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Study Note – 1 | Fundamentals of Accounting

1.1& 1.2 Basics and General Accepted Accounting Principles

Meaning of Accounting

American Institute of Certified Public Accountant defined Accounting as "Accounting is the art of recording, classifying and summarizing in a significant manner and in term of Money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof."

In simple terms Accounting can be stated as the process of recording and maintaining the Financial Information.

Procedures of Accounting

Broadly the accounting procedures are divided into two categories:

1. Generating Financial Information
2. Using the Financial Information.

Procedure to Generate Financial Information comprises of the following 6 steps:

1. **Recording:**
   This is the first step of accounting. All the transactions are recorded in the respective account book which is called as a "Journal".

   For Eg: All the transactions done by the company during a particular month will be recorded in the Journal on a daily basis.

2. **Classifying:**
   Classifying involves systematically analyzing and segregating the transactions recorded in the Journal.

   This is done by transferring the journal entries in the Ledger which clubs all the similar transactions to a particular account.

   For Eg: All the journal entries related to sales will be recorded in the Sales Ledger.

3. **Summarizing:**
   Under this step all the ledger balances are summarized and prepared in manner that is useful to the users of the Financial Statements.

   A company carries on hundreds and thousands of transactions in a financial year and the journal and ledger balances for all the transactions can run into hundreds of pages which will be lot time consuming and confusing for the users of the Financial Statements.

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Therefore, to avoid this problem a summary of all the transactions and ledger balances is presented. The preparation of this summary leads to the creation of the Financial Statements which includes the following:

i) Trial Balance
ii) Profit and Loss Statement
iii) Balance Sheet
iv) Cash Flow Statement

4. **Analyzing:**
The financial statements need to be presented in a meaningful and usable way for the users whereby they can analyze and draw the relationship among the various items of the Financial Statements.

For Eg: All items relating to a particular type of Asset can be found in the Balance Sheet Asset side such as Fixed Asset, Current Asset, Investments, etc. This classification makes it easier for the users to analyze the information presented in the Financial Statements in a systematical manner and analyze various important ratios and other meaningful information as per their requirement.

5. **Interpreting:**
This step is stated as the Final Step of Accounting whereby the financial statements are interpreted in a manner that enables the end users of the Financial Statements to derive useful information about the company's Financial Condition and profitability of the Business.

It is important from the point of view of interpretation that the companies provide an in-depth explanation the conditions under which the important transactions have happened, the impact of its occurrence, what is the likelihood of its occurrence.

6. **Communicating:**
This step is not concerned with the generation of the Financial Statements, but it deals with communicating the Financial Statements prepared using the above steps.

The Financial Statements are communicated through the distribution of annual accounting reports, mandatory fillings with the various statutory authorities.

Using the Financial Information and Users of Financial Statements (Accounting Information):

With the advancement of the global trade and rising interest of various parties in an organizations business there has been an increase in the number of stakeholder's who are interested in the using the company's Financial Statements to fulfill their various interests.

Broadly speaking the users of financial statement can be classified into 2 categories:

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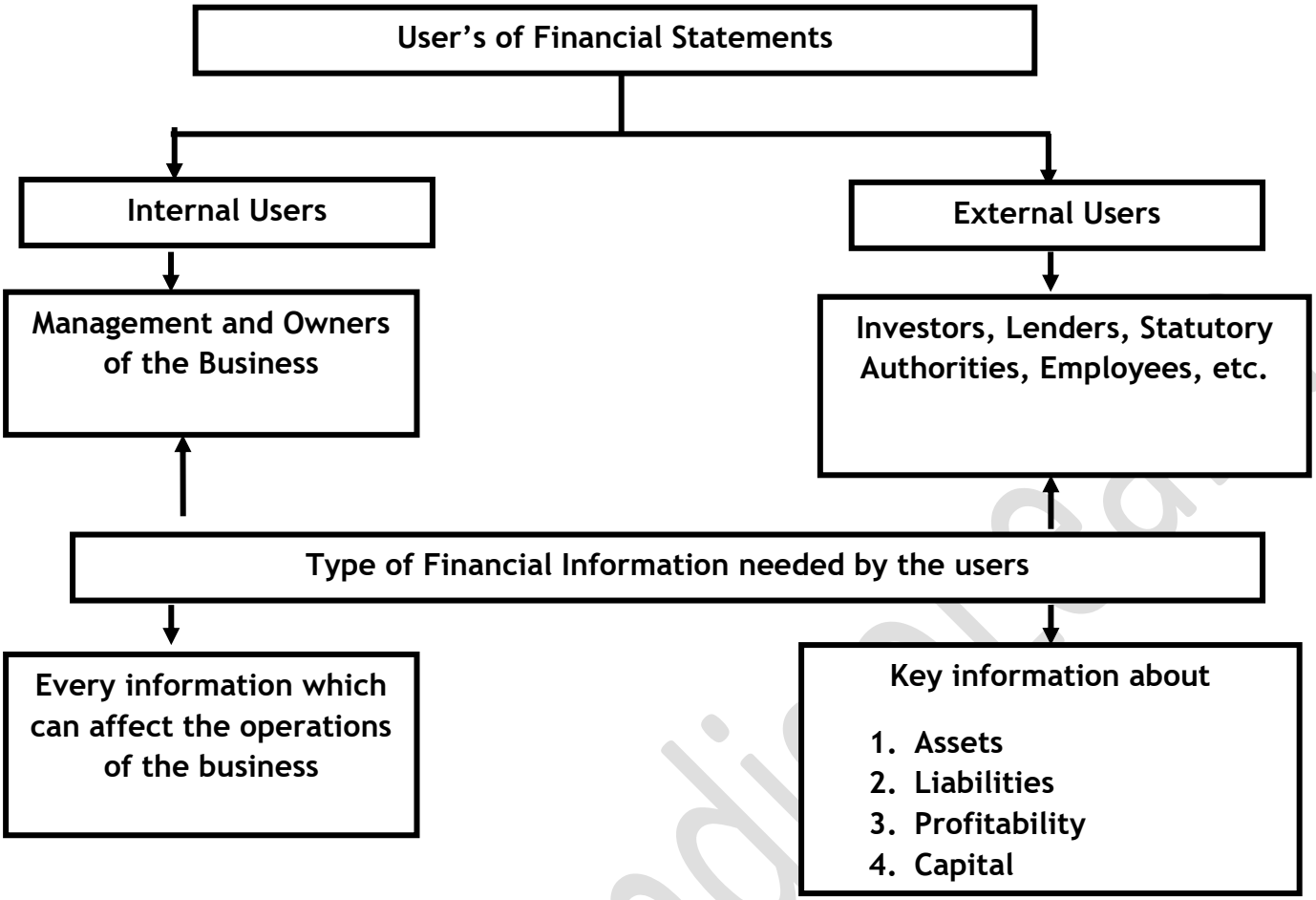

Users of Accounting Information/Financial Statements

As seen in the previous diagram the users of the Accounting Information are classified into 2 categories Internal Users and External Users.

Let us try to understand the usability of the Financial Statement to the various users:

Internal Users:

1. **Management:**
   The Management of the entity needs to take various decisions with respect to budgeting, forecasting based on the past trends and market analysis for the sake of which they need to evaluate their financial statements to get an understanding of their business has been performing and the details of their financial position which assist them in taking better decisions.

   Also, they need the various financial information to identify the shortcomings and weaknesses in their business so that they can design and act on corrective measures to improve the deficiencies.

External Users:

1. **Investors:**
   The investors of the company want to understand how the company has been performing and how is their investment growing.

   Based on that information they can take various investment related decisions such as whether to invest further or disinvest from their existing investment.

2. **Employees:**
   Employees of any company are interested in understanding how the growth of the company is?

   This is because their career growth depends on the growth of the organization at least till the time they are associated with the company.

3. **Lenders:**
   Lenders are interested in knowing how profitably the company is performing.

   This is to ensure that their loans and interest are safe with the company and will be repaid as per the contracts.

4. **Suppliers and Creditors:**
   Suppliers and Creditors are interested in using the financial information of the company with the same intention as the lenders.

   They are keen to know whether the credit balances owed to them by the company will be paid on timely basis.

   Also, they try to estimate that how long they can expect to be in business with the company in future.

5. **Customers:**
   Many of customers of any business are probably their repeat customers and if the business goes into trouble and cannot continue then it also causes hassle to the customer who needs to find a replacement of the product.

   This is especially true if the customer used the company's product as an input for its own business.

   For Eg: If ABC Company was a steel manufacturer and its customer Mr. D had a steel factory. Mr. D used to procure majority of his raw material from ABC Company.
   If for some reason ABC Company shuts down, then it would be a lot of hassle for Mr. D to find a new supplier for the same input especially if it was a customizable product.

6. **Statutory Authorities:**
   Statutory Authorities make sure that the business is operating within the laws and regulations and defined framework and for accomplishing this objective they need to rely on the Financial Statements submitted by the companies as per the rules and acts.

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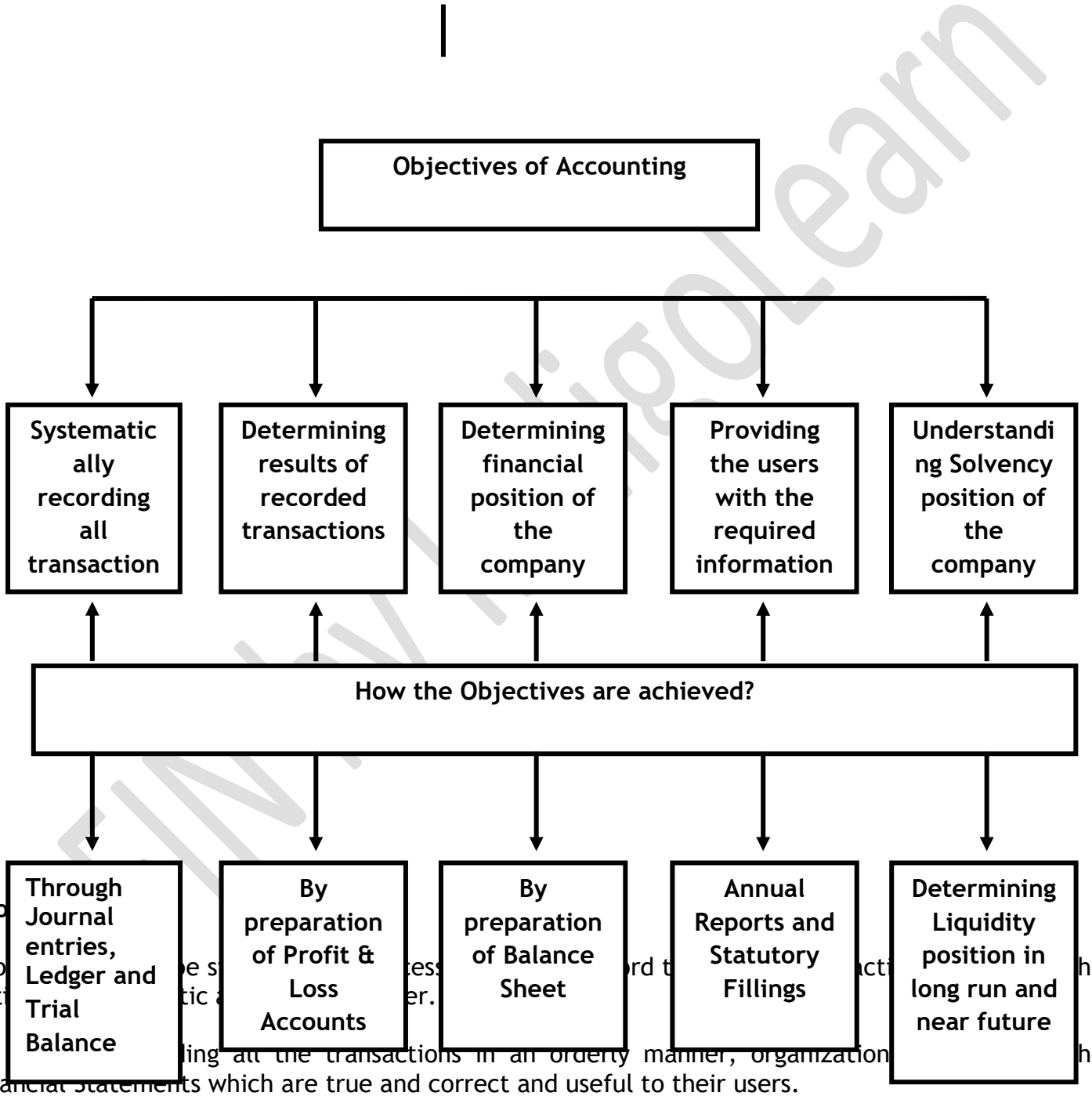
Objectives of Accounting

The objectives of Accounting and the method through which they are achieved can be understood with the help of the following diagram:



Boo

Boo e s tess ord t acti he ent tic a er.

