Invoice Price)

(3) Depreciation is to be provided on fixed assets at 10% on book value.

(4) Bad debts provision is to be maintained at 5% on debtors as at the end of the year.

(5) Cash-in-transit from branch to H.O. at 31st March 2013 was ₹1,50,000.

(6) Goods-in-transit from H.O. to branch at 31st March, 2013 at invoice price was ₹15,000.

Prepare in Columnar from, the branch and H.O. Trading and Profit and Loss Accounts for the year ended 31st March, 2013 and a combined Balance Sheet of Puskar Enterprises as on that date.

Solution:

In the books of H.O.
Columnar Trading and Profit and Loss Account

Dr. **Cr.**

Particulars	H.O. ₹	Branch ₹	Particulars	H.O. ₹	Branch ₹
To Opening Stock	24,000	60,000	By Sales	25,50,000	13,11,000
,, Purchases	27,42,000	---	,, Goods Sent to Branch	11,40,000	---
,, Goods from H.O.	---	11,25,000	,, Closing Stock	36,000	45,000
,, Gross Profit c/d	9,60,000	1,71,000			
	37,26,000	13,56,000		37,26,000	13,56,000
To Adm. & Selling Exp.	8,41,500	74,500			
,, Depreciation	1,05,000	20,000	By Gross Profit b/d	9,60,000	1,71,000
,, Stock Adjustment (for closing) 20% of (45,000+15,000)	12,000	---	,, Stock Adjustment (for opening)	12,000	---
			,, Provision for Bad Debts (old)	27,000	7,500
,, Provision for Bad Debts (new)	15,000	9,000			
Net Profit	25,500	75,000			
	9,99,000	1,78,500		9,99,000	1,78,500

Balance Sheet (Combined)
as at 31st March 2013

Liabilities		Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital		16,50,000		Fixed Assets	12,50,000	
Add: Net Profit		1,00,500		Less: Depreciation	1,25,000	11,25,000
(25,500 + 75,000)			17,50,500	Current Assets		
Current A/c – H.O.		5,25,000		Stock		
Less: Branch (Cr.)	3,60,000			H.O.	36,000	
Cash-in-transit	1,50,000			Branch	45,000	
Goods-in-transit	15,000	5,25,000			81,000	
			Nil	Less: Stock Adj.	12,000	69,000
Creditors			1,50,000			
				Goods-in-Transit		15,000
				Debtors		
				H.O.	3,00,000	
				Branch	1,80,000	
					4,80,000	
				Less; Prov. for Bad Debts	24,000	4,56,000
				Cash at Bank		
				H.O.	46,500	
				Branch	39,000	
				Cash-in-transit	1,50,000	2,35,500
			19,00,500			19,00,500

FOREIGN BRANCH

Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate.

Since the accounts are maintained in Foreign Currency they have to be translated into Reporting Currency i.e. the currency in which the Head Office transacts.

Exchange rate of Reporting Currency in not stable in relation to foreign currencies due to international demand and supply effects on various currencies. Therefore, different rates are assigned to different transactions and balances upon translation.

Applicable Exchange Rate :

Revenue Items	Average Rate for the year.
Opening Stock	Rates prevalent at the commencement of the Accounting Period i.e. Opening Rate
Closing Stock	Rates prevalent at the close of the Accounting Period i.e. Closing Rate
Fixed Asset	Translated at the original rate. If there is a change in the value of the Foreign Currency Liabilities, adjustment should be made to cost of fixed Assets in Rupees.
Depreciation	Rate used for translation of value of Fixed Assets on which the depreciation is calcutated.
Current Assets	Rates prevalent at the close of the Accounting Period i.e. Closing Rate
Current Liabilities	Rates prevalent at the close of the Accounting Period i.e. Closing Rate
Long Term Liabilities	Rate Prevalent at the close of the Accounting Period i.e. Closing Rate
Head Office Account	Balance in 'Head Office Account' in the Branch Books is taken at the Indian rupees for which 'Branch Account' in the head office books stands. It must be ensured that no transaction is left unaccounted in both the books.

Profit / Loss on Translation : Profit or Loss arising out of change in Exchange rate should be Credited/ Debited to the Profit and Loss Account for the current period.

Entries :

(a) For loss in Exchange :

Branch Profit & Loss A/c. Dr.

To, Difference in Exchange A/c.

(b) For Profit in Exchange :

Difference in Exchange A/c. Dr.

To, Branch Profit & Loss A/c.

Illustration 23.

How will you translate the following items of the Singapore Branch as on 31.03.2012.

Opening Stock $ 4,100, Goods from H. O. $ 29,400, Salaries & Wages $ 7,600, Sales $ 52,600, Closing Stock $ 1,200, Goods sent to London Branch in the H. O. Books amounted to ₹ 10,73,100, Exchange Rates : on 1.4.2012 $ 1 = ₹ 26.40, on 31.03.2013 $ 1 = ₹ 42.20, Average of 2012-2013 $ 1 = ₹ 36.50 (Here, $ refers to Singapore Dollars).

Solution:

Statement showing the Translation into Rupees

Item	$	Relevant Exchange Rate	Translated value in ₹
Opening Stock	4,100	Opening Rate as on 1.4.2012, to	4,100 × ₹ 26.40 = ₹ 1,08,240
Goods from H.O.	29,400	be taken at the Rupee Value recorded in H.O. Books	₹ 10,73,100
Salaries & Wages	7,600	Average Rate of 2012-2013	7,600 × ₹ 36.50 = ₹ 2,77,400
Sales	52,600	Average Rate of 2012-2013	52,600 × ₹ 36.50 = ₹ 19,19,900
Closing Stock	1,200	Closing Rate as on 31.3.2013	1,200 × ₹ 42.20 = ₹ 50,640

Illustration 24.

How will you translate the following items of Singapore Branch for the year 2012-13 :

Fixed Assets as on 31.3.2013 $ 70,000, Balance of Loan (taken to purchase the fixed Assets) on 31.3.2013 $ 52,000, Depreciation as on 31.3.2013 $ 10,000, Interest paid during 2013 $ 11,520.

Fixed Assets having useful life of 10 years were purchased for $ 1,00,000 on 1.4.2010 after taking a loan of $ 88,000 @ 18% interest p.a. Annual loan installment of $ 12,000 and interest were paid on 31st March each year. Exchange Rate 1.4.2010 $ 1 = ₹ 25.50, Average of 2010-11 $ 1 = 25.70, 31.3.2011 $ 1 = ₹ 26.10, Average of 2011-12 $ 1 = ₹ 26.20, 31.3.2012, $ 1 = ₹ 26.40, Average of 2012-13 $ 1 = ₹ 36.50, 31.3.2013, $ 1 = ₹ 42.20.

Solution:

Statement showing the Translation of Fixed Assets and Depreciation

Particulars	2010-11 ₹	2011-12 ₹	2012-13 ₹
A Book Value in the beginning of the year	25,50,000	23,42,520	21,02,507
B *Add* : Adjustment for increase in Foreign Currency liabilities [Amount of outstanding Loan × (Closing Rate – Opening Rate)]	52,800	22,800	10,11,200
C Adjusted Book Value of Fixed Assets (A+B)	26,02,800	23,65,320	31,13,707
D *Less* : Depreciation on Adjusted Book Value (Adjusted Book Value/Remaining Useful life)	2,60,280	2,62,813	3,89,214
E Adjusted Book Value of Fixed Assets at the end (C–D)	23,42,520	21,02,507	27,24,493

Statement showing the Translation of Long-term Loan and Interest

Particulars	2010-11	2011-12	2012-13
A Outstanding Long-term Loan in the beginning of the year (in foreign currency)	$ 88,000	$ 76,000	$ 64,000
B *Less* : Principal portion of the installment paid (in foreign currency)	$ 12,000	$ 12,000	$ 12,000
C Outstanding Long-term Loan at the end of the year (in foreign currency) [A–B]	$ 76,000	$ 64,000	$ 52,000
D Outstanding Long-term Loan at the end of the year (in Indian Rupees) [O/s Long-term Loan (in foreign currency)×Closing Rate]	₹ 19,83,600	₹ 16,89,600	₹ 21,94,400
E Interest on outstanding Long-term Loan in the beginning (in foreign currency) [O/s Long-term Loan (in foreign currency) × 18%]	$ 15,840	$ 13,680	$ 11,520
F Interest on outstanding Long-term Loan in the beginning (in Indian Rupees) [Interest in foreign currency × Average Rate]	₹ 4,07,088	₹ 3,58,416	₹ 4,20,480

8.2 DEPARTMENTAL ACCOUNTS

Introduction

Departmental Accounts helps in identifying the performance of each department. Each department is considered to be an Activity Centre. It is a tool which helps management in decision-making.

Departmentation offers the following advantages—

a. **Proper Allocation :** Expenses that relate to a particular department are estimated on an exact basis. Hence, cost and profits of each department is estimated more accurately.

b. **Control :** Availability of separate cost and profit figures for each department facilitates control. Proper control and fixation of responsibility is easier.

c. **Proper absorption :** The processing times of different products in different departments may vary. Specific cost analysis on a department-wise basis facilitates scientific cost absorption and cost assignment. This provides the right platform for product-pricing decisions also.

Difference between Branch Account and Departmental Account

The main differences between a Branch Account and a Department Accounts are:

Sl. No.	Points	Branch Accounts	Departmental Accounts
1	Allocation of expenses	In case of branch accounting allocation of common expenses does not arise.	Allocation of common wealth is the fundamental consideration here.
2	Result of the operation	It shows that trading result of each individual branch.	It shows the trading result of each individual department.
3	Maintenance of accounts	Method of Branch Accounting depends on the nature and type of branch whether dependent or independent.	It is centrally maintained.
4	Types of accounting	It is practically a condensation of accounts.	It is a segment of accounts.
5	Control	It is not possible to control all branch by the H.O.	Effective control is possible by the departmental supervisors who is closely related and who is to keep a constant watch over the departments.

Bases of Apportionment of Expenses :

Nature of Expense	Treatment	Examples
Specific Charge	When a certain expense is **specifically incurred** for one department, it should be **charged in full** to that department only.	• Depreciation of machinery on value of machinery; • Insurance on stock on the value of stock.
Shared Common Expenses	When benefits of certain expenses are shared by all departments and are capable of **precise allocation,** they should be apportioned to all departments on an **appropriate and equitable basis.**	• Rent is apportioned based on Floor Space occupied by each department. • Lighting Expenses is apportioned basis of on the number of light points (or) on the basis of floor area. • Canteen subsidy on the basis of No. of workers.
General Expenses	Common expenses which are **not capable of accurate apportionment** to various departments are dealt with **judiciously,** based on facts and circumstances of each case.	• Administration Expenses like Office Salaries may be apportioned equally among all departments or alternatively debited to General P&L Account. • Selling and Distribution Expenses may be apportioned based on Sales ratio.

Illustration 25:

From the following Trial Balance, prepare Departmental Trading and Profit and Loss Account for the year ended 31.12.2013 and a Balance Sheet as at the date in the books of Sri S. Maity:

Particulars	Dr. ₹	Cr. ₹
Stock (1.1.2013):		
Dept. A	5,400	
Dept. B	4,900	
Purchases:		
Dept. A	9,800	
Dept. B	7,350	
Sales:		
Dept. A		16,900
Dept. B		13,520
Wages:		
Dept. A	1,340	
Dept. B	240	
Rent	1,870	
Salaries	1,320	
Lighting and Heating	420	
Discount Allowed	441	
Discount Received		133
Advertising	738	
Carriage Inward	469	
Furniture and Fittings	600	
Plant and Machinery	4,200	
Sundry Debtors	1,820	
Sundry Creditors		3,737
Capital		9,530
Drawings	900	
Cash in hand	32	
Cash at Bank	1,980	
	43,820	43,820

The following information is also provided:

Rent and Lighting and Heating are to be allocated between Factory and Office in the ratio of 3:2.

Rent, Lighting and Heating, Salaries and Depreciation are to be apportioned to A and B Depts. as 2:1.

Other expenses and incomes are to be apportioned to A and B Depts. on suitable basis.

The following adjustments are to be made:

Rent Prepaid ₹370; Lighting and Heating outstanding ₹180; Depreciation of Furniture and Fittings @ 10% p.a. and Plant and Machinery @ 10% p.a.

The Stock at 31.12.2012: Dept. A ₹2,748; Dept. B ₹2,401.

Solution:

In the books of Sri S. Maity

Departmental Trading and Profit & Loss Account for the year ended 31.12.2013

Dr. **Cr**

Particulars	Dept. A ₹	Dept. B ₹	Total ₹	Particulars	Dept. A ₹	Dept. B ₹	Total ₹
To Opening Stock	5,400	4,900	10,300	By Sales	16,900	13,520	30,420
,, Purchase	9,800	7,350	17,150	,, Closing	2,748	2,401	5,149
,, Wages	1,340	240	1,580	Stock			
,, Carriage Inwards (4:3)	268	201	469[1]				
,, Rent	600	300	900[6]				
,, Lighting and Heating	240	120	360[2]				
,, Gross Profit c/d	2,000	2,810	4,810				
	19,648	15,921	35,569		19,648	15,921	35,569
To Rent	400	200	600[6]	By Gross Profit b/d	2,000	2,810	4,810
,, Advertisement	410	328	738[4]				
,, Salaries (2:1)	880	440	1,320[5]				
,, Lighting and Heating	160	80	240[2]	,, Dis. Received (4 :3)	76	57	133[7]
,, Discount Allowed (on Sales)	245	196	441[3]	,, Net Loss	339	---	---
,, Dep. On (2:1)							
Plant & Machinery	280	140	420				
Furniture & Fixture	40	20	60				
,, Net Profit	---	1,463	1,124				
	2,415	2,867	4,943		2,415	2,867	4,943

Balance Sheet as at 31.12.2013

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital	9,530		Plant and Machinery	4,200	
Add: Net Profit	1,124		Less: Depreciation	420	3,780
	10,654		Furniture and Fittings	600	
Less: Drawings	900	9,754	Less: Depreciation	60	540
Sundry Creditors		3,737			
Outstanding Liabilities:			Closing Stock:		
Lighting and Heating		180	Dept. A	2,748	
			Dept. B	2,401	5,149
			Sundry Debtors		1,820
			Prepaid Rent		370
			Cash at Bank		1,980
			Cash in Hand		32
		13,671			13,671

Workings:

Allocation of Expenses and Incomes

Sl. No.	Expense/Income	Basis	Dept. A	Dept. B
1	Carriage Inward	Purchase (4:3)	=₹ 469 x 4/7 = ₹ 268	= ₹ 469 x 3/7 = ₹ 201
2	Lighting & Heating (₹ 420 + ₹ 180)	₹ 600 (Given)		
	Factory part = 600 x 3/5 =	360	= ₹ 360 x 2/3 = ₹ 240	= ₹ 360 x 1/3 = ₹ 120
	Office part = 600 x 2/5 =	240	= ₹ 240 x 2/3 = ₹ 160	= ₹ 240 x 1/3 = ₹ 80
3	Discount Allowed	= Sales	= ₹ 441 x (16900/30420) = ₹ 245	= ₹ 441 x (13520/30420) = ₹ 196
4	Advertisement	= Sales	= ₹ 738 x (16900/30420) = ₹ 410	= ₹ 738 x (13520/30420) = ₹ 328
5	Salaries	2 : 1	= ₹ 1,320 x (2/3) = ₹ 880	= ₹ 1,320 x (1/3) = ₹ 440
6	Rent ₹ 1,500 = (₹ 1,870 – ₹ 370)	2 : 1		
	Factory part = 1,500 x 3/5 = 900		= ₹ 900 x (2/3) = ₹ 600	= ₹ 900 x (1/3) = ₹ 300
	Office part = 1,500 x 2/5 =600	2 : 1	= ₹ 600 x (2/3) = ₹ 400	= ₹ 600 x (1/3) = ₹ 200
7	Discount Received	Purchase (4:3)	= ₹ 133 x (4/7) = ₹ 76	= ₹ 133 x (3/7) = ₹ 57

Illustration 26.

The Trading and Profit & Loss Account of Bindas Ltd. for the year ended 31st March is as under :

Particulars		Amount ₹	Particulars		Amount ₹
Purchases			**Sales**		
Transistors	(A)	1,60,000	Transistors	(A)	1,75,000
Tape Recorders	(B)	1,25,000	Tape Recorders	(B)	1,40,000
Spare parts for Servicing and			Servicing and Repair Jobs	(C)	35,000
Repair Job	(C)	80,000	Stock on 31st March		
			Transistors	(A)	60,100
Salaries and wages		48,000	Tape Recorders	(B)	20,300
Rent		10,800	Spare parts for servicing &		
Sundry Expenses		11,000	repair jobs	(C)	44,600
Net Profit		40,200			
		4,75,000			**4,75,000**

Prepare Departmental Accounts for each of the three Departments A, B and C mentioned above after taking into consideration the following :

(a) Transistors and Tape Recorders are sold at the Showroom. Servicing and Repairs are carried out at the Workshop.

(b) Salaries and wages comprise as follows: Showroom 3/4th and Workshop 1/4th

It was decided to allocate the Showroom Salaries and Wages in ratio 1:2 between Departments A and B.

(c) Workshop Rent is ₹ 500 per month. Showroom Rent is to be divided equally between Departments A and B.

(d) Sundry Expenses are to be allocated on the basis of the turnover of each Department.

Solution :

Departmental P&L Accounts for the year ended 31st March (Amount in ₹)

Dr. *Cr.*

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To Purchases	1,60,000	1,25,000	—	By Sales	1,75,000	1,40,000	—
To Spares	—	—	80,000	By Services	—	—	35,000
To Salary & Wages	12,000	24,000	12,000	By Closing Stock	60,100	20,300	44,600
To Rent	2,400	2,400	6,000	By Net Loss	—	—	19,500
To Sundry Expenses*	5,500	4,400	1,100				
To Net Profit	55,200	4,500					
	2,35,100	**1,60,300**	**99,100**		**2,35,100**	**1,60,300**	**99,100**

Note : Sundry Expenses are apportioned in the ratio of Turnover (5 : 4 : 1) i.e. 1,75,000 : 1,40,000 : 35,000.

Inter Departmental Transfer

Transfer made by one department to another may be recorded either:

- **At Cost Price; and**
- **At Invoice Price i.e., Market Based Price.**

At Cost Price

When transfers are made, Recipient Department should be debited at cost price and Transferring Department should be credited at Cost Price.

Illustration 27.

Make an appropriate entry for inter transfer of goods from one department to another.

Department A transferred goods for ₹30,000 to Department B.

Solution:

In the Books of...

Journal

Date	Particulars	L/F	Dr. Amount ₹	Cr. Amount ₹
?	Department Trading (B) A/c Dr.		30,000	
	To Department Trading (A) A/c			30,000
	(Goods are transferred to Department B from Department A.)			

At Invoice Price i.e., Provision for unrealized Profit.

In case of goods transfer from one department to another, no problem arises if all goods are sold within the year. On the other hand, problem arises where all goods are not sold. Under the circumstances, appropriate adjustments must be made against the unsold stock for ascertaining the correct profit or loss. As such, provision to be made for both opening stock and closing stock. The entries for this purpose are:

For Opening Stock Reserve:

Opening Stock Reserve A/c Dr.

To General Profit and Loss A/c

For Closing Stock Reserve:

General Profit and Loss A/c Dr.

To Closing Stock Reserve A/c

Illustration 28.

Department A sells goods to Department B at a profit of 25% on cost and to department C at 10% profit on cost. Department B sells goods to Department A and Department C at a profit of 15% and 20% on sales respectively. Dept. C charges 20% and 25% profit on cost and department A and department b respectively.

Department managers are entitled to 10% commission on net profit after eliminating unrealised profit on department sales being eliminated. Departmental profit after charging managers commission but before adjustment of unrealized profits are: Dept. A ₹ 72,000; Dept. B ₹ 54,000; and Dept. C ₹ 36,000. Stock lying at different departments at the end of the year are:

Particulars	Department A ₹	Department B ₹	Department C ₹
Transfer from Department A	---	30,000	22,000
Transfer from Department B	28,000	---	24,000
Transfer from Department C	12,000	10,000	---

Find out the correct departmental profit after charging manager's commission.

Solution:

Computation of correct Profit

Particulars	Department A ₹	Department B ₹	Department C ₹
Profit after charging manager's commission.	72,000	54,000	36,000
Add back: Manager's Commission @ 1/9th	8,000	6,000	4,000
	80,000	60,000	40,000
Less: Unrealised Profit on stock	8,000	9,000	4,000*
Profit before charging Manager's Commission	72,000	51,000	36,000
Less: Manager's Commission @10%	7,200	5,100	3,600
Correct profit after charging commission	64,800	45,900	32,400

Workings:

Computation of unrealized Profit on Stock

Particulars	Department A ₹	Department B ₹	Department C ₹	Total ₹
Department - A	---	30,000 x 1/5 = ₹ 6,000	22,000 x 1/11 = ₹ 2,000	8,000
Department - B	28,000 x 15/100 = ₹ 4,200	---	24,000 x 20/100 = ₹ 4,800	9,000
Department - C	12,000 x 1/6 = ₹ 2,000	10,000 x 1/5 = ₹ 2,000	---	4,000

Illustrations 29.

Snow White Ltd has two departments — Cloth and Readymade Clothes. Ready Made Clothes are made by the Firm itself out of cloth supplied by the Cloth Department at its usual selling price. From the following figures, prepare Departmental Trading and Profit and Loss Accounts for the year ended 31st March 2013.

Particulars	Cloth Department ₹	Readymade Clothes (RM) ₹
Opening Stock on 1st April, 2012	3,00,000	50,000
Purchases	20,00,000	15,000
Sales	22,00,000	4,50,000
Transfer to Readymade Clothes Department	3,00,000	—
Expenses - Manufacturing	—	60,000
Selling	20,000	6,000
Closing Stock on 31st March, 2013	2,00,000	60,000

The Stock in the Readymade Clothes Department may be considered as consisting of 75% Cloth and 25% other expenses. The Cloth Department earned Gross Profit at the rate of 15% during the year 2011-12.

General Expenses of the business as a whole came to ₹ 1,10,000.

Solution :

Departmental Trading and Profit and Loss A/c for the year ended 31st March 2013

Dr. ***Cr.***

Particulars	Cloth (₹)	RM (₹)	Total (₹)	Particulars	Cloth (₹)	RM (₹)	Total (₹)
To Opg. Stock	3,00,000	50,000	3,50,000	By Sales	22,00,000	4,50,000	26,50,000
To Purchases	20,00,000	15,000	20,15,000	By Tfr. to RM	3,00,000	—	3,00,000
To Tfr from Cloth Dept.	—	3,00,000	3,00,000	By Closing Stock	2,00,000	60,000	2,60,000
To Mfg. Exps.		60,000	60,000				
To Gross Profit	4,00,000	85,000	4,85,000				
	27,00,000	**10,000**	**32,10,000**		**27,00,000**	**5,10,000**	**32,10,000**
To Selling Exp.	20,000	6,000	26,000	By Gross Profit	4,00,000	85,000	4,85,000
To Profit c/d	3,80,000	79,000	4,59,000				
	4,00,000	**85,000**	**4,85,000**		**4,00,000**	**85,000**	**4,85,000**
To Gen. Exp.			1,10,000	By Profit b/d			4,59,000
To Stock Reserve (See Note below)			1,575				
To Net profit			**3,47,425**				
			4,59,000				**4,59,000**

Note 1 : Stock Reserve to be additionally provided is 7,200 – 5,625 = ₹ 1,575; calculated as under :

Particulars	On Opening Stock	On Closing Stock
Rate of GP on Sales in Cloth Dept	Given = 15%	4,00,000 ÷ 25,00,000 = 16%
Element of Cloth Stock in Readymade Clothes	75% of 50,000 = 37,500	75% of 60,000 = 45,000
Stock Reserve required to be maintained	37,500 × 15% = 5,625	45,000 × 16% = 7,200

Note 2: In this case, it is possible to ascertain the Reserve already created against Unrealised Profit in the Opening Stock. In the absence of information, the Reserve should be calculated on the difference in the Opening and Closing Stocks i.e. ₹ 10,000 in this question. Since the Closing Stock has increased, the Reserve calculated would be debited to P&L A/c. In case of decrease in Stocks, the Reserve would be credited to P&L A/c.

Illustration 30.

Samudra & Co, a Partnership Firm has three departments viz. K, L, M which are under the charge of the Partners B, C and D respectively. The following Consolidated P&L Account is given below :

Dr. **Profit and Loss Account** ***Cr.***

Particulars	Amount ₹	Particulars	Amount ₹
To Opening Stocks (Note 1)	81,890	By Sales (Note 7)	4,00,000
To Purchases (Note 2)	2,65,700	By Closing Stocks (Note 8)	89,000
To Salaries and Wages (Note 3)	48,000	By Discounts Received (Note10)	800
To Rent Expenses (Note 4)	10,800		
To Selling Expenses (Note 5)	14,400		
To Discount Allowed (Note 5)	1,200		
To Depreciation (Note 6)	750		
To Net Profit for the year	67,060		
	4,89,800		**4,89,800**

From the above Account and the following additional information, prepare the Departmental P&L Accounts for the year ended 31st March, 2013.

1. Break up of Opening Stock Department wise is: K - ₹ 37,890; L - ₹ 24,000 and M - ₹ 20,000.
2. Total Purchases were as under: K - ₹ 1,40,700; L - ₹ 80,600; M - ₹ 44,400.
3. Salaries and Wages include ₹ 12,000 wages of Department M. The balance Salaries should be apportioned to the three departments as 4:4:1.
4. Rent is to be apportioned in the ratio of floor space which is as 2:2:5.
5. Selling Expenses and Discount Allowed are to be apportioned in the ratio of Turnover.
6. Depreciation on assets should be equally charged to the three departments.
7. Sales made by the three departments were: K - ₹ 1,80,000; L - ₹ 1,30,000 and M - ₹ 90,000.
8. Break up of Closing Stock Department wise is: K - ₹ 45,100; L - ₹ 22,300 and M - ₹ 21,600. The Closing Stock of Department M includes ₹ 5,700 goods transferred from Department K. However, Opening Stock does not include any goods transferred from other departments.

9. Departments K and L sold goods worth ₹ 10,700 and ₹ 600 respectively to Department M.
10. Discounts received are traceable to Departments K, L and M as ₹ 400; ₹ 250 and ₹ 150 respectively.
11. Partners are to share the profits as under: (a) 75% of the Profits of Departments K, L and M to the respective Partner in Charge, (b) Balance Profits to be credited as 2:1:1.

Solution :

1. Departmental P&L Accounts for the year ended 31st March, 2013

Dr. **Cr.**

Particulars	K (₹)	L (₹)	M (₹)	Particulars	K (₹)	L (₹)	M (₹)
To Opening Stock	37,890	24,000	20,000	By Sales	1,80,000	1,30,000	90,000
To Purchases	1,40,700	80,600	44,400	By Transfer	10,700	600	—
To Inter-Dept Trf	—	—	11,300	By Closing Stock	45,100	22,300	21,600
To Wages	—	—	12,000				
To Gross Profit c/d	57,210	48,300	23,900				
	2,35,800	**1,52,900**	**1,11,600**				
To Salaries (4:4:1)	16,000	16,000	4,000		**2,35,800**	**1,52,900**	**1,11,600**
To Rent (2:2:5)	2,400	2,400	6,000	By Gross Profit b/d	57,210	48,300	23,900
To Selling Exp	6,480	4,680	3,240	By Discounts			
To Disc. (18:13:9)	540	390	270	Received			
To Depreciation	250	250	250		400	250	150
To Net Profit c/d	31,940	24,830	10,290				
	57,610	**48,550**	**24,050**		**57,610**	**48,550**	**24,050**

2. Computation of Stock Reserve

From the above profits, Stock Reserve should be eliminated on the Closing Stock.

- GP Rate in Department K = (57,210 x 100)/1,90,700 = 30%.
- Stock Reserve = 30% on ₹ 5,700 = ₹ 1,710.

Dr. **3. Profit and Loss Appropriation Account** ***Cr.***

Particulars		Amount ₹	Particulars	Amount ₹
To Stock Reserve		1,710	By Profit b/d	67,060
To Profits transferred to Capital:			(31,940 + 24,830 + 10,290)	
B : 75% of 31,940	23,955			
C : 75% of 24,830	18,623			
D : 75% of 10,290	7,718	50,296		
To balance profits trfd in 2: 1: 1				
B : 50% of 15,054	7,527			
C : 25% of 15,054	3,763			
D : 25% of 15,054 (bal.fig)	3,764	15,054		
		67,060		**67,060**

Illustration 31.

Anand Ltd, has 3 departments X, Y and Z The following information is provided:

Particulars	X (₹)	Y (₹)	Z (₹)
Opening Stock	3,000	4,000	6,000
Consumption of direct materials	8,000	12,000	—
Wages	5,000	10,000	—
Closing Stock	4,000	14,000	8,000
Sales	—	—	34,000

Stocks of each Department are valued at cost to the Department concerned. Stocks of X are transferred to Y at a margin of 50% above Department cost. Stocks of Y are transferred to Z at a margin of 10% above departmental cost.

Other expenses were :	**(₹)**
Salaries	2,000
Printing and Stationery	1,000
Rent	6,000
Interest paid	4,000
Depreciation	3,000

Allocate expenses in the ratio of Departmental Gross Profits. Opening figures of reserves for unrealised profits on departmental stocks were: Department Y- ₹ 1,000; Department Z- ₹ 2,000.

Prepare Departmental Trading and Profit and Loss Account for the year.

Solution :

Dr. **1. Departmental Trading Account for the year ended** ***Cr.***

Particulars	X (₹)	Y (₹)	Z (₹)	Total	Particulars	X (₹)	Y (₹)	Z (₹)	Total
To Opening Stock	3,000	4,000	6,000	13,000	By Internal Transfer	18,000	33,000	—	51,000
To Direct Material	8,000	12,000	—	20,000	By Sales	—	—	34,000	34,000
To Wages	5,000	10,000	—	15,000	By Closing Stock	4,000	14,000	8,000	26,000
To Intl. Transfer	—	18,000	33,000	51,000					
To Gross Profit	**6,000**	**3,000**	**3,000**	**12,000**					
	22,000	**47,000**	**42,000**	**1,11,000**		**22,000**	**47,000**	**42,000**	**1,11,000**

Dr. **2. Departmental Profit and Loss Account for the year ended** **Cr.**

Particulars	X (₹)	Y (₹)	Z (₹)	Total (₹)	Particulars	X (₹)	Y (₹)	Z (₹)	Total (₹)
To Salaries	1,000	500	500	2,000	By Gross Profit b/d	6,000	3,000	3,000	12,000
To Printing & Stationary	500	250	250	1,000	By Net loss	**2,000**	**1,000**	**1,000**	**4,000**
To Rent	3,000	1,500	1,500	6,000					
To Interest paid	2,000	1,000	1,000	4,000					
To Depreciation	1,500	750	750	3,000					
	8,000	**4,000**	**4,000**	**16,000**		**8,000**	**4,000**	**4,000**	**16,000**

3. Calculation of Unrealised Profit on Closing Stock of Dept Y

Particulars	Department Y
Value of Closing Stock as given above	14,000
Total Cost of the Department	12,000 + 10,000 + 18,000 = 40,000
Cost of Internal Transfer in above	18,000
Value of Transferred Material in Closing Stock	14,000 × 18,000 / 40,000 = 6,300
Unrealised Profit of Dept X included in above	6,300 × 50/150 = 2,100

4. Calculation of Unrealised Profit on Closing Stock of Dept Z

Particulars		Department Z
Value of Closing Stock as given above		8,000
Profits of Department Y included in above	10% Margin = 8,000 x 10/110	= 727
Profits of Department X included in above	(8,000 – 727)×18,000/40,000×50/150 =	1,091
Total Unrealised Profit included in Dept Z Stock		1,818

Dr. **5. Adjustment of Reserves on Opening and Closing Stocks** ***Cr.***

Particulars	₹	Particulars	₹
To Net Loss b/d	4,000	By Reserve on Opening Stock (1000 + 2000)	3,000
To Reserve on Closing Stock (2100 + 1818)	3,918	By Net Loss after adjustment of Reserves	4,918
	7,918		**7,918**

Illustration 32.

Pooma Ltd. has 2 departments M & S. From the following particulars, prepare Departmental Trading Account & Consolidated Trading Account for the year ended 31st March, 2013.

Particulars	M (₹)	S (₹)
Opening Stock	20,000	12,000
Purchases	92,000	68,000
Carriage Inwards	2,000	2,000
Wages	12,000	8,000
Sales (excluding inter departmental transfers)	1,40,000	1,12,000
Purchased Goods transferred		
By S to M	10,000	—
By M to S	—	8,000
Finished Goods transferred		
By S to M	35,000	—
By M to S	—	40,000
Return of Finished Goods		
By M to S	10,000	—
By S to M	—	7,000
Closing Stock		
Purchased Goods	4,500	6,000
Finished Goods	24,000	14,000

Purchased Goods have been transferred at their respective departmental Purchase Cost & Finished Goods at Departmental Market Price. 20% of Finished Stock (Closing) at each Department represented Finished Goods received from the other Department.

Solution :

1. Departmental Trading, Profit & Loss Account for the year ended 31st March, 2013

Dr. *Cr.*

Particulars	M (₹)	S (₹)	Particulars	M (₹)	S (₹)
To Opening Stock	20,000	12,000	By Sales	140,000	112,000
To Purchases	92,000	68,000	By Transfer:		
			Purchased Goods	8,000	10,000
			Finished Goods	35,000	40,000
			By Closing Stock Purchased		
To Transfer :			Goods	4,500	6,000
Purchased Goods	10,000	8,000	Finished Goods out of t/f	4,800	2,800
Finished Goods	40,000	35,000	Balance	19,200	11,200
To Wages	12,000	8,000	By Return of Finished Goods	10,000	7,000
To Carriage Inwards	2,000	2,000			
To Return of Finished Goods	7,000	10,000			
To Gross Profit	38,500	46,000			
	2,21,500	**1,89,000**		**2,21,500**	**1,89,000**

2. Calculation of Gross Profit Ratio

Particulars	M (₹)	S (₹)
Sales	140,000	112,000
Add : Transfer of Finished Goods	35,000	40,000
Less : Return of Finished Goods	(7,000)	(10,000)
Net Sales [A]	**168,000**	**142,000**
Gross Profit [B] as calculated below	38,500	46,000
Gross Profit Ratio [B ÷ A]	**22.9%**	**32.4%**

3. Consolidated Trading Account for the year ended 31st March, 2013

Dr. *Cr.*

Particulars	Amount (₹)	Particulars		Amount (₹)
To Opening Stock (20,000+12,000)	32,000	By Sales (1,40,000 + 1,12,000)		2,52,000
To Purchases (92,000 + 68,000)	160,000	By Closing Stock		
To Wages (12,000 + 8,000)	20,000	By Purchase Goods (4,500+6,000)	10,500	
To Carriage Inwards (2,000+2,000)	4,000	By Finished Goods (24,000+14,000)	38,000	48,500
To Stock Reserve:				
[24,000 × 20%] × 32.4%	1,555			
[14,000 × 20%] × 22.9%	641			
To Net Profit	82,304			
	3,00,500			**3,00,500**

Illustration 33.

Khushi & Co has 2 departments A & B. Department A sells goods to Department B at normal selling prices. From the following particulars prepare Departmental Trading & Profit & Loss Account for the year ended 31st March, 2013 & also ascertain the Net Profit to be transferred to Balance Sheet.

Particulars	A (₹)	B (₹)
Opening stock	NIL	1,00,000
Purchases	2,00,000	23,00,000
Goods from Department B	7,00,000	—
Wages	1,60,000	1,00,000
Travelling Expenses	1,40,000	10,000
Closing stock at cost to the Department	1,80,000	5,00,000
Sales	15,00,000	23,00,000
Printing & Stationery	16,000	20,000

The following expenses incurred for the both departments were not apportioned between the departments :

Particulars	Amount (₹)
Salaries	2,70,000
Advertisement Expenses	90,000
General Expenses	8,00,000

Depreciation should be charged at 25% on the machinery value of ₹ 48,000. Advertisement Expenses are to be apportioned in the turnover ratio, Salaries in 1:2 ratio & Depreciation in 1:3 ratio between Departments A & B. General Expenses are to be apportioned in 1:3 ratio.

Solution :

1. Departmental Trading, P&L Account of Khushi & Co for the year ended 31st March, 2013

Dr. *Cr.*

Particulars	A (₹)	B (₹)	Particulars	A (₹)	B (₹)
To Opening Stock		1,00,000	By Sales	15,00,000	23,00,000
To Purchases	2,00,000	23,00,000	By Internal Transfer	—	7,00,000
To Wages	1,60,000	1,00,000	By Closing Stock	1,80,000	5,00,000
To Internal Transfer	7,00,000	—			
To Gross Profit	6,20,000	10,00,000			
	16,80,000	**35,00,000**		**16,80,000**	**35,00,000**
To Traveling Expenses	1,40,000	10,000			10,00,000
To Printing & Stationery	16,000	20,000	By Gross Profit b/d	6,20,000	
To Salaries	90,000	1,80,000			
To Advertisement Exp.	35,526	54,474			
To General Expenses	2,00,000	6,00,000			
To Depreciation (1:3)	3,000	9,000			
To Net Profit	1,35,474	1,26,526			
	6,20,000	**10,00,000**		**6,20,000**	**10,00,000**

Note :

1. GP Ratio of Department B = Gross Profit * Total Sales = 10,00,000 ÷ (23,00,000 + 7,00,000) = 33.33%
2. Advertisement Expenses are apportioned in the ratio of External Sales i.e. 15 : 23.

2. Computation of Unrealised Profit on Closing Stock :

Particulars	Department A
Value of Closing Stock as given above	1,80,000
Total Material Cost of Department A	2,00,000 + 7,00,000 = 9,00,000
Material Cost of Internal Transfer in above	7,00,000
Value of Transferred Material in Closing Stock	1,80,000 × 7,00,000/9,00,000 = 1,40,000
Unrealised Profit of Dept B included in above	1,40,000×1/3 = 46,667
(GP Ratio of Department B = 33.33% or 1/3rd)	

Dr. **3. Profit & Loss Account (after adjustment of Unrealised Profit)** *Cr.*

Particulars	Amount (₹)	Particulars	Amount (₹)
To Stock Reserve (as calculated above)	46,667	By Net Profit b/d	2,62,000
To Net Profit c/d to Balance Sheet	2,15,333	[1,26,526+1,35,474]	
	2,62,000		**2,62,000**

Illustration 34.

Department X sells goods to Department Y at a profit of 25% on cost & to Department Z at a profit of 10% on cost. Department Y sells goods to X & Z at a profit of 15% & 20% on sales, respectively.

Department Z charges 20% & 25% profit on cost to Department X & Y, respectively.

Department Managers are entitled to 10% Commission on Net Profit subject to Unrealised profits on Departmental sales being eliminated.

Departmental profits after charging manager's commission, bur before adjustment of unrealised profits are : X = ₹ 36,000; Y = ₹ 27,000; Z = ₹ 18,000

Stocks lying at different departments at the year end are as under :

Particulars	X (₹)	Y (₹)	Z (₹)
Transfer from Department X	—	15,000	11,000
Transfer from Department Y	14,000	—	12,000
Transfer from Department Z	6,000	5,000	—

Find out the correct Departmental Profits after charging Managers' Commission.

Solution :

1. Computation of Unrealised Profits

Particulars of transfer to	Department X (₹)	Department Y (₹)	Department Z (₹)	Total (₹)
From Department X to Y and Z at 25% and 10% of Cost	Nil	15,000 × 25/125 = 3,000	11,000 × 10/110 = 1,000	4,000
From Department Y to X and Z at 15% and 20% of Sales	14,000 × 15/100 = 2,100	Nil	12,000 × 20/100 = 2,400	4,500
From Department Z to X and Y at 20% and 25% of Cost	6,000×20/120 = 1,000	5,000×25/125 = 1,000	Nil	2,000

2. Computation of Correct Departmental Profits after charging Manager's Commission correctly

Particulars	Department X (₹)	Department Y (₹)	Department Z (₹)
Profits after charging Manager's Commission	36,000	27,000	18,000
Add : Wrong Commission = 10% of Profits = 1/10 on Profits before charging commission = 1/9 on Profits after charging commission	1/9 × 36,000 = 4,000	1/9 × 27,000 = 3,000	1/9 × 18,000 = 2,000
Profits before charging commission	40,000	30,000	20,000
Less : Unrealised Profits i.e. Stock Reserve	4,000	4,500	2,000
Profits qualifying for commission	36,000	25,500	18,000
Less : Commission at 10% of above	3,600	2,550	1,800
Correct Profits after charging commission	32,400	22,950	16,200

Illustration 35.

The following details are available in respect of a business for a year.

Department	Opening Stock	Purchase	Sales
X	120 units	1,000 units	1,020 units at ₹ 20.00 each
Y	80 units	2,000 units	1,920 units at ₹ 22.50 each
Z	152 units	2,400 units	2,496 units at ₹ 25.00 each

The total value of purchases is ₹ 1,00,000. It is observed that the rate of Gross Profit is the same in each department. Prepare Departmental Trading Account for the above year.

Solution :

1. Computation of Closing Stock Quantity (in units)

Particulars	X	Y	Z
Opening Stock	120	80	152
Add: Purchases	1,000	2,000	2,400
Less : Units Sold	(1,020)	(1,920)	(2,496)
Closing Stock	**100**	**106**	**56**

2. Computation of Gross Profit Ratio

We are informed that the GP Ratio is the same for all departments. Selling Price is given for each department's products but the Sale Quantity is different from that of Purchase Quantity. To find the Uniform GP Rate, the sale value of Purchase Quantity should be compared with the Total Cost of Purchase, as under. Assuming all purchases are sold, the sale proceeds would be

Department X	1,000 units @ ₹ 20.00	20,000
Department Y	2,000 units @ ₹ 22.50	45,000
Department Z	2,400 units @ ₹ 25.00	60,000
Total Sale Value of Purchase Quantity	**125,000**	
Less : Cost of Purchase	1,00,000	
Gross Profit Amount	**25,000**	
Gross Profit Ratio	25,000 ÷ 1,25,000	20% of Selling Price

3. Computation of Profit and Cost for each article

Department	Selling Price	Profit at 1/5 of SP	Cost = Sales – Profit
Department X	₹ 20.00	1/5 of ₹ 20.00 = 4.00	₹ 16.00
Department Y	₹ 22.50	1/5 of ₹ 22.50 = 4.50	₹ 18.00
Department Z	₹ 25.00	1/5 of ₹ 25.00 = 5.00	₹ 20.00

Dr. **4. Departmental Trading Account for the year ended...** ***Cr.***

Particulars	X (₹)	Y (₹)	Z (₹)	Total (₹)	Particulars	X (₹)	Y (₹)	Z (₹)	Total (₹)
To Op. stock	1,920	1,440	3,040	6,400	By Sales	20,400	43,200	62,400	126,000
To Purchase	16,000	36,000	48,000	100,000	By Cl. stock	1,600	2,880	1,120	5,600
To Gross Profit	4,080	8,640	12,480	25,200					
	22,000	46,080	63,520	131,600		22,000	46,080	63,520	131,600

Opening and Closing Stocks are valued at Cost as indicated in WN 3 above. Sale Amount in the Trading Account is computed for the Sale Quantity only. Gross Profit is calculated at 20% of Sale Value.

Illustration 36.

Anumod Ltd. is a retail store having 2 Departments P and Q. The Company maintains a Memorandum Stock Account & Memorandum Mark Up Account for each of the Departments. Supplies issued to the Departments are debited to the Memorandum Stock Account of the Department at Cost plus Mark Up, and Departmental Sales are credited to this Account. The Mark Up on supplies issued to the Departments is credited to the Mark Up Account for the Department. When it is necessary to reduce the Selling Price below the Normal Selling Price, i.e. Cost plus Mark Up, the reduction (Mark Down) is entered in the Memorandum Stock Account & Mark Up Account. Department P has a mark up of 33-1/3% on Cost, and Department Q has a mark-up of 50% on cost.

The following information has been extracted from the records of the Company for a year ended 31st December, 2013.

Particulars	P (₹)	Q (₹)
Opening Stock (at Cost) (as on 1st January, 2013)	24,000	36,000
Purchases	162,000	190,000
Sales	210,000	285,000

(i) Opening Stock of Department P includes goods on which the Selling Price has been marked down by ₹ 510. These goods were sold in January at the reduced Selling Price.

(ii) Certain goods purchased during the year for ₹ 2,700 for Department P, were transferred during the year to Department Q & sold for ₹ 4,500. Purchases & Sales are recorded in the Purchases of Department P & the Sales of Department Q respectively, but no entries have been made in respect of the transfer.

(iii) Goods purchased during the year were marked down as follows :

Particulars	P (₹)	Q (₹)
Cost	8,000	21,000
Mark down	8 0 0	4,100

At the end of the year there were some items in the stock of Department Q, which had been marked down to ₹ 2,300. With this exception, all goods marked down during the year were sold during the year at reduced prices.

4. During stock-taking at the end of the year, goods which had cost ₹ 240 were found to be missing in Department P. It was determined that loss should be regarded as irrecoverable.
5. The Closing Stock in both Departments are to be valued at Cost for the purpose of the annual accounts.

Prepare for the year ended 31st December the following accounts - (a) Trading Account; (b) Memorandum Stock Account and (c) Memorandum Mark Up Account.

Solution :

In the books of Anumod Ltd.

Dr. **1. Memorandum Stock Account** *Cr.*

Particulars	P (₹)	Q (₹)	Particulars	P (₹)	Q (₹)
To Balance b/d (given cost + 33-1/3% & 50% mark up)	32,000	54,000	By Balance b/d (mark down - given)	510	
To Purchases (given)			By Sales (given)	210,000	285,000
To Memorandum Mark Up	162,000	190,000	By Internal	2,700	—
(33-1/3% & 50% on pur.)	54,000	95,000	Transfer -per contra		
To Internal Transfer - per contra			By Memorandum Mark Up (Mark up on Transfer)	900	—
To Memorandum Mark Up (50% on Internal Tfr)	—	2,700	By Memorandum Mark Up (Mark Down - given)	800	4,100
To Memorandum Mark Up (on Marked Down Goods still in stock - See **Note 1)**	—	1,350	By Abnormal Loss-Cost transferred to P & L A/c	240	—
			By Memorandum Mark Up (Mark up on Stock Lost)	80	—
	—	344	By Balance c/d (Closing Stock - balancing figure)	32,770	54,294
	248,000	**343,394**		**248,000**	**343,394**

Note 1 : Mark Down in Unsold Stock of Department Q

$$\frac{\text{Total Mark down x Value of Stock}}{\text{Value of Mark down goods}} = \frac{4{,}100 \times 2{,}300}{27{,}400^{*}} = ₹\ \mathbf{344}$$

* Value of Mark Down Goods =

Cost = ₹ 21,000

Add: Normal Mark Up 50%		₹ 10,500	
Less: Amount Marked Down	=	₹ 4,100	(given)
	=	**₹ 27,400**	

Note 2 : Valuation of Closing Stack at cost :

Department	P (₹)	Q (₹)
Closing Stock at Invoice Price as per Memorandum Stock A/c	32,770	54,294
Closing Stock at Cost after reducing 1/3 and 1/2 on cost = 1/4 and 1/3 on the Invoice Price respectively	32,770 – 1/4 of 32,770 thereon = 24,578	54,294 - 1/3 of 54,294 thereon = **36,196**

Dr. **2. Trading Account for the year ended 31st December, 2013** *Cr.*

Particulars	P (₹)	Q (₹)	Particulars	P (₹)	Q (₹)
To Opening Stock	24,000	36,000	By Sales	210,000	285,000
To Purchases	162,000	190,000	By Internal Transfer	2,700	—
To Internal Transfer	—	2,700	By Abnormal Loss	2 4 0	—
To Gross Profit	51,518	92,496	By Closing Stock (Note 2)	24,578	36,196
	237,518	**321,196**		**237,518**	**321,196**

Dr. **3. Memorandum Mark Up Account** *Cr.*

Particulars	P (₹)	Q (₹)	Particulars	P (₹)	Q (₹)
To Balance b/d (Mark Down-given - per contra)	510	—	By Balance b/d (33-1/3% and 50% on cost given)	8,000	18,000
To Memorandum Stock A/c (Mark up on Transfer)	900		By Memorandum Stock (Mark Up on Purchase)	54,000	95,000
To Memorandum Stock A/c (Mark Down - given)	800		By Memorandum Stock (Mark Up on Int. transfer)		1,350
To Memorandum Stock A/c (Mark up on Goods Lost) still in stock)		4,100	By Memorandum Stock A/c (marked down goods		344
To Gross Profit (as above)	80	—			
To Balance c/d (bal. fig.)	51,518	92,496			
	8,192	18,098			
	62,000	**1,14,694**		**62,000**	**1,14,694**

4. Confirmation / Verification of Gross Profit

Department	P (₹)	Q (₹)
Sales (given)	210,000	285,000
Add back : Reduction/Mark down	(510+800) = 1,310	(4,100-344) = 3,756
Total	211,310	288,756
Normal Gross Profit at 1/4 and 1/3 of above	(1/4) = 52,828	(1/3) = 96,252
Less : Reduction/Mark down	1,310	3,756
Gross Profit (as per Memo Mark Up A/c)	**51,518**	**92,496**

Illustration 37.

X Limited is a retail organisation with several departments. Goods supplied to each department are debited to a Memorandum Departmental Stock Account at cost, plus fixed percentage (make-up) to give the normal selling price. The mark up is credited to a Memorandum Departmental "Mark-up Account". Any reduction in selling prices (mark-down) will require adjustment in the stock account and in mark- up account. The mark up for Department A for the last three years has been 40%. Figures relevant to Department A for the year ended 31st Dec. 2013 were as follows :

Stcok 1st January 2013 at Cost, ₹ 80,000, Purchases at Cost ₹ 1,80,000, Sales ₹ 3,20,000.

It is further ascertained that :

(a) Goods purchased in the period were marked down by ₹ 1,400 from a cost of ₹ 16,000. Marked-down stock costing ₹ 4,000 remained unsold on 31st December 2013.

(b) Stock shortages at the year end, which had cost ₹ 1,200 were to be written off.

(c) Stock at 1st Jan. 2013 including goods costing ₹ 8,200 had been sold during the year and has been mark down in the selling price by ₹ 740. The ramaining stock had been sold during the year.

(d) The departmental closing stock is to be valued at cost subject to adjustments for mark-up and mark-down.

Required : Prepare (i) A Departmental Trading Account (ii) A Memorandum Stock Account (iii) A Memorandum Mark-up Account for the year 2013.

Solution :

(i) Departmental Trading Account

Dr. *for the year ended 31st December, 2013* *Cr.*

Particulars	Amount ₹	Particulars	Amount ₹
To Opening Stock	80,000	By Sales	3,20,000
To Purchases	1,80,000	By Sortage	1,200
To Gross Profit c/d	90,150	By Closing stock	
		(₹ 40,180 – ₹ 11,230)	28,950
	3,50,150		**3,50,150**

Dr. **(ii) Memorandum Departmental Stock Account (At Selling Price)** *Cr.*

Particulars	Amount ₹	Particulars	Amount ₹
To Balance b/d (₹ 80,000 + ₹ 32,000)	1,12,000	By Profit & Loss A/c (Cost of Shortage)	1,200
To Purchases (₹ 1,80,000 + ₹ 72,000)	2,52,000	By Memorandum Departmantal Mark-up A/c (Load on Shortage)	480
		By Mark-up A/c (Mark Down in Current Purchases)	1,400
		By Debtors A/c (Sales)	3,20,000
		By Mark-up A/c (Mark Down on Opening Stock)	740
		By Balance c/d	40,180
	3,64,000		3,64,000

Dr. **(iii) Memorandum Departmental Mark up Account** Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To Memorandum Departmental Stock A/c (₹ 1,200×40/100)	480	By Balance b/d (₹ 1,12,000×40/140)	32,000
To Memorandum Departmental Stock A/c	1,400	By Memorandum Departmental Stock A/c (₹ 2,52,000×40/140)	72,000
To Memorandum Departmental Stock A/c	740		
To Gross Profit transferred to Profit & Loss A/c	90,150		
To Balance c/d [(₹ 40,180+₹ 350)×40/140 – (₹ 350)]	11,230		
	1,04,000		1,04,000

Working Note :

(i) Calculation of Cost of sales ₹

a.	Sales as per Books	3,20,000
b.	Add : Mark-down in opening stock (given)	7 4 0
c.	Add : Mark-down in sales out of current Purchases (₹ 1,400×12,000/16,000)	1,050
d.	Value of sales if there was no mark-down (a+b+c)	3,21,790
e.	Less : Gross Profit (40/140 of ₹ 3,21,790) subject to Mark Down (₹ 740 + ₹ 1,050)	91,940
f.	Cost of sales (d – e)	2,29,850

(ii) Calculation of Closing Stock ₹

a.	Opening Stock	80,000
b.	Add : Purchases	1,80,000
c.	Less : Cost of Sales	2,29,850
d.	Less : Shortage	1,200
e.	Closing Stock (a + b – c – d)	28,950

Illustration 38.

X Ltd., has a factory with two manufacturing Departments '*X*' and '*Y*'. Part of the output of Department *X* is transferred to Department *Y* for further processing and the balance is directly transferred to selling Department. The entire production of Department *Y* is directly transferred to the selling Department. Inter departmental stock transfers are made as follows :

X Department to *Y* Department at 33 1/3% over Departmental Cost.

X Department to selling department at 50% over Departmental Cost.

Y Department to selling department at 25% over Departmental Cost.

The following information is given for the year ended 31st March, 2013.

Particulars	Detp. X		Dept. Y		Selling Dept.	
	Units	₹	Units	₹	Units	₹
Opening Stock of Finished Goods	60	60,000	20	40,000	50	1,28,000
Opening Stock of Raw Materials	–	–	–	–	–	–
Raw material Consumed	–	1,82,000	–	20,000	–	–
Labour Charges	–	70,000	–	32,000	–	–
Sales	–	–	–	–	120	4,80,000
Closing Stock of Finished Goods	40	48,000	50	–	60	–

Out of the total transfer by *X* Department, 30 units were transferred to selling department, while the reamining to Department *Y*. The per unit material and labour consumption in *X* Department on production to be transferred directly to selling department is 300 per cent of the labour and material consumption on units transferred to *Y* Department. General Administration expenses ₹ 80,000.

Required : Prepare Departmental Profit and Loss Account and General Profit and Loss Account for the year ended 31.3.2013.

Solution :

Departmental Profit and Loss Account

Dr. **for the year ended 31st March, 2013** ***Cr.***

Particulars	X Dept.		Y Dept.		Selling Dept.		Particulars	X Dept.		Y Dept.		Sell Dept.	
	Qty.	₹	Qty.	₹	Qty.	₹		Qty.	₹	Qty.	₹	Qty.	₹
To Opening stock	60	60,000	20	40,000	50	1,28,000	By Stock t/f	160	3,70,000*	100	2,50,000	—	—
To Raw Material consumed		1,82,000	—	20,000	—	—	By Sales	—	—	—	—	120	4,80,000
To Units produced	140	—	—	—	—	—	By Closing Stock	40	48,000	50	1,00,000	60	1,80,000
To Labour Charges		70,000	—	32,000	—	—							
To Stock Transferred From *X* Dept.			130	2,08,000	30	1,62,000							
To Stock Transferred From Y Dept.					100	2,50,000							
To Departmental Profit t/f to General P & L A/C		1,06,000	—	50,000	—	1,20,000							
	200	4,18,000	150	3,50,000	180	6,60,000		200	4,18,000	150	3,50,000	180	6,60,000

* [₹ 2,08,000 + ₹ 1,62,000 = ₹ 3,70,000]

General Profit and Loss Account

Dr. **for the year ended 31st March, 2013** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To General Adm. Expenses	80,000	By Profit transferred from :	
To Stock Reserve for Closing Stock :		X Dept.	1,06,000
on Dept. Y	12,000	Y Dept.	50,000
on Selling Dept.	18,175	Selling Dept.	1,20,000
To Net profit	1,65,825		
	2,76,000		2,76,000

Working Notes :

(a) Selling Department

Dr. *Cr.*

Particulars	Units	Particulars	Units
To Opening Stock	50	By Sales	120
To T/f from X Dept.	30	By Closing Stock	60
To T/f from Y Dept. (Balancing figure)	100		
	180		180

(b) *Y* Department

Dr. *Cr.*

Particulars	Units	Particulars	Units
To Opening Stock	20	By T/f to Selling Department	100
To T/f from X Dept.	130	By Closing Stock	50
	150		150

(c) *X* Department

Dr. *Cr.*

Particulars	Units	Particulars	Units
To Opening Stock	60	By T/f to Selling Dept.	30
To Production (Balancing figure)	140	By T/f to Y Dept.	130
		By Closing Stock	40
	200		200

(d) Total Equivalent units produced in *X* Dept. in terms of those t/f to *Y* Dept.

= Equivalent units of those t/f to Sell Department + t/f to Y Department + Closing Stock.

= $(30 \times 300/100) + 130 + 40 = 260$

(e) Calculation of Transfer Prices and Closing Stock.

Particulars	X Dept. ₹	Y Dept. ₹	Selling Dept. ₹
A. Cost of Opening Stock	60,000	40,000	1,28,000
B. *Add* : Cost of Raw Materials Consumed	1,82,000	20,000	—
C. *Add* : Labour Charges	70,000	32,000	—
D. *Add* : T/f from X Dept.	—	2,08,000	1,62,000
E. *Add* : T/f form Y Dept.	—	—	2,50,000
F. Total Cost (A+B+C+D+E)	3,12,000	3,00,000	5,40,000
G. Equivalant Units	260	150	180
H. Average Cost per Equivalent Unit (F/G)	1,200	2,000	3,000
I. Transfer Price of 130 Units t/f to Dept. Y			
(a) Cost of 130 Units (130 × ₹ 1,200)	1,56,000		
(b) *Add* : Profit element @ 33-1/3%	52,000		
	2,08,000		
J. Transfer Price of Units t/f to Selling Dept.			
(a) Cost of Units t/f	1,08,000*	2,00,000	–
(b) *Add* : Profit element	54,000	50,000	–
	1,62,000	2,50,000	–
K. Closing Stock	48,000 (40 × ₹ 1,200)	1,00,000 (50 × ₹ 2,000)	1,80,000 (60 × ₹ 3,000)

* [₹ 1,200 × (30 × $\frac{300}{100}$)]

(f) Unrealised Profit on Increase in Closing Stock of Y Dept. (₹ 1,00,000 – ₹ 40,000)

(i) Current Cost incurred by Dept. Y

= ₹ 20,000 + ₹ 32,000 + ₹ 2,08,000 = ₹ 2,60,000

(ii) Profit charged by Dept. X included in above (₹ 2,08,000 × 1/4) = ₹ 52,000

(iii) Profit included in Increase in Closing Stock.

= (₹ 52,000 × ₹ 60,000/₹ 2,60,000) = ₹ 12,000

(g) Profit Included in output transferred by Y Deptt. to Selling Dept.

(i) Transfer Price = ₹ 2,50,000

(ii) Profit of Dept. Y included in Above (₹ 2,50,000 × 25/125) = ₹ 50,000

(iii) Cost Element of Dept. X in Transfer Price (₹ 2,50,000 – ₹ 50,000) = ₹ 2,00,000

(iv) Profit of Dept. X included in above

= (₹ 2,00,000 × ₹ 52,000/₹ 2,60,000) = ₹ 40,000

(v) Total Profit Included in Transfer price (₹ 50,000 + ₹ 40,000) = ₹ 90,000

(h) Profit Included in output transferred by X Dept. to Selling Dept.

= (₹ 1,62,000 × 50/150) = ₹ 54,000

(i) Total Profit included in output transferred to Selling Dept.

= ₹ 90,000 + ₹ 54,000 = ₹ 1,44,000

(j) Total Transfer Price for the Transfer made by X Dept. and Y Dept.

= ₹ 1,62,000 + ₹ 2,50,000 = ₹ 4,12,000

(k) Unrealised Profit included in increas in Closing Stock of Sell Dept.

= ₹ 1,44,000 × ₹ 52,000/₹ 4,12,000 = ₹ 18,175

Study Note - 9

SELF BALANCING LEDGER AND SECTIONAL BALANCING LEDGERS

This Study Note includes

9.1 Self Balancing Ledger

9.2 Sectional Balancing Ledger

9.1. SELF BALANCING LEDGER

Under Self Balancing Ledger system each ledger is prepared under double entry system and a complete trial balance can also be prepared by taking up the balances of ledger accounts. Within the ledger itself principles of double entry is completed. Under this method three ledger accounts are prepared, viz, General Ledger Adjustment Account which is maintained under Debtors Ledger and Creditors Ledger and Debtors or Sales Ledger Adjustment Account and Creditors or Purchase Ledger Adjustments Accounts which are maintained under General Ledger.

The use of these ledgers are:

Debtors Ledger: It is also known as Sold Ledger or Sales Ledger which is maintained for recording personal accounts of trade debtors. If this ledger is maintained customers account (i.e., to whom we sell goods on credit) are taken out from the general ledger and the same is maintained in this ledger. In short, this ledger deals with account relating to trade debtors.

Creditors Ledger: It is also known as Bought Ledger or Purchase Ledger which is prepared for recording personal accounts of trade creditors. By preparing this ledger creditors account (i.e., from whom we purchase goods on credit) are taken out from the general ledger and the same is maintained in this ledger. In short, this ledger deals with accounts relating to trade creditors.

General or Nominal Ledger: Needless to say that in this ledger all real accounts, nominal accounts and remaining personal accounts are opened for example:

Personal Account: Drawings, Capital, Bank, Outstanding Salary etc.

Real Account: Plant & Machinery, Land & Building, B/R, Stock, etc.

Nominal Account: Salaries, Rent, Insurance, Carriage etc.

Preparation of Trial Balance

By taking up the balances from all the three ledgers a trial balance can be prepared. We cannot prepare a trial balance from any single ledger. e.g., a trial balance cannot be prepared by taking up only the balances from debtor's ledger as it has no credit balance and so also in case of creditor's ledger as it has no debit balance. Moreover, In case of errors it becomes very difficult to locate and detect such error or errors if the trial balance is prepare by taking up either from debtors ledger only or from creditors ledger only and at the same time trial balance will not agree. Thus, the system under which each ledger is made to balance is called self-balancing system. It must be remembered that the ledger which does not balance scrutiny of the same is practically very limited.

Advantages of Self-Balancing System.

The advantages of Self-Balancing system are:

(a) If ledgers are maintained under self-balancing system it becomes very easy to locate errors.

(b) This system helps to prepare interim account and draft final accounts as a complete trial balance can be prepared before the abstruction of individual personal ledger balances.

(c) Various works can be done quickly as this system provides sub-division of work among the different employees.

(d) This system is particularly useful (i) where there are a large number of customers or suppliers and (ii) where it is desired to prepare periodical accounts.

(e) Committing fraud is minimized as different ledgers are prepared by different clerks.

(f) Internal check system can be strengthened as it becomes possible to check the accuracy of each ledger independently.

Entries in Sales or Debtors Ledger

Two types of entries are recorded, one the usual double entry and the other is self-balancing entry. Naturally, when a transaction occurs, the normal entry is to be recorded under double entry principle i.e., one account that is related to debtors/customers and the other is related to general ledger. But under self-balancing system, the entries are recorded for the adjustment account and that is why, the entries are recorded with the periodical total of Sales Day Book, Return Inward Book etc.

So, accounts which are recorded to debtors will be passed through Debtors Ledger Adjustment Account and the others are passed through General Ledger Adjustment Account.

	Transaction	Usual Entry	Self-Balancing Entry
1.	For Credit Sales	Individual Customer A/c Dr. (in Debtors Ledger) To, Sales A/c (in General Ledger)	Debtors Ledger Adjustment A/c Dr. (in General Ledger) To, General Ledger Adjustment A/c (in Debtors Ledger)
2.	For Cash/Cheque received from customers	Cash A/c Dr. (in General Ledger) To, Individual Customer A/c (in Debtors Ledger)	General Ledger Adjustment A/c Dr. (in Debtors Ledger) To, Debtors Ledger Adjustment A/c (in General Ledger)
3.	For Discount Allowed or allowance to customers	Discount Allowed A/c Dr. Or, Allowances A/c Dr. (in General Ledger) To, Individual Customer A/c (in Debtors Ledger)	Do
4.	For Bad Debts	Bad Debts A/c Dr. (in General Ledger) To, Individual Customer A/c (in Debtors Ledger)	Do
5.	For Bills Receivable received from customers	Bills Receivable A/c Dr. (in General Ledger) To, Individual Customer A/c (in Debtors Ledger)	Do

6.	For Returns Inward	Returns Inward A/c Dr. (in General Ledger) To, Individual Customer A/c (in Debtors Ledger)	Do
7.	For Bills/Cheques Received /Dishonoured	Individual Customer A/c Dr. (in Debtors Ledger) To,Bills Receivable/Bank A/c (in General Ledger)	Debtors Ledger Adjustment A/c Dr. (in General Ledger) To, General Ledger Adjustment A/c (in Debtors Ledger)
8.	For interest on Customer's overdue account or cost of carriage charged to Customers	Individual Customer A/c Dr. (in Debtors Ledger) To,Interest/ Charges A/c (in General Ledger)	

Op. Dt = Opening date of the accounting period
Cl. Dt = Closing date of the accounting period

Proforma

In the General Ledger

Dr. **Debtors Ledger Adjustment Account** ***Cr.***

Date	Particulars	Amount	Date	Particulars	Amount
Op. Dt	To, Balance b/d	**	Op. Dt	By, Balance b/d (if any)	**
Cl. Dt	" General Ledger Adjustment A/c Credit Sales	**	Cl. Dt	" General Ledger Adjustment A/c:	
	" Carriage and Sundry Charges Debited to customer-	**		" Cash/ Cheque received	**
	" Bills Receivable Dishonoured	**		" Bad Debts	**
	" Cheque received and dishonoured	**		" Return Inward	**
	" Interest and Charges etc.	**		" Discount Allowed	**
	" Refund- Cash paid to customers	**		" Other Allowances	**
	" B/R discounted and dishonoured	**		" Bills Receivable	**
	" B/R endorsed and dishonoured	**		" Transfer to or from other Ledgers	**
	" Interest charged to overdue account	**			
	" Balance c/d (if any)	**		" Balance c/d	**
		**			**

In the Debtors Ledger

Dr. **General Ledger Adjustment Account** ***Cr.***

Date	Particulars	Amount	Date	Particulars	Amount
Op. Dt	To, Balance b/d (if any)	**	Op. Dt	By, Balance b/d (if any)	**
Cl. Dt	" Debtors / Sold Ledger Adjustment A/c		Cl. Dt	" Debtors /Sold Ledger Adjustment A/c:	
	" Cash/ Cheque received	**		" Carriage and Sundry Charges	**
	" Bad Debts	**		" Bills Receivable Dishonoured	**
	" Returns Inward	**		" Cheque received and dishonoured	**
	" Discount Allowed	**		" Interest and Charges etc.	**
	" Other Allowance	**		" Refund-Cash paid paid to customers	**
	" Bills Receivable	**		" B/R discounted and dishonoured	**
	" Transfer to or from other Ledger	**		" B/R endorsed and dishonoured	**
				" Interest charged to overdue account	**
	" Balance c/d	**		" Balance c/d (if any)	**
		**			**

Note: Self –balancing entries will only be made for those transactions which affect two ledgers. Naturally, if a transaction occurs which affects the same ledger (in both sides), say, general ledger, no entry is to be required. For example, Cash Sales, which actually affect two sides of general ledger, is not to be recorded. For the same reason, Provision/Reserve for bad debts, Recovery of bad debts, Trade Discount, Bills Receivable discounted or matured etc. will not appear at all.

Illustration 1

From the following information prepare (1) Debtors Ledger Adjustment Account in the General Ledger, and (2) General Ledger Adjustment Account in the Debtors Ledger:

Particulars	Amount ₹	
Opening balance of Sundry Debtors	40,000	(Dr.)
	2,000	(Cr.)
Cash and cheques receipts	1,60,000	
Credit Sales as per Sales Day Book	2,00,000	
Discount Allowed	6,000	
Returns Inward	4,000	
Bad Debts	3,000	
Bills Receivable Received	20,000	
Bills Receivable Discounted	2,000	
Provision for Bad Debts	2,000	
Closing Credit Balance of Sundry Debtors	6,000	
Transfer from Debtors Ledger to Creditors Ledger	1,000	
Transfer from Creditors Ledgers to Debtors Ledger	1,200	

Solution :

In the books of …………….

In the General Ledger

Debtors Ledger Adjustment Account

Dr. ***Cr.***

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
?	To Balance b/d	40,000	?	By Balance b/d	2,000
	,, General Ledger			,, General Ledger	
	Adjustment A/c—			Adjustment A/c—	
	Credit Sales	2,00,000		Cash and Cheques	1,60,000
	,, Balance c/d	6,000		Returns Inward	4,000
				Discount Allowed	6,000
				Bad Debts	3,000
				Bills Receivable	20,000
				Transfer to Cr. Ledger	1,000
				,, Transfer from Creditors to Debtors Ledger	1,200
				,, Balance c/d	48,800
		2,46,000			2,46,000
?	To Balance b/d	48,800	?	By Balance b/d	6,000

In the Debtors Ledger

General Ledger Adjustment Account

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
?	To Balance b/d	2,000	?	By Balance b/d	40,000
	,, Debtors Ledger			,, Debtors Ledger	
	Adjustment A/c —			Adjustment A/c—	
	Cash and Cheques	1,60,000		Credit Sales	2,00,000
	Returns Inward	4,000		,, Balance c/d	6,000
	Discount Allowed	6,000			
	Bad Debts	3,000			
	Bills Receivable	20,000			
	Transfer to Cr. Ledger	1,000			
	,, Transfer from Creditors to Debtors Ledger	1,200			
	,, Balance c/d	48,800			
		2,46,000			2,46,000
?	To Balance b/d	6,000	?	By Balance b/d	48,800

Illustration 2

Samaresh keeps his ledger on self-balancing system. From the following particulars, you are required to write-up the individual Debtors' Account and the General Ledger Adjustment Account (in Sales ledger) during the month of January 2013:

(i) Individual Debtor's balances on 1.1.2013;
A - ₹1,530; B - ₹1,620; C - ₹1,890; and D - ₹1,170;

(ii) Transactions during the month:

Jan 2. Sold goods to A ₹ 1,710;

9. Received from B on account ₹ 300;

11. Received from A ₹ 1,500 in full settlement of his balance on 1.1.2013;

12. Sold goods to B ₹ 600;

14. B returned goods which were damaged-in-transit amounting to ₹ 180;

18. Received from C ₹ 1,800 and allowed him discount ₹ 90;

19. Received from A, a bill of exchange for ₹ 1,200 accepted by X payable on 25th January;

22. Received from B ₹ 900;

25. A's bill returned dishonoured;

28. D became insolvent and 30 paise in the rupee was received from his estate in full and final settlement;

30. Sold goods to C ₹ 1,020.

Solution :

In the books of Samaresh

In Sales Ledger

Debtors Ledger Adjustment Account

Dr. ***Cr.***

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013	To Sales Ledger Adj. A/c		2013	By Balance b/d	6,210
Jan. 31	Cash	4,851	Jan. 1	,, Sales Ledger Adj. A/c-	
	Dis. Allowed	120		Sales	3,330
	Returns Inward	180	Jan. 31	B/R Dishonoured	1,200
	B/R	1,200			
	Bad Debts	819			
	,, Balance c/d	3,570			
		10,740			10,740
			Feb. 1	By Balance b/d	3,370

A Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013			2013		
Jan. 1	To Balance b/d	1,530	Jan. 11	By Cash	1,500
,, 2	,, Sales	1,710	,, ,,	,, Dis. Allowed	30
,, 25	,, B/R Dishonoured	1,200	,, 19	,, B/R	1,200
			,, 31	,, Balance c/d	1,710
		4,440			4,440

B Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013			2013		
Jan. 1	To Balance b/d	1,620	Jan. 9	By Balance b/d	300
,, 12	,, Sales	600	,, 14	,, Returns Inward	180
			,, 22	,, Cash	900
			,, 31	,, Balance c/d	840
		2,220			2,220

C Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013			2013		
Jan. 1	To Balance b/d	1,890	Jan. 18	By Cash	1,800
,, 31	,, Sales	1,020	,, ,,	,, Dis. Allowed	90
			,, 31	,, Balance c/d	1,020
		2,910			2,910

D Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013			2013		
Jan. 1	To Balance b/d	1,170	Jan. 28	By Cash	351
				,, Bad Debts	819
		1,170			1,170

Workings:

(a)	Total Debtors' balance as on 1.1.2013	= A+B+C+D	= ₹ 1,530+₹ 1,620+₹ 1,890+ ₹ 1,170 = ₹ 6,210
(b)	Total Sales	= A+B+C	= ₹ 1,710+₹ 600+₹ 1,020 = ₹ 3,330
(c)	Total Cash Received	= A+B+C+D	= ₹ 300+₹ 1,500+₹ 1,800+ ₹ 900+ ₹ 351 = ₹ 4,851
(d)	Total Discount Allowed	= A+C	= ₹ 30+₹ 90 = ₹ 120
(e)	Returns Inward	= B	= ₹ 180
(f)	Bad Debts	= D	= ₹ 819
(g)	B/R Dishonoured	= A	= ₹ 1,200
(h)	Total Debtors' balance as on 31st January, 2013.	= A+B+C	= ₹ 1,710+₹ 840+₹ 1,020 = ₹ 3,570

Illustration 3

The summarized analysis of the accounts of the outstanding debtors of a firm at the date of the annual closing of amount as under:

Debtors	Goods Sold during the year ₹	Goods returned during the year ₹	Cash & cheque received during the year ₹	Discount allowed during the year ₹	Bill of exchange received during the year ₹
P	3,000	---	2,000	500	---
Q	2,000	500	1,000	---	---
R	5,000	---	3,000	---	---
S	10,000	1,000	6,000	500	1,000
T	12,000	1,500	8,000	1,000	1,000

Debtors' balance at the beginning of the year was ₹ 4,500. Out of the above receipts of a bill for ₹ 700 given by S was dishonoured, noting charges amounting to ₹ 20. Prepare Debtors Ledger Adjustment Account in General Ledger and General Ledger Adjustment Account in Debtors Ledger.

Solution :

In the General Ledger

Debtors Ledger Adjustment Account

Dr. ***Cr.***

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
?	To Balance b/d	4,500	?	By General Ledger Adjustment A/c	
	,, General Ledger Adjustment A/c			Cash & Cheque Received	20,000
				Returns Inwards	3,000
	Sales	32,000		Discount Allowed	2,000
	B/R Dishonoured	700		B/R	2,000
	Charges	20		,, Balance c/d	10,220
		37,220			37,220
	,, Balance b/d	10,220			

In Debtors Ledger

General Ledger Adjustment Account

Dr. ***Cr.***

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
?	To Debtors Ledger Adjustment A/c		?	By Balance b/d	4,500
				,, Debtors' Ledger Adjustment A/c	
	Cash & Cheque Received	20,000		Sales	32,000
				B/R Dishonoured	700
	Returns Inwards	3,000		Charges	20
	Discount Allowed	2,000			
	B/R	2,000			
	,, Balance c/d	10,220			
		37,220			37,220
				,, Balance b/d	10,220

Workings:

Sales = ₹ 3,000 + ₹ 2,000 + ₹ 5,000 + ₹ 10,000 + ₹ 12,000 = ₹ 32,000

Returns Inward = ₹ 500 + ₹ 1,000 + ₹ 1,500 = ₹ 3,000

Discount Allowed = ₹ 500 + ₹ 500 + ₹ 1,000 = ₹ 2,000

B/R = ₹ 1,000 + ₹ 1,000 = ₹ 2,000

Cash & Cheque Received = ₹ 2,000 + ₹ 1,000 + ₹ 3,000 + ₹ 6,000 + ₹ 8,000
= ₹ 20,000

Contra Transaction or Adverse Balance

Sometimes it may happen that debtors ledger shows a credit balance and creditor ledger shows a debit balance i.e., the adverse balance of debtors ledger and creditors ledger. Usually, credit, balance in debtors ledger may happen on account of advance taken from creditors or allowances given to customers for different products after closing the accounts. Similarly, debit balance in creditors ledger may appear on account of excess payment made or goods returned to creditors after closing the accounts etc. Thus, these contra transactions are to be adjusted. But, student must remember that credit balance in one ledger must not be set off against debit balance of another ledger. These should be treated separately.

Entries in Purchases or Creditors Ledger

In this ledger also two types of entries are to be passed viz; one deals with creditors ledger and the other deals with general ledger. At the same time, self-balancing entries should be made for adjustment accounts accordingly. Like Debtors ledger entries to be recorded with periodical total of Purchase Day Book; Returns Outward Book etc.

The entries to be made are:

	Transaction	Usual Entry	Self-Balancing Entry
1.	For Credit Purchases	Purchase A/c Dr. (in General Ledger) To, Creditors A/c (in Creditors Ledger)	General Ledger Adjustment A/c Dr. (in Creditors Ledger) To, Creditors Ledger Adjustment A/c (in General Ledger)
2.	For Cash paid to Creditors	Creditors A/c Dr. (in Creditors Ledger) To, Cash A/c (in General Ledger)	Creditors Ledger Adjustment A/c Dr. (in General Ledger) To, General Ledger Adjustment A/c (in Creditors Ledger)
3.	For Discount Received from Creditors	Creditors A/c Dr. (in Creditors Ledger) To, Discount Received A/c (in General Ledger)	Do
4.	For Bills Accepted in favour of Creditors	Creditors A/c Dr. (in Creditors Ledger) To,Bills Payable A/c (in General Ledger)	Do
5.	For Purchases Return	Creditors A/c Dr. (in Creditors Ledger) To,Returns Outward A/c (in General Ledger)	Do
6.	For Bills Payable Dishonoured	Bills Payable A/c Dr. (in General Ledger) To, Creditors A/c (in Creditors Ledger)	General Ledger Adjustment A/c Dr. (in Creditors Ledger) To,Creditors Ledger Adjustment A/c (in General Ledger)
7.	For Interest and Charges charged by Creditors	Interest / Charges A/c Dr. (in General Ledger) To, Creditors A/c (in Creditors Ledger)	Do

In General Ledger

Dr. **Creditors Ledger Adjustment Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
2013			2013		
Jan. 1	To, Balance b/d	**	Jan.1	By Balance b/d (if any)	**
Dec.31	" General Ledger Adjustment A/c		Dec.31	" General Ledger Adjustment A/c:	
	" Cash Paid	**		" Credit Purchases	**
	" Bills Payable Accepted	**		" Bills Payable Dishonoured	**
	" Discount Received	**		" Interest and Charges	**
	" Returns Outward	**		" Balance c/d(if any)	**
	" Balance c/d	**			
		**			**

In the Creditors Ledger

Dr. **General Ledger Adjustment Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
2013			2013		
Jan.1	To, Balance b/d	**	Jan.1	By,Balance b/d (if any)	**
Dec.31	" Creditors/Bought Ledger Adjustment A/c		Dec.31	" Creditors/Bought Ledger Adjustment A/c	
	" Credit Purchases	**		" Cash Paid	**
	" Bills Payable Dishonoured	**		" Bills Payable Accepted	**
	" Interest and Charges	**		" Discount Received	**
	" Balance c/d	**		" Returns Outward	**
				" Balance c/d(if any)	**
		**			**

Illustration 4

Prepare the Creditors Ledger Adjustment Account as it would appear in General Ledger and General Ledger Adjustment Account as it would appear in Creditors Ledger for the year ended 31st March 2013 from the following particulars.

Particulars	₹	Particulars	₹
Sundry Creditors (on 1.4.2012) (Cr.)	10,000	Bills Payable issues during the year	4,000
(Dr.)	1,000	Bills Payable dishonoured	2,000
Purchases (including Cash Purchase of ₹ 10,000)	50,000	Bills Payable renewed	1,000
Returns Outward	2,000	Interest on Bills Payable renewed	100
Cash paid to Creditors	20,000	Sundry Charges paid for dishonor of Bills Payable	100
Discount allowed by Creditors	3,000	Total of set-off in Debtors Ledger	3,000
Trade Discount	1,000	Sundry Creditors (on 31.3.2013) (Dr.)	4,000
Bills Receivable endorsed to Creditors	2,000		

Solution:

In the General Ledger

Creditors Ledger Adjustment Account

Dr. *Cr.*

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2012			2012		
April 1	To Balance b/d	1,000	April 1	By Balance b/d	10,000
2013	" General Ledger		2013	General Ledger	
March. 31	Adjustment A/c :		March. 31	Adjustment A/c :	
	Returns Outward	2,000		Purchase	40,000
	Cash and cheques	20,000		Bills Payable dishonoured	2,000
	Discount Received	3,000		Interest	100
	Bills receivable	2,000		Sundry Charges	100
	Bills Payable	4,000		" Balance c/d	4,000
	Bills Payable (renewed)	1,000			
	Transfer	3,000			
	" Balance c/d	20,200			
		56,200			56,200
2013 April 1	To Balance b/d	4,000	2013 April 1	By Balance b/d	20,200

In the Creditors Ledger

General Ledger Adjustment Account

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
2012			2012		
April 1	To Balance b/d	10,000	April 1	By Balance b/d	1,000
2013	" Creditors Ledger		2013	" Creditors Ledger	
March 31	Adjustment A/c :		March 31	Adjustment A/c :	
	Purchase	40,000		Returns Outward	2,000
	Bills Payable dishonoured	2,000		Cash	20,000
	Interest	100		Discount Received	3,000
	Sundry Charges	100		Bills receivable	2,000
	" Balance c/d	4,000		Bills Payable	4,000
				Bills Payable (renewed)	1,000
				Transfer	3,000
				" Balance c/d	20,200
		56,200			56,200
2013 April 1	To Balance b/d	20,200	2013 April 1	By Balance b/d	4,000

TRANSFER ENTRIES

Sometimes a person may be treated both as a debtor as well as a creditor to the firm. In other words the firm purchase goods from him and also it sells goods to him. Under the circumstances, the lower of the amount payable to and receivable from such person is to be set-off. The so called set-off amount is to be deducted both from the debtors as well as from the creditors. This is known as transfer entry.

The entry for this purpose will be Creditors Account debited and Debtors Account credit. As a result of this transfer both debtors ledger and creditors ledger together with general ledger are affected. For example, debtors include ₹ 10,000 due from Mr. A whereas Creditor include ₹ 8,000 due to Mr. A.

			₹	₹
	Usual entry is			
(a)	A (in Creditors Ledger) A/c	Dr.	8,000	
	To A (in Debtors ledger) A/c			8,000
	Under Self-balancing, the entry will be			
(a)	Creditors Ledger Adjustment A/c	Dr.	8,000	
	To General Ledger Adjustment A/c			8,000
(b)	General Ledger Adjustment A/c	Dr.	8,000	
	To Debtors Ledger Adjustment A/c			8,000
	Or			
	Direct Entry:			
	Creditors Ledger Adjustment A/c	Dr.	8,000	
	To Debtors Ledger Adjustment A/c			8,000

Illustration 5

X Ltd. furnished the following particulars:

Debtors ledger include ₹ 5,000 due from Sen & Co. whereas creditors ledger include ₹ 3,000 due to Sen & Co.

Solution:

In the books of X Ltd.
Journal (without narration)

Date	Particulars	L/F	Amount ₹	Amount ₹
?	Creditors Ledger Adjustment A/c Dr. To General ledger Adjustment A/c		3,000	 3,000
	General Ledger Adjustment A/c Dr. To Debtors Ledger Adjustment A/c		3,000	 3,000
	or Direct Entry Creditors Ledger Adjustment A/c Dr. To Debtors ledger Adjustment A/c		 3,000	 3,000

General Illustrations

Illustration 6

From the following particulars, which have been extracted from the book of G & Co., for the year ended 31.12.2013, prepare General Ledger Adjustment Account in the Creditors ledger and Debtors Ledger Adjustment Account in the General Ledger:

Particulars		Amount ₹
Debtors balance (1.1.2013)	Dr.	20,000
	Cr.	300
Creditors balance (1.1.2013)	Dr.	200
	Cr.	15,000
Purchases (including Cash ₹ 4,000)		12,000
Sales (including Cash ₹ 6,000)		25,000
Cash paid suppliers in full settlement of claims of ₹ 9,000		8,500
Cash received from customers in full settlement of claims of ₹ 15,000		14,100
Bills payable accepted (including renewals)		2,000
Bills Payable withdrawn upon renewals		500
Interest on Bills Payable renewed		20
Bills Receivable received		3,000
Bills Receivable endorsed		800
Bills Receivable as endorsed dishonoured		300
Bills Receivable discounted		1,400
Bills Receivable dishonoured		400
Interest charged on dishonoured bills		30
Transfer from one ledger to another ledger		600
Returns (Cr.)		700
Debtors balance (31.12.2013) Cr.		450
Creditors balance (31.12.2013) Dr.		10,870

Solution :

In the books of G & Co.

In the Creditors Ledger

General Ledger Adjustment Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013 Jan. 1	To Balance b/d	15,000	2013 Jan. 1	By Balance b/d	200
Dec. 31	,, Creditors Ledger Adjustment A/c:		Dec.31	Creditors Ledger Adjustment A/c	
	Purchases	8,000		Cash	8,500
	Bills Payable Withdrawn	500		Discount Received (9,000 – 8,500)	500
	Bills Receivable Dishonoured (as endorsed)	300		Returns Outward	700
	Interest	20		Bills Payable	2,000
	,, Balance c/d	350		Bills Receivable endorsed	800
				Transfer	600
				,, Balance c/d	10,870
		24,170			24,170
2014 Jan. 1	To Balance b/d	10,870	2014 Jan. 1	By Balance b/d	350

In the General Ledger

Debtors Ledger Adjustment Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013 Jan. 1	To Balance b/d	20,000	2013 Jan. 1	By Balance b/d	300
Dec.31	General Ledger Adjustment A/c:		Dec.31	,, General Ledger	
	Sales	19,000		Cash	14,100
	B/R endorsed Dishonoured	300		Discount Allowed (15,000 – 14,100)	900
	Bills Dishonoured	400		Bills Receivable Received	3,000
	Interest	30		Transfer	600
	,, Balance c/d	450		,, Balance c/d	21,280
		40,180			40,180
2014 Jan. 1	To Balance b/d	21,280	2014 Jan. 1	By Balance b/d	450

Ilustration 7

Mr. Self-reliant maintains his books on Self-Balancing Ledger. From the following particulars, prepare General Ledger Adjustment Accounts in (a) Bought Ledger, and (b) Sold ledger.

Date	Particulars	Amount ₹
1.11.2012	Bought Ledger – Debit Balance	700
	Bought Ledger – Credit Balance	30,640
	Sold Ledger – Debit Balance	66,930
	Sold Ledger – Credit Balance	1,865
	Transactions during the month of November 2012:	
	Sales	1,35,000
	Credit Sales	1,16,000
	Purchases-Credit	72,700
	Purchase-Cash	11,800
	Sales Returns (out of credit sales)	500
	Provision for Bad and Doubtful Debts	270
	Bad Debts written-off	1,000
	Amount received against Bad Debts written-off last year	600
	Purchases Returns (our of Credit Purchase)	2,500
	Cash collected from Debtors	83,000
	Cash paid to Creditors	57,500
	Discount Allowed	650
	Discount Received	320
	Interest Charged to Debtors	592
	Bills Receivable Received	10,000
	Bills Payable accepted	8,000
	Bills Receivable dishonoured	2,500
	Notary Charges debited to Party's A/c	10
	Carriage charge to customers	137
30.10.2013	Sold Ledger – Debit Balance	980
,,	Bought Ledger – Debit Balance	266

Solution :

In the books of Mr. Self-reliant

In Bought (Creditors) Ledger

General Ledger Adjustment Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2012 Nov. 1	To Balance b/d	30,640	2012 Nov. 1	By Balance b/d	700
2013 Oct. 30	,, Creditors Ledger Adjustment A/c:		2013 Oct.30	Creditors Ledger Adjustment A/c:	
	Purchases	72,700		Cash paid	57,500
	,, Balance c/d	980		Purchase Returns	2,500
				Discount Received	320
				Bills Payable	8,000
				,, Balance c/d	35,300
		1,04,320			1,04,320
2013 Nov. 1	To Balance b/d	35,300	2013 Nov. 1	By Balance b/d	980

In Sold (Debtors) Ledger

General Ledger Adjustment Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2012 Nov. 1	To Balance b/d	1,865	2012 Nov. 1	By Balance b/d	66,930
2013 Oct.30	Debtors Ledger Adjustment A/c:		2013 Oct.30	Debtors Ledger Adjustment A/c:	
	Sales Returns	500		Sales	1,16,000
	Bad Debts	1,000		Interest Charges	592
	Cash Received	83,000		Bills Receivable Dishonoured	2,500
	Discount Allowed	650		Notary Charges	10
	Bills Receivable	10,000		Carriage Charge	137
	,, Balance c/d	89,420		,, Balance c/d	266
		1,86,435			1,86,435
2013 Nov. 1	To Balance b/d	266	2013 Nov. 1	By Balance b/d	89,420

Note : Since Control Accounts (i.e., adjustments accounts) are wanted in Bought and Sold Ledger, we are to prepare General Ledger Adjustment Accounts in Bought and Sold Ledgers, respectively.

Illustration 8

Bee Bee Ltd. has three Ledgers in use ,viz., a Debtors Ledger, a Creditors Ledger and a Nominal Ledger which are all kept on the system of Self-Balancing.From the following particulars, prepare the Debtors Ledger Adjustment Accountas and Creditors Ledger Adjustment Accountas in the Nominal Ledger.

Particulars	₹	Particulars	₹
Jan. 1,2013		June 30,2013	
Balance of Sundry Debtors	30,000	Bills Payable accepted	3,000
Balance of Sundry Creditors	35,000	Bills Receivable received	6,000
30.6.2013		Returns Inward	1,750
Credit Purchase	10,000	Returns Outward	2,200
Credit Sales	19,600	Rebate allowed to Debtors	550
Cash Sales	1,500	Rebate allowed by Creditors	300
Paid to Creditors	19,750	Provision for Doubtful Debts	320
Discount allowed by them	650	Bad Debts	900
Cash received from Debtors	15,600	Bills Receivable dishonoured	750
Discount allowed to them	400		

Solution:

In the Nominal Ledger

Debtors Ledger Adjustment Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Jan 1	To Balance b/d	30,000	June 30	By Nominal Ledger	
June 30	" Nominal Ledger			Adjustment A/c :	
	Adjustment A/c :			Cash Received	15,600
	- Sales	19,600		Discount Allowed	400
	-Bills Receivable			Bills Receivable	6,000
	Dishonoured	750		Return Inward	1,750
				Rebate Allowed	550
				Bad Debts	900
				" Balance c/d	25,150
		50,350			50,350
2013					
July 1	To Balance b/d	25,150			

In the Nominal Ledger

Creditors Ledger Adjustment Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
June 30	To Nominal Ledger Adjustment A/c :		Jan. 1	By Balance b/d	35,000
	Cash paid	19,750	2013	" Nominal Ledger	
	Bills Payable	3,000	June 30	Adjustment A/c :	
	Discount Received	650		Purchases	10,000
	Return Outward	2,200			
	Rebate Received	300			
	" Balance c/d	19,100			
		45,000			45,000
			2013		
			July 1	By Balance b/d	19,100

Illustration 9

From the following particulars , which have been extracted from the book of M & Co., for the month of November 2013, prepare General Ledger Adjustment Account in the Bought Ledger and Sold Ledger:

	₹		₹
1.11.2013			
Bought Ledger- Debit Balance	1,000	Cash collected from Debtors	83,000
Bought Ledger- Credit Balance	30,920	Cash paid to Creditors	57,500
Sold Ledger- Debit Balance	66,900	Discount allowed	670
Sold Ledger- Credit Balance	1,865	Discount received	300
Transaction during the month of November 2013:			
Interest Charged to debtors	592		
Sales	1,35,000	Bills Receivable received	10,000
Credit sales	1,16,000	Bills Payable accepted	8,000
Purchases- credit	72,700	Bills Receivable Dishonoured	2,500
Purchases- cash	11,800	Notary Charges debited to Party' A/c	40
Sales return (out of Credit Sales)	500	Carriage charge to customers	137
Provision for Bad and Doubtful Debts	270		
Bad Debts written off	1,000	Bought Ledger- Debit balance	980
Amount received against B/D written-off last year	600	Sold Ledger- Credit Balance	266
Purchase Return (out of Credit Purchase)	2,500		

Solution:

In the Bought (Crditors) Ledger

General Ledger Adjustment Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Nov. 1	To Balance b/d	30,920	Nov. 1	By Balance b/d	1,000
" 30	" Creditors Ledger Adjustment A/c :		30	" Creditors Ledger Adjustment A/c :	
	Purchases	72,700		Cash Paid	57,500
	To Balance c/d	980		Purchase return	2,500
				Discount Received	300
				Bills Payable	8,000
				" Balance c/d	35,300
		1,04,600			1,04,600
2013			2013		
Dec. 1	To Balance b/d	35,300	Dec. 1	By Balance b/d	980

In the Sold (Debtors) Ledger

General Ledger Adjustment Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Nov. 1	To Balance b/d	1,865	Nov. 1	By Balance b/d	66,900
" 30	" Debtors Ledger Adjustment A/c :		" 30	" Debtors Ledger Adjustment A/c :	
	Sales return	500		Sales	1,16,000
	Bad Debts	1,000		Interest Charged	592
	Cash received	83,000		Bills receivable -Dishonoured	2,500
	Discount Allowed	670		Notary Charges	40
	Bills Receivable	10,000		Carriage Charge	137
	" Balance c/d	89,400		" Balance c/d	266
		1,86,435			1,86,435
2013			2013		
Dec. 1	To Balance b/d	266	Dec. 1	By, Balance b/d	89,400

Illustration 10

The following information is avail from the books of the trader for the period 1st Jan. to 31st March 2013:

(1) Total Sales amounted to ₹70,000 including the sale of old furniture for ₹10,000(book value is ₹12,300). The total cash sales were 80% less than total credit sales.

(2) Cash collection from Debtors amounted to 60% of the aggregated of the opening Debtors and Credit sales for the period. Discount allowed to them amounted to ₹2,600

(3) Bills receivable drawn during the period totaled ₹7,000 of which bills amounting to ₹3,000 were endorsed in favour of suppliers.Out of these endorsed bills, a Bill receivable for ₹1,600 was dishonoured for non-payament, as the party became insolvent and his estate realized nothing.

(4) Cheques received from customer of ₹5,000 were dishonoured; a sum of ₹500 is irrecoverable.

(5) Bad Debts written-off in the earlier year realized ₹ 2,500.

(6) Sundry debtors on 1st January stood at ₹40,000.

You are required to show the Debtors Ledger Adjustment Account in the General Ledger.

Solution.

In the General Ledger
Debtors Ledger Adjustment Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Jan 1	To Balance b/d	40,000	Jan 1	By General Ledger	
March 31	" General Ledger		March 31	Adjustment A/c :	
	Adjustment A/c :			Cash	54,000
	- Sales	50,000		Discount Allowed	2,600
	-Bills Receivable	1,600		Bills Receivable	7,000
	Dishonoured			Bad Debts	2,100
	-Cheque Dishonoured	5,000		" Balance c/d	30,900
		96,600			96,600
April 1	To Balance b/d	30,900			

Workings:

1. Computation of Credit Sales

   Cash Sales were 80% less than Credit Sales. So, if credit sales are ₹ 100 Cash Sales will be ₹ 20; Total Sales (Cash+Credit) will be ₹120. Total Sales (₹ 70,000 - ₹ 10,000) = ₹ 60,000

   Amount of Credit sales will be $\frac{₹\ 60{,}000 \times 100}{120}$ = ₹50,000

2. Cash received

   Cash received is 60% of opening Debtors plus Credit sales i.e. ₹40,000 + ₹50,000 = ₹90,000

   Cash Received ₹90,000 × $\frac{60}{100}$ = ₹54,000

Preparation of Two Debtors or Two Creditors Ledger

In case of big business houses where there are large number of customers or large number of creditors, they are to maintain more than one Debtors or Creditors ledger. Such division is made on the basis of either alphabetical order or on the basis of Geographical location. For example, in case of alphabetical manner ledgers may be maintained as: A-K and L-Z. Similarly, in case of Geographical location – ledgers may be maintained as (i) Eastern Region; (ii) Western Region; (iii) Southern Region and (iv) Northern Region.

It is interesting to note that the methods and procedure of preparing such ledgers are similar to the methods explained earlier, viz, A separate Debtors Ledger Adjustment Account is to be opened in General Ledger and a General Ledger Adjustment Account is opened in Debtors Ledger. In case of creditors ledger same method is also to be followed. viz, A separate Creditors ledger Adjustment Account is to be opened in General Ledger and a General Ledger Adjustment Account is to be opened in Creditors Ledger.

Rectification of Errors

The difference between the usual rectification entries (discussed earlier in study note 1) and the rectification entries to be passed under self-balancing ledger is that one has to decide whether the said error affected the total of subsidiary books or whether the said error relates to a transfer of accounts. In the case of earlier one, if it is found that the error affects the subsidiary book (purchase or sales etc.) the said error may be rectified by passing self-balancing entry plus usual self rectifying entry. It must be remembered that if the said error does not affect the total, there is no need of passing additional self-balancing entry. For example: if Sales Day Book is over cast, undoubtedly the wrong total naturally will affect (i) Sales Account; (ii) Debtors Ledger Adjustment Account (in General Ledger) and (iii) general Adjustment Account in (Debtors ledger). So the entries will be:

(i) Usual rectifying entry:

Sales A/c	Dr.
To Suspense A/c	

(ii) Under Self-balancing:

General Ledger Adjustment A/c	Dr.
(in Debtors Ledger)	
To Debtors Ledger Adjustment A/c	
(in General Ledger)	

In case of errors of commission (i.e., goods sold to Mr. P for ₹ 5,000 has been recorded as ₹ 500 only). This error does not affect the total of sales book. So the usual entry should be passed and not the second entry stated above. Thus the usual rectifying entry will be:

		₹	₹
Debtors A/c	Dr.	4,500	
To Suspense A/c			4,500

In case of transfer entries i.e., transfer from one account to another, if any errors is occurred, which is related to such transfer, two additional entries are required

(a) Same as stated above

(b) (i) If the error affects the total — the above entry under (ii)

(ii) If it does not affect the total — No Entry

(c) In case of transfer entry – rectifying self-balancing entries are recorded.

Illustration 11

The balance on the Sales Ledger Control Account of X & Co. on Sept. 3, 2013 amounted to ₹ 7,600 which did not agree with the net total of the list of Sales Ledger Balance on that date.

Errors were found and the appropriate adjustments when made balanced the books. The errors were:

(a) Debit balance in the sales ledger amounting to ₹ 206 had been omitted from the list of balances.

(b) A Bad Debt amounting to ₹ 800 had been written-off in the sales ledger, but had not been posted to the Bad Debts Account, or entered in the Control Account.

(c) An item of goods sold to S. for ₹ 500 had been entered once in the Day Book but posted to his account twice.

(d) ₹ 50 Discount Allowed to W had been correctly recorded and posted in the books. This sum had been subsequently disallowed, debited to W's account, and entered in the discount received column of the Cash Book.

(e) No entry had been made in the Control Account in respect of the transfer of a debit of ₹ 140 from Q's Account in the Sales Ledger to his account in the Purchase Ledger.

(f) The Discount Allowed column in the Cash Book had been undercast by ₹ 280.

You are required to give the journal entries, where necessary, to rectify these errors, indicating whether or not any control accounts is affected, and to make necessary adjustments in the Sales Ledger Control Account bringing down the balance.

Solution:

In the Books of ……………………
Journal

Date	Particulars	L/F	Amount ₹	Amount ₹
2013 Sept. 30 (a)	₹ 206 should be added to Sales Ledger balances and it will not affect Control Account.			
(b)	Bad Debts A/c Dr. To Sales Ledger Control A/c (Bad Debts written-off without recording in general ledger, now rectified.)		800	800
(c)	S's Account should be credited by ₹ 500. It will not affect Control Account.		---	---
(d) (i) (ii)	Discount Received A/c Dr. To Purchases Ledger Control A/c Sales Ledger Control A/c Dr. To Discount Allowed A/c (Discount previously allowed cancelled, which was wrongly treated as discount received, now rectified.)		50 50	 50 50
(e)	Purchase Ledger Control A/c Dr. To Sales Ledger Control A/c (Transfer of debit of Q's Account to Purchase Ledger, not recorded, now rectified.)		140	140
(f)	Discount Allowed A/c Dr. To Sales Ledger Control A/c (Discount allowed account undercast, now rectified.)		280	280

In General Ledger
Sales Ledger Control Account

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2012 Oct. 1	To Balance b/d	7,600	2013 Sept. 30	By Bad Debts A/c	800
				,, Purchases Ledger Control A/c	140
2013 Sept. 30	,, Discount Allowed A/c	50		,, Discount Allowed A/c	280
				,, Balance c/d	6,430
		7,650			7,650
Oct. 1	To Balance b/d	6,430			

9.2. SECTIONAL BALANCING LEDGER

Under Sectional Balancing System only general ledger is self-balanced, not like self-balancing ledger where all ledgers are self-balanced. That is why, for each individual purchase and sales ledger a control account is opened in the general ledger which are known as Total Creditors Account or Purchase Ledger Control Account and Total Debtors Account or Sales Ledger Control Account. The balance of total creditors account must be equal to the balance shown by the individual balances of creditors account and if they agree it may be assumed that purchase ledger are correctly made. Similarly, the balance of total debtors must be equal to the balance shown by the individual balances of customers account and if both of them are agreed, it may be assumed that sales ledger are correctly posted. However, the total of Sales Day Book will be debited to Total Debtors Account and in the general ledger sales account is credited. All the credit items (viz, cash received from Debtors, Bad Debts, Returns inwards, Bills Receivable etc.) are credited to total debtors account and corresponding accounts are debited. In case of Total Creditors Account, however, all the debit items (viz, cash paid to creditors, Discount Received, Returns Outward, Bills Payable etc.) are debited to Total Creditor Account and corresponding accounts are credited.

Needless to say that individual creditor account is credited in the creditors ledger with credit purchase and cash paid to creditors, Discount Received, Returns Outward etc. are naturally debited. Same principle is applied with opposite direction in Debtors Ledger i.e., individual customers account is debited in debtors ledger and Cash Received, Discount Allowed, Returns Inwards etc., are credited. In this way, individual account of the two ledgers can correctly be made.

Accounting Steps :

(a) **For Total Debtors**

Original Entry	Debtors Ledger	General Ledger
1. For Cash Receipts, Discount Allowed, Returns Inward, Bad Debts, Bills Receivable etc.	Individual Customer's Account is credited	Cash A/c Dr. Discount Allowed A/c Dr. Returns Inward A/c Dr. Bad Debts A/c Dr. Bills Receivable A/c Dr. To Total Debtors A/c
2. For Sales Day Book, Bills Receivable Dishonoured, Interest and Charges etc.	Individual Customer's Account is debited	Total Debtors A/c Dr. To Sales A/c To B/R Dishonoured A/c To Interest and Charges A/c
(b) **For Total Creditors**		
For Cash Payment, Discount Received, Returns Outward, Bills Payable etc.	Individual Creditor's Account is debited	Total Creditor's A/c Dr. To Cash A/c To Discount Received A/c To Returns Outwards A/c To Bills Payable A/c
For Purchase Day Book, Interest and Charges, etc.	Individual Creditor's Account is credited	Purchase A/c Dr. Interest & Charges A/c Dr. To Total Creditor's A/c

Ruling of 'Total Debtors Account' and 'Total Creditors Account's is presented:

Total Debtors Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance b/d	***		By Balance b/d (if any)	***
	" Credit Sales	***		" Cash/Cheque received	***
	" B/R dishonored	***		" Discount Allowed	***
	" Interest and Charges	***		" Bad Debts	***
	" Cash paid to Debtors	***		" Returns Inward	***
	" Balance c/d (if any)	***		" Bills Receivable	***
				" Transfer Balance c/d	***
		***			***

Total Creditors Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance b/d (if any)	***		By Balance b/d	***
	" Cash and Cheque paid	***		" Purchases	***
	" Discount Received	***		" B/P Dishonoured	***
	" Bills Payable	***		" Balance c/d (if any)	***
	" Returns Outward	***			
	" Transfer	***			
	" Balance c/d	***			
		***			***

Contra Transactions / Adverse Balance

Contra transactions or adverse balance should be treated accordingly like self-balancing ledger. i.e., total debtors account shows a credit balance and total creditors account shows a debit balance. The reasons, however, we have explained in earlier paragraph.

Illustration 12

Prepare Total Debtors Account (or Debtors Control Account) and Total Creditors Account (or Creditors Control Account) from the following particulars as on 31.03.2013.

Particulars	Amount ₹	Particulars	Amount ₹
Debtors balance (1.4.2012) Dr.	10,000	Discount Allowed to Debtors	3,000
(") Cr.	3,000	Credit Purchase	40,000
Creditors balance (1.4.2012) Dr.	8,000	Cash paid to Creditors	25,000
(") Cr.	1,000	Discount Received	3,000
Sales	68,000	Returns Outward	2,000
(including Cash Sales ₹ 8,000)		Bills Payable Accepted	5,000
Returns Inward	5,000	Transfer from bought ledger to sale ledger	6,000
Cash Received from Customer	35,000	Credit balance in sold ledger on 31.03.2013	4,000
Bad Debts	3,000	Debit balance in bought ledger on 31.03.2013	3,000
(Cash Received from Debtors ₹ 3,000 against a debt previously written off)	—	Noting Charges charged from Debtors	100
Bills Receivable Received	6,000		
Bills Receivable Dishonoured	2,000		
B/R endorsed to creditors	1,000		
Endorsed bill dishonoured	500		
Provision made for Bad Debts	4,000		
Provision made for Discount on Debtors	1,000		
Provision made for Discount on Creditors	1,000		

Solution :

In the books of …………………

Total Debtors or Debtors Control Account

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2012	To Balance b/d	10,000	2012	By Balance b/d	3,000
April 1	,, Sales	60,000	April 1	,, Returns Inwards	5,000
2013	(₹ 68,000 – ₹ 8,000)		2013	,, Cash Received	35,000
Mar.31	,, B/R Dishonoured	2,000	Mar.31	,, Bad Debts	3,000
	,, Total Creditors A/c	500		,, B/R Received	6,000
	(Endorsed B/R Dishonoured)			,, Discount Allowed	3,000
	,, Noting Charges	100		,, Transfer	6,000
	,, Balance c/d	4,000		,, Balance c/d	15,600
		76,600			76,600
April 1	To Balance b/d	15,600	April 1	By Balance b/d	4,000

Total Creditors or Creditors Control Account

Dr. *Cr.*

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2012	To Balance b/d	1,000	2012	By Balance b/d	8,000
April 1	,, B/R	1,000	April 1	,, Total Debtors A/c	
2013	,, Cash paid	25,000	2013	(Endorsed Bill Dishonoured)	500
Mar.31	,, Discount Received	3,000	Mar.31	,, Purchase	40,000
	,, Returns Outward	2,000		,, Balance c/d	3,000
	,, B/P accepted	5,000			
	,, Transfer	6,000			
	,, Balance c/d	8,500			
		51,500			51,500
April 1	To Balance b/d	3,000	April 1	By Balance b/d	8,500

Note: Recovery of Bad Debts, Provision for Bad Debts, Provisions for Discount on Debtors, Provision for Discount on Creditors, Cash Sales etc. will not appear in Total Debtors or Debtors Control Account.

Study Note - 10

ACCOUNTING FOR SERVICE SECTORS

This Study Note includes

10.1 Revenue Recognition (AS-9)
10.2 Construction Companies (AS-7)
10.3 Project Accounting
10.4 Accounting for Service Sectors
- **10.4.1. Accounting for Software Companies**
- **10.4.2. Accounting for ITES**
- **10.4.3. Accounting for Telecommunication Sector**
- **10.4.4. Accounting for Entertainment Services**
- **10.4.5. Hospital Accounting**
- **10.4.6. Accounting in Educational Institutions**

10.1 REVENUE RECOGNITION (AS-9)

10.1.1 Objective: The standard explains when the revenue should be recognized in profit and loss account also mentions the circumstances in which revenue recognition can be postponed. Revenue means gross inflow of cash, receivable or other consideration arising in the course of ordinary activities of an enterprise such as:

- Sale of goods
- Rendering the services
- Use of enterprises resources by others yielding interest, dividend and royalties

In other words, revenue is charge made to customers/clients for goods supplied and services rendered.

This Standard does not deal with the following aspects of revenue recognition to which special considerations apply:

(i) Revenue arising from construction contracts; [AS 7 on 'Construction Contracts']

(ii) Revenue arising from hire-purchase, lease agreements;

(iii) Revenue arising from government grants and other similar subsidies;

(iv) Revenue of insurance companies arising from insurance contracts.

Examples of items not included within the definition of "revenue" for the purpose of this Standard are:

(i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

(ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;

(iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

(iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;

(v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

10.1.2 Timing of Revenue Recognition: Revenue from sale or rendering of services should be recognized at the time of sale or rendering of services. However if at the time of sale or rendering of services there is a significant uncertainty in ultimate collection of the revenue, then the revenue recognition is postponed and in such cases revenue should be recognized only when it becomes reasonably certain that ultimate collection will be made. It also applies to the revenue arising out of escalation of price; export incentive, interest etc.

10.1.3 Revenue from Sale of Goods: Revenue is recognized when all the following **conditions** are fulfilled:

- Seller has transferred the ownership of goods to buyer for a price.

Or

- All significant risks and rewards of ownership have been transferred to buyer
- Seller does not retain any effective control of ownership on the transferred goods
- There is no significant uncertainty in collection of the amount of consideration (i.e. cash, receivables etc.)

If delivery is delayed at buyer's request and buyer takes title and accept billing, then the revenue should be recognized immediately but goods must be in hand of seller, identified and ready for delivery at the time of recognition of revenue.

Revenue Recognition when delivery of goods sold subject to **certain conditions:**

- **Installation and Inspection:** Revenue should be recognized when goods are installed at the buyer's place to his satisfaction and inspected and accepted by the buyer.
- **Sale on Approval:** Revenue should be recognized when buyer confirms his desire to buy such goods through communication.
- **Guaranteed Sales:** Revenue should be recognized as per the substance of the agreement of sale or after the reasonable period has expired.
- **Warranty Sales:** Revenue should be recognized immediately but the provision should be made to cover unexpired warranty.
- **Consignment Sales**: Revenue should be recognized only when the goods are sold to third party.
- **Special Order and Shipments:** Revenue from such sales should be recognized when the goods are identified and ready for delivery.
- **Subscription for Publication:** When items delivered vary in value from period to period, the revenue should be recognized on the basis of sales value of those items delivered. When items delivered do not vary in value from period to period, the revenue should be recognized on straight-line basis over time.
- **Installment Sales:** Revenue of sales price excluding interest should be recognized on the date of sale. Interest should be recognized proportionately to the unpaid balance.

10.1.4 Revenue from Rendering of Services: Revenue from rendering of service is generally recognized as the service is performed. The performance of service is measured by following two methods:

(i) **Completed Service Contract Method:** Revenue is recognized when service is about to be completed and no significant uncertainties exist about collection of the amount of service charges.

(ii) **Proportionate Completion Method:** The revenue recognized under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis.

The norms for revenue recognition for rendering of services under special condition are as follows:

- **Advertising and Insurance Agency Commission:** Advertising commission is recognized when advertisement appears before public and for insurance agency commission on the effective commencement or renewal date of the policies respectively.

- **Financial Service Commission:** Generally, commission charged for arranging or granting loan and other facilities should be recognized when a loan is sanctioned and accepted by borrower.
- **Admission Fee:** Revenue from artistic performance, banquets and other special events should be recognized when event takes place.
- **Tuition Fee:** Revenue should be recognized over the period of instruction.
- **Entrance and Membership Fee:** Entrance fees are generally capitalized and membership fees should be recognized on systematic and rational basis having regard to timing and nature of service provided.

10.1.5 Some Special Treatment of Revenue Recognition

Revenue from interest: Revenue from interest should be recognized on time proportion basis.

Revenue from royalties: It is recognized on accrual basis as per terms of agreement.

Revenue from dividend: It is recognized when declaring company declares dividend.

When uncertainty of collection of revenue arises subsequently after the revenue recognition, it is better to make provision for the uncertainty in collection rather than adjustment in already recognised revenue.

10.1.6 Disclosure: When revenue recognition is postponed, the disclosure of the circumstances necessitating the postponement should be made.

10.1.7 Treatment of Inter-Divisional Transfers: ICAI has announced that inter-divisional transfers/sales are not the revenue as per AS-9 "Revenue Recognition". Since in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

10.1.8 Significant difference among AS-9, IFRS/IAS-18 & US GAAP:

- The definition of "Revenue" is almost same in AS-9 and in IFRS/IAS-18; however there is no specific standard for recognizing the revenue under US GAAP. There are several pronouncements in US having varying degree of authority on an ad hoc basis.
- Under IFRS/IAS-18, the revenue recognition from rendering of services is done on the basis of percentage of completion method whereas in AS-9 revenue from rendering of services can be recognized on proportionate completion method or completed service method.
- Under IAS-18/US GAAP revenue from interest is recognized using the effective interest method.
- IFRS/IAS-18 contains the provisions for revenue swaps; however no such corresponding provisions are in AS-9.

Illustration 1:

When can revenue be recognized in the case of transaction of sale of goods?

Solution:

According to AS-9, **Revenue Recognition,** revenue from the sales transaction should be recognized only when the following provision are made/satisfied:

The seller has transferred the property in the goods to the buyer for consideration. The transfer of property in goods results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. If such risks are not involved/ associated with sale, revenue in such a situation is recognized at the time of transfer of risks and rewards of ownership to the buyer.

Moreover, no uncertainty should exist regarding the amount of consideration which will be derived from such sale of goods.

Illustration 2:

X Ltd. has recognized ₹ 10 lakhs on accrual basis from dividends on units of mutual fund of the face value of ₹ 50 lakhs held by it as at the end of the financial year 31st March, 2013. The dividends on mutual funds were declared @ 20% on 15th July 2013. The dividends were proposed on 10th April, 2013 by the declaring company. Whether the treatment is as per the relevant Accounting Standard?

Solution:

As per AS 9 , dividends from investment in shares are not recognized in the statement of Profit and Loss until a right to receive payment is established.

In the present case the dividend was proposed on 10th April, 2013, but the scheme was declared on 15th July, 2013. Thus, it is quite clear that right to receive payment is established on 15th July, 2013. So, income from dividend on units of mutual fund must be recognized by X Ltd. for the year ended 31st March, 2014.

It may be mentioned here that the recognition of ₹ 10 lakhs under accrual basis in the year 2012-13 is not as per AS -9.

Illustration 3 :

Arjun Ltd. sold farm equipment through its dealer. One of the conditions at the time of sale is payment of consideration in 14 days and, in the event of delay, interest is chargeable @ 15% p.a. The company has not realized interest from the dealers in the past. However, for the year ended 31.03.2013, it wants to recognized interest due on the balances due from dealers. The account is ascertained at ₹ 9 lakhs.

Decide whether the income by way of interest from dealers is eligible for recognition as per AS 9.

Solution:

As per AS 9, effect of uncertainties on Revenue Recognition, where the liability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. It may be appropriate to recognize the revenue only when it is reasonably certain that the ultimate collection will be made.

However, in the present case, it has been found that the company did not realized the amount of interest in the past for delayed payment made by dealers. Thus, interest can be recognized only when the ultimate collection is made or taken. Hence, in the present case, interest income is not to be considered as recognized revenue.

Illustration 4 :

Y co. Ltd. used certain resources of X Ltd. In return X Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties, respectively from Y Ltd. during the year 2012-13.

Solution:

As per AS 9, revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognized when no significant uncertainty as to measurability or collectability exists. These revenues are recognized on the following bases:

(i) **Interest** on time proportion basis taking into account outstanding and the rate applicable.

(ii) **Royalties** on an accrual basis in accordance with the terms of the relevant agreement.

Illustration 5:

Advise B Ltd. about the treatment of the following in the final statement of accounts for the year ended 31st March, 2013.

"As a result of a recently announced price revision granted by the Govt. of India w.e.f 01.07.2012 the company stands to receive ₹ 5,20,000 form its customers in respect of sales made in 2012-13."

Solution:

It becomes quite clear from the above question that, as a result of price revision granted by the Govt. additional sales are to be made for ₹ 5,20,000 in 2012-13, although the accounts are prepared for the year ended 31.03.13.

According to AS 9, if the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim ; e.g. for escalation of price etc. Revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection, will be made revenue is recognized at the time of sale or rendering services.

Thus, if there is no uncertainty as to the ultimate collection of ₹ 5,20,000, it should be recognized as revenue and may be treated accordingly in the financial statement for the period ended 31.03.2013.

Illustration 6:

Advise P Ltd. about the treatment of the following in final statement of accounts for the year ended 31.03.13:

A claim lodged with the Railways in March 2010, for loss of goods of ₹ 2,00,000 had been passed for payment in March 2013 for ₹ 1,50,000. No entry was passed in the books of the company when claim was lodged.

Solution:

It becomes clear from the above statement that accounts were prepared for the year ended 31.03.13. The problem states that there was a loss amounting for ₹ 2,00,000 in 2009-10, which was lodged in March 2010 with the Railways. The problem further states that, when the claim was lodged, no entry was passed in the books of account. This corroborate AS 9 and it says," Revenue recognition is postponed if there is any uncertainty regarding its ultimate collection."

But, ₹ 1,50,000 was settled for payment against the claim of ₹ 2,00,000 in March 2013. Needless to say that the revenue is recognized in the Financial Statement prepared for the period ended 31.03.2013 as it was passed for payment.

Illustration 7:

How would you deal with the following in the annual accounts of a company for the year ended 31.03.2013:

The Board of Directors decided on 31.03.2013 to increase the sale price of certain items retrospectively from 01.01.2013.

In view of this price revision w.e.f 01.01.2013, the company has to receive ₹ 15 lakh from its customers in respect of sales made from 01.01.13 to 31.03.13 and the accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2012-13.

Solution:

As per AS 9, revenue should be recognized only when there is no uncertainty about its ultimate collection. If any uncertainty regarding ultimate collection exists, revenue recognition is postponed. As such, whether the said ₹ 15 lakhs will be treated as recognized depends on its nature of certainty. If no uncertainty exists, the same should be treated as recognized revenue and, in the opposite case, it should be postponed.

Illustration 8:

TVSM Ltd. has taken a transit insurance policy. Suddenly, in the year 2012-13, the percentage of accident has gone up to 7% and the company wants to recognize insurance claim as revenue in 2012-13. In accordance with relevant accounting standard.

Do you agree?

Solution:

As per AS 9, where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collections, revenue is recognized at the time of sale or rendering services. Moreover, consideration receivable should reasonably be determinable. Revenue recognition is postponed if not determinable within a reasonable limit.

Thus, in this case, since there are uncertainties, recognition of revenue should be postponed by the company.

Illustration 9:

Bottom Ltd. entered into a sale deed for its immovable property before the end of the year. But registration was done with Registrar subsequent to Balance Sheet date.

But before finalization, is it possible to recognize the sale and the gain at the Balance Sheet date? Give your views with reasons.

Solution:

As per AS 9, **Revenue Recognition:** A key criterion for determining when to recognize revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and reward of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognized at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time of ownership passes.

In the present case, sale of immovable property with a gain on such sale should be recognized at the Balance Sheet date although registration for such sale had been done subsequent to the Balance Sheet date. It may be mentioned here that registration cannot bring any uncertainty as it was nothing but a technical matter.

Illustration 10:

SCL Ltd. sells agricultural products to dealers, One of the conditions of sale is that interest is payable at the rate of 2% p.m. for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2012-13, the company wants to recognize the interest receivable.

Do you agree?

Solution:

As per AS 9, **Revenue Recognition** requires that revenue is measurable at the time of sale. Interest, royalties, dividends should be recognized as revenue only where there will not be any uncertainty regarding the ultimate collection. It may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made. When there is no uncertainty as to ultimate collection, revenue is recognized at the time of sale even though payments are made by installment.

In the present case, however, SCL Ltd. cannot recognize the entire amount of interest as revenue. Recovery of interest @ 10% on outstanding balance is merely estimated which is uncertain to ultimate collection.

10.2 CONSTRUCTION CONTRACTS (AS-7)

Introduction:

10.2.1 Construction Contracts: As per **AS-7** – Construction Contract is a contract specifically negotiated for the construction of an Asset or combination of Assets closely interrelated or interdependent, for example, contract for construction of building, dam, bridge, road etc. This Accounting Standard (AS) further mentions that the following are also included in construction contracts.

- Contracts for rendering of services which are directly related to the construction of Assets, for example, service of architect, and
- Contract for destruction or restoration of Asset and the restoration of the environment following the demolition of Asset.
- For example, if the existing structure/building in a plot of land has to be demolished before new building as per new design is constructed, the destruction of building is construction contract.

10.2.2 Types of Construction Contracts: Construction contracts are of two types:—

Fixed Price Contracts: In these contracts, contractor agrees for fixed price of the contract or fixed rate per unit.

Cost plus Contracts: In these contracts, contractor is reimbursed the cost is defined plus fixed percentage of fee/ profit.

Some construction contracts may be a mix of the both.

10.2.3 Objective: Accounting for long-term construction contracts involves question as to when revenue should be recognized and how to measure the revenue in the books of contractor. There may be following two ways to determine profit or loss:

- On year to year basis based on percentage of completion or
- On completion of the contract.

However, the revised standard has eliminated the existing option, by adopting only percentage of completion method for recognizing the revenue. This method justifies the accrual system of accounting which is fundamental accounting assumption. The primary objective of this AS is the allocation of 'contract revenue' and 'contract cost' to the accounting period in which construction work is performed.

10.2.4 Applicability: This Standard is applicable in accounting for construction contracts in contractor's financial statements. In other words the AS does not apply to customer (Contractee). This would not be applicable for the construction projects undertaken by the enterprise on its own account as a commercial venture in the nature of production activities.

10.2.5 Calculation of profit or loss of a construction contract: Profit or loss of construction contract is equal to (Contract Revenue – Contract Cost).

10.2.6 Measurement of Contract Revenue: As per Para 31 of AS, the contract revenue and contract cost associated with the construction contract should recognize revenue and expenses respectively with reference to stage of completion of the contract activity at the reporting date.

Recognisition of revenue and expenses by reference to the stage of completion of a contract is generally referred as the Percentage of Completion Method; under this method revenue is recognized as revenue in the statement of profit/loss in the accounting period in which work is performed.

10.2.7 Determination of stage of completion: Stage of completion may be determined in a variety of ways like:

- Cost to cost method: the percentage of completion would be estimated by comparing total cost incurred to date with total cost expected for the entire contract:—

Percentage of Completion = (Cost to Date × 100) / (Cumulative Cost Incurred + Estimated Cost to Complete)

Current revenue from contract = Contract price × Percentage of completion – Revenue previously recognized

- By survey of work performed
- Completion of physical proportion of the contract work

While calculating the contract cost to date as mentioned above in formula following contract cost should be excluded.

- Contract cost that relates to future activity on the contract such as cost of material that have been delivered to a contract site or set aside for use of a contract but not used and applied.
- Payment made to sub-contractors in advance of work performed under the sub-contract.

Basic principles of recognition of revenue and expenses

Basic principles are as under:

- Revenue recognized in the period in which work is performed;
- Expenses recognized in the period in which the work to which expenses relate is performed.

Conditions for recognizing the contract revenue - Following conditions must be fulfilled for recognizing the contract revenue:

- Total contract revenue can be measured reliably
- It is probable that economic benefits associated with contract will flow to the enterprise / contractor
- Total contract cost and cost upto the stage of completion is measured reliably
- Contract cost attributable to contract can be clearly identified.

Uncertainty in collection amounts to expenses - When an uncertainty arises about the collectability of an amount already included in contract revenue and already recognized in profit and loss statement, it amounts to expense. This uncollectable amount of which recovery has ceased to be probable is recognized as an expense rather than as an adjustments to contract revenue.

When outcome of contract cannot be estimated reliably

In those circumstances the revenue should be recognized only to the extent of contract costs incurred of which recovery is probable, thus no profit is recognized. However contract cost recovery of which is not probable is recognized as an expense resulting in loss. But when the uncertainties no longer exist and contract outcome can be reliably estimated, recognition should be done as per this accounting standard.

Contract costs consist of the following:

Specific costs to contract - These are as under:

- Site labour cost including supervision
- Cost of material used in construction
- Depreciation of plant and equipments used on the contract
- Cost of moving plant, equipments and materials from contract site
- Cost of hiring plant
- Cost of design and technical assistance

- Estimated cost of rectification and guarantee work including expected warranty cost
- Claim from third parties
- Pre-contract cost. If it is probable that contact will be obtained

These costs should be reduced **by incidental income if any not** included in contract revenue, for example, sale of surplus/scrap material, disposal of plant and equipment at the end of contract.

Cost attributable to contract - These costs are:

- Insurance.
- Cost of design and technical assistance that is not directly related to a specific contract.
- Construction overheads.

Cost specifically chargeable to customers under the terms of contract - These costs are:

- Some general administration cost/for which reimbursement is specified.
- Development cost.
- Reimbursement of any other cost.

Cost excluded

Following costs are excluded from contract cost unless specifically chargeable under terms of contract:

- General administration cost
- Selling cost
- Research and development
- Depreciation cost of idle plant and equipment
- Cost incurred in securing the contract. Pre-contract cost - if it is not probable that contract will be obtained.

However, costs that relate directly to a contract and which are incurred in securing the contract if they can be separately identified and it is probable that contract will be obtained, such costs are also included in contract cost.

Contract revenue consists of the following :-

- Revenue/price agreed as per Contract.
- Revenue arising due to escalation clause.
- Claims - Claims is the amount that contractors seek to collect from the customer as reimbursement of cost not included in contract price.
- Increase in revenue due to increase in units of output.
- Increase or decrease in revenue due to change or variation in scope of work to be performed.
- Incentive payments to the contractors.
- Decrease in contract revenue due to penalties.

10.2.8 Provision for expected losses: When it is probable that total contract cost will exceed total contract revenue, the expected losses should be recognized as an expense irrespective of —

- Whether or not work has been commenced
- Stage of completion of contract
- The amount of profit on other contracts which are not treated as a single contract.

10.2.9 Effect of change in estimate in construction contract: As the recognition of revenue and expenses in construction contract is based on reliable estimate, nevertheless the estimate is bound to vary from one accounting period to another accounting period of the construction contract; the effect of change in estimate of contract revenue or contract cost is accounted as change in accounting estimate as per AS-5.

As per Para 21 of AS-5 the change in accounting estimates does not bring the adjustment within the definition of an extraordinary item or prior period items. Therefore, changed estimates are used to determine the amount of contract revenue and contract expenses recognized in the statement of profit and loss in the period in which the changes is made and in subsequent periods.

10.2.10 Disclosure by contractors: An enterprise (contractor) should disclose the following policy:

- The method used to determine the stage of completion of contract in progress
- The method used to determine the contract revenue recognized in the period.

In addition to policy disclosure following disclosures is also required to be made by the enterprise (contractor):

- The amount of contract revenue recognized in the period
- Contract cost incurred and recognized profit (less recognized losses) upto the reporting period
- Advance received
- Gross amount due from customers for contract work [(cost incurred + recognised profit) – (recognized losses + progress billing)]
- Gross amount due to customer for contract work [(recognized losses + progress billing) – (cost incurred + recognized profit)].

10.2.11 significant differences among AS-7, IFRS/IAS-11 and US GAAP: After the issue of AS-7 (revised) in 2002 the only method prescribed is percentage completion method to recognize the contract revenue, which is the same as AS-11. However, US GAAP in certain circumstances allows another method i.e. completed contract method for recognition of contract revenue.

US GAAP provides detailed guidance on the use of estimate in accounting for construction contract, however, no such guidance is provided under AS-7 and IAS-11.

Illustration 11:

A firm of contractors obtained a contract for completion of bridges across river Revathi. The following details are available in the records kept the year ended 31st March, 2012:

Particulars	**₹ in Lakhs**
Total Contract Price	1,000
Works Certified	500
Works not Certified	105
Estimated further cost	495
Progress payment received	400
Progress payment to be received	140

The firm seeks your advice and assistance in presentation of accounts keeping in view the requirements of AS-7 " Accounting for Construction Contract".

Solution:

As per AS 7, 'Construction Contract', when it is probable that total contract costs will exceed total revenue, the expected loss should be immediately recognized as an expense. The amount of such a loss is determined irrespective of (a) Whether or not work has commenced on the contract,(b) the stage of completion of contract activity as per AS 7.

We are to compute the anticipated loss and current loss which are computed as:

Anticipated or Foreseeable Loss

Particulars	**₹ in lakhs**
Cost of Total Contract:	
Work Certified	500
Add: Work not certified	105
Add: Estimated further cost to completion	495
	1,100
Less: Contract Price	1,000
Anticipated / Foreseeable loss	**100**

Work-in-Progress/Stage of Completion: = Work certified+ Work not certified

= ₹ (500 +105) = ₹ 605

% of work completed

605/1100 × 100 = 55%

Recognition of Contract Revenue:

Total Contract Price x 55% = ₹ (1,000 × 55%) = ₹ 550 lakhs

Amount due from/to customers = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)

= [605 + Nil – 100 – (400 + 140)] ₹ In lakhs

= [605 – 100 – 540] ₹ In lakhs

Amount due to customers = ₹ 35 lakhs

The amount of ₹ 35 lakhs will be shown in the balance sheet as liability.

The relevant disclosures under AS 7 (Revised) are given below:

Particulars	₹ In lakhs
Contract revenue	550
Contract expenses	605
Expected Losses	45
Recognized profits less recognized losses	(100)
Progress billings (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35

Illustration 12:

On 31.12.2012, Viswakarma Construction Company Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31.03.2013, the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of the additional cost for completion was ₹ 32,01,000.

What is the additional provision for foreseeable loss which must be made in the final accounts for the year ended 31.03.12 As per provisions AS 7 on " Accounting for construction contract?"

Solution:

As per AS 7, 'Construction Contract', when it is probable that total contract costs will exceed total revenue, the expected loss should be immediately recognized as an expense. The amount of such

a loss is determined irrespective of (a) Whether or not work has commenced on the contract,(b) the stage of completion of contract activity as per AS 7, (c) the amount of profit expected to arise on other contracts which are not treated as a single contract.

In this case the anticipated losses are calculated as follows:

Anticipated or Foreseeable Loss

Particulars	**₹ in lakhs**
Cost incurred	64.99
Add: Additional cost for computation	32.01
	97.00
Less: Contract Price	85.00
Anticipated / Foreseeable loss	**12.00**

Thus, as per AS 7, the whole amount of anticipated loss should be recognized and to be adjusted accordingly against the profit of the current year.

Illustration 13:

Calculate the contract revenue from the following details

(₹ In Crores)

Years

Particulars	**I**	**II**	**III**
1. Initial contract revenue	2000	2000	2000
2. Revenue increase due to escalation in IInd year	—	400	—
3. Claim			200
4. Incentive Payment			300
5. Penalties		100	

Solution:

Calculation of contract revenue

Particulars	**I**	**II**	**III**
Initial contract value	2000	2000	2000
Increase in revenue due to escalation	—	400	400
Claims	—	—	200
Incentive	—	—	300
Penalties	—	(100)	(100)
Contract revenue	2000	2300	2800

Illustration 14:

Assume a ₹10,00,000 contract that requires 3 years to complete and incurs a total cost of ₹8,10,000. The following data pertain to the construction period:

Particulars	Yr. I	Yr. II	Yr. III
Cumulative costs incurred to date	3,00,000	7,20,000	8,10,000
Estimated cost yet to be incurred at year end	6,00,000	80,000	—
Progressive billing made during the year	2,00,000	7,40,000	60,000
Collections of billings	1,50,000	6,00,000	2,50,000

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS-7.

Solution:

Particulars	Yr. I	Yr. II	Yr. III
Initial amount of Revenue agreed in contract	10,00,000	10,00,000	10,00,000
Variation	—	—	—
Total contract Revenue (A)	10,00,000	10,00,000	10,00,000
Contract cost incurred	3,00,000	7,20,000	8,10,000
Contract cost yet to be incurred to complete	6,00,000	80,000	—
Total Estimated contract cost (B)	9,00,000	8,00,000	8,10,000
Estimated profit (A-B)	1,00,000	2,00,000	1,90,000
Stage of completion	$\frac{3,00,000}{9,00,000} \times 100$ 33.1/3%	$\frac{7,20,000}{8,00,000} \times 100$ 90%	$\frac{8,10,000}{8,10,000} \times 100$ 100%

Revenue expense and profit recognized in Profit & Loss Statement

	Upto the reporting date	Recognized in Prior year	Recognized in Current year
Year I			
Revenue (10,00,000 x 3.1/3%)	3,33,333	---	3,33,333
Cost incurred	3,00,000	---	3,00,000
Profits	33,333	---	33,333
Year II			
Revenue (10,00,000 x 90%)	9,00,000	3,33,333	5,66,667
Cost incurred	7,20,000	3,00,000	4,20,000
Profits	1,80,000	33,333	1,46,667
Year III			
Contract revenue earned	10,00,000	9,00,000	1,00,000
Cost incurred	8,10,000	7,20,000	90,000
Profits	1,90,000	1,80,000	10,000

Contract Disclosure (AS-7)

(Amount in ₹)

		Yr. I	Yr. II	Yr. III
1.	Contract revenue recognized	3,33,333	9,00,000	10,00,000
2.	Contract expenses recognized	3,00,000	7,20,000	8,10,000
3.	Recognized Profit (Loss)	33,333	1,80,000	1,90,000
4.	Contract cost incurred	3,00,000	7,20,000	8,10,000
5.	Contract cost that releases to future activity recognized as an asset	NIL	NIL	NIL
6.	Progress Billing	2,00,000	9,40,000	10,00,000
7.	Unbilled contract revenue	1,33,333	NIL	NIL
8.	Advances	1,50,000	6,00,000	2,50,000
9.	Contract cost incurred and recognized Profit (Less recognized loss)	3,33,333	9,00,000	10,00,000
10.	Gross amount due from customer	1,33,333	NIL	NIL
11.	Gross amount due to customer	NIL	40,000	NIL
12.	Retention	50,000	1,90,000	NIL

10.3 PROJECT ACCOUNTING

Project accounting (sometimes referred to as **job cost accounting**) is the practice of creating financial reports specifically designed to track the financial progress of projects, which can then be used by managers to aid project management.

Project accounting differs from standard accounting in that it is designed to monitor the financial progress of a project rather than the overall progress of organizational elements. With Project Accounting, financial reports are specifically created to track the project process. Utilizing Project Accounting provides Project Managers with the ability to accurately assess and monitor project budgets and ensure that the project is proceeding on budget. Project managers can quickly address any cost overruns and revise budgets if necessary.

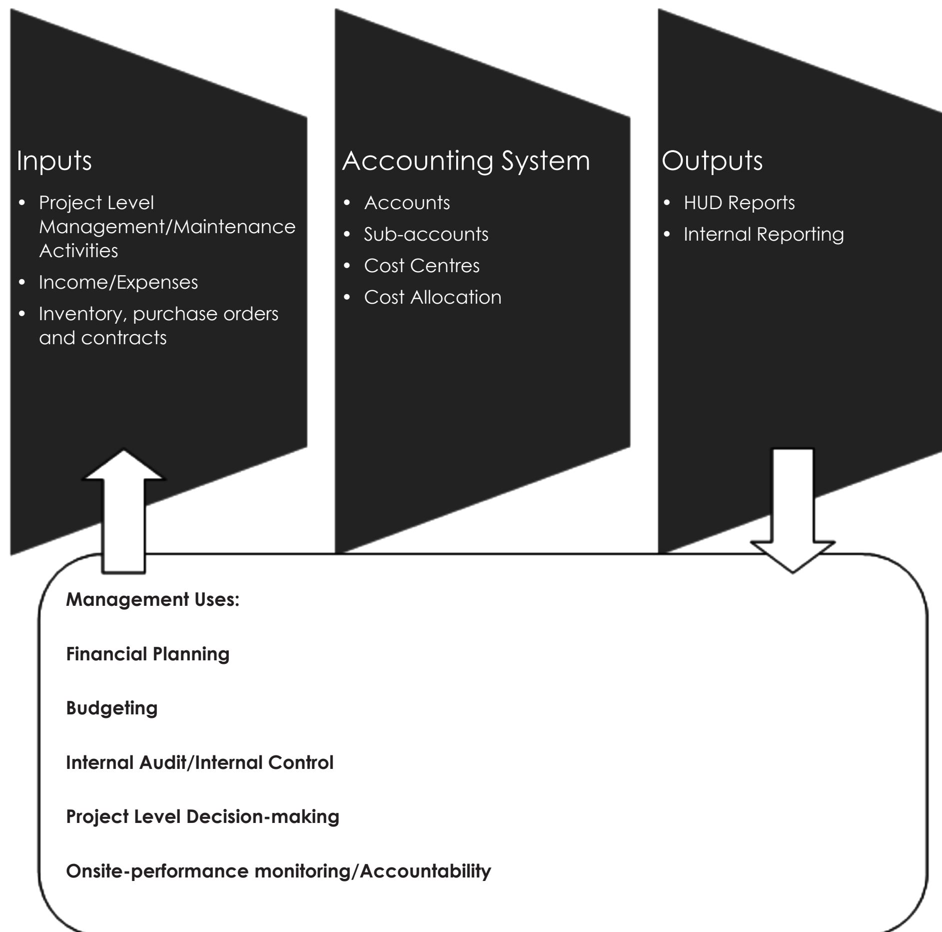
Project accounting also differs from standard accounting in the time period that it is reported. Standard accounting reports financial progress for fixed periods of time, for example, quarterly or annually. Projects can last from a few days to a number of years. During this time, there may be numerous budget revisions. The project may also be part of a larger overall project. For example, if an organization were constructing a new building that would be the larger project, however telecommunications could be handled as its own project, and as such with a separate project budget.

Costs and revenues that are allocated to projects may be further subdivided into a work breakdown structure (WBS). In utilizing project accounting, you have the flexibility to report at any such level and can also compare historical as well as current budgets.

Project accounting allows companies to accurately assess the ROI of individual projects and enables true performance measurement. Project managers are able to calculate funding advances and actual versus budgeted cost variances using project accounting. As revenue, costs, activities and labors are accurately tracked and measured, project accounting provides future benefits to the organization. Future quotes and estimates can be fine-tuned based on past project performance.

Project accounting can also have an impact on the investment decisions that companies make. As companies seek to invest in new projects with low upfront costs, less risk, and longer-term benefits, the costs and benefit information from a project accounting system provides crucial feedback that improves the quality of such important decisions.

Project Based Accounting System



10.4 ACCOUNTING FOR SERVICE SECTORS

10.4.1 Accounting for Software Companies

COMPUTER SOFTWARE ACCOUNTING

Introduction

Software is the general term describing programmes of instructions, languages and routines or procedures that make it possible for an individual to use the computer. It is any prepared set of instructions that controls the operations of the computer for computation and processing. More specifically, the term software applies to those programmes that are built within the computer. These programmes forming the software are supplied by the manufacturers and are usually named as *packages*. The hardware, the electronic, electrical, magnetic and mechanical components or devices that make the computer and software taken together form a computer *system*. It must be remembered that even a very powerful computer is useless junk without a strong support from its software.

In case computer software is acquired for sale in the ordinary course of business, it is treated as inventory and AS-2, Valuation of Inventories, is applicable. If it is meant for internal use, AS-26 is applicable.

Computer software for internal use can be either:

(i) acquired, or

(ii) internally generated.

SOFTWARE ACQUIRED FOR INTERNAL USE

The cost of a software acquired for internal use should be recognized as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of the Accounting Standard-26* of the Institute of Chartered Accountants of India which are given below:

19. The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the following definition and criteria:

Definition of an intangible asset

An *intangible asset* is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

An *asset* is a resource:

(a) Controlled by an enterprise as a result of past events; and from which future economic benefits are expected to flow to the enterprise.

Non-monetary assets are assets other than monetary assets. *Monetary* assets are money held and assets to be received in fixed or determinable amounts of money.

(b) Recognition criteria set out in this Statement.

An intangible asset should be recognized if, and only if:

(a) It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) The cost of the asset can be measured reliably.

* AS-26 applies in case of (i) enterprises whose securities are listed on an Indian recognized stock exchange and (ii) other business enterprises having annual sales exceeding ₹ 50 crores. AS-26 is mandatory for accounting periods beginning on or after 1-4-2003. For the other enterprises it shall be applicable for the accounting period commencing from 1.4.2004.

An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

An enterprise uses judgment to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition giving greater weight to external evidence.

An intangible asset should be measured initially at cost. In the determination of cost, matters stated in following paragraphs of Accounting Standard-26 are to be considered:

- If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.
- The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly

attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

- If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value. or the fair value of the securities issued whichever is more clearly evident.

INTERNALLY GENERATED COMPUTER SOFTWARE

Internally generated computer software for internal use is developed or modified internally by the enterprise solely to meet the needs of the enterprise and at no stage it is planned to sell it.

The stages of development of internally generated software may be categorized into the following two phases:

a . Preliminary project stage. i.e., the research phase.

b. Development stage.

a. Preliminary project stage, i.e., the research phase

At the preliminary project stage the internally generated software should not be recognized as an asset. Expenditure incurred in the preliminary project stage should be recognized as an expense when it is incurred. The reason for such a treatment is that at this stage of the software project an enterprise cannot demonstrate that an asset exists and from which future economic benefits are probable.

When a computer software project is in the preliminary project stage enterprises are likely to:

(i) Make strategic decisions to allocate resources between alternative projects at a given point of time. For example, should programmers develop a new Accounting System or make efforts toward correcting existing problems in an operating Accounting System.

(ii) Determine the performance requirements as well as the systems requirements for the computer software project it has proposed to undertake.

(iii) Explore alternative means e.g. should an entity make or buy the software. Should the software run on a mainframe or a client server system?

(iv) Determine that the technology needed to achieve the same.

(v) Study the requirement of a consultant to assist in the development and/or installation of the software.

b. Development stage

Internally generated software arising at the development stage should be recognized as an asset if, and only if, an enterprise can find out all of the following:

The intention of the enterprise to complete the internally generated software and use it to perform the functions needed. For example, the intention to complete the internally generated software can be demonstrated if the enterprise commits to the funding of the software project:

(i) The technical feasibility of installing the internally generated software.

(ii) The ability of the enterprise to use the software;

(iii) The probable usefulness of and economic benefits from the software.

(iv) The availability of adequate technical, financial and other resources to complete the development and to use the software; and

(v) The capacity to measure the expenditure attributable to the software during its development.

Examples of development activities in respect of internally generated software include:

Detailed programme design for the software considering product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.

Codification of requirements : The coding of computer software may begin prior to, concurrent with, or subsequent to the completion of the detailed programme design.

At the end of these stages of the development activity, the enterprise has a working 'model, which is an operative version of the computer software capable of performing all the major planned functions, and is ready for initial testing ("beta" versions).

Testing which is the process of performing the steps necessary to determine whether the developed software meets the targeted performance requirements.

At the end of the testing process, the enterprise has a master version of the internal use of software, which is a completed version together with the related user documentation and the training materials.

Cost of internally generated software

The cost of internally generated software is the sum of the expenditure incurred from the time when the software first met the recognition criteria for an intangible asset as stated in AS-26 given earlier. An expenditure which did not meet the recognition criteria as aforesaid and expensed in an earlier financial statements should not be reinstated if the recognition criteria are met later.

The cost of internally generated software comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis to create the software for its intended use. The cost includes:

(a) Expenditure on materials and services used or consumed in developing the software;

(b) The salaries, wages and other employment related costs of personnel directly engaged in developing the software;

(c) Any expenditure that is directly attributable to generate the software;

(d) Overheads related to developing the software and that can be allocated on a reasonable and consistent basis to the software (for example. an allocation of the depreciation of fixed assets, insurance premium and rent). Allocation of overheads is made on the normal acceptable basis.

The following are not components of the cost of internally generated software:

1 . Selling, administration and other general overhead expenditure unless this expenditure can be directly attributable to the development of the software;

2 . Clearly identified inefficiencies and initial operating losses incurred before software achieves the planned performance; and

3 . Expenditure on training of the staff to use the internally generated software.

Subsequent expenditure

Considerable cost may have to be incurred in modifying existing software systems. Subsequent expenditure on software after its purchase or its completion should be recognized as an expense when it is incurred unless:

(a) It is probable that the expenditure will enable the software to generate future economic benefits in excess of its originally assessed standards of performance; and

(b) The expenditure can be measured and attributed to the software reliably.

If these conditions are met, the subsequent expenditure should be added to the carrying amount of the software. Costs incurred in order to restore or maintain the future economic benefits that an enterprise can expect from the originally assessed standard of performance of existing software systems is recognized as an expense when, and only when, the restoration or maintenance work is carried out.

Period of Amortization

The depreciable amount of a software should be allocated on a systematic basis over the best estimate of its useful life. The amortization should commence when the software is available for use.

As per AS-26, there is a presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. However, due to phenomenal changes in technology, computer software is susceptible to technological obsolescence. Therefore, it is better to consider the useful life of the software much shorter, say 3 to 5 years, where required.

Method of Amortization

The amortization method used should reflect the pattern in which the software's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used.

The amortization charge for each period should be recognized as expenditure unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortization of software used in a production process is included in the carrying amount of inventories.

Disclosure

The financial statements should disclose the following for computer software, distinguishing between internally generated software and acquired software:

(a) The useful lives or the amortization rates used;

(b) The amortization methods used;

(c) The gross carrying amount and the accumulated amortization at the beginning and end of the period;

(d) A reconciliation of the carrying amount at the beginning and end of the period showing:

- (i) additions;
- (ii) retirements and disposals;
- (iii) impairment losses;
- (iv) amortization recognised during the period; and
- (v) other changes in the carrying amount during the period.

Statement on Significant Accounting Policies:

The financial statements are prepared on an accrual basis and under historical cost convention. The significant accounting policies adopted by the company regarding Fixed Assets, Depreciation and Research and Development are detailed below:

Fixed Assets and Depreciation

Fixed Assets are stated at acquisition cost.

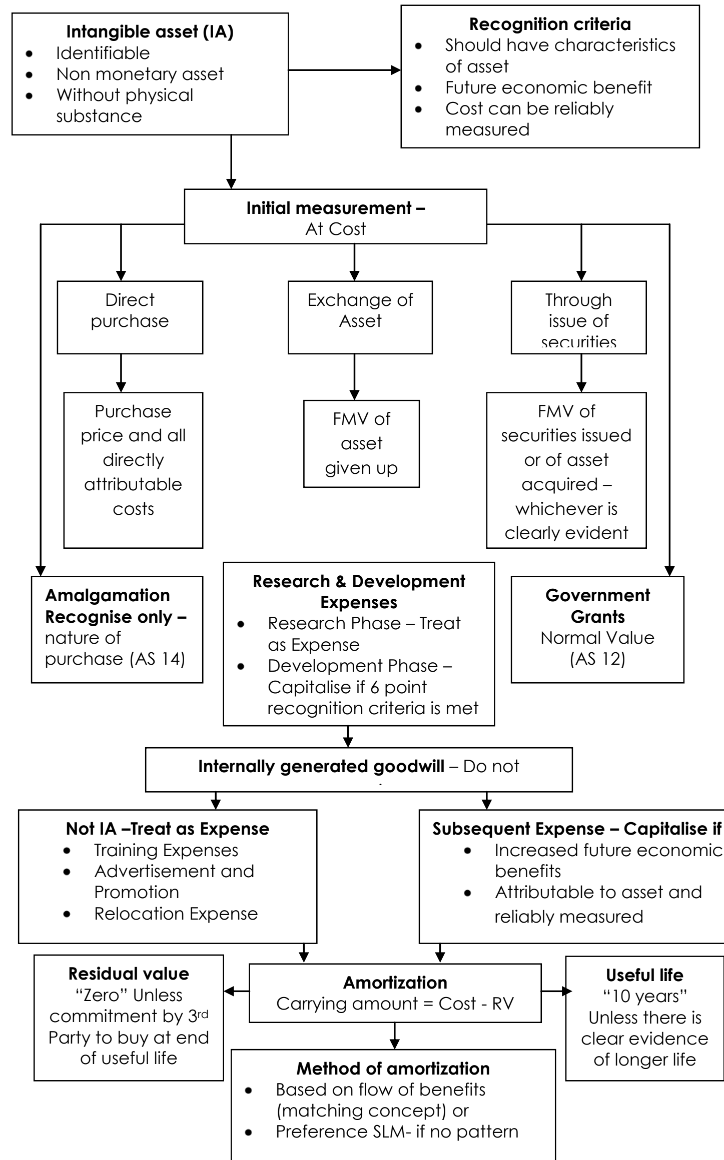
Depreciation is charged on a pro-rata basis on the straight-line method over the estimated useful lives of the assets determined as follows:

Leasehold Improvements	3 years or lease period whichever is lower
Courseware products developed and capitalised	1-3 years
Desktops/low configuration workstations, related accessories and software	2-3 years

File servers, high ended workstations/servers, networking equipment, related accessories and software	4-5 years
Library books	3 years
Assets under employee benefits scheme	3 years
All other assets	Rates prescribed under schedule XIV to Companies Act, 1956.

Further, computer systems and software forming part of plant and machinery are technically evaluated each year for their useful economic life and the unamortised depreciable amount of the asset is charged to profit and loss account as depreciation over their revised remaining useful life.

Diagrammatic representation



10.4.2. Accounting for ITES

Any activity carried out based on the application of Information Technology could be termed as IT Enabled Service (ITES). In other words IT Enabled Services cover the entire range of services which exploit information technology for empowering an organization with improved efficiency or a type of service which may not be possible to be rendered cost effectively without IT. The activity could be internal to the organisation i.e. meant to increase the operational efficiency through work force residing within the organisation or could be outsourced. The outsourced or cross-border IT enabled services is now receiving greater attention as this category of ITES has a great potential for growth and contribution towards employment opportunities in India.

Major Segments of IT Enabled Services

Following is a fairly detailed generic classification of IT Enabled Services which are already existing or which have potential for evolving into areas of entry:

- Customer Interaction Services such as Call Centres
- Finance and Accounting Services such as back office data processing for Airlines, etc.
- Engineering and Design Services such as outsourced design activities
- Human Resources Services such as outsourced payroll preparations, etc.
- Animation for movies and TV serials, cartoon strips, etc.
- Translation, Transcription and Localisation such as Medical Transcription Services.
- Network Consulting and Management covering outsourced network designing and maintenance.
- Data Search, Integration and Analysis covering areas such as preparation of legal data bases, research & preparation of reports based an data bases on past records, etc.
- Marketing Services such as bureaus for marketing products or services based on Call Centres or local market data bases, etc.
- Web Site Services for creating site contents, advertising, etc.
- Remote Education for utilising IT infrastructure to strengthen formal education system for remote and expertise starved areas.
- Medical Consultancy by providing expert advise based on data or making available data bases.
- Secretarial Services through bureaus which utilise information technology for offering secretarial help.

SIGNIFICANT ACCOUNTING POLICIES

1) Basis of preparation of Financial Statements:

   The financial statements have been prepared under the historical cost convention, on the basis of going concern and on accrual method of accounting, in accordance with Normally Accepted Accounting Principles and provisions of the Companies Act, 1956 as adopted consistently by the Company. All incomes and expenditures having material bearing on financial statements are recognized on accrual basis. The Company has complied with all the mandatory Accounting Standards ('AS') to the extent applicable as prescribed by the Company's (Accounting Standards) Rules, 2006, the provisions of the Companies Act 1956.

   The Accounting policies have been consistently applied except where a newly issued Accounting Standard is initially adopted or a revision to an existing Accounting Standard requires a change in the Accounting policy hitherto in use.

2) Use of Estimates:

The preparation of the financial statements in conformity with Normally Accepted Accounting Principles requires estimates and assumptions to be made that affect the reported amounts of the assets and liabilities on the date of financial statements and the report amount of revenues and expenses during the reported period. Difference between the actual results and estimates are recognized in the period in which it gets materialized.

3) Revenue Recognition:

(a) Revenue from services is recognized based on time and material and billed to the clients as per the terms of the contract. In the case of fixed price contracts, revenue is recognized on periodical basis based on units executed and delivered.

(b) Revenue from sale of software is recognized on delivery and transfer of ownership of the software to the clients.

(c) Revenue from sale of software licenses are recognized upon delivery where there is no customization required. In case of customization the same is recognized over the life of the contract using the proportionate completion method.

(d) Other Income: Interest income is accounted on accrual basis. Dividend income is accounted for when right to receive is established i.e. when the declaring company declares the dividend

10.4.3. Accounting for Telecommunication Sector

Accounting and Financial Reporting Issues

The entire business framework of telecom companies revolves around the regulatory and licensing framework and hence it is essential to understand some important regulatory levies paid by telecom companies. These regulatory levies are discussed in the following paragraphs:

Licence Fee: Telecom Licenses are granted by the Department of Telecommunications (DoT) of the Government of India on payment of an entry fee. For licensing purposes, India has been divided into three categories of circles.

While the charges for the Metro circle are high, the fee for state licenses categorised as B or C circles are lower. Upon commencement of services, operators pay a license fee based on the Adjusted Gross Revenue (AGR) on a quarterly basis. The accounting practice for treatment of the license fee varies from one operator to another. Some operators consider the entry fee as deferred revenue expenditure to be amortised over the period of the license, and charge it off fully in the year of payment to maintain a healthy balance sheet. As regards the license fee quarterly the annual fees paid as a percentage of AGR, the same is charged off in the year of payment. In this regard, it is interesting to note the treatment of the license fee paid in the initial year. An interesting treatment adopted by some companies was the amortising of the annual license fee over the balance license period. This treatment was adopted on the ground that it is only the payment mechanism which is annual, the benefits of the license fee payment is likely to accrue to the operator over the balance license period.

However, with the increase of Mergers & Acquisition (M&A) activities in the telecom sector and with acquisitions of previous licenses by a new set of foreign investors, these exotic treatments were reversed to give a more realistic picture of the state of affairs of the operations.

Although many of the telecom operators are not listed and their financial status is not readily available, it can be safely concluded that most of the operators have now adopted the practice of charging the full license fee to the year of incurrence. This practice will go a long way in providing a transparent picture of the profitability of operators.

It is also interesting to note that telecom operators have to pay a license fee to the Department of Telecommunications (DoT), on account of sale of handsets, which is essentially a trading activity, not subject to licensing. A non-licensed entity is not liable to pay any license fee to DoT on handset sales, whereas a licensed entity has to pay the fee. The Government should consider excluding handsets from the ambit of the license fee so that telecom companies stop resorting to several complex accounting and operational routes to avoid paying the license fee.

Interconnection Usage Charges (IUC):

Telecom operators have to interconnect their networks for forwarding calls made by their customers to customers of other operators or vice versa. Thus, operators have to pay charges for network usage based on guidelines announced by Telecom Regulatory Authority of India (TARI) from time to time. These interconnection charges have been reduced over the years thus making calls affordable and cheap.

Access Deficit Charges (ADC): Access deficit charges or ADC as it is popularly called is paid by telecom operators to fixed service providers like BSNL, MTNL and Reliance Infocomm for meeting their rural telephony obligation as part of IUC charges payable by operators.

Some of the key issues related to accounting treatment of telecom companies are:

Revenue Accounting: Revenue accounting is the most critical accounting process for any telecom operator, which in turn depends to a large extent on the efficacy and robustness of the billing system and a smart revenue assurance process. The billing system is one of the most advanced software systems of a telecom network. It is the network's main component, as it has to process each and every Call Detail Register (CDR) generated by the switching system. Telecom operators prepare multiple monthly billing cycles for all their customers. This is based on the total number of customers and their category within each network. Revenues are booked based on the total billing (also estimated billing is taken for the break up period) for each bill cycle, post the accounting assessment for prepaid revenues and deferred income. While the majority of operators carry out billing in arrears for rental and call charges.

Revenue accounting is more complex for prepaid cards, which constitute the lion's share of revenue for operators. Collections against sale of prepaid cards and refill vouchers are recognised as revenues only after customers utilize the services or on expiry of refill period, subsequent to expiry. In case of prepaid cards, the majority of telecom operators have deployed the Intelligent Network (IN) system to monitor the usage of prepaid services on a real time basis and they can disconnect services when customers breach their set threshold limits.

Thus, for prepaid services, revenue recognition is based on reports generated by the IN system.

The revenue accountant has to be conversant with complex billing systems and various interfaces that the billing system has with other network systems like the mediation system, IN, SAP, etc.

Depreciation: As per Indian GAAP, companies are required to provide for depreciation as per rates specified in Schedule XIV of The Companies Act, 1956. This is in stark difference to the U.S. GAAP, where depreciation is required to be provided based on estimated useful life of the assets. With large investments in Indian telecom companies by global investors including Hutchison and Vodafone, many Indian telecommunication companies have voluntarily adopted U.S. GAAP practices for depreciating their telecom assets based on estimated useful life. Due to an absence of regulatory policies regarding the useful life of assets, there remain gaps in assessing the estimated useful life of these assets as they vary from one operator to another. In case of telecommunications equipment that have no alternative use, the maximum estimated useful life of an asset cannot exceed the period for which the license has been granted.

Debtors Provisioning: This is a major bone of contention for telecom operators. As per Industry norms, unpaid billed amounts over three billing cycles (or ninety days approximately) are classified as non-recoverable. Similarly, dues from other telecom operators on account of roaming receivables or interconnection charges are provided in case of dues exceeding 180 days, net of payable.

While companies follow the 90-day norm for collection and credit control purposes, disclosure of debts on this basis is not required. Schedule VI requires disclosure of debts in 0 - 180 and 190 days and above category. Thus, the user of financial statements cannot make a realistic estimate of actual defaults of the company, and this significantly impacts the true and fair view of the state of affairs. Therefore, due to an absence of industry specific guidance, telecom companies are not obliged to make provisions for dues in the 90 – 180 day category.

However, telecom operators also receive dues from other telecom companies on account of roaming, IUC, NLD charges, etc. for which provisions are made based on recoverability and dues in the higher bracket.

Segmental Reporting: As with other industries that do not follow segmented reporting based on the various products offered, cellular companies treat prepaid and postpaid services as the same product offered, calling them 'telecom services'. Therefore, no segmented results are provided to distinguish between prepaid and post-paid services by GSM mobile providers. Integrated telecom players like Bharti Televentures Limited have classified their business into four segments – Mobile, Broadband, Long Distance, Enterprise and Others. For purposes of geographical segmentation, Bharti discloses results for the Indian region as one geographical area and rest of the world as another geographical area. VSNL has revised its reportable segments into two categories. For the year ended 31st March 2005, it revised its segments to consider "Telephony and Related Services", including international and national voice and data services and Internet services. "Other Services" include transponder lease, television up-linking, gateway packet switching services and video conferencing facilities. VSNL has identified geographical segments as India (58%), USA (11%), Saudi Arabia (3%), UAE (8%) and Others.

In case of geographical segmentation, Bharti Televenture's disclosure is limited to India (90%) and the rest of the world (country-wise details are not relevant, as they amount to less than 90%).

Some of the indicators used by the telecommunications Industry are as follows:

EBITDA: EBITDA or Earning before Interest, Tax, Depreciation and Amortisation is an indicator of the operating margin of a telecom operator. The average EBITDA margin for a telecom operator ranges from 36% to 20% .

ARPU: The Average Revenue Per User (APRU) or subscriber is an indication of the net recurring revenue per subscriber per month earned by the telecom operator. This is calculated by dividing the monthly net revenue by the average subscriber base. ARPU includes monthly rentals, airtime /call charges, VAS charges, and all other charges as reduced by Pass Through. ARPU does not include non- recurring revenues like handset sales, installation fees, revenue from roaming services from other networks, etc. Due to a large variation between prepaid and postpaid services, the ARPU is calculated separately for both these services. ARPU for prepaid services is generally lower (approximately 40% less) as compared to post-paid services bringing down the blended ARPU. For June 2005 and September 2005, the blended ARPU on an all India basis has fallen from ₹381 in June 2005 to ₹374 in September 2005. It is interesting to note that the Indian telecom industry has witnessed a continuous fall of ARPU on a Q2Q basis due to falling airtime rates, stiff.

MOU: The Minutes of Usage (MOU) is the total duration of minutes for which a customer uses a telecommunication network during a given month. In the nascent days of mobile telecommunication in India, airtimes rates were very high and a customer had to pay for incoming calls as well. During those days, the MOU ranged from 110 to 150 minutes per month, as customers were wary of making calls.

However, with falling rates, the MOU has steadily reduced. As on September 2005, the blended MOU was in the range of 367 minutes signifying a multi-fold increase in network utilization.

The MOU is also analysed between prepaid and post-paid services and further drilled down between incoming and outgoing. In the current billing system, a customer does not pay for any incoming calls. However, incoming calls bring in revenue for a telecom operator in the form of IUC charges paid by other service providers for terminating calls.

RPM: Revenue Per Minute is the blended tariff, which an operator provides across various tariff plans or customer segments. This is obtained by dividing the total revenue for a month or period by the relevant MOU. While the per minute rates are generally higher in case of low rental plans and prepaid services, on an overall basis, the business planner has to ensure that he maintains an equilibrium of total MOU and RPM.

Churn: Churn indicates disconnection of services of a customer from the network. Telecom operators offer various attractive schemes and packages to prevent churn. Churn may take place voluntarily when existing customers move out of the local coverage area permanently or they decide to change their service providers. Churn can also be forced by the service provider in disconnecting mobile services of defaulting or fraudulent customers to keep credit under control. When a customer voluntarily disconnects services, it is termed as voluntary churn. Churn occurs due to seasonal patterns or also due to aggressive sales marketing by competing operators to increase their own market share.

Proforma A— Capital Cost of Plant & Machinery and Network Equipment:

This schedule contains details of Gross Block, Depreciation and Net Block of assets deployed for each business activity of the operator like Basic Telephony, Cellular Telephony, etc.

Proforma B— Statement of the Cost of Operation

Proforma C— Quantitative Information:

This schedule requires disclosure of Installed Switch Capacity, Traffic Capacity (in Earnings),Capacity Utilisation, the number of Points of Interconnection, the number of E1 Links, the total duration of calls, average duration per call, traffic analysis between incoming and outgoing calls, etc.

Proforma D— This schedule requires allocation of various costs to business activities or revenue segments of the company.