By ling all the transactions in an orderly manner, organization he Financial Statements which are true and correct and useful to their users.

The main objective of Book-Keeping is to provide proper summary of all the financial and non-financial transactions entered by the company which would help the company in systematic preparation of the Financial Statements.

The main objective of Book-Keeping is to maintain a Complete Record of all the Transactions in a systematic manner which is useful in determining the Financial Results on the business.

Often, Book-Keeping is confused with Accounting. It is important to note that Book-Keeping is a part of Accounting. Accounting in itself is a big domain and not restricted to Book-Keeping.

The following table will enable you to understand the important points of Distinction between Book-Keeping and Accounting:

Point of Distinction	Book-Keeping	Accounting
Objective	Systematic Recording of Transactions	Summarizing of Recorded Transactions
Basis for	It is basis for preparation of Financial Statements	It is the basis for communicating the results of operations
Are Financial Statements parts of it?	Financial Statements do not form a part of Book-Keeping	Financial Statements are part of Accounting
Basis for Managerial Decisions	Managerial Decisions cannot be made on the basis of Book-Keeping	Managerial Decisions are made based on the statements prepared under Accounting
Sub-Fields	There is no Sub-Field of Book-Keeping	Accounting has various sub-fields such as Managerial Accounting, Financial Accounting, Cost Accounting, etc.

Sub-Fields of Accounting

Book-Keeping can be stated as the process/activity to record the various transactions entered

Accounting is not just restricted to the preparation and presentation of the Financial Statements to the users. It has various domains which are designed to serve the various purposes:

1. **Financial Accounting:**
   This field of Accounting deals in preparation and presentation of the financial statements to the users. The Financial Accounting main objective is determining profitability and financial position of the business at a particular point of time.

2. **Management Accounting:**
   This field of Accounting is specifically designed to provide customized and specialized information to the managers of the organization which would assist them in planning and taking appropriate steps in achieving the goals of the organization.

3. **Cost Accounting:**

This field of Accounting is specifically designed to determine the cost and its allocation which is crucial in determining profitability of the business.

4. **Social Responsibility Accounting:**
   With the increasing awareness about the social issues and involvement of the various business houses in view to work for profit and support a cause along with the advancement in the laws relating the CSR there has been a significant increase in the spending towards social causes.

   The companies who are spending towards CSR are highly interested in knowing whether the amount spent by them is able to fulfill the cause and generate the impact it had expected through the spending.

   The measurement of the social benefits created, and the lives impacted is the main objective of the Social Responsibility Accounting.

   For Eg: If Company ABC had spent Rs.1.00 Cr during F.Y.2017-2018 for promoting education among the low-income kids. It would like to know the number of kids who got enrolled in the schools via their programs for which they had spent amount of Rs.1.00 Cr.

5. **Human Resource Accounting:**
   Of all the expenditure incurred by the businesses they can be measured by using the standards, measurements and valuation principles provided by various laws, regulations and AS.

   Except for the Human Resource, which is the only expenditure incurred by the company to develop and maintain the human resource which will be able to provide the company benefits across the years. However, it is written off as expense in the year it is incurred.

   Human Resource Accounting attempts to identify measure and report the investment made in the Human Resource of the entity.

Limitations of Accounting

Accounting has some limitations which are important to be aware of. Since the Financial statements are the basis of communicating the performance and financial position it is important to be aware of the limitations in the presence of which the Financial Statements have been prepared:

The Limitations of Accounting are as follow:

1. **Non-Monetary items are not considered:**
   The most important factor to determine the worth of a business is their employee, their skill and dedication which are nowhere found on the Financial Statements.

2. **Balance Sheet is valid only for a particular point of time:**
   The Balance Sheet which reflects the financial position of the business is valid only for a particular point of time. A single additional transaction can alter the balance sheet drastically.

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However, to overcome this limitation the auditors disclose the events occurring after the balance sheet date.

3. **Time Value of Money:**
   The Monetary factors such as Inflation, Time value of Money, etc. are ignored in preparation of Accounting.

4. **Use of Estimates:**
   Some Accounting Estimates such as provision for doubtful debts, useful life of the Fixed Asset, etc. depends on the estimates and judgments made by the management and accounting personnel.

   Since human judgment is involved it can lead to error in estimation of the same which can have an impact on the Financial Statements.

Questions

1. Identify whether the following are transactions which would be recorded in the Financial Statement or not?

   i) Mr. A asked for Quotation of goods and received a quotation of Rs.5.00/- Lac from Mr. B. Will this be recorded as purchase in the Books of Mr. A?
   Will not be recorded

   ii) Mr. B received an order for Rs.10.00/- Lac and raised an invoice to Mr. C for the same. Will this be recorded as sales in the books of Mr. B?
   Will be recorded

2. Which of the following is not an internal user of the Company's Financial Statement?

   i) CEO of the company
   ii) Employees of the company – Not an internal user
   iii) CFO of the company
   iv) Directors of the company

3. Limitation of Accounting is that it:

   i) It does not use estimates.
   ii) It accounts only for Monetary Items – Is a Limitation
   iii) Accounts for time value of Money
   iv) Balance Sheet is valid throughout the year.

1.3 Accounting Concepts and Conventions

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Need for Accounting Concepts, Conventions and Principles

Accounting is stated as the Language through which the results of the operations of the company are communicated to the various stakeholders.

How would the Financial Statements of various companies look like when they are prepared by various accountants based on their understanding of the norms and notions of accounting due to absence of any standardized policy? It would literally cause chaos because the result of operations prepared by two different accountants for the same set data would be showing different results rendering it useless.

To avoid this issue and establish uniformity and comparability among the financial statements of various entities and across the period of time for same entity framework of GAAP "Generally Accepted Accounting Principles" have been established.

GAAP provides all the concepts, conventions and principles on the basis of which the Financial Statements of the entity needs to be prepared.

Accounting Concepts:

Accounting Concepts defines the assumptions which form the basis of preparation of Financial Statements.

Accounting Principles:

Accounting principles provide explanation of current practices and a guide for selection of practices where alternative treatments exist.

Accounting Principles need to satisfy the following conditions:

1. They should be based on real assumptions.
2. They must be simple, understandable and explanatory.
3. They must be followed consistently.
4. They should be able to reflect future predictions.
5. They should be informational for the users.

Accounting Conventions:

Accounting Conventions are the conventions which arise in the company Accounting Process due to the application of the principles and practices over a period of time.

Let us look at the Concepts, Conventions and Principles:

1. **Entity Concept:**
   Entity Concepts states that the business enterprise and the owner of the enterprise are two separate entities and have their own identities. The transactions occurring between the two should be clearly recorded as transaction between two different persons.

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For Eg: If an amount of Rs.10,000/- is withdrawn by Mr. A from his business, it should be treated as a Drawings from business and not as a Expense of the Business.

2. **Money Measurement Concept:**
   As per this Concept only those transactions which can be measured in Monetary Terms are to be recorded.

   Any transaction which cannot be measured in monetary terms should not be recorded even though it may be materially significant in value.

   For Eg: The Human Resource of any organization is its biggest strength, but it will not be recorded anywhere in the Financial Statement because it cannot be measured in Monetary Terms.

3. **Periodicity Concept:**
   As per this Concept companies need to prepare their accounts at a regular interval comprising of fixed period of time and not at the end of the life of the business.

   Using this concept only the Financial Statements of the company are prepared for every 12 months also known as "Financial Year".

   It can be stated that the periodicity concept helps in achieving the following objectives:
   - Comparing financial statements of different periods of time.
   - Uniform and consistent accounting treatment for ascertaining the profit/loss and assets/liabilities of the business.
   - Matching current period revenues with current period expenses for getting correct results of the business operations during a given period of time.

4. **Accrual Concept:**
   As per the Accrual Concept of Accounting all transactions and events of business are recognized o a Mercantile Basis.

   It means that all expenses and losses are recognized in the period during which they have occurred irrespective of the fact whether they have been paid or not and all income and gains are recognized in the period during which they have been earned irrespective of the fact whether they have been received or not.

5. **Matching Concept:**
   As per the Matching Concept all the expenses incurred should be matched to the corresponding revenue earned from those expenses. In Simple words it can be stated that for all the revenue recognized during a period the corresponding expenses should be recorded during that period.

   For Eg: ABC Company had purchased 1000 quantity of goods for reselling and had sold 600 of those in the current financial year.

   Then at the end of the Financial Year the Cost of Goods Sold will be booked only for 600 units and the balance 400 will be transferred to Ending Inventory which will be transferred to COGS when they are sold.

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6. **Going Concern Concept:**
   As per the Going Concern Concept it is assumed that the entity intends to continue its operations for the foreseeable future and has no intentions of drastically reducing its scale of operations.

   If it has any intention to scale down its operations materially or it is intending to close down its operation then it is liable to disclose the same to the users of the Financial Statements.

7. **Cost Concept:**
   As per the Cost Concept the assets are supposed to be measured at their historical cost i.e. their original cost of purchase.

   This concept is mainly applied to long term assets such as Fixed Assets. Because current assets are valued at cost or market value whichever is realizable.

   For Eg: If ABC company had acquired a Machinery worth Rs.10.00 Lacs 10 years back and had spend Rs.2.00 Lac towards its installation. Then the cost of the machine will be carried over across the years at Rs.12.00 Lac Less Accumulated Depreciation.

8. **Realization Concept:**
   As per the Realization Concept any change in the value of the assets is to be recognized only when the asset has been sold and the amount has been realized.

   This means that companies do not need to revalue their assets every year as per the realizable value. However, they need to adjust the cost of the asset when they are sold.

   For Eg: ABC Company had machinery with book value of Rs.5.00 Lac as on August 2018 whose market value was Rs.6.00 Lac which was sold for Rs.5.50 Lac. In Sep 2018.

   Here ABC Co. would not revalue the asset at Rs.6.00 Lac in August 2018 and then record the sale in Sep recognizing a loss of Rs.50 thousand.

   ABC Co. would be directly booking the asset value at Rs.5.00 Lac and a gain of Rs.50 thousand when asset is sold in September.

9. **Dual Aspect Concept:**
   This concept is the basis on which the Double Entry System of Book-Keeping is based on. As per this concept every transaction has 2 effects.

   This can be summarized in the following manner:

   Effect of Changes in Asset

   i) ↑ In one Asset, ↓ in other Asset.
   ii) ↑ In one Asset, ↑ in Liability.
   iii) ↓ In one Asset, ↑ in other Asset.
   iv) ↓ In one Asset, ↓ in Liability.

   Effect of Changes in Liability

   v) ↑ In one Liability, ↓ in other Liability.

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vi) ↑ In one Liability, ↑ in Asset.
vii) ↓ In one Liability, ↑ in other Liability.
viii) ↓ In one Liability, ↓ in Asset.

For Eg: When the business pays of dues to its creditors, it results in reduction of Asset (Cash & Bank) and reduction of liability (Creditors Balance).

10. Conservatism Concept:

This Concept states that accountants should not record anticipated income but they need to record the anticipated losses.

As the name itself suggest this concept is based on Conservatism principle which means that all the possible expenses and losses are reported which have not even occurred yet but the income and gains are reported only once they are realized. Resulting in preparation of most conservative Financial Statements.

11. Consistency Concept:

This Concept states that the enterprises should follow the accounting policies on a consistent basis from one period to another and should change their accounting policy only when the exceptional circumstances arise.

The intention of this concept is to ensure the comparability of financial statements across a period of time. Financial Statements can be compared across a period of time only when they are prepared using the same accounting policies and principles for the period being compared.

The exceptional circumstances under which the companies can change the accounting policies are as stated below:

i) To prepare the accounts in line with the newly issued Accounting Standards.
ii) To comply with the provisions of Law.
iii) If the circumstances have changed and it is felt that only by the adoption of the New Accounting Standards the company's financial results will be shown in a true and fair manner.

12. Materiality Concept:

This Concept allows the accountant to ignore all the other concepts of accounting which have been discussed till now under the condition that the result of ignoring all the other concepts will not make the financial statements materially misstated.

According to the Materiality concept all the items which have significant effect on the financial statements should be disclosed and all the items which are insignificant in value and will only increase the work of the accountant but are not relevant to the users should be ignored.

For Eg; When the business purchases some stationery items such as calculator which are going to be used for a more than a year, they are not classified as Fixed Asset and depreciated accordingly. They are expensed off as a Expense under Printing and Stationery for the year.

This is because the cost of calculator is no material enough to impact the decision of the users of the Financial Statement.

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Characteristics of Financial Statements

The 4 qualitative characteristics of Financial Statement that make them useful to their users are as follow:

1. Understandability:
The Financial Statements should be easily understandable by the users.

It is assumed that the users of these Financial Statements have a basic understanding of the Business and Accounting to study the information presented in them.

The Financial Statements contain information about complex matters that are to be supposed to be reported. However, they should not be omitted just because they are complex in nature to understand.

2. Relevance:
The information presented in the Financial Statement should be relevant to the users.

It means that the users should be able to use the information presented in making their economic decisions.

3. Reliable:
The information presented in the Financial Statements should be reliable.

Quality of reliability is established when the Financial Statements are free from material errors and bias and represents all the information in a faithful manner.

4. Comparable:
The information presented should be comparable. It should be comparable with the entities past performance as well as with the different entities across the same and other industries.

Comparability can be established when the financial statements are presented using the consistent principles and policies across the years.

The other characteristics which enhance the value of the Financial Statements are as follow:

5. Materiality:
The information is said to be material if its misstatement either by way of omission of wrong presentation can influence the economic decision of the user which is based on the financial statements.

Therefore, it is important the Financial Statements present all the material information.

6. Substance over Form:
The information presented should be indicating the true nature or intention of the transactions rather than focusing on the legality of the transaction.

For Eg: if the ABC Co. had purchased a asset of Rs.10.00 Lac by paying an advance amount of Rs.1.00 Lac. However, the official transfer is not made in the name of the ABC Co.

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In this situation ABC Co. will record the asset in its balance sheet and create a creditor for the balance amount. Even though the official transfer is not made by considering the substance over the form the asset is recorded in the books of ABC Co.

7. Neutrality:

If the financial statement are prepared and presented with a view to influence the decision of the user they are said to be biased and not neural.

A neutral financial statement is the one which presents the information as it is without any intention to influence the decision of the users.

8. Prudence:

Quality of Prudence states that the Financial Statements have been prepared using professional judgment needed in determining the estimates needed in the preparation of the financial statements.

However, by using prudence one should not resort to unethical practices such as creation of hidden reserves, overstatement or understatement of assets and liabilities, incomes and expenses, etc.

9. Faithful Representation:

Financial Statements should faithfully represent all the transactions and events related to the period for which the financial statements are being presented.

10. Full, Fair and Adequate Disclosure:

Full disclosure states that nothing should be omitted from the Financial Statements.

Fair disclose states that all the transactions should be accounted for in manner that presents the financial statement in a true and fair manner.

Adequate disclosure states that all the information which could influence the decision of the user should be presented in adequate detail.

11. Completeness:

To establish reliability it is important that the information presented is complete in all material aspects. Information can be false or misleading and thus irrelevant and reliable if it is not complete in all material aspects.

Questions:

1. Identify the effect on Asset and Liability of the following transactions.

   i) Mr. A paid outstanding creditors balance of Rs.10,000
   Asset decreases, Liability Decreases.

   ii) Mr. B sold goods worth Rs.10,000 for cash?
   Asset decreases (Inventory), Asset Increases (Cash/Bank).

2. Which of the following is not a qualitative characteristic of Financial Statement?

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i) Comparability
ii) Completeness – Not an qualitative characteristics
iii) Relevance
iv) Reliability

3. A company needs to apply same method of depreciation due to which accounting concept:

i) Consistency – For Consistency
ii) Money Measurement
iii) Periodicity
iv) Accrual

4. What are the situations under which company can change its Accounting Policy?

1.4 Capital and revenue expenditure and receipts

Capital Expenditure

Capital Expenditure is that expense whose benefits last for more than one accounting period.

For Eg: Purchase of Fixed Assets is a capital expenditure since its benefit is going to be lasting for more than 1 accounting period.

Revenue Expenditure

Revenue Expenditure is that expense whose benefit is going to expire within a single accounting period or is incurred in relation to the sales made during the accounting period.

For Eg: Cost of Goods Sold in relation to the sales made.

Factors determining whether expenditure is CAPITAL or REVENUE in nature:

1. **Nature of Business:**
   The Nature of business is an important factor in determining whether a expense is capital or revenue in nature.

   For Eg: For a company dealing in sale of computers, purchase of computer will be a part of revenue expenditure. However, for company dealing in groceries purchase of computer will be capital expenditure.

2. **Is the Expenditure Recurring or Not?**
   The expenditure which are recurring on a fixed basis and whose benefit is exhausted within a single accounting period is revenue expenditure. For eg: Salaries paid on monthly basis.

   The Expenses which are incurred once in a while such as purchase of Fixed Asset is a capital expenditure.

3. **Purpose of Expense:**

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If the expense helps in generating income over more than one accounting period it is a capital expenditure.

If the expense is useful in generating income in the current accounting period, then it is revenue expenditure.

4. **Materiality:**
   The most important factor is the materiality of the amount involved. If the amount of expenditure is not material enough to be classified as a capital expenditure it will be written off as a Revenue Expenditure in the current period itself.

Revenue Receipts:

Revenue Receipts are the receipts which are received in the normal course of the business operations. It is important to note that the revenue receipt is not equal to cash receipts.

Revenue receipts are credited to the profit & loss account.

For Eg: Collection from Debtors for the sales made.

Capital Receipts:

Capital Receipts are the receipts which are not revenue in nature. Capital receipts realized from sale of asset are first utilized to reduce the outstanding value of the asset in the company's balance sheet and any surplus or deficit is transferred to Profit & Loss Account.

For Eg: An asset whose value is Rs.1.00 Lac in the books of Accounts is sold for Rs1.10 Lac.
Here the Rs.1.00 lac out of the proceeds will be credited to the asset value to make it 0. And the balance Rs.10 thousand will be transferred to credit side of Profit & Loss Account.

Questions:

1. Identify which of the following is Capital/Revenue Expenditure or Capital/Revenue Receipt.

   i) Purchase of Computer worth Rs.1.00 lac by company dealing in computers for maintaining its accounts.
   Capital Expenditure (Even though it is dealing in computers it is purchased the computer for maintaining its accounts and not for sale).

   ii) Payment of Rent in advance for 2 years.
   Rent Expense for current year is revenue expense but the rent paid for the next year is capital expense.

   iii) Cash Sale of Rs.1.00 Lac
   Revenue Receipt

   iv) Sale of old Fixed Asset by the company at a loss of Rs. 50 thousand.
   Capital Receipt

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1.5 Accounting for Depreciation

What is Depreciation?

Concept of Depreciation

Fixed Assets includes Property, plant and equipment that are tangible and which are used in the production or supply of goods or services or for administrative purposes and are expected to be used during more than a period of one accounting year i.e. more than twelve months.

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

i. Wear and tear due to its use in business.
ii. Passage of time even when it is not being used.
iii. Obsolescence and outdating due to technological or other changes.
iv. Decrease in market value.
v. Depletion of the assets especially in case of mines and other natural reserves.

To arrive at the correct income for the current accounting period it is important to account for value of portion of property, plant and equipment utilized for generating revenue during that period. The portion of Property, Plant & Equipment allocated to an accounting year is called depreciation.

As per Schedule II under the Companies Act, 2013, Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value. The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

The 3 important factors affecting the amount of depreciation are:

i. Estimated useful life of the asset

ii. Cost of the asset

iii. Residual value of the asset at the end of the of its estimated useful life

Objectives of Providing Depreciation:

The basic objectives for providing depreciation are as follow:

i. Correct income measurement.

ii. To find True Asset value.

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iii. To Ensure Sufficient Funds are available for replacement.

iv. To determine the true cost of production.

Factors affecting Measurement of Depreciation

Following factors are taken into consideration while computing the depreciation.

i. Cost of the asset

ii. Estimated useful life of the asset.

iii. Estimated scrap value at the end of useful life of the asset.

Cost of the Fixed Asset (i.e. Property, Plant and Equipment) comprises of the following:

i. The purchase price including import duties and taxes and deducting the trade discounts and rebates.
ii. Any cost incurred to bring the asset to its present condition to put it to its intended usage
iii. The costs of preparing the site on which an asset is to be located.

Examples of costs directly attributable costs are:
i. Cost of labor for bringing the asset to its present condition.
ii. Cost to prepare the site.
iii. Delivery and Handling costs
iv. Installation costs
v. Cost of testing
vi. Professional fees e.g. engineers & technicians hired to install the equipment

Thus, all the expenses which are necessary for asset to bring it in condition and location of desired used will become part of cost of the asset.

Methods of Computing Depreciation

There are several methods of computing depreciation, in this chapter we are going to focus on 3 methods which are as follow:

i. Straight-Line Method
ii. Diminishing Balance Method
iii. Sum of Years of Digits Method
iv. Annuity Method
v. Sinking Fund Method

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vi. Machine Hour Method
vii. Units of Production Method
viii. Depletion Method

Straight-Line Method

This method is also known as Fixed Installment Method. According to this method, an equal amount of depreciation is written off every year so as to reduce the cost of the asset to nil or its salvage value at the end of its useful life.

The advantage of this method is that it is the easiest methods to apply and gives accurate results in case of leases and also in case of plant and machinery are assumed to have a constant usage across years.

The formula to compute the depreciation and the rate of depreciation under straight line method is as follow:

$$\text{Straight Line Depreciation} = \frac{\text{Cost of Asset} - \text{Salvage Value}}{\text{Useful Life of the Asset}}$$

$$\text{Straight Line Depreciation Rate} = \frac{\text{Straight Line Depreciation}}{\text{Cost of the Asset}} \times 100$$

Diminishing Balance Method

This method is also known as Reducing Balance Method. According to this method, a Fixed Percentage of depreciation is computed on the Asset Value every year so as to reduce the asset value to Nil or it's Salvage Value at the end of its useful life.

Under this method, the depreciation amount decreases from year to year due to which the earlier years suffer incur a higher depreciation expense as compared to the later years.

Under this method, the value of asset can never be completely extinguished, which happens in the earlier explained Straight Line Method. This method assumes that the cost of repairs will increase with the passage of time. Therefore, depreciation is higher in earlier years and lower in the later years when the cost of the asset is expected to be lower in the later years.

The formula to compute the depreciation under the diminishing balance method is as follow:

$$\text{Diminishing Balance Depreciation} = 1 - \sqrt[n]{\frac{\text{Residual Value}}{\text{Cost of Asset}} \times 100}$$

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Here, n = useful life of the asset

Accounting Entries under Straight Line and Diminishing Balance Method:

There are two approaches to account for depreciation. The entity can either opt to have a provision for depreciation account and credit the annual depreciation in that provision account, thereby the asset account remains at the same historical cost or else it can directly credit the depreciation amount to the asset account and reduce the asset balance on an annual basis.

Accounting Entries under the Provision Method:	
For Charging Depreciation	Depreciation Account Dr. To Provision for Depreciation Account
Transferring Depreciation to Profit & Loss Account	Profit & Loss Account Dr. To Depreciation Account
Accounting Entries under the Direct Method:	
For Charging Depreciation	Depreciation Account Dr. To Asset Account
Transferring Depreciation to Profit & Loss Account	Profit & Loss Account Dr. To Depreciation Account

Example:

ABC Co. acquired a equipment on 1st July, 2016 at a cost of Rs.9,00,000 and spent Rs.1,00,000 on its installation. The books are closed on 31st December every year.