10.4.4 ENTERTAINMENT

Cinema, Theatre, Jatra and Circus

1. These organizations have substantial similarity in respect of incomes viz., sale of tickets, programmes, advertisement and the like. These can better be recorded in Cash Book with these columns. The daily sales of tickets are recorded in the Daily Return of Tickets sold and this must be in agreement with the Register of Stamps of Amusement Taxes.
2. The Distributors have the above incomes as against which Amusement Tax is a direct charge. Hire charges of films, advertisement, wages for different groups of staff are to be considered along with rent or depreciation of the buildings, furniture, Projectors and other equipments. Accounts for each book should be drawn by the Distributors. For Producers the income are sale and hire of films as against which fees of artists, expenses of outdoor shooting, charges of studios, remuneration of Cameramen, Music Directors, Directors etc. are charged. Working Account of each feature should be separately drawn out by Producers.
3. In Theatres also similar accounts are maintained. Salaries of Orchestra, cost of dresses, remuneration of artists, rents etc. are considered as running expenses and are recorded preferably in columnar form of Cash Book. The cost of scenery, equipment etc. is capitalized and depreciation is charged along with depreciation on furniture and fixture. The accounts of Jatra Party may also be maintained in the same way but usually collections are on contract basis rather than on the basis of sales of tickets.
4. In Circus, accounts for collection and expenses may be maintained in the same way as above. Special care should be given to Live Stock Account and preferably different Live Stock Accounts for different animals should be maintained. Working Account should be drawn for each establishment usually running over a few months; as generally they are of mobile type.

Hotels, Restaurants and Caterers

1. The accounting scheme of the organization will, of course, depend upon its size and exact nature and requirements, but the principle of accounting remains same as in all cases. There may be provision for serving of refreshment only, or for serving of launches and dinners usually with provisions of refreshments; there may be arrangement of bar, and lodging may also be provided. Some may have special section for catering at different places on the occasion of marriage and the like. At any rate, purchases of various types of items should be separately recorded and similarly accounts for sales of various types of items must be separately maintained to disclose the correct position and for helping in proper control.

2. Purchases and expenses may better be recorded through Analytical Purchase Book and Cash Book. The Purchase Day Book and payments side of Cash Book will be provided with columns for: Wines and Minerals; Groceries and Provisions; Cigarettes and Cigars; Cutlery, Glass and Plates; Bedding and Linens; Furniture and Fixtures; Establishment; and the like. There will be a Ledger Column also in Cash Book to show disbursement on behalf of visitors.

3. The Receipt side of Cash Book and Sales Book may have analysis columns as : Dinner and Launches, Breakfast, Bar, Cigarettes and Cigars, etc. in Cash Book there will be further columns for Visitors' Ledger and Personal Ledger.

4. The Sales Book is better maintained together with the account of each visitor (when lodging is provided) in the form of what is known as Window Ledger or Visitors' Ledger. Account for each day is maintained for each visitor together with details of charges (same as are shown in bills submitted to them ultimately) and the Room No. is indicated against each visitor. The vertical total shows the Debit Total for each visitor, and credits are shown below. The horizontal totals indicate totals of different types of charges during the whole day. The daily total may be posted in ledger or may be carried forward to next day and added up with next day total and carried forward and so on, ultimately being posted to ledger (it required) say, at the end of the month. When there are many rooms and guests, a number of pages has to be used every day. A pro-forma Visitors Ledger (Window Ledger

5. The items may be repeated by the side of Daily Total column to avoid confusion as there may be many columns for visitors in every page. The b/f and c/f. columns may also be avoided and Daily Totals may be posted in the General Ledger.

6. Stock Ledger must be maintained in details to have thorough control over purchases, usage and sales of different items, and periodical stock must be carried out.

7. At the time of preparation of Final Accounts adjustment entries must be passed for meals, accommodation etc. of the staff and proprietor by crediting these items as against Salaries and Wages or Drawings, as the case may be. It will be better to draw out Working Accounts for different sections as Bar, Accommodation, Restaurant, Supply of Launches and Dinners. The rates and taxes and building repairs, depreciation on beddings together with attendant's wages and proportionate establishment charges are charged against Accommodation Account whereas collections for accommodation are credited to this accounts.

8. Cost of meat, eggs, fish and poultry, stores, groceries and provisions are apportioned in between Restaurant Section and Launches and Dinners. Depreciation on glass and china, cutlery and plates, table linens etc. should be similarly apportioned. Separate accounts may also be necessary for Billiard Room, Banquet Halls, Garage, Laundry and the like.

Doctors, Druggists and Nursing Homes

1. Practicing Doctors, whether G. P. (General Practitioners) or specialists, maintain diary, and all details, charges, special points are noted there. From these the Incomes are grouped and recorded in daily Cash Book having columns for visits, consultation fees, prescription served etc. if a number of specialists carry on in partnership further columns may be necessary for charge for pathological examinations, surgical operations, X'Ray and other plates, special therapy etc.

2. The expenses are also grouped in Cash Book as medical and surgical equipments and plants, special and general furniture and fixture, medicines and drugs, bandaging materials etc. and other expenses. Patients' Ledger may have to be maintained. In case of Dentists, purchases of dentures (i.e. artificial teeth etc.) and connected materials are to be recorded in separate columns.
3. In case of dispensing Chemists and druggists, Sales Book and Purchases Book are to be ruled with columns for: Prescriptions served, drugs, patent medicines, baby foods, bandaging materials and the like.
4. In case of Nursing Homes accounts for the cabin and bed rents, expenses, and collections from patients should be maintained separately from those for charges for attendance by Doctors and Surgeons, supply of drugs and medicines etc. Similarly, accounts for food and diet should be separately maintained. Columnar Purchases Book, Charges Book and Cash Book may be maintained for each bed.

10.4.5. Accounting for Hospital

Measuring Revenues and Expenses with Accrual Accounting

Accountants measure profit or loss by applying a concept called accrual accounting. This is a way of accurately comparing the organization's income against its expenses over time. The timing in "recognizing" each of these events is central to the accrual method, which is used by all organizations. In healthcare, accrual accounting entails deciding when patients have received services for which the organization is entitled to income, as well as how and when the cost of these services is measured. Key points of accrual accounting include the following:

Income (revenue) is earned when services are provided. A patient in a bed is receiving a service. Expenses are the costs of providing material and service to the parties that receive the service, when the service is being provided.

The timing of when an organization gets paid for the services it renders, or when it pays for the materials and services it purchases, is irrelevant to the accrual accounting method. Cash flow is a separate issue for consideration.

The accurate measurement of profits or losses depends upon the correct matching of services provided and the costs of providing these services.

Services and materials can be paid for long after they have been received and consumed; reimbursement for services provided may occur long after the provision thereof, but the synchronization of cash flows with the proper measurement of income and expense is usually accidental. To illustrate these ideas, let's look first at the measurement of inpatient revenue.

Allocation of Revenue (Income)

There are several ways of being paid for patient care. The recognition of revenue depends upon the payment method. Imaginative payers may come up with new reimbursement approaches during these turbulent times, but currently there are three key methods:

Case Basis: Also called prospective payment, this has been the dominant reimbursement method due to the adoption by Medicare of diagnosis-related groups (DRGs), now called Medicare severity diagnosis-related groups (MS-DRGs). These are described fully in the section entitled, How Hospitals Are Paid. Within specified parameters, the hospital or health system is paid a set fee for the care of a patient who has a certain condition, regardless of how long he or she is hospitalized or how many resources are consumed during the stay.

Per Diem: Under this type of reimbursement, the hospital or health system receives an agreed-upon amount per patient day. For a long time, per diem was the only method of payment used, but it was cost per diem. The provider set the price. Now it is contractual per diem, and the payer generally sets the price.

Capitation: The hospital or health system receives a fixed amount per enrolled individual per month or year to cover a specified list of medical services. The provider is paid regardless of whether medical services are used and conversely bears all cost overruns.

A fourth payment method used by commercial indemnity plans and some PPOs involves payment of a percentage of charges.

Realization of Revenue

When does the healthcare organization realize income for providing service to patients? Theoretically, hospitals or health systems accrue income continuously while the patient is in the hospital. Measuring income continuously, however, is neither practical nor necessary.

For the cash basis, patient revenue in a particular month is the total of the following:

The full fee for all patients admitted and discharged in the specific month; plus

The prorated portion of total revenue for all patients admitted in a previous month and discharged in this month; plus

The prorated portion for all patients who are still in the facility past the month's end.

By prorated, we mean the estimate of the portion of the total fee that we consider earned for the patient's care, as at the end of the period. This process seems straightforward in terms of its logic, but prorated allocation is difficult. There are also complications in applying appropriate rates.

For the per diem basis, income is determined by multiplying the per diem rate by the number of days actually spent by patients in the hospital during the time period being accounted for.

Observations about the revenue recognition implications of capitation appear in the section entitled,

Revenue realization is simpler for outpatient activity. Since service is rendered on a one-day basis, there are no allocation issues.

Cash Accounting

Cash accounting is a simple alternative to accrual accounting. Using this method, an organization recognizes income when the payer pays for the service; the organization incurs an expense when it pays for the costs involved. With cash accounting, a crore rupees sale in December 2012, paid for in 2013, is income in 2013.

Cash accounting and cash flow are not the same things. Cash accounting is one approach for recognizing income and expense; cash flow is an analysis of past, present, or prospective cash activity. Cash flow is a vital indicator of an organization's financial performance. Cash accounting is mentioned here only to facilitate an understanding of the accrual methodology.

Expense Recognition

A number of timing issues arise in recognizing expenses under the accrual method. The first and easy case involves recognizing the steady flow of invoices for materials and services that are to be consumed promptly to provide patient care. Typically, such transactions are recognized as expenses when the invoices are recorded.

Recognize Expenses Immediately

Invoices are recorded as expenses, these are recognized goods and services are consumed quickly.

A second category involves the purchase of goods and services for which an obligation is incurred, but where the goods and services are used during more than one accounting time period. For example, consider an insurance premium that is paid on July 1 and provides insurance protection for one year from that date. If the accounting year ends in December, it is necessary to prorate the premium. One half is an expense of the current period; the other half is an asset pending transfer to the expense category in the next year. These items are commonly called prepaid expenses and appear on the asset side of the organization's balance sheet.

Prepayments

Payments for goods and services that are consumed over more than one accounting period record portion consumed in current period as expense. Defer portion not consumed as an asset called prepaid expenses.

A third category of expense recognition involves charges for services that have been provided to the organization but, for various reasons, no paperwork yet exists. For example, our auditors finish the 2012 audit in 2013. To recognize that cost in 2012, an entry must be made even before there is final knowledge of the amount. Such transactions, known as accrued expenses, run the gamut from situations where the overlap into a future period is very brief, to new circumstances that will not be explicit until sometime well into the future.

There are many types of accruals, but a common example involves payrolls. At the end of a month, wages and salaries for the last few days of the month will not be recorded until the payroll for that week is paid, for example, during the first week of the following month. The cost of the overlapping days belongs to the current month and is a liability on the liability side of the organization's Balance Sheet.

Depreciation

Buildings, major equipment, and computers are fixed assets. They last for a relatively long time and are disposed of when their productivity declines due to advances in technology, the high cost of repairs, and so forth. To recognize such items as expenses, we allocate their cost over their estimated useful life and enter that amount on the income statement. We call this depreciation.

Accountants base the depreciation calculation on the cost of the asset and its expected life. A percentage of the cost is then apportioned to each accounting period of the item's useful life. Even though the market value of certain fixed assets, notably land and buildings, may appreciate dramatically, these increases do not appear on the financial statements and do not affect the depreciation calculation. Incidentally, the value attributed to land itself cannot be depreciated. The cash flows associated with financing a depreciating asset do not enter into the depreciation accounting charge. A separate accounting entry recognizes the purchase of the asset, which may also involve creating a liability.

10.4.7. Accounting for Educational Institutions

This 'Guidance Note on Accounting by Schools' primarily focuses to address the various issues by establishing sound accounting practices and recommending uniform formats of income and expenditure account and balance sheet.

An accounting framework primarily comprises the following:

(a) Elements of financial statements basically comprising income, expenses, assets and liabilities

The framework aims to identify which items should be considered as income, expenses, assets and liabilities, for the purpose of including the same in the financial statements by defining the aforesaid terms.

(b) Principles for recognition of items of income, expenses, assets and liabilities

These principles lay down the timing of recognition of the aforesaid items in the financial statements. In other words, these principles lay down when an item of income, expense, asset or liability should be recognised in the financial statements.

(c) Principles of measurement of items of income, expense, assets and liabilities

These principles lay down at what amount the aforesaid items should be recognised in the financial statements.

(d) Presentation and disclosures principles

These principles lay down the manner in which the financial statements are to be presented and the disclosures which should be made therein.

It may be noted that what is considered as an asset, e.g., land and furniture, by a business entity is an asset for a not-for-profit organization also. Same is the case for items of income, expenses and liabilities. Similarly, insofar as the recognition principles are concerned, it is felt that there is no difference in preparing the financial statements of business entities and not-for-profit organisations such as schools. For example, the timing of the recognition of a grant as an income in the financial statements of an organisation does not depend upon the purpose for which the organisation is run. A grant is recognised as income in the financial statements, under accrual basis of accounting, when it becomes reasonably certain that the grant will be received and that the organisation will fulfill the conditions attached to it, and under cash basis of accounting at the time when the grant is actually received. Thus, a business entity and a not-for-profit organisation would follow the aforesaid criteria for recognition of grant as income depending upon the basis of accounting (i.e., cash or accrual basis, discussed hereinafter) followed by the respective organisation rather than the purpose for which the organisation is run. Similarly, principles for recognition of expenses, assets and liabilities would be the same for a business entity and a not-for-profit organisation.

Insofar as the measurement principles are concerned, the same principles are relevant to a not-for-profit organisation as well as to a business entity. For example, depreciation of an asset represents primarily the extent to which the asset is used during an accounting period by an organisation.

Thus, whether an asset, such as a photocopying machine, is used by a school or a business entity, the measure of charge by way of depreciation depends primarily upon the use of the asset rather than the purpose for which the organisation is run, i.e., profit or not-for-profit motive. Accordingly, the measurement principles for income, assets and liabilities should be the same for business entities and not-for-profit organisations such as schools.

Basis of Accounting

The commonly prevailing bases of accounting are:

(a) cash basis of accounting; and

(b) accrual basis of accounting.

Under cash basis of accounting, transactions are recorded when the related cash receipts or cash payments take place. Thus, revenue (e.g., from fees, etc.) is recognised when cash is received. Similarly, expenditure on acquisition and maintenance of assets used in rendering of services by an organisation as well as on employee remuneration and other items is recorded when the related payments are made. No subsequent account is taken of whether the asset is still in use, has reached the end of its useful life, or has been sold. Thus, cash-based information fails to show a proper picture of financial position and performance. A cash-based system does not provide information about total costs of an organisation's activities.

Accrual basis of accounting is the method of recording transactions by which revenues, expenses, assets and liabilities are reflected in the accounts in the period in which they accrue. Accrual basis of accounting attempts to record the financial effects of the transactions and other events of an enterprise in the period in which they occur rather than recording them in the period(s)in which cash is received or paid by the organisation. Accrual basis recognizes that the economic events that affect an organisation's performance often do not coincide with the cash receipts and payments. The goal of accrual basis of accounting is to relate the accomplishments (measured in the form of revenues) and the efforts (measured in terms of costs) so that the reported net income measures an organisation's performance during a period rather than merely listing its cash receipts and payments. Apart from income measurement, accrual basis of accounting recognises assets, liabilities or components of revenues and expenses for amounts received or paid in cash in past, and amounts expected to be received or paid in cash in future. One of the resultant advantages is that it offers the opportunity to the organization to improve management of assets. Similarly, accrual-based accounting provides useful information about the real level of an organisation's liabilities, relating to both debts and other obligations such as employee entitlements. Accrual is, thus, a scientific basis of accounting and has conceptual superiority over the cash basis of accounting.

Study Note - 11

ACCOUNTING FOR SPECIAL TRANSACTIONS

This Study Note includes

11.1 Bills of Exchange
11.2 Consignment Accounting
11.3 Joint Venture Accounts
11.4 Sales of Goods on Approval or Return Basis
11.5 Account Current
11.6 Investment Account
11.7 Insurance Claim (Loss of Stock and Loss of Profit)

11.1 BILLS OF EXCHANGE

11.1.1 Introduction

Business activity involves exchange of goods or services for money. A business transaction gets 'closed' if the exchange is settled immediately. When goods are purchased from supermarket and paid for in cash the settlement is instant. Same is the case when we go to a restaurant, have food and pay either by cash or credit card. Most of the settlements are not on cash basis, where payment for goods or services is deferred at the behest of both parties to the transaction. Such deferred payments are done through instruments like cheques, pay order, letter of credit, promissory note, bills of exchange, hundies etc. These instruments facilitate credit transactions and hence sometimes they are referred to as credit instruments or negotiable instruments. Even in ancient times some credit instrument like hundies were extremely popular.

In case of credit transaction, the supplier normally gets a promise from the customer that he will settle the payment at a future date as agreed. It could either be a promissory note or bill of exchange. The promissory note is written by the customer as an undertaking to pay the money, whereas the bill of exchange is a note drawn by the seller and accepted by the buyer. In India, the Negotiable Instruments Act 1981 governs the provisions for bills of exchange. As per this act, the bill of exchange is defined as " an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain some of money only to the order of the certain person or to the bearer of the instrument"

Based on this definition the following features of a bill of exchange are noticed:

(a) It's an instrument in writing.
(b) It contains an unconditional order.
(c) It's signed by the drawer.
(d) It's drawn on a specific person.
(e) There is an order to pay a specific sum of money.
(f) It must be dated.
(g) It specifies to whom the payment is to be made e.g. to the maker or to person mentioned by him or to the bearer.
(h) The amount of money to be paid must be certain.

(i) It must be properly stamped

(j) It may be made payable on demand, or after a definite period of time.

Whereas, a bill of exchange is drawn by seller and accepted by buyer; a promissory note, on the other hand, is created by the buyer as an undertaking to pay to the seller.

Specimen of a bill of exchange:

Stamp	Address of Drawer Date
Three months after date pay to a sum of ₹ 50,000 (Fifty Thousands only) far the value received.	
To B accepted	
(B's signature & stamp)	
	A (Drawer)

11.1.2 Parties to Bill of Exchange

The parties involved in transaction that uses bill of exchange as a mode of settlement are:

(a) Drawer: He is a person who draws the bill. Typically, he is the seller or a creditor.

(b) Drawee: He is the person on whom the bill is drawn. Normally, he is the buyer or debtor. He has to pay the amount of the bill to the drawer on the due date.

(c) Payee: He is the person to whom the amount of bill is payable. He may be the drawer himself or the creditor of the drawer.

(d) Endorsee: He is the person in whose favour the bill is endorsed by the drawer. He is usually the creditor of the drawer.

(e) Drawee in case of need: Sometimes the name of another person is mentioned as the person who will accept the bill if the original drawee does not accept it: such a person is called the 'Drawee in case of need'.

Suppose, 'A' sells goods to 'B' for ₹ 1,00,000. 'A' draws a bill on 'B' who accepts the same to pay this amount after 90 days. Here, 'A' is the drawer and 'B' is the drawee. If 'A' specifies that the amount will be paid to 'C', then 'C' will be the payee.

It is necessary that the bill is accepted by the drawee. Only then it becomes a valid negotiable instrument. Such accepted and signed bill of exchange is usually 'noted' with 'notary public'. Such noting is usually done when the bill is dishonoured.

11.1.3 Holder and Holder in Due Course

Holder

According to Sec 8 of the Negotiable Instruments Act a Holder is "Any person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the parties thereon". It indicates the person who is legally entitled to receive the money due on the instrument is called the 'Holder'.

Holder in Due Course

According to Sec 9 of the Negotiable Instruments Act, the holder in due course is a particular kind of holder. The holder of a negotiable instrument is called holder in due course if he/she satisfies the following conditions:

(a) He/she has obtained the instrument for valuable consideration.

(b) He/she became the holder of the instrument before the maturity of the instrument.

(c) He/she must acquire the instrument bona fide and having no cause to believe that, any defect existed in the title of the person from whom he derived his title.

Calculation of Due Date

Date of Maturity is also known as Due Date. The date on which the amount of the bill becomes payable is called 'Due Date' or 'Date of Maturity'. The period between the date of drawing of the bill and the due date is called Tenure of the Bill. To compute due date, three days (called Grace Period) are included to the date of maturity of the period of the bill.

The date of maturity of the period of bills depends on whether the bill is payable on date or bill is payable on sight. If the bill is payable on date, the date of maturity is computed by including tenure of bill to the making of the bill.

Date of maturity can be understood with the help of the following example:

Date of Drawing	12.12.2012
Tenure	+ 3 Months
	12.03.2013

However, If the bill becomes due at sight, the date of maturity is counted by including tenure of the bill to the date of acceptance of the bill. In that case, the due date of the bill is calculated as follows:

Date of Acceptance	16.12.2012
Tenure	+ 3 months
	16.3.2013

The due date of the bill after including grace period of 3 days is 15.3.2013 if the bill is payable at date and 19.3.2013 if the bill is payable at sight.

For computing the date of maturity, following points should be noted:

1. Days of grace are allowed on bills payable on maturity of a fixed period. In case of bills payable on demand, amount is required to be paid on presentation and no grace period is allowed.

2. If period of the bill matures on a date which is not there in the month in question, then the due date is taken as the last date of the month. For example, if a bill is drawn on 31.1.2013 and the period of the bill is 3 months, the period bill becomes payable on 30.4.2013 and after including grace days, due date is 3.5.2013.

3. In case the expiry date of a bill falls on a holiday, the bill becomes payable on the preceding day. But when the maturity date is a bank holiday or a Sunday and the second day of grace is also a holiday, the bill is payable on the next working day.

4. The tenure of the bill can be explained in months or in days. The due date of bill should be computed considering this fact in mind. Hence, if S draws bill on A on 31.1.2013 of one month, the maturity date of the bill is computed as follows :

Date of Drawing	31.1.2013
Tenure	+1 month
	28.2.2013
Days of Grace	+ 3 days
	03.03.2013

However, if tenure of the bill is 30 days, the expiry date of the bill is computed as follows :

Date of Drawing	31.1.2013
Tenure	+ 30 days
	02.03.2013
Days of Grace	+ 3 days
	5.3.2013

Hence, tenure of one month and 30 days are different.

11.1.4 Acceptance of a Bill of Exchange

When the drawee puts his signature across the face of a bill of exchange with or without the words "accepted", it is called acceptance.

A bill, except in certain special cases, requires acceptance; otherwise the liability of the drawee cannot be established thereon.

Acceptance may be General or Qualified. When the drawee accepts liability to pay the amount mentioned in the bill in full, without any condition or limitation, it is a case of general acceptance. When the drawee accepts subject to some qualifications as regards amount, tenor, domicile etc. it is a case of qualified acceptance.

11.1.5 Endorsement of a Bill

Endorsement is the act of signing a negotiable instrument by the maker or holder thereof for the purpose of transferring his rights to somebody else. The person making the endorsement is called the 'endorser', the person to whom it is endorsed is called the 'endorsee'.

A negotiable instrument payable to order may be transferred only by endorsement and delivery, but a negotiable instrument payable to bearer can be transferred by delivery only.

Endorsement may be of various kinds, such as:

(1) **Blank (or general):** In such an endorsement, the endorser puts his signature only without any further instruction. An instrument so endorsed becomes payable to bearer even though it was originally payable to order.

(2) **Special (or in full)**: In such an endorsement, the endorser in addition to his signature specifies the name of the person to whom or in whose favour the instrument is payable. Further negotiation of an instrument which is endorsed in full would require the endorsee's signature.

(3) **Restrictive:** This endorsement has the effect of restricting further negotiation and transfer.

(4) **Conditional:** In such an endorsement the endorser imposes some condition while endorsing the instrument. Fulfillment of the stated condition is essential before payment can be demanded.

(5) **'Sans Recours':** This is an endorsement whereby the endorser expressly conveys that he does not incur any liability to any subsequent party in the event of dishonour of the instrument.

(6) **'Sans frais'**: The endorsement exempts the endorser from liability for expenses.

(7) **Facultative:** In such an endorsement the endorser waives some rights to which he is entitled in case of dishonour.

11.1.6 Discounting a Bill

If the holder of a bill wants to get the money of the bill before its due date, he can do so by selling the bill to a bank or a Discounting House who in consideration of a charge called discount, provides him with ready cash. This is known as discounting the bill. Discount charged by the bank is the interest at a certain rate per cent per annum on the amount of the bill for its unexpired period, i.e., the period from the date of discounting upto the date of maturity. This discount has no connection with the cash discount and must not be confused therewith.

11.1.7 Dishonour of Bill

Dishonour of a Bill means that the acceptor refuses to honour his commitment on due date and for this, payment of the bill on presentation does not take place. At the time of dishonour of a bill, original relationship between the parties is restored, that is, the drawee again becomes the debtor of the drawer in his books and drawer is treated then as a creditor in the books of drawee. Moreover, the drawer becomes liable here to compensate the bank (or for that matter endorsee) if the bill is not retained by the drawer till date of the maturity.

To provide a legal evidence of dishonour, the fact of dishonour is to be noted on the bill by 'Notary Public'. The fact of dishonour which he is recording is called 'noting' and the amount charged by him for his services are called 'noting charges'. These charges are to be paid by the holder of the bill on the date of default. Actually the acceptor of the bill is liable for the dishonour, the noting charges paid by the holder are to be reimbursed by the acceptor.

11.1.8 Renewal of Bills

Sometimes the drawee of a bill is not able to meet the bill on due date. He may request the drawer to draw a new Bill for the amount due. Sometimes he pays a certain amount out and accepts a first bill for the balance for which he has to pay a certain amount of interest which is either paid in cash or is included with the fresh bill. This bill is known as Renewal of Bills. That, the amount of the new bill will be face value of the original bill minus cash payment, if any, plus interest for the renewed period.

11.1.9 Retirement of Bill

Sometimes the drawee pays the bill before the date of maturity. Under the circumstances, the drawer allows certain amount of rebate or discount which is calculated on certain percentage p.a. basis. The rebate is calculated from the date of payment to the date of maturity.

11.1.10 Accounting entries

For the convenience of accounting, bills are classified into (i) Bills Receivable and (ii) Bills Payable. All bills are –

(i) Bills Receivable to those who receive the bills, and

(ii) Bills Payable to those who accept the bills.

Thus, the same bill is both a Bill Receivable and a Bill Payable.

Holder, of the bill, however, has following four options available to him :

(a) He may retain the bill till the date of maturity

(b) He may get the bill discounted

(c) He may endorse it to a third party in settlement of a debt

(d) He may send it to his banker for collection.

Usual entries for bill transactions are given below:

Transactions	Drawer's Books	Drawee's Books
When the bill is drawn and accepted	Bills Receivable A/c ... Dr. To Drawee's A/c	Drawer's A/c ... Dr. To Bills Payable A/c
When the bill is duly honoured on maturity	Bank A/c ... Dr. To Bills Receivable A/c (This entry will be made if the drawer retains the bill till due date and receives payment)	Bills Payable A/c ... Dr. To Bank A/c
When the bill is endorsed to a creditor	Endorsee's A/c ... Dr. To Bills Receivable A/c	
When the bill is discounted with the bank	(i) Bank A/c ... Dr. To Bills Receivable A/c (with full amount of the bill)	
	(ii) Discount on Bills A/c ... Dr. To Bank A/c (with the amount of discount)	
	Alternative combined entry : Bank A/c ... Dr. Discount on B ills A/c ... Dr. To Bills Receivable A/c	
When the bill is sent to bank for collection and the bill is duly collected	(i) When sent: Bills for Collection A/c ... Dr. To Bills Receivable A/c	
	(ii) When collected: Bank A/c ... Dr. To Bills for Collection A/c	
When the bill is retired before maturity	Bank A/c ... Dr. Discount on Bills (or Rebate) A/c ... Dr. To Bills Receivable A/c	Bills Payable A/c ... Dr. To Bank A/c `` Discount on Bills (or Rebate) A/c
When the bill is dishonoured	(i) If retained by the drawer till maturity: Drawee's A/c ... Dr. To Bills Receivable A/c	Bills Payable A/c ... Dr. To Drawer's A/c
	(ii) If discounted with Bank Drawee's A/c ... Dr. To Bank A/c	Bills Payable A/c ... Dr. To Drawer's A/c
	(iii) If endorsed to a creditor: Drawee's A/c ... Dr. To Endorsee's A/c	Bills Payable A/c ... Dr. To Drawer's A/c

Transactions	Drawer's Books	Drawee's Books
	(iv) If sent to Bank for collection: Drawee's A/c ... Dr. To Bills for Collection A/c	Bills Payable A/c ... Dr. To Drawer's A/c
When Noting Charges are paid on dishonoured bill	(i) If paid by drawer: Drawee's A/c ... Dr. To Bank A/c	Noting Charges A/c ... Dr. To Drawer's A/c
	(ii) If paid by endorsee: Drawee's A/c ... Dr. To Endorsee's A/c	Noting Charges A/c ... Dr. To Drawer's A/c
	(iii) If paid by discounting Bank: Drawee's A/c ... Dr. To Bank A/c	Noting Charges A/c ... Dr. To Drawer's A/c
When the bill is renewed for a further period	(i) For cancellation of the old bill: Drawee's A/c ... Dr. To Bills Receivable A/c	Bills Payable A/c ... Dr. To Drawer's A/c
	(ii) For interest on the extended period: Drawee's A/c ... Dr. To Interest A/c	Interest A/c ... Dr. To Drawer's A/c
	(iii) For drawing the new bill : Bills Receivable A/c ... Dr. To Drawee's A/c	Drawer's A/c ... Dr. To Bills Payable A/c

11.1.11 Types of Bills of Exchange

(a) **Trade bill:** This bill is drawn to settle a trade transaction.

(b) **Accommodation bill:** This bill is used without a trade transaction and is for mutual benefit. If Mr. X is in need of money, he draws a bill on his friend Mr. Y who accepts it. This bill is then discounted with bank (bank will pay money before due date) and the money is shared between X and Y. On the due date, Y will pay to the bank and X will pay Y his share.

Law generally does not recognise such bills.

11.1.12 Operating Cycle of the Trade Bill of Exchange

We will see the cycle in case of a trade bill of exchange. There is a trade transaction to begin with. The seller will then draw a bill on the buyer who will accept it and return it back to the seller. The seller has four options:

(a) Retain the bill with him till maturity and then present the bill to the buyer to claim the money on that date.

(b) Discount the bill with the bank if urgent money is needed. The bank will deduct discounting charges and pay the drawer. The bank will collect the bill from the drawee on due date.

(c) Endorse the bill to his creditor to settle his liability towards the creditor. Here, on the due date the creditor of the drawer will receive money from the drawee.

(d) Send the bill to the bank for collection. Here, the bank will keep the bill with them till maturity, collect the payment on the due date and credit it to the A/c of the drawer. Bank charges commission for such activity.

The bill of exchange, being a credit instrument, means a right to claim for the drawer and an obligation to pay for the drawee. For the drawer, the bill is Bill Receivable (often referred to as B/R) since he has to get the money on due date. This is a monetary asset shown under current assets in books of the drawer.

For the drawee, the bill is Bill Payable (often referred to as B/P) since he has to make the payment on the due date. This is shown under current liability in the books of the drawee.

For endorsee, it represents a monetary asset (B/R).

If on the due date the payment of the bill is not done, it is said to have dishonoured. When bill is dishonoured, the old claims of trade transaction is reopened.

11.1.13 Promissory Note

A person, by whom any amount is payable himself prepares and signs a written undertaking to pay. Here the credit document is called a 'Promissory Note'. It's a written document and contains an undertaking or promise to pay. As per Indian Negotiable Instrument Act, a 'Promissory Note' is "an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker to pay a certain sum of money to, or to the order of, a certain person." The person to whom the amount is payable is called Promisee or Payee.

A specimen of Promissory Note which is prepared by Mr. A.Chakraborty in favour of Mr.R.K.Nandy is as follows:

₹15,000

12-03-2013
J-49, B.N. Marg,
New Delhi

I, promise to pay Mr. R. K. Nandy after 3 months on order, the sum of ₹15,000 (Rupees Fiteen Thousands only) for value Received.

Place:
Date : 16/03/2013

Sd/-
A.Chakraborty
16-03-2013

11.1.14 Essential features of Promissory Note

Essential Features of Promissory Note are as follows:

(i) It is a written document and adequately signed by the maker or promisor.

(ii) It must contain an undertaking or promise to pay a definite amount given in both figures and words.

(iii) The amount is payable either on demand or on the maturity of a fixed period.

(iv) The amount is payable either to a prescribed person or to his/her order. The person to whom the amount should be payable is known promisee or payee.

11.1.15 Difference between Bills of Exchange and Promissory Note

The differences between these two items are as under:

Bills of Exchange	Promissory Note
1. It is drawn by the seller.	1. It is drawn by the purchaser.
2. It involves an order to make payment.	2. It involves a promise to make payment
3. It consist of three parties, viz. the drawer, the acceptor and the payee.	3. It consist of two parties, namely, the promisor (or maker) and promisee (or payee)
4. To be effective, it must be accepted.	4. It does not need acceptance.
5. Drawer and the payee can be the same person.	5. Maker and payee cannot be the same person.
6. Acceptor is required to make payment on due date. In case of any default, drawer is liable to pay the amount to payee.	6. Drawer or maker is required to make payment on due date.

11.1.16 Proportionate Discount Charges

If the date of maturity of a bill falls on a date of a month within the accounting year, discounting of bill can be done without any problem. But when the date of maturity falls on a month of the next year i.e. the due date falls on two accounting periods, problem will arise. In such a situation, proportionate amount of discount will be charged to Profit and Loss Account. This can be understood with the help of the following example:

A bill was drawn on 1st November, 2013 for ₹20,000 for 3 months. The bill was discounted by the bank on same day @12% p.a. Therefore, the total amount of discount will be ₹600 (i.e. $20{,}000 \times \frac{12}{100} \times \frac{3}{12}$).
So 2/3rd of ₹600, i.e. ₹400 will be transferred to Profit and Loss Account for the year ended 31st December, 2013.

Treatment of Discount in the Books of the Bank

The following entries are recorded in the books of the bank:

a. When the bill is discounted:

Bill Discounted A/c Dr.

To, Customer's Current A/c

To, Discounting on Bill A/c

b. When amount is received from the drawee:

Cash A/c Dr.

To, Bills Discounted A/c

	Transactions	Entries in the books of Drawer	Entries in the books of Drawee
1	If the bill is drawn	Bills Receivable A/c Dr. To, Drawee A/c	Drawer A/c Dr. To, Bills Payable A/c
2	If the bill is discounted by the bank	Cash/Bank A/c Dr. Discount A/c Dr. To, Bills Receivable A/c	—
3	If the bill is honoured at the due date	—	Bills Payable A/c Dr. To, Cash / Bank A/c

Illustration 1.

Mohan sold goods to Sohan for ₹ 50,000. On 1st Jan 2013, Mohan drew a bill for three months on Sohan who accepted the same. Pass necessary journal entries in the books of Mohan and Sohan in following situations:

(a) The bill is retained by Mohan till 31st March and Sohan paid it on that day upon presentation.

(b) Bill is discounted with the bank and the bank pays ₹ 49,000 to Mohan. Sohan paid the bill on due date.

(c) Mohan endorsed the bill to Rohan (his creditor) in settlement of his claim for ₹ 51,000. The bill is settled on the due date.

(d) Mohan sent the bill to the bank for collection on due date. The bank collected bill amount and after deducting collection charges of ₹ 100 paid the balance to Mohan.

Solution:

Entries in the books of Mohan

(a) Bill is retained by Mohan:

	Particulars	L.F.	Dr. (₹)	Cr. (₹)
On getting Sohan's acceptance	B/R A/c Dr. To, Sohan's A/c (Being the bill accepted by Sohan)		50,000	 50,000
On payment on 31-03-13	Bank A/c Dr. To, B/R A/c (Being the payment received against the B/R)		50,000	 50,000

(b) Bill is discounted by Mohan:

	Particulars	L.F.	Dr. (₹)	Cr. (₹)
On getting Sohan's acceptance	B/R A/c Dr. To, Sohan's A/c (Being the bill accepted by Sohan)		50,000	 50,000
On discounting	Bank A/c Dr. Discount A/c Dr. To, B/R A/c (Being Sohan's acceptance discounted)		49,000 1,000	 50,000

On the date of maturity, as the bill is settled by Sohan to bank, there will be no entry in Mohan's books.

(c) Bill is endorsed to Rohan by Mohan:

	Particulars	L.F.	Debit (₹)	Credit (₹)
On getting Sohan's acceptance	B/R A/c Dr. To, Sohan's A/c (Being the bill accepted by Sohan)		50,000	 50,000
On endorsement	Rohan's A/c Dr. To, B/R A/c To, Discount A/c (Being B/R endorsed to Rohan and discount availed)		51,000	 50,000 1,000

(d) Bill is sent for collection to bank by Mohan:

	Particulars	L.F.	Dr. (₹)	Cr. (₹)
On getting Sohan's acceptance	B/R A/c Dr. To, Sohan's A/c (Being the bill accepted by Sohan)		50,000	 50,000
On sending bill for collection	Bill for Collection A/c Dr. To, B/R A/c (being bill sent to bank for collection)		50,000	 50,000
On payment on due date	Bank A/c Dr. Collection Charges A/c Dr. To, Bills for Collection A/c (being payment received on bill collected)		49,900 100	 50,000

Entries in the books of Sohan

In all four situations, since the bill was honoured, the entries will be same as below.

	Particulars	L.F.	Debit (₹)	Credit (₹)
On acceptance of bill drawn by Mohan	Mohan's A/c Dr. To, B/P A/c (Being the bill of Mohan accepted)		50,000	 50,000
On payment on due date	B/P A/c Dr. To, Bank A/c (Being payment of bill)		50,000	 50,000

11.1.17 Insolvency of Drawee (Acceptor)

Insolvency of acceptor means that he cannot pay the amount owed by him. Therefore , on insolvency of the acceptor, bill will be treated as dishonoured and entries for dishonour of bill will be passed in the books of respective parties. Later on , when some amount is realized from the property or estate of the insolvent acceptor, entry for cash received is passed and the balance of amount due from the insolvent acceptor is treated as bad debts. In the books of acceptor the amount not paid is transferred to deficiency account (or profit and loss account). Normally, the amount paid by the insolvent person is expressed as percentage of the amount due and is called the 'Rate of Dividend'. For example, if ₹25,000 is payable by Mr. A to Mr. B and Mr. A is declared insolvent and a dividend of 20% is declared, journal entries for the final settlement are passed as under:

In the books of Mr. A

Particulars	L.F.	Dr. (₹)	Cr. (₹)
Mr. B A/c Dr.		25,000	
To, Cash A/c			5,000
To, Deficiency A/c			20,000

In the books of Mr. B

Particulars	L.F.	Dr. (₹)	Cr. (₹)
Cash A/c Dr.		5,000	
Bad Debts A/c Dr.		20,000	
To, Mr. A A/c			25,000

In case of insolvency, it is better to prepare acceptor's account to work out the amount finally owed by him. Then, calculate cash received on account of dividend declared and the amount of bad debts.

Illustration 2.

A owes B ₹ 21,000. On 1.1.2013 he accepts a Bill for 3 months for ₹ 20,000 in full settlement. On the same date B discounts the Bill from his Banker at 6% p.a.

Before the due date, A becomes bankrupt and B receives first and final dividend of 20 paise in the rupee.

Write up the necessary accounts to record the above transactions in the books of B.

Solution:

In the books of B

A Account

Dr. | | | | | Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Jan. 1	To, Balance b/d	21,000	Jan. 1	By, Bills Receivable A/c	20,000
April 4	To, Bank	20,000	April 4	By, Discount A/c	1,000
	To, Discount A/c	1,000		By, Cash A/c	4,200
				By, Bad Debts A/c	16,800
		42,000			**42,000**

Bills Receivable Account

Dr. | | | | | Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Jan. 1	To, A A/c	20,000	Jan. 1	By, Bank A/c	19,700
				By, Discount A/c	300
		20,000			**20,000**

Illustration 3.

Sagar purchased goods worth ₹ 1,000 from Ravi for which the latter drew a bill on the former, payable after one month. Sagar accepted it and returned it to Ravi. Ravi endorsed it to Kamal, and Kamal to Amal. Amal discounted the bill with State Bank of India at 6% p.a. On maturity, the bill was dishonoured, noting charge being ₹ 10.

Show the entries in the books of all the parties including the books of State Bank of India.

Solution:

In the books of Ravi

Journal Entries

Date	Particulars	L. F.	Dr. (₹)	Cr. (₹)
	Sagar A/c Dr. To, Sales A/c (Goods sold to Sagar)		1,000	 1,000
	Bills Receivable A/c Dr. To, Sagar A/c (Bills drawn and accepted by Sagar for 1 month)		1,000	 1,000
	Kamal A/c Dr. To, Bills Receivable A/c (Bill endorsed to Kamal)		1,000	 1,000
	Sagar A/c Dr. To, Kamal A/c (Bill endorsed to Kamal dishonoured by Sagar including noting charge of ₹ 10)		1,010	 1,010

In the books of Sagar
Journal Entries

Date	Particulars	L. F.	Dr. (₹)	Cr. (₹)
	Purchase A/c Dr.		1,000	
	To, Ravi A/c			1,000
	(Goods purchased from Ravi)			
	Ravi A/c Dr.		1,000	
	To, Bills Payable A/c			1,000
	(Bill accepted for 1 month)			
	Bill Payable A/c Dr.		1,000	
	Noting Charge A/c Dr.		10	
	To, Ravi A/c			1,010
	(Bill dishonoured at maturity, noting charge being ₹ 10)			

In the books of Kamal
Journal Entries

Date	Particulars	L. F.	Dr. (₹)	Cr. (₹)
	Bills Receivable A/c Dr.		1,000	
	To, Ravi A/c			1,000
	(Bill received from Ravi)			
	Amal A/c Dr.		1,000	
	To, Bills Receivable A/c			1,000
	(Bill received from Ravi endorsed to Amal)			
	Ravi A/c Dr.		1,010	
	To, Amal A/c			1,010
	(Bill endorsed to Amal dishonoured on maturity, noting charge being ₹ 10.)			

In the books of Amal
Journal Entries

Date	Particulars	L. F.	Dr. (₹)	Cr. (₹)
	Bills Receivable A/c Dr.		1,000	
	To, Kamal A/c			1,000
	(Bill received from Kamal.)			
	Bank A/c Dr.		995	
	Discount A/c Dr.		5	
	To, Bills Receivable A/c			1,000
	(Bill received from Kamal discounted by the Bank at 6% p.a.)			
	Kamal A/c Dr.		1,010	
	To, Bank A/c			1,010
	(Bill received from Kamal dishonoured, noting charge being ₹ 10.)			

In the books of State Bank of India
Journal Entries

Date	Particulars	L. F.	Dr. (₹)	Cr. (₹)
	Bill Discounted A/c Dr.		1,000	
	To, Amal's Current A/c			995
	To, Discount A/c			5
	(Amal's bill discounted which is due after 1 month.)			
	Amal's Current A/c Dr.		1,010	
	To, Bills Discounted A/c			1,000
	To, Cash A/c			10
	(Bill received from Amal dishonoured at maturity, noting charge being ₹ 10.)			

Illustration 4.

Sunil owed Anil ₹ 80,000. Anil draws a bill on Sunil for that amount for 3 months on 1st April 2013. Sunil accepts it and returns it to Anil. On 15th April 2013, Anil discounts it with Citi Bank at a discount of 12% p.a. On the due date the bill was dishonoured, the bank paid noting charges of ₹ 100. Anil settles the bank's claim along with noting charges in cash. Sunil accepted another bill for 3 months for the amount due plus interest of ₹ 3,000 on 1st July 2013. Before the new bill became due, Sunil retires the bill with a rebate of ₹ 500. Show journal entries in books of Anil.

Solution:

Journal entries in the books of Anil

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2013	Bills Receivables A/c Dr		80,000	
April, 1	To, Sunil's A/c			80,000
	(Being acceptance by Sunil)			
April, 15	Bank A/c Dr		78,000	
	Discount A/c Dr		2,000	
	To, Bills Receivables A/c			80,000
	(Being discounting of the bill @ 12% p.a. & discounting charges for 2.5 months)			
June, 30	Sunil's A/c Dr.		80,100	
	To, Bank A/c			80,100
	(Being dishonour of the bill & noting charges paid by bank)			
June, 30	Bank A/c Dr.		80,100	
	To, Cash			80,100
	(Being cash paid to bank)			
July, 1	Sunil's A/c Dr.		3,000	
	To, Interest			3,000
	(Being interest due from Sunil)			
July, 1	Bills Receivables A/c Dr.		83,100	
	To, Sunil's A/c			83,100
	(Being new acceptance by Sunil for ₹ 80,100 & interest of ₹ 3,000)			
July, 1	Bank A/c Dr.		82,600	
	Rebate A/c Dr.		500	
	To, Bills Receivables A/c			83,100
	(Being the amount received on retirement of the bill)			

Illustration 5.

On 1st April 2013 Mr. Bala draws a bill of ₹ 1,20,000 on Mr. Lala for the amount due for 4 months. On getting acceptance, on 5th April 2013, Bala endorses it to Mr. Kala in full settlement of his claim of ₹1,40,000 by paying the difference in cash. Lala approached Bala on 25th July saying that he needed to renew the bill for a further period of 4 months at an interest of 12% p.a. which Bala accepted. A fresh bill including interest was accepted by Lala on 1st August 2013. Bala settled his liability to Kala by cheque. This was duly settled on the due date. Pass journal entries in the books of Bala and Lala. Also show Bills Receivables A/c and bills Payable A/c.

Solution:

Journal entries in the Books of Bala

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2013 April 1	Bills Receivables A/c To, Lala's A/c (Being acceptance by Lala)	Dr.		1,20,000	 1,20,000
April 5	Kala's A/c To, Cash A/c To, Bills Receivables A/c (Being bill endorsed to Kala & cash payment made to him)	Dr.		1,40,000	 20,000 1,20,000
July 25	Lala's A/c To, Kala's A/c (Being cancellation of bill for renewal)	Dr.		1,20,000	 1,20,000
July 25	Lala's A/c To, Interest A/c (Being interest due from Lala)	Dr.		4,800	 4,800
July 25	Kala's A/c To, Bank A/c (Being claim of Mr. Kala settled)	Dr.		1,20,000	 1,20,000
August, 1	Bills Receivables A/c To Lala's A/c (Being acceptance by Lala with interest)	Dr		1,24,800	 1,24,800
Nov. 31	Bank A/c To Bills Receivables A/c (Being payment received on due date)	Dr		1,24,800	 1,24,800

Dr. Bills Receivable Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
1.4.2013	To Lala A/c	1,20,000	5.4.2013	By Kala A/c	1,20,000
1.8.2013	To Lala A/c	1,24,800	30.11.2013	By Bank A/c	1,24,800
		2,44,800			2,44,800

Journal entries in the Books of Lala

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
April, 1	Bala's A/c Dr. To Bills Payable A/c (Being acceptance of Bala's bill)		1,20,000	1,20,000
July, 25	Bills Payable A/c Dr. To Bala's A/c (Being cancellation of the bill for renewal)		1,20,000	1,20,000
August,1	Interest A/c Dr. To Bala's A/c (being interest due to Bala)		4,800	4,800
August,1	Bala's A/c Dr. To Bills Payable A/c (Being Bala's bill accepted with interest)		1,24,800	1,24,800
Nov. 30	Bills Payable A/c Dr. To Bank A/c (Being settlement of the bill due)		1,24,800	1,24,800

Dr. **Bills Payable Account** Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
25.7.2013	To Bala A/c	1,20,000	1.4.2013	By Bala A/c	1,20,000
30.11.2013	To Bank A/c	1,24,800	1.8.2013	By Bala A/c	1,24,800
		2,44,800			2,44,800

Illustration 6

On 1st January, 2013, P draws three moths bill of exchange for ₹ 30,000 on his debtor, Q who accepts it on the same date. P discounts the bill on 4th January, 2013 with his bankers, the discount rate being 6% p.a.

On the due date, the bill is dishonored, the noting charges being ₹ 200. Q immediately makes an offer to P to pay him ₹ 10,000 cash on account and to settle the balance by agreeing to accept one bill of exchange for ₹ 12,000 at one month and the other for the balance at three months, the latter including interest at 12% p.a. for both the bills.

P accepts the arrangement. The bill for ₹ 12,000 is met on the due date, but the other bill is dishonored.

Show Q's Account and Bills Receivable Account in the books of P.

Solution:

In the books of P

Dr. **Q's Account** Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Jan. 1	To, Balance b/d	30,000	Jan. 1	By, Bills Receivable A/c	30,000
April 4	To, Bank Interest A/c [12,000 x (12/100×1/12) + 8,200 x(12/100 x 3/12)]	366	April 4	By, Bank A/c By, Bills Receivable A/c By, Bills Receivable A/c (8,200 + 366)	10,000 12,000 8,566
July 7	To, Bills Receivable A/c	8,566	July 7	By Balance c/d	8,566
		69,132			69,132
July 8	To Balance b/d	8,566			

Dr.		Bills Receivable Account			Cr.
Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Jan. 1	To, Q A/c	30,000	Jan. 4	By, Bank A/c	29,550
April 4	To, Q A/c	12,000		By, Discount A/c	450
	To, Q A/c	8,566		$(30{,}000 \times \frac{6}{100} \times \frac{3}{12})$	
			May 7	By, Bank A/c	12,000
			July 7	By, Q A/c	8,566
		50,666			50,666

Illustration 7.

Short owes Slow ₹ 6,000 for which the former accepts a three months bill drawn by the latter. Slow immediately discounts the bill with his banker Strong Bank, at 12%. On the due date the bill is dishonoured and Strong Bank pays ₹ 20 as noting charge.

Short pays ₹ 1,180 including interest of ₹ 200 and gives another bill at three months for the balance. Slow endorses the bill to his creditor Slim in full settlement of his debts for ₹ 5,100. Slim discounts the bill with his banker Strong Bank who charges ₹ 40 as discount. Before maturity Short becomes bankrupt and a first and final dividend of 20 paise in a rupee is realized from his estate.

Show the journal entries in the books of Slim and Strong Bank and ledger account of Short in the book of Slow.

Solution:

In the books of Slim
Journal Entries

Date	Particulars		L. F.	Dr. (₹)	Cr. (₹)
	Bills Receivable A/c	Dr.		5,040	
	Discount Allowed A/c	Dr.		60	
	To, Slow A/c				5,100
	(Endorsed bill received from Slow in full settlement.)				
	Bank A/c	Dr.		5,000	
	Discount A/c	Dr.		40	
	To, Bills Receivable A/c				5,040
	(Bill discounted by the bank.)				
	Slow A/c	Dr.		5,100	
	To, Bank A/c				5,040
	To, Discount Allowed A/c				60
	(Bill dishonoured at maturity.)				

In the books of Strong Bank
Journal Entries

Date	Particulars	L. F.	Dr. (₹)	Cr. (₹)
	Bills Discounted A/c Dr.		6,000	
	To, Slow Current A/c			5,820
	To, Discount A/c			180
	(Bill discounted which is due for 3 months.)			
	Noting Charges A/c Dr.		20	
	To, Cash A/c			20
	(Noting charges incurred for dishonor of the bill.)			
	Slow Current Account A/c Dr.		6,020	
	To, Bills discounted A/c			6,000
	To, Noting Charges A/c			20
	(Bill dishonoured, noting charge being ₹ 20.)			
	Bills Discount A/c Dr.		5,040	
	To, Slim Current A/c			5,000
	To, Discount A/c			40
	(Bill discounted which is due for 3 months.)			
	Slim Current A/c Dr.		5,040	
	To, Bills Discounted A/c			5,040
	(Bill dishonored at maturity.)			

In the books of Slow
Short Account

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To ,Balance b/d		6,000	By, Bills Receivable A/c		6,000
To, Strong Bank A/c		6,020	By, Cash A/c		1,180
To, Interest A/c		200	By, Bills Receivable A/c		5,040
To, Slim A/c		5,040	By, Cash A/c	1,008	
			By, Bad Debts A/c	4,032	5,040
		17,260			17,260

Illustration 8.

Pass journal entries in the books of Hema for the following transactions :

(i) Hema's acceptance to Nanda for ₹ 5,000 renewed for 3 month with interest at 10% p.a.

(ii) Nalini's acceptance to Hema was for ₹ 10,000 was retired one month before due date at a discount of 12% p.a.

(iii) Discounted Natasha's acceptance to Hema for ₹ 4,000 with the bank for ₹ 3,920

(iv) Neela requests Hema to renew her acceptance for ₹ 3,500 for 3 months. Hema accepted on the condition that interest of ₹ 100 was paid in cash which Neela did.

(v) Received an acceptance from Geeta for ₹ 1,200 and it was endorsed to Seeta in full settlement of her claim.

Solution:

In the Books of Hema
Journal Entries

	Particulars		L.F	Debit (₹)	Credit (₹)
(i)	Bills Payable A/c	Dr.		5,000	
	To, Nanda's A/c				5,000
	(Being cancellation of Nanda's bill for renewal)				
	Interest A/c	Dr.		125	
	To, Nanda's A/c				125
	(Being interest due to Nanda)				
	Nanda's A/c	Dr.		5,125	
	To, Bills Payable A/c				5,125
	(Being acceptance given for new bill)				
(ii)	Bank A/c	Dr.		9,900	
	Discount A/c	Dr.		100	
	To, Bills Receivable A/c				10,000
	(Being Nalini's acceptance retired at discount)				
(iii)	Bank A/c	Dr.		3,920	
	Discount A/c	Dr.		80	
	To, Bills Receivable A/c				4,000
	(Being Natasha's acceptance discounted)				
(iv)	Neela's A/c	Dr.		3,500	
	To, Bills Receivables A/c				3,500
	(Being Neela's acceptance cancelled for renewal)				
	Cash A/c	Dr.		100	
	To, Interest A/c				100
	(Being interest received from Neela in cash)				
	Bills Receivable A/c	Dr.		3,500	
	To, Neela's A/c				3,500
	(Being Neela acceptance for new bill)				
(v)	Bills Receivable A/c	Dr.		1,200	
	To, Geeta A/c				1,200
	Geeta A/c	Dr.		1,200	
	To, Bills Receivable A/c				1,200

Illustration 9

X bought goods from Y for ₹ 4,000. Y draws a bill on 1.1.2013 for 3 months which was accepted by X for this purpose. On 1.3.2013, X arranged to retire the bill at a rebate of 12% p.a. Show the entries in the books of X and Y.

Solution:

In the books of Y
Journal

Date	Particulars		L.F	Dr. (₹)	Cr. (₹)
2013 Jan 1	X A/c To, Sales A/c (Goods sold to X)	Dr.		4,000	 4,000
Jan 1	Bills Receivable A/c To, X A/c (Bills drawn for 3 months)	Dr.		4,000	 4,000
March 1	Cash A/c Rebate Allowed A/c To, Bills Receivable A/c (Bills retired under a rebate of 12% p.a.)	Dr. Dr.		3,954 46	 4,000

Rebate = ₹ 4,000 x 12/100 x 35/365 (1st March to 4th April) = ₹ 46.

In the books of X
Journal

Date	Particulars		L.F	Dr. (₹)	Cr. (₹)
2013 Jan 1	Purchase A/c To, Y A/c (Goods purchased from Y)	Dr.		4,000	 4,000
Jan 1	Y A/c To, Bills Payable A/c (Bills accepted for 3 months)	Dr.		4,000	 4,000
March 1	Bills Payable A/c To, Cash A/c To, Rebate Received A/c (Bills retired under a rebate of 12% p.a.)	Dr.		4,000	 3,956 46

11.1.18 Operating Cycle of the Accommodation Bill of Exchange

The basis for accommodation bill is not a trade transaction. It is drawn to accommodate the financial requirements of drawer or even a drawee. This transaction presupposes trust and understanding between the parties to the transaction. The drawer normally discounts this bill with the bank. The amount received from bank is either retained by the drawer for himself or shared between the drawer and the drawee. On the date of maturity, the drawee settles the bill with bank by effecting payment. The drawer will pay the drawee either full amount of the bill or his share. Accounting entries for accommodation bill are:

Situations	Drawer's books		Drawee's books	
Drawing of a bill	B/R A/c To, Drawee A/c	Dr.	Drawer A/c To, B/P A/c	Dr.
Discounting with bank	Bank A/c Discount A/c To, B/R A/c	Dr. Dr.	No Entry	
Payment on due date	Drawee A/c To, Bank A/c	Dr.	B/P A/c To, Bank A/c	Dr.

Illustration 10.

Following information is given to you by Govind from his books:

On 1st April 2012 he had with him bills of ₹ 1,50,000 accepted by his customers and ₹ 1,00,000 worth accommodation bills accepted by his friends. He had accepted bills worth ₹ 90,000 for his suppliers and ₹ 75,000 worth accommodation bills for his friends.

During the year the following transactions took place:

(i) He raised bills of ₹ 3,75,000 which were accepted by his customers.

(ii) He accepted bills of ₹ 2,25,000 for his suppliers.

(iii) He accepted accommodation bills of ₹ 60,000 for his friends.

(iv) His friend accepted accommodation bills of ₹ 1,25,000 for him.

(v) He honoured on due dates trade bills of ₹ 1,75,000 and accommodation bills of ₹ 85,000.

(vi) He received payments on due dates for trade bills of ₹ 4,00,000 and accommodation bills of ₹ 1,50,000.

(vii) He endorsed bills of ₹ 25,000 to his suppliers, which were honoured by the acceptors.

(viii) His customers endorsed bills of ₹ 30,000 to him which he accepted in favour of his suppliers.

(ix) Accommodation bills were settled on the due dates and money was paid and received duly.

Prepare Bills Receivable A/c and Bills Payable A/c for both trade and accommodation bills.

Solution:

Dr. Bills Receivable Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
1.4.2012	To Balance b/d	1,50,000	31.3.2013	By Bank A/c	4,00,000
31.3.2013	To Debtors A/c	3,75,000	31.3.2013	By Suppliers A/c	25,000
			31.3.2013	By Balance c/d	1,00,000
		5,25,000			5,25,000

Dr. Bills Payable Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.3.2013	To, Bank A/c	1,75,000	1.4.2012	By Balance b/d	90,000
31.3.2013	To, Debtors A/c	30,000	31.3.2013	By Suppliers A/c	2,25,000
31.3.2013	To, Balance c/d	1,10,000			
		3,15,000			3,15,000

Dr. Accommodation Bills Receivable Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
1.4.2012	To, Balance b/d	1,00,000	31.3.2013	By, Bank A/c	1,50,000
31.3.2013	To, Friends A/c (acceptors)	1,25,000	31.3.2013	By, Balance c/d	75,000
		2,25,000			2,25,000

Dr. Accommodation Bills Payable Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.3.2013	To, Bank A/c	85,000	1.4.2012	By, Balance b/d	75,000
31.3.2013	To, Balance c/d	50,000	31.3.2013	By, Friends A/c (drawers)	60,000
		1,35,000			1,35,000

Dr. Friends (acceptors of bills) Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.3.2013	To, Bank A/c	1,50,000	1.4.2012	By, Balance b/d	1,00,000
31.3.2013	To, Balance c/d	75,000	31.3.2013	By, Accommodation B/R A/c	1,25,000
		2,25,000			2,25,000

Dr. Friends (drawers of bills) Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
1.4.2012	To, Balance b/d	75,000	31.3.2013	By, Bank A/c	85,000
31.3.2013	To, Accommodation B/P A/c	60,000	31.3.2013	By, Balance c/d	50,000
		1,35,000			1,35,000

Illustration 11.

Vijay draws a bill for ₹ 60,000 and Anand accepts the same for mutual accommodation of both of them to the extent of Vijay 2/3rd and Anand 1/3rd. Vijay discounts it with bank for ₹ 56,400 and remits 1/3rd share to Anand. Before the due date, Anand draws another bill for ₹ 84,000 on Vijay in order to provide funds to meet the first bill on same sharing basis. The second bill is discounted at ₹ 81,600. With these proceeds, the first bill is settled and ₹ 14,400 were remitted to Vijay. Before the due date of the second bill, Vijay becomes insolvent and Anand receives a dividend of only 50 paise in a rupee in full satisfaction. Pass journal entries in the books of Vijay.

Solution:

In case of accommodation bills, the proceeds of discounting are shared by parties as agreed. The discounting charges are also shared in agreed proportion. Here, the ratio between Vijay and Anand is given as two-thirds and one-third. The first bill of ₹ 60,000 is discounted at ₹ 56,400 which means the discounting charges are ₹ 3,600. The share of each one is:

	1st Bill		2nd Bill	
	Proceeds (₹)	**Discount (₹)**	**Proceeds (₹)**	**Discount (₹)**
Vijay (2/3rd)	37,600	2,400	54,400	1,600
Anand (1/3rd)	18,800	1,200	27,200	800
Total	56,400	3,600	81,600	2,400

Further, as Vijay has become insolvent, the amount due to Anand is settled at 50% of total. To calculate this amount, it's necessary to post all transactions to Anand's account and arrive at the balance.

In the Books of Vijay
Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Bills Receivable A/c	Dr.		60,000	
	To, Anand's A/c				60,000
	(Being bill drawn on Anand)				
	Bank A/c	Dr.		56,400	
	Discount A/c	Dr.		3,600	
	To, Bills Receivables A/c				60,000
	(Being discounting of bill)				
	Anand's A/c	Dr.		20,000	
	To, Bank A/c				18,800
	To, Discount A/c				1,200
	(Being 1/3rd proceeds paid to Anand)				
	Anand's A/c	Dr.		84,000	
	To, Bills payable A/c				84,000
	(being acceptance of bill)				
	Bank A/c	Dr.		14,400	
	Discount A/c	Dr.		1,600	
	To, Anand's A/c				16,000
	(Being proceeds of discounting 2nd bill)				
	Bills Payable A/c	Dr.		84,000	
	To, Anand's A/c				84,000
	(Being dishonour of bill)				
	Anand's A/c	Dr.		56,000	
	To, Bank A/c				28,000
	To, Deficiency A/c				28,000
	(Being payment of 50% & balance proved to be bad)				

Dr. **Anand's Account** **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To, Bank A/c	18,800	By B/R A/c	60,000
To, Discount A/c	1,200	By Bank A/c	14,400
To, B/P A/c	84,000	By Discount A/c	1,600
		By B/P A/c	84,000
To, Bank A/c	28,000		
To, Deficiency A/c	28,000		
	1,60,000		1,60,000

Illustration 12.

Rahim, for mutual accommodation, draws a bill for ₹ 3,000 on Ratan. Rahim discounted it for ₹ 2,925. He remits ₹ 975 to Ratan. On the due date, Rahim is unable to remit his dues to Ratan to enable him to meet the bill. He, however, accepts a bill for ₹ 3,750 which Ratan discounts for ₹ 3,625. Ratan sends ₹ 175 to Rahim after discounting the above bill. Rahim becomes insolvent and a dividend of 80 paise in the rupee is received from his estate.

Pass the necessary journal entries in the books of both the parties.

Solution:

In the books of Rahim

Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bills Receivable A/c Dr. To, Ratan A/c (Bill drawn for mutual accommodation and accepted by Ratan.)		3,000	 3,000
	Bank A/c Dr. Discount A/c Dr. To, Bills Receivable A/c (Bill discounted by the bank.)		2,925 75	 3,000
	Ratan A/c Dr. To, Bank A/c To Discount A/c (1/3 Proceeds remitted to Ratan.)		1,000	 975 25
	Ratan A/c Dr. To, Bills Payable A/c (Bill accepted.)		3,750	 3,750
	Bank A/c Dr. Discount A/c Dr. To, Ratan A/c (Proceeds received from Ratan including discount charges.)		175 75	 250
	Bills Payable A/c Dr. To, Ratan A/c (Bill dishonored since e became insolvent.)		3,750	 3,750
	Ratan A/c Dr. To, Bank A/c `` Deficiency A/c (Cash paid to Ratan @80 paise in the rupee and balance transferred to deficiency account.)		2,250*	 1,800 450

***** This amount can be ascertained by preparing Ratan's Account in Rahim's book.

In the books of Ratan
Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Rahim A/c To, Bills Payable A/c (Bill accepted for mutual accommodation)	Dr.		3,000	 3,000
	Bank A/c Discount A/c To, Rahim A/c ($\frac{1}{3}$ proceeds received from Rahim including discount)	Dr. Dr.		975 25	 1,000
	Bills Receivable A/c To, Rahim A/c (Bill drawn and accepted by Rahim)	Dr.		3,750	 3,750
	Bank A/c Discount A/c To, Bills Receivable A/c (Bill discounted)	Dr. Dr.		3,625 125	 3,750
	Rahim A/c To, Bank A/c "Discount A/c (Proceeds remitted to Rahim including discount)	Dr.		250	 175 75
	Rahim A/c To, Bank A/c (Bill honoured at maturity)	Dr.		3,750	 3,750
	Bills Payable A/c To, Bank A/c (Bill honoured at maturity)	Dr.		3,000	 3,000
	Bank A/c Bad Debt A/c To, Rahim A/c (Amount realised from the official liquidator of Rahim @ 80 paise in the rupee and the balance proved bad)	Dr. Dr.		1,800 450	 2,250

Note:

Sharing discount:

After discounting of the 1st bills, Rahim received	₹ 2,000 (including discount)
Add: Amount remitted by Ratan (after discounting of the 2nd bill).	₹ 175
Total benefit received by Rahim.	₹ 2,175

Now,

After discounting of the 2nd bill Ratan received ₹ 3,625 (Net)

∴ Proportion of Rahim to Ratan = $\frac{₹\ 2,175}{₹\ 3,625} \times 125 = ₹\ 75$

∴ Rahim is to bear = ₹ 75 of discounting charges, and the balance by Ratan.

Illustration 13.

On 1.7.2013 Salil, for mutual accommodation of himself and Sunil, drew on the other a bill for ₹ 10,000 payable at 3 months date. The bill was discounted with Central Bank of India at 5% and half of the proceeds were remitted to Sunil on 2.7.2013.

On 2.7.2013, Sunil drew a bill on Salil for ₹ 4,000 payable at 3 months' date. He discounted the bill with Bank of India at 10% and remitted half the proceeds to Salil.

Sunil became bankrupt on 31.8.2013 and only 25% was received by Salil on 15.9.2013 as the first and final dividend from his estate. Write the journal entries in the books of Salil.

Solution:

In the books of Salil
Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2013 July 1.	Bills Receivable A/c To, Sunil A/c (Bill drawn for mutual accommodation for 3 months)	Dr.		10,000	 10,000
July 2.	Bank A/c Discount A/c To, Bills Receivable A/c (Bill discounted by the bank)	Dr. Dr.		9,875 125	 10,000
July 2.	Sunil A/c To, Bank A/c To, Discount A/c (Half the proceeds remitted to Sunil)	Dr.		5,000	 4,937.5 62.5
July 2.	Sunil A/c To, Bills Payable A/c (Bill accepted for 3 months)	Dr.		4,000	 4,000
July 2.	Bank A/c Discount A/c To, Sunil A/c (Proceeds received from Sunil)	Dr. Dr.		1,950 50	 2,000
Aug. 31	Sunil A/c To, Bank A/c (Bill dishonoured as Sunil became insolvent)	Dr.		10,000	 10,000
Sept. 15	Bank A/c Bad Debts A/c To, Sunil A/c (Amount realized from the official liquidator of Sunil @ 25% and the balance proved bad)	Dr. Dr.		1,750 5,250	 7,000

Illustration 14.

On 1.1.2013, Pandit, for mutual accommodation of himself and Thakur, drew upon the latter a 3 months' bill for ₹ 12,000 which was duly accepted. Pandit discounted the bill at 6% p.a. on 4.1.2013 and remitted half of the proceeds to Thakur.

On 1.2.2013, Thakur drew and Pandit accepted a bill at 3 months' for ₹ 4,800. On 4.2.2013, Thakur discounted the bill at 6% p.a. and remitted half of the proceeds to Pandit.

At maturity Pandit met his acceptance but Thakur failed to meet his and Pandit had to take it up. Pandit drew and Thakur accepted a new bill at 2 months on 4.5.2013 for the amount due to Pandit plus ₹ 100 as interest. On 1.7.2013, Thakur became insolvent and first and final dividend of 50 paise in the rupee was received from his estate on 30.09.2013.

Pass necessary journal Entries in the books of Pandit.

Solution:

In the books of Pandit
Journal Entries

Date	Particulars		L. F.	Dr. (₹)	Cr. (₹)
2013					
Jan. 1	Bills Receivable A/c	Dr.		12,000	
	To, Thakur A/c				12,000
	(Bill Drawn on Thakur.)				
Jan.4	Bank A/c	Dr.		11,820	
	Discount A/c	Dr.		180	
	To, Bills Receivable A/c				12,000
	(Bill discounted by bank.)				
	Thakur A/c	Dr.		6,000	
Jan.4	To, Bank A/c				5,910
	To, Discount A/c				90
	(Half of the proceeds remitted to Thakur.)				
	Thakur A/c	Dr.		4,800	
Feb. 1	To, Bills Payable A/c				4,800
	(Bill accepted.)				
	Bank A/c	Dr.		2,364	
Feb. 1	Discount A/c	Dr.		36	
	To, Thakur A/c				2,400
	(Half of the proceeds received from Thakur.)				
	Thakur A/c	Dr.		12,000	
Apr. 4	To, Bank A/c				12,000
	(Bill dishonoured at maturity.)				
May 4	Bills Payable A/c	Dr.		4,800	
	To, Bank A/c				4,800
	(Bills honoured at maturity.)				
	Thakur A/c	Dr.		100	
May 4	To, Interest A/c				100
	(Interest becomes due)				
	Bills Receivable A/c	Dr.		8,500	
May 4	To, Thakur A/c				8,500
	(Fresh bill drawn on Thakur.)				
July 1	Thakur A/c	Dr.		8,500	
	To, Bills Receivable A/c				8,500
	(Bill dishonoured at maturity.)				
Sept. 30	Bank A/c	Dr.		4,250	
	Bad Debts A/c	Dr.		4,250	
	To, Thakur A/c				8,500
	(Dividend received from Thakur's estate @ 50 in a rupee)				

11.2 CONSIGNMENT ACCOUNTING

11.2.1 Introduction

The sales activity of any business can be organized in different ways. With the customers spread all over, the business entity cannot afford to have only minimum selling points nor can it have its own resources to have the outlets all over. The business volumes cannot be limited in any case. The core competence of a manufacturing company is to produce a good quality product. It creates a network of its own outlets, dealers, commission agents, institutions etc to distribute its products efficiently and effectively. Thus the selling may be handled directly through own salesmen or indirectly through agents.

In case of direct selling, the company usually has depots all over. The stocks are transferred to these depots and from there finally sold to ultimate customers. This involves huge expenses and problems of maintaining the same on a permanent basis. Hence, the firm could appoint agents to whom stocks will be given. These agents distribute the products to ultimate customers and receive commission from the manufacturer. One such way of indirect selling is selling through consignment agents. The relationship between consignor and consignee is that of Principal-Agent relationship.

Difference between Sale and Consignment

1. In sale the property in goods is transferred to the buyer immediately whereas in consignment the property is transferred to the buyer only when goods are sold by the consignee. The ownership of goods remains with the consignor when goods are transferred to the consignee by the consignor.
2. In sale, the risk attaching to the goods passes with ownership to the buyer. In case of a consignment, the risk attaching to the goods does not pass to the consignee who acts as a mere agent. If there is any damage or loss to the goods it is borne by the consignor provided the consignee has taken reasonable care of the goods and the damage or loss is not due to his negligence.
3. The relationship of consignor and consignee is that of a principal and an agent as in a contract of agency whereas the relationship of buyer and seller is governed by the Sale of Goods Act.
4. Unsold goods on consignment are the property of the consignor and may be returned if not saleable in the market whereas goods sold on sale basis are normally not returnable unless there is some defect in them.

11.2.2 Main Terms of Consignment Trade

Consignor – He is the person who sends goods to agents e.g. a manufacturer or wholesaler.

Consignee – He is the agent to whom goods are sent for selling.

Proforma Invoice – When the consignor sends the goods to the consignee, he prepares only a proforma invoice and not an invoice. A proforma invoice looks like an invoice but is really not one. The objective of the proforma invoice is only to convey information to the consignee regarding quantity, varieties and prices of goods sent and expenses incurred and not to make him liable like a trade debtor.

After Ordinary Commission

Over-riding Commission – It is an extra commission allowed over and above the normal commission is generally offered for the following reasons :

(i) When the agent is required to put in hard work in introducing a new product in the market.

(ii) Where he is entrusted with the work of supervising the performance of other agents in a particular area.

(iii) For effecting sales at prices higher than the price fixed by the consignor.

Ordinary Commission – This is a fee payable by consignor to consignee for sale of goods when the consignee does not guarantee the collection of money from ultimate customer. The % of such commission is generally lower.

Del Credre Commission – This is additional commission payable to the consignee for taking over additional responsibility of collecting money from customers. In case, the customers do not pay the consignee takes over the loss of bad debts in his books. Although it's paid for taking over risk of bad debts that arise out of credit sales only, this commission is calculated on total sales and not on credit sales.

Account Sales – This is a periodical statement prepared by consignee to be sent to the consignor giving details of all sales (cash and credit), expenses incurred and commission due for sales, destroyed-in-transit or in godown and deducting the amount of advance remitted by him.

11.2.3 Operating Cycle of Consignment Arrangement

(i) Goods are sent by consignor to the consignee.

(ii) Consignee may pay some advance or accept a bill of exchange.

(iii) Consignee will incur expenses for selling the goods.

(iv) Consignee maintains records of all cash and credit sale.

(v) Consignee prepares a summary of results called as Account sales.

(vi) Consignor pays commission to the consignee.

Sometimes, the consignor may send the goods at a price higher than cost so that the consignee gets no knowledge of the real cost of goods which is confidential for the consignor.

11.2.4 Accounting for Consignment Business

The consignor and consignee keep their own books of accounts. The consignor may send goods to many consignees. Also, a consignee may act as agent for many consignors. It is appropriate that both of them would want to know profit or loss made on each consignment. There are certain new accounts that are to be opened in addition to regular accounts as cash or bank.

The objective of consignor in making accounts relating to consignment is two-fold viz.

(i) To ascertain the results (profit/loss) of consignment and incorporate them in his profit and loss account.

(ii) To make final settlement with the consignee.

To achieve these objectives, he prepares respectively two accounts, viz. 'Consignment Account' and 'Consignee Account'. The former is a nominal account and latter is a personal account. A separate consignment account as well as consignee account is prepared in respect of every consignment. It is important to observe that the two accounts are prepared by the consignor in addition to other accounts in his ledger to incorporate the results of consignments in his books.

When goods are dispatched on Consignment no entry can be made in the Sales Account as this is not a sale, and, until the goods are sold, they remain the legal property of the consignor. For the same reason the consignee's personal account cannot be debited with the value of the goods consigned. He is not a debtor until the goods are sold.

As an agent, the consignee is not liable to pay for the goods received on consignment. Therefore, he makes no entry in his financial books on such receipts. As, however, he is liable to account for the goods received, he keeps as adequate record in an appropriate memorandum book. Apart from this his only concern is to record the expenses he has incurred, the sales, his commission and his financial relationship with the consignor. A personal account for the consignor is the only additional account a consignee needs to record his consignment transactions.

Let us see the entries in the books of consignor as well as consignee :

Situations	**Consignor's books**	**Consignee's books**
On sending goods	Consignment A/c Dr. To Goods Sent on Consignment	No Entry
On expenses for sending goods	Consignment A/c Dr. To Cash/Bank/Creditors for Expenses A/c	No Entry
For advance received from consignee	Cash/ Bank/ Bill Receivables A/c Dr. To Consignee's Personal A/c	Consignor's Personal A/c Dr. To Cash/ Bank/ Bills Payable A/c
On expenses incurred by consignee	Consignment A/c Dr. To Consignee's Personal A/c	Consignor's Personal A/c Dr. To Cash/ Bank/ Creditors for expenses A/c
On consignee reporting sales	Consignee's Personal A/c Dr. To Consignment A/c	Cash/ Bank/ Consignment Debtors A/c Dr. To Consignor's Personal A/c
For commission due	Consignment A/c Dr. To Consignee's Personal A/c	Consignor's Personal A/c Dr. To Commission A/c
For Bad Debts	Consignment A/c Dr. To Consignee's Personal A/c	Consignor's Personal A/c Dr. To Consignment Debtors A/c
For closing the consignment account	For profit : Consignment A/c Dr. To General Profit and Loss A/c. For Loss General Profit and Loss A/c Dr. To Consignment A/c	No entry
For the final settlement	Cash/ Bank/ B/R A/c Dr. To Consignee A/c	Consignor A/c Dr. To Cash/ Bank/ B/P A/c
For closing the Goods Sent on Consignment Account	Goods sent on Consignment A/c Dr. To Trading/ Purchases A/c	No entry
On closing stock	Stock on Consignment A/c Dr. To Consignment A/c	No Entry

11.2.5 Del Credere Commission and Bad Debts

Sometimes the consignor allows an extra commission to the consignee in order to cover the risk of collection from customer on account of credit sales which is known as Del Credere Commission. Naturally, if debt is found to be irrecoverable the same must be borne by the consignee. There will be no effect in the books of consignor. In short, credit sales will be treated as cash sales to consignor. If no Del credere commission is given by the consignor to the consignee, the amount of Bad debts must be borne by the consignor.

Entries in the Books of Consignor

(a) When Del Credere Commission is given

(i)	**For Credit Sales –** Consignee's Personal A/c Dr. To, Consignment A/c
(ii)	**For Bad Debts –** No Entry
(iii)	**For Del Credere Commission —** Consignment A/c Dr. To, Consignee's Personal A/c

(b) When Del Credere Commission is not given

(i)	**For Credit Sales –** Consignment Debtors A/c Dr. To, Consignment A/c
(ii)	**For Bad Debts –** Consignment A/c Dr. To, Consignment Debtors A/c
(iii)	**(a) For realization of Cash —** Cash A/c Dr. To, Consignment Debtors A/c } if collected by Consignor
	(b) Consignee's Personal A/c Dr. To, Consignment Debtors A/c } if collected by Consignee

Entries in the Books of Consignee

(a) When Del Credere Commission is given

(i)	**For Credit Sales –** Consignment Debtors A/c Dr. To, Consignor A/c
(ii)	**For Bad Debts –** Bad Debts A/c Dr. To, Consignment Debtors A/c
(iii)	**For realization of cash from cash from Debtors —** Cash/ Bank A/c Dr. To, Consignment Debtors A/c
(iv)	**For Closing Bad Debts A/c-** Commission Received A/c Dr. To, Bad Debts A/c

(b) When Del Credere Commission is not given –

There will be no entry against a bad debts entry in the books of consignee.

11.2.6 Valuation of Stock

Unsold stock on consignment should properly valued; otherwise final accounts cannot be prepared. Usually, unsold stock on consignment is value at cost price plus proportionate expenses of the consignor plus proportionate non recurring expenses of consignee.

Alternatively, total cost of goods plus total expenses incurred by the consignor plus total non recurring expenses of the consignee are to be added and stock should valued on the basis of proportionate unsold goods.

But it must be remember while valuing stock on consignment, the usual principle for valuation of stock, that stock should be valued at cost price or market price whichever is less.

The entry will be:

Stock on Consignment A/c Dr.

To, Consignment A/c

Needless to say that unsold stock on consignment will appear in the asset side of Balance Sheet.

Illustration 15.

X Ltd. of Gujrat purchased 5,000 sarees @ ₹ 100 per saree. Out of these 3,000 sarees were sent on consignment to Y Ltd. of Kolkata at the selling price of ₹ 150 per saree. The consignors paid ₹ 5,000 for packing and freight.

Y Ltd. sold 2,500 sarees @ ₹ 160 per saree and incurred ₹ 500 for selling expenses and remitted ₹ 2,50,000 to Gujrat on account. They are entitled to a commission of 5% on total sales plus a further of 25% commission on any surplus price realized over ₹ 150 per saree.

1,500 sarees were sold at Gujrat @ ₹ 110 per saree.

Owing to fall in market price, the value of stock of saree in hand is to be reduced by 5%. Your are required to prepare (i) Consignment Account, and (ii) Y Ltd. Account.

Solution:

(i) In the books of X Ltd.

Dr. **Consignment Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	To Goods Sent on Consignment A/c (300 × ₹100)	3,00,000		By Y Ltd. A/c —sale proceeds (2,500 × ₹160)	4,00,000
	" Bank A/c —paying freight	5,000		" Stock on Consignment A/c (W.N. 1)	45,125
	" Y Ltd A/c				
	—selling expenses	500			
	—commissions (W.N. 2)	26,250			
	" Profit and Loss A/c —profit on consignment transferred	1,13,375			
		4,45,125			4,45,125

Dr. **Y Ltd. A/c** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	To Consignment A/c —sale proceeds	4,00,000		By Bank A/c —advance	2,50,000
				" Consignment A/c	
				—selling expenses	500
				—commissions	26,250
				" Balance c/d	1,23,250
		4,00,000			4,00,000

Workings:

1. **Valuation of unsold stock**

	(₹)
Total cost (500 × ₹100)(without considering expenses)	50,000
Less: Reduction in price @5%	2,500
	47,500
Less: Y Ltd.'s commission @5%	2,375
	45,125

2. **Computation of Commissions**

	(₹)
Total sales @₹160 per saree (2,500 × ₹160)	4,00,000
Less: In excess of ₹150 per saree	3,75,000
Surplus price realised	25,000
Commission to be calculated as under:	
On total sales @5% (₹4,00,000 × 5%)	20,000
Add: 25% on ₹25,000	6,250
	26,250

1,500 sarees which were sold @₹110 is not related to consignment account

11.2.7 Losses on Consignment

There are two types of losses which may arise in case of a consignment transaction, viz.

(a) Normal Loss, and

(b) Abnormal Loss

(a) Normal Loss – Normal Losses arise as a result of natural causes, e.g. evaporation, leakage, breakage etc., and they are inherent in nature. Since normal loss is a charge against gross profit no additional adjustment is required for this purpose. Moreover, as the same is a part of cost of goods, when valuation of unsold stock is made in case of consignment account the quantity of such loss (not the amount) should be deducted from the total quantity of the goods received by the consignee in good condition. Thus,

Value of closing stock will be $= \text{Total Value of goods sent} \times \dfrac{\text{Unsold quantity}}{\text{Good quantity received by consignee}}$

Illustration 16.