Prepare the Machinery Account and Depreciation Account for 2016 & 2017 using:

i. Straight Line Method @ 10% Depreciation per annum
ii. Diminishing Balance Method @ 15% Depreciation per annum

i. Machinery and Depreciation Account under Straight Line Method:

Dr.	Machinery Account				Cr.
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2016			2016		
Jul-01	To Bank A/c	900,000	Dec-31	By Depreciation A/C	50,000
	To Bank A/c (Installation)	100,000		10% on 10,00,000 for 6 months	
			Dec-31	By Balance c/d	950,000
	TOTAL	**1,000,000**		**TOTAL**	**1,000,000**
2017			2017		
Jan-01	To Balance b/d	950,000	Dec-31	By Depreciation A/C	100,000
				10% on 10,00,000 for 12 months	
			Dec-31	By Balance c/d	850,000
	TOTAL	**950,000**		**TOTAL**	**950,000**

Dr.	Depreciation Account				Cr.
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2016			2016		
Dec-31	To Machinery A/c	50,000	Dec-31	By Profit & Loss A/C	50,000
	TOTAL	**50,000**		**TOTAL**	**50,000**
2017			2017		
Dec-31	To Machinery A/c	100,000	Dec-31	By Profit & Loss A/C	100,000
	TOTAL	**100,000**		**TOTAL**	**100,000**

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i. Machinery and Depreciation Account under Diminishing Balance Method:

Dr.	Machinery Account				Cr.
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2016			2016		
Jul-01	To Bank A/c	900,000	Dec-31	By Depreciation A/C	75,000
	To Bank A/c (Installation)	100,000		15% on 10,00,000 for 6 months	
			Dec-31	By Balance c/d	925,000
	TOTAL	**1,000,000**		**TOTAL**	**1,000,000**
2017			2017		
Jan-01	To Balance b/d	925,000	Dec-31	By Depreciation A/C	142,500
				15% on 9,50,000 for 12 months	
			Dec-31	By Balance c/d	782,500
	TOTAL	**925,000**		**TOTAL**	**925,000**

Dr.	Depreciation Account				Cr.
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2016			2016		
Dec-31	To Machinery A/c	75,000	Dec-31	By Profit & Loss A/C	75,000
	TOTAL	**75,000**		**TOTAL**	**75,000**
2017			2017		
Dec-31	To Machinery A/c	142,500	Dec-31	By Profit & Loss A/C	142,500
	TOTAL	**142,500**		**TOTAL**	**142,500**

Sum of Years Digit Method:

This method is also known as Reducing Balance Method. According to this method, the depreciation formula is derived based on the number of years of the asset.The formula to compute the depreciation under the sum of year's method is as follow:

$$\frac{\text{The number of years of remaining life of the asset}}{\text{Total of all digits of the life of the asset}}$$

Example:

ABC Co. acquired a equipment on 1st January, 2010 at a cost of Rs.20,00,000 which had a life of 10 years and scrap value of Rs2,40,000/- . The books are closed on 31st December every year.

Prepare the Machinery Account and Depreciation Account for 2015 using Sum of Digits method of depreciation:

Dr.	Machinery Account				Cr.
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2015			2016		
Jan-01	To Balance b/d	720,000	Dec-31	By Depreciation A/C	160,000
	(As per the working note)				
			Dec-31	By Balance c/d	560,000
	TOTAL	**720,000**		**TOTAL**	**720,000**
2016					
Jan-01	To Balance b/d	560,000			

Working Notes for the above computation:

1. Computation of Depreciation for 2010-2014:

$$\frac{(10+9+8+7+6)}{10(10+1)/2} \times (2000000-240000) = 40/55 \times 1760000 = 1280000$$

2. Computation of WDV as on 1-1-2015:

   2000000 – 1280000 = Rs.720000/-

3. Depreciation for 2015:

   (2000000 – 240000) X 5/55 = Rs160000/-

4. Annuity Method:

Under this method of depreciation, the interest which is lost on capital invested on the asset and is written off. It is based on the assumption that the amount invested in acquiring the asset, if would have been invested elsewhere, would have earned

interest which must be recorded as part of the cost of asset.

This method is suitable for writing off the amounts paid for long leases which involve a considerable capital outlay. It is not practicable to adopt this method for writing off depreciation of plant and machinery on account of frequent changes in the value of such assets which would necessitate the recalculation of the amount of depreciation to be written off annually.

The relevant Journal Entries involved in this method are as follow:

Accounting Entries under the Annuity Method:	
For charging interest on asset account	Asset Account Dr. To Interest Account
For charging depreciation on asset	Depreciation Account Dr. To Depreciation\Provision for depreciation Account
For transferring depreciation to Profit and Loss Account	Profit & Loss Account Dr. To Depreciation Account
For transferring interest to Profit and Loss Account	Interest Account Dr. To Profit & Loss Account

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Example:

ABC Co. acquired a lease is purchased on 1st April, 2013 for 4 years at a cost of Rs. 4,00,000. It is proposed to depreciate the lease by the annuity method charging 5 percent interest. A reference to the annuity table shows that to depreciate Rs.1 by annuity method over 4 years charging 5% interest, one must write off a sum of Rs.0.282012 [To write off Rs.2,00,000 one has to write off every year Rs. 112,804.80 i.e. 0.282012 × 4,00,000].

Prepare the Lease Account for four years and also the relevant entries in the profit and loss account.

Dr.	Lease Account				Cr.
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2013-2014					
Apr-01	To Bank A/c	400,000	Mar-31	By Depreciation A/C	112,804
Mar-31	To Interest A/c	20,000	Mar-31	By Balance b/d	307,196
	(5% on Rs.400000)				
	TOTAL	**420,000**		**TOTAL**	**420,000**
2014-2015					
Apr-01	To Balance b/d	307,196	Mar-31	By Depreciation A/C	112,804
Mar-31	To Interest A/c	15,360	Mar-31	By Balance b/d	209,752
	(5% on Rs.307196)				
	TOTAL	**322,556**		**TOTAL**	**322,556**
2015-2016					
Apr-01	To Balance b/d	209,752	Mar-31	By Depreciation A/C	112,804
Mar-31	To Interest A/c	10,488	Mar-31	By Balance b/d	107,435
	(5% on Rs.209752)				
	TOTAL	**220,239**		**TOTAL**	**220,239**
2016-2017					
Apr-01	To Balance b/d	107,435	Mar-31	By Depreciation A/C	112,804
Mar-31	To Interest A/c	5,369			
	TOTAL	**112,804**		**TOTAL**	**112,804**

Dr.	Profit & Loss Account				Cr.
Date	Particulars	Amount	Date	Particulars	Amount
2013-2014			2013-2014		
Mar-31	To Depreciation A/c	112,804	Mar-31	By Interest A/C	20,000
2014-2015			2014-2015		
Mar-31	To Depreciation A/c	112,804	Mar-31	By Interest A/C	15,360
2015-2016					
Mar-31	To Depreciation A/c	112,804	Mar-31	By Interest A/C	10,488
2016-2017					
Mar-31	To Depreciation A/c	112,804	Mar-31	By Interest A/C	5,369

Sinking Fund Method:

When a large sum of money is required for replacement of the fixed asset at the end of its effective life, organizations invest the amount equal to depreciation and the amount earned on that investment is re-invested. The account in which the amount is kept aside is referred to as Sinking Fund Account.

When the asset is due for replacement, the securities are sold and the new asset is purchased with the proceeds of their sale. The book value of the old asset, at the time, is transferred to the Sinking Fund Account. Any amount realized on sale of the old asset, as well as the profit or loss on sale of securities is transferred to the Sinking Fund Account and it is closed off by transfer of the balance of the Profit and Loss Account or General Reserve.

Accounting Entries under the Sinking Fund Method in First Year	
For transfer of depreciation to Sinking Fund	Depreciation Account Dr. To Sinking Fund Account
For charging depreciation to profit and loss account	Profit & Loss Account Dr. To Depreciation Account
For investment of amount of depreciation	Sinking Fund Investment Account Dr. To Bank Account
For interest earned on sinking fund investment	Bank Account Dr. To Interest on Sinking Fund Investment Account Interest on Sinking Fund Investment Account Dr. To Sinking Fund Account
Accounting Entries under the Sinking Fund Method in Subsequent Year	

For transfer of depreciation to Sinking Fund	Depreciation Account Dr. To Sinking Fund Account
For charging depreciation to profit and loss account	Profit & Loss Account Dr. To Depreciation Account
For investment of amount of depreciation	Sinking Fund Investment Account Dr. To Bank Account

investment at the end of useful life of the asset	Bank Account Dr. To Sinking Fund Investment Account
If Sale is Profit	Sinking Fund Investment Account Dr. To sinking Fund Account
If Sale is Loss	Sinking Fund Account Dr. To Sinking Fund Investment Account
For transfer of the amount to the extent of book value of the asset from asset account to Sinking Fund	Sinking Fund Account Dr. To Asset Account
Any surplus in Sinking fund account to be transferred to General Reserve Account	Sinking Fund Account Dr. To General Reserve Account
Any deficit, may be transferred to Profit and Loss Account	Profit & Loss Account Dr. To Sinking Fund Account

Example:

On 1st April, 2013, ABC & Co. purchased the Equipment for Rs.20,00,000. The life of the asset was only 3 years and would expire on 31st March, 2016.
ABC & Co. decided to set up a sinking fund.

During the three years following transactions took place:

2014 31st March: A contribution from profits of Rs. 6,40,000 was made and this sum was invested.

2014 5th Oct.: Investments which originally costed Rs. 2,20,000 were sold for Rs. 2,40,000 and the proceeds of sale were re-invested.

2015 31st March: A contribution from profits of Rs. 6,40,000 was made; interest on investments of Rs. 32,000 was received and these amountswere reinvested.

2015 15th September: Investments which originally costed Rs. 4,20,000 were sold at a profit of Rs. 40,000 and proceeds of sale were re-invested.

2016 31st March: Interest on investments Rs. 96,000 was received which was not invested. All existing investments were sold for Rs. 13,20,000. A contribution from profit of an amount required to make up the sinking fund to Rs. 20,00,000 was made and this amount was not invested.

Prepare Sinking Fund and Sinking Fund Investment Account for the years 2013-14, 2014-15, 2015-16.

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Dr.	Sinking Fund Account				Cr.
Date	Particulars	Amount	Date	Particulars	Amount
2014			2014		
Mar-31	To Balance c/d	640,000	Mar-31	By Depreciation A/c	640,000
	TOTAL	**640,000**		**TOTAL**	**640,000**
2015			2015		
Mar-31	To Balance c/d	1,332,000	Apr-01	By Balance b/d	640,000
			Oct-05	By Sinking Fund Investment A/c	20,000
			Mar-31	By Interest on Sinking Fund InvestmentA/c	32,000
			Mar-31	By Depreciation A/c	640,000
	TOTAL	**1,332,000**		**TOTAL**	**1,332,000**
2016			2016		
Mar-31	To Sinking Fund Investment A/c	52,000	Apr-01	By Balance b/d	1,332,000
Mar-31	To Asset A/c	2,000,000	Sep-15	By Sinking Fund Investment A/c	40,000
			Mar-31	By Interest on Sinking Fund InvestmentA/c	96,000
			Mar-31	By Depreciation A/c	584,000
				(Balancing Figure)	
	TOTAL	**2,052,000**		**TOTAL**	**2,052,000**

Dr.	Sinking Fund Investment Account				Cr.
Date	Particulars	Amount	Date	Particulars	Amount
2014			2014		
Mar-31	To Bank A/c	640,000	Mar-31	By Balance c/d	640,000
	TOTAL	**640,000**		**TOTAL**	**640,000**
2015			2015		
Apr-01	To Balance c/d	640,000	Oct-05	By Bank A/c (Sales)	240,000
Oct-05	To Sinking Fund A/c (Profit on Sale)	20,000	Mar-31	By Balance c/d	1,332,000
Oct-05	To Bank A/c (Investment of Sales Proceeds)	240,000			
2016					
Mar-31	To Bank A/c (Investment of Depreciation amount and interest)	672,000			
	TOTAL	**1,572,000**		**TOTAL**	**1,572,000**
2016			2016		
Apr-01	To Balance b/d	1,332,000	Sep-15	By Bank A/c	460,000
Sep-15	To Sinking Fund A/c (Profit on Sale)	40,000	Mar-31	By Bank A/c	1,320,000
Sep-15	To Bank A/c (Investment of Sales Proceeds)	460,000	Mar-31	By Sinking Fund A/c (Loss on Sale)	52,000
	TOTAL	**1,832,000**		**TOTAL**	**1,832,000**

1. Machine Hours Method:

Under this method, Depreciation is calculated on the basis of hours that the concerned machine worked. The machine hour rate of the depreciation is calculated after estimating the total number of hours that machine would work during its whole life.

Example:

A machine was purchased for Rs. 20,00,000 having an estimated total working of 30,000 hours. The scrap value is expected to be Rs. 4,00,000 and anticipated machine hours usage is as follows :

Year

1 – 2 3,000 hours per year
3 – 5 4,000 hours per year
6 – 7 6,000 hours per year

Compute the Annual Depreciation under Machine Hour Rate Method.

Statement showing the Annual Depreciation under Machine Hours Method

Year	Annual Depreciation
1-2	3000/30000 X (2000000-400000) = Rs.160000/- Per Year
3-5	4000/30000 X (2000000-400000) = Rs.213333/- Per Year
6-7	6000/30000 X (2000000-400000) = Rs.320000/- Per Year

2. **Production of Units Method:**

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

Depreciation for the period = Depreciable Amount X $\frac{\text{Production during the period}}{\text{Estimated total production}}$ The

method is applicable to machines producing product of uniform specifications.

Example:

A machine is purchased for Rs. 10,00,000. Its estimated useful life is 8 years. The machine is expected to produce 10 lakh units during its life time. Expected distribution pattern of production is as follows:

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Yearly Production

1-3 100,000 units per year
4-6 150,000 units per year
7-8 125,000 units per year

Required

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

Statement showing the Annual Depreciation under Yearly Production Method

Year	Annual Depreciation
1-2	100000/1000000 X 1000000 = Rs.100000/- Per Year
3-5	150000/1000000 X 1000000 = Rs.150000/- Per Year
6-7	125000/1000000 X 1000000 = Rs.125000/- Per Year

3. Depletion Method:

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

Example:

ABC & Co. took a quarry on 1-1-2015 for Rs. 1,00,00,000. As per technical estimate the total quantity of mineral deposit is 5,000 tonnes. Depreciation was charged on the basis of depletion method.

Extraction pattern is as follows:

Year Quantity of Mineral extracted

2015 1,000 tonnes
2016 2,000 tonnes
2017 2,000 tonnes

Statement showing the Annual Depreciation under Depletion Method

Year	Annual

	Depreciation
2015	1000/5000 X 10000000 = Rs.2000000/-
2016	2000/5000 X 10000000 = Rs.4000000/-
2017	2000/5000 X 10000000 = Rs.4000000/-

Profit or Loss on the sale or disposal of Property, Plant & Equipment:

Whenever any depreciable asset is sold during the year, depreciation is charged on it for the period it has been used in the sale year. The written down value after charging such depreciation is used for calculating the profit or loss on the sale of that asset. The resulting profit or loss on sale of the asset is ultimately transferred to profit and loss account.
Example:

The book value of the asset as on 1st April, 2017 is Rs.25,00,000. Depreciation is charged on the asset @20%. On 1st October 2017, the asset is sold for Rs.10,00,000. In such a situation, profit or loss on the sale will be calculated as follows:

Particulars	Amount
Book Value as on 1st April 2017	2500000
Less: Depreciation for 6 months @ 15% (1st April to 1st October)	187500
Written Down Value as on 1st October 2017	2312500
Less: Sales Proceeds as on 1st October 2017	1000000
Loss on Sale of the Asset	**1312500**

Change in the Method of Depreciation:

If there has been a significant change in the expected consumption pattern of the asset the method should be changed to reflect the changed pattern.

Whenever any change in depreciation method is made. Such change in method is treated as change in accounting estimate as per Accounting Standards whose effect needs to be quantified and disclosed. A change in an accounting estimate may affect the current period or both the current period and future periods.

Example:

Cost of Machine: Rs.20,00,000
Residual Value: NIL
Useful life: 10 years.

The company charges depreciation on straight line method for the first four years and thereafter decides to adopt written down value method by charging depreciation @

15%. (Calculated based on useful life).

Compute the depreciation for the 5th year. Depreciation already charged for the first 4 years as per straight line method is Rs. 8,00,000. Therefore, WDV for 5th year is Rs. 3,00,000 Therefore in the profit and loss account of the 5th year, the depreciation of Rs. 3,00,000 (25% of Rs. 12,00,000) should be debited.

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Revision of the Estimated Useful Life of Property, Plant & Equipment:

The residual value and the useful life of an asset needs to be reviewed every financial year-end and, if the company expects a change in an estimated useful life of the asset in accordance with Accounting Standards then the unamortized depreciable amount needs to be charged over the remaining estimated useful life of the asset.

Example:

A Machine costing Rs. 10,00,000 is depreciated on straight line basis, assuming 10 years working life and Nil residual value, for five years. The estimate of remaining useful life after fifth year was re-evaluated for 8 years only.

Calculate depreciation for the sixth year.

Particulars	Amount
Depreciation per year = Rs. 10,00,000 / 10	Rs.1000000/-
Depreciation on SLM charged for five years = Rs. 100,000 x 5 years = Rs.500000	Rs.500000/-
Book value of the asset at the end of fifth year = Rs. 10,00,000 – Rs. 5,00,000	Rs.500000/-
Remaining useful life as per previous estimate	5 Years
Remaining useful life as per revised estimate	3 Years
Depreciation from the sixth year onwards = Rs.5,00,000 / 3	Rs.166667/-

Re-Evaluation of the Fixed Asset:

As a Result of Re-evaluation of the fixed asset there can either be an increase in the value of the Fixed Asset or a Decrease in the Fixed Asset.

If there is an increase in the fixed asset, in case revaluation is done first time then the increase is credited directly to revaluation surplus. In case of Subsequent Reevaluation, it is recognized in the Statement of Profit and loss to the extent it was initially reduced and it also decreases the asset previously recognized in the Statement of profit and loss.

If there is an increase in the fixed asset, Charged to the Statement of profit and loss and if the subsequent revaluation decreases the asset value when it was increases during the previous revaluation then the Decrease should be debited directly to owners' interests under the heading of Revaluation surplus to the extent of any credit balance existing in the Revaluation surplus in respect of that asset.

Example:

A machine of cost Rs.15,00,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. At the end of fourth year, the machine was revalued upwards by Rs. 200,000 the remaining useful life was reassessed at 8 years.

Particulars	Amount
Depreciation per year for the 3 years = Rs. 15,00,000 / 10 X 3	Rs.450000/-
Rs. Rs. 4,50,000	Rs.1050000/-
Rs. Rs. 200,000	Rs.1250000/-
Remaining useful life as per previous estimate	6 Years
Remaining useful life as per revised estimate	8 Years
Depreciation from the fifth year onwards = Rs.12,50,000 / 8	Rs.156250/-

Provision for Repairs and Renewals:

Expenditure incurred for repairs, renewals and maintenance on Fixed Assets varies over the life of the asset. Therefore, to equalize the charge of repairs and renewals, sometimes a Provision for Repairs and Renewals Account is opened.

Total of such expenses that may be incurred over the working life is estimated beforehand and the Average amount of the expenditure is debited to Profit and Loss Account and credited to Provision for Repairs and Renewals Account irrespective of actual expenses incurred.

Annually the Provision for Repairs and Renewals Account is debited and Repairs Account is credited for actual expenses incurred. The balance in provision for Repairs and Renewals Account is carried forward and in the end or on sale of the asset, the account is closed by transfer to the Asset Account for any balance left.

Example:

The following particulars are available with regard to company's Fixed Assets:

Balance in Prov. for Repairs and Renewals Account as on 31.3.2015 Rs. 10,00,000

Actual repairs charged/incurred during the year ended
31.3.2016 Rs. 5,00,000
31.3.2017 Rs. 3,00,000

The company makes an annual provision of Rs.2,00,000 on repairs and renewals.

Prepare the Provision for Repairs and Renewals Account for the years 2015-2016 and

2016-2017.

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Dr.	Provision for Repairs and Renewals Account				Cr.
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
31.03.2016	To Repairs A/c	500,000	01.04.2015	By Balance b/d	1,000,000
31.03.2016	By Balance c/d/	700,000	31.03.2016	By Profit & Loss A/c	200,000
	TOTAL	**1,200,000**		**TOTAL**	**1,200,000**
31.03.2017	To Repairs A/c	300,000	01.04.2016	By Balance b/d	700,000
31.03.2017	By Balance c/d/	600,000	31.03.2017	By Profit & Loss A/c	200,000
	TOTAL	**900,000**		**TOTAL**	**900,000**
			01.04.2017	By Balance b/d	600,000

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Questions

Question 1:

ABC Co. acquired a equipment on 1st July, 2016 at a cost of Rs.20,00,000 and spent Rs.5,00,000 on its installation. The books are closed on 31st December every year.

Prepare the Machinery Account and Depreciation Account for 2016 & 2017 using:

ii. Straight Line Method @ 20% Depreciation per annum

iii. Diminishing Balance Method @ 25% Depreciation per annum

Question 2:

On 1st April, 2013, ABC & Co. purchased the Equipment for Rs.10,00,000. The life of the asset was only 3 years and would expire on 31st March, 2016.
ABC & Co. decided to set up a sinking fund.

During the three years following transactions took place:

2014 31st March: A contribution from profits of Rs. 5,00,000 was made and this sum was invested.

2014 5th Oct.: Investments which originally costed Rs. 1,00,000 were sold for Rs. 1,50,000 and the proceeds of sale were re-invested.

2015 31st March: A contribution from profits of Rs. 7,00,000 was made; interest on investments of Rs. 50,000 was received and these amountswere reinvested.

2015 15th September: Investments which originally costed Rs. 6,00,000 were sold at a profit of Rs. 50,000 and proceeds of sale were re-invested.

2016 31st March: Interest on investments Rs. 100,000 was received which was not invested. All existing investments were sold for Rs. 15,40,000. A contribution from profit of an amount required to make up the sinking fund to Rs. 25,00,000 was made and this amount was not invested.

Prepare Sinking Fund and Sinking Fund Investment Account for the years 2013-14, 2014-15, 2015-16.

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Illustrations

Question: 1
Jain Bros. acquired a machine on 1st July,2015 at a cost of Rs. 14,00,000 and spent Rs. 1,00,000 on its installation. The firm writes off depreciation at 10% p.a. of the original cost every year. The books are closed on 31st December every year
Show the Machinery Account and Depreciation Account for the year 2015 and 2016.

Question: 2
Jain Bros. acquired a machine on 1st July,2015 at a cost of Rs. 14,00,000 and spent Rs. 1,00,000 on its installation. The firm writes off depreciation at 10% p.a. every year. The books are closed on 31st December every year.
Show the Machinery Account on diminishing balance method for the year 2015 and 2016.

Question: 3
M/s Akash purchased a machine for Rs. 10,00,000. Estimated useful life and scrap value were 10 years and Rs. 1,20,000 respectively. The machine was put to use on 1.1.2010.
Show Machinery Account and Depreciation Account in their books for 2015 by using sum of years digits method.

Question: 4
A machine was purchased for Rs. 30,00,000 having an estimated total working of 24,000 hours. The scrap value is expected to be Rs. 2,00,000 and anticipated pattern of distribution of effective hours is as follows

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

Determine Annual Depreciation under Machine Hour Rate Method.