From the following particulars ascertain the value of unsold stock on Consignment.

Goods sent (1,000 kgs.)	₹ 20,000
Consignor's expenses	₹ 4,000
Consignees non-recurring expenses	₹ 3,000
Sold (800 kgs.)	₹ 40,000
Loss due to natural wastage (100 kgs.)	

Solution:

Value of unsold stock	₹
Total cost of goods sent	20,000
Add : Consignor's expenses	4,000
Add : Non-recurring expenses	3,000
Cost of (1,000 kgs – 100 kgs) = 900 kgs.	27,000

∴ Value of unsold stock (1,000 – 800 – 100) = 100 kgs. will be $= ₹\ 27{,}000 \times \frac{100 \text{ kgs.}}{900 \text{ kgs.}}$

$= ₹\ 3{,}000$

(b) Abnormal Losses - Abnormal Losses arises as a result of negligence/ accident etc., e.g., theft, fire etc. Before ascertaining the result of the consignment, value of abnormal loss should be adjusted. The method of calculation is similar to the method of calculating unsold stock. Sometimes insurance company admits the claim in part or in full. The same should also be adjusted against such abnormal loss.

While valuing the abnormal loss the proportionate expenses are taken only upto the stage of the loss. For example, if goods are lost in the transit on way to the consignee's place, the value of abnormal loss will include the basic cost of the goods plus proportionate expenses of the consignor only and not the proportionate expenses of consignee because consignee has spent nothing on account of these goods.

Treatment of Abnormal Loss

(i) For abnormal Loss –

Abnormal Loss A/c Dr

To Consignment A/c

(ii) For the insurance claim due / received by the consignor -

Insurance Co./Bank A/c Dr

To Abnormal Loss A/c

(iii) If goods are not insured -

Profit & Loss A/c Dr

To Abnormal Loss A/c

(iv) For transferring the net loss -

Profit & Loss A/c Dr

To Abnormal Loss A/c

Illustration 17.

5,000 shirts were consigned by Raizada & Co. of Delhi to Zing of Tokyo at cost of ₹ 375 each. Raizada & Co. paid freight ₹ 50,000 and Insurance ₹ 7,500.

During the transit 500 shirts were totally damaged by fire. Zing took delivery of the remaining shirts and paid ₹ 72,000 on custom duty.

Zing had sent a bank draft to Raizada & Co. for ₹ 2,50,000 as advance payment. 4,000 shirts were sold by him at ₹ 500 each. Expenses incurred by Zing on godown rent and advertisement etc. amounted to ₹ 10,000. He is entitled to a commission of 5%

One of the customer to whom the goods were sold on credit could not pay the cost of 25 shirts.

Prepare the Consignment Account and the Account of Zing in the books of Raizada & Co. Zing settled his account immediately. Nothing was recovered from the insurer for the damaged goods.

Solution:

In the books of Raizada & Co.

Dr. **Consignment Account** **Cr.**

Particulars		Amount (₹)	Particulars	Amount (₹)
To, Goods Sent on Consignment A/c (5,000 x ₹ 375)		18,75,000	By, Zing A/c - Sale proceeds (3,975 x ₹ 500)	19,87,500
To, Bank A/c			By, Consignment Debtors A/c	
- Freight	50,000		- Credit Sales (25 x ₹ 500)	12,500
- Insurance	7,500	57,500	By, Abnormal Loss A/c (W.N. 1)	1,93,250
To, Zing A/c			By, Stock on Consignment A/c	2,01,250
- Custom Duty	72,000		(W.N.2)	
- Godown Rent, Advertisement etc	10,000			
- Commissions @5% on total Sales (4,000×500×5%)	1,00,000	1,82,000		
To, Consignment Debtors A/c				
- Bad Debts		12,500		
To, Profit and Loss A/c				
- Profit on Consignment transferred		2,67,500		
		23,94,500		**23,94,500**

Dr. **Zing Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment A/c		By, Bank Draft A/c	
Sale Proceeds	19,87,500	Advance	2,50,000
		By, Consignment A/c	
		Expenses & Com.	1,82,000
		By, Bank A/c	
		Final Settlement	15,55,500
	19,87,500		**19,87,500**

Dr. **Abnormal Loss Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment A/c	1,93,250	By, Profit and Loss A/c	1,93,250
	1,93,250		**1,93,250**

Workings:

1. Valuation of goods Lost-in-transit and unsold Stock: **(₹)**

Total Cost	18,75,000
Add: Consignor's Expenses	57,500
C.P. of 5,000 Shirts	19,32,500
Less: Lost-in-transit	
$\left(\frac{₹\ 19,32,500 \times 500}{5,000}\right)$	(1,93,250)
Add: Non-recurring Ex. of Consignee	72,000
C.P. of 4,500 Shirt	**18,11,250**

2. Value of unsold Stock $\frac{₹18,11,250 \times 500}{4,500}$ = ₹ 2,01,250

Note:

Since Del Credere Commission is not given by the consignor to the consignee, amount of bad debt is to be charged against Consignment Account.

Simultaneous Normal Loss and Abnormal Loss

Illustration 18.

Lubrizols Ltd. of Mumbai consigned 1,000 barrels of lubricant oil costing ₹ 800 per barrel to Central Oil Co. of Kolkata on 1.1.2013. Lubrizols Ltd. paid ₹ 50,000 as freight and insurance. 25 barrels were destroyed on 7.1.2013 in transit. The insurance claim was settled at ₹ 15,000 and was paid directly to the consignor.

Central Oil took delivery of the consignment on 19.1.2013 and accepted a bill drawn upon them by Lubrizols Ltd., for ₹ 5,00,000 for 3 months. On 31.3.2013 Central Oil reported as follows:

(i) 750 barrels were sold as ₹ 1,200 per barrel.

(ii) The other expenses were:

	(₹)
Clearing charges	11,250
Godown Rent	10,000
Wages	30,000
Printing, Stationery, Advertisement	20,000

25 barrels of oil were lost due to leakage which is considered to be normal loss.

Central Oil Co. is entitled to a commission of 5% on all the sales affected by them. Central Oil Company paid the amount due in respect of the consignment on 31st March itself.

Show the Consignment Account, the Account of Central Oil Co., and the Lost –in-Transit Account as they will appear in the books of Lubrizols Ltd.

Solution:

In the books of Lubrizols Ltd.

Consignment to Kolkata Account

Dr. Cr.

Date	Particulars	Amount (₹)	Amount (₹)	Date	Particulars	Amount (₹)
2013				2013		
Jan. 1	To Goods sent on Consignment A/c (1,000 x ₹ 800)		8,00,000	Jan. 7	By, Abnormal Loss A/c	21,250
Mar.31	To, Bank A/c – Expenses		50,000	Mar.31	By, Central Oil Co. A/c Sale proceeds (750 x ₹ 1,200)	9,00,000
	To, Central Oil Co. A/c				By, Stock on Consignment A/c	1,76,842
	Freight	11,250				
	Godown Rent	10,000				
	Wages	30,000				
	Printing etc.	20,000	71,250			
	To, Central Oil Co. A/c Commissions @5%		45,000			
	To, Profit on Consignment A/c (Transferred to Profit & Loss A/c)		1,31,842			
			10,98,092			**10,98,092**

Central Oil Co. Ltd. Account

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Mar.31	To, Consignment to Kolkata A/c -Sale Proceeds	9,00,000	Jan.7	By, Bills Receivable A/c	5,00,000
			Mar.31	By, Consignment to Kolkata A/c	
				- Expenses	71,250
				- Commission	45,000
				By, Bank (amount due)	2,83,750
		9,00,000			**9,00,000**

Abnormal Loss Account

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
Jan. 7	To, Consignment to Kolkata A/c	21,250	Jan.7	By Bank-Insurance Claim A/c	15,000
			Mar.31	By, Profit and Loss A/c (bal. fig.)	6,250
		21,250			**21,250**

Workings:

Valuation of Goods Lost-in-transit and Unsold Stock:

	(₹)
Total Cost (1,000 x ₹ 800)	8,00,000
Add: Consignor's Expenses	50,000
Value of 1,000 barrels	8,50,000
Less: Lost-in-transit $25 \times \frac{₹\ 8,50,000}{1,000}$	21,250
Add: Non-recurring expenses of Consignee	11,250
Value of (1,000 – 25 – 25) = 950 Kg.	**8,40,000**

Therefore, Value of Stock = $200 \times ₹ \frac{₹\, 8{,}40{,}000}{950}$ = ₹ 1, 76, 842 (App.)

11.2.8 Invoice Price Method

Sometimes, the Consignor does not want to reveal the cost of goods to the Consignee and therefore, invoices goods at a price which is higher than the Cost Price. Such price is known as 'Invoice Price' and the difference between the Invoice Price and the Cost Price is called 'loading'. It may also be noted that invoice price need not necessarily be same as selling price unless the Consignor directs the Consignee to sell the goods at the invoice price itself.

When goods are sent at invoice price, to ascertain correct profit/loss on consignment, the items recorded at invoice price should be brought down to Cost Price level. For this purpose, the loading included in various items (like Opening Stock, Goods Sent on Consignment, Goods Returned by Consignee, Closing Stock) should be eliminated by passing the necessary adjusting entries in the books of Consignor only.

Entries in the books of Consignor :

	When goods are invoiced at cost	When goods are invoiced at invoice price
For goods sent on consignment	Consignment A/c ... Dr. To Goods Sent on Consignment A/c (with the cost of goods)	Consignment A/c ... Dr. To Goods Sent on Consignment A/c (with the invoice price of goods)
Adjustment Entry for removing loading	No Entry	Goods Sent on Consignment A/c ... Dr. To Consignment A/c (with the amount of loading)
For goods returned by consignee	Goods Sent on Consignment A/c ... Dr. To Consignment A/c (with the cost of goods)	Goods Sent on Consignment A/c ... Dr. To Consignment A/c (with the invoice price of goods)
Adjustment Entry for removing loading	No Entry	Consignment A/c ... Dr. To Goods Sent on Consignment A/c (with the amount of loading)
For opening stock	Consignment A/c ... Dr. To Stock on Consignment A/c (with the cost of opening stock)	Consignment A/c ... Dr. To Stock on Consignment A/c (with the invoice price of opening stock)
Adjustment Entry for removing loading	No Entry	Stock Reserve A/c ... Dr. To Consignment A/c (with the amount of loading)
For closing stock	Stock on Consignment A/c ... Dr. To Consignment A/c (with the cost of closing stock)	Stock on Consignment A/c ... Dr. To Consignment A/c (with the invoice price of closing stock)
Adjustment Entry for removing loading	No Entry	Consignment A/c ... Dr. To Stock Reserve A/c (with the amount of loading)

Illustration 19.

Mr. X, the consignor, consigned goods to Mr. Y 100 Radio sets valued ₹ 50,000. This was made by adding 25% on cost. Mr. X paid ₹ 5,000 for freight and insurance. 20 sets are lost – in- transit for which Mr. X recorded ₹ 5,000 from the Insurance company.

Mr. Y received remaining goods in good condition. He incurred ₹ 4,000 for freight and miscellaneous expenses and ₹ 3,000 for godown rent. He sold 60 sets for ₹ 50,000. Show the necessary ledger account in the books of Mr. X assuming that Mr. Y was entitled to an ordinary Commission of 10% on sales and 5% Del Credere Commission on sales. He also reported that ₹ 1,000 were provide bad .

Solution:

In the books of Mr.X

Dr. Consignment Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Goods Sent on Consignment A/c	50,000	By, Goods Sent on Consignment A/c (Loading) (₹ 50,000x25/125)	10,000
To, Bank A/c – Expenses	5,000	By, Y A/c – Sale Proceeds	50,000
To, Y A/c		By, Abnormal Loss A/c	11,000
- Freight and Misc. Expenses	4,000		
- Godown Rent	3,000		
To, Abnormal Loss A/c (Loading)	2,000	By, Stock on Consignment A/c	12,000
To, Stock surplus A/c	2,000		
To, Y A/c			
- Commission (ordinary) @ 10%	5,000		
- Del credere Commission @ 5%	2,500		
To, Profit and Loss A/c			
- Profit on Consignment A/c	9,500		
	83,000		**83,000**

Dr. Y Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment A/c – Sale proceeds	50,000	By, Consignment A/c	
		- Expenses	7,000
		- Commission	7,500
		By, Balance c/d	35,500
	50,000		**50,000**

Dr. Abnormal Loss Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment A/c	11,000	By, Consignment A/c (Loading)	2,000
		By, Bank A/c – Insurance Claim	5,000
		By, Profit and Loss A/c	4,000
		- Loss transferred	
	11,000		**11,000**

Workings:

(1) Calculation of Loading:

	I.P.	Load	C.P.
	125	25	100
	50,000		$\frac{100 \times 50,000}{125}$ = ₹ 40,000

∴ Loading = ₹(50,000 – 40,000) = ₹ 10,000

Loading Per Set = ₹ 10,000 ÷ 100 = ₹ 100

(2) Valuation of Goods Lost – in – transit and Unsold stock

	₹
Total Invoice Price	50,000
Add: Consignor's Expenses	5,000
Invoice Price of 100 sets	55,000
Less: Lost In Transit $\frac{20 \times 55,000}{100}$	11,000
	44,000
Add: Non recurring Expenses of Mr. Y	4,000
I. P. of 80 sets	48,000

∴ For Unsold Stock of (100 – 20 -60) = 20 sets

$= \frac{48,000 \times 20}{80}$ = ₹ 12,000

(3) Loading on Abnormal Loss = 20 x ₹ 100 = ₹ 2,000

(4) Stock surplus = 20 sets x ₹ 100 = ₹2,000

(5) Since Del Credere Commission is given there will not be any entry for bad debts.

Illustration 20.

From the following two statements, prepare Consignment A/c and Consignee's A/c in the books of Consignor, presuming that the goods were invoiced at 20% above cost.

M/s Vijay & Company — To: M/s Jyoti Electric House

Mumbai — Pune

No 2355 — Proforma Invoice — Date: 21st April 2013

Particulars of goods sent on consignment:	Amount (₹)	Amount (₹)
800 Fans @ ₹ 1680 per fan		13,44,000
Add: Expenses Paid:		
Freight	4000	
Insurance	6000	
Sundries	2000	12,000
Total		13,56,000
E & O E sd/-		
Mumbai For Vijay & Company		

<table>
<tr><td colspan="3">M/s Jyoti Electric House To: M/s Vijay & Company
Pune Mumbai
(Account sales of 800 fans received from Vijay & Company, Mumbai)
Date: 21st September 2013</td></tr>
<tr><td></td><td>Amount (₹)</td><td>Amount (₹)</td></tr>
<tr><td>Sale proceeds of 600 Fans @ ₹ 2000 per fan</td><td></td><td>12,00,000</td></tr>
<tr><td>Less: Expenses Paid :</td><td></td><td></td></tr>
<tr><td>Advertising</td><td>4,500</td><td></td></tr>
<tr><td>Insurance</td><td>1,500</td><td></td></tr>
<tr><td>Octroi</td><td>12,000</td><td></td></tr>
<tr><td>Commission @10%</td><td>1,20,000</td><td>(1,38,000)</td></tr>
<tr><td>Total</td><td></td><td>10,62,000</td></tr>
<tr><td>Less: Bill Accepted</td><td></td><td>7,50,000</td></tr>
<tr><td>Less: Bank draft enclosed</td><td></td><td>3,12,000</td></tr>
<tr><td>E & O E sd/-
Mumbai Jyoti Electric House</td><td></td><td></td></tr>
</table>

Solution:

In the Books of M/s. Vijay & Co.

Dr. Consignment to Pune Account Cr.

Particulars	**Amount (₹)**	**Particulars**	**Amount (₹)**
To, Goods Sent on Consignment A/c	13,44,000	By, M/s Jyoti Electric House's A/c	12,00,000
To, Bank A/c (freight, Insurance & Sundries)	12,000	By, Goods Sent on Consignment A/c (loading)	2,24,000
To, M/s Jyoti Electric House's A/c		By, Consignment Stock A/c (@ invoice value)	3,42,000
Expenses	18,000		
Commission	120,000		
To, Stock Reserve A/c (loading on stock)	56,000		
To, P & L A/c	2,16,000		
	17,66,000		17,66,000

Dr. Jyoti Electric House's Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment A/c	12,00,000	By, Consignment A/c (expenses)	18,000
		By, Consignment A/c (commission)	1,20,000
		By, Bank A/c	3,12,000
		By, Bills Receivable A/c	7,50,000
	12,00,000		12,00,000

Loading on consignment	₹
Invoice price of fans consigned	1,680
Loading is 20% on cost	
Thus loading to be removed 20/120 × 1680	280
Total loading removed (800 × 280)	2,24,000
Value of closing Stock	
Original invoice value	13,44,000
Consignor's expenses	12,000
Consignee's non-recurring expenses (Octroi only)	12,000
Loading on consignment	13,68,000
Total fans sent	800
Fans sold	600
In Stock	200
Hence, stock value (13,68,000/800 × 200)	3,42,000
Loading to be removed (200 × 280)	56,000

Illustration 21

On 1.7.2012, Mantu of Chennai consigned goods of the value of ₹ 50,000 to Pandey of Patna. This was made by adding 25% on cost. Mantu paid ₹ 2,500 for freight and ₹ 1,500 for insurance. During transit $\frac{1}{10}$th of the goods was totally destroyed by fire and a sum of ₹ 2,400 was realised from the insurance company. On arrival of the goods, Pandey paid ₹ 1,800 as carriage to godown. During the year ended 30th June 2013, Pandey paid ₹ 3,600 for godown rent and ₹ 1,900 for selling expenses. $\frac{1}{9}$ th of the remaining goods was again destroyed by fire in godown and nothing was recorded from the insurance company. On 1.6.2013, Pandey sold half ($\frac{1}{2}$) the original goods for ₹ 30,000 and charged a commission of 5% on sales as on 30.6.2013, Pandey sent a bank draft to Mantu for the amount so far due from him.

You are required to prepare the following ledger accounts in the books of Mantu of Chennai for the year ended 30.6.2013.

(a) Consignment to Patna Account; (b) Goods Destroyed by Fire Account; and (c) Personal Account of Pandey.

Solution:

In the books of Mantu of Chennai

Consignment to Patna Account

Dr. Cr.

Particulars		Amount (₹)	Particulars	Amount (₹)
To Goods Sent on Consignment A/c		50,000	By, Goods Sent on Consignment A/c - Loading	10,000
To, Bank A/c				
Freight	2,500			
Insurance	1,500	4,000	By, Pandey A/c Sale Proceeds	30,000
To, Pandey A/c				
Carriage Inward	1,800		By, Goods Destroyed by Fire A/c	11,000
Godown Rent	3,600		By, Stock on Consignment A/c	16,800
Selling Expenses	1,900	7,300		
To, Pandey A/c				
Commission (5% on ₹ 30,000)		1,500		
To, Goods Destroyed by Fire A/c Loading		2,000		
To, Stock Suspense A/c Loading on unsold stock		3,000		
		67,800		**67,800**

Note: There is no normal Profit or Loss on Consignment.

Goods Destroyed by Fire Account

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment to Patna A/c		By, Consignment to Patna A/c Loading	2,000
In transit	5,400		
In Godown	5,600		
		By, Bank A/c – Insurance claim	2,400
		By, Profit & Loss A/c	6,600
	11,000		**11,000**

Pandey Account

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment to Patna A/c		By, Consignment to Patna A/c	
Sale proceeds	30,000	Expense	7,000
		Commission	1,500
		By, Draft A/c	21,200
	30,000		**30,000**

Working:

Valuation of goods destroyed by fire and unsold stock

Particulars	Amount (₹)
Invoice Price of Goods sent	50,000
Add: Consignor's Expenses	4,000
	54,000
Less: Lost-in-Transit ($\frac{1}{10}$ x ₹ 54,000)	5,400
Goods received ($\frac{9}{10}$ th of ₹ 54,000)	48,600
Add: Non- recurring expenses of Pandey	1,800
	50,400
Less: Value of goods destroyed by fire in godown ($\frac{1}{9}$th of ₹ 50,400)	5,600
Value of $\frac{8}{10}$ th	**44,800**

$\therefore$ Goods available for sale $\frac{9}{10} - (\frac{1}{9}\text{th of } \frac{9}{10}) = \frac{9}{10} - \frac{1}{10} = \frac{8}{10}$

Goods sold $\frac{1}{2}$ $\therefore$ Unsold goods = $\frac{8}{10} - \frac{1}{2} = \frac{3}{10}$th

$\therefore$ Value of unsold stock = ₹ 44,800 x $\frac{3}{10}$ x $\frac{10}{8}$ = ₹ 16,800

Loading on goods destroyed = ₹ 10,000 x $\frac{2}{10}$ = ₹ 2,000

Loading on unsold stock = ₹ 10,000 x $\frac{3}{10}$ = ₹ 3,000.

Illustration 22.

Usha sent goods costing ₹ 75,50,000 on consignment basis to Gayatri on 1st Feb 2013 @ 8.5% commission. Usha spent ₹ 8,25,000 on transportation. Gayatri spent ₹ 5,25,000 on unloading. Gayatri sold 88% of the goods for ₹ 90,00,000, 10% of the goods for ₹ 10,00,000 and the balance are taken over by her at 10% below the cost price. She sent a cheque to Usha for the amount due after deducting commission.

Show Consignment to Gayatri A/c and Gayatri's A/c in the books of Usha.

Solution

Calculation of sales	**Cost (₹)**	**Invoice (₹)**
Goods sent	75,50,000	
88% of the goods	66,44,000	90,00,000
10% of goods	7,55,000	10,00,000
Total sales	73,99,000	1,00,00,000
Goods taken over by Gayatri	1,51,000	1,35,900

There is no closing stock here as all unsold goods were taken over by Gayatri. The commission is payable only on sales to outsiders and not on goods taken over by Gayatri.

Thus, commission is 8.5% on ₹ 10,000,000 i.e. ₹ 8,50,000

The required ledger Accounts are shown below.

In the Books of Usha

Dr. Consignment to Gayatri Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Goods Sent on Consignment A/c	75,50,000	By Gayatri's A/c (sales)	10,000,000
To Bank A/c (transportation)	8,25,000	By Gayatri's A/c (goods taken over)	1,35,900
To Gayatri's A/c :			
Unloading charges	5,25,000		
Commission	8,50,000		
To P & L A/c	3,85,900		
	1,01,35,900		**1,01,35,900**

Dr. Gayatri's Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Consignment A/c	1,01,35,900	By Consignment A/c (expenses)	5,25,000
		By Consignment A/c (commission)	8,50,000
		By Bank A/c	87,60,900
	1,01,35,900		**1,01,35,900**

Illustration 23.

Shri Babubhai oil mills of Baroda sent 10000 kg of oil to M/s Gupta & Sons in Delhi. The cost of oil is ₹ 40 per kg. Babubhai paid ₹ 5,000 as freight and ₹ 2,500 as insurance. In transit 250 kg of oil was accidently destroyed for which insurance company paid ₹ 450 in full settlement to Babubhai.

M/s Gupta & Sons took delivery of the balance. Later they reported that 7500 kg was sold @ ₹ 60 per kg. Expenses incurred by them were rent ₹ 2,000, advertisement ₹ 5,000 and salaries ₹ 5000. M/s Gupta & Sons are entitled to commission of 3% and Del Credre commission of 1.5%. One customer who purchased 1000 kg paid only 80% of the amount due. M/s Gupta & Sons also reported loss of 100 kg due to leakage. The final amount due was settled. Prepare necessary ledger accounts in the books of Babubhai.

Solution:

In the Books of Shri Babubhai

Dr. Consignment to Delhi Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Goods Sent on Consignment A/c	4,00,000	By, M/s Gupta & Sons' A/c (sales)	4,50,000
To, Bank A/c (Freight and Insurance)	7,500	By, Abnormal Loss A/c	10,188
To, M/s Gupta & Sons' A/c :		By, Consignment Stock A/c	86,849
Expenses	12,000		
Commission	20,250		
To P & L A/c (Balancing figure)	1,07,287		
	5,47,037		547,037

Dr. **M/s Gupta & Sons' Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment A/c	4,50,000	By, Consignment A/c (expenses)	12,000
		By, Consignment A/c (commission)	20,250
		By, Bank A/c	4,17,750
	4,50,000		450,000

Calculation of Abnormal Loss: 250 kg of oil lost in transit		
Cost of 250 kg @ 40/kg	10,000	
Proportionate expenses of Babubhai (250/10000*7500)	188	10,188
Calculation of closing stock	Kg	
Oil consigned to Delhi	10,000	
Less: Lost in transit	(250)	
Less: Normal loss due to leakage	(100)	
Less: Quantity sold	(7,500)	
Stock in hand	2,150	
	₹	
Basic cost of stock consigned @ ₹ 40	400,000	
Less : Cost of abnormal loss	(10,188)	
Cost of stock after normal loss of 100kg	389,812	
Thus cost of 2150 kg (3,89,812/9,650*2150)	86,849	
Calculation of commission		
Ordinary @ 3% on 4,50,000	13,500	
Del Credre @ 1.5% on 4,50,000	6,750	
	20,250	

As the consignee has paid Del Credre Commission, the responsibility of bad debts is his. Hence no entry is needed to be passed in the books of consignor.

Illustration 24.

Sangita Machine Corporation sent 200 sewing machines to Rita agencies. It spent ₹ 7500 on packing. The cost of each machine was ₹ 2,000, but it was invoiced at 20% above cost. 20 machines were lost in transit & insurance company accepted claim of ₹ 20,000 only.

Rita agencies paid freight of ₹ 9,000, carriage ₹ 3,600, Octroi ₹ 1,800 and rent ₹ 1800. They sold 150 machines at ₹ 3,500 per machine. They were entitled to commission of 5% on invoice price and additional 20% of any excess realized on invoice price and 2% Del Credre commission. They accepted a bill drawn by Sangita Machine Corporation for ₹ 3,00,000 and remitted the balance by demand draft along with account sale. Draw up necessary ledger accounts in the books of Sangita Machine Corporation and Rita Agencies.

Solution:

Books of Sangita Machine Corporation

Dr. Consignment to Rita Agencies Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Goods Sent on Consignment A/c	4,80,000	By Goods Sent on Consignment A/c (loading)	80,000
To, Bank A/c (Packing Expenses)	7,500	By Abnormal Loss A/c	48,750
To Rita Agencies A/c		By Consignment Stock A/c	75,525
Freight	9,000	By Rita Agencies' A/c (sales 150 @ 3500)	5,25,000
Carriage	3,600		
Octroi	1,800		
Rent	1,800		
Commission	61,500		
To Abnormal loss A/c (load removed)	8,000		
To Stock Reserve A/c	12,000		
To P & L A/c	1,44,075		
	7,29,275		**7,29,275**

Dr. Rita Agencies Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Consignment A/c	5,25,000	By Consignment A/c (expenses)	16,200
		By Consignment A/c (commission)	61,500
		By Bills Receivable A/c	3,00,000
		By Bank A/c (balancing figure)	1,47,300
	5,25,000		**5,25,000**

Calculation of abnormal loss 20 machines lost in transit

Cost of 20 machines @ ₹ 2400	₹ 48,000
Proportionate expenses of Babubhai (20/200*7500)	₹ 750
	₹ **48,750**

Calculation of Closing Stock

	₹
Invoice value of 30 machines @ 2400	72,000
Add : Consignor's proportionate expenses	1,125
Add : Consignee's proportionate expenses	2,400
	75,525
Stock reserve 30 machines @ ₹400	12,000

Calculation of Commission

Invoice price of machines sold	₹	
(2400*150)	360,000	
Commission @ 5% on this	18,000	(a)
Excess over invoice value		
(5,25,000-3,60,000)	165,000	
Commission @ 20% on this	33,000	(b)
Del Credre Commission @ 2% on 5,25,000	10,500	(c)
Total Commission (a+b+c)	61,500	

Books of Rita Agencies

Dr. Sangita Machine Corporation Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Cash A/c (expenses)	16,200	By, Consignment A/c (sales)	5,25,000
To, Commission A/c	61,500		
To, Bills Payable A/c	3,00,000		
To, Bank A/c (balancing figure)	1,47,300		
	5,25,000		5,25,000

11.2.9 Advance from Consignee as Security Money:

Usually the consignor takes certain some of money as advance by way of cash/draft/bill etc from the consignee against the goods that are sent for sale to the consignee. The so called advance money is automatically adjusted against the total dues in order to determine the net amount payable. If the advance money is not treated as security money, then the entire amount of advance money may be adjusted even if a part of goods are sold. But if the advance money is treated as security money, in that case, the proportionate amount of such advance money will be carried forward. The entries in the books of both consignee and consignor will be:

In the books of Consignor		In the books of Consignee	
Cash/ Draft/Bill Receivable A/c	Dr.	Consignor A/c	Dr.
To, Consignee's Personal A/c		To, Cash/ Draft/B/P A/c	

Illustration 25.

Ram of Patna consigns to Shyam of Delhi for sale at invoice price or over. Shyam is entitled to a commission @ 5% on invoice price and 25% of any surplus price realized. Ram draws on Shyam at 90 days sight for 80% of the invoice price as security money. Shyam remits the balance of proceeds after sales, deducting his commission by sight draft.

Goods consigned by Ram to Shyam costing ₹ 20,900 including freight and were invoiced at ₹ 28,400. Sales made by Shyam were ₹ 26,760 and goods in his hand unsold at 31st Dec, represented an invoice price of ₹ 6,920. (Original cost including freight ₹ 5,220). Sight draft received by Ram from Shyam upto 31st Dec was ₹ 6,280. Others were in- transit.

Prepare necessary Ledger Accounts in the books of Ram.

Solution:

In the books of Ram

Consignment to Delhi Account

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Goods Sent on Consignment A/c	28,400	By, Goods Sent on Consignment A/c	7,500
To, Y A/c – Commission	2,394	(Loading) ₹ (28,400- 20,900)	
To, Stock Reserve A/c	1,700	By, Shyam A/c – Sale proceeds	26,760
₹(6,920 – 5,220)		By, Stock on Consignment A/c	6,920
To, Profit and Loss A/c-	8,686		
Profit on consignment transferred			
	41,180		41,180

Shyam Account

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment to Delhi A/c	26,760	By, Bills Receivable A/c	22,720
To, Balance c/d (₹ 6,920 x 80%)	5,536	By, Consignment to Delhi A/c - commission	2,394
		By, Draft A/c	6,280
		By, Draft- in- Transit A/c	902
	32,296		32,296

Goods sent on Consignment Account

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment to Delhi A/c	7,500	By, Consignment to Delhi A/c	28,400
To, Trading A/c (bal.fig)	20,900		
	28,400		28,400

Workings:

Calculation of Commission:	₹
Invoice value of goods	28,400
Less: Unsold stock	6,920
Invoice value of goods sold	21,480
Total sale proceeds	26,760
Less: Invoice value of goods sold	21,480
Surplus price	5,280
Commission @ 5% on ₹ 21,480	1,074
Add: @ 25% on ₹ 5,280	1,320
	2,394

Deficiency of Stock

The consignee may discover some deficiency in stock on his actual physical stock taking. The value of loss arising out of such deficiency will be calculated in the same way as the value of unsold stock. This will be brought into account by debiting Stock Deficiency Account and crediting Consignment Account. Stock Deficiency Account will be closed by transfer to the debit of Consignment Account or preferably of Profit & Loss Account. If, however, there is an arrangement that any deficiency of stock

will be made good by the consignee, the Deficiency Account will be closed by transfer to the debit of the Consignee's Personal Account.

Illustration 26.

R of Ranchi consigned goods costing ₹1,60,000 to B of Bombay. The terms of the consignment were:

(a) Consignee to get a commission of 5 per cent on cash sales and 4 per cent on credit sales.

(b) Any goods taken by the consignee himself or goods lost through consignee's negligence, shall be valued at cost plus 12½ per cent and no commission will be allowed on them.

The expenses incurred by the consignor were: Carriage and freight ₹ 6,720 and Insurance ₹ 3,440. The consignor received ₹ 50,000 as advance against the consignment. Account Sales together with a draft for the balance due was received by the consignor showing the following position:

Goods costing ₹ 1,28,000 were sold for cash at ₹ 1,40,000 and on credit at ₹ 1,08,000. Goods costing ₹ 8,000 were taken by B and goods costing ₹ 4,000 were lost through B's negligence. The expenses incurred by B were: Advertisement ₹ 1,720; other selling expenses ₹ 1,080.

Show the ledger accounts in the books of R.

Solution:

Books of R

Dr. **Consignment to Bombay Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Goods Sent on Consignment A/c	1,60,000	By B:	
`` Bank—Expenses :		Cash sales	1,40,000
Carriage and freight	6,720	Goods taken over:	
Insurance	3,440	8,000+ 12½ %	9,000
" B A/c :		Goods Lost: 4,000 + 12½%	4,500
Advertisement	1,720	`` Consignment Debtors A/c	
Selling expenses	1,080	—Credit sales	1,08,000
Commission on:		" Consignment Stock A/c	21,270
Cash sales	7,000	(W.N. 1)	
Credit sales	4,320		
`` Profit on Consignment			
transferred to P/L A/c	98,490		
	2,82,770		2,82,770

Working Note:

1.

Valuation of unsold stock	₹
Cost price of goods sent	1,60,000
Add: Expenses : 6,720 + 3,440	10,160
	1,70,160

Value of unsold stock: $\frac{20,000}{1,60,000}$ x ₹ 1,70,160 = ₹ 21,270

B (Consignee) Account

Dr. *Cr.*

Particulars	Amount (₹)	Particulars	Amount (₹)
To Consignment to Bombay A/c :		By Bank—advance	50,000
Cash sales	1,40,000	" Consignment to Bombay A/c :	
Goods taken over	9,000	Advertisement	1,720
Goods lost	4,500	Selling expenses	1,080
		Commission	11,320
		" Bank—remittance	89,380
	1,53,500		1,53,500

Consignment Debtors Account

Dr. *Cr.*

Particulars	Amount (₹)	Particulars	Amount (₹)
To Consignment to Bombay A/c	1,08,000	By Balance c/f	1,08,000
	1,08,000		1,08,000

Goods Sent on Consignment Account

Dr. *Cr.*

Particulars	Amount (₹)	Particulars	Amount (₹)
To Trading A/c – transfer	1,60,000	By Consignment to Bombay A/c	1,60,000
	1,60,000		1,60,000

Return of Goods by the Consignee

If any goods are returned by the consignee to the consignor, Goods Sent on Consignment Account is debited and Consignment Account is credited. Consignment Account is debited with expenses paid by the Consignee on such return. In Consignee's book, however, no entry is required for return, because no entry is passed for receiving the goods. For expenses on return Consignor's A/c is debited and bank is credited.

Illustration 27.

On February 21, 2013, Birch of Calcutta consigned to his agent, Larch of Guwahati, 90 bicycles, which cost ₹ 180 each, insurance and freight amounting to ₹ 1,080. Larch is entitled to a commission of 10 per cent on gross sales.

On March 2, 2013, Larch returned 10 bicycles, which were of wrong colour and paid return freight and insurance, ₹ 200.

Birch whose financial year ends on June 30,2013, received from Larch an account sales, made up to that date; this showed that, Larch had sold 60 bicycles for ₹ 21,600, and that he had paid warehouse charges ₹ 360 and Carriage on sale ₹ 300. Larch sent a sight draft in settlement of the balance due, on which Birch incurred bank charges ₹ 60.

Larch sold the remaining bicycles for ₹ 6,300, incurring expenses ₹ 160. He sent Birch a second account sales made up to September 30, 2013, accompanied by a sight draft for the balance due, on which Birch paid bank charges ₹ 40.

You are required to prepare the following accounts as they would appear in the books of Birch:

(a) Consignment to Guwahati Account.

(b) Goods sent on Consignment Account, and

(c) Personal Account of Larch.

Solution:

Books of Birch

Consignment to Guwahati Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
21.2.2013	To Goods Sent on Consignment A/c — 90 × ₹ 180	16,200	21.3.2013	By Goods Sent on Consignment A/c — return 10 × ₹ 180	1,800
	Bank : Insurance and freight	1,080			
2.3.2013	To Larch A/c — return freight and insurance	200	30.6.2013	By Larch A/c — sale proceeds of 60 bicycles	21,600 3,870
30.6.2013	To Larch A/c: Warehouse charges 360 Carriage 300 Commission 2,160		”	Balance c/d — consignment stock	
”	Profit on Consignment transferred to P/L A/c	2,820 6,970			
		27,270			27,270
1.7.2013	To Balance b/d	3,870			
30.9.2013	To Larch A/c : Expenses 160 Commission 630		30.9.2013	By Larch A/c — sale proceeds of 20 bicycles	6,300
”	Profit on Consignment transferred to P/L A/c	790 1,640			
		6,300			6,300

Dr. **Goods Sent on Consignment Account** Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2.3.2013	To Consignment to Guwahati A/c — return	1,800	21.2.2013	By Consignment to Guwahati A/c	16,200
30.6.2013	To Trading A/c — transfer	14,400			
		16,200			16,200

Dr. **Larch (Consignee) Account** Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
30.6.2013	To Consignment to Guwahati A/c — Sale proceeds	21,600	30.6.2013	By Consignment to Guwahati A/c — Return freight and insurance	200
		14,400	30.6.2013	By Consignment to Guwahati A/c Warehouse charges 360 Carriage 300 Commission 2,160	2,820
				" Bank – Balance received	18,580
		21,600			21,600
30.9.2013	To Consignment to Guwahati A/c — Sale proceeds	6,300	2.3.2013	By Consignment to Guwahari A/c Expenses 160 Commission 630	790
				" Bank – Balance received	5,510
		6,300			6,300

Working Notes:

1. Bank charges have been considered as a general financial charge which will, therefore, be debited to Profit & Loss A/c. Alternatively, these can be treatedas an expense of the consignment and debited to Consignment Account.

2.

Valuation of unsold stock on 30-6-92	₹
Cost of 90 bicycles @ ₹ 180 per bicycle	16,200
Less : Cost of bicycles returned : 10 x ₹ 180	1,800
	14,400
Add : Insurance and freight	1,080
Value of 80 bicycles	15,480

Value of unsold stock (20 bicycles): $\frac{20}{80}$ x ₹ 15,480 or ₹ 3,870.

11.3 JOINT VENTURE ACCOUNTS

11.3.1 Introduction

Joint Venture is a temporary form of business organization. There are certain business activities or projects that may involve higher risks; higher investments and even they demand multi-skills. In such cases, an individual person may not be able to muster all resources. Hence two or more people having requisite skill sets come together to form a temporary partnership. This is called a Joint Venture. There is a Memorandum of Undertaking (MOU) signed for this purpose.

The business activities for which Joint Ventures (JV) are formed could be :

- Construction of dams, bridges, roads etc
- Buying & selling of goods for a particular season
- Producing a film
- Purchasing land selling plots

The basic features of a Joint Venture business are :

(i) It is done for a specific purpose and hence has a limited duration.

(ii) The partners are called co-venturers.

(iii) The profit or loss on joint venture is shared between the co-venturers in the agreed ratio.

(iv) The co-venturers may or may not contribute initial capital.

(v) The JV is dissolved once the purpose of the business is over.

(vi) The accounts of the co-venturers are settled immediately on dissolution.

(vii) A joint venture has no name.

11.3.2 Accounting Entries

There may be three ways of maintaining the books of account for the joint venture business. They are:

(a) Where separate books of accounts are maintained

(b) Where no separate books of accounts are maintained

(c) Memorandum Joint Venture

11.3.2.1 (a) When Separate Books are Maintained

As the business duration is short, the books of accounts are not very comprehensive. The basic purpose is to know profit or loss on account of the joint venture.

(a) Like a normal P & L A/c, a "Joint Venture A/c" is opened which records all transactions related to the activities carried out. The net result of this a/c will be either profit or loss.

(b) To record cash/bank transactions a "Joint Bank A/c" is maintained. This could take a form of cash book with cash and bank column. It will record, the initial contributions made by each co-venturer, proceeds of sales, expenses and distribution of net balances among co-venturers on dissolution of the venture.

(c) To record transaction related to co-venturers, "Co-Venturers' personal A/cs" are also maintained.

The accounting entries are normally as follows:

No.	Transaction	Entry
1	Contribution of co-venturers	Joint Bank A/c Dr. [with total] To, Co-Venturers A/c [with individual sum contributed]
2	On purchase of goods	Joint Venture A/c Dr. To, Joint Bank/ Supplier's/ Co-Venturers A/c
3	On making payment to suppliers of goods	Supplier's A/c. Dr. [with total] To, Cash/ Joint Bank/ B/P A/c [with payment made] To, Joint Venture A/c [with discount received]
4	On supply of goods out of own stock by any of the co-venturers	Joint Venture A/c Dr. To, Co-Venturer's Personal A/c
4	On payment of expenses	Joint Venture A/c Dr. To, Joint Bank/ Co-Venturers A/c
5	For sale of goods sold	For cash Joint Bank A/c Dr. To Joint Venture A/c For credit Customer's A/c Dr. To, Joint Venture A/c By any Co-venturers Co- Venturer's A/c Dr. To, Joint Venture A/c
6	On receiving payment from a customer	Cash/ Joint Bank/ B/R A/c Dr. [with payment received] Joint Venture A/c Dr. [with discount allowed/ bad debts] To, Customer's A/c [with total]
7	Contract / sale price received in form of shares / cash	Joint Bank A/c Dr. Shares A/c Dr. To Joint Venture A/c
8	Commission / salary to co-venturers	Joint Venture A/c Dr. To Co-Venturers A/c
9	Unsold goods taken over by co-venturers	Co-Venturers A/c Dr. To Joint Venture A/c
10	Shares taken over by co-venturers	Co-Venturers A/c Dr. To Shares
11	If shares are sold in open market	Joint Bank A/c Dr. To Shares
12	For profit on joint venture	Joint Venture A/c Dr. To Co-Venturers A/c
13	For loss on joint venture	Co-Venturers A/c Dr. To Joint Venture A/c

No.	Transaction	Entry	
14	For final distribution of funds	In case of a debit balance	
		Joint Bank A/c	Dr.
		To, Co-Venturer's Personal A/c	
		In case of a credit balance	
		Co-Venturers A/c	Dr.
		To Joint Bank A/c	

Illustration 28.

Aditya and Amit entered into a joint venture to buy and sale Ganesh idols for the Ganesh festival. They opened a Joint Bank A/c. Aditya deposited ₹ 2,00,000 and Amit ₹ 1,50,000. Aditya supplied Ganesh idols worth ₹ 25,000 and Amit supplied decoration material worth ₹ 15,000.

The following payments were made by the venture:

(a) Cost of Ganesh idols purchased ₹ 2,50,000

(b) Transportation charges ₹ 12,000

(c) Advertising ₹ 7,500 and Sundry Expenses ₹ 2,500

They sold idols for ₹ 4,00,000 for cash. Aditya took over some idols for ₹ 30,000 and Amit took over remaining for ₹ 10,000. The profit or losses were to be shared equally between co-venturers. Prepare Joint Venture A/c, Joint Bank A/c and each Co-Venturer's A/c.

Solution:

Dr. — Joint Venture Account — Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Aditya A/c – Materials	25,000	By, Joint Bank A/c –sales	4,00,000
To, Amit A/c – Materials	15,000	By, Aditya A/c	30,000
To, Joint Bank A/c – Materials	2,50,000	By, Amit A/c	10,000
To, Joint Bank A/c – Transport	12,000		
To, Joint Bank A/c – Advertising	7,500		
To, Joint Bank A/c – Sundry	2,500		
To, Profit on Venture A/c :			
Aditya	64,000		
Amit	64,000		
	4,40,000		4,40,000

Dr. — Joint Bank Account — Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Aditya A/c	2,00,000	By, Joint Venture A/c : materials	2,50,000
To, Amit A/c	1,50,000	By, Joint VentureA/c : transport	12,000
To, Joint Venture A/c - sales	4,00,000	By, Joint Venture A/c : advertising	7,500
		By, Joint Venture A/c : sundry	2,500
		By, Aditya A/c : closing	2,59,000
		By, Amit A/c : closing	2,19,000
	7,50,000		7,50,000

Dr.	Aditya's Account		Cr.
Particulars	**Amount (₹)**	**Particulars**	**Amount (₹)**
To Joint Venture A/c - material	30,000	By, Joint Bank	2,00,000
To Joint Bank A/c - closing	2,59,000	By, Joint Venture - materials	25,000
		By, Joint Venture – profit	64,000
	2,89,000		2,89,000

Dr.	Amit's Account		Cr.
Particulars	**Amount (₹)**	**Particulars**	**Amount (₹)**
To Joint Venture A/c - material	10,000	By Joint Bank A/c	1,50,000
To Joint Bank A/c - closing	2,19,000	By Joint Venture A/c - materials	15,000
		By Joint Venture A/c– profit	64,000
	2,29,000		2,29,000

Illustration 29.

Prabir and Mihir doing business separately as building contractors undertake jointly to build a skyscraper for a newly started public limited company for a contract price of ₹ 1,00,00,000 payable as ₹ 80,00,000 in cash and the balance by way of fully paid equity shares of the new company. A Bank A/c was opened for this purpose in which Prabir paid ₹ 25,00,000 and Mihir ₹ 15,00,000. The profit sharing ratio was agreed as 2:1 between Prabir and Mihir. The transactions were:

(a) Advance received from the company ₹ 50,00,000

(b) Wages to contractors ₹ 10,00,000

(c) Bought materials ₹ 60,00,000

(d) Material supplied by Prabir ₹ 10,00,000

(e) Material supplied by Mihir ₹ 15,00,000

(f) Architect's fees paid from Joint Bank account ₹ 21,00,000

The contract was completed and the price was duly paid. The joint venture was duly closed by Prabir taking all the shares at ₹ 18,00,000 and Mihir taking over the balance material for ₹ 3,00,000. Prepare the Joint Venture A/c, Joint Bank A/c. Co-venturer's A/cs and Shares A/c.

Solution:

Dr.	Joint Venture Account		Cr.
Particulars	**Amount (₹)**	**Particulars**	**Amount (₹)**
To, Joint Bank A/c – wages	10,00,000	By, Joint Bank A/c - advance	50,00,000
To, Joint Bank A/c - material	60,00,000	By, Joint Bank A/c - balance price	30,00,000
To, Joint Banks A/c - Architect	21,00,000	By, Shares A/c – received	20,00,000
To, Prabir A/c - material	10,00,000	By, Mihir A/c - stock taken	3,00,000
To, Mihir A/c - material	15,00,000	By, Prabir A/c - 2/3rd loss	10,00,000
To, Shares A/c - loss	2,00,000	By, Mihir A/c - 1/3rd loss	5,00,000
	1,18,00,000		1,18,00,000

Dr.	Joint Bank Account		Cr.
Particulars	**Amount (₹)**	**Particulars**	**Amount (₹)**
To, Prabir A/c	25,00,000	By, Joint Venture A/c – wages	10,00,000
To, Mihir A/c	15,00,000	By, Joint Venture A/c – materials	60,00,000
To, Joint Venture A/c - advance	50,00,000	By, Joint Venture A/c – Architect	21,00,000
To, Joint Venture A/c - balance	30,00,000	By, Prabir A/c - balance paid	7,00,000
		By, Mihir A/c - balance paid	22,00,000
	1,20,00,000		1,20,00,000

Prabir's Account

Dr. Particulars	Amount (₹)	Particulars	Cr. Amount (₹)
To, Shares A/c – taken	18,00,000	By, Joint Bank A/c	25,00,000
To, Joint Venture A/c - loss	10,00,000		
To, Joint Bank A/c - Balance paid	7,00,000	By, Joint Venture A/c - material	10,00,000
	35,00,000		35,00,000

Mihir's Account

Dr. Particulars	Amount (₹)	Particulars	Cr. Amount (₹)
To, Joint Venture A/c – stock taken	300,000	By, Joint Bank A/c	15,00,000
To, Joint Venture A/c – Loss	500,000		
To, Joint Bank A/c - Balance paid	22,00,000	By, Joint Venture - material	15,00,000
	30,00,000		30,00,000

Shares Account

Dr. Particulars	Amount (₹)	Particulars	Cr. Amount (₹)
To, Joint Venture A/c	20,00,000	By, Prabir A/c	18,00,000
		By, Joint Venture A/c - loss	2,00,000
	20,00,000		20,00,000

Illustration 30.

P and Q entered into a joint venture for underwriting the subscription at par of 25,000 shares of ₹ 10 each of a Joint Stock Company. They agreed to share profits or losses in the ratio of $\frac{3}{5}$ and $\frac{2}{5}$, respectively. The consideration for guaranteeing the subscription was 250 other shares of ₹ 10 each fully paid to be issued to them.

The public took up 24,000 of the shares and the remaining shares of the guaranteed issue were taken up by P and Q who provide cash equally. The entire shareholding of the venture was then sold through other brokers, 60% at a price of ₹ 9.50 less brokerage 50 paisa per share, 20% at a price of ₹ 9.75 less brokerage 50 paisa per share and the balance were taken over by P and Q equally at ₹ 9.00 per share.

Prepare a Joint Venture Account, the Joint Bank Account, and Capital Accounts of P and Q.

Solution :

In the books of P and Q
Joint Venture Account

Dr. Particular	Amount (₹)	Particular	Cr. Amount (₹)
To, Joint Bank A/c	10,000	By, Joint Bank A/c	9,063
Cost of 1,000 shares @ ₹ 10		Sale proceeds of shares	
		By, P's Capital A/c	1,125
To, Capital A/c		Shares taken	
– Profit on Venture :		By, Q's Capital A/c	1,125
– P-788		Shares taken	
– Q-525	1,313		
	11,313		11,313

Dr. **Joint Bank Account** **Cr.**

Particular	Amount (₹)	Particular	Amount (₹)
To, P's Capital A/c	5,000	By, Joint Venture A/c	10,000
To, Q's Capital A/c	5,000	(Cost of shares)	
To, Joint Venture A/c	9,063	By, P's Capital A/c	4,663
		By, Q's Capital A/c	4,400
	19,063		**19,063**

Dr. **Capital Account** **Cr.**

Particular	P Amount (₹)	Q Amount (₹)	Particular	P Amount (₹)	Q Amount (₹)
To, Joint Venture A/c	1,125	1,125	By Joint Book A/c		
– Shares taken			(Cost of shares)	5,000	5,000
"Joint Bank A/c	4,663		"Joint Venture Profit A/c	788	
— Final Payment		4,400	"Joint Venture Profit A/c		525
	5,788	**5,525**		**5,788**	**5,525**

Working :

Cost of 1,000 shares @ ₹ 10 = ₹ 10,000 to be contributed by P and Q equally, i.e., ₹ 5,000 each

Calculation of sale proceeds :

	₹	
Share purchased	1,000	
Taken as Com.	250	
	1,250	
60% of 1,250 = 750 × ₹ 9 (i.e. ₹ 9.50 – .50) =		₹ 6,750
20% of 1,250 = 250 × ₹ 9.25 (i.e. ₹ 9.75 – .50) =		₹ 2,313
80%		9,063

20% of 1,250 = 250 × ₹ 9 = ₹ 2,250 to be taken by P and Q equally, i.e. ₹ 1,125 each.

11.3.2.2 (b) When no Separate Books of Accounts are Maintained

The co-venturers may decide not to keep separate books of account for the venture if it is for a very short period of time. In this case, all co-venturers will have account for the transactions in their own books. Here no Joint Bank A/c is opened and the co-venturers do not contribute in cash. Goods are supplied by them from out of their stocks and expenses for the venture are also settled the same way.

Each co-venturer will prepare a Joint Venture A/c and the other Co-Venturer's A/c in his books. Naturally, the profit or loss is separately calculated by each co-venturer. Each co-venturer will take into A/c all transactions i.e. done by himself and by his co-venturer as well.

The accounting entries are:

In books of Co-venturer A		In books of co-venturer B	
When goods are supplied and expenses paid by A			
Joint Venture A/c To, Goods A/c To, Cash / Bank A/c	Dr.	Joint Venture A/c To, A's A/c	Dr.
When goods are supplied by B and expenses paid by B			
Joint Venture A/c To, B's A/c	Dr.	Joint Venture A/c To, Goods A/c To, Cash / Bank A/c	Dr.
When advance is given by A to B or bill accepted by A			
B's A/c To, Cash / Bank A/c To, B/P A/c	Dr.	Cash / Bank A/c B/R A/c To, A's A/c	Dr. Dr.
When sale proceeds are received by A			
Cash / Bank A/c To, Joint Venture A/c	Dr.	A's A/c To, Joint Venture A/c	Dr.
When sale proceeds are received by B			
B's A/c To, Joint Venture A/c	Dr.	Cash / Bank A/c To, Joint Venture A/c	Dr.
For unsold goods taken over by A			
Goods A/c To Joint Venture A/c	Dr.	A's A/c To Joint Venture A/c	Dr.
For unsold goods taken over by B			
B's A/c To, Joint Venture A/c	Dr.	Goods A/c To, Joint Venture A/c	Dr.
For profit on joint venture business			
Joint Venture A/c To, B's A/c To, P & L A/c	Dr.	Joint Venture A/c To, A's A/c To, P & L A/c	Dr.
For loss on joint venture business			
B's A/c P & L A/c To, Joint Venture A/c	Dr. Dr.	A's A/c P & L A/c To, Joint Venture A/c	Dr. Dr.

After closure the business of joint venture, the co-venturer who has received surplus cash will remit it to the other co-venturer.

As a variation from this system, the co-venturers may decide to maintain a separate 'Memorandum Joint Venture A/c' in joint books. In this transactions made by each co-venturer is shown against their name. This A/c will show profit or loss. The co-venturers will keep an account called "Joint venture with co-venturer A/c" wherein all transactions done by him only are recorded.

Illustration 31.

John and Smith entered into a joint venture business to buy and sale garments to share profits or losses in the ratio of 5:3. John supplied 400 bales of shirting at ₹ 500 each and also paid ₹ 18,000 as carriage & insurance. Smith supplied 500 bales of suiting at ₹ 480 each and paid ₹ 22,000 as advertisement & carriage. John paid ₹ 50,000 as advance to Smith.

John sold 500 bales of suiting at ₹ 600 each for cash and also all 400 bales of shirting at ₹ 650 each for cash. John is entitles for commission of 2.5% on total sales plus an allowance of ₹ 2,000 for looking after business. The joint venture was closed and the claims were settled.

Prepare Joint Venture A/c and Smith's A/c in the books of John and John's A/c in the books of Smith.

Solution:

Books of John

Joint Venture Account

Dr. Particulars	Amount (₹)	Particulars	Amount (₹) Cr.
To, Goods A/c - shirting (400x500)	2,00,000	By, Cash A/c – sales	
To, Bank A/c - carriage & insurance	18,000	shirting (500 x 600)	3,00,000
To, Smith A/c - suiting (500x480)	2,40,000	suiting (400 x 650)	2,60,000
To, Smith A/c - advt & Carriage	22,000		
To, Commission A/c - 2.5%	14,000		
To, Allowance A/c	2,000		
To, P & L A/c (5/8th share)	40,000		
To, Smith A/c (3/8th share)	24,000		
	5,60,000		5,60,000

Smith's Account

Dr. Particulars	Amount (₹)	Particulars	Amount (₹) Cr.
To, Cash A/c - advance	50,000	By, Joint Venture A/c - suiting	2,40,000
To, Cash A/c - balance paid	2,36,000	By, Joint Venture A/c - expenses	22,000
		By, Joint Venture A/c - profit	24,000
	2,86,000		2,86,000

Books of Smith

John's Account

Dr. Particulars	Amount (₹)	Particulars	Amount (₹) Cr.
To, Joint Venture A/c - sales	5,60,000	By, Cash A/c - advance	50,000
		By, Joint Venture A/c - shirting	2,00,000
		By, Joint Venture A/c - expenses	18,000
		By, Joint Venture A/c - commission	14,000
		By, Joint Venture A/c - Allowance	2,000
		By, Joint Venture A/c - profit	40,000
		By, Cash A/c - balance paid	2,36,000
	5,60,000		5,60,000

11.3.2.3 (c) Memorandum Joint Venture Account

When all the parties keep accounts, the method adopted for recording the transactions relating to joint venture, is called Memorandum Joint venture method. Here each Co-Venturer records only those joint venture transactions which are affected by him with the help of a personal account designed as 'Joint Venture with……….(Name of the other Co-Venturer)……Account'. It is debited with the amount of purchases/supplies made and expenses incurred by the Venturer.

Each Co-Venturer sends a periodic statement of joint venture transactions effected by him only, to the other Co-Venturer and on receipt of the aforesaid statement, each Co-Venturer prepares Memorandum Joint Venture Account in order to ascertain the profit/loss on Joint Venture transactions.

Since this account is in fact, not a part and parcel of double entry system the word 'memorandum' is prefixed.

Journal Entries: The journal entries which may be required at any point of time, are summarized below:

	Entry		
1.	(a) On receipt of any amount/Bills Receivable from other Co-Venturer: Cash/Bank/Bills Receivable A/c To, Joint Venture with ………….A/c	 Dr.	
1.	(b) On discounting Bills Receivable: Bank A/c Joint Venture with ………….A/c To, Bills Receivable A/c	 Dr. Dr.	 (with net proceeds) (with discount) (with total)
2.	On purchase of goods: Joint Venture with ………….A/c To, Cash/Bank A/c To, Supplier's A/c	 Dr.	 (with total) (with cash purchase) (with credit purchase)
3.	On making payment to supplier Supplier's A/c To, Cash/Bank/Bills Payable A/c To, Joint Venture with ………….A/c	 Dr.	 (with total) (with payment made) (with discount received)
4.	On supply of goods out of own stock: Joint Venture with ………….A/c To, Purchases/Goods sent on Joint Venture A/c To, Sales A/c	 Dr.	 (if supplies at cost) (if supplies at profit)
5.	On payment of expenses: Joint Venture with ………….A/c To, Cash/Bank A/c To, Creditor's A/c	 Dr.	 (with total) (with cash expenses) (with outstanding expenses)
6.	On sale of goods: Cash/Bank A/c Customer's A/c To, Joint Venture with ………….A/c	 Dr. Dr.	 (with cash sales) (with credit sales) (with total)
7.	On receiving payment from a customer: Cash/Bank A/c Joint Venture with ………….A/c To, Customer's A/c	 Dr. Dr.	 (with the payment received) (discount allowed/bad debt) (with total)
8.	On taking away of unsold goods: Goods sent on Joint Venture A/c To, Joint Venture with ………….A/c	 Dr.	
9.	On considering some commission/salary to the Co-Venturer: Joint Venture with ………….A/c To, Commission/Salary A/c	 Dr.	
10.	On recording the share of Profit/Loss: (a) When profit- Joint Venture with ………….A/c To, Profit & Loss A/c (b) When loss- Profit & Loss A/c To, Joint Venture with ………….A/c	 Dr. Dr.	
11.	On settlement of balance of Joint Venture with ……..A/c: (a) When there is a debit balance: Cash/Bank A/c To, Joint Venture with ………….A/c (b) When there is a credit balance: Joint Venture with ………….A/c To, Cash/Bank A/c	 Dr. Dr.	

Illustration 32.

Ravi and Suresh entered into a Joint Venture for purchase and sale of electronic goods, sharing profit & loss in this ratio of 3:2. They also agreed to receive 5% commission on their individual sales and the following information was extracted from the records.

July 1. 2013 : Ravi purchased goods worth ₹ 1,90,000 financed to the extent of 90% out of his funds and balance by loan from his uncle Shyam.

Aug. 1 2013 : Ravi sent goods costing ₹ 1,70,000 to Suresh and paid ₹ 1,410 as freight. Suresh paid ₹ 13,410 to Ravi.

Oct. 1 2013 : Suresh sold all the goods sent to him. Ravi paid the loan takes from his uncle including interest of ₹ 350.

All sales by either party were made at as uniform profit of 40% after cost. On Nov. 30, 2013, they decided to close the venture by transforming the balance of goods unsold lying with Ravi at a cost of ₹ 9,000 to a wholesale dealer. You are required to prepare the Memorandum Joint Venture Account, Joint Venture with Ravi in the books of Suresh and Joint Venture with Suresh in the books of Ravi. They further disclosed that goods worth ₹ 4,000 were taken personally by Ravi at an agreed price of ₹ 5,000.

Solution:

Dr. Memorandum Joint Venture Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
July 1.	To, Ravi – Purchase 1,71,000		Oct. 1.	By, Suresh–Sale	2,38,000
	To, Loan – Purchase 19,000	1,90,000	Nov.30.	Proceeds	
				(₹ 1,70,000 + 40%)	
Aug. 1.	To, Ravi – Freight	1,410		By, Ravi – Stock taken	5,000
Oct. 1.	To, Ravi – Interest on Loan	350		By, Ravi – Sale Proceeds	9,800
	To, Suresh – Commission	11,900		(₹1,90,000-₹1,70,000 –	
	(5% on ₹ 2,38,000)			₹ 9,000 – ₹ 4,000)	
				= ₹ 7,000 + 40% of 7,000	
Nov.30.	To, Ravi – Commission	490		By, Ravi - Stock	9,000
	(5% on ₹ 9,800)			(transferred to wholesale	
	To, Profit on Venture:			dealer)	
	Ravi - ($\frac{3}{5}$) 34,590				
	Suresh - ($\frac{2}{5}$) 23,060	57,650			
		2,61,800			**2,61,800**

In the books of Ravi

Dr. Joint Venture with Suresh Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013		
July 1.	To, Bank	1,90,000	Aug. 1.	By, Cash	13,410
	(Purchase of goods)				
Aug. 1.	To, Bank (freight)	1,410	Nov.30.	By, Stock taken	5,000
Oct. 1.	To, Bank (Interest on loan)	350		By, Stock transferred to wholesale dealer	9,000
Nov.30.	To, Commission	490		By, Bank(Sale Proceeds)	9,800
	To, Share of Profit	34,590		By, Bank (final settlement)	1,89,630
		2,26,840			**2,26,840**

In the books of Suresh
Joint Venture with Ravi

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013			2013 Oct 1	By Bank(Sale Proceeds)	2,38,000
Aug. 1.	To Cash	13,410			
Oct. 1.	`` Commission	11,900			
Nov.30.	`` Share of Profit	23,060			
	`` Bank (final settlement)	1,89,630			
		2,38,000			**2,38,000**

Illustration 33.

M and N decided to work in partnership with the following scheme, agreeing to share profits as under :

M — ¾th share.

N—¼th share.

They guaranteed the subscription at par of 10,00,000 shares of ₹ 1 each in U Ltd. And to pay all expenses up to allotment in consideration of U. Ltd. issuing to them 50,000 other shares of ₹1 each fully paid together with a commission @ 5% in cash which will be taken by M and N in 3 : 2.

M and N introduced cash as follows:

		₹
M—	Stamp Charges, etc.,	4,000
	Advertising Charges	3,000
	Printing Charges	3,000
N—	Rent	2,000
	Solicitor's Charges	3,000

Application fell short of the 10,00,000 shares by 30,000 shares and N introduced ₹ 30,000 for the purchase of those shares.

The guarantee having been fulfilled, U Ltd. handed over to the venturers 50,000 shares and also paid the commission in cash. All their holdings were subsequently sold by the venturer N receiving ₹ 18,000 and M ₹ 50,000.

Write-up necessary accounts in the books of both the parties on the presumption that Memorandum Joint Venture Account is opened for the purpose.

Solution :

Dr. **Memorandum Joint Venture Account** Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To, N : Cost or Shares		30,000	By M : Commission ($\frac{3}{5}$)		30,000
To, M : Stamp Charges etc,	4,000		N : Commission ($\frac{2}{5}$)		20,000
Advertising Charges	3,000		By M : Sale Proceeds		50,000
Printing Charges	3,000	10,000	N : Sale Proceeds		18,000
To, N : Rent	2,000				
Solicitor's Charges	3,000	5,000			
To, Profit on Venture :					
To, M — ¾	54,750				
To, N — ¼	18,250	73,000			
		1,18,000			**1,18,000**

In the books of M

Dr. **Joint Venture with N** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Bank : Stamp, Adv. and Printing Charges	10,000	By, Bank : Commission	30,000
		By, Bank : Sale Proceeds	50,000
To, Share of Profit	54,750		
To, Bank (Remittance)	15,250		
	80,000		**80,000**

In the books of N

Dr. **Joint Venture with M** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Bank : Cost of Shares	30,000	By, Bank : Commission	20,000
To, Bank : Rent and Solicitor's Charges	5,000	By, Bank : Sale Proceeds	18,000
To, Share of Profit	18,250	By, Bank (Remittance)	15,250
	53,250		**53,250**

11.3.3 Joint Venture Business on Consignment Principle

The co-venturers may decide to appoint an agent for selling goods on their behalf on consignment basis. He is allowed expenses and commission on sales. The agent would remit the cash to co-venturers. In such case in addition to Joint Venture A/c and the co-venturer's A/c a separate Account is maintained for the agent as well.

The Agent's A/c is debited with the sales proceeds received by him and credited with the expenses incurred and commission payable to him.

Hence additional entries are:

(i) Goods sold by the agent
Agent's A/c Dr.
To, Joint Venture A/c

(ii) Expenses & commission entitled to agent
Joint Venture A/c Dr.
To, Agent's A/c

(iii) Payment received from agent
Bank A/c Dr.
To, Agent's A/c

(iv) Cash paid by agent to co-venturers
Co-Venturers' A/c Dr.
To, Agent's A/c

Illustration 34.

Sahani and Sahu entered into a joint venture to sale 800 bags of food grains. The business risks are to be shared in the ratio of 3:2 between them. Sahani supplied 400 bags at ₹ 800 per bag and paid freight ₹ 8,000 and insurance ₹ 2,000. Sahu sent 400 bags at ₹ 1,000 per bag. He paid ₹ 2,500 as freight, Insurance ₹ 8,000 and sundry expenses as ₹ 500. Sahani paid ₹ 50,000 as advance to Sahu.

They appointed Sandeep as agent for sale of grains. Sandeep sold all bags at ₹ 1,200 per bag. He deducted ₹ 21,000 as his expenses and commission of 5% on sales. He remitted ₹ 6,00,000 by cheque to Sahani and the balance to Sahu by way of a bill of exchange. The co-venturers settled their accounts. Prepare Joint Venture A/c Sahu's A/c and Sandeep's A/c in the books of Mr. Sahani.

Solution:

Books of Sahani

Dr. Joint Venture Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Food grains A/c (400*800)	3,20,000	By, Sandeep A/c - sales (800*1200)	9,60,000
To, Bank A/c - freight & insurance	10,000		
To, Sahu A/c -food grains(400*1000)	4,00,000		
To, Sahu A/c - expenses	11,000		
To, Sandeep A/c - expenses	21,000		
To, Sandeep A/c - commission 5%	48,000		
To, Profit & Loss A/c 3/5th share	90,000		
To, Sahu A/c 2/5th share	60,000		
	9,60,000		**9,60,000**

Dr. Sahu's Account (Co-venturer) Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Bank A/c - advance	50,000	By, Joint Venture A/c - grains	4,00,000
To, Sandeep A/c - bill	2,91,000	By, Joint Venture A/c - expenses	11,000
To, Bank A/c - final balance	1,30,000	By, Joint Venture A/c - profit share	60,000
	4,71,000		**4,71,000**

Dr. Sandeep's Account (Agent) Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Joint Venture A/c - sales	9,60,000	By, Joint Venture A/c - expenses	21,000
		By, Joint Venture A/c - commission	48,000
		By, Bank A/c - cheque received	6,00,000
		By, Sahu A/c - Bill	2,91,000
	9,60,000		**9,60,000**

11.3.4 Conversion of Consignment in to JV

A variation could be that an ongoing consignment arrangement may get converted into a joint venture arrangement. In Such case, a normal accounting for consignment business is done till the conversion. Upon the conversion, the balance stock on consignment is transferred to the Joint Venture A/c and from that day onwards, accounting is done on the basis of principles followed for joint venture.

Illustration 35.

Daga of Kolkata sent to Lodha of Kanpur goods costing ₹ 40,000 on consignment at a commission of 5% on gross sales. The packaging and forwarding charges incurred by consignor amounted to ₹ 4,000. The consignee paid freight and carriage of ₹ 1,000 at Kanpur. Three-fourth of the goods were sold for ₹ 48,000. Then the consignee remitted the amount due from him to consignor along with the account sale, but he desired to return the goods still lying unsold with him as he was not agreeable to continue the arrangement of consignment. He was then persuaded to continue on joint venture basis sharing profit or loss as Daga 3/5th and Lodha 2/5th.

Daga then supplied another lot of goods of ₹ 20,000 and Lodha sold out all the goods in his hand for ₹ 50,000 (gross). Daga paid expenses ₹ 2,000 and Lodha ₹ 1,700 for the second lot of goods.

Show necessary Ledger A/c in the books of both parties. No final settlement of balance due is yet made.

Solution:

Books of Daga

Dr. Consignment to Lodha Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Goods Sent on Consignment A/c	40,000	By, Lodha's A/c (sales)	48,000
To, Bank A/c (packing & dispatching)	4,000	By, Joint Venture with Lodha A/c	
To, Lodha's A/c :		(stock transferred on conversion to JV)	11,250
Freight & Carriage	1,000		
Commission	2,400		
To, P & L A/c	11,850		
	59,250		**59,250**

Dr. Lodha's Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Consignment A/c - sales	48,000	By, Consignment A/c- expenses	1,000
		By, Consignment A/c - commission	2,400
		By, Cash A/c	44,600
	48,000		**48,000**

Dr. Joint Venture with Lodha Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Consignment to Lodha A/c	11,250	By, Balance c/d	42,280
To, Goods A/c	20,000		
To, Bank A/c - expenses	2,000		
To, P & L A/c (profit)	9,030		
	42,280		**42,280**

Books of Lodha

Dr. Daga's Account (as consignor) Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Cash A/c- expenses	1,000	By, Bank A/c – sales	48,000
To, Commission A/c	2,400		
To, Bank A/c - remittance	44,600		
	48,000		**48,000**

Joint Venture with Daga Account

Dr. Particulars	Amount (₹)	Particulars	Cr. Amount (₹)
To, Cash A/c - expenses	1,700	By, Bank A/c – sales	50,000
To, P & L A/c (profit)	6,020		
To, Balance c/d	42,280		
	50,000		**50,000**

Working note:

Memorandum Joint Venture Account

Dr. Particulars	Amount ₹	Particulars	Cr. Amount ₹
To, Daga A/c - goods	11,250	By, Lodha A/c – sales	50,000
To, Daga A/c- goods	20,000		
To, Daga A/c- expenses	2,000		
To, Lodha A/c- expenses	1,700		
To, Net Profit :			
Daga 3/5th Share	9,030		
Lodha 2/5th share	6,020		
	50,000		**50,000**

Illustration 36.

Satish and Sunit made a JV to underwrite the subscription at par of the equity share capital of Soft Systems Ltd. consisting of 100,000 shares of ₹ 10 each. They agreed to pay all expenses up to the allotment of shares. They agreed to share profits or losses in the ratio of 3:2. The consideration in return for this underwriting was allotment of 12,000 other shares of ₹ 10 each at par to be issued to them fully paid. Satish provided for ₹ 12,000 registration fees, ₹ 11,000 advertisement, ₹ 7,500 for printing & distributing prospectus and ₹ 2,000 for printing & stationery. Sunit paid ₹ 3,000 office rent, ₹ 13,750 as legal charges, and ₹ 9,000 salary of clerks. The issue fell short by 15,000 shares. Satish took these over on joint A/c by paying for the same in full. He sold the entire holding at ₹ 12 (net). Sunit sold the 12,000 shares allotted as consideration at the same price.

Prepare necessary ledger accounts in the books of both parties.

Solution:

Books of Satish

Joint Venture Account

Dr. Particulars	Amount (₹)	Particulars	Cr. Amount (₹)
To, Bank A/c - expenses :		By, Bank A/c- sales	
Registration Fees	12,000	15000 shares @12	1,80,000
Advertising	11,000	By, Sunit's A/c – sales	
Prospectus Printing	7,500	12000 shares @12	1,44,000
Printing & Stationery	2,000		
To, Sunit's A/c - expenses :			
Office rent	3,000		
Legal charges	13,750		
Salary	9,000		
To, Bank A/c - 15,000 shares @ ₹ 10	1,50,000		
To, P & L A/c (3/5th share)	69,450		
To, Sunit A/c (2/5th share)	46,300		
	3,24,000		**3,24,000**

Dr. **Sunit's Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Joint Venture A/c - sales	1,44,000	By, Joint Venture A/c – expenses	25,750
		By, Joint Venture A/c - profit	46,300
		By, Bank A/c - balance paid	71,950
	1,44,000		**1,44,000**

Books of Sunit

Dr. **Satish's Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To, Joint Venture A/c - sales	1,80,000	By, Joint Venture A/c - expenses	32,500
To, Bank A/c - balance paid	71,950	By, Joint Venture A/c - cost of shares	1,50,000
		By, Joint Venture A/c - profit	69,450
	2,51,950		**2,51,950**

Joint Ventures running for more than one accounting period:

If a joint venture runs for more than one accounting period, it poses a special problem of calculation of the closing stock. The stock should be valued on the basis of basic cost plus proportionate non-recurring expenses and it should be shown in the memorandum joint venture account on the credit side at the end of the year and on the debit side of the memorandum joint venture account of the next year. The other accounts should be made in the usual manner. However, if the co-ventures are interested in an interim settlement at the end of the first year, they should bring in their proportionate share in the value of the closing stock in their respective 'Joint Venture with Co-Venturer Account' and finally settle their account. The share of stock should be carried forward and shown on the debit side of the 'Joint Venture with Co-venturer Account;

Illustration 37.

On 1st January, 2012 Pandey and Parker entered into a Joint Venture to consign goods to Parekh to be sold on their joint risk. They agreed to share profits and losses in the ratio of 3:2. On 15th April, 2012, Pandey consigned goods to the value of ₹3 6,000 and incurred expenses amounting to ₹3,000. On 1st July, 2012, Parker also consigned goods to the value of ₹22,000 and incurred expenses amounting to ₹1,800.

On 15thNovember, 2012, Parekh sold 80% of the total goods for ₹60,000 and remitted the proceeds to Pandey after deducting 5% commission on sales. On 31st December, 2012, on which date accounts were prepared, an interim settlement was effected between Pandey and Parker.

On 15thAugust, 2013, Parekh sold the remainder of the total goods for ₹8,000 and remitted the proceeds to Parker, less 5% commission on sales. On 31st October, 2013, a final settlement was effected between Pandey and Parker.

You are required:

(a) to show the account in the books of each co-venturer to record his own transactions, and

(b) to prepare a Memorandum Joint Venture Account.

Books of Pandey

Joint venture With Parker Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
15.4.12	To Goods sent on consignment A/c To Bank expenses A/c	36,000 3,000	15.11.12	By Consignment sales A/c	60,000
15.11.12	To Commission on sales	3,000	31.12.12	By balance c/d (3/5 of 12,560)	7,536
31.12.12	To Profit and Loss A/ c	4,056			
	To Bank A/c	21,480			
		67,536			**67,536**
1.1.13	To balance b/d	7,536	31.10.13	By Profit & Loss A/c	2,976
				By Bank A/c	4,560
		7,536			**7,536**

Books of Parker

Joint venture With Pandey Account

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.07.12 31.12.12	To Goods sent on consignment A/c To Bank A/c expenses To Profit & Loss A/c	22,000 1,800 2,704	15.08.12 31.12.12	By Bank A/c By balance c/d (2/5 of 12,560)	21,480 5,024
		26,504			**26,504**
01.01.13	To Balance b/d	5,024	15.08.13	By Consignment A/c (sales Proceeds)	8,000
15.08.13	To Commission A/c	400			
31.10.13	To Bank A/c	4,560	31.10.13	By Profit & Loss A/c	1,984
		9,984			**9,984**

Memorandum Joint venture A/c

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
15.04.12	To Goods sent on Consignment—Pandey To bank - Expenses	36,000 3,000	15.11.12	By Consignment Sales (parekh) By Consignment Stock	60,000 12,560
31.07.12	To Goods sent on Consignment – Parker To bank - expenses	22,000 1,800			
15.11.12	To Commission on sale	3,000			
31.12.12	To Profit Pandy 4,056 Parker 2,704	6,760			
		72,560			**72,560**
01.01.13	To consignment Stock	12,560	15.08.13 31.10.13	By Consignment Sales (parekh) By Loss: Pandey 2,976 Parker 1,984	8,000 4,960
15.08.13	To Commission on sale	400			
		12,960			**12,960**

*** Consignment Stock**

Total Goods sent on consignment of both Pandey and parker is 36,000 + 22,000 =	58,000
Add: Expenses of both Pandey and Parker (3,000 + 1,800) =	4,800
	62,800
80% of 62,800 =	50,240
20% of 62,800 (80% of total goods were sold) =	12,560

11.4 SALE OF GOODS ON APPROVAL OR RETURN BASIS

11.4.1 Introduction

Sometimes goods are sent to Customs with an option either to accept the goods or to reject the goods within a stipulated time. This type of transactions is known as "Sale on Approval Basis" or "Sale on Return Basis". The main purpose of this type of sale is to boost up sales although this facility usually goes to very few reliable customers.

It must be remembered that when goods are sold on approval basis it is nothing but a mere transfer of goods and not the ownership. Since the ownership is not transferred it cannot be called a sale. It will be treated as a sale only when the approval of customer is received about the goods.

11.4.2 Methods of Accounting

Three methods of accounting are usually followed for recording "sale on approval or return basis" transactions, viz.

(a) When there are only a few transactions

(b) When there are considerable number of transactions

(c) When there are many transactions.

(a) When there are only a Few Transactions

Accounting steps:

(i) When goods are sent

Debtors A/c Dr.

To, Sales A/c

(ii) If goods are taken or approval is received

NO ENTRY

(iii) When goods are returned

Sales A/c Dr.

To, Debtors A/c

(iv) When goods are not taken or returned

Closing stock A/c Dr.

To, Trading A/c

(at cost price)

(v) If the consent of the customer is not yet received

(a) Sales A/c Dr.

To, Customer A/c

(b) Closing stock A/c Dr.

To, Trading A/c

Illustration 38.

Mr. Haridas sends goods to his customers on sale or return basis. The following transactions took place during the month of April 2013 :

			₹
April	4.	Goods sent on Sale or Return basis at cost plus 20%	60,000
	8.	Goods returned by customers	15,000
	20.	Sale information received from customers	30,000
	30.	No intimation received about the goods (i.e., neither sold nor returned)	12,000

Assume that the accounts are closed on 31st March every year and Haridas records the above transactions as ordinary sales basis.

Solution:

In the books of Haridas
Journal

Date	Particulars	L.F	Debit ₹	Credit ₹
4.4.2013	Debtors A/c Dr. To, Sales A/c (Being goods sent on sale or approval basis and treated as sales)		60,000	 60,000

8.4.2013	Returns Inward/ Sales A/c To, Debtors A/c (Being goods returned by customers)	Dr.		15,000	15,000
20.4.2013	NO ENTRY			1,000	1,000
30.4.2013	Sales A/c To, Trading A/c (Being the cancellation entry)	Dr.		12,000	12,000
	Closing Stock A/c To, Trading A/c (Recorded at cost price)	Dr.		10,000	10,000

(b) When there are Considerable Number of Transactions

Under the circumstances, the recording of transactions is not done as per above method. In this case, a separate Sales or Return Day Book is maintained. It is divided into four parts viz.,

(i) First column – for recording goods sent on approval

(ii) Second column – for recording goods which are sold

(iii) Third column – for recording goods which are returned, and

(iv) Fourth column – for recording balance of stock of goods

Illustration 39.

Mr. X sends out the following goods to his customers on sale or return basis in the month of April 2013. You are requested to prepare Sale or Return Day Book for the month of April 2013 for the following transactions assuming that the transactions are in considerable numbers.

Date	Particulars	Amount (₹)	Date	Particulars
2013 April 1	A Sen	2,000	2013 April 5	Retained all
5	P Das	1,000	9	Returned all
12	T Mukherjee	3,000	20	50% retained and 50% returned
18	H Banerjee	500	25	Goods returned value ₹400 and no intimation was received for the balance
30	C Saha	1800		Neither intimation received nor goods returned

Solution:

Sale or Return Day Book

Goods sent out			Goods sold			Goods returned		Balance
Date	Particulars	Amount (₹)	Date	LF	Amount (₹)	Date	Amount (₹)	Amount (₹)
2013 April 1	A Sen	2,000	2013 April 5		2,000			
5	P Das	1,000				April 9	1,000	
12	T Mukherjee	3,000	20		1,500	20	1,500	
18	H Banerjee	500				25	400	100
30	C Saha	1,800						1,800

Value of stock amounted to ₹1,900 and valuation should be made on the basis of cost price or market price whichever is lower.

(c) When there are many Transactions

This method is applicable where the number of transactions in a period is fairly large and numerous in character. Under this circumstances, the following three books are opened :

(i) Sale or return Day Book;

(ii) Sale or Return Journal; and

(iii) Sale or Return Ledger

(i) Sale or Return Day Book;

Sale or Return Day Book records the transactions relating to goods sent on sale or return on approval basis where such transactions are accrued. This book can be compared with the subsidiary books, viz. Sale Day Book, Purchase Day Book, etc.

Format of Sale or Return Day Book is given below :

Sale or Return Day Book

Date	Particulars, Name of the parties	Sale or return ledger folio no.	Amount (₹)

(ii) Sale or Return Journal

Goods sold					Goods returned			
Date	**Particulars**	**Sale or return LF No.**	**Sales LF No.**	**Amount (₹)**	**Date**	**Particulars**	**Sale or return LF No.**	**Amount (₹)**

(iii) Sale or Return Ledger:

Like ordinary sale, i.e., when sales are made, they are at first recorded in Sales Book and then personal account is debited and Sales Account is credited. In the same manner, transactions which are recorded in the Sale or Return Book, i.e., personal account are debited and Sale or Return account credited. Thus, a separate ledger viz., Sale or Return ledger is opened for recording the transactions of the parties to whom goods have been sent on Sale or Return Basis.