Question:5
A machine is purchased for Rs. 20,00,000. Its estimated useful life is 10 years with a residual value of Rs. 2,00,000.
The machine is expected to produce 1.5 lakh units during its lifetime. Expected distribution pattern of production is as follows:

Year	Units of Production per year
1 – 3	20,000 units
4 – 7	15,000 units
8 – 10	10,000 units

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

Question: 6
M/s Surya took lease of a quarry on 1-1-2013 for Rs. 1,00,00,000. As per technical estimate the total quantity of mineral deposit is 2,00,000 tonnes
Depreciation was charged on the basis of depletion method. Extraction pattern is given in the following table:

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Year	Quantity of Mineral extracted (in Tonnes)
2013	2,000
2014	10,000
2015	15,000

Show the Quarry Lease Account and Depreciation Account for each year from 2013 to 2015.

Question: 7

A firm purchased on 1st January,2015 certain machinery for Rs. 5,82,000 and spent Rs. 18,000 on its erection. On July 1,2015 another machinery for Rs. 2,00,000 was acquired. On 1st July,2016 the machinery purchased on 1st January,2015 having become obsolete was auctioned for Rs. 3,86,000 and on the same date fresh machinery was purchased at a cost of Rs. 4,00,000. Depreciation was provided for annually on 31st December at the rate of 10 per cent p.a. on written down value

Prepare Machinery Account.

Question: 8

M/s Anshul commenced business on 1st January 2011, when they purchased plant and equipment for Rs. 7,00,000. They adopted a policy of charging depreciation at 15% per annum on diminishing balance basis and over the years, their purchases of plant have been:

Date	Amount (Rs.)
01-01-2012	1,50,000
01-01-2015	2,00,000

On 1-1-2015 it was decided to change the method and rate of depreciation to straight line basis. On this date remaining useful life was assessed as 6 years for all the assets purchased before 1.1.2015 and 10 years for the asset purchased on 1.1.2015 with no scrap value.

Calculate the difference in depreciation to be adjusted in the Plant and Equipment Account for the year ending 31st December,2015.

Question: 9

A Machine costing Rs. 6,00,000 is depreciated on straight line basis, assuming 10 years working life and Nil residual value, for three years. The estimate of remaining useful life after third year was reassessed at 5 years.

Calculate depreciation for the fourth year

Question: 10

The following particulars are available from the books of a public company having a large fleet of vehicles:

Particulars	Amount (Rs.)
Balance in Provision for Repairs and Renewals Account as on 31.03.2016	11,50,000
Actual repairs charged/incurred during the year ended	

31.03.2016	7,50,000
31.03.2017	3,20,000

The company makes an annual provision of Rs. 4,00,000 on repairs and renewals.
Draw up the Provision for Repairs and Renewals Account for the years 2015-2016 and 2016-2017.

Question: 11
On 1st April,2013, Z Limited purchased the lease of property for Rs. 10,00,000. The lease would expire on 31st March,2016. Z Ltd. decided to set up a sinking fund. The Sinking Fund was to be credited (or debited) with an annual contribution from profit, the interest on the investments and any profits (or losses) made on the realisation of the sinking fund investments. The sinking fund was to be represented by specific investment, and any sums made available to the sinking fund were to be immediately invested, except at the termination of the fund.
During the three years following transactions took place:

- 31st March,2014 A contribution from profits of Rs. 3,20,000 was made and this sum was invested
- 13th Oct,2014 Investments which originally costed Rs. 1,10,000 were sold for Rs. 1,20,000 and the proceeds of sale were re-invested
- 31st March,2015 A contribution from profits of Rs. 3,20,000 was made; interest on investments of Rs. 16,000 was received and these amounts were reinvested
- 9th August,2015 Investments which originally costed Rs. 2,10,000 were sold at a profit of Rs. 20,000 and proceeds of sale were re-invested
- 31st March,2016 Interest on investments Rs. 48,000 was received which was not invested
- All existing investments were sold for Rs. 6,60,000
- A contribution from profit of an amount required to make up the sinking fund to Rs. 10,00,000 was made and this amount was not invested

Prepare Sinking Fund and Sinking Fund Investment Account for the years 2013-14, 2014-15, 2015-16.

Question: 12
On 1st April,2013, Z Limited purchased the lease of property for Rs. 10,00,000. The lease would expire on 31st March,2016. Z Ltd. decided to set up a sinking fund. The Sinking Fund was to be credited (or debited) with an annual contribution from profit, the interest on the investments and any profits (or losses) made on the realisation of the sinking fund investments. The sinking fund was to be represented by specific investment, and any sums made available to the sinking fund were to be immediately invested, except at the termination of the fund.
During the three years following transactions took place:

- 31st March,2014 A contribution from profits of Rs. 3,20,000 was made and this sum was invested

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- 13th Oct,2014 Investments which originally costed Rs. 1,10,000 were sold for Rs. 1,20,000 and the proceeds of sale were re-invested
- 31st March,2015 A contribution from profits of Rs. 3,20,000 was made; interest on investments of Rs. 16,000 was received and these amounts were reinvested
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- 31st March,2016 Interest on investments Rs. 48,000 was received which was not invested. All existing investments were sold for Rs. 6,60,000
- A contribution from profit of an amount required to make up the sinking fund to Rs. 10,00,000 was made and this amount was not invested

Prepare Lease A/c and Depreciation A/c for the years 2013-2014, 2014-2015, 2015-2016.

1.6 Rectification of Errors

What are ERRORS?

Since Accounting involves a huge amount of recurring and record-keeping task it is highly possible that sometimes unintentional omission or commission of amounts and accounts may happen during the preparation of the accounts while recording them. This is known as ERROR in ACCOUNTING.

It is also possible that there may be due to mathematical mistake due to which the trial balance may not agree.

Whatever kind of error has occurred it is important to rectify the error that have occurred and been detected so that the Financial Statements show a True and Fair view of the various transactions and events.

How the errors can occur?

1. **Wrong Entry of amounts in the books of accounts.**
   For Eg: Sales of Rs. 15650/- recorded as sales of Rs.15065/-

2. **Wrong posting of the Subsidiary Books.**
   For Eg: As per the Purchase Books the total purchases for the month of August 18 was of Rs. 19250/- recorded as purchases of Rs.19520/- while posting it in the Ledger.

3. **Posting the entries in the wrong account:**
   For Eg: Purchases from Mr. A are posted as purchases from Mr.B

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STAGES OF ERRORS:

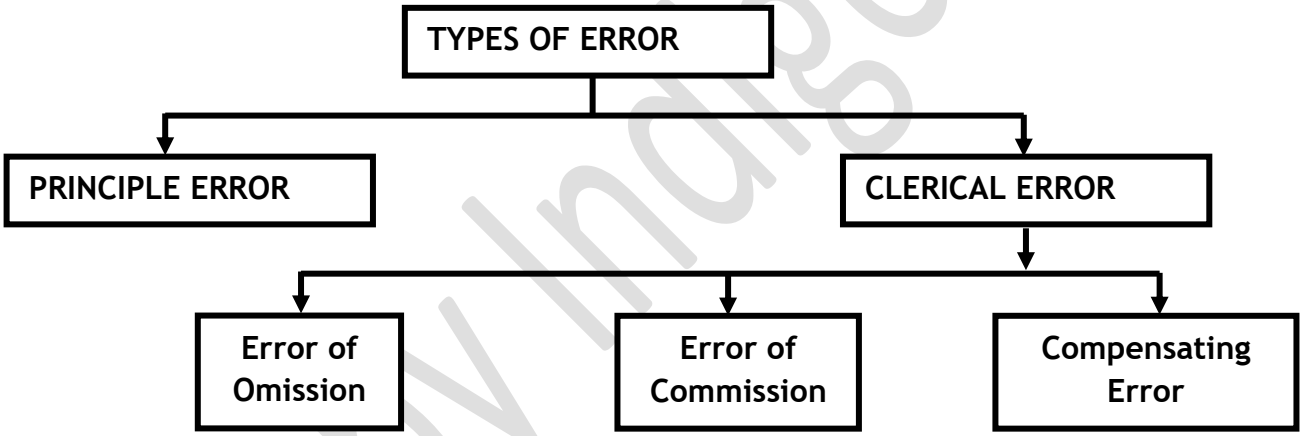
Till now we have been able to see that accounting involves multiple processes from recording a transaction to posting ledger to preparation of the Financial Statements.

An error can occur at any stage; broadly speaking the error can occur during any of the following stages based on the flow of the process:

1. When recording the transaction in Journal.
2. While posting entries in the Ledger.
3. Balancing the Ledger Accounts.
4. Preparing the Trial Balance.

TYPES OF ERRORS:

Classification of errors can be understood from the following table:



Error of Principle:

This error occurs when the transactions are recorded in a fundamentally wrong manner ignoring the principles of Accounting.
For Eg: When the purchase of Computer (Fixed Asset) is recorded as office expense.

Clerical errors:

1. Error of Omission:

This error occurs when the recording of transactions is omitted from the books of accounts.
For Eg: Omitting to record a purchase entry from the journal or omitting to record the journal entry in the ledger.

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2. Error of Commission:

This error occurs when the amounts are posted in the wrong account, or a debit amount is written on the credit side, or the amounts are written wrong.

3. Compensating Errors:

These are the errors whose combine effect cancels out each other. For Eg: if salaries account is overbooked by Rs. 1000/- and the office expense is under booked by the same amount i.e. Rs.1000/- then the final profit remains unaffected. These types of errors are known as "COMPENSATING ERRORS".

Apart from the above mentioned classification based on principle of error or clerical error there is also another category of error which can occur which is based on whether they affect the trial balance or not.

The errors which affect the trial balance are as stated below:

(i) Wrong casting of the subsidiary books.
(ii) Wrong balancing of an account.
(iii) Posting an amount on the wrong side.
(iv) Posting the wrong amount.
(v) Omitting to post an amount from a subsidiary book.
(vi) Omitting to post the totals of subsidiary book.
(vii) Omitting to write the cash book balances in the trial balance.
(viii) Omitting to write the balance of an account in the trial balance.
(ix) Writing a balance in wrong column of the trial balance.
(x) Totaling the trial balance wrongly.

The errors which do not affect the trial balance are as stated below:

(i) Omitting an entry altogether from the subsidiary book.
(ii) Making an entry with the wrong amount in the subsidiary book.
(iii) Posting an amount in a wrong account but on the correct side, e.g., an amount to be debited to A debited to B, the trial balance will still agree.

Steps to Locate the Error:

If the trial balance does not agree then it is a first indicator that there are errors in the accounts and there can be various reasons the existence of errors which needs to be enquired upon and rectified.

The following steps helps in identifying the errors:

1. The two columns of the Trial Balance should be verified and is there are multiple amounts which are represented by a single amount in the trial Balance then even those amounts should be verified again.

For eg: if the trial balance shows only a single amount for Trade Payables for the various accounts then the list of the trade payables should also be verified.

2. Verify the Cash and Bank Balances written in the trial balance.

3. The exact difference in the trail balance should be determined. All the ledgers should be scrutinized thoroughly to verify whether any amount of the exact difference has been omitted from recording in the trial balance.

4. The Ledger accounts should be re balanced.

5. Recheck the casting of subsidiary books.

6. Posting of the amount equal to the difference in the trial balance or the half amount of the difference should be checked. If the amounts are posted on the wrong side the difference doubles up.
   For Eg: If the amount of Rs.1000 to be posted in the debit side is posted on the credit side then the trial balance would be showing a difference of Rs. 2000/-. The omission of Debit of Rs.1000/- and additional credit of Rs.1000/-

7. If the difference still exists a complete checking of the entire books of accounts would be necessary.

Rectification of an Error

Errors always need to be corrected in a systematic way such that the effect of the error is nullified and the correct entry is also shown in the accounts.

The rectification of error depends on which stage the error is detected. The stage at which the rectification needs to happen depends on the following stages:

1. Before Preparation of Trial Balance
2. After the preparation of Trial Balance but before the preparation of the Final Accounts.
3. After preparation of Final Accounts.

Rectification of error before preparation of trial balance:

These categories of errors are identified during or before preparation of the Trial Balance and corrective entries need to be made to rectify the same.