Illustration 40.

X Ltd. sends out the following goods to their customers during the period April 2013 on Sale or Return basis.

Date	Particulars	Amount (₹)	Date	Particulars
2013 April 1	S Bose	2,000	2013 April 8	Retained all
5	S Basu	1,000	12	Returned all
8	S Sen	500	18	Goods sold for ₹ 400 and the balance returned
20	S Mukherjee	1,500	25	Goods returned ₹ 800 but no intimation regarding the balance
25	S Das	1,200		

Show how the transactions will be recorded in the books of the firm assuming that the transactions are large in number.

Solution:

In the books of X Ltd.
Sale or Return Day Book

Date	Particulars, Name of the Parties	Sale or Return Ledger Folio No.	Amount (₹)
2013 April 1	S Bose	15	2,000
5	S Basu	16	1,000
8	S Sen	17	500
20	S Mukherjee	18	1,500
25	S Das	19	1,200
			6,200 S or R L.F. No. 1

Sale or Return Journal

Goods sold					Goods returned			
Date	Particulars	Sale or Return LF No.	Sales LF No.	Amount (₹)	Date	Particulars	Sale or Return LF No.	Amount (₹)
2013 April 8	S Bose	15	40	2,000	2013 April 12	S Basu		1,000
18	S Sen	17	45	400	18	S Sen		100
					25	S Mukherjee		800
				2,400 S or Ret LF No. 1				1,900 S or Ret LF No. 1

Sale or Return Ledger

Dr. **Goods on Sale or Return Account** Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013	To, Sundries (Sales)	2,400	2013	By Sundries	6,200
April	To, Sundries (Returns)	1,900	April		
	To, Balance c/d	1,900			
		6,200			6,200

Dr. **S Bose Account** Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 April 1	To, Goods on Sale or Return A/c.	2,000	2013 April 8	By, Goods on Sale or Return A/c. (Sales)	2,000
		2,000			2,000

Dr. **S Basu Account** Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 April 5	To, Goods on Sale or Return A/c.	1,000	2013 April 12	By, Goods on Sale or Return A/c. (Returns)	1,000
		1,000			1,000

Dr. **S Sen Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 April 8	To, Goods on Sale or Return A/c.	500	2013 April 18	By, Goods on Sale or Return A/c. (Sales)	400
				By, Goods on Sale or Return A/c. (Returns)	100
		500			500

Dr. **S Mukherjee Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 April 20	To, Goods on Sale or Return A/c.	1,500	2013 April 25	By, Goods on Sale or Return A/c. (Returns)	800
				By, Balance c/d	700
		1,500			1,500

Dr. **S Das Account** **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 April 1	To, Goods on Sale or Return A/c.	1,200	2013 April 8	By, Goods on Sale or Return A/c. (Sales)	1,200
		1,200			1,200

Trial Balance as at 30th April 2013

Heads of Income	Debit (₹)	Credit (₹)
Goods on Sale or Return A/c.		1,900
S Mukherjee A/c.	700	
S Das A/c.	1,200	
	1,900	1,900

Illustration 41.

S Ltd. sells goods on Sale or Return basis. Customers having the choice of returning the goods within 9 months. During April 2013, the following are the details of the goods sent.

Date	Customers	Value (₹)	Proforma Invoice No.
2013 April 2	G	20,000	002
4	H	36,000	005
16	I	50,000	017
20	J	16,000	020
24	K	42,000	031
28	L	60,000	060

Within the stipulated time G and I returned the goods while H, J and K informed that they have accepted the goods. Show the following accounts in the books of the firm.

Sale on Approval Account and Customers for Sale on Approval Account as on 15th May 2013.

Solution.

In the books of S Ltd.

Dr. Sale on Approval Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2012 April	To, Customers for Sale on Approval A/c.		2012 April	By, Customer for Sale on Approval A/c.	
2	- Returned by G	20,000		- G	20,000
4	- Sold to H	36,000		- H	36,000
16	- Returned by I	50,000		- I	50,000
20	- Sold to J	16,000		- J	16,000
24	- Sold to K	42,000		- K	42,000
30	To, Balance c/d	60,000		- L	60,000
		2,24,000			**2,24,000**

Dr. Customers for Sale on Approval Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2013 April	To, Sale on Approval A/c.		2013 April	By, Sale on Approval A/c.	
				- Returned by G	20,000
2	- G	20,000		- Sold to H	36,000
4	- H	36,000		- Returned by I	50,000
16	- I	50,000		- Sold to J	16,000
20	- J	16,000		- Sold to K	42,000
24	- K	42,000		By, Balance c/d	60,000
28	- L	60,000			
		2,24,000			**2,24,000**

11.5 ACCOUNT CURRENT

Account current represents any personal account on which periodical settlements are made. The formal, periodic transcript of such an account, sent by one party to another, concluding with the balance receivable or payable together with the interest due or payable to date. After incorporating the same, the balance will show either as a debit or as credit.

Account current is headed with the names of two parties. The party to whom the account is rendered is named first and is written as "X is Account Current with Y".(if Y is rendering account to X). Account Current is primarily used in case of : (a) Consignor and consignee; (b) Branch and Head office; (c) Customers and Bankers; (d) Principal and his agents etc.

Common form of Account Current is :

X in Account Current with Y

(Interest to 31st March….. at 8% P.a.)

Dr. Cr.

Date	Particulars	Amount (₹)	Days	Products	Date	Particulars	Amount (₹)	Days	Products

Calculation of Interest:

There are different methods that are used while calculating interest viz (a) Forward or Ordinary Method; (b) Product Method, (c) Backward or Epoque method; (d) Red Ink Interest Method.

(a) Forward Method:

Under this method each and individual transaction is treated separately. Interest is calculated from the date of transactions to the date of settlement at the respective dates. If interest charged is more than interest receivable , interest account will be debited and vice versa in the opposite case. The main disadvantage of this method is to calculate the amount of interest for each individual transactions. It is rather a tedious one.

Illustration 42.

Show Account Current rendered by Bijoy to Ashish for the half year ended Dec, 2013, calculating interest 12 % P.a.

Particulars	₹
On 1st July, 2013 Ashish owes Bijoy	4,000
On 1st September, 2013 Ashish remits cash	1,200
On 1st October, 2013 Ashish purchased goods from Bijoy	2,400
On 1st November, 2013 Ashish remits cash	3,600

Solution:

Ashish in Account Current with Bijoy
(Interest to 31st December, 2013 at 12% P.a.)

Date	Particulars	Months	Interest (₹)	Amount (₹)	Date	Particulars	Months	Interest	Amount (₹)
2013 July 1	To, Balance b/d (W.N. 1)	6	240	4,000	2013 Sept1	By, Cash (W.N. 2)	4	48	1,200
Oct 1	To, Sales (W.N. 3)	3	72	2,400	Nov 1	By, Cash (W.N. 4)	2	72	3,600
Dec 31	Interest – Contra			192	Dec, 31	By,Balance of Interest A/c – contra		192	
					Dec, 31	By,Balance c/d			1,792
			312	6,592				312	6,592

Workings:

Calculation of Interest:

1. ₹ 4,000 ×(12/100)×(6/12) = ₹ 240 ;

2. ₹ 1,200 ×(12/100)×(4/12) = ₹48

3. ₹ 2,400 ×(12/100)×(3/12) = ₹ 72

4. ₹ 3,600×(12/100)×(2/12) = ₹ 72

(b) Product Method :

Under this method each transaction is multiplied by the number of days which is to be calculated from the date of transaction to the date of closing the accounts in order to get the product of each transaction and ascertain the balance of product column. Naturally, interest should be calculated on the balance of the product. Interest so calculated will be recorded in the larger side of the amount column.(But care must be taken regarding calculation of interest i.e. while calculating no. of days, the date of transaction must be excluded but opening balance which is brought forward from the previous month must be included). After incorporating interest ascertain the closing balance in case of amount column and the product column.

Illustration 43.

Reckoning interest @5% p.a. from the following particulars:

		(₹)
July 1	Balance owing by B. Saha	3,000
July 15	Goods sold to B. Saha	1,500
Aug 19	Cash received from B. Saha	1,500
Sept 1	B. Saha accepted A. Sen's draft at 3 month's date	1,000
Oct 20	Goods purchased from B. Saha	500
Nov 15	Goods sold to B. Saha	1,000
Dec 20	Cash received from B. Saha	1,000

Solution:

Dr. **B. Saha in Account Current with A. Sen** **Cr.**

Date	Particulars	Amount (₹)	Days	Product (₹)	Date	Particulars	Amount (₹)	Days	Product (₹)
Jul 1	To Balance b/d	3,000	184	5,52,000	Aug 19	By Cash A/c	1,500	134	2,01,000
Jul 15	" Sales A/c	1,500	169	2,53,500	Sept 1	" Bills Receivable A/c	1,000	121	1,21,000
Nov 15	" Sales A/c	1,000	46	46,000	Oct 20	" Purchases A/c	500	72	36,000
Dec 31	" Interest A/c	66			Dec 20	" Cash A/c	1,000	11	11,000
					Dec 31	" Balance c/d	1,566		4,82,500
		5,566		8,51,500			5,566		8,51,500

Interest = ₹ 4,82,500 × 5/100 × 1/365 = ₹ 66

Workings:

Calculation of number of days

	Jul + Aug + Sep + Oct + Nov + Dec	Total days
From Jul 1 to Dec 31	= 31 + 31 + 30 + 31 + 30 + 31	184
Jul 15 to " "	= 16 + 31 + 30 + 31 + 30 + 31	169
Aug 19 to " "	= 0 + 12 + 30 + 31 + 30 + 31	134
Sept 1 to " "	= 0 + 0 + 29 + 31 + 30 + 31	121
Oct 20 to " "	= 0 + 0 + 0 + 11 + 30 + 31	72
Nov 15 to " "	= 0 + 0 + 0 + 0 + 15 + 31	46
Dec 20 to " "	= 0 + 0 + 0 + 0 + 0 + 11	11

(c) Backward/Epoque Method :

This is particularly the reverse method of the previous method. Under this method , interest is calculated from the starting date to the date of transactions. As such, interest should be calculated on the closing balance(excluding interest) and no interest should be calculated on the opening balance. The amount of interest is to be written off the shorter side in the amount column and amount column is balanced at last.

The following illustration will help us to understand the principle.

Illustration 44.

X has the following transactions with Y

Date	Particulars	₹
2013 Jan, 1	Sold goods to Y	3,000
Feb, 15	Received cash form Y	1,200
Mar, 5	Bought goods from Y	8,000
April, 15	Paid to Y	5,400

Prepare an Account current to be recorded to be rendered by X to Y under backward Method for the period to 30th June, 2013 reckoning interest @12% P.a.

Solution:

Y is Account Current with X
(Interest to 30th June 2013 @ 12% P.a.)

Dr. **Cr.**

Date	Particulars	Amount (₹)	Days	Products (₹)	Date	Particulars	Amount (₹)	Days	Products (₹)
2013 Jan 1	To, Sales A/c	3,000	1	3,000	2013 Feb 15	By Cash	1,200	46	55,200
April 15	To, cash	5,400	106	5,72,400	March 5	By Purchase	8,000	65	5,20,000
June 30	To, Balance (₹ 800)	-	182	1,45,600	June 30	By Balance of product			1,45,800
June 30	To Balance c/d	847.93			June 30	By Interest on the balance of Product (w.N. 1)	47.93		
		9,247.93		7,21,000			9,247.93		7,21,000

Workings:

1. Interest on balance of product = ₹ 1,45,800 × 12/100 × 1/365 = ₹ 47.93

(d) RED INK INTEREST METHOD:

Interest is computed, in an account current, on the amount of a transaction from the due date of the transaction to the closing date of the period. In case of bills and future dated invoices the due dates may fall either within the accounting period or outside the accounting period. In case of the former, ordinary procedure is followed; but in the latter case interest from the closing date to such due date is customary written in red ink. This interest is hence known as Red-ink Interest. The significance of red-ink interest is that, if it appears on the credit side it will be taken as if it appears on the debit side and vice-versa. Thus, red-ink interest may be written in ordinary ink on the opposite side of the account. In Epoque Method red-ink interest adjustment is not necessary.

Where the rate of interest differs in respect of debits and credits, interest should be computed for debits and credits separately, instead of on the balance of the products. This should be remembered irrespective of any method.

Illustration 45.

Make out an Account Current under Red Interest Method to be rendered by X for the period of 30th June, 2012 at 12% P.a. X had in the following transactions with Y.

Date	Particulars	₹
2012, Jan 1	Balance due from Y	6,000
Jan, 15	Sold goods to Y	7,200
Feb, 20	Purchased goods from Y	8,800
April, 20	Accepted a bill drawn on 15th April and due on 18th July	8,000
May, 15	Purchased goods from Y (Payment due on 15th July)	2,000

Solution:

Y is Account Current with X

(Paid to 30th June,2012 recurring Interest@ 12% P.a.)

Date	Particulars	Amount (₹)	Days	Product (₹)	Date	Particulars	Amount (₹)	Days	Product (₹)
2012 Jan 1	To, Balance b/d	6,000	182	10,92,000	2012 Feb20	By, Purchase	8,800	131	11,52,800
Jan, 15	To, Sales	7,200	167	12,02,400	May 15	By, Purchase due on15th July)	2,000	15	30,000
April, 20	To, B/P A/c (due on 18th July)	8,000	18	1,44,000	June, 30	By, Red ink Product A/c-contra			1,44,000
June, 30	To, Red ink-contra			30,000	June, 30	By, Balance of product			11,41,600
June, 30	To, Interest once of balance of product	375			June, 30	By, Balance c/d	10,775		
		21,575		**24,68,400**			**21,575**		**24,68,400**
Juy, 11	To, balance b/d	10,775							

Workings:

Calculation of Interest:

1. ₹ 11,41,600 × 12/100 × 1/365 = ₹ 375

Where Rates of Interest are Different:

Some times different rates of interest are used for debit items and credit items respectively (if n case of borrowings business, where daily balance of accounts is used).In that case, interest is calculated on the total product of debit items and total product of credit items and the balance of interest is shown in the books.

Illustration 46.

Lakshaya opened an account in Punjab National Bank on 1.1.2013 by depositing ₹ 500. His deposits during the period of months ended 31.3.2013 were ₹ 1,000 (10.1.2013), ₹ 3000 (2.2.2013), ₹ 6,000 (27.2.2013) and ₹ 4,000 (15.3.2013).

His withdrawals were ₹ 2,500 (25.1.2013), ₹ 1,500 (15.2.2013), ₹ 3,000 (2.3.2013) and ₹ 2,000 (25.3.2013). The bank charges 14% interest on debit balances and gives 10% on credit balance. Prepare the account current of Lakshaya with Punjab National Bank according to product of Balances Method.

Solution:

Lakshaya in Account Current with Punjab National Bank as at 31-3-2013

Date	Due Date	Particulars	Amount (Dr.)	Amount (Cr.)	Dr. or Cr.	Balance	Days	Product (Dr.)	Product (Cr.)
1.1.13	1-1-13	By Cash A/c	--	500	Cr.	500	9	--	4,500
10.1.13	10-1-13	By Cash A/c	--	1,000	Cr.	1,500	15	--	22,500
25.1.13	25-1-13	To Self	2,500	--	Dr.	1,000	8	8,000	--
2.2.13	2-2-13	By Cash A/c	--	3,000	Cr.	2,000	13	--	26,000
15.2.13	15-2-13	To Self	1,500	--	Cr.	500	12	--	6,000
27.2.13	27-2-13	By Cash A/c	--	6,000	Cr.	6,500	3	--	19,500
2.3.13	2-3-13	To self	3,000	--	Cr.	3,500	13	--	45,500
15.3.13	15-3-13	By Cash A/c	--	4,000	Cr.	7,500	10	--	75,000
25.3.13	25-3-13	To Self	2,000	--	Cr.	5,500	6	--	33,000
31.3.13	31-3-13	By Interest A/c*	--	60.50				--	--
31.3.13	31-3-13	To balance c/d	5,560.50	--				--	--
			14,560.50	**14,560.50**				**8,000**	**2,32,000**

* Interest on ₹ 2,32,000 allowed for 1 day @ 10% = 63.56
Interest on ₹ 8,000 charged for 1 day @ 14% = 3.06
Net Interest allowed to Lakshaya = 60.50

11.6 INVESTMENT ACCOUNTS

An investment account is actually the account of an asset. For invest in each separate security, a separate Investment Account is maintained. At the top of the account, the nature of the investment and interest or dividend dates are stated.

Usually three money columns are provided on each side of the Investment Account. These columns are — Nominal, Capital and Income (of Interest).

In the nominal column, the nominal value of each purchase or sale is recorded. In the Capital Column, the actual cost of purchase or the actual selling price is recorded. Interests received or receivable and any adjustment in respect of interests are recorded in the Income Column.

The accounting entries related to Investment Accounts are being discussed later. But before that, we should acquaint ourselves with some important terms.

Investments are Accounted following AS-13 (Accounting for Investments) for investors and as per AS-2 (Valuation of Invetories) for Investments held as stock-in-trade. Interest and Profit or Loss on sale of Investments are accounted for in the following manner :-

Cum-Interest or Cum-Dividend Purchases

Cum-Interest or Cum-Dividend means the quoted price of shares/instruments on which a dividend has been declared includes the right to receive the dividend. The term attaches from the date of declaration to the date appearing in the resolution on which the holders are said to be of record. Thus the capital cost of investment is computed after deducting the accrued interest or dividend from the quoted price of shares or instruments. Thus, Cum-Dividend/Cum-Interest = Quoted Price – Actual Cost.

Entries

(a) For purchase of Cum-Interest/Cum-Dividend Interest

Investment A/c	Dr.	- Cost
Interest/Dividend A/c	Dr.	- Interest
To Bank A/c		- Quoted Price

(b) For receiving interest/dividend at due date

Bank A/c	Dr.
To Interest/Dividend A/c	

Example:

P Ltd. acquires 2000, 12% Debenture of T Ltd. on 1.4.2013 at ₹ 105 Cum-interest (face value of debentures ₹ 100). Interest is paid on 30th June and 31st December every year. Accounts are closed on 31st December 2013. Ascertain the amount of interest and cost of debentures.

Solution:

Cost of Investment	₹
Total payments to be made – 2000 X ₹ 105	2,10,000
Less: Inclusion of Interest to be excluded:	
(from 1.1.2013 to 1.4.2013 i.e., 3 months)	
Or ₹ 2,00,000 x (12/100)×(3/12) =	6,000
	2,04,000

∴ Cost of Investment ₹ 2,04,000; Interest ₹ 6,000.

Ex-Interest or Ex-Dividend Purchases

It is just the opposite of the above, i.e., quoted price does not include the amount of interest/dividend. Thus, for ascertaining cost price, interest/Dividend is to be added to the amount of quoted price.

Entries

(a) For purchase of Ex-Interest/Ex-Dividend Purchase:

Investment A/c Dr. - Quoted Price
Interest/Dividend A/c Dr. - Interest
To Bank A/c - Total

(b) For receiving interest/dividend at due date:

Bank A/c Dr.
To Interest/Dividend A/c

Example:

Take above example assuming that the debentures are purchased at ₹ 95 Ex-Interest.

Ascertain the amount of interest and cost of Debentures.

Solution:

Cost of Investments	₹
Total payment to be made: 2000 x ₹ 95	1,90,000
Add: Interest to be added (from 1.1.2013 to 1.4.2013) i.e., 3 months	
2,000 x ₹ 100 = ₹ 2,00,000 x (12/100)×(3/12) =	6,000
Total Payment	**1,96,000**

∴ Cost of Investment ₹ 1,96,000; Interest ₹ 6,000.

Cum-Interest/Cum-Dividend Sales

When investments are sold at Cum-Interest or Cum-Dividend, it means the same include accrued interest. Thus, to find out cost of investment amount of interest will be deducted from the so called quoted price of investments. (i.e., Cost Price = Quoted Price – Interest/Dividend). Special attention must be given while selling investments regarding the brokerage or commissions. The same must be deducted.

Entries

(a) For the sale of Cum-Interest/Cum-Dividend Investments

Bank A/c Dr. - Quoted Price
To Investments A/c -(Quoted Price – Interest/Dividend)
To Interest/Dividend A/c - (Interest/Dividend)

(b) For profit on sale of investments:

Investment A/c Dr.
To Profit & Loss A/c

In case of loss on sale of investment, the entry will be reversed.

Example:

P Ltd. sell 2000, 12% Debentures (Face value ₹ 100 each) from T Ltd. at ₹ 105 Cum-Interest on 1.9.2013. Interest is payable on 30th June and 31st December every year. Find out the actual amount to be received.

Solution:

	₹
Total amount Received 2000 x ₹ 105	2,10,000
Less: Interest (from 1.7.2013 to 1.9.2013) i.e., 2 months	
Or, 2000 x ₹ 100 = ₹ 2,00,000 x (12/100)×(2/12) =	4,000
Actual amount to be received	**2,06,000**

Ex-Interest/Ex-Dividend Sales

It is just the opposite of the above method. In short, Quoted price does not include interest/dividend. So, to find out actual amount to be received, amount or interest/dividend must be added to quoted price.

(Actual amount to be received = Quoted Price + Interest/Dividend)

Example:

P Ltd. sell 200, 12% Debentures (face vale ₹ 100 each) from T. Ltd. at ₹ 95 Each (ex-interest) on 1.11.2012. Interest is payable on 30th September, and 31st December every year. Find out the actual amount to be received.

Solution:

	₹
Total amount Received 2000 x ₹ 95	1,90,000
Add: Interest (from 1.10.2012 to 1.11.2012) i.e., 1 month	
On ₹ 2,00,000 x (12/100)×(1/12) =	2,000
Actual amount to be received	**1,92,000**

Illustration 47.

On 1.1.2013, 6% 200 Debentures of ₹ 100 each of Y and were held as investments by X Ltd. at a cost of ₹ 18,200. Interest is payable on 31st December.

On 1.4.2013, ₹ 4,000 of such Debentures were purchased by X Ltd. @ ₹ 98 and on 1.1.2013. ₹ 6,000 Debentures were sold at ₹ 96 ex-interest. On 1.12.2013 ₹ 8,000 Debentures were sold @ ₹ 99 cum-interest. On 31.12.2013, X Ltd. sold ₹ 10,000 Debentures @ ₹ 95.

Prepare Investment Account for 6% Debentures of X Ltd. in the books of X Ltd. ignore income-tax.

Solution:

In the Books of X Ltd.

Investment Account

(6% Debentures of Y Ltd. of ₹ 100 each)

Date	Particulars	No. of Debentures ₹	Value ₹	Date	Particulars	No. of Debentures ₹	Value ₹
2013				2013			
Jan. 1	To Balance b/d	200	18,200	Jan. 1	By Bank – Sale	60	5,760
April 1	" Bank – Purchases	40	3,920	Dec. 1	" Bank – Sale	80	7,480
	" Profit & Loss A/c Profit	—	620	Dec 31	" Bank - Sale	100	9,500
		240	22,740			240	22,740

Working :

80 Debentures which were sold on 1.12.2013 at ₹ 99 cum-interest is inclusive of accrued interest for 11 months (i.e., ₹ 5.50). The same is to be deducted from the sale price (i.e., ₹ 99 – ₹ 5.50 = ₹ 93.50).

Illustration 48.

Investors Ltd. held on 1.1.2013 ₹ 60,000 of 12% Government securities (Tax free) of ₹ 100 each at ₹ 56,500. On 1.6.2013, the company purchased a further of ₹ 40, 000 of the Security at 96½ cum-interest, brokerage being ½%.

On 31.7.2013, ₹ 50,000 of security was sold at 94½ ex-interest, brokerage being ½%. On 1.12.2013, ₹ 20,000 of the security was again sold at ₹ 96.

Interest on the security was paid each year on 31st March and 30th September and was credited by the bank on 3rd April and 4th October, respectively. The price of the security on 31.12.2013 was 96. Investors Ltd. closes its books on 31st December each year.

Draw up the Investment Account in the books of Investors Ltd.

Solution :

In the Books of Investors Ltd.

Investment Account

(12% Govt. Security – tax free)

Date	Particulars	Nominal ₹	Interest ₹	Principal ₹	Date	Particulars	Nominal ₹	Interest ₹	Principal ₹
2013 Jan. 1	To Balance b/d (Interest)	60,000	1,800	56,500	2013 April 3	By Bank (Interest on ₹ 60,000 for 6 months @ 12% p.a.)	---	3,600	---
June1	,, Bank Purchases at 96½ Cum-Interest- Brokerage ½%	40,000	800	38,000	July 31	,, Bank – (Sales at 94½ Ex-Interest – Brokerage ½%	50,000	2,000	47,000
Dec.31	,, Profit & Loss A/c (Interest transferred)		7,300						
				---	Oct. 4	,, Bank Interest on ₹ 50,000 for 6 months @ 12% p.a.	---	3,000	---
					Dec. 1	,, Bank Sales at 96 Cum-Interest	20,000	400	18,800
					Dec. 31	,, Profit & Loss A/c -Loss on sale	---	---	350
					Dec. 31	,, Balance c/d At cost 94½% Interest on ₹ 30,000 for 3 months @ 12% p.a.	30,000	900	28,350
		1,00,000	**9,900**	**94,500**			**1,00,000**	**9,900**	**94,500**

Illustration 49.

Bonanzaa Ltd. held on 1.4.2012 ₹ 2,00,000 of 9% Govt. Loan (2013) at ₹ 1,90,000 (Face value of Loan ₹ 100 each). Three months' interest had accrued on the above date. On 31st May 2012 the company purchased the same Govt. loan of the face value of ₹ 80,000 at ₹ 95 (Net) cum-interest. On 1st June 2012, ₹ 60,000 face value of the loan was sold at ₹ 94 (Net) ex-interest. Interest on the loan was paid each on 30th June and 31st December and was credited by the bank on the same date. On 30th Nov. 2012 ₹ 40,000 face value of the loan was sold at ₹ 97 (Net) cum-interest. On 1st Dec. 2012, the company purchased the same loan ₹ 10,000 at per ex-interest. On 1st March 2013, the company sold ₹ 10,000 face value of the loan at ₹ 95 ex-interest. The market price of the loan on 31st March 2013 was ₹ 96.

Draw up the 9% Govt. Loan (2013) Account in the books of Bonanzaa Ltd. FIFO method shall be followed and the balance of the loan held by the company shall be valued at Total average cost or market price, whichever is lower. Calculation shall be made to the nearest rupee or multiple thereof.

Solution:

In the Books of Bonanzaa Ltd.
9% Govt. Loan (2013) Account
(Interest Payable: 30th June and 31st December)

Dr. **Cr.**

Date	Particulars	L.F.	Nominal ₹	Interest ₹	Principal ₹	Date	Particulars	L.F.	Nominal ₹	Interest ₹	Principal ₹
2012 Apr.1	To Bal. b/d		2,00,000	4,500	1,90,000	2012 June 1	By Bank A/c - Sale		60,000	2,250	56,400
May 31	" Bank A/c - Purchase		80,000	3,000	73,000	June 30	" Bank A/c (Int. for 6 months)		---	9,900	---
Dec.1	" Bank A/c - Purchase		10,000	375	10,000	Nov. 30	" Bank A/c - Sale		40,000	1,500	37,300
2013 Mar. 31	" Profit and Loss - Interest transferred)		---	18,525	---	Dec. 31	" " Bank A/c (Int. for 6 months)		---	8,550	---
						2013 Mar. 1	" Bank A/c - Sale		10,000	150	9,500
						Mar. 31	" P&L A/c - Loss on Sale		---	---	1,300
							,, Balance c/d		1,80,000	4,050	1,68,500
			2,90,000	**26,400**	**2,73,000**				**2,90,000**	**26,400**	**2,73,000**

Workings:

1. Interest on 1.4.2012

Nominal ₹ 2,00,000

(for 3 months i.e., from 1.1.2012 to 1.4.2012)

= ₹ 2,00,000 x 9/100 x 3/12 = ₹ 4,500

2. Purchase (Cum-Interest) on 31.5.2012

Total Cost (800 x ₹ 95)	76,000
Less: Interest (from 1.1.2012 to 31.05.2012) on	3,000
Nominal value, i.e., (800 x ₹ 100)	
₹ 80,000 x 5/100 x 3/12	
	73,000

3.	**Sale (Ex-Interest) on 1.6.2012)**	
	Selling price (600 x ₹ 94)	56,400
	Interest own (from 1.1.2012 to 1.6.2012)	
	₹ 60,000 x 9/100 x 5/12	2,250
4.	**Interest on 30.6.2012**	
	On ₹ 2,20,000 (i.e., ₹ 2,80,000 – ₹ 60,000)	
	i.e. (₹ 2,20,000 x 9/100 x 6/12)	9,900
5.	**Sale (Cum-Interest) on 30.11.2012)**	
	Total amount (400 x ₹ 97)	38,800
	Less: Interest (from 30.06.2012 – 30.11.2012)	
	i.e., (₹ 40,000 x 9/100 x 5/12)	1,500
		37,300
6.	**Purchase and Interest on 1.12.2012**	
	Actual cost -	10,000
	Nominal Value	10,000
	Interest (from 30.06.2012 to 1.12.2012)	
	On ₹ 10,000 x 9/100 x 5/12	375
7.	**Interest on 31.12.2012**	
	On ₹ 1,90,000 x 9/100 x 6/12 (Nominal ₹ 1,90,000)	8,550
8.	**Sale and (Ex-Interest on 1.3.2013)**	
	Actual Proceeds (100 x ₹ 95)	9,500
	Nominal Value	10,000
9.	**Interest on 31.03.2013**	
	Nominal ₹ 1,80,000	
	Interest on ₹ 1,80,000 x 9/100 x 6/12	4,050

10. Statement showing the Profit or Loss on Sale of Investment and Valuation of Stock

Date	Particulars	Nominal ₹	Principal ₹	Selling Price ₹	Profit ₹	Loss ₹
2012						
April 1	Balance b/d	2,00,000	1,90,000	---	---	---
May 31	Purchase	80,000	73,000	---	---	---
		2,80,000	2,63,000			
June 1	Sales $\left(\frac{60,000}{2,00,000} \times 1,90,000\right)$	60,000	57,000	56,400	---	600
		2,20,000	2,06,000			
Nov. 30	Sales $\left(\frac{40,000}{2,00,000} \times 1,90,000\right)$	40,000	38,000	37,300	---	700
		1,80,000	1,68,000			
Dec. 1	Purchases	10,000	10,000			
		1,90,000	1,78,000			
2013 Mar. 1	Sales $\left(\frac{10,000}{2,00,000} \times 1,90,000\right)$	10,000	9,500	9,500	---	---
		1,80,000	1,68,500			

As the market price is more i.e., 1,800 x ₹ 96 = ₹ 1,72,800 than the cost price of ₹ 1,68,500; Cost Price is taken.

Investment in Shares

(1) **Dividend Received:**

(a) If received out of Pre-Acquisition Profit, the Dividend Received is to be recorded in the "Capital" Column.

(b) If received out of Post-Acquision Profit, the dividend received should be credited to the "Income" Column.

(2) **Bonus Shares Received:** Bonus Shares are received without making any payment. The nominal value of Bonus Shares is to be recorded in the **nominal column** debit side as — "To Bonus Shares." **No entry is to be recorded in the** Capital **Column.**

(3) **Right Shares:** These are offered first to the existing shareholders at a price lower than the market price.

A business holding some equity shares as investments, may get the offer of right shares. The business may accept the right shares or sell the rights to others for some consideration.

On the other hand, a business can buy rights from others on payment of some consideration. Thus—

(a) **If an existing investor gets the offer to buy some right** shares **and** accepts **the** offer — **the nominal value of the Right Shares Accepted** is to be recorded in the **nominal** column and the **Amount Paid** in the **Capital** Column.

(b) **If the right is sold out to others** — The total amount received from the sale should be credited to the "Capital" column on the credit side. **No entry** is required in the **"Nominal"** Column.

(c) **If Rights are Purchased from others —** The **amount paid** should be debited to **"Capital"** Column.

Illustration 50.

Mr. Shape dealt on the stock exchange and had purchased and sold leading scripts but did not maintain his accounts in a proper manner. He furnished the following data:

Investment on hand as at July 1, 2012

300-3% Conversion Loan 1982-84 of ₹ 100 each purchased at ₹ 60.

250-Equity shares of ₹ 10 each of Everlite Limited at ₹ 18 per share.

1,000-9% Preference shares of ₹ 100 each of Prosperous Limited at ₹ 95.

Transactions during the year

Purchases:

750 Equity Shares of ₹ 10 each of Evelite Ltd. at ₹ 23.

250 Equity Shares of ₹ 10 each of Small Limited at ₹ 9.

125 Equity Shares of ₹ 10 each of Bright Shipping Ltd. at ₹ 12.

Sold

100-3% Conversion Loan 1982-84 at ₹ 65.

100-9% Preference Shares of Prosperous Ltd. at ₹ 99.

Interest/Dividend Received

3% Conversion Loan – Interest Received ₹ 900.

9% Preference Shares of Prosperous Ltd. ₹ 9,000.

Everlite Ltd. – Dividend at 20 per cent on 1,000 shares ₹ 2,000.

Everlite Limited issued Bonus shares and Mr. Shape received 1,000 shares of the Company as Bonus Shares.

You are required to show the Investment Account in the Books of Mr. Shape.

Solution:

In the Books of Mr. Shape
Investment Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2012			2012		
July 1	To Balance b/d 300, 3% Conversion Loan 1982-84 of ₹ 100 at ₹ 60.	18,000	June 30	By Bank Sale of 100 – Conversion Loan 1982-84 3% of ₹ 100 at ₹ 65	6,500
	250 Equity Shares of ₹ 10 of E. Ltd. at ₹ 18	4,500		100, 9% Pref. Shares of ₹ 100 each at ₹ 99	9,900
	1,000, 9% Pref. Shares of ₹ 100 each at ₹ 95 of P. Ltd.	95,000		,, Balance c/d 200, 3% Conversion Loan 1982-84 of ₹ 100 at ₹ 60	12,000
2013 June 30	,, Bank – Purchases of 750 Equity Shares of ₹ 10 each at ₹ 23	17,250		900, 9% Pref. Shares of ₹ 100 each at ₹ 95 of P. Ltd.	85,500
	250 Equity Shares of ₹ 10 each at ₹ 9 of Small Ltd.	2,250		1,000 Equity Shares E. Ltd. of ₹ 10 each.	21,750
	125 Equity Shares of ₹ 10 each at ₹ 12 of B.S. Ltd.	1,500		250 Equity Share of ₹ 10 each of Small Ltd. at ₹ 9	2,250
	,, Profit & Loss A/c: 3% Conversion loan 1982-84	500		125 Equity Share of ₹ 10 each of B.S. Ltd. at ₹ 12.	1,500
	9% Pref. Shares of Prop. Ltd.	400			
		1,39,400			**1,39,400**

Illustration 51.

On 1st March, 2013, XY Corporation Ltd purchased ₹ 30,000, 5% Government Stock at ₹ 95 cum –interest. On 1st May, 2013 the company sold ₹ 10,000 of stock at ₹ 97 cum – interest. On 15th December, 2013, another ₹ 10,000 stock was sold at ₹ 93 ex - interest. On 31st December, 2013, the closing date of the financial year, the fair market value of the stock was ₹ 92. Half yearly interest is received every year as on 30th June and 31st December.

Prepare a ledger account in the Investment Ledger assuming that the stock transfer book is closed 20 days before the date of payment of interest. Assume investments are current investments.

Solution:

In the books of XY Corporation Ltd.
5% Government stock Account
[Interest Payable: 30th June & 31st December]

Dr. **Cr.**

Date	Particulars	Nominal value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal value	Interest (₹)	Cost (₹)
1.3.13	To, Bank A/c[1]	30,000	250	28,250	1.5.13	By, Bank A/c[2]	10,000	167	9,533
1.5.13	To, P&L A/c[2]	-	-	117	30.6.13	By Bank A/c(Int)	-	500	-
					15.12.13	By, Bank A/c[3]	10,000	208	9,300
					15.12.13	By, P& L A/c[5]	-	-	116
31.12.13	To, P&L A/c	-	875	-	31.12.13	By Bank A/c(Int)	-	250	-
					31.12.13	By, P& L A/c	-	-	218
					31.12.13	By, Balance c/d[4]	10,000	-	9,200
		30,000	**1,125**	**28,367**			**30,000**	**1,125**	**28,367**

Working Notes:

(1) Purchase of stock (cum interest) on 01.03.2013

Nominal Value	**30,000**
Total amount paid (300 x ₹ 95)	28,500
Less: Accrued Interest for 2 months (30,000 x 5/100 x 2/12)	250
Cost	28,250

(2) Sale of stock (cum interest) on 01.05.2013

Nominal Value	**10,000**
Sale proceeds (100 x ₹ 97)	9,700
Less: Accrued Interest for 4 months (10,000 × 5/100 × 4/12)	167
	9,533
Profit on sale of ₹ 10,000 stock on 01.05.2013	
Sale proceeds	9,533
Less: Avg Cost (₹ 28,250 /30,000 x 1000)	9,416
Profit on sale	117

(3) Sale of stock (EX-interest) on 15.12.2013

Nominal Value	**10,000**
Sale proceeds (100 x ₹ 93)	9,300
Less: Accrued Interest for 5 months (10,000 x 5/100 x 5/12)	208

(4) Cost of stock on 31.12.2013

(i) Cost price (28,250/30,000 x 10,000)	9,416
(ii) Fair Market value (100 x ₹ 92)	9,200
Value of stock will be ₹ 9,200(being lower than cost price)	

(5) Loss on sale of ₹ 10,000 stock on 15.12.2013

Sale proceeds	9,300
Less: Average Cost (2,82,000/3,00,000 x 90,000)	9,416
Loss on sale	116

11.7 INSURANCE CLAIMS

In course of running a business, an abnormal or accidental loss may occur in the form of a fire, theft, natural calamity, strike, etc. As a result, the assets of the business and mainly stock of goods are destroyed partially or wholly. Such an accident also causes a disruption of the normal business activities. To replenish the mutilated assets, the business immediately needs some money. So, to cover the risks of such losses, it takes on a policy with the Insurance Companies so as to recover a part or whole of the loss.

The business pays insurance premium yearly or quarterly or as per agreement. If any accidental loss occurs, the business has to compute the amount of loss and file a claim for compensation to the Insurance Company. The Insurance Company, in turn, appoints loss assessors to investigate the reasons and extent of the loss. As per the report of the loss assessor, insurance claims are met.

Loss of Stock

Of the different forms of accidental losses, loss by fire is the most common one. A fire insurance policy is taken to cover two types of losses: 1. Loss of assets (including Stock) and 2. Loss of Profits.

As stocks constitute a considerable portion of the working capital of any business and specially for trading concerns, any loss of stock directly affects the solvency of the business. A business has to cover this risk adequately.

If stock records and stock are destroyed, it becomes difficult to ascertain the amount of stock lost. When the loss suddenly occurs, up-to-date value of stock does not become available.

Computation of claim for Loss of Stock:

It requires two steps:

1. Calculation of value of stock on the date of fire:

If exact value of stock is not available, a Memorandum (or Estimated) Trading Account has to be prepared starting from the very next date of the last accounting period and ending on the date of fire. Its Specimen is given below :

Trading Account

For the period (1st day of the current accounting year to the date of fire)

Dr. **Cr.**

Particulars	Amount	Particulars	Amount
To Opening Stock To Purchase (less returns) To Any other Expense like Wages, etc. chargeable to Trading A/c To Gross Profit (Calculated at usual rate on sales)		By Sales (less returns) By Stock on sale Return (If goods sent on approval are lying with customers but yet to be confirmed, then Cost price of such goods) By Stock on consignment (lying with consignee at cost) By Closing Stock (Balancing figure)	

Note :

(a) Usual rate of gross profit may not be given. In that case, it should be found out from information given. If required a Trading Account for the preceding accounting period/periods may have to be prepared to find out the rate of gross profit.

(b) Adjustments may be necessary while preparing the Trading Accounts of the current period and preceding accounting years for slow-moving items, abnormal or defective items not fetching same rate of gross profit, goods distributed as samples, goods taken away by proprietors, over or under valuation of stocks, omission of recording of stocks, etc.

2. Calculation of Actual Claim

(i)	Take the book value of stock on date of fire (ascertained from the memorandum Trading Account)	—
(ii)	Deduct : The value of any stock saved or salvaged	—
(iii)	Actual value of stock lost	—

The Insurance Policy contains provisions regarding the claim for Stock Lost.

Please remember that-

(i) Even if the insured value of the goods is higher, the claim should be limited to the amount of actual loss.

(ii) If actual loss exceeds the amount of the insured value, the claim is to be limited usually by applying the Average clause.

Average Clause: It is a clause contained in a fire insurance policy. It encourages full insurance and discourages under-insurance. The insured person also has to bear a portion of loss himself in case the value of-stock lost is more than the value of the policy. The net claim as per this clause is—

$$\text{Net Claim} = \text{Actual Loss of Stock} \times \frac{\text{Policy Value}}{\text{Value of Stock on the date of fire}}$$

In this respect, it should be remembered that—

(a) If there is any Salvaged Stock, that is deducted from the Value of Stock on the date of fire. If there is no Salvaged Stock, It is a case of total loss. The net claim should be limited to the Policy Value.

(b) Average clause cannot be applied in case the Policy value is equal to or more than the Actual Stock Lost [that is, there is equal or over insurance].

Elimination of Abnormal/ Defective Items : Goods which cannot fetch the usual rate of gross profit are considered as unusual or abnormal items.

For preparing the Memorandum Trading Account, the portion of the value of such goods which has not yet been written off, should be deducted from the Opening Stock. If any such goods have been purchased in the current period, the Cost Price of such goods should be deducted from purchases. If any portion of such goods have been sold in the current period, the Selling Price should be deducted from current sales. Lastly if any portion of such, goods remains unsold on the date of fire, the agreed value of such portion should be added with the estimated value of normal stock to arrive at the estimated value of (total) stock on that date.

Similar adjustments may be required while preparing the Trading Account of the last financial year/s, if abnormal items existed then.

As an alternative measure, columnar Trading Account Showing normal and abnormal items separately may be prepared.

Illustration 52.

A fire occurred on 15th September 2013 in the premises of Sen & Co. from the following figures, calculate the amount of claim to be lodged with the insurance company for loss of stock.

Particulars	Amount ₹
Stock at cost on 1.1.2012	40,000
Stock at cost on 1.1.2013	60,000
Purchases in 2012	80,000
Purchase from 1.1.2012 to 15.9.2013	1,76,000
Sales in 2012	1,20,000
Sales from 1.1.2013 to 15.9.2013	2,10,000

During the current year cost of purchase has risen by 10% above last years' level. Selling prices have gone up by 5%. Salvage value of stock after fire was ₹ 4,000.

Solution:

Memorandum Trading Account for the period from 1.1.2013 to 15.9.2013

Dr. **Cr.**

Particulars	Current Year ₹	Last Year ₹	Particulars	Current Year ₹	Last Year ₹
To Opening Stock	60,000	60,000	By, Sales	2,10,000	2,00,000
,, Purchase	1,76,000	1,60,000	By, Closing Stock	1,32,000	1,20,000
,, Gross Profit	1,06,000 (bal. fig.)	1,00,000 (50% of Sales)			
	3,42,000	3,20,000		3,42,000	3,20,000

Working:

1. **Value of Closing Stock**

	₹
Stock at last years' level	60,000
Add: 10% increase in cost of purchase	6,000
	66,000

Amount of Claim	₹
Closing Stock	1,32,000
Less: Stock Salvaged	4,000
Actual Value of Stock last	1,28,000

Actual Value of Stock Loss

Trading Account (for ascertaining rate of Gross Profit)
For the year ended 31.12.2012

Dr. Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To, Opening Stock	40,000	By, Sales (less returns)	1,20,000
To, Purchase (less returns)	80,000	By, Closing Stock	60,000
To, Gross profit (bal. fig.)	60,000		
	1,80,000		1,80,000

∴ Percentage of gross profit on sales = (Gross Profit/Sales) x100

= (₹60,000/₹1,20,000)×100

= 50%

Illustration 53.

Mr. X's godown was destroyed by fire on 1.6.2013 when the goods in stock were insured for ₹ 60,000. The following particulars are given:

Balance Sheet (Extract)
as at 31st December 2012

Liabilities	Amount ₹	Asset	Amount ₹
Creditor for goods	20,000	Stock (including goods held by agent ₹ 2,000)	36,000
		Debtors	70,000

Transactions upto 31st May, 2013 include:

Particulars	Amount ₹	Particulars	Amount ₹
Cash Received from Debtors	3,40,000	Cash paid to Creditors	2,20,000
Bad Debt written off	3,500	Discount Received	1,000
Balance on 31.5.2013:			
Debtors	70,000		
Creditors	30,000		

Additional information

(i) Debtors on 31.5.2013, included an amount owing from the agent from sales to date ₹ 4,000 less 10% commission and his expenses amounting to ₹ 100 on 31.5.2013 – the agent still held the said goods valued at ₹ 3,600 (at selling price).

(ii) Sales (total) for the periods include ₹ 1,600 for goods which have the selling price reduced by 50% and also ₹ 6,000 reduced by 25%.

(iii) The normal mark up is 50% on cost and except the above, all sales can be assumed to be at the full selling price.

(iv) All the goods were destroyed and there was no salvage value of the goods.

Calculate the amount of claim.

Solution:

In the Books of Mr. X

Debtors Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013			2013		
Jan 1	To Balance b/d	70,000	May 31	By Cash Received	3,40,000
May 31	,, Sales (bal. fig.)	3,40,000		,, Bad Debts	3,500[1]
				,, Balance c/d	66,500
		4,10,000		(excluding form agent)	4,10,000

Creditors Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2013			2013		
May, 31	To Cash paid	2,20,000	Jan. 1	By Balance b/d	20,000
	,, Discount Received	1,000	2013		
	,, Balance c/d	30,000	May 31	,, Purchase (bal. fig)	2,31,000
		2,51,000			2,51,000

Godown Stock Account

Dr. **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2012		34,000	2012	By Cost of Goods Sold	2,29,066[2]
May, 31	To Balance b/d		May	,, Stock at Agents	3,067[3]
	(₹ 36,000 – ₹ 2,000)	2,31,000	31.	,, Stock Destroyed by fire	32,867
	,, Purchase from the Creditors)	2,65,000		(bal. fig)	2,65,000

Thus, amount of claim which will be lodged for ₹ 32,867.

Workings:

1. Bad Debts

Particulars		Amount ₹
Sales		4,000
Less: Commission @10%	400	500
Expenses	100	3,500

2. Cost of Goods Sold

Sales ₹	Normal Selling Price ₹	Cost ($^2/_3$ of Selling Price) ₹
1,600	3,200	2,133
6,000	8,000[6,000 × (100/75)]	5,333
3,32,400 (bal. fig.)	–	2,21,600
3,40,000		2,29,066

3. Stock at Agent

Sales ₹	Cost ₹
4,000	2,667 (₹ 4,000 × $^2/_3$)
—	2,400 (₹ 3,600 × $^2/_3$)
	5,067
Less: Agents' hand at the beginning	2,000
	3,067

Illustration 54.

X Ltd. has taken out a fire policy of ₹ 1,60,000 covering its stock. A fire occurred on 31st March, 2013. The following particulars are available :

	₹
Stock as on 31.12.2012	60,000
Purchases to the date of fire	2,60,000
Sales to the date of fire	1,80,000
Carriage Inwards	1,600
Commission on purchase to be paid	@2%
Gross Profit Ratio @ 50% on cost	

You are asked to ascertain (i) total loss of stock; (ii) amount of claim to be made against the Insurance Company assuming that the policy was subject to average clause. Stock salvage amounted to ₹ 41,360.

Solution:

In the books of X Ltd.

Memorandum Trading Account

Dr. **for the period ended 31st March, 2013** Cr.

Particulars	₹	₹	Particulars	₹
To, Opening Stock		60,000	By, Sales	1,80,000
" Purchase	2,60,000		" Closing Stock	2,06,800
Add: Carriage Inward	1,600		(bal. figure)	
Add: Com. on Purchase	5,200	2,66,800		
" Gross Profit		60,000		
(@ 50% on cost or 33 % on sale)		3,86,800		3,86,800

Note: Carriage Inward and Com. on Purchase are direct expenses and hence, these are added to purchases.

Loss of Stock:

	₹
Stock at the date of fire	2,06,800
Less: Stock Salvaged	41,360
Loss of Stock	**1,65,440**

Amount of claim applying Average Clause

$$\text{Amount of Claim} = \text{Actual Loss} \times \frac{\text{Amount of Policy}}{\text{Value of stocks at the date of fire}}$$

= ₹ 1,65,440 × (₹ 1,60,000/ ₹ 2,06,800)

= ₹ 1,28,000

Illustration 55.

A fire occurred in the premises of Sri. G. Vekatesh on 1.4.2013 and a considerable part of the stock was destroyed. The stock salvaged was ₹ 28,000. Sri Venkatesh had taken a fire insurance policy for ₹17,10,000 to cover the loss of stock by fire.

You are required to ascertain the insurance claim which the company should claim from the insurance company for the loss of stock by fire. The following particulars are available:

	₹		₹
Purchases for the year 2012	9,38,000	Stock on 1.1.12	1,44,000
Sales for the year 2012	11,60,000	Stock on 31.12.2012	2,42,000
Purchases from 1.1.13 to 1.4.13	1,82,000	Wages paid during 2012	1,00,000
Sales from 1.1.13-1.4.13	24,00,000	Wages paid 1.1.13-1.4.13	1,80,000

Sri Venkatesh had in June 2012 consigned goods worth ₹ 50,000, which unfortunately were lost in an accident. Since there was no insurance cover taken, the loss had to be borne by him full.

Stocks at the end of each year for and till the end of calendar year 2011 had been valued at cost less 10%. From 2012, however there was a change in the valuation of closing stock which was ascertained by adding 10% to its costs.

Solution:

In order to find the rate of gross profit on sales for the year 2012, the following Trading Account is to be prepared for the same year as:

Trading Account

For the year ended 31st Dec. 2012

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To, Opening Stock	1,60,000	By, Sales	11,60,000
1,44,000 × (100/90)		By, Stock lost by Accident	50,000
To, Purchases	9,38,000	By, Closing Stock (2,42,000 ×100/110)	2,20,000
To, Wages	1,00,000		
To, Profit & Loss A/c (G.P. transferred)	2,32,000		
	14,30,000		**14,30,000**

Rate of Gross Profit on Sales = 2,32,000/11,60,000 × 100 = 20%

Trading A/c for the period (from 1.1.13-1.4.13)

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To, Opening Stock	2,20,000	By, Sales	2,40,000
To, Purchases	1,82,000	By, Closing Stock	2,28,000
To, Wages	18,000		
To, Profit & Loss A/c (G.P. @20% of sales)	48,000		
	4,68,000		**4,68,000**

Amount of Claim = Stock destroyed – Salvaged

= ₹ 2,28,000 – ₹ 28,000

= ₹ 2,00,000

As the policy amount is less than the value of stock destroyed, average clause is applicable. Here, the amount of claim will be:

Net Claim = Loss of Stock × (Amount of Policy / Stock at the date of fire)

= 2,00,000 × (1,71,000 / 2,28,000) = 1,50,000/-

Illustration 56.

On 1.4.2013, godown of Y Ltd. was destroyed by fire. The records of the company revealed the following particulars:

	₹
Stock on 1.1.2012	75,000
Stock on 31.12.2012	80,000
Purchases during 2012	3,10,000
Sales during 2012	4,00,000
Purchase from 1.1.2013 to the date of fire	75,000
Sales from 1.1.2013 to the date of fire	1,00,000

In valuing Closing Stock of 2012, ₹ 5,000 was written off whose cost was ₹ 4,800. Part of this stock was sold in 2013 at a loss of ₹ 400, at ₹ 2,400. Stock salvaged was ₹ 5,000. The godown and the cost of which was fully insured.

Indicate from above amount of claim to be made against the insurance company.

Solution:

(a) For ascertaining the rate of Gross Profit

In the books of X Ltd.

Trading Account

Dr. **for the year ended 31.12.2012** **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To, Opening Stock		75,000	By, Sales		4,00,000
" Purchases	3,10,000		" Closing Stock	80,000	
Less: Purchase of Abnormal items of goods	4,800	3,05,200	Add: Loss on value of abnormal items (₹5,000 – ₹4,800)	200	80,200
" Gross Profit (bal. fig.)		1,00,000			
		4,80,200			**4,80,200**

Percentage of Gross Profit on sales $= \frac{₹\ 1,00,000}{₹\ 4,00,000} \times 100$

$= 25\%$

Memorandum Trading Account

for the period ended 31st March, 2013

Dr. **Cr.**

Particulars	₹	Particulars	₹	₹
To, Opening Stock	80,200	By, Sales	1,00,000	
" Purchases	75,000	Less: Sale of abnormal Stock (₹ 2,400 – ₹ 400)	2,000	98,000
" Gross Profit (@25% on ₹ 98,000)	24,500	" Closing Stock (bal. fig.)		81,700
	1,79,700			**1,79,700**

Alternative approach

In a combined form

Trading Account

for the year ended 31st December, 2013

Dr. **Cr.**

Particulars	Normal Items ₹	Abnormal Items ₹	Total ₹	Particulars	Normal Items ₹	Abnormal Items ₹	Total ₹
To Opening Stock	75,000	---	75,000	By Sales	4,00,000	---	4,00,000
,, Purchase	3,05,200	4,800	3,10,000	,, Closing Stock	80,200	(-) 200	80,000
,, Gross Profit @25% on sales	1,00,000	---	1,00,000	,, Gross Loss	---	5,000	5,000
	4,80,200	4,800	4,85,000		4,80,200	4,800	4,85,000

Memorandum Trading Account

for 3 months ending 31st March, 2013

Dr. **Cr.**

Particulars	Normal Items ₹	Abnormal Items ₹	Total ₹	Particulars	Normal Items ₹	Abnormal Items ₹	Total ₹
To Opening Stock	80,200	(-) 200	80,000	By Sales	98,000	2,000	1,00,000
,, Purchase	75,000	---	75,000	,, Closing Stock (bal. fig)	81,700	2,400[1]	84,100
,, Gross Profit	24,500	4,600	29,100				
	1,79,700	4,400	1,84,100		1,79,700	4,400	1,84,100

1. 50% of ₹ 4,800 i.e., remaining abnormal stocks are valued at cost.

Amount of Claim	₹
Value of Stock at the date of fire	84,100
Less: Stock Salvaged	5,000
	79,100

Illustration 57.

On 30.09.2013 the stock of Harshvardhan was lost in a fire accident. From the available records the following information is made available to you to enable you to prepare a statement of claim of the insurer:

Particulars	Amount ₹	Particulars	Amount ₹
Stock at cost on 1.4.2012	75,000	Sales less returns for the year ended 31.3.2013	6,30,000
Stock at cost on 31.3.2013	1,04,000	Purchase less returns up to 30.09.2013	2,90,000
Purchases less returns for the year ended 31.3.2013	5,07,500	Sales less returns up to 30.09.2013	3,68,100

In valuing the stock on 31.03.2013 due to obsolescence 50% of the value of the stock which originally cost ₹ 12,000 had been written-off. In May 2013, ¾th of these stocks had been sold at 90% of original cost and it is now expected that the balance of the obsolete stock would also realize the same price, subject to the above, G.P had remained uniform throughout stock to the value of ₹ 14,400 was salvaged.

Solution:

Memorandum Trading Account

for the period ended 30.09.2013

Dr. **Cr.**

Particulars	Normal Items ₹	Abnormal Items ₹	Total ₹	Particulars	Normal Items ₹	Abnormal Items ₹	Total ₹
To Opening Stock	98,000	6,000	1,04,000	By Sales	3,60,000	8,100	3,68,100
,, Purchase (Less: Returns)	2,90,000	---	2,90,000	(Less returns)			
,, Gross Profit (25% on Normal Sales)	90,000	4,800	94,800	,, Closing Stock	1,18,000	2,700	1,20,700
	4,78,000	10,800	4,88,800		4,78,000	10,800	4,88,800

∴ **Amount of Claim**	₹
Stock at the date of fire	1,20,700
Less: Stock Salvaged	14,400
	1,06,300

Workings:

Trading Account

for the year ended 31.03.2013

Dr. Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To Opening Stock	75,000	By Sales (Less: Returns)	6,30,000
,, Purchase (Less: Returns)	5,07,500	,, Closing Stock	1,10,000[1]
,, Gross Profit	1,57,500		
	7,40,000		7,40,000

So, Percentage of Gross Profit on sales = $\frac{₹1,57,500}{₹6,30,000}$ x 100 = 25%

1. Closing Stock

Particulars	Amount ₹
Closing Stock	1,04,000
Add: Stock Written off	6,000
	1,10,000

2. Sale of Abnormal Items of goods

₹ 12,000 × $\frac{3}{4}$ × (90/100) = ₹ 8,100

3. Closing Stock of Abnormal Items

₹ 12,000 × $\frac{1}{4}$ × (90/100) = ₹ 2,700

Illustration 58.

The factory premises of Toy company were engulfed in fire on 31st March 2013, as a result of which a major part of stock burnt to ashes. The stock was covered by policy for ₹ 1,00,000, subject to Average Clause.

The records at the office revealed the following information:

1. (a) The Company sold goods to dealers on one month credit at dealer's price which is catalogue price less 15%. A cash discount is allowed @ 5% for immediate payment.
   (b) The goods are also sold to agents at catalogue price less 10% against cash payment.
   (c) Goods are sent to branches at catalogue price.
   (d) Catalogue price is cost + 100%.
2. The sale/despatch during the period up to date of fire is –
   (a) Sale to Dealer ₹ 3,40,000 (without Cash Discount)
   (b) Sale to Dealer ₹ 3,23,000 (Net of Cash Discount)

(c) Sale to Agent ₹ 90,000

(d) Despatch to branches ₹ 3,00,000.

3. Stock on 1.1.2013 was ₹ 2,50,000 at catalogue price. Purchases at cost from 1.1.2013 to 31st March, 2013 ₹ 6,25,000.

4. Salvaged Stock valued at ₹ 45,000.

Compute the amount of claim to be lodged.

Solution:

In the books of Toy Company

Let the Cost price be ₹ 100.

Catalogue price will be ₹ 200 (i.e., ₹ 100 + 100%)

Agents' Price will be ₹ 180 (i.e., ₹ 200 -10%)

Dealers' Price will be ₹ 170 (i.e., ₹ 200 – 15%)

Dealers' Price when cash discount is allowed will be ₹ 161.50 (i.e., 170 – 5% on ₹ 170).

Ascertainment of Loss of Stock

		₹	₹
Opening Stock (₹ 2,50,000 × 50%)			1,25,000
Add: Purchases			6,25,000
			7,50,000
Less: Cost of Goods Sent:			
(i)	To Dealers (₹ 3,40,000 × $\frac{100}{170}$)	= 2,00,000	
(ii)	To Dealers (₹ 3,23,000 × $\frac{100}{161.50}$)	= 2,00,000	
	[Enjoying Cash Discount]		
(iii)	To Agents (₹ 90,000 × $\frac{100}{180}$)	= 50,000	
(iv)	To Branches (₹ 3,00,000 × $\frac{100}{200}$)	= 1,50,000	
			6,00,000
Closing Stock at Cost			1,50,000
Less: Salvaged Stock			45,000
∴ **Loss of Stock**			**1,05,000**

Here, claims should be lodged after applying Average Clause: as policy value is less than the loss of stock

Net claim = Loss of Stock x (Policy Value/Stock at the date of fire)

= ₹ 1,05,000 x (1,00,000/1,50,000) = ₹ 70,000

Illustration 59.

A fire occurred in the premises of M/s Fireprone Co. on 30th May 2013. From the following particulars, relating to the period from 1.1.2013, you are required to ascertain the amount of claim to be filed with the insurance company for the loss of stock.

Sl. No.	Particulars	Amount ₹
1.	Stock as per Balance Sheet as at 31st December, 2012	99,000
2.	Purchases (including purchase of Machinery costing ₹ 30,000)	1,70,000
3.	Wages (including wages for the installation of Machinery ₹ 3,000)	50,000
4.	Sales (including goods sold on approval basis amounting to ₹ 49,500. No confirmation has been received in respect of $\frac{2}{3}$ of such goods sold on approval basis.)	2,75,000
5.	Sales value of goods drawn by partners	15,000
6.	Cost of goods sent to consignee on 15th May 2013, lying unsold with them	16,500
7.	Sales value of goods distributed as free samples	1,500

The average rate of gross profit had been 20% in the past. The selling price had been increased by 20% with effect from 1.1.2013.

For valuing the stocks for the Balance Sheet as at 31st Dec. 2012, ₹ 1,000 had been written-off in respect of a slow moving item, the cost of which was ₹ 5,000. A portion of those goods were sold at a loss of ₹ 500 on the original cost of ₹ 2,500. The remainder of the stock was now estimated to be worth the original cost.

Subject to the above exceptions, the gross profit had remained at a uniform rate throughout. The value of goods salvaged was estimated at ₹ 25,000.

The concern had taken an insurance policy for ₹ 60,000 which was subject to the average clause.

Solution:

In the books of M/s Fireprone Co. Ltd.

Memorandum Trading Account for the period from 1.1.2013 to 30.5.2013

Dr. **Cr.**

Particulars		Normal Items ₹	Abnormal Items ₹	Particulars	Normal Items ₹	Abnormal Items ₹
To Opening Stock		95,000	5,000	By Sales (W.N. 1)	2,40,000[1]	2,000
,, Purchase	1,70,000			,, Closing Stock	22,000[2]	---
Less: Machinery	30,000		---	lying with customers on approval		
	1,40,000		---	(W.N. 2)		
Less: Goods sent				`` Loss	---	500
To Consignor	16,500			`` Closing Stock	72,500	2,500
	1,23,500			(bal. fig.)		
Less: Drawings (W.N. 3)	10,000					
	1,13,500					
Less: Advertisement	1,000	1,12,500				
,, Wages (50,000 – 3,000)		47,000				
'' Gross Profit (@$33\frac{1}{3}$% on Sales)		80,000				
		3,34,500	5,000		3,34,500	5,000

Amount of Claims = Value of Stock at the date of fire + Value of Abnormal Items – Stock Salvaged

= ₹ 72,500 + ₹ 2,500 – ₹ 25,000 = ₹ 50,000.

Claims after applying Average Clause = Loss of Stock x (Value of Policy/Closing Stock)

= ₹50,000 x (60,000/75,000) = ₹ 40,000

Workings:

1. Normal Sales

Particulars	Amount ₹
Total Sales	2,75,000
Less: Sold on approval (₹ 49,500 x $\frac{2}{3}$)	33,000
	2,42,000
Less: Abnormal Items (Slow moving)	2,000
	2,40,000

2. Goods Sold on Approval

Particulars	Amount ₹
Goods Sold on approval (₹ 49,500 x 2/3)	33,000
Less: Gross Profit @$33^1/_3$%	11,000
	22,000

3. Drawing by Partners

Particulars	Amount ₹
Goods taken	15,000
Less: Gross Profit @$33^1/_3$%	5,000
	10,000

4. Goods Distributed as free sample i.e., Advertisement

Particulars	Amount ₹
Goods distributed (SP)	1,500
Less: Gross Profit $33^1/_3$%	500
	1,000

5. Rate of Old Gross Profit

Old Gross Profit Ratio is 20%

6. Revised Gross Profit

Particulars	Amount ₹
Selling Price = ₹ 100 + ₹ 20	120
Cost Price (No Change) (₹ 100 – ₹ 20)	80
Profit	**40**

∴ **Gross Profit Ratio** = 40/120 = $33^1/_3$%

Illustration 60.

A fire occurred in the premises of a timber merchant on the night on 31st December. 2012. Goods worth ₹ 25,000 only could be salvaged. The following further information is available:

(i) The accounting year ends on 31st March every year.

(ii) The closing stock on 31st March 2012 was valued at ₹ 1,10,000. This was 10% above the cost.

(iii) The purchases during the period from 1st April 2012 to 31st December 2012 accounted to ₹ 5,50,000 as per the purchase register. However, goods worth ₹ 30,000 were received on 3rd January, 2013.

(iv) The sales during the period from 1st April 2012 to 31st December. 2012 amounted to ₹ 6,45,000 and included goods sold on approval basis for which the period of approval was not yet over on 31st December, 2012. The goods so sold on approval basis had been invoiced at ₹ 30,000, which was 50% above the cost.

(v) On 30th December, 2012, goods worth ₹ 60,000 had been sent to a commission agent on consignment basis.

(vi) The wages paid during the period from 1st April 2012 to 31st December, 2012 amounted to ₹ 40,000 and included ₹ 10,000 paid to workers engaged in construction work.

(vii) The amount spent on carriage inward during the period from 1st April, 2012 to 31st December, 2012 was ₹ 25,000.

(viii) It was agreed to take the gross profit ratio as the weighted average of the gross profit ratios of the preceding four years.

For this purpose, greater weight was to be given to later years, also, an item purchased in July 2012 for ₹ 20,000 and sold in August 2012 at a loss of ₹ 5,000 was not be considered separately.

(ix) The gross profit and sales of the preceding four years were:

Years	Gross Profit	Sales
2008 – 09	1,04,000	4,00,000
2009 – 10	90,000	4,50,000
2010 – 11	1,15,200	4,80,000
2011 - 12	1,42,800	5,10,000

(x) The merchant had obtained a policy of ₹ 1,00,000 to cover the loss of stock by fire and the policy contained the average clause.

You are required to determine the amount of claim to be lodged with the insurance company for the stock destroyed by fire.

Solution:

Calculation of Weighted Average G.P. Ratio

Year	G.P.	Sales	G.P. Ratio	Weight	Product
2008 – 09	1,04,000	4,00,000	26	1	26
2009 – 10	90,000	4,50,000	20	2	40
2010 – 11	1,15,200	4,80,000	24	3	72
2011 - 12	1,42,800	5,10,000	28	4	112
				10	250

∴ Average G.P. Ratio = 250/10 = 25%

Memorandum Trading Account

(1.4.2012 to 31.12.2012)

Dr. **Cr.**

Particulars	Normal Items ₹	Abnormal Items ₹	Particulars	Normal Items ₹	Abnormal Items ₹
To Opening Stock	1,00,000	---	By Sales	6,00,000	15,000
,, Purchase	5,00,000	20,000	,, Goods Sent on Approval	20,000	---
(5,50,000 – 30,000 – 20,000)		---	,, Goods Sent on Consignment	60,000	---
,, Wages	30,000	---	,, Profit and Loss A/c (Loss)	---	5,000
,, Carriage Inward	25,000	---	,, Stock Destroyed by Fire	1,25,000	---
'' Gross Profit	1,50,000		(bal. fig.)		
	8,05,000	20,000		8,05,000	20,000

Amount of Claim

Particulars	Amount ₹
Stock at the date of fire	1,25,000
Less: Stock Salvaged	25,000
Loss of Stock	**1,00,000**

Applying the Average Clause, the amount of claim =

(Value of Policy/Stock at the fire)×Loss of Stock = (₹ 1,00,000/ ₹ 1,25,000) x ₹ 1,00,000 = ₹ 80,000

B. LOSS OF PROFIT

Introduction

A fire may create a consequential loss to a business over and above the instantaneous damage of stock. It disrupts normal activities for some time during which the business has to go on paying standing charges like rent, salaries etc. without any effective return. It also causes a loss of profits which the business could have earned if normality was not disturbed by the accident.

A business may cover the risk of such loss by taking out a "Loss of Profit" or "Consequential Loss Policy". It is a separate Policy. But any claim under this Policy is admitted provided the claim for loss of asset is also admitted under a different policy.

We should remember that loss of profit insurance cover the following risk which happened as a result of fire. Viz, (a) Loss of Net Profit; (b) payments made for standing (fixed) overhead charges, e.g., Salaries, Rent, Depreciation etc. (c) Any additional cost of working.

Certain Important Terms

Standing Charges

Standing charges or fixed overhead charges are to be paid even if there is a reduction in turnover or stoppage of work which include; Rent, Rates and Taxes; Salaries to payment Staffs; Depreciation of fixed Assets, Director's Remuneration; Sundry standing charges which are restricted to 5% of the total of specified insured standing charges. Under loss of profit insurance, gross profit means net profit + insured standing charges.

Indemnity Period

"The period commences at the date of damage and ends not later than the stated number of months thereafter. This is the maximum period in respect of which the insurers are liable and should the business recover and becomes normal before the expiry of such period, liability at once ceases." In short, it comes from the period of damage upto the date when the business begins its normal operational activities or it is the period commencing on the day on which the damages occurs and may vary from three months to a period of years. The period is selected by the proposer and should be sufficient to extend over the full period of any likely interruption.

Indemnity

Indemnity is the difference between the actual profit earned after the damage and that which should have been earned had no damage occurred.

Standard Turnover

The turnover during that period in the twelve months immediately preceding the date of the damage which corresponds with the indemnity period.

Annual Turnover

It is the period of 12 months immediately before the date of damage.

Net Profit

It is the ordinary net profit of the business which is disclosed by the income statement excluding capital receipts and payments. It excludes non-operating income (i.e., income from investment) for the purpose of insurance indemnity.

Gross Profit

Gross Profit is the total of the net profit plus insured standing charges. If there is no net profit the amount would be insured standing charges less such a proportion of any net trading loss.

Example:

Particulars	Amount ₹
Gross Profit (from Trading Account) (Sale ₹ 16,000 Less: non-standing charges ₹ 4,000)	12,000
All standing charges	15,000
Net Loss	3,000
Insured standing charges say	14,000

Now, for profit for insurance purpose

Gross profit will be considered as: ₹ 14,000/15,000 × ₹ 12,000 = ₹ 11,200

Calculation of the amount of claim under "loss of Profit" Policy

1. Find out the rate of Gross Profit [after considering trend of business etc.]
2. Find out the short sales [Standard turnover – Actual turnover of the period of dislocation]
3. Find out Gross Profit on short sales.
4. Find out the Amount Admissible for Additional Expenses

   It should be the minimum of :

   (a) Actual expenses (b) Gross profit on additional sales generated by additional expenditure

   and (c) Additional expenses $\times \dfrac{\text{Net Profit + Insured Standing Charges}}{\text{Net Profit + All Standing Charges}}$ or

   Additional Expenses $\times \dfrac{\text{Gross Profit on Annual Turnover}}{\text{Gross Profit on Annual Turnover + Uninsured Standing Charges}}$

5. Add (3) and (4). From the total deduct saving in any insured standing charge during the period of indemnity. The result is gross claim.
6. Under average clause : Net Claim = Gross Claim $\times \dfrac{\text{Policy Value}}{\text{Gross Profit on Aannual Turnover}}$

Illustration 61.

From the following particulars prepare a claim for loss of profits under the Consequential Loss Policy.

Date of Fire: June 30, 2013

Period of indemnity: Six Months

Particulars	Amount ₹
Sum Insured	25,000
Turnover for the year ended June 30, 2013	1,00,000
Net Profit for the accounting year ending March 31, 2013	6,250
Standing charges for the accounting year ending March 31, 2013	14,250
Turn Over for the year ending March 31, 2013	99,000
Turn Over for the indemnity period from 1.7.13 – 31.12.13	28,000
Turn Over for the period from 1.7.12 – 31.12.12	55,000

The turnover of the year 12-13 had shown a tendency of increase of 10% over the turnover of the preceding year.

Solution:

Short Sales

Particulars	Amount ₹
Standard Turnover (from 1.7.12 – 31-12-12)	55,000
Add: 10% increase in 12-13	5,500
	60,500
Less: Actual Sales	28,000
Short Sales	32,500

Rate of gross Profit on Sales

= (Net Profit + Insured Standing Charges) / Sales x 100 = 20.70%

Gross Claim

Particulars	Amount ₹
Gross Profit on short sales = 32,500 x 20.70%	6,730
Add : Increased Cost of Workings	NIL
	6,730
Less: Saving in Standing Charges	NIL
Amount of Gross Claim	6,730

Illustration 62.

There was a serious fire in the premises of M/s ABC on 1.9.2013. Their business activities were interrupted until 31st December, 2013, when normal trading conditions were re-established. M/s. ABC are insured under the loss or profit policy for ₹ 42,000 the period of indemnity being six months. You are able to ascertain the following information.

(i) The net profit for the year ended 31st December, 2012 was ₹ 20,000

(ii) The annual insurable standing charges amounted to ₹ 30,000, of which ₹ 2,000 were not included in the definition of insured standing charges under the policy.

(iii) The additional cost of working in order to investigate the damage caused by the fire amounted to ₹ 600 and but for the expenditure the business would have had to shut down.

(iv) The savings in insured standing charges in consequence of the fire amounted to ₹ 1,500.

(v) The turnover for the period for four months ended April 30, August 31, December 31, in each of the years 2012 and 2013 was as follows:

Year	Amount ₹	Amount ₹	Amount ₹
2012	65,000	80,000	95,000
2013	70,000	80,000	15,000

You are required to compute the relevant claim under the terms of the loss of profit policy.

Solution:

Short Sales

Particulars	Amount ₹
Standard Turnover (four months ended 31st December, 2012	95,000
Less: Actual Sales (four months ended 31st December, 2013)	15,000
Short Sales	80,000

Reduction of Gross Profit

$$\text{G.P. Ratio} = \frac{\text{Net Profit + Insured Standing Charges}}{\text{Turnover}} \times 100$$

= [₹ 20,000 + ₹ 28,000/ ₹ 2,40,000) × 100] = 20%

∴ Reduction in gross profit in short sales = ₹ 80,000 x 20% = ₹ 16,000

Additional cost of working for mitigating damage ₹ 600

As all standing charges are not insured, amount admissible for additional expenses

$$= \frac{\text{Net Profit + Insured Standing Charges}}{\text{Net Profit + All Insured Standing Charges}} \times \text{Additional Expenses}$$

$$= \frac{₹\ 20,000 + ₹\ 28,000}{₹\ 20,000 + ₹\ 30,000} \times ₹\ 600 = ₹\ 576$$

Total Claim

Particulars	Amount ₹
Gross Profit on short sales	16,000
Add: Additional cost of workings	576
	16,576
Less: Savings in Standing Charges	1,500
Gross Claim	15,076

Applying Average Clause

$$\text{Net Claim} = \frac{\text{Policy Amount}}{\text{Gross Profit on Aannual Turnover}} \times \text{Gross Claim} = \frac{₹\ 42,000}{₹\ 49,000^*} \times ₹\ 15,076 = ₹\ 12,922$$

* Gross Profit on Annual Turnover = Sales for 12 months ended 31st August, 2012 is ₹ 2,45,000

= ₹ 2,45,000 × 20% = ₹ 49,000

Illustration 63.

A fire occurred on 1st July, 2012 in the premises of A. Ltd. and business was practically disorganized up to 30th November 2012. From the books of account, the following information was extracted:

Sl. No.	Particulars	Amount ₹
1.	Actual turnover from 1st July 2013 to November, 2013	1,20,000
2.	Turnover from 1st July to 30th November, 2012	4,00,000
3.	Net Profit for the last financial year	1,80,000
4.	Insured Standing Charges for the last financial year	1,20,000
5.	Turnover for the last financial year	10,00,000
6.	Turnover for the year ending 30th June, 2013	11,00,000
7.	Total Standing Charges for the year	1,44,000

The company incurred additional expenses amounting to ₹ 18,000 which reduced the loss in turnover. There was also a savings during the indemnity period of ₹ 4,972.

The company holds a 'Loss of Profit' policy for ₹ 3,30,000 having an indemnity period for 6 months. There has been a considerable increase in trade and it has been agreed that an adjustment of 20% be made in respect of upward trend in turnover.

Compute claim under 'Loss of Profit Insurance'.

Solution:

Particulars		Amount ₹
Short Sales:		
Standard Turnover (from 1.7.2012 to 30.11.2012)		4,00,000
Add: Increase @ 20%		80,000
		4,80,000
Less: Actual Sales during indemnity period		1,20,000
(i.e., from 1.7.2013 to 30.11.2013)		3,60,000
∴ Gross Profit @30% on Short Sales (₹ 3,60,000 x 30%) =		1,08,000
Additional Expenses:		
Least of the following:		
(a) Actual amount	18,000	
(b) Gross Profit on additional sales @30%	36,000	
(c) $\frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Net Profit} + \text{All Standing Charges}} \times \text{Additional Expenses}$	16,972	16,972
$= \frac{3,96,000}{₹4,20,000} \times ₹\ 18,000 = 16,972$		1,24,972
Less: Saving in Expenses		4,972
		1,20,000

Net Claim = Amount of Claim x (Amount of Policy/G.P. on Annual Adjusted Turnover

= ₹ 1,20,000 x (₹ 3,30,000/₹ 3,96,000) = ₹ 1,00,000

Note:

1. Rate of Gross Profit : $\frac{₹3,00,000}{₹10,00,000}$ x 100 = 30%

Illustration 64.

Madhu & Co. effected a policy of insurance covering Loss of Profit and standing charges to the extent of ₹ 5,00,000 (based upon previous year's profit) plus an allowance of ₹ 1,00,000 for profit and standing charges expected to accrue from increased turnover, the period 0f indemnity being 3 months. The turnover for the previous year ended 31st March was ₹ 15,00,000 and for the ensuing year was estimated at ₹ 18,00,000.

A fire occurred on 1st November. The following relative figures have been ascertained:

Months	Sales – previous year ₹	Sales Budget – current year ₹	Actual Sales ₹
November	80,000	96,000	Nil
December	1,10,000	1,32,000	Nil
January	1,20,000	1,44,000	32,000

Upon investigation, you find that the increased sales for the past 7 months were over-estimated by 50% and the ratio of expenses was consistent with such reduction. The additional expenses of carrying on the business during partial disablement amounted to ₹ 7,000.

Prepare statement of claim against Insurance Company.

Solution:

Months	Previous years' Sale ₹	Budgeted Sales ₹	Actual Sales ₹	Short Sales ₹
November	80,000	88,000 *	Nil	88,000
December	1,10,000	1,21,000*	Nil	1,21,000
January	1,20,000	1,32,000*	32,000	1,00,000
				3,09,000

Rate of Gross Profit on Sales = $\frac{\text{G.P. (Net Profit + Standing Charges)}}{\text{Sales/Turnover}}$ x 100

= (₹ 5,00,000/ ₹ 15,00,000) × 100 = $33^1/_3$%

∴ Claim for Loss of Profit will be = ₹ 3,09,000 × $33\frac{1}{3}$ % = ₹ 1,03,000

Add: Additional Expenses = ₹ 7,000

₹ 1,10,000

* [80,000 + 50% of 16,000 (96,000 – 80,000)]

** [1,10,000 + 50% of 22,000 (1,32,000 – 1,10,000)]

***[1,20,000 + 50% of 24,000 (1,44,000 – 1,20,000)]

Illustration 65.

From the following particulars, you are required to prepare a statement of claim for O.K. Ltd., whose business premises was partly destroyed by fire:

Sum insured (from 31st December, 2011)	₹ 2,00,000
Period of indemnity	12 months
Date of damage	1st. January 2012
Date on which disruption of business ceased	31st October 2012

The subject matter of the policy was gross profit, but only net profit and certain standing charges are included:

The books of account revealed as:

(a) The gross profit for the financial year 2011 was ₹ 1,80,000.

(b) The actual turnover for financial year 2011 was ₹ 6,00,000 which was also the turnover in this case.

(c) The turnover for the period 1st January to 31st October, in the year preceding the loss, was ₹ 5,00,000.

During dislocation of the position, it was learnt that in November-December 2011, there has been an upward trend in business done (compare with the figure of the previous years) and it was stated that has the loss not occurred, the trading results for 2012 would have been better than those of the previous years.

The Insurance company official appointed to assess the loss accepted this view and adjustments were made to the pre-damaged figures to bring them up to the estimated amounts which would have resulted in 2012 but for the fire.

The pre-damaged figures to bring them up to the estimated amounts which would have resulted in 2012 but for the fire.

The pre-damaged figures together with agreed adjustments were:

Turnover for 2011

Period	Pre-damaged figures ₹	Adjustment to be added ₹	Adjusted standard turnover ₹
January	45,000	5,000	50,000
Feb. to Oct.	4,55,000	25,000	4,80,000
Nov. to Dec.	1,00,000	5,000	1,05,000
	6,00,000	35,000	6,35,000
Gross Profit	1,80,000	23,200	2,03,200

Rate of Gross Profit 30% (Actual for 2011), 32% (adjusted for 2012).

Increased cost of working amounted to ₹ 90,000.

There was a clause in the policy relating to savings in insured standard charges during the indemnity period and this amounted to ₹ 14,000.

Standing Charges not covered by insurance amounted to ₹ 10,000 p.a. The annual turnover for January was nil and for the period February to October 2012 ₹ 4,00,000.

Solution:

Shortage in turnover

Period	Adjusted Standard Turnover ₹	Actual Turnover ₹	Shortage ₹
January	50,000	---	50,000
Feb. to October	4,80,000	4,00,000	80,000
	5,30,000	4,00,000	1,30,000

Amount of Claim

Particulars	Amount ₹
Reduction in turnover = ₹ 1,30,000 × (32/100) =	41,600
Add: Increased Cost of working:	85,778
$= \dfrac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Net Profit} + \text{All Standing Charges}} \times \text{Additional Expenses}$	
$= \dfrac{2{,}03{,}200}{1{,}03{,}200 + 10{,}000} \times ₹\ 90{,}000$	
	1,27,378
Less: Savings in Insured Standing Charges	14,000
	99,778

∴ Application of Average Clause = Amount of Claim x (Amount of Policy/G.P. of Annual Adjusted Turnover)

$$= ₹\ 99{,}778 \times \frac{₹\ 2{,}00{,}000}{₹\ 2{,}03{,}200}$$

$$= ₹\ 98{,}207$$

Illustration 66.