The Rectification has to be done in 2 steps:

i) Pass a reverse entry of the wrong entry. This will nullify the effect of the wrong entry.
ii) Pass the correct Journal entry to ensure that proper effect of transactions is accounted.

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Example:
Purchase of Fixed Asset for Rs. 1,00,000/- from ABC & Co. has been booked under Purchases. Rectify the same.

The following states the wrong entries made and the correct entry to be passed for the rectification.

Wrong Entry	Reversal of Wrong entry	Correct Entry
Purchase A/c Dr. 100000 To ABC & Co. A/c 100000	ABC & Co. A/c Dr. 100000 To Purchases 100000	Fixed Assets A/c Dr. 100000 To ABC & Co. A/c 100000

Rectification of error after preparation of trial balance but before preparation of Final Accounts:

Sometimes when the trial balance does not agree it is made to agree artificially by opening a Suspense Account. If the debit total of the trial balance is higher than the suspense account is credited, and it is debited if the total of the credit side of the trial balance is higher.

All those errors which needs to be rectified by a Journal entry but were not able to be rectified due to the absence of complete journal entry will be rectified with the use of Journal Entry by using suspense account as the other part of the Journal.

Example:
Pass the rectification entry for the following errors using a Suspense Account:

1. The Sales book total is under casted by Rs.10,000/-
2. Goods Sold to Mr. B for Rs.2000/- But the accountant credited Mr. B instead of Debiting.
3. Discount received from Mr. C for Rs.500/- has been omitted from the discount column of the cash book. However, the discount is properly accounted in Mr. C Account.

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DATE	PARTICULARS		L.F.	DEBIT (Rs.)	CREDIT (Rs.)
	Suspense A/c	Dr.		10,000	
	To Sales A/c				10,000
	(Being Sales increased for the amount undercasted)				
	Mr. B A/c	Dr.		4,000	
	To Suspense A/c				4,000
	(Being Amont wrongly credited to Mr. B rectified)				
	Suspense A/c	Dr.		500	
	To Discount Received A/c				500
	(Being Disocunt Received not recorded previously accounted for)				

DR. **SUSPENSE ACCOUNT** CR.

DATE	PARTICULARS	J.F.	AMOUNT (Rs.)	DATE	PARTICULARS	J.F.	AMOUNT (Rs.)
	To Sales A/c		10,000		By Difference in Trial Balance		6,500
	To Discount Received A/c		500		By Mr. B A/c		4,000
	TOTAL		**10,500**		**TOTAL**		**10,500**

Rectification of error in the next accounting Period:

All the errors discussed so far were on the assumption that these errors have taken place during the current year. However, sometimes the books of accounts for a particular period are prepared along with the errors itself. These errors however, need to be rectified in the following year.

For instance the purchase for the year 2017 were over stated by Rs.10000/- but the Financials of the year 2017 were finalized along with the errors itself and it was only in 2018 the company realized the presence of error in 2017 financial statements and intended to rectify it.

If the company rectifies the error by reducing the purchases in 2018 by Rs. 10000/- then it would be reducing the purchases for the year 2018 instead of 2017. It is to avoid these

situations a special account named "PROFIT & LOSS ADJUSTMENT ACCOUNT" is used to rectify the errors of previous years.

It is to be noted that at the end of the current accounting period the balance of Profit & Loss Adjustment Account will be transferred to the Profit & Loss Account itself.

Example:
Mr. A was unable to agree the trial balance for 2017 and directly posted the differences in the Profit and Loss account. In 2018, the Auditors of the company revealed the following errors committed in 2017.

Rectify the mistakes noted above and use the Profit & Loss Adjustment Account wherever necessary:

i) Purchase of a Fixed Asset was debited to Printing & Stationery Account for Rs.5,000. Depreciation on Fixed Assets is levied at 10%.
ii) Sales account was overstated by Rs.20,000.
iii) A credit sale of goods to Mr. A for Rs.5,000 entered as a purchase.
iv) Rs. 1000 due by Mr. C was omitted from recording into the trial balance.
v) Purchase of goods from Mr. R for 5,000 was omitted to be recorded.
vi) Amount of Rs.2525 of purchase was wrongly posted as Rs.5252.

DATE	PARTICULARS	L.F.	DEBIT (Rs.)	CREDIT (Rs.)
	Fixed Assets A/c Dr.		4,500	
	To Profit & Loss Adjustment A/c			4,500
	(Being Purchase of Fixed Asset wrongly debited to Printing & Stationery rectified and asset is capitalised at the Depreciated value)			
	Profit & Loss Adjustment A/c Dr.		20,000	
	To Suspense A/c			20,000
	(Being Sales account overstated in previous year rectified)			
	Mr. A A/c Dr.		5,000	
	To Profit & Loss Adjustment A/c			5,000
	(Being Credit sales made to Mr.A recorded as Purchases now rectified)			
	Account Receivable A/c Dr.		1,000	
	To Suspense A/c			1,000
	(Being Accounts receivable not recorded last year now accounted)			

	Profit & Loss Adjustment A/c Dr.		5,000	
	To Mr.R A/c			5,000
	(Being Purchases made from Mr. R not recorded last year now accounted for)			
	Suspense A/c Dr.		2,727	
	To Profit & Loss Adjustment A/c			2,727
	(Being excess posting of purchases of Rs.5252 instead of Rs.2525 now rectified)			
	Mr. A Capital A/c Dr.		12773	
	To Profit & Loss Adjustment A/c			12773
	(Being Balance of Profit & Loss Adjustment Account trnasferred to Capital Account)			
	Suspense A/c Dr.		18273	
	To Mr. A Capital A/c			18273
	(Being balance of Suspense Account trnasferred to Mr.A Capital A/c)			

Questions:

Question -1

The following errors have occurred in the Books of Accounts of Mr. A and have been identified before the preparation of the trial Balance. Pass the wrong entries and the correct entries for the same.

i) Purchase of Fixed Asset for Rs. 10,000/- from ABC & Co. has been booked under Purchases.
ii) Sales of Rs. 5000/- to Mr. B were recorded as Sales to Mr. D.
iii) Omitted to record cash sales of Rs. 1000/-.

Question - 2

The Following errors have been identified after the preparation of the trial balance but before the preparation of Final Accounts. Correct the errors using suspense account wherever necessary:

i) Goods of the value of Rs.1000 returned by Mr. A were not recorded as sales return.

ii) Discount received for Rs.500/- for making early payment was not recorded in the discount received ledger. But the same was recorded in the cash book.
iii) Goods Purchased from Mr. B for Rs.4500/- were recorded in Purchases but the same was recorded in Mr. B A/c

Question – 3

The Following errors have been identified in the next year and the entity wants to rectify the same using Profit & Loss Adjustment Account.

i) Purchase of a Fixed Asset was debited to Purchase Account for Rs.10,000. Depreciation on Fixed Assets is levied at 20%.
ii) Sales account was understated by Rs.5,000.
iii) A credit purchase of goods from Mr. B for Rs.2,000 entered as a sales to Mr. B.

Illustrations

Illustration – 1

The following errors, affecting the account for the year 2015 were detected in the books of Jain Brothers, Delhi:

(1) Sale of old Furniture Rs 150 treated as sale of goods
(2) Receipt of Rs 500 from Ram Mohan credited to Shyam Sunder
(3) Goods worth Rs 100 brought from Mohan Narain have remained unrecorded so far
(4) A return of Rs 120 from Mukesh posted to his debit
(5) A return of Rs 90 to Shyam Sunder posted as Rs 9 in his account
(6) Rent of proprietor's residence, Rs 600 debited to rent A/c
(7) A payment of Rs 215 to Mohammad Sadiq posted to his credit as Rs125
(8) Sales Book added Rs 900 short
(9) The total of Bills Receivable Book Rs 1,500 left unposted

You are required to pass the necessary rectifying entries and show how the trails balance would be affected by the error.

Illustration – 2

Write out the Journal Entries to rectify the following errors, using a Suspense Account.

i. Goods of the value of Rs.100 returned by Mr. Sharma were entered in the Sales Day Book and posted therefrom to the credit of his account
ii. An amount of Rs.150 entered in the Sales Returns Book, has been posted to the debit of Mr. Philip, who returned the goods
iii. A sale of Rs. 200 made to Mr. Ghanshyam was correctly entered in the Sales Day Book but wrongly posted to the debit of Mr. Radheshyam as Rs. 20
iv. Bad Debts aggregating Rs.450 were written off during the year in the Sales ledger but were not adjusted in the General Ledger

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v. The total of "Discount Allowed" column in the Cash Book for the month of September,2015 amounting to Rs.250 was not posted

Illustration – 3

Mr. Roy was unable to agree the Trial Balance last year and wrote off the difference to the Profit and Loss Account of that year. Next Year, he appointed a Chartered Accountant who examined the old books and found the following mistakes:

1. Purchase of a scooter was debited to conveyance account Rs.3,000.
2. Purchase account was over-cast by Rs.10,000.
3. A credit purchase of goods from Mr. P for Rs. 2,000 entered as a sale.
4. Receipt of cash from Mr. A was posted to the account of Mr. B Rs. 1,000
5. Receipt of cash from Mr. C was posted to the debit if his account Rs.500.
6. Rs.500 due by Mr. Q was omitted to be taken to the trial balance.
7. Sale of goods to Mr. R for Rs.2,000 was omitted to be recorded.
8. Amount of Rs. 2,395 of purchase was wrongly posted as Rs.2,593.

Mr. Roy used 10% depreciation on vehicles. Suggest the necessary rectification entries

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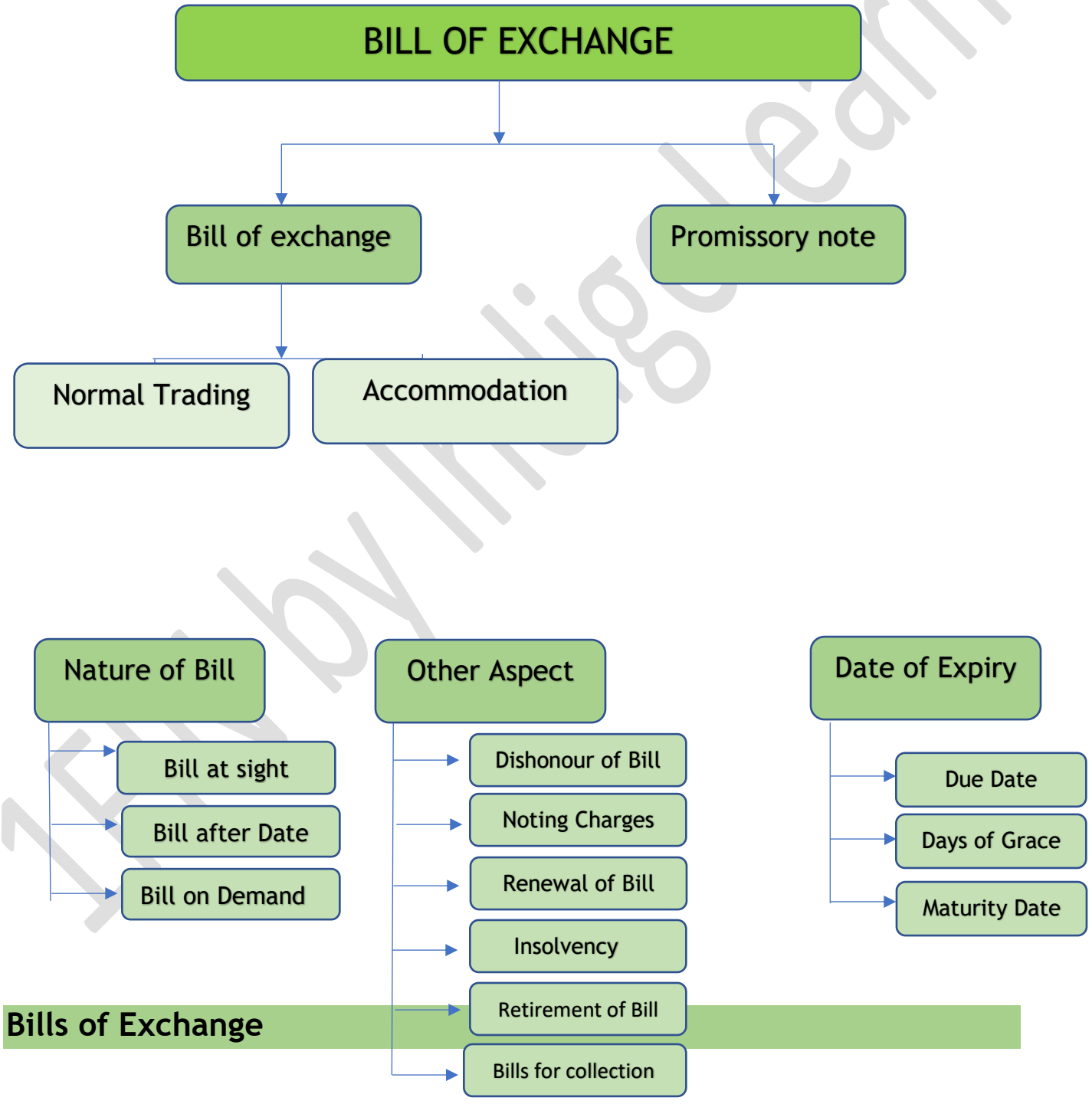
Study Note 2 |Accounting for Special Transactions