A Loss of Profit Policy was taken for ₹ 80,000. Fire occurred on 15th March 2012. Indemnity period was for three months. Net profit for 2011 year ending on 31st December was ₹ 56,000 and standing charges (all insured) amounted to ₹ 49,600. Determine insurance claims from the following details available from quarterly sales tax returns:

Particulars	2009 ₹	2010 ₹	2011 ₹	2012 ₹
From 1st June to 31st March	1,20,000	1,30,000	1,42,000	1,30,000
From 1st April to 30th June	80,000	90,000	1,00,000	40,000
From 1st July to 30th September	1,00,000	1,10,000	1,20,000	1,00,000
From 1st October to 31st Dec.	1,36,000	1,50,000	1,66,000	1,60,000

Sales from 16.03.2011 to 31.03.2011 were ₹ 28,000

,, ,, 16.03.2012 ,, 31.03.2012 ,, ₹ Nil

,, ,, 16.06.2011 ,, 31.06.2011 ,, ₹ 24,000 and

,, ,, 16.06.2012 ,, 31.06.2012 ,, ₹ 6,000

Solution:

Short Sales = Standard Sales[1] – Actual Sales during indemnity period

= 1,14,400 (i.e., ₹ 1,04,000 + 10%[3]) – ₹ 34,000[2]

= ₹ 80,400.

$$\text{Rate of Gross Profit} = \frac{56,000 + 49,600}{5,28,000}$$

= 20%

Gross Profit on short sales @ 20%

= 20% of 80,400 = ₹ 16,080

1. Standard Sales = Sales from 16.03.2011 to 31.03.2011 + Sales from 1.4.2011 to 15.6.2011 – Sales from 16.6.2011 to 30.6.2012

   = ₹ 28,000 + ₹ 1,00,000 – ₹ 24,000

   = ₹ 1,04,000.

2. Actual Sales = Sales from 16.03.2012 to 15.6.2012 + Sales from 1.4.2012 to 30.6.2012 – Sales from 16.6.2012 to 30.6.2012

   = ₹ Nil + ₹ 40,000 – ₹ 6,000

   = ₹ 34,000

3. Percentage of Increasing trend in Sales:

Total Sales for 2009 (₹ 1,20,000 + ₹ 80,000 + ₹ 1,00,000 + ₹ 1,36,000) = ₹ 4,36,000

,, ,, ,, 2010 (₹ 1,30,000 + ₹ 90,000 + ₹ 1,10,000 + ₹ 1,50,000) = ₹ 4,80,000

,, ,, ,, 2011 (₹ 1,42,000 + ₹ 1,00,000 + ₹ 1,20,000 + ₹ 1,66,000) = ₹ 5,28,000

$$\text{Now, Percentage of Increase in Sales in 2010 over 2009} = \frac{₹\ 44,000}{₹\ 4,36,000} \times 100 = 10\%$$

$$\text{Percentage of Increase in Sales in 2011 over 2010} = \frac{₹\ 48,000}{₹\ 4,80,000} \times 100 = 10\%$$

$$\therefore \text{Average Rate is } \frac{10\% + 10\%}{2} = 10\%$$

Application of Average Clause = Amount of Claim x (Amount of Policy/G.P. on Annual Adjusted Turnover)

$$= ₹\ 16,080 \times \frac{₹\ 80,000}{₹\ 1,19,680}$$

= ₹ 10,749 (approx).

Particulars	Amount ₹
Calculation of G.P. on Annual (Adjusted) Turnover	
Sales from 16.03.2011 to 31.03.2011	28,000
Sales from 01.04.2011 to 30.06.2011	1,00,000
Sales from 01.07.2011 to 30.09.2011	1,20,000
Sales from 01.10.2011 to 31.12.2011	1,66,000
Add: 01.01.2012 to 15.03.2012	1,30,000
	5,44,000
Add: 10% Increase	54,400
Adjusted Sales	**5,98,400**

∴ G.P. on Adjusted Sales = ₹ 5,98,400 x 20% = ₹ 1,19,680.

Loss of Stock and consequent Loss of Profit

Illustration 67.

XY Ltd. give the following Trading and Profit and Loss Account for the year ended 31st December, 2012.

Trading and Profit and Loss Account
for the year ended 31December, 2012

Particulars	Amount ₹	Particulars	Amount ₹
To Opening Stock	25,000	By Sales	4,00,000
,, Purchase	1,50,000	,, Closing Stock	35,000
,, Wages (₹ 20,000 for skilled workers)	80,000		
,, Manufacturing Expenses	60,000		
,, Gross Profit	1,20,000		
	4,35,000		4,35,000
,, Other Administration Expenses	30,000	By Gross Profit	1,20,000
,, Advertising	10,000		
,, Selling Expenses (fixed)	20,000		
,, Commission on Sales	24,000		
,, Carriage Outwards	8,000		
,, Net Profit	28,000		
	1,20,000		**1,20,000**

The company had taken out policies both against loss of stock and against loss of profit, the amounts being ₹ 40,000 and ₹ 86,000. Fire occurred on 1st May 2013 and, as a result of which, sales were seriously affected for the period of 4 months. You are given the following further information:

(a) Purchases, wages and other manufacturing expenses for the first 4 months of 2013 were ₹ 50,000; ₹ 25,000 and ₹ 18,000, respectively.

(b) Sales for the same period were ₹ 1,20,000

(c) Other sales figure were as follows:

Particulars	Amount ₹
From 01.01.2012 to 30.04.2012	1,50,000
,, 01.05.2012 to 31.08.2012	1,80,000
,, 01.05.2013 to 31.08.2013	30,000

(d) Due to rise in wages net profit during 2013 was expected to decline by 2% on sales.

(e) Additional expenses incurred during the period after fire amounted to ₹ 70,000. The amount of the policy included ₹ 60,000 for expenses leaving ₹ 10,000 uncovered. Ascertain the claim for stock and for loss of profit.

Solution:

A. **Claim for Loss of Stock**

Trading Account

for the year ended 1st January to 1st May, 2013

Dr. **Cr.**

Particulars	Amount ₹	Particulars	Amount ₹
To Opening Stock	35,000	By Sales	1,50,000
,, Purchase	50,000	,, Closing Stock (bal. fig.)	11,600
,, Wages	25,000		
,, Manufacturing Expenses	18,000		
,, Gross Profit @ 28%[1] on sales	33,600		
	1,61,600		1,61,600

Claim for Loss of Stock will be ₹ 40,000 (i.e., the amount of policy and not more).

1. G.P. of 2012 = $\frac{₹\ 1,20,000}{₹\ 4,00,000} \times 100$ = 30% - 2% decrease = 28%

B. **Loss of Profit**

Short Sales = Standard Sales – Actual Sales during indemnity period

= ₹ 1,44,000 – ₹ 30,000

= ₹ 1,14,000

	₹	₹
Sales from 1.5.2012 to 31.8.2012	1,80,000	
Less: 20% reduction in 2013 over 2012 ($\frac{₹ 30,000}{₹ 1,50,000} \times 100$)	36,000	
	1,44,000	
Gross Profit on Short Sales = 20% on ₹ 1,14,000		22,800
Add: Increased Cost of Workings:		
Least of the following	₹	
(i) Actual Amount	70,000	
(ii) G.P. on additional sales ₹ 30,000 × 20%	6,000	
(iii) Addl. Exp. × $\frac{\text{G.P.}}{\text{G.P. Uninsured Charges}}$		
$= ₹ 70,000 \times \frac{₹ 59,200^2}{₹ 69,200}$	59,885	6,000
Amount of Claim		28,800

Note: As the policy amount (i.e., ₹ 86,000) is higher than the Gross Profit (i.e., ₹ 59,200) question of average clause will not arise.

Workings:

1. Percentage of G.P. on Sales for 2012 **:** G.P. =N.P. + Insured Standing Charges

= ₹ 28,000 + ₹ 60,000

= ₹ 88,000

$\therefore$ G.P. Ratio = $\frac{₹ 88,000}{₹ 4,00,000} \times 100$ = 22% - 2% decrease for wages

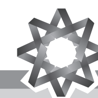
= 20%

2. G.P. (Adjusted) on Annual Turnover:

Sales (1.1.2012 to 31.12.2012) +		
(1.1.2013 to 30.4.2013)	=	₹ 4,00,000 + ₹ 1,20,000
	=	₹ 5,20,000
Less: from 1.1.2012 to 30.4.2012	=	₹ 1,50,000
		₹ 3,70,000
Less: Reduced by 20%	=	₹ 74,000
	=	**₹ 2,96,000**
$\therefore$ G.P. on ₹ 2,96,000 x 20%	=	**₹ 59,200**

Study Note - 12

BANKING, ELECTRICITY AND INSURANCE COMPANIES



This Study Note includes

12.1 Accounting of Banking Companies

12.2 Accounting of Electricity Companies

12.3 Accounting of Insurance Companies

12.1 ACCOUNTING OF BANKING COMPANIES

A bank is a commercial institution, licensed to accept deposits and acts as a safe custodian of the spendable funds of its customers. Banks are concerned mainly with the functions of banking, i.e., receiving, collecting, transferring, buying, lending, investing, dealing, exchanging and servicing (safe deposit, custodianship, agency, trusteeship) money and claims to money both domestically and internationally. The principal activities of a bank are operating current accounts, receiving deposits, taking in and paying out notes and coins, and making loans.

Banking activities undertaken by banks include personal banking (non-business customers), commercial Banking (small and medium-sized business customers) and corporate banking (large international and multinational corporations).

According to Charles J. Woelfel:

A complete banking service would comprehend a variety of functions, including any of the following:

(1) Receive demand deposits and pay customers' cheques drawn against them, and operate Automated Teller Machines (ATM);

(2) Receive time and savings deposits, issue negotiable orders of withdrawal, and pay interest thereon, as well as provide Automatic Transfer Service (ATS) for funds from serving accounts to cover cheques;

(3) Discount notes, acceptances and bills of exchange;

(4) Supply credit to business firms with or without security, issue letters of credit and accept bills drawn thereunder;

(5) Transfer money at home and abroad;

(6) Make collections and facilitate exchanges;

(7) Issue drafts, cashier's cheques, money orders, and certify cheques;

(8) Furnish safe deposit vault service;

(9) Provide custodianship for securities and other valuables;

(10) Provide personal loans, credit and services to individuals, and lend or discount customer installment receivables of vendors;

(11) Act in a fiduciary capacity for individuals, as well as establish common trust funds;

(12) Provide corporate trust services (stock transfer agent, registrar, paying agent, escrow agent, and indenture trustee);

(13) Act as factors and engage in equipment leasing;

(14) Deal in Government securities and underwrite general obligations of state and municipal securities;

(15) Invest in government and other debt securities;

(16) Act as fiscal agent or depository for the Central Government, states and subdivisions of states;

(17) Provide miscellaneous services such as place orders in securities for customers; act as insurance agent of incidental to banking transactions; serve as finder to bring buyers and sellers together; act as travel agent and issue letters of credit and traveler's cheques; provide club accounts and other special purpose accounts; act as agent for accepting service of legal process of incidental normal banking or fiduciary transactions of the bank; act as pay role issuer; establish charitable foundations, invest in small business investment corporations and bank service corporations; deal in foreign exchange; buy and sell gold bullion under license from the Treasury Department, and foreign coin; provide domestic and international correspondent banking services, etc.

In India, banking activities are governed by The Banking Regulation Act, 1949. As per the provisional Section 5(b) of the said Act, "banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or other-wise, and withdrawable by cheque, drafts, order or otherwise.

Section 5(c) defines "Banking Companies" as any company which transacts the business of banking in India. However, any company which is engaged in the manufacture of goods or carries on any trade and which accept deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause.

Business of Banking Companies

As per the provision of Section 6 of the Banking Regulation Act, 1949, a banking company may engage in any one or more of the following forms of business, in addition to the business of banking. These are:

(a) The borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments, and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveler's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes: the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise, the providing of safe deposit vaults; the collecting and transmitting of money and securities;

(b) Acting as agents for any Government or local authority or any other person or persons; the carrying on of agency business of any description, including the clearing and forwarding of goods, giving of receipts and discharges, and otherwise acting as an attorney on behalf of customers; but excluding the business of a managing agent or secretary and treasurer of a company;

(c) Contracting for public and private loans and negotiating and issuing the same;

(d) The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock, debentures, or debenture stock of any company, corporation or association, and the lending of money for the purpose of any such issue;

(e) Carrying on and transacting every kind of guarantee and indemnity business;

(f) Managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

(g) Acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(h) Undertaking and executing trusts;

(i) Undertaking the administration of estates as executor, trustee or otherwise;

(j) Establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependants or connections of such persons; granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing money for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

(k) The acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company;

(l) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account, or otherwise dealing with all or any part of the property and rights of the company;

(m) Acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this sub-section;

(n) Doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

(o) Any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

Restriction on Business of Banking Company

Section 8 of the Banking Regulation Act, 1949, imposes certain restrictions on the business of a banking company. These are as follows:

(i) No banking company shall directly or indirectly deal in the buying, selling or bartering of goods, except in connection with the realisation of security given to or held by it;

(ii) No banking company can engage in any trade, or buy, sell or barter goods for others otherwise than in connection with bills of exchange received for collection or negotiation or with such of its business or is referred to in clause (i) of sub-section (1) of section 6.

Some Important Provisions of the Banking Regulation Act, 1949

Time limit for disposal of Non-banking Assets (Section – 9)

Non-banking assets must be disposed off within 7 years from the date of acquisition or period extended by RBI.

Minimum paid up capital and reserve [Section 11]

Banking Company	Minimum Aggregate Value of Paid up Capital and Reserve
1. **In case of a Banking Company incorporated outside India:** (a) having a place(s) of business in the city of Mumbai or Kolkata or both (b) not having a place(s) of business in the city of Mumbai or Kolkata or both	₹ 20 lacs ₹ 15 lacs

2. **In case of a banking company incorporated in India:**	
(a) having place of business in more than one State including place(s) business in the city of Mumbai or Kolkata or both	₹ 10 lacs
(b) having all its places of business in one state and none of which is in the city of Mumbai or Kolkata	₹ 1 lac + ₹ 10,000 for each of other places of business in the district in which it has its principal place of business + ₹ 25,000 for each place of business elsewhere in the state subject of maximum of ₹ 5 lacs

Restriction as to payment of dividend [Sections 15 (1) and (2)]

Before paying any dividend, a banking company has to write off completely all its capitalised expenses including preliminary expenses, organisation expenses, share-selling commission, brokerage, and amounts of losses incurred by tangible assets. However, a banking company may pay dividend on its shares without writing off:

1. the depreciation in the value of its investment in approved securities in any case where such depreciation has not actually been capitalised or accounted for as a loss;
2. the depreciation in the value of its investment in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;
3. the bad debts in any case where adequate provision for such debts had been made to the satisfaction of the auditor of the banking company.

Minimum transfer of profits to reserve fund [Section 17]

Every banking company incorporated in India is required to transfer at least 25% of its profit to the reserve fund.

The profit of the year as per the profit and loss account prepared u/s 29 is to be taken as base for the purpose of such transfer and transfer to reserve fund should be made before declaration of any dividend.

If any banking company makes any appropriation from the reserve fund or securities premium account, it has to report to the Reserve Bank of India the reasons for such appropriation within 21 days.

Cash Reserve (Section 18)

Every non-scheduled bank has to maintain a cash reserve at least to the extent of at % prescribed (by RBI) of its demand and time liabilities in India on the last Friday of the second preceding fortnight.

Cash reserve can be maintained by way of a balance in the Current Account with the Reserve Bank or by way of net balance in current accounts.

Restrictions on Loans and Advances (Section 20)

No banking company shall

(a) grant any loans or advances on the security of its own shares, or

(b) enter into any commitment for granting any loan or advance to or on behalf of

   (i) Any of its directors,

   (ii) Any firm, in which any of its directors is interested as partner, manager, employee or guarantor, or

   (iii) Any company (not being a subsidiary of the banking company or a company registered under Section 25 of the Companies Act, 1956 or a Government Company) of which any

of the directors of the banking company is a director, manager, employee or guarantor or in which he holds substantial interest, or

(iv) Any individual, in respect of whom any of its directors is a partner or guarantor.

Liquidity norms (Section 24)

Every banking company has to maintain in cash, gold or unencumbered approved securities, an amount at % prescribed (by RBI) of its demand and time liabilities in India.

However, this percentage is changed by the Reserve Bank of India from time to time considering the general economic conditions.

This is in addition to the average daily balance which a scheduled bank is required to maintain under Section 42 of the Reserve Bank of India Act, and in case of other banking companies, the cash reserve required to be maintained under Section 18 of the Banking Regulation Act.

Unclaimed deposits

Every banking company is required to submit a return in the prescribed form and manner to the Reserve Bank of India at the end of each calendar year of all accounts in India which could not be operated for 10 years.

This report is to be submitted within 30 days after the close of each calendar year.

In case of fixed deposit, such 10 years are to be reckoned from the date of expiry of the fixed period.

Bank's Book-Keeping System

Entering transactions in the ledger directly from vouchers Under bank's Bookkeeping system, every transaction particularly concerning the customers is entered in the personal ledger directly from vouchers as soon as it takes place.

The objective of the system is

(a) to keep up-to-date detailed ledgers,

(b) to balance the trial balance every day,

(c) to keep all control accounts in agreement with the detailed ledgers.

Main Characteristics of a Bank's Book-Keeping System

The main characteristics of a bank's system of book-keeping are as follows:

Voucher Posting	Entries in the personal ledger are made directly from vouchers instead of being posted from the books of prime entry.
Voucher Summary Sheets	The vouchers entered into different personal ledgers each day are summarised on summary sheets, totals of which are posted to the control accounts in the general ledger.
Daily Trial Balance	The general ledger trial balance is extracted and agreed everyday.
Continuous Checks	All entries in the detailed personal ledgers and summary sheets are checked by persons other than those who have made the entries. A considerable force of such check is employed, with the general result that most clerical mistakes are detected before another day begins.
Control Accounts	A trial balance of the detailed personal ledgers is prepared periodically, usually every two weeks, agreed with general ledger control accounts.
Double Voucher System	Two vouchers are prepared for every transaction not involving cash-one debit voucher and another credit voucher.

Book of Accounts

1. **General Ledger**	The General Ledger contains: (a) Control Accounts of all personal ledgers. (b) Profit and Loss Account. (c) Assets' Accounts. (d) Contra Accounts. **Usefulness** It facilitates the preparation of Balance Sheet.
2. Profit and Loss Ledger	The Profit and Loss Ledger contains: (a) Detailed Accounts of Revenue items. (b) Detailed Accounts of Expense items. **Usefulness** It facilitates the preparation of Profit and Loss Account.

Principal Books of Accounts

Subsidiary Books

1. Personal Ledgers	(a) Current Accounts Ledger. (b) Saving Bank Accounts Ledgers. (c) Fixed Deposit (often further classified by length of period of deposit) Ledgers. (d) Loan Ledger. (e) Overdraft Ledger. (f) Cash Credit Ledger. (g) Customers' Acceptances, Endorsements and Guarantee Ledgers.
2. Bill Registers	(a) Inward Bills for Collection. (b) Outward Bills for Collection. (c) Bills Discounted and Purchased Register.

Subsidiary Registers

1. Demand Drafts, Telegraphic Transfers and Mail Transfers issued on Branches and Agencies.
2. Demand Drafts, Telegraphic Transfers and Mail Transfers received from Branches and Agencies.
3. Letters of Credit.
4. Letters of Guarantee

Memoranda Books

1. Departmental Journals	Maintain a record of all the transfer entries originated by each department
2. Cash Department's	(a) Receiving Cashiers' Cash Book (pay-in-slips are vouchers). (b) Paying Cashiers' Cash Book (Bearer Cheques/drafts etc. are vouchers). (c) Main Cash Book (by person other than cashier). (d) Cash Balance Book.
3. Clearing Department's	(a) Outward Clearing (for cheques received from customers): (i) Clearing Cheques Received Book. (ii) Bank wise List of above Cheques (one copy of which is sent to the clearing house together with cheques). (b) Inward Clearing (for cheques issued by customers received from other Banks).
4. Loans and Overdraft Departments'	(a) Registers for shares and other securities held on behalf of each customer. (b) Summary Books of Securities giving details of Government securities, shares of individual companies etc. (c) Godown registers maintained by the godown-keeper of the bank. (d) Price register giving the wholesale price of the commodities pledged with the bank. (e) Overdraft Sanction register. (f) Drawing Power book. (g) Delivery Order books. (h) Storage books.
5. Deposits Department	(a) Account Opening and Closing registers. (b) For Fixed Deposits, Rate register giving analysis of deposits according to rates. (c) Due Date Diary. (d) Specimen signature book.

6. Establishment department	(a) Salary and allied registers, such as attendance register, leave register, overtime register, etc. (b) Register of fixed assets, e.g. furnitures and fixtures, motor cars, vehicles, etc. (c) Stationery registers. (d) Old records register.
7. General	(a) Signature book of bank's officers. (b) Private Telegraphic Code and Cyphers.

Statistical Books

(a) To record Average Balance in Loan and Advances etc.
(b) To record Deposits received and amount paid out each month in the various departments.
(c) Number of Cheques paid.
(d) Number of Cheques, Drafts, Bills etc. collected.

THE THIRD SCHEDULE

(See Section 29)

Form 'A'

FORM OF BALANCE SHEET

Balance Sheet of .....

Balance Sheet as on 31st March.....

('000 omitted)

	Schedule No.	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
Capital and Liabilities			
Capital	1		
Reserves & Surplus	2		
Deposits	3		
Borrowings	4		
Other Liabilities and Provisions	5		
Total			
Assets			
Cash and balances with RBI	6		
Balances with banks and money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total			
Contingent liabilities Bills for collection	12		

FORM B

FORM OF PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH

	Schedule No.	Year ended 31.3 (Current Year)	Year ended 31.3 (Previous Year)
I. Income			
Interest earned	13		
Other Income	14		
Total			
II. Expenditure			
Interest Expended	15		
Operating Expenses	16		
Provision and contingencies			
Total			
III. Profit /Loss			
Net Profit/(Loss) (–) for the year			
Profit/(Loss) (–) brought forward			
Total			
Transfer to statutory reserve			
Transfer to other reserve Proposed Dividend			
Balance carried forward to Balance sheet			
Total			

Note: 1. The total income includes income of foreign branches at ₹ _

2. The total expenditure includes expenditure of foreign branches at ₹___

3. Surplus / Deficit of foreign branches ₹_____

SCHEDULES

Details of all schedules are in below:

A. Capital and Liabilities

1. **Capital**
2. **Reserve and Surplus**: It includes Statutory Reserve, Capital Reserve, Security Premium, Revenue and other Reserve and Profit and Loss Account balance.
3. **Deposits**: It includes Demand Deposits, Savings Bank Deposits and Term Deposits.
4. **Borrowings:** (i) It includes Borrowings from Reserve Bank of India, other banks, others institutions and agencies. (ii) Borrowing outside India.
5. **Other Liabilities and Provisions**: It includes Bills payable, inter-office adjustments (net), interest accrued, others (including provisions) provision for bad debts, provision for taxation.

B. Assets

6. **Cash and Balances with Reserve Bank of India**: Cash in hand (including foreign currency notes); and balances with Reserve Bank of India are shown under this item.
7. **Balances with Banks and Money at Call and Short Notice**: In India Balances with banks; money at call and short notice are shown under this item.

   Outside India — Current Account other Deposit Accounts, Money at call and short notice.
8. **Investments:** Investment in Government securities, other approved securities, shares, debentures and bonds, subsidiaries and /or joint ventures, others, gold etc., are shown under this item.
9. **Advances**: Bills purchased and discounted, cash credit, overdrafts and loans payable on demand; and term loans etc. are shown under this item.
10. **Fixed Assets**: Premises, other fixed assets (including furniture and fixtures) are shown under this item.
11. **Other Assets**: Inter-office adjustments, interest accrued, tax paid in advance, stationery and stamps, non-banking assets acquired in satisfaction of claims are shown under this item.
12. **Contingent Liabilities**: It is shown by way of a footnote. It represents liabilities not provided in the Balance Sheet.

Profit and Loss Account

Profit and Loss Account of a banking company is also prepared in vertical form. 'Form B' of the Third Schedule of the Banking Regulation Act, 1949 is to be used for preparing Profit and Loss Account. It is divided into four sections:

I. Income;

II. Expenditure;

III. Profit/Loss; and

IV. Appropriations.

C. Income:

The schedules of Income are:

13. **Interest Earned**. It includes interest/discount on advances/bills, income on investments, interest on balances with RBI etc. It should be noted that according to the new form, bad debts and provision for bad debts, other provisions are not to be deducted from the interest earned. For greater transparency in accounts, these items are shown as separate items in the Profit and Loss Account.
14. **Other income**. It includes commission, exchange and brokerage, profit on sale of investments, profit on revaluation of investments, profit on sale of land, building and other assets, profit on exchange transaction, and income earned by way of dividends from subsidiaries, etc.

D. Expenditure

15. **Interest expended**. Interest paid on deposits, interest on RBI borrowings; interest on inter- bank borrowings, etc., are shown under this item.
16. **Operating expenses**. Salaries and wages of staff; rent, rates and taxes; printing and stationery; advertisement; depreciation on banks' properties; director's fees; auditor's fees; law charges; postage; repairs; insurance; etc., are shown under this item.

    Third item of this section is provisions and contingencies. Provision for bad debts, provision for taxation and other provisions are shown under this item.

III. Profit/Loss

In this section, profit/loss for the current year (difference between income and expenditure explained above) and brought forward profit/loss are shown.

IV. Appropriations

In this section, amount transferred to statutory reserve as per Section 17; amount transferred to other reserve; proposed dividend, etc., are shown. The balance is transferred to the Balance Sheet.

Schedule 17 is Notes to Accounts and Schedule 18 is Principal Accounting Policies.

FORM OF SCHEDULES

SCHEDULE 1 - CAPITAL

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. For Nationalised Banks		
Capital (Fully owned by Central Government)		
II. For Banks Incorporated Outside India		
Capital		
(i) (The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head)		
(ii) Amount of deposit kept with the RBI under Section 11(2) of Banking Regulation Act, 1949		
Total		
III. For Other Banks		
Authorised Capital		
.... shares of ₹ .... each		
Issued Capital		
.... shares of ₹ .... each		
Subscribed Capital		
.... shares of ₹ .... each		
Called-up Capital		
.... shares of ₹ .... each		
Less: Calls unpaid		
Add: Forfeited shares		

SCHEDULE 2 - RESERVES AND SURPLUS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Statutory Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
II. Capital Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
III. Securities Premium		
Opening Balance		
Additions during the year		
Deductions during the year		
IV. Revenue and other Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
V. Balance in Profit and Loss Account		
Total (I + II + III + IV + V)		

SCHEDULE 3 - DEPOSITS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
A. I. Demand Deposits		
(i) From banks		
(ii) From otners		
II. Savings Bank Deposits		
III. Term Deposits		
(i) From banks		
(ii) From others		
Total (I + II + III)		
B. (i) Deposits of branches in India		
(ii) Deposits of branches outside India		
Total		

SCHEDULE 4 - BORROWINGS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Borrowings in India		
(i) Reserve Bank of India		
(ii) Other Banks		
(iii) Other Institution and agencies		
II. Borrowings Outside India		
Total (I + II)		
Secured borrowings in I and II above. ₹…..		

SCHEDULE 5 - OTHER LIABILITIES AND PROVISIONS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Bills Payable		
II. Inter-Office adjustments (net)		
III. Interest accrued		
IV. Others (Including Provisions)		
Total		

SCHEDULE 6 - CASH AND BALANCES WITH RESERVE BANK OF INDIA

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Cash in hand (including foreign currency notes)		
II. Balances with RBI		
(i) in Current Account		
(ii) in Other Accounts		
Total (I + II)		

SCHEDULE 7 - BALANCES WITH BANKS AND MONEY AT CALL & SHORT NOTICE

Particulars	As on 31.3. (Current Year)	As on 31.3 (Previous Year)
I. In India		
(i) Balances with Banks		
(a) In Current Accounts		
(b) In Other Deposit Accounts		
(ii) Money at Call and Short Notice		
(a) With Banks		
(b) With other institutions		
Total (i + ii)		
II. Outside India		
(i) in Current Accounts		
(ii) in Other Deposit Accounts		
(iii) Money at Call and Short Notice		
Total (i + ii + iii)		
Grand Total (I + II)		

SCHEDULE 8 - INVESTMENTS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Investments in India		
(i) Government Securities		
(ii) Other Approved Securities		
(iii) Shares		
(iv) Debentures and Bonds		
(v) Subsidiaries and/or Joint Ventures		
(vi) Others (to be specified)		
Total		
II. Investments Outside India		
(i) Government securities (including local authorities)		
(ii) Subsidiaries and/or Joint Ventures abroad		
(iii) Other investments (to be specified)		
Total		
Grand Total (I + II)		

SCHEDULE 9 - ADVANCES

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
A. (i) Bills Purchased and Discounted		
(ii) Cash Credits, Overdrafts and Loans Payable on Demand		
(iii) Term Loans		
Total		
B. (i) Secured by Tangible Assets		
(ii) Covered by Bank/Government Guarantees		
(iii) Unsecured		
Total		
C. I. Advances in India		
(i) Priority Sectors		
(ii) Public Sector		
(iii) Banks		
(iv) Others		
Total		
II. Advances Outside India		
(i) Due from Banks		
(ii) Due from others		
(a) Bills Purchased and Discounted		
(b) Syndicated Loans		
(c) Others		
Total		
Grand Total (C. I and II)		

SCHEDULE 10 - FIXED ASSETS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Premises		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
II. Other Fixed Assets (including Furniture and Fixtures)		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
Grand Total (I + II)		

SCHEDULE 11 - OTHER ASSETS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Inter-Office Adjustments (net)		
II. Interest Accrued		
III. Tax paid in Advance / Tax deducted at source		
IV. Stationery and Stamps		
V. Non-banking assets acquired in satisfaction of claims		
VI. Others		
Total		

SCHEDULE 12 - CONTINGENT LIABILITIES

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Claims against the bank not acknowledged as debts		
II. Liability for partially paid investments		
III. Liability on account of outstanding forward exchange contracts		
IV. Guarantees given on behalf of constituents		
(a) In India		
(b) Outside India		
V. Acceptances, endorsements and, other obligations		
VI. Other items for which the bank is contingently liable		
Total		

SCHEDULE 13 -INTEREST EARNED

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Interest /discount on advances /bills		
II. Income on investments		
III. Interest on balances with Reserve Bank of India and other inter-bank funds		
IV. Others		
Total		

SCHEDULE 14 - OTHER INCOME

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Commission, exchange and brokerage		
II. Profit on sale of investments		
Less: Loss on sale of investments		
iii. Profit on revaluation of investments		
Less: Loss on revaluation of investments		
IV. Profit on sale of land, buildings and other assets		
Less: Loss on sale of land, buildings and other assets		
V. Profit on exchange transactions		
Less: Loss on exchange transactions		
VI. Income earned by way of dividends etc., from subsidiaries/ companies and/or joint ventures abroad / in India		
VII. Miscellaneous Income		
Total		

SCHEDULE 15 - INTEREST EXPENDED

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Interest on deposits		
II. Interest on Reserve Bank of India /inter-bank borrowings		
III. Others		
Total		

SCHEDULE 16 - OPERATING EXPENSES

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Payments to and provisions for employees		
II. Rent, taxes and lighting		
III. Printing and stationery		
IV. Advertisement and publicity		
V. Depreciation on Bank's property		
VI. Directors' fees, allowances and expenses		
VII. Auditors' fees and expenses (including branch auditors fees and expenses)		
VIII. Law Charges		
IX. Postages, Telegrams, Telephones, etc.		
X. Repairs and maintenance		
XI. Insurance		
XII. Other expenditure		
Total		

@ In case there is any unadjusted balance of loss, the same may be shown under this item with appropriate foot-note.

Disclosure of Accounting Policies

In order to show that the financial position of banks represent a true and fair view, the Reserve Bank of India has directed the banks to disclose the accounting policies regarding the key areas of operations along with the notes of account in their financial statements for the accounting year ending 31.3.1991 and onwards, on a regular basis. The accounting policies disclosed may contain the following aspects subject to modification by individual banks:

(1) General

The accompanying financial statements have been prepared on the historical cost and conform to the statutory provisions and practices prevailing in the country.

(2) Transactions involving Foreign Exchange

(a) Monetary assets and liabilities have been translated at the exchange rates, prevailing at the close of the year. Non-monetary assets have been carried in the books at the historical cost.

(b) Income and expenditure items in respect of Indian branches have been translated at the exchange rates, ruling on the date of the transaction and in respect of overseas branches at the exchange rates prevailing at the close of the year.

(c) Profit or loss on pending forward contracts has been accounted for.

(3) Investments

(a) Investments in Governments and other approved securities in India are valued at the lower of cost or market value.

(b) Investments in subsidiary companies and associate companies (i.e., companies in which the bank holds at least 25 per cent of the share capital) have been accounted for on the historical cost basis.

(c) All other investments are valued at the lower of cost or market value.

(4) Advances

(a) Provisions for doubtful advances have been made to the satisfaction of the auditors:

(i) In respect of identified advances, based on a periodic review of advances and after taking into account the portion of advance guaranteed by the Deposit Insurance and Credit Guarantee Corporation, the Export Credit and Guarantee Corporation and similar statutory bodies.

(ii) In respect of general advances, as a percentage of total advances taking into account the guidelines issued by the Government of India and the Reserve Bank of India.

(b) Provisions in respect of doubtful advances have been deducted from the advances to the extent necessary and the excess have been included under "Other Liabilities and Provisions".

(c) Provisions have been made on a gross basis. Tax relief, which will be available when the advance is written-off, will be accounted for in the year of write-off.

(5) Fixed Assets

(a) Premises and other fixed assets have been accounted for at their historical cost. Premises which have been revalued are accounted for at the value determined on the basis of such revaluation made by the professional values, profit arising on revaluation has been credited to Capital Reserve.

(b) Depreciation has been provided for on the straight line/diminishing balance method.

(c) In respect of revalued assets, depreciation is provided for on the revalued figures and an amount equal to the additional depreciation consequent of revaluation is transferred annually from the Capital Reserve to the General Reserve/Profit and Loss Account.

(6) Staff Benefits

Provisions for gratuity/pension benefits to staff have been made on an accrual/casual basis. Separate funds for gratuity/pension have been created.

(7) Net Profit

(a) The net profit disclosed in the Profit and Loss Account is after:

(i) Provisions for taxes on income, in accordance with the statutory requirements.

(ii) Provisions for doubtful advances.

(iii) Adjustments to the value of "current investments" in Government and other approved securities in India, valued at lower of cost or market value.

(iv) Transfers to contingency funds.

(v) Other usual or necessary provisions.

(b) Contingency funds have been grouped in the Balance Sheet under the head "Other Liabilities and Provisions".

SOME SPECIAL TRANSACTIONS

Interest on Doubtful Debts

When a debt is found to be doubtful at the end of the accounting year, a question may arise whether the interest on that should be credited to Interest Account or not. There is no doubt that interest has accrued; but it is equally clear that the realisation of this interest is doubtful.

Therefore, as a prudent accounting policy, such interest should be transferred to Interest Suspense Account by means of the following entry:

Loan Account	Dr.
To Interest Suspense Account	

In the Balance Sheet, it should be shown on the liability side.

Next year, if a part of interest is realised and the balance becomes bad, the following entry should be passed

Interest Suspense Account	Dr. [Total interest]
To Interest Account	[Interest realised]
To Loan Account	[Interest unrealized]

It should be noted that if a debtor becomes insolvent, the bank should not take interest into account after the date of insolvency.

Illustration 1:

When closing the books of a bank on 31.12.2012 you find in the loan ledger an unsecured balance of ₹ 2,00,000 in the account of a merchant whose financial condition is reported to you as bad and doubtful. Interest on the same account amounted to ₹ 20,000 during the year.

How would you deal with this item of interest in 2012 account?

During the year 2013, the bank accepts 75 paise in the rupee on account of the total debt due up to 31.12.2012.

Show the entries and the necessary accounts showing the ultimate effect of the transactions in 2013 books of account under Interest Suspense Method.

Solution:

Under Interest Suspense Method

When preparing the 2012 accounts the sum of ₹ 20,000 due from the merchant on account of interest should not be carried to Profit and Loss Account, because its recovery was doubtful. It should, therefore, be transferred to an Interest Suspense Account which would appear as a liability in Balance Sheet on 31.12.2012.

In the Books of Bank Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
2012 Dec. 31	Merchant A/c Dr. To Interest Suspense A/c (Interest due transferred to Interest Suspense A/c)		20,000	 20,000
	Interest Suspense A/c Dr. Bad Debts A/c Dr. To Merchant A/c (Interest not received and balances transferred to Bad Debts A/c)		5,000 50,000	 55,000
	Cash A/c Dr. To Merchant A/c (Amount received @ 0.75 p in the rupee from the merchant.)		1,65,000	 1,65,000
	Interest Suspense A/c Dr. To Profit and Loss A/c (Interest received out of Interest Suspense transferred)		15,000	 15,000

In the Books of the Bank

Dr. **Merchant's Account** ***Cr.***

Date	Particulars	₹	Date	Particulars	₹
2012 Dec. 31	To Balance b/d Int. Suspense A/c	2,00,000 20,000	2012 Dec. 31	By Balance c/d	2,20,000
		2,20,000			2,20,000
2013 Jan. 1	To Balance b/d	2,20,000		By Cash (Dividend @ 75p in the rupee)	1,65,000
				" Int. Suspense A/c (amount of Int. not covered)	5,000
			2013 Dec. 31	" Bad Debts	50,000
		2,20,000			2,20,000

Interest Suspense Account

Dr. *Cr.*

Date	Particulars	₹	Date	Particulars	₹
2012 Dec. 31	To Balance c/d	20,000	2012 Dec. 31	By Merchant's A/c	20,000
		20,000			20,000
2013 Dec. 31	To Merchant's A/c	5,000	2013 Jan. 1	By Balance b/d	20,000
	" Profit & Loss A/c	15,000			
		20,000			20,000

Notes:

1. Interest amounting to ₹20,000 due from customer has been debited to him by crediting Interest Suspense Account (and not to Interest A/c as its recovery is doubtful) and Interest Suspense A/c will appear in the liability side of the Balance Sheet.
2. Actual amount of interest which has been received in cash, i.e. ₹15,000, is transferred to P&LA/c.

Principal Accounting Policies :

(a) Foreign Exchange Transactions

(i) Monetary assets and liabilities have been translated at the exchange rate prevailing at the close of year. Non-monetary assets have been carried in the books at the historical cost.

(ii) Income and Expenditure items in respect of Indian branches need to be translated at the exchange rates on the date of transactions and in respect of foreign branches at the exchange rates prevailing at the close of the year.

(iii) Profit or Loss on foreign currency position including pending forward exchange contracts have been accounted for at the exchange rates prevailing at the closing of the year.

(b) Investment

Permanent category investments are valued at cost. Valuation of investment in current category depends on the nature of securities. While valuation of government securities held as current investments have been made on yield to maturity basis, the investments in shares of companies are valued on the basis of book value.

(c) Advances

Advances due from sick nationalised units under nursing programmes and in respect of various sticky, suit filed and decreed accounts have been considered good on the basis of–

(i) Available estimated value of existing and prospective primary and collateral securities including personal worth of the borrowers and guarantors.

(ii) The claim lodged/to be lodged under various credit guarantee schemes.

(iii) Pending settlement of claims by Govt.

Provisions to the satisfaction of auditors have been made and deducted from advances. Tax relief available when the advance is written off will be accounted for in the year of write-off.

(d) Fixed Assets

The premises and other fixed assets except for foreign branches are accounted for at their historical cost. Depreciation has been provided on written down value method at the rates specified in the Income Tax Rules, 1962. Depreciation in respect of assets of foreign branches has been provided as per the local laws.

Acceptance, Endorsement and Other Obligations

These are the liabilities of a bank which are taken by a bank on behalf of its customers and appear in the liabilities side of the Balance Sheet. For this purpose bank takes corresponding indemnities from its customers to avoid any trouble which may appear in future. In addition to that bank also takes adequate securities. These items are shown under the head Contingent Liabilities in Schedule – 12. These items include: Bills accepted by the bank on behalf of its customers, letter of credit etc.

Illustration 2:

From the following details prepare "Acceptances, Endorsements and other Obligation A/c" as would appear in the general ledger.

On 1.4.12 Acceptances not yet satisfied stood at ₹ 22,30,000. Out of which ₹ 20 lacs were subsequently paid off by clients and bank had to honour the rest. A scrutiny of the Acceptance Register revealed the following:

Client	Acceptances/ Guarantees	Remarks
	(₹)	
A	10,00,000	Bank honoured on 10.6.12
B	12,00,000	Party paid off on 30.9.12
C	5,00,000	Party failed to pay and bank had to honour on 30.11.12
D	8,00,000	Not satisfied upto 31.3.13
E	5,00,000	-do-
F	2,70,000	-do-
Total	42,70,000	

Solution:

Acceptances, Endorsements and other Obligation Account

(in general ledger)

Dr. **Cr.**

Date	Particulars	Amount (₹ '000)	Date	Particulars	Amount (₹ '000)
2012-13	To, Constituents' liabilities for acceptances/guarantees etc. (Paid off by clients)	20,00	1.4.11	By, Balance b/d	22,30

Date	Particulars	Amount (₹ '000)	Date	Particulars	Amount (₹ '000)
	To, Constituent's liabilities for acceptances/ guarantees etc (Honoured by bank ₹ 22.30 lakhs less ₹ 20 lakhs)	2,30	2012-13	By, Constituents liabilities for acceptances/ guarantees etc. A 10,00 B 12,00 C 5,00 D 8,00 E 5,00 F 2,70	42,70
10.6.12	To, Constituents' liabilities for acceptances / guarantees etc. (Honoured by bank)	10,00			
30.9.12	To, Constituents' liabilities for acceptances / guarantees etc. (Paid off by party)	12,00			
30.11.12	To, Constituent's liabilities for acceptances / guarantees etc. (Honoured by bank on party's failure to pay)	5,00			
31.3.13	To, Balance c/d (Acceptances not yet satisfied)	15,70			
		65,00			65,00

Illustration 3:

From the following details prepare "Acceptances, Endorsements and other Obligation A/c" as would appear in the general ledger.

On 1.4.12 Acceptances not yet satisfied stood at ₹ 33,45,000. Out of which ₹ 30 lacs were subsequently paid off by clients and bank had to honour the rest. A scrutiny of the Acceptance Register revealed the following:

Client	Acceptances/Guarantees	Remarks
	(₹)	
P	15,00,000	Bank honoured on 10.6.12
Q	18,00,000	Party paid off on 30.9.12
R	7,50,000	Party failed to pay and bank had to honour on 30.11.12
S	12,00,000	Not satisfied upto 31.3.13
T	7,50,000	-do-
X	4,05,000	-do-
Total	**64,05,000**	

Solution:

Acceptances, Endorsements and other Obligation Account
(in General Ledger)

(₹ '000)

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2012-13	To Constituents' liabilities for acceptances/guarantees etc. (Paid off by clients)	3,000	1.4.12	By, Balance b/d	3,345
	To Constituent's liabilities for acceptances/ guarantees etc. (Honoured by bank ₹ 33.45 lakhs less ₹ 30 lakhs)	345	2012-13	By, Constituents' liabilities for acceptances/ guarantees etc. P 1,500 Q 1,800 R 750 S 1,200 T 750 X 405	6,405
10.6.12	To Constituents' liabilities for acceptances/guarantees etc. (Honoured by bank)	1,500			
30.9.12	To Constituents' liabilities for acceptances/guarantees etc. (Paid off by party)	1,800			
30.11.12	To Constituent's liabilities for acceptances/guarantees etc. (Honoured by bank on party's failure to pay)	750			
31.3.13	To Balance c/d (Acceptances not yet satisfied)	2,355			
		9,750			**9,750**

REBATE ON BILLS DISCOUNTED

One of the major functions of a bank is to discount customers' bill. We know that when the bill is discounted by the bank Bill Discounted and Purchased Account should be debited with full amount and Customers' Current Account is credited for such discounting by the bank with net amount. In this way, total amount of discount so earned during this year is credited to Interest and Discount Account. Discount is calculated from the period of discounting the bill to the date of maturity of the bill. This is the usual transactions which are recorded in the books of bank for discounting of the bill. No problem will arise if the entire amount of discount is received during the period. In real world situation, this is not happened as the bill may not have matured for payment during the period of closing the accounts. Thus, an adjustment is required for discounting of those bills which are related to next accounting periods.

Entries

(i) For adjustment

Interest & Discount A/c Dr.

To Rebates on bill Discounted Account

Computation of Rebates on Bills Discounted

Rebate on Bills Discounted = Amount of Bill x Rate of Discount × $\frac{\text{Unexpired Period}}{12}$

Illustration 4:

In Calculate Rebate on Bills discounted as on 31 December, 2011 from the following data and show journal entries:

	Date of Bill	₹	Period	Rate of Discount
(i)	15.10.2011	50,000	5 months	8%
(ii)	10.11.2011	30,000	4 months	7%
(iii)	25.11.2011	40,000	4 months	7%
(iv)	20.12.2011	60,000	3 months	9%

Solution:

(a) Calculation of Rebate on Bills Discounted

₹	Due Date	Days after 31 December, 2013	Discount Rate	₹
50,000	18/03/2012	31+29+18=78	8%	852.46
30,000	13/03/2012	31+29+13=73	7%	418.85
40,000	28/03/2012	31+29+28=88	7%	673.22
60,000	23/03/2012	31+29+23=83	9%	1,224.59
Total				3,169.12

Date	**Particulars**	**Dr.** ₹	**Cr.** ₹
Dec.31	Interest and Discount Account Dr.	3,169.12	
	To, Rebate on Bills Discounted		3,169.12
	(Being the provision for unexpired discount required at the end of the year)		

Illustration 5:

On 31 March, 2011 Victory Bank Ltd. had a balance of ₹18 crores in "rebate on bill discounted" account. During the year ended 31st March, 2012, Victory Bank Ltd. discounted bills of exchange of ₹ 8,000 crores charging interest at 18% p.a., the average period of discount being for 73 days. Of these, bills of exchange of ₹ 1,200 crores were due for realization from the acceptor/customers after 31st March, 2012, the average period outstanding after 31st March, 2012 being 36.5 days.

Victory Bank Ltd. asks you to pass journal entries and show the ledger accounts pertaining to:

(i) Discounting of Bills of Exchange; and

(ii) Rebate on bill Discounted.

Solution:

In the books Victory Bank Ltd.

Journal

(₹ in Crores)

Date	Particulars		L.F	Debit (₹) Crore	Credit (₹) Crore
2012	Rebate on Bill Discounted A/c	Dr.		18.00	
	To, Discount on Bills A/c				18.00
	(Being the transfer of opening balance to Rebate on Bill Discounted Account)				
	Bills Purchasesd and Discounted A/c	Dr.		8,000	
	To, Client A/c				7,712.00
	To, Discount on bills A/c [₹ 8,000 crores × $\frac{18}{100}$ × $\frac{73}{365}$]				288.00
	(Being the discounting of bills during the year)				
	Discount on bills A/c	Dr.		21.60	
	To, Rebate on Bills Discounted A/c				21.60
	(Being the provision for unexpired discount as on 31.03.2012)				
	Discount on bills A/c	Dr.		284.40	
	To, Profit and Loss A/c				284.40
	(Being the amount of income for the year from discounting of bills of exchange transferred to Profit and Loss Account)				

Ledger of Victory Bank Ltd.

Rebate on Bills Discounted Account

(₹ in Crores)

Dr. **Cr.**

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
1.4.11	To, Discount on bills A/c	18.00	1.4.11	By Balance b/d	18.00
31.3.12	To Balance c/d	21.60	31.3.12	By Discount on bills A/c (Rebate required)	21.600
		39.60			39.60

Discount on Bills Account

(₹ in Crores)

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.3.12	To Rebate on Bills Discount A/c	21.60	1.4.11	By Rebate on Bills	18.00
"	To Profit and Loss A/c (Transfer)	284.40	2011-12	By Bills Purchased and Discount A/c	288.00
		306.00			306.00

Secured and Unsecured Advance

Secured advance means where a bank grantS advance to its customers against any tangible security. Similarly, where as advance is granted by a bank to its customers without taking any tangible security, the same is called unsecured advance. It is needless to mention here that when an advance is granted by a bank to its customers against any tangible security, bank can dispose off the said security for the realization of principle and interest in case of default. The status of securities and the value of such securities must be mentioned by every bank is Schedule 9. Before granting credit every bank must compare with the market value of securities so pledged to the bank and the amount of advance granted by the bank together with the amount of interest.

Illustration 6:

The books of a bank include a loan of ₹ 5,00,000 advanced on 30.09.2012, interest changeable @ 16% p.a. compounded quarterly. The security for the loan being 7,000 shares of ₹100 each in a public limited company valued @ ₹ 90 each. There is no repayment till 31.12.2013. On 31.12.2013, the value of shares declined to ₹ 80 per share.

How would you classify the loan as secured or unsecured in the Balance Sheet?

Solution:

Date	Particulars	Amount (₹)
31.12.2013	Balance of Loan (Principal)	5,00,000
	Add: Outstanding Interest	1,08,326[1]
	Total claim	6,08,326
	Less: Value of security at that date 7,000 shares x ₹ 80	5,60,000
		48,326

∴ Classification : Secured ₹ 5,60,000

Unsecured ₹ 48,326

Workings

1. Calculation of Outstanding Interest

Quarters ending	Interest (₹)		Closing balance with principal (₹)
31.12.2012	20,000	$\left(₹\,5,00,000 \times \frac{16}{100} \times \frac{3}{12}\right)$	5,20,000
31.03.2013	20,800	$\left(₹\,5,20,000 \times \frac{16}{100} \times \frac{3}{12}\right)$	5,40,800
30.06.2013	21,632	Do	5,62,432
30.09.2013	22,497		5,84,929
31.12.2013	23,397		6,08,326
	1,08,326		

RBI's Prudential Accounting Norms

Just to control the lending activities, the recommendation of Narasimhan Committee was accepted by RBI. As per the recommendation, RBI's Prudential Accounting Norms are:

(a) Recognition of Income;

(b) Classification of Assets; and

(c) Provision for Loans and Advances

A. **Recognition of Income:**

As per RBI's norms, every bank must recognize its income

(i) Under Cash Basis (for income under non-performing asset); and

(ii) Under Accrual Basis (for income on performing assets).

Illustration 7:

Given below are details of interest on advance of a Commercial Bank as on 31.03.2013:

(₹ in Crore)

Particulars	**Interest Earned (₹)**	**Interest Received (₹)**
Performing Assets		
Term Loan	240	160
Cash Credit and Overdraft	1,500	1,240
Bills Purchased and Discounted	300	300
Non-Performing Assets		
Term Loan	150	10
Cash Credit and Overdraft	300	24
Bills Purchased and Discounted	200	40

Find out the income to be recognized for the year ended 31st March 2013.

Solution:

As per RBI Circular, Interest on non-performing assets are considered on Cash Basis whereas interest on performing assets are considered on Accrual Basis.

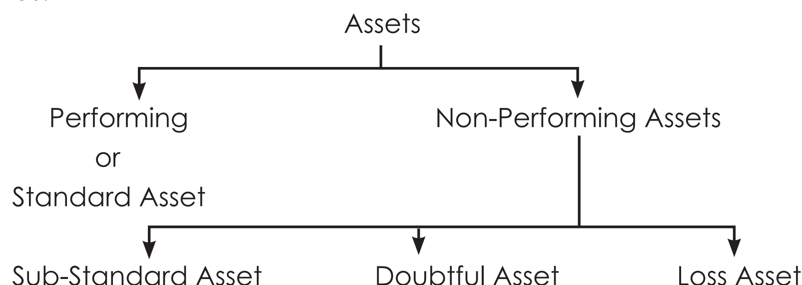
Statement Showing the Recognition of Income

(₹ in Crore)

Particulars	Amount (₹)	Amount (₹)
1. **Interest on Term Loans**		
(i) Performing Assets	240	
(ii) Non-performing Assets	10	250
2. **Interest on Cash Credit and Overdraft**		
(i) Performing Assets	1,500	
(ii) Non-performing Assets	24	1,524
3. **Interest on Bills Purchased and Discounted**		
(i) Performing Assets	300	
(ii) Non-performing Assets	40	340
Income to be Recognised		2,114

Classification of Assets

Assets are classified as:



Standard or Performing Asset

Practically, these assets bear a little amount of risk like normal risk. They do not create any trouble regarding there realization.

Provision required = **0.40%**

Restructured Advances:

- Restructured accounts classified as standard advances will attract a provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract a provision for the period covering moratorium and two years thereafter;
- Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision (as prescribed from time to time) in the first year from the date of upgradation.

Banks will hold provision against the restructured advances as per the extant provisioning norms.

The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated November 26, 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from June 1, 2013 and increase in a phased manner for the stock of restructured standard accounts as on May 31, 2013 as under:

- 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)
- 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)
- 5.00 per cent - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

1. Sub-Standard Advances:

Advances classified as "sub-standard" will attract a provision of 15 per cent as against the 10 per cent. The "unsecured exposures" classified as sub-standard assets will attract an additional provision of 10 per cent, i.e., a total of 25 per cent as against the 20 per cent. However, "unsecured exposures" in respect of Infrastructure loan accounts classified as sub-standard, in case of which certain safeguards such as escrow accounts are available, will attract an additional provision of 5 per cent only i.e. a total of 20 per cent as against 15 per cent.

2. Doubtful Advances:

Doubtful Advances will continue to attract 100% provision to the extent the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.

However, in respect of the secured portion, following provisioning requirements will be applicable:

The secured portion of advances which have remained in "doubtful" category up to one year will attract a provision of 25 per cent (as against 20 per cent);

The secured portion of advances which have remained in "doubtful" category for more than one year but upto 3 years will attract a provision of 40 per cent (as against 30 per cent); and

The secured portion of advances which have remained in "doubtful" category for more than 3 years will continue to attract a provision of 100%.

Rates of Provisioning for Non-Performing Assets and Restructured Advances

Category of Advances	**Rate (%)**
Standardd Advances	
(a) Direct advances to agricultural and SME	0.25
(b) Advances to Commercial Real Estate (CRE) Sector	1.00
(c) All other loans	0.40
Sub-standard Advances	
Secured Exposures	15
Unsecured Exposures in respect of Infrastructure loan accounts where certain safeguards such as escrow accounts are available.	20
Unsecured other loans	25
Doubtful Advances – Unsecured Portion	100
Doubtful Advances – Secured Portion	
For Doubtful upto 1 year	25
For Doubtful > 1 year and upto 3 years	40
For Doubtful > 3 years	100

As per RBI DBOD Circular No.BP.BC 94/21.04.048/2011-12 dated 18/05/2011.

Loss Asset

The asset which are not realizable at all are known as loss assets. The entire amount should be written off or full provision should be made for the amount of outstanding provision @100% for such assets.

HOW TO MAKE PROVISION IN RESPECT OF ADVANCES COVERED BY THE GUARANTEES OF DICGC/ECGC

In the case of advances guaranteed by Export Credit Guarantee Corporation (ECGC) or by Deposit Insurance and Credit Guarantee Corporation (DICGC), provision is required to be made only for the balance in excess of the amount guaranteed by these corporations.

In case the bank also holds a security in respect of an advance guaranteed by ECGC/DICGC, the realizable value of the security should be deducted from the outstanding balance before the ECGC/ DICGC guarantee is off-set.

Where there is an upper limit to which the ECGC. DICGC guarantee applies, this fact should be duly recognized in computing the amount of provision required.

Statement showing the calculation of Provision

	₹
A. Amount Outstanding	xxx
B. Less: Realizable value of Security (if any held)	(xxx)
	xxx
C. Less: ECGC/DICGC cover (% limited to ....)	(xxx)
D. Unsecured Portion [A-B-C]	xxx
E. Provision required for unsecured portion of Doubtful Asset @100%	xxx
F. Provision required for secured portion of Doubtful Asset @ 25%,/40%/100%	xxx
G. Total Provision required [E+F]	xxx

Illustration 8:

From the following information of details of advances of X Bank Limited calculate the amount of provisions to be made in Profit and Loss Account for the year ended 31.3.2012:

Asset classification	₹ in lakhs
Standard	6,000
Sub-standard	4,400
Doubtful:	
For one year	1,800
For two years	1,200
For three years	800
For more than three years	600
Loss assets	1,600

Solution:

Statement showing provisions on various performing and non-performing assets

Asset Classification	Amount	Provision	Amount of Provision
	₹ in Lakhs	%	₹ in lakhs
Standard	6,000	0.40	24
Sub-standard[1]	4,400	15	660
Doubtful			
One year	1,800	25	450
2 years	1,200	40	480
3 years	800	40	320
More than 3 years	600	100	600
Loss assets	1,600	100	1,600
			4,134

Illustration 9:

From the following information, compute the amount of provisions to be made in the Profit and Loss Account of a Commercial bank:

	Assets	₹ in lakhs
(i)	Standard (Value of security ₹ 6,000 lakhs)	7,000
(ii)	Sub-standard	3,000
(iii)	Doubtful	
	(a) Doubtful for less than one year (Realisable value of security ₹ 500 lakhs)	1,000
	(b) Doubtful for more than one year, but less than 3 years (Realisable value of security ₹ 300 lakhs)	500
	(c) Doubtful for more than 3 years (No security)	300

Solution:

	Asset (₹ in lakhs)	% of provision	Provision (₹ in lakhs)
Standard	7,000	0.40	28
Sub-standard	3,000	15	450
Doubtful (less than one year)			
On secured portion	500	25	125
On unsecured portion	500	100	500
Doubtful (more than one year but less than three years)			
On secured portion	300	40	120
On unsecured portion	200	100	200
Doubtful Unsecured (more than three years)	300	100	300
Total provision			1,723

Provisions for Loans and Advances

How much amount of provision should be made depends on the quality of assets. Sometimes the value of securities which are taken by the bank against loans and advances, as per RBI norms, are reduced i.e., their realizable value are reduced. That is why proper provisions must be made on those securities (asset) as per RBI norms.

Illustration 10:

From the particulars given below, ascertain the amount of provision to be made against the advances of SBI, Kolkata.

(₹ in '00,000)

Particulars	Amount (₹)
Total amount of Loans & Advances	120
Advance fully secured	70
Advance overdue for 15 months	20
Advance overdue for more than 2½ year but less than 3 years	10
(Secured by mortgage of land & building valued ₹ 5 lakhs)	—
Unsecured Advance not recoverable	20

Solution:

Statement Showing the Ascertainment of Provisions **(₹ in '00,000)**

Type of Advance	Amount (₹ in lakh)	Percentage of Provisions (%)	Amount of Provision (₹)
Standard Asset	70	0.40%	28,000
Sub-Standard Asset	20	15%	3,00,000
Doubtful Asset	10	(Unsecured provision + 40% of secured provision)	7,00,000*
Loss Asset	20	100%	20,00,000
			30,28,000

* Unsecured Provision (₹ 10,00,000 - ₹ 5,00,000) ₹ 5,00,000 + 40% of ₹ 5,00,000

= ₹ 5,00,000 + ₹ 2,00,000

= ₹ 7,00,000

Provisions covered by Guarantee of DICG/ECGC in case of advance :

Illustration 11.

Rajatapeeta Bank Ltd. had extended the following credit lines to a Small Scale Industry, which had not paid any Interest since March, 2006:

	Term Loan	Export Loan
Balance Outstanding on 31.03.2012	₹ 35 lakhs	₹ 30 lakhs
DICGC/ECGC cover	40%	50%
Securities held	₹ 15 lakhs	₹ 10 lakhs
Realisable value of Securities	₹ 10 lakhs	₹ 08 lakhs

Compute necessary provisions to be made for the year ended 31st March, 2012.

Solution:

Particulars	**Term loan (₹ in lakhs)**	**Export credit (₹ in lakhs)**
Balance outstanding on 31.3.2012	35.00	30.00
Less: Realisable value of Securities	10.00	8.00
	25.00	22.00
Less: DICGC cover @ 40%	10.00	–
ECGC cover @ 50%	___	11.00
Unsecured balance	15.00	11.00

Required Provision:

	Term loan (₹ in lakhs)	**Export credit (₹ in lakhs)**
100%* for unsecured portion	15.00	11.00
100% for secured portion	10.00	8.00
Total provision required	25.00	19.00

* The above solution has been provided based on the latest NPA provisions (as per the Master Circular issued by RBI.

Illustration 12.

From the following information find out the amount of provisions required to be made in the Profit & Loss Account of a commercial bank for the year ended 31st March, 2013:

(i) Packing credit outstanding from Food Processors ₹ 90 lacs against which the bank holds securities worth ₹ 22.50 lacs. 50% of the above advance is covered by ECGC. The above advance has remained doubtful for more than 3 years.

(ii) Other advances :

Assets classification	₹ in lacs
Standard	4500
Sub-standard	3300
Doubtful :	
For one year	1350
For two years	900
For three years	600
For more than 3 years	450
Loss assets	900

Solution:

(i) **(₹ in lacs)**

	(₹)	(₹)
Amount outstanding (packing credit)	90.00	
Less : Realisable value of securities	22.50	
	67.50	
Less : ECGC cover (50%)	33.75	
Net Unsecured Balance	33.75	
Required provision :		
Provision for unsecured portion (100%)		33.75
Provision for secured portion (100%)*		22.50
		56.25

(ii) Other advances :

(₹ in lacs)

Assets	**Amount**	**% of**	**Provision**
	₹	**provision**	₹
Standard	4500	0.40*	18
Sub-standard	3300	15	495
Doubtful :			
For one year	1350	25	337.5
For two years	900	40	360
For three years	600	40	240
For more than three years	450	100*	450
Loss	900	100	900
Required provision	12,000		2800.5

Note : Doubtful advances have been taken as fully secured. However, in case, the students assume that no security cover is available for these advances, provision will be made for 100%.

* As per the Master Circular issued by RBI.

Preparation of Profit and Loss Account

Illustration 13.

The following are the figures extracted from the books of New Generation Bank Limited a scheduled Commercial Bank as on 31.3.2013:

	(₹)
Interest and discount received	37,05,738
Interest paid on deposits	20,37,452
Issued and subscribed capital	10,00,000
Salaries and allowances	20,00,000
Directors fee and allowances	30,000
Rent and taxes paid	90,000
Postage and telegrams	60,286
Statutory reserve fund	8,00,000

	(₹)
Commission, exchange and brokerage	1,90,000
Profit on Exchange Transaction	65,000
Profit on sale of investments	2,00,000
Depreciation on bank's properties	30,000
Statutory expenses	40,000
Preliminary expenses	25,000
Auditor's fee	5,000

The following further information is given:

(i) A customer to whom a sum of ₹ 10 lakhs has been advanced has become insolvent and it is expected only 50% can be recovered from his estate.

(ii) There were also other debts for which a provision of ₹1,50,000 was found necessary by the auditors.

(iii) Rebate on bills discounted on 31.3.2012 was ₹12,000 and on 31.3.2013 was ₹16,000.

(iv) Provide ₹ 6,50,000 for Income-tax.

(v) The directors desire to declare 10% dividend.

Prepare the Profit and Loss account of New Generation Bank Limited for the year ended 31.3.2013 and also show, how the Profit and Loss account will appear in the Balance Sheet, if the Profit and Loss account opening balance was Nil as on 31.3.2012.

Solution:

New Generation Bank Limited

Profit and Loss Account for the year ended 31st March, 2013

	Particulars	**Schedule**	**Year ended 31.03.2013 (₹ in '000s)**
I.	**Income:**		
	Interest earned	13	3,701.74
	Other income	14	455.00
	Total		4,156.74
II.	**Expenditure**		
	Interest expended	15	2,037.45
	Operating expenses	16	480.29
	Provisions and contingencies (500 + 150 + 650)		1,300.00
	Total		3,817.74
IIII.	**Profits/Losses**		
	Net profit for the year		339.00
	Profit brought forward		Nil
	Total		339.00
IV.	**Appropriations**		
	Transfer to statutory reserve (25%)		84.75
	Proposed dividend		100.00
	Balance carried over to balance sheet		154.25
	Total		339.00

The Profit & Loss Account balance of ₹154.25 thousand will appear in the Balance Sheet under the head 'Reserves and Surplus' in Schedule 2.

Year ended 31.3.2013

(₹ in '000s)

	Schedule 13 – Interest Earned	
I.	Interest/discount on advances/bills (Refer W.N.)	3,701.74
	Total	3,701.74
	Schedule 14 – Other Income	
I.	Commission, exchange and brokerage	190.00
II.	Profit on sale of investments	200.00
III.	Profit on Exchange Transaction	65.00
	Total	455.00
	Schedule 15 – Interest Expended	
I.	Interests paid on deposits	2,037.45
	Total	2,037.45
	Schedule 16 – Operating Expenses	
I.	Payment to and provisions for employees	200.00
II.	Rent, taxes and lighting	90.00
III.	Depreciation on bank's properties	30.00
IV.	Director's fee, allowances and expenses	30.00
V.	Auditors' fee	5.00
VI.	Law (statutory) charges	40.00
VII.	Postage and telegrams	60.29
VIII.	Preliminary expenses	25.00*
	Total	480.29

*It is assumed that preliminary expenses have been fully written off during the year.

Working Note:

Interest/discount (net of rebate on bills discounted)	3,705.74
Add: Rebate on bills discounted on 31.3.2012	12.00
Less: Rebate on bills discounted on 31.3.2013	(16.00)
	3,701.74

Illustration 14.

The following are the figures extracted from the books of Y Bank Ltd. [Scheduled Commercial Bank] as on 31.3.2013.

Other information: **(Amount in ₹)**

Interest and Discount received	20,30,000	Directors' fees and allowance	12,000
Interest paid on Deposits	12,02,000	Rent and taxes paid	54,000
Issued and Subscribed Capital	5,00,000	Stationery and printing	12,000
Reserve under Section 17	3,50,000	Postage and Telegram	25,000
Commission, Exchange and Brokerage	90,000	Other expenses	12,000
Rent received	30,000	Audit fees	4,000
Profit on sale of investment	95,000	Depreciation on Bank's properties	12,500
Salaries and Allowances	1,05,000		

(i) Provision for bad and doubtful debts necessary ₹ 2,00,000.

(ii) Rebate on bills discounted as on 31.3.2013 ₹ 7,500.

(iii) Provide ₹ 3,50,000 fo income tax.

(iv) The directors desire to declare 10% dividend.

Make the necessary assumption and prepare the Profit and Loss Account in accordance with the law.

Solution:

In the books of Y Bank Ltd.

Profit and Loss Account for the year ended 31st March, 2013

		Schedule No.	Year ended 31.3.2013 (Current Year) ₹	Year ended 31.3.2012 (Previous Year) ₹
I.	**Income**			
	Interest earned	13	20,22,500	
	Other income	14	2,15,000	
	Total		22,37,500	
II.	**Expenditure**			
	Interest expended	15	12,02,000	
	Operating expenses	16	2,36,500	
	Provisions and contingencies (Note 1)		5,50,000	
	Total		19,88,500	
III.	**Profit / Loss**			
	Net Profit / Loss (–) for the year		2,49,000	
	Profit / Loss (–) brought forward		—	
	Total		2,49,000	
IV.	**Appropriations**			
	Transfer to Statutory Reserves		62,250	
	(25% of Net Profit) (Note 3)			

	Transfer to Other Reserves		—	
	Proposed dividend (10% of ₹ 5,00,000) (Note 4)		50,000	
	Balance carried over to Balance Sheet		1,36,750	
	Total		2,49,000	

Working Notes :

(1) Calculation of Provisions and Contingencies

	₹
Provision for doubtful debts :	2,00,000
Provision for Income tax	3,50,000
	5,50,000

(2) It is assumed that Rebate on Bill Discounted as on 31.3.2012 was nil.

(3) As per the provision of section 17 of the Banking Regulation Act, 1949 amount to be transferred to Statutory Reserve should not be less than 25% of Net Profit.

(4) It is assumed that the dividend has been proposed as per RBI guidelines.

(5) Corporate Dividend tax is payable when dividend is proposed / paid.

Schedule 13: Interest Earned

		₹	₹
I.	Interest and Discount received	20,30,000	
	Less: Rebate on bill discounted as on 31.3.2013	7,500	20,22,500
II.	Income on Investments		
III.	Interest on balances with RBI and other inter-bank fund		
IV.	Others		
	Total		20,22,500

Schedule 14: Other Income

		₹
I.	Commission, exchange and brokerage	90,000
II.	Rent received	30,000
III.	Net Profit on sale of investments	95,000
IV.	Net Profit on revaluation of investments	—
	Less : Net Loss on revaluation of investments	—
V.	Net Profit on sale of land, buildings & other assets	—
VI.	Net Profit on exchange transactions	—
VII.	Income earned by way of dividends etc from subsidiaries/joint ventures setpu abroad/in India	—
VIII.	Miscellaneous Income	—
	Total	2,15,000

Schedule 15: Interest Expended

		₹
I.	Interest on Deposits	12,02,000
II.	Interest on RBI / Inter-bank borrowings	—
III.	Others	—
	Total	12,02,000

Schedule 16 : Operating Expenses

		₹
I.	Payment to and provision for employees	1,05,000
II.	Rent, taxes and lighting	54,000
III.	Printing and stationery	12,000
IV.	Advertisement and publicity	—
V.	Depreciation on Bank's property	12,500
VI.	Directors' fees and allowances	12,000
VII.	Auditor's fees and expenses	4,000
VIII.	Law charges	—
IX.	Postage and telegram	25,000
X.	Repairs and maintenane	—
XI.	Insurance	—
XII.	Other expenditure	12,000
	Total	2,36,500

Preparation of Balance Sheet

Illustration 15.

From the following trial balance and the additional information, prepare a Balance Sheet of Lakshmi Bank Ltd. a Scheduled Commercial Bank as at 31st March, 2013:

Debit balance	**₹ (in Lakhs)**
Cash Credits	1,218.15
Cash in hand	240.23
Cash with Reserve Bank of India	67.82
Cash with other Banks	132.81
Money at call and short notice	315.18
Gold	82.84
Government securities	365.25
Current Accounts	42.00
Premises	133.55
Furniture	95.18
Term Loan	1,189.32
	3,882.33
Credit balance	**₹ (in Lakhs)**
Share Capital (29,70,000 equity shares of ₹ 10 each, fully paid up)	297.00
Statutory Reserve	346.50

Net Profit for the year (before appropriation)	225.00
Profit & Loss Account (Opening balance)	618.00
Fixed deposit Accounts	775.50
Savings Deposit Accounts	675.00
Current Accounts	780.18
Bills Payable	0.15
Borrowings from other Banks	165.00
	3,882.33

Additional Information :

(i) Bills for collection : ₹ 18,10,000

(ii) Acceptance and endorsements : ₹ 14,12,000

(iii) Claims against the bank not acknowledged as debts : ₹ 55,000

(iv) Depreciation charged on premises : ₹ 1,10,000 and Furniture : ₹ 78,000

Solution:

Lakshmi Bank Ltd.

Balance Sheet as on 31.3.2013

Details	**Schedule No.**	**Amount (₹ in Lakhs)**
Capital and Liabilities:		
Capital	1	297.00
Reserves and Surplus	2	1,189.50
Deposits	3	2,230.68
Borrowings	4	165.00
Other Liabilities and Provisions	5	0.15
Total		3,882.33
Assets :		
Cash and Balance with RBI	6	308.05
Balances with Banks and Money at Call and Short Notice	7	489.99
Investments	8	448.09
Advances	9	2,407.47
Fixed Assets	10	228.73
Total		3,882.33
Contingent Liabilities	12	14.67
Bills for Collection		18.10

Schedules

Schedule 1 - Capital

	₹ (in lakh)
Issued, Subscribed and Called – up Capital	297.00
(29,70,000 @₹ 10)	

Schedule 2 - Reserves and Surplus

	₹ (in lakh)	₹ (in lakh)
1. Statutory Reserve		346.50
Add: 20% of ₹ 2,25,00,000		56.25
(Assumed to be an unscheduled Bank)		402.75
2. Profit & Loss A/c Opening	618.00	
Add: Current Year		
₹ (2,25,00,000 – 56,25,000)	168.75	786.75
		1,189.50

Schedule 3 - Deposit

	₹ (in lakh)
1. Demand Deposits	780.18
2. Savings Bank Deposits	675.00
3. Term Deposit	775.50
	2,230.68

Schedule 4 - Borrowings

	₹ (in lakh)
Borrowings from other Banks	165.00

Schedule 5 - Other Liabilities

	₹ (in lakh)
Bills Payable	0.15

Schedule 6 - Cash and Balances with RBI

	₹ (in lakh)
Cash in Hand	240.23
Balances with RBI	67.82
	308.05

Schedule 7 - Balances with Banks and Money at Call and Short Notice

	₹ (in lakh)
Cash with other Banks	132.81
Money at Call and short Notice	315.18
Current Accounts	42.00
	4,89.99

Schedule 8 - Investment

	₹ (in lakh)
Government securities	365.25
Gold	82.84
	4,48.09

Schedule 9 - Advances

	₹ (in lakh)
Cash Credit	1,218.15
Term Loans	1,189.32
	2,407.47

Schedule 10 - Fixed Assets

	₹ (in lakh)	₹ (in lakh)
Premises	1,34,65,000	
Less : Depreciation	(1,10,000)	133.55
Furniture	95,96,000	
Less : Depreciation	(78,000)	95.18
		228.73

Schedule 11 - Other Assets — NIL

Schedule 12 - Contingent Liabilities

	₹ (in lakh)	₹ (in lakh)
Acceptance and Endrosements	14.12	
Claims against the Bank not acknowledge as Debts	0.55	
		14.67

CAPITAL ADEQUACY NORMS

Objectives of Capital Adequacy Norms

The fundamental objectives are:

(a) To strengthen the soundness and stability of the banking system,

(b) To achieve a high degree of consistency in its application to banks in different countries.

Minimum Capital Adequacy Ratio

All India Scheduled Commercial Banks (excluding Regional Rural Banks) as well as foreign banks operating in India are required to achieve 9% Capital Adequacy Ratio (i.e. Ratio of Capital fund to Risk Weighted Assets and off Balance Sheet Items).

Meaning of Capital Funds

(a) The Basel Committee has defined capital in two tiers – Tier I and Tier II.

12.2 ACCOUNTING OF ELECTRICITY COMPANIES

The Electircity Act, 2003

The Electricity Act, 2003 replaced the followign three existing legislations, namely:

1. The Indian Electricity Act, 1910,
2. The Electricity (Supply) Act, 1948 and
3. The Electricity Regulatory Commissions Act, 1998.

It extends to whole of India except the State of Jammu and Kashmir.

Main Features of the Electricity Act, 2003

(i) The activities like generation, transmission and distribution of power have been separately identifited.

(ii) The Act de-licenses power generation completely (except for hydro power projects, over a certain size).

(iii) 10% of the power supplied by supplers and distributors to the consumers has to be genrated using renewable and non-conventional sources of energy.

(iv) Setting up State Electricity Regulatory Commisson (SERC) made mandatory.

(v) Appellate Tribunal to hear appeals against the decision of the CERC and SERCs.

(vi) Ombudsman scheme for consumers' grievance redressal.

(vii) Provision for private licensees in transmission and entry in distribution through an independent network.

(viii) Metering of all electiricity supplied made obligatory.

(ix) Provision relating to theft of electricity made more strict.

Central Electricity Authority

The Central Government has the power to constitute a body called Central Electicity Authority generally to exercise prescribed functions and perform prescribed duties. The office of the CEA is an "Attached Office" of the Ministry of Power. The CEA is responsible for the technical coordination and supervision of programmes and is also entrusted with prescribed statutory functions.

Constitution: The CEA shall consist of not more than 14 Members (including its Chairperson), of whom not more than 8 shall be full-time members to be appointed by the Central Government. The Central Government appoints one of the full time members to be the chairman of the Authority.

Central Electricity Regulatory Commission (CERC)

Meaning: The Central Electricity Regulatory Commission shall be a body corporate, having perpetual succession and a common seal with power to acquire, hold and dispose of property, both movable and immovable, and to contract and shall, by the said name, sue or be sued.

Constitution: The Central Commission shall consist of the following Members namely:

(i) A chairperson and 3 Members

(ii) The Chairperson of the Authority who shall be the Member, ex-officio.

Appointment: The Chairperson and Members of the Central Commission shall be appointed by the Central Government on the recommendation of the Selection Committee.

Functions: The functions of the Central Commission include regulating the tariff of generating companies, the inter-state transmission of electricity, to issue licenses, to levy fees, to fix trading margin etc.

State Electricity Commission (SEC)

Meaning: The State Electricity Commission shall be a body corporate, having perpetual succession and a common seal with power to acquire, hold and dispose of property, both movable and immovable, and to contract and shall, by the said name, sue or be sued.

Functions: The functions of the State Commission include determining the tariff of generation, supplying, transmission and wheeling of electricity companies, wholesale, bulk or retail, regulating the inter-state transmission of electricity, to issue licenses, to levy fees, to fix trading margin etc.

How to Account for Security Deposit

Legal Provisions:

(i) The Distribution Licensee may require the consumer to deposit sufficient security against the estimated payment which may become due to him in respect of elecricity supplied to the consumer.

(ii) The Distribution Licensee shall pay interest equivalent to the Bank Rate or more, as may be specified by the concerned State Commission, on the security and refund such security on the request of the person who gave such security.

(iii) Determination of Security Deposit amount for a consumer

= Load x Load Factor of the category in which the consumer falls x (Billing cycle + 45 days) x Current tariff.

Accounting of Security Deposit :

Journal of Distribution Licensee

Date	Particulars	L.F.	*Dr.* (₹)	*Cr.* (₹)
2013 April 2	**(i) On Receipt of Security Deposit** Bank A/c Dr. To Security Deposit A/c (Being the Security Deposit received)		10,00,000	10,00,000
2014 Mar. 31	**(ii) On Making Provision for Interest Accrued on Security Deposit** Interest Expense A/c Dr. To Interest Accrued on Security Deposit A/c (Being the Provision for Interest Accrued on Security Deposit Made)		1,00,000	1,00,000
	(iii) On Adjustment of Interest Accrued on Security Deposit in Consumer's Bill Interest Accrued on Security Deposit A/c Dr. To Sales Turnover A/c (Being the Adujstment of Interest Accured on Security Deposit in Consumer's Bill)		1,00,000	1,00,000

Reporting of Security Deposit In Balance Sheet of Distribution Licensee:

1. Balance of Security Deposit A/c at the end of the accounting period should be disclosed as a Non-current liability in the Balance Sheet as the same is, in substance, not repayable within a period of 12 months from the reporting date and hence does not satisfy any of the conditions of classifying a liability as current.
2. Balance of Interest Accrued on Security Deposit A/c at the end of the accounting period should be disclosed as Non-current liability in the Balance Sheet as the same is, in substance, not repayable within a period of 12 months from the reporting date and hence does not satifsty any of the conditions of classifying a liability as current.

How to Account for Service Line cum Development (SLD) Charges Received from Consumers

Accounting Practices:

Following different accounting and reporting practices are noticed in published Financial Statements of some Electicity Companies:

Accounting Practice 1: SLD is accounted for as a liability and subsequently proportionate amount is transferred to Income Statement during the expected life of the Asset.

Accounting Practice 2: SLD is accounted for as Reserve as the amount is not refundable and disclosed under the head Reserves and Surplus without transferring any proportionate amount to Income Statement during the expected life of the Asset.

Accounting Practice 3: SLD is accounted for as **Capital Reserve** as the amount is not refundable and subsequently proportionate amount is transferred to Income Statement during the expected life of the Asset to match against depreciation on total cost of such asset.

Notes:

- Balance of Capital Service Line Contributions A/c at the end of the accounting period should be disclosed as Capital Reserve under the head 'Reserves and Surplus' as it is not refundable to consumers.
- Balance of Capital Service Line Contributions A/c at the end of the accounting period should be disclosed as **Capital Reserve** under the head 'Reserves and Surplus' wherein the amount transferred to Income Statement is shown as deduction. The amount transferred matches proportionately against depreciation charged on total cost of such asset in the Statement of Profit and Loss.

Accounting Practice 4: SLD is accounted for as reduction in the cost of Non-Current Asset and depreciation is provided on such reduced cost.

Accounting of Service Line Cum Development (SLD) Charges under Accounting

Practice 3:

Journal of Distribution Licensee

Date	Particulars		L.F.	Dr. (₹)	Dr. (₹)
	(i) On Receipt of SLD Charges				
2013	Bank A/c	Dr.		10,00,000	
April 2	To Capital Service Line Contributions A/c				
	(Being the SLD Charges received)				10,00,000
2014	**(ii) On Transfer of Proportionate Amount to Income Statement**				
March 3	Capital Service Line Contributions A/c	Dr.		1,00,000	
	To Statement of Profit and Loss				1,00,000
	(Being the Transfer of Proportionate amount to the Income Statement)				

How to Account for Grant Received under APDRP

(i) Grant received under the Accelerated Power Development and Reforms Programme (APDRP) of the Ministry of Power, Government of India towards capital expenditure is treated as capital receipt and accounted as Capital Reseve and subsequently adjusted as income (by transfer to the Statement of Profit and Loss) in the same proportion as the depreciation written off on the assets acquired out of the Grant.

(ii) The depreciation for the year to be debited to the Statement of Profit and Loss on asset acquired out of grant match against portion of grant transferred from Capital Reserve.

(iii) The unadjusted balance of capital reserve is disclosed under the head, Reseves and Surplus in the Balance Sheet.

(iv) In the Cash Flow Statement Grant received under APDRP is reported under Financing Acitivty.

(v) At any time if the ownership of the assets acquired, out of the grants, vest with the Government, the grants (Capital Reserve) are adjusted in the carrying cost of such assets.

(v) The grant-in-aid assistance received by the utility under APDRP and its utilisation shown under the head Capital Expenditure made during the year is not considered for calculation of Annual Revenue Requirement (ARR) of the utility for the year.

Accounting for Depreciation

(i) As per 2009 Regulation, it has been stated in the Tariff Policy that the depreciation rates for the assets shall be specified by the Central Electricity Regulatory Commission (CERC) and these rates of depreciation shall be applicable for the purpose of trarlff as well as accounting.

(ii) The Office of the Comptroller and Auditor General of India (CAG) has expressed an opinion that power sector companies shall be governed by the rates of depreciation as notified by the CERC for providing depreciation in respect of generating assets in the account instead of the rates as per the Companies Act, 1956. Accordingly, a Company should revise its accounting policies relating to charging of depreciation w.e.f. 1st April 2009 considering the rates and methodology nofitied by the CERC for determination of tariff through Regulations, 2009.

(iii) As per 2009 Regulations, depreciation represents a **Cash Flow for Repayment of Loan** not by allowing Advance against Depreciation but by prescribing higher rates of depreciation for initial years of loan redemption.

(iv) The CERC prescribes following two methods of depreciation:

    (i) The Staight line Method by application of a fixed rate over the fair life of the asset.

    (ii) Optimized Depreciated Replacement cost (ODRC) based method under which the depreciation could be a method for replacement of the asset.

Calculation of Depreciation for the purpose of Tariff as per Regulation 21

(i) The value base for the purpose of depreciation shall be the historical cost of the asset.

(ii) The historical capital cost of the asset shall include additional capitalisation on accout of Foreign Exchange Rate Variation up to 31.3.2004 already allowed by the Central Government Commission.

(iii) Land other than the land held under lease and the land for reservoir in case of hydro generating station shall not be a depreciable asset and its cost shall be excluded from the capital cost while computing depreciable value of the asset.

(iv) Depreciation shall be calculated annually, based on Straight Line Method over the useful life of the asset and at the rates prescribed in Appendix III to these regulations.

(v) The **Residual Life** of the asset shall be considered as **10 years.**

(vi) The **Salvage Value** of the Asset shall be considered as **10%.**

(vii) Depreciation shall be allowed upto maximum of **90% of the historical cost** of the asset.

(viii) On repayment of entire loan, the remaining depreciable value shall be spread over the balance useful life of the asset.

(ix) Depreciation shall be chargeable from the first year of operation. In case of operation of the asset for part of the year, depreciation shall be **charged on pro rata basis.**

APPENDIX-III DEPRECIATION SCHEDULE

Assets	SLM Depreciation Rate (Salvage Value = 10%)
1. Land under full ownership	0.00%
2. Land under Lease	3.34%
3. (a) Building & Civil Engineering Works other than Kutcha Roads	3.34%
(b) Temporary Erections such as Wooden Structures	100.00%
4. IT Equipments	15.00%
5. Self Propelled Vehicles	9.50%
6. Portable Air Conditioning Plants	9.50%
7. (a) Apparatus other than Motors let on hire	9.50%
(b) Motors let on hire	6.33%
8. Communication Equipments	6.33%
9. Office Furniture,Furnishing,Equipments,Fittings & Apparatus	6.33%
10. Any other Assets *(for example)* (a) Plants & Machinery in generating stations (b) Cooling Towers & Circulating Water Systems (c) Hydraulic Works Forming part of the Hydro-dams,etc. (d) Transformers & Switchgear (e) Lighting Arrestor,Batteries,Overhead lines including cable support (f) Meters (g) Static Air Conditioning Plants (h) Street Light Fittings (i) Vehicles other than Self Propelled Vehicles	5.28%

How to Calculate Weighted Average Rate of Depreciation

Step 1: Calculate Depreciation on Individual Assets (other than Freehold Land) at the Rates as per Appendix III.

= Cost of the Asset x Prescribed Rate of Depreciation.

Step 2: Calculate Total Depreciation on All Assets (other than Freehold Land).

i.e. is the sumassion of depreciation calculated on each asset

= Depreciation on $Asset_1$ +Depreciation on $Asset_2$ +- ···········

Step 3: Calculate Total Capital Cost of All Assets (other than Freehold Land).

Step 4: Calculate Weighted Average Rate of Depreciation.

$$\frac{\text{Total Depreciation on All Assets (other than Freehold Land)}}{\text{Total Capital Cost of All Assets (other than Freehold Land)}} \times 100$$

Illustration 16.

From the following calculate Weighted Average Rate of Depreciation considering the rates as per Appendix-III

Assets	Closing Balance at Cost
1. Land under full ownership	14,30,000
2. Land under Lease	4,30,000
3. (a) Building & Civil Engineering Works other than Kutcha Roads	33,00,000
(b) Railways Sidings	40,00,000
(c) Temporary Erections such as Wooden Structures	10,00,000
4. IT Equipments	20,00,000
5. Self Propelled Vehicles	30,00,000
6. Portable Air Conditioning Plants	25,00,000
7. (a) Apparatus other than Motors let on hire	15,00,000
(b) Motors let on hire	2,00,000
8. Communication Equipments	5,00,000
9. Office Furniture,Furnishing, Equipments,Fittings & Apparatus	5,00,000
10. Plants & Machinery in generating stations	2,52,00,000
11. Cooling Towers & Circulating Water Systems	10,00,000
12. Hydraulic Works Forming part of the Hydro-dams,etc.	20,00,000
13. Transformers & Switchgear	2,05,00,000
14. Lighting Arrestor,Batteries,Overhead lines including cable support	42,00,000
15. Meters	20,00,000
16. Static Air Conditioning Plants	1,00,00,000
17. Street Light Fittings	47,85,000
18. Vehicles other than Self Propelled Vehicles	2,15,000

Solution:

WEIGHTED AVERAGE RATE OF DEPRECIATION

Assets	Rate	Cost	Depreciation
1. Landunderfullownership	0.00%	14,30,000	0
2. LandunderLease	3.34%	4,30,000	14,362
3. (a) Building & Civil Engineering Works othert han Kutcha Roads	3.34%	33,00,000	1,10,220
(b) Railways Sidings	3.34%	40,00,000	1,33,600
(c) Temporary Erections such as Wooden Structures	100.00%	10,00,000	10,00,000
4. IT Equipments	15.00%	20,00,000	3,00,000
5. Self Propelled Vehicles	9.50%	30,00,000	2,85,000
6. Portable Air Conditioning Plants	9.50%	25,00,000	2,37,500
7. (a) Apparatus other than Motors let on hire	9.50%	15,00,000	1,42,500
(b) Motors let on hire	6.33%	2,00,000	12,660
8. Communication Equipments	6.33%	5,00,000	31,650
9. Office Furniture, Furnishing, Equipments, Fittings & Apparatus	6.33%	5,00,000	31,650
10. Plants & Machinery in generating stations	5.28%	2,52,00,000	13,30,560
11. Cooling Towers & Circulating Water Systems	5.28%	10,00,000	52,800
12. Hydraulic Works Forming part of the Hydro-dams, etc.	5.28%	20,00,000	1,05,600
13. Transformers & Switchgear	5.28%	2,05,00,000	10,82,400
14. Lighting Arrestor, Batteries, Overhead lines including cable support	5.28%	42,00,000	2,21,760
15. Meters	5.28%	20,00,000	1,05,600
16. Static Air Conditioning Plants	5.28%	1,00,00,000	5,28,000
17. Street Light Fittings	5.28%	47,85,000	2,52,648
18. Vehicles other than Self Propelled Vehicles	5.28%	2,15,000	11,352
1otal		9,02,60,000	59,89,862

Total Capital Cost of All Assets (other than Freehold land) = 9,02,60,000 -14,30,000 = 8,88,30,000

Weighted Average Rate of Depreciation

$$= \frac{\text{Total Depreciation on All Assets (other than Freehold land)}}{\text{Total Capital Cost of All Assets (other than Freehold Land)}} \times 100$$

$$= \frac{59,89,862}{888,30,000} \times 100 = 6.7431\%$$

Illustration 17.

Calculate depreciation as per 2009 regulations from the following information of an Electricity generation project

(i) Date of commercial operation i.e. 1.9.2010.

(ii) The details of actual expenditure incurred up to the date of commercial operation i.e 1.9.2010 and projected expenditure to be incurred from the date of commercial operation up to 31.3.2014 for the assets under Transmission system.The details of apportioned approved cost as on the date of commercial operation and projected expenditure to be incurred for the above mentioned assets is summarized below:

[₹ in lakh]

Apportioned approved cost	Actual Cost Incurred as on the date of commercial operation	Proposed Expenditure from the date of commercial operation to 31.3.2011	Proposed Expenditure for 2011-12	Total Expenditure completion cost
4,20,000	4,00,000	1,00,000	20,000	5,20,000

(iii)

Average Rate of Depreciation Calculated as per rates Specified in Appendix-III	5.3	5.2	5.2	5.2

Additional capital expenditure of 20,000 lakh has been considered out of 1,00,000 lakh for the year 2010-11 and no further additional capital expenditure has been considered as capital cost has been restricted to apportioned approved cost in the absence of revised capital expenditure.

Solution:

Computation of Depreciation

Particulars	**2010-11**	**2011-12**	**2012-13**	**2013-14**
A. Opening Gross Block	4,00,000	4,20,000	4,20,000	4,20,000
B. Additional Capital exp.	20,000	0.00	0.00	0.00
C. Closing Gross Block [A+B]	4,20,000	4,20,000	4,20,000	4,20,000
D. Average Gross Block [(A+C)/2]	4,10,000	4,20,000	4,20,000	4,20,000
E. Weighted Average Rate of Depreciation	5.3	5.2	5.2	5.2
F. Period	7 months	12 months	12 months	12 months
G. Depreciation (D × E × F/12)	12,676	21,840	21,840	21,840

Illustration 18.

Calculate depreciation upto 2013-14 as per 2009 regulations from the following information of XYZ Power generation Project

Date of commercial operation/Work Completed Date	11-Jan-1996
Beginning of Current year	1-Apr-2011
Useful life	35 years

		(Figures in ₹ Crores)
1.	Capital Cost at beginning of the year 2011-12	222.00
2.	Additional Capltiisation during the year: 2012-13	10.56
	2013-14	29.44
3.	Value of Freehold Land	12.00
4.	Depreciation recovered up to 2009-10	48.60
5.	Depreciation recovered in 2010-11	5.40

Note: Capital Cost and Accumulated Depreciation at the beginning of the year are as per tariff order FY 2011-12

Solution:

Name of the Power Station:	XYZ Power Generation Project
Date of commercial operation/Work Completed Date:	11-Jan-1996
Beginning of Current year:	1-Apr-2011
Useful life:	35 years
Remaining Usefullife:	20 years

Statement showing the Calculation of Depreciation

Particulars	2011-12	2012-13	2013-14
A. Opening Capital Cost	222.00	222.00	232.56
B. Additional Capital Cost	0.00	10.56	29.44
C Closing Capital Cost	222.00	232.56	262.00
D. Average Capital Cost [(A + C)/2]	222.00	227.28	247.28
E. *Less:* Cost of Freehold Land	12.00	12.00	12.00
F. Average Capital Cost for Depreciation (D - E)	210.00	215.28	235.28
G. Depreciable value (90% of F)	189.00	193.75	211.75
H. Depreciation recovered upto prev. year *(48.6 + 5.4)	*54.00	60.75	67.75
I. Balance Depreciation to be recovered (G - H)	135.00	133.00	144
J. Balance useful life out of 35 years	20.00	19.00	18.00
K. Yearly depreciation from 2011-12 (I/J)	6.75	7.00	8.00
L. Depreciation recovered upto the year (H + K)	60.75	67.75	75.75

How to calculate Advance Against Depreciation (AAD) for the purpose of tariff as per Regulation 21

AAD shall be the **least** of the following **two** amounts:

1. Difference between loan repayment amount (not exceding 10% of loan amount as per regulation 20) and Depreciation as per Schedule
2. Difference between Cumulative Repayment of Loan and Cumulative Depreciation up to that year.
3. **Statement showing the Calculation of AAD for Tariff Purposes**

Particulars	1st year	2nd year	3rd year
A. Repayment of Loan (Not exceeding 10% of Loan Amount)			
B. Depreciation during the year			
C. Difference between A & B (A - B)			
D. Cumulative Repayment of Loan			
E. Cumulative Depreciation (Excluding AAD) at the beginning			
F. Difference between D & E (D - E)			
G. Advance Against Depreciation (AAD) (Minimum of C & F)			

4. **Statement showing the Calculation of Depreciation for Tariff Purposes**

Particulars	1st year	2nd year	3rd year
A. Opening Capital Cost			
B. Additional Capital Cost			
C. Closing Capital Cost			
D. Average Capital Cost [(A+ C}/2]			
E. *Less:* Cost of Freehold Land			
F. Average Capital Cost for Depreciation (D - E)			
G. Weighted Average Rate of Depreciation			
H. Annualized Depreciation (F x G)			
I. Advance Against Depreciation (AAD)			
J. Total Depreciation (including AAD) for Tariff (H + I)			

Illustration 19.

From the following information Calculate Depreciation and Advance against Depreciation as per Regulation 21 of the Central Electricity Regulatory Commission (Terms and Conditons of Tariff) Regulations, 2004.

- Date of Commercial Operation of COD = 1st April 2010
- Approved opening Capital cost as on 1st April 2010 = 1,50,000
- Weighted Average Rate of Depreciation: 3.5%
- Details of allowed Additional Capital Expenditure. Repayment of Loan and Weighted Average Rate of Interest on Loan is as follows:

	1st year	2nd year	3rd year	4th year
Additional Capital Expenditure (Allowed}	10,000	3,000	2,000	2,000
Repayment of Loan	8,000	10,000	10,000	11,000
Weighted Average Rate of Interest on Loan	7.4	7.5	7.6	7.5

Solution:

1. COMPUTATION OF DEPRECIATION

Particulars	1st year	2nd year	3rd year	4th year
A. Opening Capital Cost	1,50,000	1,60,000	1,63,000	1,65,000
B. Additional Capital Cost	10,000	3,000	2,000	2,000
C. Closing Capital Cost (A + B)	1,60,000	1,63,000	1,65,000	1,67,000
D. Average Capital Cost [(A + C)/2]	1,55,000	1,61,500	1,64,000	1,66,000
E. Weighted Average Rate of Dep.	3.5%	3.5%	3.5%	3.5%
F. Annualized Depreciation (D x E)	5,425	5,652.50	5,740	5,810
G. Advance Against Depreciation (AAD)	2,575	4,347.50	4,260	5,190
H. Total Depreciation (including AAD) for Tariff (F +G)	8,000	10,000	10,000	11,000

2. COMPUTATION OF ADVANCE AGAINST DEPRECIATION (AAD)

Particulars	1st year	2nd year	3rd year	4th year
A. Repayment of Loan (10% of Loan Amou	8,000	10,000	10,000	11,000
B. Depreciation (Excluding AAD)	5,425	5,652.5	5,740	5,810
C. Difference between A & B (A - B)	2,575	4,347.50	4,260	5,190.50
D. Cumulative Repayment of Loan	8,000	18,000	28,000	39,000
E. Cumulative Depreciation (Excluding AAD) at the beg.	5,425	11,077.5	16,817.50	22,627.5
F. Difference between D & E (D - E)	2,575	6,922.50	11,182.50	16,372.5
G. Advance Against Depreciation (AAD) (Minimum of C & F)	2,575	4,347.50	4,260	5,190

Debt-Equity Ratio as per Regulation 20

1. In case of the genrating stations for which investment approval is accorded on or after 1.4.2004, Debt and Equity in the ratio of **70:30** shall be considered for determination of tariff.
2. Where Equity actually employed is more than 30%, Equity in excess of 30% shall be treated as **Notional Loan.**
3. Where Equity actually employed is less than 30%, the acutal Debt and Equity shall be considered for determination of tariff.

How to calculate Interest on Loan Capital as per Regulation 21

(i) Interest on loan capital shall be computed loan-wise on the loans arrived at in the manner indicated in Regulation 20.

(ii) **Statement showing the Calculation of Interest on Loan**

Particulars	1st year	2nd year	3rd year
A. Opening Loan (70% or Actual% of Opening Capital w.e.f)			
B. Additional Loan (70% of admitted Add. Capital Exp.)			
c. Less: Repayment of Loan during the year			
D. Net Closing Loan (A + B-C)			
E. Average Loan [(A+ D)/2]			
F. Weighted Average Rate of Interest on Loan			
G. Interest on Loan (E x F)			

How to calculate Return on Equity for the Purpose of Tariff as per Regulation 21

1. Return on Equity shall be computed on the Equity base (as per Regulation 20) @ 14% p.a.
2. Statement showing the Calculation of Return on Equity

Particulars	1st year	2nd year	3rd year
A. Opening Equity (30% or Actual% of Opening Capital w.e.f.)			
B. Additional Equity (30% of admitted Add.Capital Exp.)			
C. Closing Equity (A + B)			
D. Average Equity [(A+ C)/2]			
E. Return on Equity (D x 14%)			

Illustration 20.

From the following information Calculate Return on Equity as per Regulation 21 of the CentralElectricity Regulatory Commission (Terms and Conditons of Tariff) Regulations, 2004:

1. Date of Commercial Operation of COD = 1st April 2010
2. Approved Opening Capital Cost as on 1st April 2010 = ₹ 15,00,000
3. Details of allowed Additional Capital Expenditure. Repayment of Loan and Weighted Average Rate of Interest on Loan is as Follows

	1st year	2nd year	3rd year	4th year
Additional Capital Expenditure (Allowed)	1,00,000	30,000	20,000	10,000

Solution:

Computation of Return of Equity

Particulars	1st year	2nd year	3rd year	4th year
A. Opening Equity (30%)	4,50,000	4,80,000	4,89,000	4,95,000
B. Additional Equity (30%)	30,000	9,000	6,000	3,000
c. Closing Equity (A + B)	4,80,000	4,89,000	4,95,000	4,98,000
D. Average Equity [(A + C)/2]	4,65,000	4,84,500	4,92,000	4,96,500
E. Return on Equity (D x 14%)	65,100	67,830	68,880	69,510

Illustration 21.

The trial balance of Tulsian Electric Supply Ltd. For the year ended 31st March, 2013 is as below:

Particulars	***Dr.*** **Amount (₹ in '000)**	***Cr.*** **Amount (₹ in '000)**
Share Capital:		
Equity Shares of ₹10 each		50,000
14% Preference Shares of ₹100 each		15,000
Patents and trade mark	2,504	
15% Debentures		24,700
16% term loan		15,300
Land (additons during the year 20,50)	12,450	
Building (additions during the year 50,80)	35,134	
Plant & Machinery	57,058	
Mains	4,524	
Meters	3,150	
Electrical Instruments	1,530	
Office Rurniture	2,450	
Capital Reserve		4,020
Contingency Reserves		12,030
General Reserve		1,000
Transformers	16,440	
Opening Balance of Profit & Loss Account		350
Profit for the year 2012-13 subject to adjustments		5,000
Stock in hand	12,050	
Sundry Debtors	6,246	
Contingency Reserve Investments:		
SBI Bonds-2020	10,010	
Other Investments	2,000	
Cash & Bank	3,254	
Public lamps	3,040	
Depreciation Fund		25,816
Sundry Creditiors		6,524
Proposed dividend		12,100
	1,71,840	1,71,840

During 2012-13 1,00,000, 14% Preference Shares were redeemed at a premium of 10% out of proceeds of fresh issue of equity shares of necessary amounts at a premium of 10%

Required prepare for the above period general balance sheet as on 31st March, 2013 as per the revised schedule VI:

Adjustments:

1. Transfer to Contingency Reserve ₹ 1,70,000 & to General Reserve ₹ 2,00,000
2. Loss on Contingency Reserve Investment ₹ 10,000
3. Make a Provision for debts considered doubtful of ₹ 1,014,000

Solution:

Tulsian Electric Supply Ltd.

Balance Sheet as at 31st March, 2013

Particulars	Note No.	(₹ in '000)
I. EQUITYANDLIABILITIES		
(1) Shareholders' Funds		
(a) Share Capital	1	65,000
(b) Reserves and Surplus	2	21,376
(2) Non-Current Liabilities		
(a) Long-term Borrowings	3	40,000
(3) Current Liabilities		
(a) Trade Payables		6,524
(b) Short-Term Provisions	4	12,100
Total		1,45,000
II. ASSETS		
(1) Non-Current Assets		
(a) Fixed Assets		
(i) Tangible Assets	5	1,09,960
(ii) Intangible Assets		2,504
(b) Non-Current Investments	6	12,000
(2) Current Assets		
(a) Inventories		12,050
(b) Trade Receivables	7	5,232
(c) Cash and Cash Equivalents		3,254
Total		1,45,000

Notes To Accounts:

1. Share Capital

Authorised Capital	
50,00,000 shares of 10 each	50,000
2,50,000 14% Pref. Shares of 100 each	25,000
	75,000

Issued & Subscribed Capital	
50,00,000 shares of 10 each	50,000
2,50,000 14% Pref. Shares of 100 each	25,000
Less: 1,00,000 14% Pref. Shares of 100 each	(10,000)
	65,000

2. Reserves and Surplus

Capital Reserve		4,020
Contingency Reserve (12,030 + 170 – 10)		12,190
General Reserve (1,000 + 200)		1,200
Profit & Loss Account		
Opening Balance	350	
Add: Profit for the period	5,000	
Less: Transfer to General Reserve	(200)	
Less: Transfer to Contingency Reserve	(170)	
Less: Provision for Doubtful Debts	(1,014)	3,966
Total		**21,376**

3. Long-term Borrowings

15% Debentures	24,700
16% Term Loan	15,300
	40,000

4. Short-term Provisions

Proposed Dividend	12,100
	12,100

5. Tangible Assets

Land (10,400 + 20,50)	12,450
Building (30,054 + 50,80)	35,134
Plant & Machinery	57,058
Mains	4,524
Meters	3,150
Electrical Instruments	1,530
Office Rumiture	2 450
Transformers	16 440
Public lamps	3 040
Less: Depreciation Fund	(25 816)
Total	**1,09,960**

6. Non-Current Investments

SBI Bond-2020 (10,010 – 10)	10,000
Other Investments	2,000
	12,000

7. Trade Receivables

Sundry Debtors	6,246
Less : Provision for Doubtful Debts	(1,014)
	5,232

OPTIMISED DEPRECIATED REPLACEMENT COST (ODRC METHOD)

15.1 The Optmised Depreciated Replacement Cost [ODRC] Method involves:

(i) Assessment of the gross current replacement cost of modern equivalent assets.

(ii) Making an adjustment for over design, over capacity and redundant assets and then,

(iii) Depreciating this optimum gross current replacement cost to reflect the anticipated effective working life of the asset from new, the age of the asset and the estimated residual value at the end of the asset's working life.

The ODRC method comprises the following steps:

Step 1: Preparing a detail Asset Register containing data on quantity, location, physical condition, age and maintenance of the assets.

Step 2: Calculation of the Replacement Cost (i.e. Cost of replacing the assets with modern equivalent assets).

Step 3: Assessment of Depreciation. The new assets at replacement costs identified earlier need to be depreciated in case the life of the existing asset is lower than the life of the new assets.

Step 4: System Optimisation: This is done to measure the most cost effective way of delivering service, in terms of capacity and quality to meet the requirements.

This involves three levels:

• Capacity Optimisation both in size and number

• Optimisation of spares

• Optimisation of unit costs

An immediate shift to the ODRC Method Is not recommended due to:

– Problems in producing a detailed Asset Register.

– Absence of norms for standard lives of assets.

– Absence of construction cost estimates

– Lack of data on future load growth.

The ODRC Method would be better because:

– It will ensure that the price shocks are gradually administered to the customers.

– It will ensure greater acceptability to users since over capacity issues will be addressed and cost reductions possible from new technologies will be incorporated in the valuation.

– The valuation will reflect the cost of replacement utitlites will be able to assess the timrng and financing requirements with a greater degree of certainty.

12.3 ACCOUNTING OF INSURANCE COMPANIES

INTRODUCTION

Several people exposed to a particular type of risk contribute small amounts called premiums to an insurance fund from which the unfortunates who actually suffer the risk are compensated. Insurance business is essentially a way of averaging the risks.

A policy is a contract entered into between the insurance companies called the 'insurer' and the person insuring his risk called the 'insured'.

Policy specifies all the conditions subject to which the policy is issued. These conditions bind both the parties.

The policy is in the form of a document which the insurance company issues after receiving the premium.

Thus Insurance is essentially a method of averaging risks.

Types of Policies

Depending on the type of risk, there are several types of insurance policies.

Risks of fire are covered by **fire policies**.

Marine risks of goods, vessels and freights of goods are covered by **marine insurance policies.**

Losses of theft are covered by **Burglary insurance**.

There are miscellaneous policies to insure **accidents, fidelity of employees, loss of profits in the event of fire and accidents and deaths to employees at work spots.**

Life insurance takes primarily two forms. In the case of **endowment policy**, the insured obtains a specified sum in the event of the insured obtaining a specified age or to the family in case the insured dies before attaining specified age. They may be again with or without profit policies. Whereas in the case of whole life policies the family of the insured (to be exact the nominee mentioned in the policy) receives a specified sum on the death of insured.

The premiums would be less in the case of whole life policies compared to endowment policies for the insured of the same age.

Principles of Insurance

There are several principles governing insurance business, the important of which are discussed below.

Principle of indemnity. Insurance is a contract of indemnity. The insurer is called indemnifier and the insured is the indemnified. In a contract of indemnity, only those who suffer loss are compensated to the extent of actual loss suffered by them. One cannot make profit by insuring his risks.

Insurable interest. All and sundry cannot enter into contracts of insurance. For example, *A* cannot insure the life of B who is a total stranger. But if *B*, happens to be his wife or his debtor or business manager, *A* has insurable interest and therefore he can insure the life of B. For every type of policy insurable interest is insisted upon. In the absence of such interest the contract will amount to a wagering contract.

Principle of *uberrimae fidei*. Under ordinary law of contract there is no positive duty to tell the whole truth in relation to the subject-matter of the contract. There is only the negative obligation to tell nothing but the truth. In a contract of insurance, however there is an implied condition that each party must disclose every material fact known to him. This is because all contracts of insurance are contracts *of uberrimea fidei, i.e.,* contracts of utmost good faith. This is because the assessment of the risk and the determination of the premium by the insurer depends on the full and frank disclosure of all material facts in the proposal form.

Distinction between Life and Non-life Insurance

There are certain basic differences between life policies and other types of policies. These are listed below:

(1) Human life cannot be valued exactly. Therefore each insured is permitted to insure his life for a specified sum, depending on his capacity to pay premiums. This is also one form of investment and the policy amount depends on his investment decision. In the event of the policy maturing the insurer must pay the policy amount as actual loss cannot be determined. This is not the case with other policies. Other policies are contracts of indemnity. Therefore not withstanding the amount for which the policy is taken, the insurer would pay (reimburse) only the actual loss suffered or the liability incurred.

(2) Life insurance contracts are long-term contracts. Once a policy is taken premiums have to be paid for number of years till maturity and the policy amount is paid on maturity. Of course, a life policy can be surrendered after certain number of years and the insured is paid a proportion of the premiums paid known as surrender value. In the case of other policies they are for a short period of one year although the policy can be renewed year after year.

(3) Life insurance is known also by another term 'assurance' since the insured gets an assured sum. Other policies are known as insurance.

(4) The determination of profit is by different methods for life and general insurance business. In the case of life business periodically actuaries estimate the liability under existing policies.

On that basis a valuation Balance Sheet is prepared to determine the profit. In the case of general insurance business a portion of the premium is carried forward as a provision for unexpired liability and the balance net of claims and expenses is taken as profit (or loss).

IMPORTANT PROVISIONS OF THE INSURANCE ACT, 1938

The Insurance Act, 1938 and the rules framed thereunder have an important bearing on the preparation of accounts by insurance companies. Some of the provisions have become irrelevant after the nationalization of general insurance. Some provisions have been amended by The Insurance Laws (Amendment) Act, 2015 and these have been separately listed.

(1) Forms for final accounts [Sec 11(1)]. Every insurer, on or after the date of the commencement of the Insurance Laws (Amendment) Act,2015, in respect of insurance business transacted by him and in respect of his shareholders' funds, shall at the expiration of each financial year, prepare with reference to that year, balance sheet, a profit and loss account, a separate account of receipts and payments, a revenue account in accordance with the regulations as may be specified.

(2) Audit. The Act provides that the company carrying on general insurance business be audited as per the requirements of the Companies Act, 2013.

(3) Register of policies [Sec 14](1)(a)] Every insurer shall maintain a record of policies, in which shall be entered, in respect of every policy issued by the insurer, the name and address of the policyholder, the date when the policy was effected and a record of any transfer, assignment or nomination of which the insurer has notice.

(4) Register of claims. The insurer must also maintain a register of claims for record of claims, every claim made together with the date of the claim, the name and address of the claimant and the date on which the claim was discharged, or in the case of a claim which is rejected, the date of rejection and the grounds thereof.

(5) Approved investments (27B) All assets of an insurer carrying on general insurance business shall subject to such conditions, if any, as may be prescribed, be deemed to be assets invested or kept invested in approved investments specified in this section.

(6) Payment of commission to authorized agents (Sec 40). No person shall, pay or contract to pay any remuneration or reward, whether by way of commission or otherwise for soliciting or procuring insurance business in India to any person except an insurance agent or an intermediary or insurance intermediary in such manner as may be specified by the regulations.

(7) Sec 40 (C). Every insurer transacting insurance business in India shall furnish to the Authority, the details of expenses of management in such manner and form as may be specified by the regulations made under this Act.

(8) Sec 64VA Every insurer and re-insurer shall at all times maintain an excess of value of assets over the amount of liabilities of, not less than fifty per cent of the amount of minimum capital as stated under Section 6 and arrived at in the manner specified by the regulations.

BOOKS REQUIRED TO BE MAINTAINED BY INSURANCE COMPANIES

Under the Insurance Act, 1938 it is obligatory on the part of all insurance companies including the general insurance companies to maintain the following books which may be called 'statutory books'.

1. **The registrar of policies.** This book contains the following particulars in respect of each policy issued:
   (a) The name and address of the policyholder;
   (b) The date when the policy was effected; and
   (c) A record of any assignment of the policy.
2. **The register of claims.** This book should contain the following particulars in respect of each claim:
   (a) The date of claim;
   (b) The name and address of the claimant;
   (c) The date on which the claim was discharged; and
   (d) In the case of a claim which is rejected, the date of rejection and the ground for rejection.
3. **The register of licensed insurance agents.** This book should contain the following particulars in respect of each agent:
   (a) Name and address of every insurance agent appointed;
   (b) The date of appointment; and
   (c) The date on which appointment ceased, if any.

In addition to the statutory books mentioned above, insurance companies also maintain the following subsidiary books for recording the transactions:

(i) Proposal register
(ii) New premium cash book
(iii) Renewal premium cash book
(iv) Agency and branch cash book
(v) Petty cash book
(vi) Claims cash book
(vii) General cash book
(viii) Agency credit journal
(ix) Agency debit journal
(x) Lapsed and cancelled policies book

(xi) Chief journal

(xii) Commission book

(xiii) Agency ledger

(xiv) Policy loan ledger

(xv) General loan ledger

(xvi) Investment ledger

ACCOUNTS OF LIFE INSURANCE BUSINESS

Nationalization of Life Insurance Business. In 1956 life insurance business was nationalized by transferring all such business to the Life Insurance Corporation established for the purpose. The main objects of nationalization were:

(1) To ensure absolute security to the policy holder in the matter of life insurance protection.

(2) To spread insurance much more widely and in particular to the rural areas, and

(3) As a further step in the direction of more effective mobilization of public savings.

Some of the important provisions of the Life Insurance Corporation Act, 1956 which are worth noting are stated below:

(1) **Section 30.** Except to the extent otherwise expressly provided in this Act, on and from the appointed day the Corporation shall have the exclusive privilege of carrying on life insurance business in India; and on and from the said day any certificate to registration under the Insurance Act held by any insurer immediately before the said day shall cease to have effect in so far as it authorises him to carry on life insurance business in India.

(2) **Section 37**. The sums assured by all policies issued by the Corporation including any bonuses declared in respect thereof and, subject to the provisions contained in section 14 the amounts assured by all policies issued by any insurer the liabilities under which have vested in the Corporation under this Act, and all bonuses declared in respect thereof, whether before or after the appointed, day shall be guaranteed as to payment in cash by the Central Government.

(3) **Section 6.** Functions of the Corporation.

(a) The general duty of the Corporation is to carry on life insurance business whether in or outside India and to develop the life insurance business to the best advantage of the community.

(b) In addition the Corporation has the power:

(i) To carry on capital redemption business, annuity certain business or re-insurance business,

(ii) To invest the funds of the Corporation,

(iii) To acquire, hold and dispose of any property for the purpose of its business, and

(iv) To advance or lend money upon the security of any movable or immovable property or otherwise.

(4) **Sections 18 and 19.** The central office is located at Mumbai and has zonal offices at Mumbai, Kolkata, Delhi, Kanpur and Chennai.

There may be established as many divisional offices and branches in each zone as may be decided by the Corporation in accordance with the guidelines issued by the Insurance Regulatory and Development Authority established under the Insurance Regulatory and Development Authority Act, 1999 in this regard.

The general superintendence and direction of the Corporation affairs is carried on by an executive committee consisting of not more than 5 members. The investment committee advises the Corporation in matters relating to investment of funds. This committee can have a maximum of 8 members of which 4 must be members of the Corporation.

As per Section 4 the Corporation consists of not more than 15 members appointed by the Central Government and one of them nominated will act as the Chairman.

(5) **Sections 20.** The Corporation may appoint one or more persons to be the Managing Director or Directors of the Corporation, and every Managing Director shall be a whole-time officer of the Corporation and shall exercise such powers and perform such duties as may be entrusted or delegated to him by the Executive Committee or the Corporation

(6) **Section 24.** The Corporation has its own fund and all the receipts are credited to such fund and all payments are made there from.

(6) **Section 25.** The accounts of the Corporation shall be audited by auditors duly qualified to act as auditors of companies under the law for the time being in force relating to companies, and the auditors shall be appointed by the Corporation with the previous approval of the Central Government and shall receive such remuneration from the Corporation as the Central Government may fix.

Every auditor in the performance of his duties shall have at all reasonable times access to the books, accounts and other documents of the Corporation.

The auditors shall submit their report to the Corporation and shall also forward a copy of their report to the Central Government..

(7) **Section 26.** There must be an actuarial valuation at least once in every year and the Corporation must submit the report to the Central Government.

(8) **Section 27.** At the end of each financial year the Corporation is required to prepare and submit a report to the Central Government giving an account of its activities during the previous financial year and also an account of the planned activities for the next financial year.

(9) **Section 28.** Ninety-five percent (or a higher percentage approved by the Central Government) from actuarial valuation made under Section 26 shall be allocated to or reserved for the policyholders of the Corporation and the remainder either paid to the Central Government or utilized for such purposes and in such manner as the Government may determine.

(10) **Section 28A.** If for any financial year profits accrue from any business (other than life insurance business) carried on by the Corporation, then, after making provision for reserves and other matters for which provision is necessary or expedient, the balance of such profits shall be paid to the Central Government.

(11) **Section 29.** The Central Government shall cause the report of the auditors under section 25, the report of the actuaries under section 26 and the report giving an account of the activities of the Corporation under section 27 to be laid before both Houses of Parliament as soon as may be after each such report is received by the Central Government.

Types of Policies.

As stated earlier, under a contract of life insurance an insurance company guarantees to pay a fixed sum of money to the insured on his attaining a certain age or to his nominees or legal heirs on his death. The contract in its written form is called a policy and broadly there are two types of policies. They are (1) whole life policy, and (2) Endowment policy. Under whole life policy the insured does not get the amount during his life time. The amount is paid only to his nominees or heirs on his death. In the case of Endowment policy the amount is paid to the insured on his attainment of a specified age or if he dies before, the amount is paid to his nominees or heirs. As explained later life insurance company

ascertains the profits once in two years. 95% of such profits are distributed to policyholders as bonus. Such bonus is to be credited only to 'with profit policies'. The holders of 'without profit policies' have no right to the bonus. Naturally the premium is comparatively less in the case of 'without profit policies' than in the case of 'with profit policies'. In recent years the reversionary bonus has been around ₹ 20 per thousand sum assured per annum on Endowment policies and ₹ 25 per thousand sum assured per annum on whole life policies.

Annuity Business.

Life insurance companies also do annuity business. Annuity refers to fixed annual payment made by the insurance company to the insured on his attaining a specified age. The insured deposits lump sum amount by way of consideration for the annuity granted. This is a method under which the person purchasing the annuity receives back his money with interest. Annuity paid represents an expenditure of the life insurance business and the consideration received for annuities is an item of income.

Surrender Value.

In the case of life policy, the policy normally has value only when it matures. But to facilitate the promotion of business, insurance companies assign value to the policy on the basis of the premiums paid. Insurance companies will be prepared to pay such value on the surrender of the policy by a needy policy holder desiring to realize the policy. Therefore the value is referred to as 'surrender value'. Surrender value is usually nil until at least two annual premiums are paid. Amount paid as surrender value is an expenditure and is similar to claims paid.

Paid-up Policy.

A policy holder, who has difficulty in paying the premium, may be allowed an option to get the policy paid-up. In such a case, the policyholder is relieved from the obligation of paying off the rest of premium, but he will not get the full value of policy which is calculated as follows:

$$\text{Paid-up Value} = \text{Sum assured} \times \frac{\text{No. of premiums paid}}{\text{Total number of premiums payable}}$$

The amount paid on maturity in respect of paid-up policies is included in the amount of claims.

Bonus: It is nothing but the share of profit which is payable by the insurance company to the policyholders. Bonus may be of three types –

Cash Bonus: It is paid to the policyholders in cash when the Valuation Balance Sheet is prepared.

Reversionary Bonus: It is added to the policy amount and is paid together with the policy amount when matured for payment.

Bonus in reduction of premium: It is just applied in reducing further premiums.

Interim Bonus — It is a bonus declared between dates of two valuation Balance Sheets. It is for a period for which valuation is not complete.

Bonus in Reduction of Premium: In all the cases of general insurance the policy is always taken for one year and it is to be renewed after the expiry of the policy. Whether the policy is renewed with the same company, or a fresh policy is taken with some other company, it is a standing practice that the company usually grants a reduction in premium at the prescribed rate if the insured has not made any claim. This rate of reduction increases every year for usually three years if the insured does not make any claim continuously year after year.

Premium: The payment made by the insured to the Insurance Company in consideration of the contract of Insurance. The premium is generally paid annually. In some cases it may be paid at shorter intervals. A point to be noted is the premium amount has to be paid "front end" i.e., before the commencement of the insurance cover/policy.

Claims: A claim occurs when any policy fail due for payment. In case of Life Insurance, it arises on death or on maturity of policy. In case of General Insurance, it arises only when the loss occurs. While calculating the claim outstanding at the end, the claim intimated as well as the claim intimated and accepted both are considered.

The adjustment entry required is:

Claims A/c Dr.

To Claims intimated and accepted but not paid A/c

To Claims intimated but not accepted and paid A/c

At the starting of the next period a reverse entry is passed, so that when these claims intimated are paid, they may not influence the claims account of next year. However, if company rejects any claim, such amount should be transferred to the insurance fund account and not to the claims account.

Commission: Generally, Insurance Companies get business through agents; these agents receive commission on the basis of the amount of premium they generate for the Insurance Company. Commission paid to Agents is shown as a debit (expense) in the Revenue Accounts.

Re-insurance:

Re-insurance means the transfer of a part of risk by the insurer. This is particularly done when the amount of insurance is very high and when it is very difficult to bear the entire risk by a single insurer, a part of the risk is to be insured with some other insurance companies.

Double Insurance: When the same risk and the same subject matter is insured with more than one insurer, i.e., more than one insurance company, the same is called Double Insurance.

Ceding Company: An insurance company that shifts part or all of a risk it has assumed to another insurance company. The Ceding company shares the premium amount it has received to cover the risk, with the second insurance company called the Reinsurer. In return the Reinsurer company pays commission to the Ceding company for getting the business.

Life Assurance Fund.

This represents the excess of revenue receipts over revenue expenditure relating to life business. The fund is available to meet the aggregate liability on all policies outstanding. Revenue Account is prepared every year to ascertain the balance of life insurance fund at the end of the year. In the preparation of Revenue Account, the opening balance of the life insurance fund is the starting point. Other items of revenue income are credited to the fund and revenue items of expense are debited. The resulting figure is the closing balance of the revenue fund.

Illustration 22.

The Revenue Account of a life insurance company shows the life assurance fund on 31st March, 2013 at ₹ 62,21,310 before taking into account the following items:

(i) Claims covered under re-insurance ₹ 12,000.

(ii) Bonus utilized in reduction of life insurance premium ₹ 4,500.

(iii) Interest accrued on securities ₹ 8,260.

(iv) Outstanding premium ₹ 5,410.

(v) Claims intimated but not admitted ₹ 26,500.

What is the life assurance fund after taking into account the above omissions?

Solution:

Statement showing Life Assurance Fund

Particulars	Amount (₹)	Amount (₹)	Amount (₹)
Balance of Fund as on 31st March, 2013			62,21,310
Add:			
Interest on securities		8,260	
Premium outstanding		5,410	13,670
			62,34,980
Less:			
Claims outstanding	26,500		
Covered under re-insurance	12,000	14,500	
Bonus in reduction of premium		4,500	19,000
Balance of Life Assurance Fund			62,15,980

Valuation Balance Sheet.

The balance in the life assurance fund cannot be taken as the profit made by the life insurance business. For the purpose of ascertaining the profit, the insurance company should calculate its net liability on all outstanding policies. This calculation is done by experts called actuaries and is a highly complicated mathematical process. Prior to nationalization, insurance companies were having this computation once in three years. Since nationalization, L.I.C. is having such valuation once every two years. For calculating net liability, the actuaries calculate the present value of future liability on all the policies in force as well as present value of future premium to be received on policies in force. The excess of the present value of future liability over the present value on future premium is called the net liability.

It is by comparing the life insurance fund and net liability in respect of policies, that profit in respect of life insurance business can be ascertained. If the life insurance fund is more than the net liability, the difference represents the profit. On the other hand, the excess of net liability over the life assurance fund represents the loss for the inter-valuation period.

According to Section 28 of the Life Insurance Corporation Act, 1956, 95% of the profit of life business must be distributed to the policyholders by way of "Bonus" on with-profit policies and the remaining 5% has to be utilized for such purposes as the Government may determine. The profit or loss of life insurance business is ascertained by preparing a statement called 'Valuation Balance Sheet' which is reproduced below.

Valuation Balance Sheet as on..............................

To Net liability as per actuary's valuation		By Life Assurance Fund as per Balance Sheet
To Surplus (Net Profit)		By Deficiency (Net loss)

Illustration 23:

The life insurance fund of Prakash Life Insurance Co. Ltd. was ₹ 34,00,000 on 31st March, 2013. Its actuarial valuation on 31st March, 2013 disclosed a net liability of ₹ 28,80,000. An interim bonus of ₹ 40,000 was paid to the policyholders during the previous two years. It is now proposed to carry forward ₹ 1,10,000 and to divide the balance between the policyholders and the shareholders. Show *(a)* the Valuation Balance Sheet, *(b)* the net profit for the two-year period, and (c) the distribution of the profits.

Solution:

In the Books of Prakash Life Insurance Co. Ltd.

Valuation Balance Sheet as on 31st March, 2013

Liabilities	Amount (₹)	Assets	Amount (₹)
To Net liability	2,880,000	By Life Assurance Fund	3,400,000
To Net Profit	520,000		
	3,400,000		3,400,000

Net profit for the two-year period	
Profit as per Valuation Balance Sheet	5,20,000
Add: Interim Bonus paid during the previous two years	40,000
Net Profit	5,60,000
Distribution of the profits	
Net Profit	5,60,000
Less: Amount proposed to be carried forward	1,10,000
Balance	4,50,000
Share of policyholders (95% of ₹ 4,50,000)	4,27,500
Less: Interim bonus paid	40,000
Amount due to policyholders	3,87,500
Share of Shareholders (5% of ₹ 4,50,000)	22,500

Illustration 24:

Heaven Life Insurance Co. furnishes you the following information:

Particulars	Amount (₹)
Life Insurance fund on 31.3.2013	52,00,000
Net liability on 31.3.2013 as per actuarial valuation	40,00,000
Interim bonus paid to policyholders during intervaluation period	3,00,000

You are required to prepare:

(i) Valuation Balance Sheet;

(ii) Statement of Net Profit for the valuation period; and

(iii) Amount due to the policyholders.

Solution:

(i) **Heaven Life Insurance Co.**

Valuation Balance Sheet as at 31st March, 2012

Liabilities	Amount (₹)	Assets	Amount (₹)
To Net Liability as per actuarial valuation	40,00,000	By Life Assurance Fund	52,00,000
To Surplus	12,00,000		
	52,00,000		52,00,000

(ii) **Statement showing Net Profit for the valuation period**

Particualrs	Amount (₹)
Surplus as per Balance Sheet (i.e., Valuation Balance Sheet)	12,00,000
Add: Interim bonus paid	3,00,000
	15,00,000

(iii) **Amount due to policyholders**

Particualrs	Amount (₹)
95% of net profit due to policyholders (95% of ₹ 15,00,000)	14,25,000
Less: Interim bonus already paid	3,00,000
Amount due to policyholders	11,25,000

Illustration 25:

Prudence Life Insurance Co. furnishes you the following information:

Particualrs	Amount (₹)
Life Insurance fund on 31.3.2013	1,30,00,000
Net liability on 31.3.2013 as per actuarial valuation	1,00,00,000
Interim bonus paid to policyholders during intervaluation period	7,50,000

You are required to prepare :

(i) Valuation Balance Sheet;

(ii) Statement of Net Profit for the valuation period; and

(iii) Amount due to the policyholders.

Solution:

(i) **Prudence Life Insurance Co.**

Valuation Balance Sheet as at 31st March, 2013

Liabilities	Amount (₹)	Assets	Amount (₹)
To, Net Liability as per actuarial valuation	100,00,000	By, Life Assurance Fund	130,00,000
To, Surplus	30,00,000		
	130,00,000		130,00,000

(ii) **Statement showing Net Profit for the valuation period**

Particualrs	Amount (₹)
Surplus as per Balance Sheet (i.e., Valuation Balance Sheet)	30,00,000
Add: Interim bonus paid	7,50,000
	37,50,000

(iii) **Amount due to policyholders**

Particualrs	Amount (₹)
95% of net profit due to policyholders (95% of ₹ 37,50,000)	35,62,500
Less: Interim bonus already paid	7,50,000
Amount due to policyholders	28,12,500

Illustration 26:

From the following figures of Well Life assurance Co. Ltd. prepare a Valuation Balance Sheet and Profit Distribution Statement for the year ended 31st March 2014. Also pass necessary journal entries to record the above transactions with narrations:

Particulars	₹ (in lakhs)
Balance of Life Assurance Fund as on 1.4.2013	167.15
Interim bonus paid in the valuation period	25.00
Balance of Revenue Amount for the year ended 31.3.2014	240.00
Net Liability as per valuer's Certificates as on 31.3.2014	165.00

The company declares a revisionary bonus of ₹185 per ₹1,000 and gave the policyholders an option to take bonus in cash ₹105 per ₹1,000. Total business conducted by the company was ₹600 lakhs. The company issued profit policy only, 3/5 th of the policyholders in value opted for cash bonus.

Solution:

In the Books of Well Assurance Co. Ltd.
Valuation Balance Sheet
As at 31st March 2014

Liabilities	Amount (₹)	Assets	Amount (₹)
Net Liabilities as per Actuarial Valuation Surplus/Net Profit	1,65,00,000 75,00,000	Life Insurance Fund	2,40,00,000
	2,40,00,000		2,40,00,000

Distribution Statement, i.e. Distribution of Surplus	₹
Surplus/ Net Profit	75,00,000
Add: Interim Bonus Paid	25,00,000
	1,00,00,000

Policyholders' shares @95% of ₹1,00,00,000	95,00,000
Less: Interim Bonus paid	25,00,000
	70,00,000

Shareholders' Share @ 5% of ₹1,00,00,000	5,00,000

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹
?	Life Assurance Fund A/c Dr. To, Profit and Loss A/c (Surplus/Net Profit transferred to P&L A/c as per Valuation Balance Sheet)		75,00,000	75,00,000
	Profit and Loss A/c Dr. To, Bonus (in cash) Payable A/c (Bonus paid in cash)		37,80,000	37,80,000
	Profit and Loss A/c Dr. To, Life Assurance Fund A/c (Revisionary Bonus payable transferred to Life assurance Fund)		44,40,000	44,40,000

Workings:

1.	**Bonus Payable in Cash**
	@ ₹ 105 per ₹ 1,000
	On 3,60,00,000 (₹6,00,00,000× $\frac{3}{5}$)
	= ₹ $\frac{3,60,00,000}{1,000}$ ×105
	= ₹ 37,80,000

2.	**Revisionary Bonus**
	@ ₹ 185 per ₹ 1,000
	On 2,40,00,000 (₹6,00,00,000× $\frac{2}{5}$)
	= ₹ $\frac{2,40,00,000}{1,000}$ ×185
	= ₹44,40,000

IRDA REGULATIONS REGARDING PREPARATION OF FINANCIAL STATEMENTS

IRDA has issued fresh regulations regarding the preparation of financial statements and Auditor's Report on 14th August, 2000. The salient features which differ from the requirements of Insurance Act, 1938 are listed below.

(1) Insurers will in addition to the earlier statements will have to prepare a receipts and payments account (cash flow statement). This statement must be prepared in accordance with AS-3 using the direct method given in the standard.

(2) Insurers doing life insurance business should comply with the requirements of Schedule A.

The Schedule, among other things, gives the following forms:

Revenue Account	Form A-RA
Profit and Loss Account	Form A-PL
Balance Sheet	Form A-BS

The profit and loss account and balance sheet are given in summary form.

There are 15 Schedules, the first four relating to profit and loss account and the remaining eleven relate to balance sheet which give the details of the summary heads. Schedule 5 deals with share capital. It is followed by a connected Schedule 5A, which, gives the pattern of shareholding.

(3) Insurers doing general insurance business should comply with the requirements of Schedule B.

The schedule among other things gives the following forms:

Revenue Account	Form B-RA
Profit and Loss Account	Form B-PL
Balance Sheet	Form B-BS

As in the case of life business the profit and loss account and the balance sheet are given in summary form. The details are to be shown in the accompanying schedules. Here also the first four relate to profit and loss account and the rest eleven pertaining to balance sheet. Schedule 5A gives the pattern of shareholding. In both the schedules profit and loss appropriation account is dispensed with and the appropriations are accommodated in the profit and loss account.

(4) The report of the auditors on the financial statements of every insurer and re-insurer must conform to the requirements of Schedule C. The Authority reserves the right to issue guidelines on the

appointment, continuance or removal of auditors. These guidelines can include matters relating to qualifications, experience, rotation and period of appointment of auditors.

(5) The financial statements must be accompanied by a management report given in part *(iv)* in Schedules A and B as well. The report deals with compliance of certain requirements of the regulations, provision of solvency margins, disclosure with regard to the overall risk exposure and the strategy adopted to mitigate the same. It also includes ageing of claims indicating the average period taken to settle the claims, computing market value of investments, its impact on balance sheet and a review of asset quality performance of investments in terms of portfolios such as real estate, loans, investments, etc. Finally, the report includes a responsibility statement indicating the compliance with the accounting standards, financial statements reflecting a true and fair view, maintenance of adequate accounting records, preparation of accounts on a going-concern basis and the existence of an internal audit system consistent with the size and nature of business.

(6) The financial statements should disclose the contingent liabilities, the accounting policies and the departures from such policies with reasons therefore.

(7) Premium recognition. Premium is the main revenue for insurance business. In the case of life business premium is to be recognized on due basis. In the case of general insurance premium is to be recognized as income over the contract period or the period of risk whichever is appropriate.

Unearned premium and premium received in advance both of which represent income not relating to the accounting period must be disclosed separately in the financial statements. Unearned premium is the premium for the period of unexpired risk. Premium received in advance represents the premium received prior to the commencement of risk. In other words, the premium relates entirely to subsequent accounting periods. A provision should be made for unearned premium. Both premium received in advance and unearned premium are shown separately in the balance sheet under the heading 'Current Liabilities'.

(8) *Premium Deficiency*. It is the sum of expected claim costs, related expenses and maintenance costs exceeding the related unearned premium.

(9) *Actuarial Valuation of claims liability-in some cases.* Previously there was no need for actuarial valuation in general insurance. Now the regulations require estimation of claims made in respect of contracts exceeding four years, must be recognized on actuarial basis, subject to the regulations of the Authority.

(10) *Catastrophe reserve*. Such a reserve should be created by the insurers towards losses which might arise due to entirely unexpected set of events and not for any specific known purpose. Investment of the funds of this reserve must be made in accordance with the prescription of Authority.

(11) Valuation of investments must be made in the manner prescribed by the Authority.

(12) Loans must be measured on historical cost subject to impairment provisions.

The Regulations issued by IRDA regarding the preparation of Financial Statements and Auditors' Report of Insurance Companies on 14th August, 2000 are given in Appendix. The student is advised to familiarise with new forms of Revenue Accounts and Final Accounts and the connected Schedule.

APPENDIX INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY, NEW DELHI

The Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2000

In exercise of the powers conferred by Section 114A of the Insurance Act, 1938, (4 of 1938), the Authority, in consultation with the Insurance Advisory Committee, hereby makes the following regulations, namely:

1. Short title and commencement-

(1) These regulations may be called the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2002.

(2) They shall come into force from the date of their publication in the *Official Gazette*.

2. Definitions

(1) In these regulations, unless the context otherwise requires

(a) "Act" means the Insurance Act, 1938 (4 of 1938) ;

(b) 'Authority" means the Insurance Regulatory and Development Authority established under sub-section (1) of Section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999);

(c) All words and expressions used herein 'and not defined but defined in the Insurance Act, 1938 (4 of 1938), or in the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), or in the Companies Act, 1956 (1 of 1956), shall have the meanings respectively assigned to them in those Acts.

3. Preparation of financial statements, management report and auditor's report

(1) An insurer carrying on life insurance business, after the commencement of these Regulations, shall comply with the requirements of Schedule A.

(2) An insurer carrying on general insurance business, after the commencement of these Regulations, shall comply with the requirements of Schedule B:Provided that this sub-regulation shall apply, *mutatis mutandis,* to reinsurers, until separate regulations are made.

(3) The report of the auditors on the financial statements of every insurer and reinsurer, shall be in conformity with the requirements of Schedule C, or as near as thereto as the circumstances permit.

(4) The Authority may, from time to time, issue separate guidelines in the matter of appointment, continuance or removal of auditors of an insurer or reinsurer, as the case may be, and such guidelines may include prescriptions regarding qualifications and experience of auditors, their rotation, period of appointment, etc.

SCHEDULE A

(See Regulation 3)

PART I

Accounting principles for preparation of financial statements:

1. **Applicability of Accounting Standards:** Every Balance Sheet, Revenue Account [Policyholders' Account], Receipts and Payments Account [Cash Flow Statement] and Profit and Loss Account [Shareholders' Account] of an insurer shall be in conformity with the Accounting Standards (AS) issued by the ICAI, to the extent applicable to insurers carrying on life insurance business, except that:

   (i) Accounting Standard 3 (AS 3)-Cash Flow Statements-Cash Flow Statement shall be prepared only under the Direct Method.

   (ii) Accounting Standard 17 (AS 17)-Segment Reporting-shall apply irrespective of whether the securities of the insurer are traded publicly or not.

2. **Premium:** Premium shall be recognized as income when due. For linked business the due date for payment may be taken as the date when the associated units are created.

3. **Premium Deficiency:** Premium deficiency shall be recognized if the sum of expected claim costs, related expenses and maintenance costs exceeds related unearned premiums.

4. **Acquisition Costs:** Acquisition costs, if any, shall be expensed in the period in which they are incurred.

   Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts *(i.e.,* commencement of risk).

5. **Claims Cost:** The ultimate cost of claims shall comprise the policy benefit amount and claims settlement costs, wherever applicable.

6. **Actuarial Valuation:** The estimation of liability against life policies in force shall be determined by the appointed actuary of the insurer pursuant to his annual investigation of the life insurance business. Actuarial assumptions are to be disclosed by way of notes to the account.

   The liability shall be so calculated that together with future premium payments and investment income, the insurer can meet all future claims (including bonus entitlements to policyholders) and expenses.

7. **Procedure to determine the Values of Investments:** An insurer shall determine the values of investments in the following manner:

   (a) *Real Estate-Investment Property*: The value of investment property shall be determined at historical cost, subject to revaluation at least once in every three years. The change in the carrying amount of the investment property shall be taken to Revaluation Reserve.

   The insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred.

   Gains/losses arising due to changes in the carrying amount of real estate shall be taken to Equity under 'Revaluation Reserve'. The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the carrying amount previously recognized in Equity under the heading 'Revaluation Reserve' in respect of a particular property and being recycled to the relevant Revenue Account or Profit and Loss Account on sale of that property.

   The bases for revaluation shall be disclosed in the notes to account. The Authority (IRDA) may issue directions specifying the amount to be released from the revaluation reserve for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except for the amount that is released to policyholders as per the authority's direction, no other amount shall be distributed to shareholders out of Revaluation Reserve Account.

   An impairment loss shall be recognized as an expense in the Revenue/Profit and Loss Account immediately, unless the asset is carried at revalued amount. Any impairment loss of a revalued asset shall be treated as a revaluation decrease of that asset and if the impairment loss exceeds the corresponding Revaluation Reserve, such excess shall be recognized as an expense in the Revenue/Profit and Loss Account.

   (b) *Debt Securities.* Debt securities, including Government Securities and Redeemable Preference Shares, shall be considered as "held to maturity" securities and shall be measured at historical cost subject to amortisation.

   (c) *Equity Securities and Derivative Instruments that are traded in active markets*: Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value on the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price at the stock exchanges where the securities are listed shall be taken.

   The insurer shall assess on each balance sheet date whether any impairment of listed equity security (ies) /derivative(s) instruments has occurred.

   An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and willing sellers is normal and the prices are publicly available.

   Unrealised gains/losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head "Fair Value Change Account". The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading 'Fair Vale Change Account', in respect of a particular security and being recycled to the relevant Revenue Account or Profit and Loss Account on actual sale of that listed security.

   The Authority may issue directions specifying the amount to be released from the Fair Value Change Account for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except

for the amount that is released to policyholders as per the Authority's prescription, no other amount shall be distributed to shareholders out of Fair Value Change Account. Also, any debit balance in Fair Value Change Account shall be reduced from Profit/Free Reserves while declaring dividends.

The insurer shall assess, on each balance sheet date, whether any impairment has occurred. An impairment loss shall be recognized as an expense in Revenue/Profit and Loss Account to the extent of the difference between the remeasured fair value of the security/investment and its acquisition cost as reduced by any previous impairment loss recognized as expense in Revenue/ Profit and Loss Account. Any reversal of impairment loss, earlier recognized in Revenue/ Profit and Loss Account shall be recognized in Revenue/Profit and Loss Account.

(d) *Unlisted and other than actively traded Equity Securities and Derivative Instruments*:

Unlisted equity securities and derivative instruments and listed equity securities and derivative instruments that are not regularly traded in active markets shall be measured at historical cost. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of the investment over its carrying amount. The increased carrying amount of the investment due to the reversal of the provision shall not exceed the historical cost.

For the purposes of this regulation, a security shall be considered as being not actively traded, if its trading volume does not exceed ten thousand units in any trading session during the last twelve months.

8. Loans: Loans shall be measured at historical cost subject to impairment provisions. The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be less than the aggregate amount of loans which are subject to defaults of the nature mentioned below:

(i) interest remaining unpaid for over a period of six months; and

(ii) instalment(s) of loan falling due and remaining unpaid during the last six months.

9. Linked Business: The accounting principles used for valuation of investments are to be consistent with principles enumerated above. A separate set of financial statements, for each segregated fund of the linked businesses, shall be annexed.

Segregated funds represent funds maintained in accounts to meet specific investment objectives of policyholders who bear the investment risk. Investment income/gains and losses generally accrue directly to the policyholders. The assets of each account are segregated and are not subject to claims that arise out of any other business of the insurer.

10. Funds for Future Appropriation: The funds for future appropriation shall be presented separately.

The funds for future appropriation represent all funds, the allocation of which, either to the policyholders or to the shareholders, has not been determined by the end of the financial year.

PART II

Disclosures forming part of Financial Statements

A. The following shall be disclosed by way of notes to the Balance Sheet:

1. Contingent Liabilities:

(a) Partly paid-up investments

(b) Underwriting commitments outstanding

(c) Claims, other than those under policies, not acknowledged as debts

(d) Guarantees given by or on behalf of the company

(e) Statutory demands/liabilities in dispute, not provided for

(f) Re-insurance obligations

(g) Others (to be specified).

2. Actuarial assumptions for valuation of liabilities for life policies in force.
3. Encumbrances to assets of the company in and outside India.
4. Commitments made and outstanding for Loans, Investments and Fixed Assets.
5. Basis of amortisation of debt securities.
6. Claims settled and remaining outstanding for a period of more than six months on balance sheet date.
7. Value of contracts in relation to investments, for:
   (a) Purchases where deliveries are pending; and
   (b) Sales where payments are overdue.
8. Operating expenses relating to insurance business: basis of allocation of expenditure to various segments of business.
9. Computation of managerial remuneration.
10. Historical costs of those investments valued on fair value basis.
11. Basis of revaluation of investment property.

B. The following accounting policies shall form an integral part of the financial statements:

1. All significant accounting policies in terms of the accounting standards issued by the ICAI and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies, followed by the insurer, shall be stated in the manner required under Accounting Standard (AS-1) issued by ICAI.
2. Any departure from the accounting policies shall be separately disclosed with reasons such departure.

C. The following information shall also be disclosed:

1. Investments made in accordance with any statutory requirement should be disclosed separately together with its amount, nature, security and any special rights in and outside India;
2. Segregation into performing/non-performing investments for purpose of income recognition as per the directions, if any, issued by the Authority;
3. Assets to the extent required to be deposited under local laws or otherwise encumbered in or outside India;
4. Percentage of business sector-wise;
5. A summary of financial statements for the last five years, in the manner as may be prescribed by the Authority;
6. Bases of allocation of investments and income thereon between Policyholders' Account and Shareholders' Account; and
7. Accounting Ratios as may be prescribed by the Authority.

PART III

General instructions for preparation of Financial Statements

1. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet, Revenue Account, Profit and Loss Account and Receipts and Payments Account shall be given.
2. The figures in the financial statements may be rounded off to the nearest thousands.

3. Interest, dividends and rentals receivable in connection with an investment should be stated at gross amount, the amount of Income Tax Deducted at Source should be included under Advance Taxes paid and Taxes Deducted at Source.

4. (I) For the purposes of financial statements, unless the context otherwise requires

   (a) the expression 'Provision' shall, subject to (II) below mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy;

   (b) the expression 'Reserve' shall not, subject to as aforesaid, include any amount written off or retained by way of providing for depreciation, renewal or diminution in value of assets or retained by way of providing for any known liability or loss;

   (c) The expression 'Capital Reserve' shall not include any amount regarded as free for distribution through the Profit and Loss Account; and the expression 'Revenue Reserve' shall mean any reserve other than a Capital Reserve;

   (d) the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(II) Where:

   (a) any amount written off or retained by way of providing for depreciation renewals or diminution in value of assets, or

   (b) any amount retained by way of providing for any known liability or loss is in excess of the amount which in the opinion of the Directors is reasonably necessary for the purpose, the excess shall be treated as a Reserve and not Provision.

5. The company shall make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.

6. Risks assumed in excess of the statutory provisions, if any, shall be separately disclosed indicating the amount of premiums involved and the amount of risks covered.

7. Any Debit Balance of the Profit and Loss Account shall be shown as deduction from uncommitted Reserves and the balance, if any, shall be shown separately.

PART IV

Contents of Management Report

There shall be attached to the financial statements, a management report containing, *inter alia,* the following duly authenticated by the management:

1. Confirmation regarding the continued validity of the registration granted by the Authority;

2. Certification that all the dues payable to the Statutory Authorities have been duly paid;

3. Confirmation to the effect that the Shareholding Pattern and any transfer of shares during the year are in accordance with the statutory or regulatory requirements;

4. Declaration that the management has not directly or indirectly invested outside India the funds of the holders of policies issued in India;

5. Confirmation that the required Solvency Margins have been maintained;

6. Certification to the effect that the values of all the assets have been reviewed on the date of Balance Sheet and that in his (Insurer's) belief the assets set forth in the Balance Sheets are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings "Loans", "Investments", "Agents Balances", "Outstanding Premiums", "Interest, Dividends and Rents outstanding", "Interest, Dividends and Rents accruing but not due", "Amount due from

other persons or Bodies carrying on insurance business", "Sundry Debtors", "Bills Receivable", "Cash" and the several items specified under "Other Accounts";

7. Certification to the effect that no part of the life insurance fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938, relating to the application and investment of the life insurance funds;

8. Disclosure with regard to the overall risk exposure and strategy adopted to mitigate the same;

9. Operations in other countries, if any, with a separate statement giving the management's estimate of country risk and exposure risk and the hedging strategy adopted;

10. Ageing of claims indicating the trends in average claim settlement time during the preceding five years;

11. Certification to the effect as to how the values, as shown in the Balance Sheet, of the investments and stocks and shares have been arrived at, and how the Market Value thereof has been ascertained for the purpose of comparison with the values so shown;

12. Review of asset quality and performance of investment in terms of Portfolios, *i.e.*, separately in terms of Real Estate, Loans, Investments, etc.; and,

13. A responsibility statement indicating therein that—

    (a) In the preparation of Financial Statements, the applicable accountings tender principles and policies have been followed along with proper explanations relating to material departures, if any,

    (b) The management has adopted accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give true and fair view of the state of affairs of the company at the end of the financial year and of the Operating Profit or Loss and of the Profit or Loss of the company for the year,

    (c) The management has taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the applicable provisions of the Insurance Act, 1938/ Companies Act, 1956, for safeguarding the assets of the company and for preventing and detectingfraud and other irregularities,

    (d) The management has prepared the financial statements on a Going Concern Basis, and

    (e) The management has ensured that an Internal Audit System commensurate with the size and nature of the business exists and is operating effectively.

PART V

Preparation of Financial Statements

(1) An insurer shall prepare the Revenue Account [Policyholders' Account], Profit and Loss Account [Shareholders' Account] and the Balance Sheet in Form A-RA, Form A-PL and Form A-BS, as prescribed in this Part, or as near thereto as the circumstances permit.

Provided that an insurer shall prepare Revenue Account for the undermentioned businesses separately and to that extent the application of AS-17 shall stand modified:

(a) Participating policies and Non-Participating Policies;

(b) Linked, Non-linked and Health Insurance;

(c) Business within India and Business outside India.

(2) An insurer shall prepare separate Receipts and Payments Account in accordance with the Direct Method prescribed in AS 3-"Cash Flow Statement" issued by the ICAI.

The new format of Revenue Account (Policyholders' Account Form A-RA), Profit and Loss Account (Shareholders' Account Form A-PL) and Balance Sheet (Form A-BS) are given below :

LIFE INSURANCE BUSINESS

FORM A-RA

Name of the Insurer:

Registration No. and date of Registration with the IRDA

REVENUE ACCOUNT for the year ended 31st March, 20...

Policy holders' Account (Technical Account)

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Premiums Earned-Net			
(a) Premium	1		
(b) Re-insurance ceded			
(c) Re-insurance accepted			
Income from Investments			
(a) Interest, Dividends & Rent-Gross			
(b) Profit on sale/Redemption of Investments			
(c) Loss on sale/Redemption of Investments			
(d) Transfer/Gain on revaluation/ change in Fair Value*			
Other Income (to be specified)			
Total (A)			
Commission	2		
Operating Expenses related to Insurance Business	3		
Other Expenses (to be specified)			
Provisions (other than taxation)			
(a) For diminution in the value of investments (Net)			
(b) Others (to be specified)			
Total (B)			
Benefits Paid (Net)	4		
Interim Bonuses Paid			
Change in valuation of liability against life policies in force			
(a) Gross**			
(b) Amount ceded in Re-insurance			
(c) Amount accepted in Re-insurance			
Total (C)			
Surplus/(Deficit) (D) = (A) - (B) - (C)			
Appropriations			
Transfer to Shareholders' Account			
Transfer to Other Reserves (to be specified)			
Transfer to Funds for Future Appropriations			
Total (D)			

Notes:

* Represents the deemed realised gain as per norms specified by IRDA.

** Represents Mathematical Reserves after Allocation of Bonus.

The Total Surplus shall be disclosed separately with the following details:

(a) Interim Bonus Paid:

(b) Allocation of Bonus to Policyholders:

(c) Surplus shown in the Revenue Account

(d) Total Surplus: [(a) + (b) + (c)):

FORM A-PL

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

PROFIT & LOSS ACCOUNT for the year ended 31st March, 20…..

Shareholders' Account (Non-technical Account)

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Balance brought forward from/transferred to the Policyholders Account (Technical Account)			
Income from Investments:			
(a) Interest, Dividends & Rent-Gross			
(b) Profit on sale/Redemption of Investments			
(c) Loss on sale/Redemption of Investments			
Other Income (To be specified)			
Total (A)			
Expenses other than those directly related to the insurance business			
Provisions (Other than taxation)			
(a) For diminution in the value of investments (Net)			
(b) Others (to be specified)			
Total (B)			
Profit/ (Loss) before tax			
Provision for Taxation			
Profit/ (Loss) after tax			
Appropriations			
(a) Brought forward Reserve/Surplus from the Balance Sheet			
(b) Interim dividends paid during the year			
(c) Proposed Final Dividend			
(d) Dividend Distribution on Tax			
(e) Transfer to reserves/other accounts (to be specified)			
Profit carried forward to the Balance Sheet			

Notes:

(a) In case of premiums, **less** re-insurance in respect of any segment of insurance business of total premium earned, the same shall be disclosed separately.

(b) Premium income received from business concluded in and outside India shall be separately disclosed.

(c) Re-insurance premiums whether on business ceded or accepted are to be brought into account gross (i.e., before deducting commissions) under the head Re-insurance premiums.

(d) Claims incurred shall comprise claims paid, settlement costs wherever applicable and change in the outstanding provision for claims at the year-end.

(e) Items of expenses and income in excess of one per cent of the total premiums (*less* re-insurance) or ₹ 5,00,000 whichever is higher, shall be shown as a separate line item.

(f) Fees and expenses connected with claims shall be included in claims.

(g) Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.

(h) Interest, dividends and rentals receivable in connection with an investment should be stated as gross amount, the amount of income tax deducted at source being included under 'Advance Taxes paid and Taxes Deducted at Source'.

(i) Income from rent shall include only the Realised Rent. It shall not include any Notional Rent.

FORM A-BS

Name of the Insurer:

Registration No. and date of Registration with the IRDA

BALANCE SHEET *As At* 31*st March,* 20.......

Particular	**schedule**	**Current Year (₹ '000)**	**Previous Year (₹ '000)**
Sources of funds			
Shareholders' funds:			
Share Capital	5		
Reserves and Surplus	6		
Credit/[Debit] Fair value change account			
Sub-total			
Borrowings	7		
Policyholders' Funds:			
Credit/ [Debit] Fair value change account			
Policy Liabilities			
Insurance Reserves			
Provision for Linked Liabilities			
Sub-total			
Funds for Future Appropriations			
Total			
Application of Funds:			
Investments			
Shareholders'	8		
Policyholders'	8A		
Assets held to cover linked liabilities			
Loans	9		
Fixed Assets	10		

Particular	schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Current Assets:			
Cash and Bank Balances	11		
Advances and Other Assets	12		
Sub-Total (A)			
Current Liabilities	13		
Provisions	14		
Sub-Total (B)			
Net current assets (C) = (A – B)			
Miscellaneous Expenditure (to the extent not written off or adjusted)	15		
Debit Balance in Profit & Loss Account (Shareholders' Account)			
Total			

Contingent Liabilities

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Partly paid-up investments		
2. Claims, other than against policies, not acknowledged as debts by the Company		
3. Underwriting Commitments outstanding		
4. Guarantees given by or on behalf of the Company		
5. Statutory Demands/Liabilities in dispute, not provided for		
6. Re-insurance obligations		
7. Others (to be specified)		
Total		

Schedules Forming Part of Financial Statements
Schedule 1
Premium

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. First year premiums		
2. Renewal Premiums		
3. Single Premiums		
Total Premiums		
Premium Income from business written:		
1. In India		
2. Outside India		
Total premium (Net)		

Notes. Re-insurance premiums whether *on* business ceded *or* accepted are to be brought into account, before deducting commission, under the head *of* Re-insurance premiums.

Schedule 2

Commission Expenses

Particulars	**Current Year (₹ '000)**	**Previous Year (₹ '000)**
Commission Paid		
Direct-First year Premiums		
- Renewal Premiums		
- Single Premiums		
Add: Commission on Re-insurance Accepted		
Less: Commission *on* Re-insurance Ceded		
Net Commission		

Note. The profits/commissions if any, are to be combined with the Re-insurance accepted *or* Re insurance ceded figures.

Schedule 3

Operating Expenses Related to Insurance Business

Particulars	**Current Year (₹ '000)**	**Previous Year (₹ '000)**
1. Employees' Remuneration & Welfare Benefits		
2. Travel, Conveyance and Vehicle Running Expenses		
3. Rents, Rates & Taxes		
4. Repairs		
5. Printing & Stationery		
6. Communication Expenses		
7. Legal & Professional Charges		
8. Medical Fees		
9. Auditors' Fees, Expenses, etc		
(a) as auditor		
(b) as adviser or in any other capacity, in respect of		
(i) Taxation Matters		
(ii) Insurance Matters		
(iii) Management Services; and		
(c) in any other capacity		
10. Advertisement and Publicity		
11. Interest & Bank Charges		
12. Others (to be specified)		
13. Depreciation		
14. Total		

Notes:

(a) Items of expenses in excess of one per cent of the net premium or ₹. 5,00,000 which-ever is higher, shall be shown as a separate line item.

(b) Under the sub-head "Others", 'Operating Expenses (Insurance Business)' shall include items like foreign exchange gains or losses and other items.

Schedule 4

Benefits Paid [Net]

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Insurance Claims: *(a)* Claims by Death, *(b)* Claims by Maturity, *(c)* Annuities/Pensions in payment, *(d)* Other benefits, specify		
2. (Amount ceded in Re-insurance): *(a)* Claims by Death, *(b)* Claims by Maturity, *(c)* Annuities/Pensions in payment, *(d)* Other benefits, specify		
3. Amount accepted in Re-insurance: *(a)* Claims by Death, *(b)* Claims by Maturity, *(c)* Annuities/Pensions in payment, *(d)* Other benefits, specify		
Total		
Benefits paid to claimants: 1. In India 2. Outside India **Total Benefits paid (Net)**		

Notes:

(a) Claims include claims settlement costs, wherever applicable.

(b) The legal and other fees and expenses shall also form part of the claims cost, wherever applicable.

Schedule 5

Share Capital

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. **Authorized Capital** Equity Shares of ₹........ each 2. **Issued Capital** Equity Shares of ₹....... each 3. **Subscribed Capital** .... Equity Shares of ....₹ 4. **Called-up Capital** Equity Shares of...... ₹ 5. **Less:** Calls unpaid **Add:** Shares forfeited (Amount originally paid up) **Less:** Par value of Equity Shares bought back **Less:** Preliminary Expenses [**Expenses including commission or brokerage on Underwriting or subscription of shares]**		
Total		

Notes:

(a) Particulars of the different classes of Capital should be separately stated.

(b) The amount capitalized on account of issue of Bonus Shares should be disclosed.

(c) In case any part of the Capital is held by a holding company, the same should be separately disclosed.

Schedule 5A – Pattern of Shareholding

[As certified by the Management]

Shareholders	Current Year		Previous Year	
	Number of Shares	% of Holding	Number of Shares	% of Holding
Shares Promoters • Indian • Foreign Others				
Total				

Schedule 6 – Reserves and Surplus (Shareholders)

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Capital Reserve		
2. Capital Redemption Reserve		
3. Share Premium		
4. Revaluation Reserve		
5. General Reserves		
Less: Debit balance in Profit and Loss Account, if any		
Less: Amount utilised for buy-back		
6. Catastrophe Reserve		
7. Other Reserves (to be specified)		
8. Balance of Profit in Profit and Loss Account		
Total		

Note. Additions to and deductions from the Reserves should be disclosed under each of the specified heads.

The Reserves and Surplus (Shareholders) as above shall be further segregated and disclosed as Reserves and Surplus — (1) In India, and (2) Outside India

Schedule 6A may be prepared for Insurance Reserves of Policyhloders.

Schedule 7 – Borrowings

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Debentures/ Bonds		
2. Fixed Deposits		
3. Banks		
4. Financial Institutions		
5. Other entities carrying on insurance business		
6. Other (to be specified)		
Total		

Notes:

(a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the Security under each sub-head.

(b) Amounts due within 12 months from the date of Balance Sheet should be shown separately.

Schedule 8 – Investments-Shareholders

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Long-term investments		
1. Government Securities and Government Guaranteed Bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
Short-term Investments		
1. Government Securities and Government Guaranteed Bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
Total		
Investments		
1. In India		
2. Outside India		
Total		

Schedule 8A Investments-Policyholders

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Long-term Investments		
1. Government Securities and Government Guaranteed Bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
4. Investments in Infrastructure and Social sector		
5. Other than Approved Investments		
Short-term Investments		
1. Government securities and Government Guaranteed Bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
4. Investments in Infrastructure and Social Sector		
5. Other than Approved Investments		
Total		
Investments		
1 . In India		
2 . Outside India		
Total		

Notes: (applicable to Schedules-8 and 8A):

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) **Holding company** and subsidiary shall be construed as defined in the Companies Act, 1956.

(ii) **Joint Venture** is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint contro1.

(iii) **Joint control** is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(iv) **Associate** is an enterprise in which the company has significant influence and which is neither a subsidiary nor a joint venture of the company.

(v) **Significant influence** (for the purpose of this Schedule) means participation in t h e financial and operating policy decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for examples, by representation on the board of directors, participation in the policy-making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 per cent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demon started that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

(b) Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.

(c) Investments made out of catastrophe reserve should be shown separately.

(d) Debt securities will be considered as "held to maturity" securities and will be measured at historical costs subject to amortisation

(e) Investment property means a property [land or building or part of a building or both) held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.

Schedule 9 – Loans

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. **Security-wise Classification**		
Secured		
(a) On mortgage of property		
– In India		
– Outside India		
(b) On shares, Bonds, Govt. Securities, etc.		
(c) Others (to be specified)		
Unsecured		
(a) Loans against policies		
(b) Others (to be specified)		
Total		
2. **Borrower-wise classification**		
(a) Central and State Governments		
(b) Banks and Financial Institutions		
(c) Subsidiaries		
(d) Companies		
(e) Loans against policies		
(f) Others (to be specified)		
Total		
3. **Performance-wise classification**		
(a) Loans classified as standard		
– In India		
– Outside India		
(b) Non-standard loans **less** provisions		
– In India		
– Outside India		
Total		
4. **Maturity-wise classification**		
(a) Short-term		
(b) Long-term		
Total		

Notes:

(a) Short-term loans shall include those, which are repayable within 12 months from the date of Balance Sheet. Long-term loans shall be the loans other than short-term loans.

(b) Provisions against Non-Performing loans shall be shown separately.

(c) The nature of the Security in case of all Long-Term Secured Loans shall be specified in each case. Secured Loans for the purposes of this schedule, means Loans Secured wholly or partly against an asset of the Company.

(d) Loans considered doubtful and the amount of provision created against such Loans shall be isclosed.

SCHEDULE 10 – Fixed Assets

(₹'000)

Particulars	Cost/ Gross Block				Depreciation				Net Block	
	Opening	Additions	Deductions	Closing	Up to Last Year	For the Year	On Sales/ Adjustments	To Date	As at year end	Previous year
Goodwill										
Intangibles (specify)										
Land-Freehold										
Leasehold Property										
Buildings										
Furniture and Fittings										
Information Technology Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
TOTAL										
PREVIOUS YEAR										

Note:

Assets included in land, property and building above exclude Investment Properties as defined in Note (e) to Schedule 8.

Schedule 11 – Cash and Bank Balances

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Cash (including Cheques, Drafts and Stamps)		
2. Bank Balances		
(*a*) Deposit Accounts		
• Short-term (due within 12 months of the date of Balance Sheet)		
• Others		
(*b*) Current Accounts		
(*c*) Others (to be specified)		
3. Money at Call and Short Notice		
(*a*) With Banks		
(*b*) With other Institutions		
4. Others (to be specified)		
Total		
Balances with non-scheduled banks included in 2 and 3 above		
Cash & Bank Balances		
1. In India		
2. Outside India		
Total		

Note: Bank balance may include Remittances-in-transit. If so, the nature and amount should be separately stated.

Schedule 12 – Advances and other assets

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Advances		
1. Reserve Deposits with Ceding Companies		
2. Advances to ceding companies		
3. Application money for investments		
4. Pre-Payments		
5. Advances to Officers/Directors		
6. Advance Tax paid and Taxes Deducted at Source		
7. Others (to be specified)		
Total (A)		
Other Assets		
1. Income accrued on investments		
2. Outstanding premiums		
3. Agents' Balances		
4. Foreign agencies' Balances		
5. Due from other entities carrying on Insurance business		
6. Due from Subsidiaries/Holding Company		
7. Re-insurance claims/balances receivable		
8. Deposit with Reserve Bank of India [Pursuant to Section 7 of Insurance Act, 1938]		
9. Others (to be specified)		
Total (B)		
Total (A + B)		

Notes:

(a) The items under the above heads shall not be shown net of provisions for doubtful amounts.

The amount of provision against each head should be shown separately.

(b) The term 'officer' should conform to the definition of the word 'officer' under the Companies Act, 1956.

Schedule 13 – Current Liabilities

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Agents' Balances		
2. Balances due to other insurance companies		
3. Advances from Treaty Companies		
4. Deposits held on re-insurance ceded		
5. Premiums received in advance		
6. Sundry creditors		
7. Due to subsidiaries/holding company		
8. Claims outstanding		
9. Annuities due		
10. Due to Officers/Directors		
11. Others (to be specified)		
Total		

Schedule 14 – Provisions

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. For taxation (**less** payments and taxes deducted at source)		
2. For proposed Dividends		
3. For Dividend Distribution Tax		
4. Bonus Payable to the Policyholders		
5. Others (to be specified)		
Total		

Schedule 15 – Miscellaneous Expenditure
(To the extent not written off or adjusted)

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Discount allowed in issue of shares/debentures		
2. Others (to be specified)		
Total		

Notes:

(a) No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless:

1. Some benefit from the expenditure can reasonably be expected to be received in future, and

2. the amount of such benefit is reasonably determinable.

(b) The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure.

Illustration 27.

The following balances appeared in the books of Happy Mutual Life Assurance Society Ltd. as on 31 March 2014:

(₹ in lakh)

Dr. **Cr.**

Particulars	₹	Particulars	₹
Claims less reassurance paid during the year		Life Assurance Fund at the beginning of the year	1,00,000
By death	4,400	Premium less Re-assurances	30,000
By maturity	3,000	Claims less reassurances outstanding	
Annuities	12	At the beginning of the year:	
Furniture and Office Equipment at cost		By death	1,800
(including ₹80 lakh bought during the year)	500	By maturity	1,200
		Credit balances pending adjustments	120
Printing and Stationery	154	Consideration for annuities granted	4
Cash with Bank in current account	2,700	Interest, dividends and rents	3,600
Cash and stamp in hand	60	Registration and other Fees	4
Surrenders less Reassurances	80	Sundry Deposits	200
Commission	500	Taxation Provision	600
Expenses of Management	6,200	Premium Deposits	2,300
Sundry Deposits with Electricity Companies	2	Sundry Creditors	700
		Contingency Reserve	300
Advance Payment of Tax	100	Furniture and Office Equipment	80
Sundry Debtors	100	Depreciation Account	
Agents Balances	200	Building Depreciation Account	600
Income Tax	900		
Income Tax on Interest, Dividend and Rents	1,000		
Loans and Mortgages	300		
Loans on Policies	6,500		
Investments (₹500 lakh deposited with Reserve Bank of India)	1,04,000		
House Property at Cost (including ₹ 170 lakh added during the year)	10,800		
	1,41,508		1,41,508

From the foregoing balances and the following information, prepare the Balance Sheet of Happy Mutual Life Assurance Society Ltd. as on 31st March 2014 and its Revenue Account for the year ended on that date:

(i) Claims less reassurance outstanding at the end of the year: By death ₹ 1,200 lakh, By maturity ₹ 800 lakh.

(ii) Expenses outstanding ₹ 120 lakh and prepaid ₹ 30 lakh.

(iii) Provide ₹ 90 lakh for depreciation on buildings,₹ 30 lakh for depreciation on furniture and office equipment and ₹ 220 lakh for taxation.

(iv) Premiums outstanding ₹4056 lakh, commission thereon ₹ 130 lakhs.

(v) Interests, dividends and rents outstanding (net) ₹ 60 lakh and interests and rents accrued (net) ₹ 700 lakh.

Solution:

Happy Mutual Life Assurance Society Ltd.

Form A-RA

Revenue Account for the Year Ended 31 st March 2014

Particulars	Schedule	Current Year (₹ in lakh)	Previous Year (₹ in lakh)
Premium earned-net	1	34,056	
Income from Investments			
Interest, Dividends and Rent (Gross) (3600 + 60 + 700)		4,360	
Other Income:			
Annuities granted		4	
Registration and other Fees		4	
Total (A)		38,424	
Commission	2	630	
Operating Expenses	3	6,564	
Provision for Tax		1,520	
Total (B)		8,714	
Benefits paid (net)	4	6,492	
Total (c)		6,492	
Surplus (D)=A-B-C		23,218	

Form A-BS

Balance Sheet as on 31st March 2014

Particulars	Schedule	Current Year (₹ in lakh)	Previous Year (₹ in lakh)
Share Capital	5		
Reserves and Surplus	6	1,23,518	
Borrowings	7	2,500	
Total		1,26,018	
Application of Funds			
Investment:			
Shareholders'	8	1,13,610	
Loans	9	6,800	
Fixed Assets	10	390	
Total		1,20,800	
Current Assets:			
Cash and Bank Balance	11	2,760	
Advances and Other Assets	12	5,748	
Sub-Total (A)		8,508	
Current Liabilities	13	3,070	
Provisions	14	220	
Sub-Total (B)		3,290	
Net Current Assets = Sub-Total (A) - Sub-Total (B)		1,26,018	

Note: Since the question is silent about the preparation of Profit & Loss Account, as such (From A-PL) is not prepared.

Thus Provision for Taxation and adjustments are shown in Revenue Account.
Schedules forming parts of Financial Statements

Workings:

Schedule 1: Premium Earned	₹
Premium	30,000
Add: Outstanding	4,056
	34,056

Schedule 2: Commission	₹
Commission Paid	500
Add: Commission on Re-Insurance Accepted	130
	630

Schedule 3: Operating Expenses	₹	₹
Expenses of management	6,200	
Add: Outstanding	120	
	6,320	
Less: Prepaid	30	6,290
Printing & Stationary		154
Depreciation on:		
Building	90	
Furniture	30	120
		6,564

Schedule 4: Benefits (Paid)	₹	₹
Insurance Claims:		
By Death-		
Paid	4,400	
Add: Outstanding at the ends	1,200	
	5,600	
Less: Outstanding at the beginning	1,800	3,800
By Maturity-		
Paid	3,000	
Add: Outstanding at the end	800	
	3,800	
Less: Outstanding at beginning	1,200	2,600
Annuities		12
Surrender, less Re-insurance		80
		6,492

Schedule 5: Share Capital	₹
Share Capital	Nil
	Nil

Schedule 6: Reserves & Surplus	₹
Contingency Reserve	300
Add: Other Life Assurance Fund	1,23,218
	1,23,518

Schedule 7: Borrowings	₹
Premium Deposit Add: Sundry Deposits	2,300 200
	2,500

Schedule 8: Investments	₹	₹
Investment in House Property Additions	10,630 170	
 Less: Depreciation Other Investments	10,800 690	 10,110 1,03,500
		1,13,610

Schedule 9: Loans	₹
Mortgage Policies	300 6,500
	6,800

Schedule 10: Fixed Assets	₹
Furniture (420-30)	390
	390

Schedule 11: Cash and Book Balance	₹
Cash + Stamps Bank at Current A/c	60 2,700
	2,760

Schedule 12: Advance and Other Assets	₹	₹
Advances:		
Prepaid Expenses	30	
Adv. Payment of Tax	100	130
Other Assets:		
Int. Dividend & Rent Outstanding		60
Int. Dividend Rent Accruing		700
Outstanding Premium		4,056
Agents' balance		200
Sundry Debtors		100
Deposit with RBI		500
Deposit with Electricity Co.		2
		5,748

Schedule 13: Current Liabilities	₹
Creditors	700
Outstanding Expenses	120
Com. Due but not paid	130
Claims outstanding	2,000
Credit balance Pending adjustments	120
	3,070

Schedule 14: Provisions	₹
Provisions for Tax	220
	220

Schedule 15: Miscellaneous	₹
Misc. Expenses	Nil
	Nil

B. GENERAL INSURANCE

General Insurance consists of (i) Fire; (ii) Marine (iii) Accidental Insurance. Before incorporating I.R.D.A. (in 2012) general insurance was administrated by General Insurance Corporation of India (GICI). Every general insurance company must prepare their accounts separately for each type of insurance. Usually the policies are issued for one year. It must be remembered that liabilities of the insurer will arise when the insured suffers any loss due to fire accident etc. If no loss is suffered by the insured no compensation will be paid and the premium which has already been paid will neither be adjusted nor be carried forward for the next year.

(a) **Fire Insurance:** Fire insurance means insurance against any loss which is caused by fire. As per Sec 2(6A) of the insurance Act "Fire Insurance Business means the business of effecting otherwise than incidentally to some other class of business contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire Insurance policy. "

(b) **Marine Insurance:** As per Sec 3 of Marine Insurance Act, 1963 "A contract of marine insurance is an agreement whereby the insurer undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against marine losses, that is to say , losses incidental to marine adventure. Similarly, Sec 4 (1) states that "a contract of marine insurance may, by its express terms, Or by usage of trade, be extended so as to protect the insured against losses on inland water or any land risk which may be incidental to any sea voyage.

(c) **Accidental Insurance:** Usually accidental insurance policies contain various conditions which safeguards the interest of insurer. Question of compensation will not arise if no accident happens. Practically, it is mere a contract by which the insurer promises to pay a certain some of money to the insured in case of injury by accident and to the dependants of the insured in case of death by accident. It is not a contract of indemnity. The insurer is not required to indemnity assured.

In our country some private Companies have come to play: some of them are: Reliance General Insurance Company, Bajaj Alliance General Insurance Co. Ltd. Tata AIG, General Insurance, HDFC - Chubb General Insurance etc.

EXPLANATION OF SPECIAL TERMS PECULIAR TO INSURANCE BUSINESS

Nature of business of an insurance company is different from that of a manufacturing, a trading or a banking company. Because of this, types and sources of expenses and incomes of such a company are different from those usually found in other business concerns. In order to explain these incomes and expenses some new terms are used. It is thus necessary for a student to understand these terms first.

Claims. The business of an insurance company is to cover the risk of the insured for a consideration called premium. If the risk falls on the insured then he makes a claim on the insurance company. This is the first item which appears on the debit side of revenue account. Claim is shown after deducting the Re-insurance claim and also after adjusting it in the light of information given in the problem. It may be noted that it is not the actual amount paid but the actual loss borne which is important for revenue account. In order to calculate the loss on account of claim the claim outstanding at the end is added and claim outstanding in the beginning is deducted. It should be noted that in keeping with the convention of conservatism, the claim intimated is taken at par with the claim intimated and accepted but not

paid. Thus while calculating the claim outstanding at the end the claim intimated as well as the claim intimated and accepted both are considered. The adjustment entry required for this will be as follows:

Debit Claims account

Credit Claims intimated and accepted but not paid account

Credit Claims intimated but not accepted and paid account

At the commencement of the next period a reverse entry is passed, so that when these claims intimated are paid, they may not influence the claims account of next year. However, if company rejects any claim, such amount should be transferred to the insurance fund account and not to the claims account.

Illustration 28.

From the following, you are required to calculate the loss on account of claim to be shown in the revenue account for the year ending 31st December, 2012 :

Claims:

Intimated in	***Admitted in***	***Paid in***	₹
2011	2011	2012	15,000
2012	2012	2013	10,000
2010	2011	2011	5,000
2010	2011	2012	12,000
2012	2013	2013	8,000
2012	2012	2012	1,02,000

Claim on account of Re-insurance was ₹ 25,000.

Solution:

	₹
Total claim paid in 2012 : ₹ (1,02,000 + 12,000 + 15,000)	1,29,000
Less: Outstanding in the beginning, *i.e.*, intimated in 2011 or earlier whether accepted in 2011 & accepted in 2012 (₹ 15,000+ ₹ 12,000)	27,000
	1,02,000
Add: Outstanding at the end, i.e., intimated in 2012 whether accepted in 2012 or in 2013 ₹ (10,000 + 8,000)	18,000
	1,20,000
Less Re-insurance claim	25,000
Claims to be shown in Revenue Account	95,000

Notes;

1. It may be seen that the column for 'admitted in' is useless for calculating loss on account of claim. This is a mere information.
2. No.3 item 'intimated in 2010, admitted in 2011, paid in 2011 ₹ 5,000 is useless as the amount paid in 2011 is not included in the amount paid in 2012.

Claims must include all expenses directly incurred in relation to assessment of claims. For examples expenses like survey fees, fees of Police Reports, Legal fees, Court expenses and other similar charges should be included under the head claims. However, it should not include any establishment or

administrative expenses except in so far as they relate to any employee, exclusively employed or surveyor assessment of losses [Note *(a)* to the revenues account] When the account is furnished under the Provision of Sec. 11 of the Insurance Act, 1938, separate figures for claims paid to claimants in India and claimants paid outside India should be given [Note *(d)* to the revenue account].

Bonus in reduction of premium:

In all the cases of general insurance the policy is always taken for one year and it is to be renewed after the expiry of the policy. Whether the policy is renewed with the same company, or a fresh policy is taken with some other company, it is a standing practice that the company usually grants a reduction in premium at the prescribed rate if the insured has not made any claim. This rate of reduction increases every year for usually three years if the insured does not make any claim continuously year after year. For example, the General Insurance Companies in India allow the following rates of reduction for a motor cycle: 1st year 15%; 2nd year 25%;

3rd year 30%. This reduction is called bonus in reduction of premium. In fact this transaction should be divided into two parts-first, the total premium (without any reduction) should be assumed to be received and then reduction granted should be assumed to be paid separately. Thus total premium (without reduction) should be treated as income and bonus which is subtracted should be treated as an expense. Thus-

If net premium received is	126
Bonus in reduction of premium is	14

The revenue account on the credit side will show ₹ 140 (₹ 126 + ₹ 14) as income and on the debit side ₹ 14 as an expense. The journal entry is :

Bonus in reduction of premium Account Dr

To Premium Account

Bonus.

In the case of life policies with profits, policyholders are given the right to participate in the profits of the business. After nationalization, policyholders are given 95% of profits of L.I.C. by way of bonus. Bonus can be paid in cash, adjusted against the future premiums due from the policy holders or it can be paid on the maturity of the policy, together with the policy amount. Bonus paid in the end along with the policy amount is called **Reversionary Bonus**.

Re-insurance.

Sometimes the insurer considers a particular risk too much for his capacity and may re-insure a part of the risk with some other insurer. Such an arrangement between two insurers is referred to as reinsurance. In such a case the first insurer cannot retain all the premium on the policy for himself. Depending on the share of risk undertaken by the second insurer, proportionate premium must be ceded by the first insurer. Likewise if such a policy matures, the claim will have to be shared by both the insurers in the agreed ratio. These adjustments will have to be shown in the accounts of both the insurers. In the accounts of the first insurer amount of claim recovered from the second insurer has to be deducted from the total claim payable by him. Similarly, the premium ceded to the second insurer has to be deducted from the total premium received. In the accounts of the second insurer, claims paid include claims paid on account of Re-insurance and premiums received include premium received on re-insurance business.

Commission on re-insurance ceded /accepted.

The business of the company is fetched through its agents who are paid commission according to the amount of business they are getting for the company. When company gets re-insurance business it has to pay commission to some other company. This commission is called **'commission on re-insurance accepted'** and is shown as an expense in the revenue account. When a company passes on a part of business to some other company then this company (which gives business) gets commission from the

company to whom such business is given. This commission is called **'commission on re-insurance ceded'** and is a gain to the company surrendering the business. It appears on the credit side of revenue account.

Reserve for unexpired risk.

This is applicable in General Insurance business only. This is in the nature of provision for claims that may arise in respect of policies which are subsisting on the date of balance sheet. Since premium has already been received in respect of such policies, provision must be made for the claims that may arise out of such policies. Insurance business is peculiar in that the premium is received in advance but the risk can arise on any day. In general insurance the policy is issued for a year which means the risk is covered for a year. Chances of the risk covered occurring do not come down proportionately with the passage of time. For example, if on the balance sheet date the unexpired period of a particular policy is one month (eleven months having expired) we cannot say that the risk on the policy is reduced to 1/ 12th of the total risk. Even on the last day of the policy company's risk is as high as it was on the day the policy was issued. Therefore, insurance companies must provide for the risks associated with all such policies for which the premia has been received and the policies are still in force. Thus a large portion of the premia collected must be kept in reserve for unexpired risk. Keeping in view the nature of the business, the Executive Committee of the General Insurance Council

(which has been set up under the Insurance Act to supervise general insurance companies)

has laid down that in the case of marine insurance the provision for unexpired risk should be 100% of the net premium and in the case of other businesses (like accident, fire, theft, etc.) the provision should be 50% of the net premium. The provision made on the balance sheet date will be shown on the debit side of the revenue account instead of subtracting from premia. The balance of provision also appears in the balance sheet on the liabilities side under the heading 'balance of funds and accounts'. This provision will be transferred to the credit side of next year's revenue account. Thus in the revenue account the balance of the previous year appears on the credit side and the balance provided for the current year appears on the debit side.

Additional reserve for unexpired risk.

In a particular year the management may feel that the percentage of premia recommended by the General Insurance Council is not sufficient to meet the unexpired risks. In such a situation they may provide additional reserve. Such additional reserve will also be debited to the revenue account. The balance will be shown in the balance sheet as in the case of normal reserve, and will be transferred to the credit of next year's revenue account. If in the problem given, there is no instruction regarding additional reserve it means no such reserve is required. As the provision of additional reserve is the discretionary right of the management it is not correct to carry forward such reserve even though there is no instruction about it in the problem.

REVENUE ACCOUNT (Form B-RA):

As per IRDA Regulations 2012, every General Insurance Company must prepare their Revenue Account according to Schedule B. Needless to say that separate Revenue Account should be prepared for each individual unit viz marine, fire etc. Naturally, the result of the operation of each individual unit can be known from this account for a particular accounting period which is very important. It is prepared under accrual basis of accounting.

Financial Statement of General Insurance Companies:

As per IRDA regulations, financial statement of General Insurance Companies consists of three parts viz (a) Revenue Account, (b) Profit and Loss Account and (c) Balance Sheet.

FORM B - RA

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

Revenue Account for the year ended 31st March, 20..

(To be prepared separately fire, marine and miscellaneous insurance)

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Premiums Earned (net) Others (to be specified) Interest, Dividend and Rent -Gross	1		
Total (A)			
Claims Incurred (Net) Commission Operating Expenses related to Insurance Business Others – To be specified	2 3 4		
Total (B)			
Operating Profit / (loss) from Fire/ Marine/ Miscellaneous Business (A-B)			

Profit and Loss Account (Form B-PL):

Profit and Loss Account of General Insurance Company is prepared to know the overall operating result of the company. It includes income from investment in the form of dividend, interest, rent etc. Similarly it also includes expenses relating to insurance business, bad debts, provision for doubtful debts, provision for taxation etc. At the same time, all appropriation items, viz payment of dividend (interim and proposed), transfer to reserve etc. will appear in its appropriation part.

FORM B - PL

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

Profit & Loss Account

for the year ended 31st March 20...

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
1. **Operating Profit/(Loss)**			
(a) Fire Insurance			
(b) Marine Insurance			
(c) Miscellaneous Insurance			
2. **Income from investments**			
(a) Interest, Dividend & Rent-Gross			
(b) Profit on sale of investments			
Less: Loss on sale of investments			
3. Other income (To be specified)			
Total (A)			
4. **Provisions (other than taxation)**			
(a) For diminution in the value of investments			
(b) Others (to be specified)			
5. **Other expenses**			
(a) Expenses other than those related to Insurance Business			
(b) Others (To be specified)			
Total (B)			
Profit Before Tax			
Less: Provision for Taxation			
Profit After Tax			
Less: Catastrophe Reserve*			
Profit available for appropriation			

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Appropriations (a) Interim Dividends paid during the year (b) Proposed Final Dividend (c) Dividend Distribution Tax (d) Transfer to any Reserves or Other Accounts (to be specified)			
Balance of profit/loss brought forward from last year			
Balance carried forward to Balance Sheet			

* Cumulative Shortfall in the Catastrophe appropriation ₹…….pending surplus.

Balance Sheet (Form B-BS)

As per IRDA regulation 2002, Balance Sheet of General Insurance Company is prepared under vertical form. It has two sections, viz (a) Sources of funds and (b) Application of funds.

FORM – B –BS

Name of the Insurer :

Registration No. and Date of Registration with the IRDA

Balance Sheet as at 31st March, 20……..

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Sources of Funds: Shareholders' Funds: Share Capital Reserves and Surplus Fair Value Change account **Borrowings**	 5 6 7		
Total			
Application of Funds: Investments Loans Fixed assets Current Assets: Cash and bank balance Advances and other assets	 8 9 10 11 12		
Sub-total (A)			
Current Liabilities Provision	13 14		
Sub-total (B)			
Net Current Assets (C) = (A)- (B) Miscellaneous expenditure (to the extent not written-off or adjusted) Debit balance in Profit & Loss Account	 15		
Total			

Contingent Liabilities

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
1. Partly paid-up Investments			
2. Claims, other than against Policies, not acknowledged as Debts by the Company			
3. Underwriting Commitments Outstanding			
4. Guarantees given by or on behalf of the Company			
5. Statutory Demands/Liabilities in dispute, not provided for			
6. Re-insurance Obligations			
7. Others (to be specified)			
Total			

Schedules Forming Part of Financial Statements

Schedule 1

Premium Earned (Net)

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Premium from direct business written		
Add: Premium on reinsurance accepted		
Less: Premium on reinsurance ceded		
Net Premium		
Adjustment for changes in unearned Premium		
Adjustment for changes in premium received in advance		
Total Premium Earned (Net)		
Less: Adjustment for change in provision for Unexpired Risks		
Premium Income from business effected:		
In India		
Outside India		
Total Premium Earned (Net)		

Notes:

(a) In case of premiums less re-insurance, in respect of any segment of insurance business exceeds 10 per cent of total premium earned, the same shall be disclosed separately.

(b) Re-insurance premiums whether on business ceded or accepted are to be brought into account, before deducting commission, under the head of re-insurance premiums.

Schedule 2

Claims Incurred (Net)

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Claim paid		
Direct		
Add: Re-insurance accepted		
Less: Re-insurance Ceded		
Net Claims paid		
Total Claims Incurred		
Claims paid to claimants		
In India		
Outside India		
Total Claims Incurred		

Notes:

(a) Incurred But Not Reported (IBNR), Incurred But Not Enough Reported (IBNER)claims should be included in the amount for Claims.

(b) Claims include Claims Settlement Costs.

(c) The Surveyor Fees, Legal and Other Expenses shall also form part of Claims Cost.

(d) Claims cost should be adjusted for estimated salvage value if there is a sufficient certainty of its realisation.

Schedule 3

Commission

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Commission paid		
Direct		
Add: Re-insurance Accepted		
Less: Commission on Re-insurance Ceded		
Net Commission		

Note: The profit/commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

Schedule 4

Operating Expenses Related to Insurance Business

Particulars	Current Year (₹'000)	Previous Year (₹'000)
1. Employees' remuneration & welfare benefits		
2. Managerial Remuneration		
3. Travel, Conveyance & Vehicle running expenses		
4. Rents, rates & taxes		
5. Repairs		
6. Printing & Stationary		
7. Communication expenses		
8. Legal & professional charges		
9. Medical fees		
10. Auditors' fees, expenses etc.		
(a) As auditor		
(b) As advisor or in any other capacity, in respect of		
(i) Taxation matters		
(ii) Insurance matters		
(iii) Management services; and		
(c) In any other capacity		
11. Advertisement and Publicity		
12. Interest & Bank Charges		
13. Others (to be specified)		
14. Depreciation		
Total		

Notes:

(a) Items of expenses in excess of one per cent of net premium or ₹ 5,00,000, whichever is higher, shall be shown as a separate line item.

(b) Under the sub-head "Others", "Operating Expenses (Insurance Business)" shall include items like foreign exchange gains or losses and other items.

Schedule 5

Share Capital

Particulars	**Current Year** (₹ '000)	**Previous Year** (₹ '000)
1. **Authorized Capital**		
Equity Shares of ₹each		
2. **Issued Capital**		
Equity Shares of ₹ .... each		
3. **Subscribed Capital**		
Equity Shares of ₹ .... each		
4. **Called-up Capital**		
Equity Shares of ₹ .... each		
5. **Less:** Calls unpaid		
Add: Equity shares forfeited (Amount originally paid up)		
Less: Preliminary expenses		
[Expenses including commission or brokerage on underwriting or subscription of shares]		
Total		

Notes:

(a) Particulars of the different classes of capital should be seperately stated.

(b) The amount capitalized on account of issue of bonus shares should be disclosed.

(c) In case any part of the capital is held by a holding company, the same should be sepa- rately disclosed.

Schedule 5A

Share Capital Pattern of Shareholding

[As certified by the Management]

	Current Year		**Previous Year**	
	Number of Shares	**%of Holding**	**Number of Shares**	**%of Holding**
Promoters				
* Indian				
* Foreign Others				
Total				

Schedule 6

Reserves and Surplus

Particulars	Current Year (₹'000)	Previous Year (₹'000)
1. Capital Reserve		
2. Capital Redemption Reserve		
3. Share Premium		
4. General Reserves		
Less: Debit balance in Profit and Loss Account		
Less: Amount utilized for Buy-back		
5. Catastrophe Reserve		
6. Other reserves (to be specified)		
7. Balance of Profit in Profit & Loss Account		
Total		

Note: Additions to and deductions from the reserves should be disclosed under each of the specified heads.

The Reserves and Surplus (Shareholders) as above shall be further segregated and disclosed as Reserves and Surplus – (1) In India, and (2) Outside India.

Schedule 7

Borrowings

Particulars	Current Year (₹'000)	Previous Year (₹'000)
1. Debentures / Bonds		
2. Fixed Deposits		
3. Banks		
4. Financial Institutions		
5. Other entities carrying on insurance business		
6. Others (to be specified)		
Total		

Notes:

(a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.

(b) Amounts due within 12 months from the date of Balance Sheet should be shown separately.

Schedule 8
Investments

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Long-term Investments		
1. Government Securities and Government Guaranteed bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
Short-term Investments		
1. Government Securities and Government Guaranteed bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investments Properties-Real Estate		
Total		
Investments		
1. In India		
2. Outside India		
Total		

Notes:

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) **Holding company** and Subsidiary shall be construed as. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policy-making process, material inter-company transactions, interchange of managerial defined in the Companies Act, 1956.

(ii) **Joint venture** is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

(iii) **Joint control** is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(iv) **Associate** is an enterprise in which the company has significant int1uence and which is neither a subsidiary nor a joint venture of the company.

(v) **Significant influence** (for the purpose of this Schedule) means participation in the financial and operating policy decisions of a company, but not necessarily control of those policies personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 per cent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than

20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

(b) Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.

(c) Investments made out of catastrophe reserve should be shown separately.

(d) Debt securities will be considered as "held to maturity" securities and will be measured at historical cost subject to amortisation.

(e) Investment property means a property [land or building or part of a building or both] held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.

Schedule-9
Loans

Particulars	Current Year (₹'000)	Previous Year (₹'000)
1. **Security-Wise Classification:**		
Secured:		
(a) On mortgage of property		
(i) In India		
(ii) Outside India		
(b) Other Shares, Bonds, Govt. Securities		
(c) Others (to be specified)		
Unsecured:		
Total		
2. **Borrower-Wise Classification:**		
(a) Central and State Governments		
(b) Banks and Financial Institutes		
(c) Subsidiaries		
(d) Others (to be specified)		
Total		
3. **Performance-Wise Classification:**		
(a) Loans classified as standard		
(i) In India		
(ii) Outside India		
(b) Non-performing loans *less* provisions		
(i) In India		
(ii) Outside India		
Total		
4. **Maturity-Wise Classification:**		
(a) Short Term		
(b) Long Term		
Total		

Notes:

(a) Short-term loans shall include those, which are repayable within 12 months of the balance sheet date. Long-term loans shall be the loans other than short-term loans.

(b) Provisions against non-performing loans shall be shown separately.

(c) The nature of the security in case of all long-term secured loans shall be specified in each case. Secured loans for the purpose of this schedule, means secured wholly or partially against an asset of the company.

(d) Loans considered doubtful and the amount of provision created against such loans shall be disclosed.

Note : Assets included in land, building and property above exclude Investment Properties as defined in Note (e) to Schedule 8.

Schedule 10
Fixed Assets

Particulars	Cost/Gross Block Depreciation				Depreciation				Net Block	
	Opening	Additions	Deductions	Closing	Upto Last Year	For the Year	On Sales/ Adjustments	To Date	As at year end	Previous Year
Goodwill Intangibles (specify) Land-Feehold Leasehold Property Buildings Furniture & Fittings Information Technology Equipment Vehicles Office Equipment Others (Specify nature)										
Total										
Previous Year										

Schedule 11
Cash and Bank Balances

Particulars	**Current Year (₹ '000)**	**Previous Year (₹ '000)**
1. Cash (including Cheques, Drafts and Stamps) 2. Bank Balances (a) Deposit Accounts – Short-term (due within 12 months of date of Balance Sheet) – Others (b) Current Accounts (c) Others (to be specified) 3. Money at Call and Short Notice (a) With Banks (b) With other Institutions 4. Others (to be specified)		
Total Balances with Non-Scheduled banks included in 2 and 3 above		
Cash & Bank Balances		
1. In India 2. Outside India		
Total		

Note: Bank balance may include remittances-in-transit. If so, the nature and amount should be separately stated.

Schedule 12

Advances and other Assets

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Advances		
1. Reserve deposits with ceding companies		
2. Advances to ceding companies		
3. Application money for investments		
4. Prepayments		
5. Advances to Officers/ Directors		
6. Advance tax paid & taxes deducted at source		
7. Others (to be specified)		
Total (A)		
Other Assets		
1. Income accrued on investments		
2. Outstanding Premiums		
3. Agents' Balances		
4. Foreign Agencies' balances		
5. Due from other Insurance Entities		
6. Due from subsidiaries/holding		
7. Reinsurance claims/balances receivable		
8. Deposit with Reserve Bank of India [Pursuant to Section 7 of Insurance Act,1938]		
9. Others (to be specified)		
Total (B)		
Total (A+B)		

Notes:

(a) The items under the above heads shall not be shown net of provisions for doubtful amounts.

The amount of provision against each head should be shown separately.

(b) The term 'officer' should conform to the definition of the word 'officer' given under the Companies Act, 2013.

Schedule 13

Current Liabilities

Particulars	**Current Year (₹ '000)**	**Previous Year (₹ '000)**
1. Reserve for Licensed premium		
2. Agents Balances		
3. Balances due to other insurance companies		
4. Advances from Treaty Companies		
5. Deposits held on re-insurance ceded		
6. Premiums received in advance		
7. Sundry Creditors		
8. Due to subsidiaries/holding company		
9. Claims Outstanding		
10. Due to Officers/Directors		
11. Others (to be specified)		
Total		

Schedule 14

Provisions

Particulars	**Current Year (₹ '000)**	**Previous Year (₹ '000)**
1. Reserve for Unexpired risk		
2. For taxation (less advance tax paid and taxes deducted at source)		
3. For proposed dividends		
4. For dividend distribution tax		
5. Others (to be specified)		
Total		

Schedule 15

Miscellaneous Expenditure

(To the extent not written off or adjusted)

Particulars	**Current Year (₹ '000)**	**Previous Year (₹ '000)**
1. Discount Allowed in issue of shares/ debentures		
2. Others (to be specified)		
Total		

Notes:

1. No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless:
   (a) some benefit from the expenditure can reasonably be expected to be received in future, and
   (b) The amount of such benefit is reasonably determinable.

2. The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure.

Computation of "premium income," "claims expense" and "commission expense" in the case of an insurance company:

Premium Income : The payment made by the insured as consideration for the grant of insurance is known as premium. The amount of premium income to be credited to revenue account for a year may be computed as :

		₹
Premium received on risks undertaken during the year (direct & re-insurance accepted)		–
Add : Receivable at the end of year (direct & re-insurance accepted)		–
Less : Receivable at the beginning of year (direct & re-insurance accepted)		–
Premium on re-insurance ceded:		
Less : Paid during the year	–	
Add : Payable at the end of year	–	
Less : Payable at the beginning of year	–	
Premium income		–

Claims expenses : A claim occurs when a policy falls due for payment. In the case of alife insurance business, it will arise either on death or maturity of policy that is, on the expiry of the specified term of years. In the case of general insurance business, a claim arises only when the loss occurs or the liability arises.

Claims Incurred:

		₹
Claims Settled during the year		—
— Direct business		—
— Re-insurance acceptor		—
Add: Legal charges, if any		—
Add: Surveyor's charges		—
Add: Payment to Co-insurance		—
		—
Less: Received from Co-insurance	—	
Received from Re-insurance	—	—
		—
Add: Estimated liability at the end of the year		—
		—
Less: Estimated liability at the beginning of the year		—
Claims as expenses		—

Commission expenses : Insurance Regulatory and Development Authority Act, 1999 regulates the commission payable on policies to agents. Commission expense to be charged to revenue account is computed as follows :

	₹
Commission paid (direct & re-insurance accepted)	–
Add : Commission payable at the end of the year (direct & re-insurance accepted)	–
Less : Commission payable at the beginning of the year (direct & re-insurance accepted)	–
Commission expense	–

Illustration 29.

Khush Raho Insurance Co. Ltd. furnishes you the following information :

(i) On 31.3.2013 it had reserve for unexpired risks to the tune of ₹100 crore. It comprised of ₹37.5 crore in respect of machine insurance business; ₹50 crore in respect of fire insurance business and ₹12.5 crore in respect of miscellaneous insurance business.

(ii) It is the practice of Khush Raho Insurance Co. Ltd. to create reserve at 100% of net premium income in respect of marine insurance policies and at 50% of net premium in respect of fire and miscellaneous insurance business.

(iii) During the year 31st March, 2014 the following business was conducted :

Particulars	**Marine** (₹ crores)	**Fire** (₹ crores)	**Miscellaneous** (₹ crores)
Premia collected from : (a) Insured (other than insurance companies) in respect of policies issued	45	107.5	30
(b) Other insurance companies in respect of risks undertaken	17.5	12.5	10
Premia paid/payable to other insurance companies on business ceded	16.75	10.75	17.5

Khush Raho Insurance Co. Ltd. asks you to :

(i) Pass journal entries relating to “unexpired risks reserve”

(ii) Show in columnar form Unexpired Risks Reserve Account for the year ended 31st March, 2014.

Solution:

Journals

Date	Particulars	L.F	Dr. ₹ Crore	Cr. ₹ Crore
31.3.14	Marine Revenue A/c Dr. To Unexpired Risks Reserve A/c (Excess of closing provision for unexpired risks of ₹ 45.75 crore over opening provision of ₹ 37.50 crore charged to Marine Revenue A/c)		8.25	 8.25
31.3.14	Fire Revenue A/c Dr. To Unexpired Risks Reserve A/c (Excess of closing provision for unexpired risks of ₹ 54.63 crore over opening provision of ₹ 50.00 crore charged to Fire Revenue A/c)		4.63	 4.63
31.3.14	Unexpired Risks Revenue A/c Dr. To Miscellaneous Revenue A/c (Excess of opening provision for unexpired risks of ₹ 12.5 crore over the required closing balance of ₹ 11.25 crore in the provision account credited to Miscellaneous Reserve Account)		1.25	 1.25

Working Notes :

Required closing balance in Unexpired Risks Reserve Account:

For Marine business = ₹ (45 +17.5 –16.75)= ₹ 45.75

For Fire business = [(107.5 + 12.5 – 10.75)/2] = ₹ 54.63

For miscellaneous business = [(30 + 10 – 17.5)/2] = ₹ 11.25

Dr. **Unexpired Risks Reserve Account (₹ in crore)** **Cr.**

Date	Particulars	Marine	Fire	Misc.	Date	Particulars	Marine	Fire	Misc.
2014	To, Revenue A/c	—	—	1.25	2014	By, Balance b/d	37.5	50.00	12.5
	To, Balance c/d	45.75	54.63	11.25		By, Revenue A/c	8.25	4.63	—
		45.75	54.63	12.50			45.75	54.63	12.50

Illustration 30.

Indian Insurance Co. Ltd. furnishes you with the following information :

(i) On 31.12.2013 it had reserve for unexpired risk to the tune of ₹ 40 crores. It comprised of ₹ 15 crores in respect of marine insurance business : ₹ 20 crores in respect of fire insurance business and ₹ 5 crores in respect of miscellaneous insurance business.

(ii) It is the practice of Indian Insurance Co. Ltd. to create reserves at 100% of net premium income in respect of marine insurance policies and at 50% of net premium income in respect of fire and miscellaneous income policies.

(iii) During 2014, the following business was conducted :

	Marine (₹ in crores)	Fire (₹ in crores)	Miscellaneous (₹ in crores)
Premia collected from :			
(a) Insureds in respect of policies issued	18	43	12
(b) Other insurance companies in respect of risks undertaken	7	5	4
Premia paid/payable to other insurance companies on business ceded	6.7	4.3	7

Indian Insurance Co. Ltd. asks you to :

(a) Pass journal entries relating to "Unexpired risks reserve".

(b) Show in columnar form "Unexpired risks reserve" account for 2012

Solution:

(a) Journal of Indian Insurance Co. Ltd.

Date	Particulars	L.F	Dr. ₹ Crore	Cr. ₹ Crore
31.12.14	Marine Revenue A/c Dr.		3.30	
	To Unexpired Risks Reserve A/c			3.30
	(Being the difference between closing provision of ₹ 18.30 crores (18 + 7 – 6.7) and opening provision of ₹ 15 crores charged to marine revenue account)			
	Fire Revenue A/c Dr.		1.85	
	To Unexpired Risks Reserve A/c			1.85
	(Being the difference between closing provision of ₹ 21.85 crores [(43 + 5 – 4.3)/2] and opening provision of ₹ 20 crores charged to fire revenue account)			
	Unexpired Risks Reserve A/c Dr.		0.50	
	To Miscellaneous Revenue A/c			0.50
	(Being the excess of opening balance of ₹ 5 crores over the required closing balance of ₹ 4.5 crores [(12 + 4 – 7)/2] credited to miscellaneous revenue account)			

(b) Unexpired Risks Reserve Account

(₹ in crores)

		Marine	Fire	Miscel-laneous			Marine	Fire	Miscel-laneous
31.12.14	To Revenue A/c	–	–	0.50	1.1.14	By Balance b/d	15.00	20.00	5.00
	To Balance c/d	18.30	21.85	4.50	31.12.14	By Revenue A/c	3.30	1.85	–
		18.30	21.85	5.00			18.30	21.85	5.00

Note : Alternatively, the opening balances of unexpired risk reserves may be reversed in the beginning of year by transfer to Revenue account and fresh reserve of full required amount may be created at the end of the year which will be carried forward as closing balances.

Illustration 31.

From the following figures appearing in the books of Fire Insurance division of a General Insurance Company, show the amount of claim as it would appear in the Revenue Account for the year ended 31st March, 2014 :

Particulars		Direct Business	Re-Insurance
		₹	₹
Claim paid during the year		46,70,000	7,00,000
Claim Payable —	1st April, 2013	7,63,000	87,000
	31st March, 2014	8,12,000	53,000
Claims received		–	2,30,000
Claims Receivable —	1st April, 2013	–	66,000
	31st March, 2014	–	1,13,000
Expenses of Management		2,30,000	–
(includes ₹ 35,000 Surveyor's fee and ₹ 45,000			
Legal expenses for settlement of claims)			

Solution :

General Insurance Company

(Abstract showing the amount of claims)

Particulars	₹ '000	₹ '000
Claims less Re-insurance :		
Paid during the year	52,20	
Add : Outstanding claims at the end of the year	7,52	
	59,72	
Less : Outstanding claims at the beginning of the year	7,84	51,88

Working Notes :

	Particulars	₹ '000	₹ '000
1.	Claims paid during the year		
	Direct business	46,70	
	Reinsurance	7,00	53,70
	Add : Surveyor's fee	35	
	Legal expenses	45	80
			54,50
	Less : Claims received from re-insurers		2,30
			52,20
2.	Claims outstanding on 31st March, 2014		
	Direct business	8,12	
	Reinsurance	53	8,65
	Less : Claims receivable from re-insurers		1,13
			7,52
3.	Claims outstanding on 1st April, 2013		
	Direct business	763	
	Reinsurance	87	8,50
	Less : Claims receivable from re-insurers		66
			7,84

Illustration 32.

From the following figures appearing in the books of Fire Insurance division of XYZ General Insurance Company, show the amount of claim as it would appear in the Revenue Account for the year ended 31st March, 2014 :

Particulars		Direct Business	Re-Insurance
		₹	₹
Claim paid during the year		7005000	1050000
Claim Payable —	1st April, 2013	1144500	130500
	31st March, 2014	1218000	79500
Claims received		–	345000
Claims Receivable —	1st April, 2013	–	97500
	31st March, 2014	–	169500
Expenses of Management (includes ₹ 52500 Surveyor's fee and ₹ 67500		345000	–
Legal expenses for settlement of claims)			

Solution:

XYZ General Insurance Company

(Abstract showing the amount of claims)

Particulars	₹ '000	₹ '000
Claims *less* Re-insurance :		
Paid during the year	7830.00	
Add : Outstanding claims at the end of the year	1128.00	
	8958.00	
Less : Outstanding claims at the beginning of the year	1177.00	7781.00

Working Notes :

	Particulars	₹ '000	₹ '000
1.	Claims paid during the year		
	Direct business	7005.00	
	Reinsurance	1050.00	8055.00
	Add : Surveyor's fee	52.50	
	Legal expenses	67.50	120.00
			8175.00
	Less : Claims received from re-insurers		345.00
			7830.00
2.	Claims outstanding on 31st March, 2014		
	Direct business	1218.00	
	Reinsurance	79.50	1297.50
	Less : Claims receivable from re-insurers		169.50
			1128.00
3.	Claims outstanding on 1st April, 2013		
	Direct business	1144.50	
	Reinsurance	130.50	1275.00
	Less : Claims receivable from re-insurers		98.00
			1177.50

Illustration 33.

ABC Fire Insurance Co. Ltd. commenced its business on 1.4.2013. It submits you the following information for the year ended 31.3.2014:

Particulars	₹ in lakh
Premiums received	1500.0
Re-insurance premiums paid	100.0
Claims paid	700.0
Expenses of Management	300.0
Commission paid	50.0
Claims outstanding on 31.3.2014	100.0
Create reserve for unexpired risk @40%	

Prepare Revenue account for the year ended 31.3.2014.

Solution:

Form B – RA (Prescribed by IRDA)

Name of the Insurer: ABC Fire Insurance Co. Ltd.

Registration No. and Date of registration with the IRDA…………………..

Revenue Account for the year ended 31st March, 2014

	Particulars	Schedule	Current year ended on 31st March, 2014
			₹ in lakh
1.	Premiums earned (Net)	1	14,00.0
2.	Change in provision for unexpired risk (NIL–5,60,000)	2	(560.0)
	Total (A)		840.0
1.	Claims incurred (Net)	3	800.0
2.	Commission		50.0
3.	Operating Expenses	4	300.0
	Total (B) (1+2+3)		1150.0
	Operating Profit/(Loss) from Fire Insurance Business [C =(A - B)]		(310.0)

Schedule 1

Premiums earned (Net) ₹ in lakh

Premium received	1500.0
Less: Premium on re-insurance paid	100.0
	1400.0

Schedule 2

Reserve for unexpired risk @ 40% on net premium

₹1400.0 × 40/100 = 560.0

Schedule 3

Claims ₹ in lakh

Claims paid	700.0
Add: Claims outstanding on 31.3.2012	100.0
	800.0

Schedule 4

Operating expenses ₹ in lakh

Expenses of Management	300.0

Illustration 34.

Prepare the Fire Insurance Revenue A/c as per IRDA regulations for the year ended 31st March, 2014 from the following details:

Particulars	₹
Claims paid	4,90,000
Legal expenses regarding claims	10,000
Premiums received	13,00,000
Re-insurance premium paid	1,00,000
Commission	3,00,000
Expenses of management	2,00,000
Provision against unexpired risk on 1st April, 2013	5,50,000
Claims unpaid on 1st April, 2013	50,000
Claims unpaid on 31st March, 2014	80,000

Create Reserve for Unexpired Risk @ 50%.

Solution:

FORM B - RA

Name of the Insurer:

Registration No. and Date of Registration with the IRDA:

Fire Insurance Revenue Account

for the year ended 31st March, 2014

	Particulars	**Schedule**	**Amount (₹)**
(1)	Premium earned	1	11,50,000
(2)	Other income		-
(3)	Interest, dividend and rent		-
	Total (A)		11,50,000
(4)	Claims incurred	2	5,30,000
(5)	Commission	3	3,00,000
(6)	Operating expenses related to Insurance business	4	2,00,000
	Total (B)		10,30,000
	Operating Profit (A)- (B)		1,20,000

Schedule 1 : Premium earned (net)	₹
Premium received	13,00,000
Less: Re-insurance premium	1,00,000
Net premium	12,00,000
Adjustment for change in reserve for unexpired risks (Refer W.N.)	50,000
	11,50,000

Schedule 2 : Claims Incurred	₹
Claims paid including legal expenses (4,90,000 + 10,000)	5,00,000
Add : Claims outstanding at the end of the year	80,000
Less : Claims outstanding at the beginning of the year	(50,000)
Total claims incurred	5,30,000

Schedule 3 : Commission	₹
Commission paid	3,00,000
	3,00,000

Schedule 4: Operating expenses	₹
Expenses of management	2,00,000
	2,00,000

Working Note:

Change in the provision for unexpired risk	₹
Unexpired risk reserve on 31st March, 2012 =50% of net premium	
i.e. 50% of ₹12,00,000 (See Schedule 1)	6,00,000
Less : Unexpired risk reserve as on 1st April 2013	5,50,000
Change in the provision for unexpired risk	50,000

Illustration 35.

The following are the Balance of Hari Insurance Co. Ltd as on 31.03.2014 -

Particulars	₹ 000's	Particulars	₹ 000's
Capital (Shares of ₹10)	320,00	Transfer Fees	1,00
Unclaimed Dividends	8,50	Income Tax Paid	120,00
Amount Due to other Insurance Companies	34,50	Mortgage Loan (Dr.)	975,00

Particulars	₹ 000's	Particulars	₹ 000's
Balance of Funds as on 01.04.2013		Sundry Debtors	25,00
Fire Insurance	800,00	Other Approved Securities	37,00
Marine Insurance	950,00	Government Securities	1020,00
Miscellaneous Insurance	218,65	Debentures	465,50
Sundry Creditors	72,50	Equity Shares of Joint Stock Companies	225,00
Deposit and Suspense Account (Cr.)	22,80	Claims Less Re-Insurance	
Profit and Loss Account (Cr.)	122,10	- Fire	450,00
Agents Balance (Dr.)	135,00	- Marine	358,90
Interest Accrued but not due (Dr.)	22,50	- Miscellaneous	68,00
Due from other Insurance Companies	64,50	Premium Less Re- Insurance	
Cash on Hand	3,50	- Fire	1762,50
Balance in Current Account with Bank	84,80	- Marine	1022,50
Furniture and Fixtures WDV (Cost ₹ 1,00,00)	58,00	- Miscellaneous	262,25
Stationery Stock	1,40	Interest and Dividends Received on Investments	58,50
Expenses of Management		Tax Deducted at Source on Interest	11,70
- Fire Insurance	280,00	Commission	
- Marine Insurance	160,00	- Fire	500,00
- Miscellaneous Insurance	40,00	- Marine	350,00
- Others	30,00	Miscellaneous	80,00
Foreign Rates and Taxes - Marine	8,00		
Outstanding Premium	82,00		

You are required to make the following provision: (in ₹ 000's)

1. Depreciation on Furniture -10% of Original Cost.
2. Fair Value of Investment of Joint Stock Companies Shares on 31.03.2014 - ₹ 215,00
3. Transfer to General Reserve ₹ 10,0
4. Outstanding Claims as on 31.03.2014 - (₹ in 000's)
   (a) Fire - ₹ 200,00
   (b) Marine - ₹ 50,00
   (c) Miscellaneous - ₹ 32,50
5. Provision for Tax at 50%, Proposed Dividends at 20%. Provision for Unexpired Risks is to be made as follows:
   (a) On Marine Policies 100% of Premium Less Re-Insurance
   (b) On Other Policies 50% of Premium Less Re-Insurance

The Shares of the Company are fully held by Indian Promoters.

Prepare the Revenue and Profit and Loss Account for the year ended 31.3.2014, and Balance Sheet as on that date.

Solution:

1. Form -B-RA- Revenue Account of Hari Insurance Co. Ltd for the year ended 31.3.2014 (in ₹ 000's)

	Particulars	Sch.	This Yr.			Last Yr.
			Fire	Marine	Misc.	
	Premium Earned (Net)	1	1681,25	950,00	349,77	
	Total (A)		**1681,25**	**950,00**	**349,77**	
1.	Claims Incurred (Net)	2	650,00	408,90	100,50	
2.	Commission	3	500,00	350,00	80,00	
3.	Operating Expenses related to Insurance Business	4	280,00	168,00	40,00	
	Total (B)		**1430,00**	**926,90**	**220,50**	
	Operating Profit/(Loss) from Insurance Business (A - B)		251,25	23,10	129,27	
	Appropriations: Transfer to Shareholder's Account		251,25	23,10	129,27	
	Total (C)		**251,25**	**23,10**	**129,27**	

2. Form-B-PL - Profit and Loss Account of Hari Insurance Co. Ltd for the year ending 31.3.2014 (in ₹ 000s)

	Particulars	Sch.	This Yr.	Last Yr.
1.	**Operating Profit / (Loss) from Insurance Business**			
	(a) Fire Insurance		251,25	
	(b) Marine Insurance		23,10	
	(c) Miscellaneous Insurance		129,27	
2.	**Income from Investments** Interest, Dividend and Rent - Gross		58,50	
3.	**Other Income** - Transfer Fees		1,00	
	Total (A)		**463,12**	
4.	**Provisions (other than Taxation)**			
5.	**Other Expenses**			
	(a) Depreciation on Fixed Assets		10,00	
	(b) Depreciation on Joint Stock Company Shares		10,00	
	(c) Expenses of Management		30,00	
	Total (B)		**5,000**	
	Profit Before Tax **(A - B)** **Less:** Provision for Taxation **(WN 5)**		413,12 (206,56)	
	Profit After Tax = Profit Available for Appropriation		206,56	
	Appropriations: (a) Proposed Final Dividend (20% of ₹ 320,00) (b) Transfer to any Reserve or other Accounts - General Reserve		(64,00) (10,00)	
	Balance of Profit / Loss Brought forward from last year		122,10	
	Balance carried forward to Balance Sheet		**25466**	

3. Form-B-BS - Balance Sheet of Titan Insurance Co. Ltd as at 31.3.2014 (in ₹ 000's)

Particulars	Sch.	This Yr.	Last Yr.
Sources of Funds			
Shareholders' Funds			
Share Capital	5	320,00	
Reserve and Surplus	6	264,66	
Fair Value Change Account		10,00	
Borrowings	7	–	
Total		**594,66**	
Application of Funds			
Investments	8	1747,50	
Loans	9	975,00	
Fixed Assets	10	48,00	
Current Assets			
Cash and Bank Balances	11	88,30	
Advances and Other Assets (329,00 + 1,40)	12	330,40	
Sub Total (A)		**3189,20**	
Current Liabilities	13	420,80	
Provisions	14	2173,74	
Sub Total (B)		**2594,54**	
Net Current Assets (C) = (A - B)	15	(2175,84)	
Miscellaneous Expenditure (to the extent not written off or adjusted)			
Total		**594,66**	

Schedule 1 - Premium Earned (Net)

Particulars	This Yr.			Last Yr.
	Fire	Marine	Misc.	
Net Premium	1762,50	1022,50	262,25	
Adjustment for change in Reserve for Unexpired Risks **(Note)**	(81,25)	(72,50)	87,52	
Total Premium Earned (Net)	**1681,25**	**950,00**	**349,77**	

Note: Amount to be transferred to Unexpired Risk Reserve is as under -

Particulars	Fire	Marine	Miscellaneous
Closing Balance of Reserve required	50% of 1762,50 = 881,25	100% of 1022,50 = 1022,50	50% of 262,25 = 131,13
Less: Opening Balance of Reserve available	800,00	950,00	218,65
Additional Reserve required	**81,25**	**72,50**	**87,52**

Schedule 2 - Claims Incurred (Net)

Particulars	This Yr.			Last Yr.
	Fire	Marine	Misc.	
Net Claims Paid	450,00	358,90	68,00	
Add: Claims Outstanding at the end of the Year	200,00	50,00	32,50	
Less: Claims Outstanding at the beginning of the Year	—	—	—	
Total Claims Incurred	**650,00**	**408,90**	**100,50**	

Schedule 3 - Commission

Particulars	This Yr.			Last Yr.
	Fire	Marine	Misc.	
Commission Paid - Direct	500,00	350,00	80,00	
Net Commission	**500,00**	**350,00**	**80,00**	

Schedule 4 - Operating Expense related to Insurance Business

	Particulars	This Yr.			Last Yr.
		Fire	Marine	Misc.	
1.	Rents, Rates and Taxes (Foreign Rates and Taxes)	280,00	8,00	40,00	
2.	Others Expenses of Management		160,00		
	Total	**280,00**	**168,00**	**40,00**	

Schedule 5 - Share Capital

	Particulars	This Yr.	Last Yr.
1.	**Authorised Capital** -.......Equity Shares of ₹ ... each		
2.	**Issued, Subscribed and Paid Up Capital** - 32 Lakh Equity Shares of ₹ 10 each	320,00	
	Total	**320,00**	

Schedule 5A - Pattern of Shareholding

	Shareholder	This Yr.		Last Yr.	
		No. of Shares	% of Holding	No. of Shares	% of Holding
1.	Promoters				
	(a) Indian	32 Lakhs	100%	32 Lakhs	100%
	(b) Foreign	-	-	-	-
2.	Others	-	-	-	-
	Total	**32 Lakhs**	**100%**	**32 Lakhs**	**100%**

Schedule 6 - Reserves and Surplus

	Particulars	This Yr.	Last Yr.
1. 2.	General Reserve	10,00	
	Balance of Profit in Profit and Loss Account	254,66	
	Total	**264,66**	

Schedule 7 - Borrowings - NIL

Schedule 8 - Investments Shareholders

	Particulars	This Yr.	Last Yr.
1.	**Long Term Investments**		
2.	Govt. Securities and Govt, guaranteed bonds including Treasury Bills	1020,00	
3.	Other Approved Securities	37,00	
	Other Investments		
	(a) Shares (Equity Shares)	225,00	
	(b) Debentures / Bonds	465,50	
	Total	**1747,50**	

Schedule 9 - Loans

Particulars	This Yr.	Last Yr.
Security-wise Classification: Secured On Mortgage of Property	975,00	
Total	**975,00**	

Note: Borrower-wise, Performance-wise and Maturity-wise classification not given, due to absence of information.

Schedule 10 - Fixed Assets

	Cost / Gross Block				Accumulated Depreciation				Net Block	
Particulars	**Opg.**	**Addn.**	**Dedns.**	**Clg.**	**Opg.**	**For the Year**	**Sales/ Adj.**	**Clg.**	**Opg.**	**Clg.**
Furniture & Fittings	**100,00**	**-**	**-**	**100,00**	**42,00**	**10,00**	**-**	**52,00**	**58,00**	**48,00**

Schedule 11 - Cash and Bank Balance

	Particulars	This Yr.	Last Yr.
1.	Cash (including Cheques, Drafts and Stamps)	3,50	
2.	Bank Balance - Current Account	84,80	
	Total	**88,30**	

Schedule 12 - Advances and Other Current Assets

	Particulars	This Yr.	Last Yr.
1.	**Advances**	**NIL**	
2.	**Other Assets**		
	(a) Income Accrued on Investments	22,50	
	(b) Outstanding Premiums	82,00	
	(c) Agents' Balance	135,00	
	(d) Due from Other Entities carrying on Insurance Business	64,50	
	(e) Others - Stationery Stock	1,40	
	(f) Others - Sundry Debtors	25,00	
	Total	**330,40**	

Schedule 13 - Current Liabilities

	Particulars	This Yr.	Last Yr.
1.	Balances due to other Insurance Companies	34,50	
2.	Deposit and Suspense A/c	22,80	
3.	Sundry Creditors	72,50	
4.	Claims Outstanding (₹ 200,00 + ₹ 50,00 + ₹ 32,50)	282,50 -	
5.	Unclaimed Dividend	8,50	
	Total	**420,80**	

Schedule 14 - Provisions

	Particulars	This Yr.	Last Yr.
1.	For Taxation (Less Advance Tax paid and Taxes Deducted at Source) (WN 6)	74,86	
2.	For Proposed Dividends	64,00	
3.	Reserve for Unexpired Risk - **(Refer Note below Schedule 1)**		
	(a) Fire	881,25	
	(b) Marine	1022,50	
	(c) Miscellaneous	131,13	
	Total	**2173,74**	

Schedule 15 - Miscellaneous Expenditure - NIL

5. Calculation of Provision for Taxation

Particulars	₹ 000's
Net Profit Before Tax	413,12
Taxable Profit	413,12
Provision for Tax at 50% of Taxable Profit	**206,56**

6. Provision for Taxation A/c

Particulars	₹ 000's	Particulars	₹ 000's
To Bank (Amount paid)	120,00	By Profit and Loss A/c	206,56
To Tax Deducted at Source	11,70		
To balance c/d **(balancing figure)**	**74,86**		
Total	**206,56**	**Total**	**206,56**

Illustration 36.

From the following balances extracted from the books of Udyog General Insurance Company Limited as on 31.3.2014, you are required to prepare Revenue Accounts in respect of Fire and marine Insurance business for the year ended 31.3.2014 to and a Profit and Loss Account for the same period :

Particulars	₹	Particulars	₹
Directors' Fees	80,000	Interest received	19,000
Dividend received	1,00,000	Fixed Assets (1.4.2013)	1,00,000
Provision for Taxation (as on 1.4. 2013)	85,000	Income-tax paid during the year	60,000

Particulars	Fire	Marine
Outstanding Claims on 1.4.2013	28,000	7,000
Claims paid	1,00,000	80,000
Reserve for Unexpired Risk on 1.4.2013	2,00,000	1,40,000
Premiums Received	4,50,000	3,30,000
Agent's Commission	40,000	20,000
Expenses of Management	60,000	45,000
Re-insurance Premium (Dr.)	25,000	15,000

The following additional points are also to be taken into account :

(a) Depreciation on Fixed Assets to be provided at 10% p.a.

(b) Interest accrued on investments ₹ 10,000.

(c) Closing provision for taxation on 31.3.2014 to be maintained at ₹ 1,24,138

(d) Claims outstanding on 31.3.2014 were Fire Insurance ₹ 10,000; Marine Insurance ₹ 15,000.

(e) Premium outstanding on 31.3.2014 were Fire Insurance ₹ 30,000; Marine Insurance ₹ 20,000.

(f) Reserve for unexpired risk to be maintained at 50% and 100% of net premiums in respect of Fire and Marine Insurance respectively.

(g) Expenses of management due on 31.3.2014 were ₹ 10,000 for Fire Insurance and ₹ 5,000 in respect of marine Insurance.

Solution:

Form B – RA (Prescribed by IRDA)
Udyog General Insurance Co. Ltd
Revenue Account for the year ended 31st March, 2014
Fire and Marine Insurance Businesses

Particulars	Schedule	Fire Current Year	Marine Current Year
		₹	₹
Premiums earned (net)	1	4,55,000	3,35,000
Change in provision for unexpired risk (Note A)		(-)27,500	(-) 1,95,000
Interest, Dividends and Rent – Gross		—	—
Double Income Tax refund		—	—
Profit on sale of motor car		—	—
Total (A)		4,27,500	1,40,000
Claims incurred (net)	2	82,000	88,000
Commission	3	40,000	20,000
Operating expenses related to Insurance business	4	70,000	50,000
Bad debts		—	—
Indian and Foreign taxes		—	—
Total (B)		1,92,000	1,58,000
Profit from Marine Insurance business (A-B)		2,35,500	(18000)

Schedules forming part of Revenue Account

Schedule 1 – Premium Earned (Net)

Particulars	Fire (₹)	Marine(₹)
Premium from direct business written (Note 3)	4,80,000	3,50,000
Less: Premium on re-insurance ceded	25,000	15,000
Net Premium	4,55,000	3,35,000

Schedule 2 – Claims Incurred (Net)

Particulars	Fire (₹)	Marine(₹)
Premium from direct business written (Note 3)	4,80,000	3,50,000
Less: Premium on re-insurance ceded	25,000	15,000
Net Premium	4,55,000	3,35,000
Adjustment for change in reserve for unexpired risks (Note 4)	(27,500)	(1,95,000)
Total Premium Earned (Net)	4,27,500	1,40,000

Schedule 3 – Commission

Particulars	Fire (₹)	Marine(₹)
Agents' Commission	40,000	20,000

Schedule 4 – Operating Expenses related to Insurance Business

Particulars	Fire (₹)	Marine(₹)
Expenses on management paid	60,000	45,000
Add: Outstanding	10,000	5,000
	70,000	50,000

Form B-PL

Udyog General Insurance Co. Ltd.

Profit and Loss Account for the year 31st March, 2014

Particulars	Schedule	Current Year	Previous Year
		₹	₹
Operating Profit/(Loss)			
(a) Fire Insurance		2,35,500	
(b) Marine Insurance		(18,000)	
(c) Miscellaneous Insurance		—	
Income From Investments			
(a) Interest, Dividend & Rent–Gross (b) Profit on sale of investments Less : Loss on sale of investments		1,29,000	
Other Income (To be specified)			
Total (A)		3,46,500	
Provisions (Other than taxation)		—	
Depreciation		10,000	
Other Expenses –Director's Fee		80,000	
Total (B)		90,000	
Profit Before Tax		2,56,500	
Provision for Taxation		—	
Profit After Tax		1,57,362	

Working Notes :

		Fire	Marine
		₹	₹
1.	Claims under policies less reinsurance		
	Claims paid during the year	1,00,000	80,000
	Add: Outstanding on 31st March, 2014	10,000	15,000
		1,10,000	95,000
	Less : Outstanding on 1st April, 2013	28,000	7,000
		82,000	88,000
2.	Expenses of management		
	Expenses paid during the year	60,000	45,000
	Add: Outstanding on 31st March, 2014	10,000	5,000
		70,000	50,000
3.	Premiums less reinsurance		
	Premiums received during the year	4,50,000	3,30,000
	Add: Outstanding on 31st March, 2014	30,000	20,000
		4,80,000	3,50,000
	Less : Reinsurance premiums	25,000	15,000
		4,55,000	3,35,000

4. Reserve for unexpired risks is 50% of net premium for fire insurance and 100% of net premium for marine insurance.

5. **Provision for Taxation Account**

Date	Particulars	₹	Date	Particulars	₹
31.3.2014	To Bank A/c		1.4.2013	By Balance b/d	85,000
	(taxes paid)	60,000	31.3.2014	By P & L A/c	99,138
31.3.2014	To Balance c/d	1,24,138			
		1,84,138			1,84,138

Note A:

Adjustment for change in Reserve for Unexpired Risk:

Particulars	Fire (₹)	Marine (₹)
Opening balance of Reserve for Unexpired Risk	2,00,000	1,40,000
Closing balance of Reserve for Unexpired Risk	2,27,500	3,35,000
	(27,500)	(1,95,000)

50% of ₹ 4,55,000 (Net Premium)

50% of ₹ 3,35,000 (Net Premium)

Illustration 37.

From the following information as on 31st March, 2014, prepare the Revenue Accounts of Future Bima Co. Ltd. engaged in Marine Insurance Business:

	Particulars		Direct Business (₹)	Re-insurance (₹)
I.	Premium :			
	Received		24,00,000	3,60,000
	Receivable	– 1st April, 2013	1,20,000	21,000
		– 31st March, 2014	1,80,000	28,000
	Premium paid		2,40,000	–
	Payable	– 1st April, 2013	–	20,000
		– 31st March, 2014	–	42,000
II.	Claims :			
	Paid		16,50,000	1,25,000
	Payable	– 1st April, 2013	95,000	13,000
		– 31st March, 2014	1,75,000	22,000
	Received		–	1,00,000
	Receivable	– 1st April, 2013	–	9,000
		– 31st March, 2014	–	12,000
III.	Commission :			
	On Insurance accepted		1,50,000	11,000
	On Insurance ceded		–	14,000

Other expenses and income:

Salaries – ₹ 2,60,000; Rent, Rates and Taxes – ₹ 18,000; Printing and Stationery – ₹ 23,000; Indian Income Tax paid – ₹ 2,40,000; Interest, Dividend and Rent received (net) – ₹ 1,15,500; Income Tax deducted at source – ₹ 24,500; Legal Expenses (Inclusive of ₹ 20,000 in connection with the settlement of claims) – ₹ 60,000; Bad Debts – ₹ 5,000; Double Income Tax refund – ₹ 12,000; Profit on Sale of Motor car ₹ 5,000.

Balance of Fund on 1st April, 2013 was ₹ 26,50,000 including Additional Reserve of ₹ 3,25,000. Additional Reserve has to be maintained at 5% of the net premium of the year.

Solution:

From B – RA (Prescribed by IRDA)

Name of the Insurer: Future Bima Co. Ltd.

Registration No. and Date of Registration with IRDA.

Revenue Account for the year ended 31st March, 2014.

Particulars	Schedule	₹
Premiums earned – net	1	25,21,750
Interest, Dividends and Rent – Gross (Note 5)		1,40,000
Total (A)		26,61,750
1. Claims Incurred (Net)	2	17,81,000
2. Commission	3	1,47,000
3. Operating expenses related to Insurance Business	4	3,41,000
Total (B)		22,69,000
Operating Profit / (Loss) from Fire Insurance Business C = (A – B)		3,92,750

Schedule 1 – Premium Earned (Net)

Particulars	₹	₹
Premium from direct business written (Note 1)	24,60,000	
Add: Premium on re-insurance accepted (Note 2)	3,67,000	
	28,27,000	
Less: Premium on re-insurance ceded (Note 3)	2,62,000	25,65,000
Adjustment for Change in Reserve for Unexpired Risk:		
Opening balance of unexpired reserve	26,50,000	
Less: Closing balance of unexpired reserve (Note 4)	26,93,250	(43,250)
Total Premium Earned (Net)		25,21,750

Schedule 2 – Claims Incurred (Net)

Particulars	₹	₹
Claims Paid:		
Direct	16,50,000	
Re-insurance	1,25,000	17,75,000
Add: Legal expenses		20,000
		17,95,000
Less: Claims received from re-insurance		1,00,000
		16,95,000
Add: Outstanding claims at the end of the year (Note 6)		1,85,000
		18,80,000
Less: Outstanding claims at the beginning of the year (Note 7)		99,000
		17,81,000

Schedule 3 – Commission

Particulars	₹	₹
Commission Paid:		
Direct	1,50,000	
Add: Re-insurance accepted	11,000	
	1,61,000	
Less: Commission on re-insurance ceded	14,000	1,47,000

Schedule 4 – Operating Expenses Related to insurance Business

Particulars	₹	₹
Salaries		2,60,000
Rent, Rates and Taxes		18,000
Printing and Stationery		23,000
Legal Expenses:		
Total	60,000	
Less: Related to Claims	20,000	40,000
		3,41,000

Working Notes:

(1) Premium from Direct Business

Particulars	₹	₹
Premium received	24,00,000	
Add: Receivable on 31st March, 2014	1,80,000	
	25,80,000	
Less: Receivable on 1st April, 2013	1,20,000	24,60,000

(2) Premium on Re-insurance Accepted

Particulars	₹	₹
Premium received	3,60,000	
Add: Receivable on 31st March, 2014	28,000	
	3,88,000	
Less: Receivable on 1st April, 2013	21,000	3,67,000

(3) Premium on Re-insurance Ceded

Particulars	₹	₹
Premium received	2,40,000	
Add: Payable on 31st March, 2014	42,000	
	2,82,000	
Less: Payable on 1st April, 2013	20,000	2,62,000

(4) Unexpired Risk on 31st March, 2014

Particulars	₹	₹
100% of ₹ 25,65,000 (Net Premium income)		25,65,000
Additional Reserve – 5% of ₹ 25,65,000		1,28,250
		26,93,250

(5) Interest, Dividend and Rent (Net)

Particulars	₹	₹
Interest, Dividend and Rent (Net)		1,15,500
Add: Tax Deducted at Source		24,500
		1,40,000

Note: Interest, Dividend and Rent are to be shown in the Revenue Account at Gross figure.

(6) Claims Outstanding on 31st March, 2014

Particulars	₹	₹
Direct business	1,75,000	
Re-insurance	22,000	1,97,000
Less: Claims receivable from re-insurer		12,000
		1,85,000

(7) Claims Outstanding on 1st April, 2013

Particulars	₹	₹
Direct business	95,000	
Re-insurance	13,000	1,08,000
Less: Claims receivable from re-insurer		9,000
		99,000

Note: Marine Revenue Account is prepared to find out the operating profit of the marine insurance business. Therefore, any income or expense which are not related to marine insurance business are not to be taken into consideration. All common incomes and expenses are shown in the Profit and Loss Account of the General Insurance Company. Based on this, the following items are not to be taken into consideration for the preparation of Marine Revenue Account. The items are : (i) Double income-tax refund; (ii) Profit on sale of motor car; (iii) Bad debts; (iv) Income-tax paid; and (v) Tax deducted at source.

Illustration 38:

The following are the Balance of Hari Insurance Co. Ltd as on 31.03.2014 -

Particulars	₹ 000's	Particulars	₹ 000's
Capital (Shares of ₹10)	320,00	Transfer Fees	1,00
Unclaimed Dividends	8,50	Income Tax Paid	120,00
Amount Due to other Insurance Companies	34,50	Mortgage Loan (Dr.)	975,00

Particulars	₹ 000's	Particulars	₹ 000's
Balance of Funds as on 01.04.2013		Sundry Debtors	25,00
Fire Insurance	800,00	Other Approved Securities	37,00
Marine Insurance	950,00	Government Securities	1020,00
Miscellaneous Insurance	218,65	Debentures	465,50
Sundry Creditors	72,50	Equity Shares of Joint Stock Companies	225,00
Deposit and Suspense Account (Cr.)	22,80	Claims Less Re-Insurance	
Profit and Loss Account (Cr.)	122,10	- Fire	450,00
Agents Balance (Dr.)	135,00	- Marine	358,90
Interest Accrued but not due (Dr.)	22,50	- Miscellaneous	68,00
Due from other Insurance Companies	64,50	Premium Less Re- Insurance	
Cash on Hand	3,50	- Fire	1762,50
Balance in Current Account with Bank	74,80	- Marine	1022,50
Furniture and Fixtures WDV (Cost ₹ 1,00,00)	58,00	- Miscellaneous	262,25
Stationery Stock	1,40	Interest and Dividends Received on Investments	58,50
Expenses of Management		Tax Deducted at Source on Interest	11,70
- Fire Insurance	280,00	Commission	
- Marine Insurance	160,00	- Fire	500,00
- Miscellaneous Insurance	40,00	- Marine	350,00
- Others	30,00	Miscellaneous	80,00
Foreign Rates and Taxes - Marine	8,00	Donation paid (No 80G Benefit)	10,00
Outstanding Premium	82,00		

You are required to make the following provision: (in ₹ 000's)

1. Depreciation on Furniture -10% of Original Cost.
2. Fair Value of Investment of Joint Stock Companies Shares on 31.03.2014 - ₹ 215,00
3. Transfer to General Reserve ₹ 10,0
4. Outstanding Claims as on 31.03.2014 - (₹ in 000's)
   (a) Fire - ₹ 200,00
   (b) Marine - ₹ 50,00
   (c) Miscellaneous - ₹ 32,50
5. Provision for Tax at 50%, Proposed Dividends at 20%. Provision for Unexpired Risks is to be made as follows:
   (a) On Marine Policies 100% of Premium Less Re-Insurance
   (b) On Other Policies 50% of Premium Less Re-Insurance

The Shares of the Company are fully held by Indian Promoters.

Prepare the Revenue and Profit and Loss Account for the year ended 31.3.2014, and Balance Sheet as on that date.

Solution:

1. Form -B-RA- Revenue Account of Hari Insurance Co. Ltd for the year ended 31.3.2014 (in ₹ 000's)

	Particulars	**Sch.**	**This Yr.**			**Last Yr.**
			Fire	**Marine**	**Misc.**	
	Premium Earned (Net)	**1**	1681,25	950,00	349,77	
	Total (A)		**1681,25**	**950,00**	**349,77**	
1. 2. 3.	Claims Incurred (Net) Commission Operating Expenses related to Insurance Business	**2** **3** **4**	650,00 500,00 280,00	408,90 350,00 168,00	100,50 80,00 40,00	
	Total (B)		**1430,00**	**926,90**	**220,50**	
	Operating Profit / (Loss) from Insurance Business (A - B)		251,25	23,10	129,27	
	Appropriations: Transfer to Shareholder's Account		251,25	23,10	129,27	
	Total (C)		**251,25**	**23,10**	**129,27**	

2. Form-B-PL - Profit and Loss Account of Hari Insurance Co. Ltd for the year ending 31.3.2014 (in ₹ 000s)

	Particulars	Sch.	This Yr.	Last Yr.
1.	**Operating Profit / (Loss) from Insurance Business**			
	(a) Fire Insurance		251,25	
	(b) Marine Insurance		23,10	
	(c) Miscellaneous Insurance		129,27	
2.	**Income from Investments** Interest, Dividend and Rent - Gross		58,50	
3.	**Other Income** - Transfer Fees		1,00	
	Total (A)		**463,12**	
4.	**Provisions (other than Taxation)**			
5.	**Other Expenses**			
	(a) Depreciation on Fixed Assets		10,00	
	(b) Depreciation on Joint Stock Company Shares		10,00	
	(c) Expenses of Management		30,00	
	(d) Donations		10,00	
	Total (B)		**60,00**	
	Profit Before Tax **(A - B)** **Less:** Provision for Taxation **(WN 5)**		403,12 (206,56)	
	Profit After Tax = Profit Available for Appropriation		196,56	
	Appropriations:			
	(a) Proposed Final Dividend (20% of ₹ 320,00)		(64,00)	
	(b) Transfer to any Reserve or other Accounts - General Reserve		(10,00)	
	Balance of Profit / Loss Brought forward from last year		122,10	
	Balance carried forward to Balance Sheet		**24,466**	

3. Form-B-BS - Balance Sheet of Titan Insurance Co. Ltd as at 31.3.2014 (in ₹ 000's)

Particulars	Sch.	This Yr.	Last Yr.
Sources of Funds			
Shareholders' Funds			
Share Capital	5	320,00	
Reserve and Surplus	6	254,66	
Fair Value Change Account		10,00	
Borrowings	7	–	
Total		**584,66**	
Application of Funds			
Investments	8	1747,50	
Loans	9	975,00	
Fixed Assets	10	48,00	
Current Assets			
Cash and Bank Balances	11	78,30	
Advances and Other Assets (329,00 + 1,40)	12	330,40	
Sub Total (A)		**317,920**	

Current Liabilities Provisions	13 14	420,80 2173,74	
Sub Total (B)		**2594,54**	
Net Current Assets (C) = (A - B) Miscellaneous Expenditure (to the extent not written off or adjusted)	 15	(2185,84)	
Total		**584,66**	

Schedule 1 - Premium Earned (Net)

Particulars	This Yr.			Last Yr.
	Fire	Marine	Misc.	
Net Premium Adjustment for change in Reserve for Unexpired Risks **(Note)**	1762,50 (81,25)	1022,50 (72,50)	262,25 87,52	
Total Premium Earned (Net)	**1681,25**	**950,00**	**349,77**	

Note: Amount to be transferred to Unexpired Risk Reserve is as under -

Particulars	Fire	Marine	Miscellaneous
Closing Balance of Reserve required **Less:** Opening Balance of Reserve available	50% of 1762,50 = 881,25 800,00	100% of 1022,50 = 1022,50 950,00	50% of 262,25 = 131,13 218,65
Additional Reserve required	**81,25**	**72,50**	**87,52**

Schedule 2 - Claims Incurred (Net)

Particulars	This Yr.			Last Yr.
	Fire	Marine	Misc.	
Net Claims Paid **Add:** Claims Outstanding at the end of the Year **Less:** Claims Outstanding at the beginning of the Year	450,00 200,00 —	358,90 50,00 —	68,00 32,50 —	
Total Claims Incurred	**650,00**	**408,90**	**100,50**	

Schedule 3 - Commission

Particulars	This Yr.			Last Yr.
	Fire	Marine	Misc.	
Commission Paid - Direct	500,00	350,00	80,00	
Net Commission	**500,00**	**350,00**	**80,00**	

Schedule 4 - Operating Expense related to Insurance Business

	Particulars	This Yr.			Last Yr.
		Fire	Marine	Misc.	
1. **2.**	Rents, Rates and Taxes (Foreign Rates and Taxes) Others Expenses of Management	280,00	8,00 160,00	40,00	
	Total	**280,00**	**168,00**	**40,00**	

Schedule 5 - Share Capital

	Particulars	This Yr.	Last Yr.
1.	**Authorised Capital** -.......Equity Shares of ₹ ... each		
2.	**Issued, Subscribed and Paid Up Capital** - 32 Lakh Equity Shares of ₹ 10 each	320,00	
	Total	**320,00**	

Schedule 5A - Pattern of Shareholding

	Shareholder	This Yr.		Last Yr.	
		No. of Shares	% of Holding	No. of Shares	% of Holding
1.	Promoters				
	(a) Indian	32 Lakhs	100%	32 Lakhs	100%
	(b) Foreign	-	-	-	-
2.	Others	-	-	-	-
	Total	**32 Lakhs**	**100%**	**32 Lakhs**	**100%**

Schedule 6 - Reserves and Surplus

	Particulars	This Yr.	Last Yr.
1. 2.	General Reserve	10,00	
	Balance of Profit in Profit and Loss Account	244,66	
	Total	**254,66**	

Schedule 7 - Borrowings - NIL

Schedule 8 - Investments Shareholders

	Particulars	This Yr.	Last Yr.
1.	**Long Term Investments**		
2.	Govt. Securities and Govt, guaranteed bonds including Treasury Bills	1020,00	
3.	Other Approved Securities	37,00	
	Other Investments		
	(a) Shares (Equity Shares)	225,00	
	(b) Debentures / Bonds	465,50	
	Total	**1747,50**	

Schedule 9 - Loans

Particulars	This Yr.	Last Yr.
Security-wise Classification: Secured		
On Mortgage of Property	975,00	
Total	**975,00**	

Note: Borrower-wise, Performance-wise and Maturity-wise classification not given, due to absence of information.

Schedule 10 - Fixed Assets

	Cost / Gross Block				Accumulated Depreciation				Net Block	
Particulars	**Opg.**	**Addn.**	**Dedns.**	**Clg.**	**Opg.**	**For the Year**	**Sales/ Adj.**	**Clg.**	**Opg.**	**Clg.**
Furniture & Fittings	**100,00**	**-**	**-**	**100,00**	**42,00**	**10,00**	**-**	**52,00**	**58,00**	**48,00**

Schedule 11 - Cash and Bank Balance

	Particulars	This Yr.	Last Yr.
1.	Cash (including Cheques, Drafts and Stamps)	3,50	
2.	Bank Balance - Current Account	74,80	
	Total	**78,30**	

Schedule 12 - Advances and Other Current Assets

	Particulars	This Yr.	Last Yr.
1.	**Advances**	**NIL**	
2.	**Other Assets**		
	(a) Income Accrued on Investments	22,50	
	(b) Outstanding Premiums	82,00	
	(c) Agents' Balance	135,00	
	(d) Due from Other Entities carrying on Insurance Business	64,50	
	(e) Others - Stationery Stock	1,40	
	(f) Others - Sundry Debtors	25,00	
	Total	**330,40**	

Schedule 13 - Current Liabilities

	Particulars	This Yr.	Last Yr.
1.	Balances due to other Insurance Companies	34,50	
2.	Deposit and Suspense A/c	22,80	
3.	Sundry Creditors	72,50	
4.	Claims Outstanding (₹ 200,00 + ₹ 50,00 + ₹ 32,50)	282,50	
5.	Unclaimed Dividend	8,50	
	Total	**420,80**	

Schedule 14 - Provisions

	Particulars	This Yr.	Last Yr.
1.	For Taxation (Less Advance Tax paid and Taxes Deducted at Source) (WN 6)	74,86	
2.	For Proposed Dividends	64,00	
3.	Reserve for Unexpired Risk - **(Refer Note below Schedule 1)**		
	(a) Fire	881,25	
	(b) Marine	1022,50	
	(c) Miscellaneous	131,13	
	Total	**2173,74**	

Schedule 15 - Miscellaneous Expenditure - NIL

5. Calculation of Provision for Taxation

Particulars	₹ 000's
Net Profit Before Tax	403,12
Add : Donation not allowed as a Deduction u/s 80G of the Income Tax Act, 1956	10,00
Taxable Profit	413,12
Provision for Tax at 50% of Taxable Profit	**206,56**

6. Provision for Taxation A/c

Particulars	₹ 000's	Particulars	₹ 000's
To Bank (Amount paid)	120,00	By Profit and Loss A/c	206,56
To Tax Deducted at Source	11,70		
To balance c/d **(balancing figure)**	**74,86**		
Total	**206,56**	**Total**	**206,56**