2.1 Bills of Exchange



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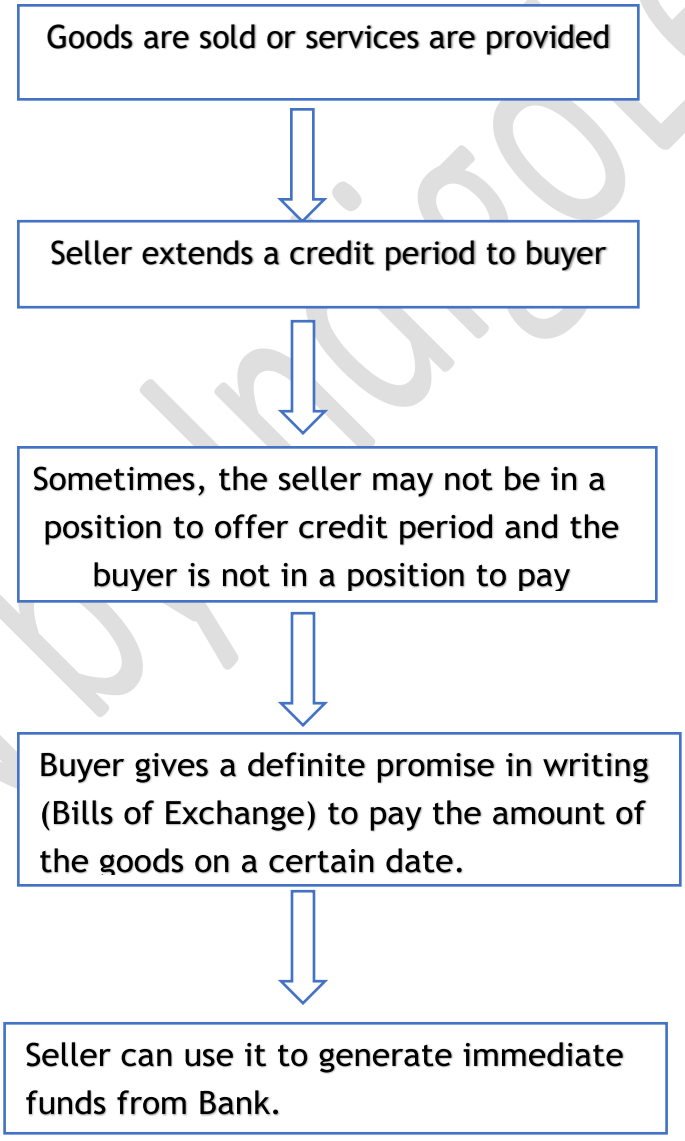
Definition

- Instrument in **writing**,
- Containing an **unconditional order** signed by the maker,
- **Directing** certain person to pay a certain sum of money
- Only to or to the order of a **certain** person or to the bearer of the instrument.
- When such an order is **accepted** in writing on the face of the order itself,
- It becomes a valid bill of exchange.

Concept



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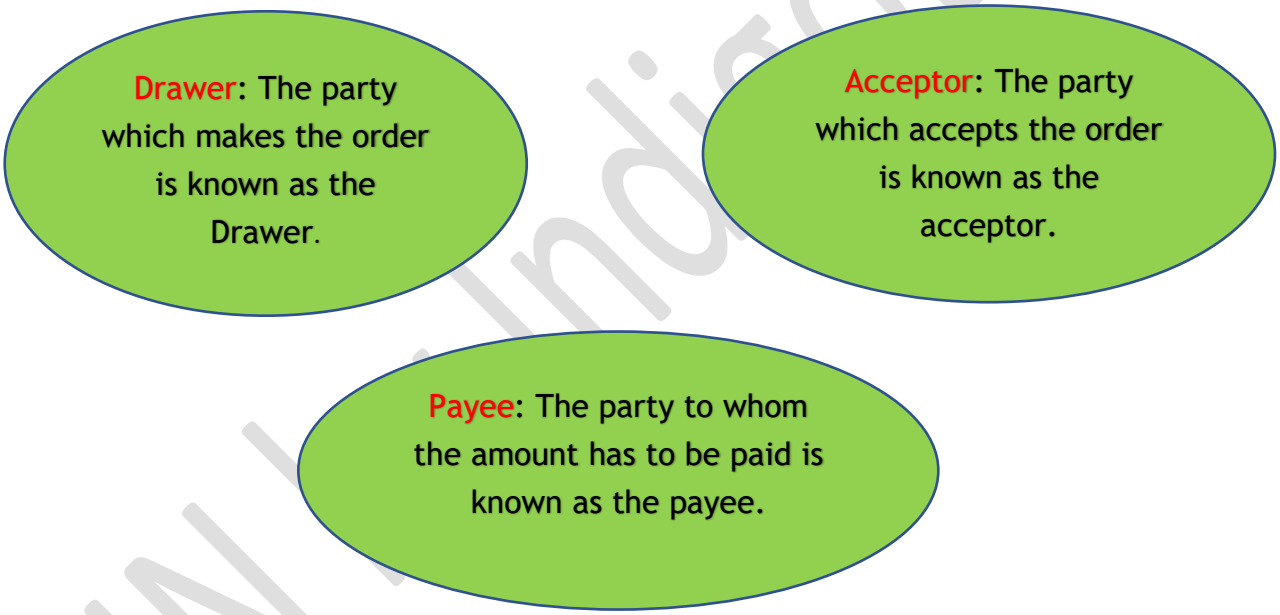
Characteristics

- It must be in **writing.**
- It must be **dated.**
- It must contain an **order** to pay a certain sum of money.
- The promise to pay must be **unconditional.**
- The money must be payable to a **definite person** or to his order to the bearer.
- The draft must be **accepted for payment** by the party to whom the order is made.
- It should be properly **stamped.**
- Payment must be in **legal currency** of the country.
- A Bill of Exchange can be passed on to another person by **endorsement.**



Foreign Bill of Exchange

- A bill of exchange drawn for **foreign trade operations** known as Foreign Bill of Exchange.
- A foreign bill of exchange is one which is drawn in one country and is payable in another.
- It is generally drawn up in **triplicate** wherein each copy is sent by separate post so that at least one copy reaches the intended party.
- Payment will be made only on **one of the copies** and when such payment is made the other copies become useless.

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Example

1. A bill drawn in India on a person resident outside India and made payable outside India.
2. A bill drawn outside India on a person resident outside India.
3. A bill drawn outside India and made payable in India.
4. A bill drawn outside India and made payable outside India.

Promissory Notes

Definition

- A promissory note is an **instrument in writing**,
- Not being a bank note or currency note
- Containing an **unconditional undertaking** signed by the maker to pay a certain sum of money
- Only to or to the order of a **certain person.**

Characteristics

- It must be in **writing**.
- It must contain a clear **promise to pay**. Mere acknowledgement of a debt is not a promissory note.
- The promise to pay must be **unconditional** "I promise to pay 50,000 as soon as I can" is not an unconditional promise.
- The promiser or maker must **sign** the promissory note.
- The maker must be a **certain person**.
- The payee (the person to whom the payment is promised) must also be **certain**.
- The sum payable must be **certain**. "I promise to pay 50,000 plus all fine" is not certain.
- Payment must be in **legal currency** of the country.
- It should not be made payable to the **bearer**.
- It should be properly **stamped**.
- It does not require any **acceptance**.

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BILLS OF EXCHANGE V/S PROMISSORY NOTES

BILLS OF EXCHANGE	PROMISSORY NOTE
A bill contains an unconditional order to pay.	A promissory note contains only a promise to pay certain sum of money.
There are generally 3 parties (Drawer, Drawee and Payee) in bill of exchange.	There are 2 parties (Maker and Payee) in promissory note.
A bill is paid by Acceptor.	A promissory note is paid by maker.
A bill is drawn by creditor.	A promissory note is made by debtor.
The drawer and payee may be same person in case of bill of exchange	In promissory note maker and payee cannot be same person.
In a bill of exchange the liability of drawer is secondary and conditional.	In a promissory note the liability of a maker is primary and absolute.
A bill of exchange can be accepted conditionally.	A promissory note cannot be made conditionally.
In a bill of exchange, notice of dishonor must be given.	Notice of dishonor is not required in case of promissory note.
In case of dishonor, a bill of exchange must be noted and protested.	Noting and protest is not required in case of dishonor of a promissory note.

TERM OF A BILL

1) When a bill is drawn ***after sight***

Term of the bill: Begins from the date of 'sighting' i.e. when the bill is accepted.

2) When a bill is drawn ***after date***

Term of the bill: Begins from the date of drawing the bill.

EXPIRY /DUE DATE OF BILL

- The date on which the term of the bill terminates is called as '**Expiry/Due Date of**

the bill'.

DAY OF GRACE

- Every instrument payable otherwise than on demand entitled to **three days** of grace.

DATE OF MATURITY OF BILL

- The date which comes after adding **three days** to the expiry/due date of a bill, is called the **date of maturity**.
- The maturity of a promissory note or bill of exchange is the date at which it **falls due**.
- Every promissory note or bill of exchange gets matured on the third day after the day on which it is expressed to be payable , except when it is expressed to be payable

  (i) on **demand**,
  (ii) at **sight**, or
  (iii) on **presentment**

BILL AT SIGHT

- Bill at Sight means the instruments in which **no time** for payment is mentioned.
- A promissory note or bill of exchange is payable **on demand**-
  - when **no time** for payment is specified, or
  - when it is **expressed** to be payable on demand, or

  at sight or on presentment.

Point to be remember

- ❖ At sight' and 'presentment' means **on demand**.
- ❖ An instrument payable on demand may be **presented for payme**nt at any time.
- ❖ **Days of grace** is not to added to calculate maturity for such types of bill.
- ❖ A **cheque** is always payable on demand.

BILL AFTER DATE

- Bill after date means the instrument in which **time for payment** is mentioned.
- A promissory note or bill of exchange is a time instrument when it is expressed

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to be payable-

- After a **specified period.**
- on a **specific day**
- after **sight**
- on the happening of event Which is **certain to happen.**

Point to be remember

*The expression '**after sight**' means-*

- *In a promissory note, after **presentment for sight.***
- *In a bill of exchange, **after acceptance or noting for non-acceptance or protest for non-acceptance.***

- A cheque cannot be a time instrument because the cheque is always payable on demand.
- Though a cheque can be postdated, and which can be presented on or after such date.
- A cheque has validity of 90 days from its date after that it becomes void, normally termed as 'Stale Cheque' as bank will not honour such cheque.

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CALCULATION OF DUE DATE OF A BILL

When the bill is made payable on a specific date.

That specific date will be the due date

When the bill is made payable at a stated number of months(s) after date.

That date on which the term of the bill shall expire will be the due date.

When the bill is made payable at a stated number of days after date.

That date which comes after adding stated number of days to the date of bill, shall be the due date.

Note : the date of bill is excluded

When the due date is a public holiday.

The preceding business day will be the due date.

When the due date is an emergency/due unforeseen holiday.

The next following day will be the date.

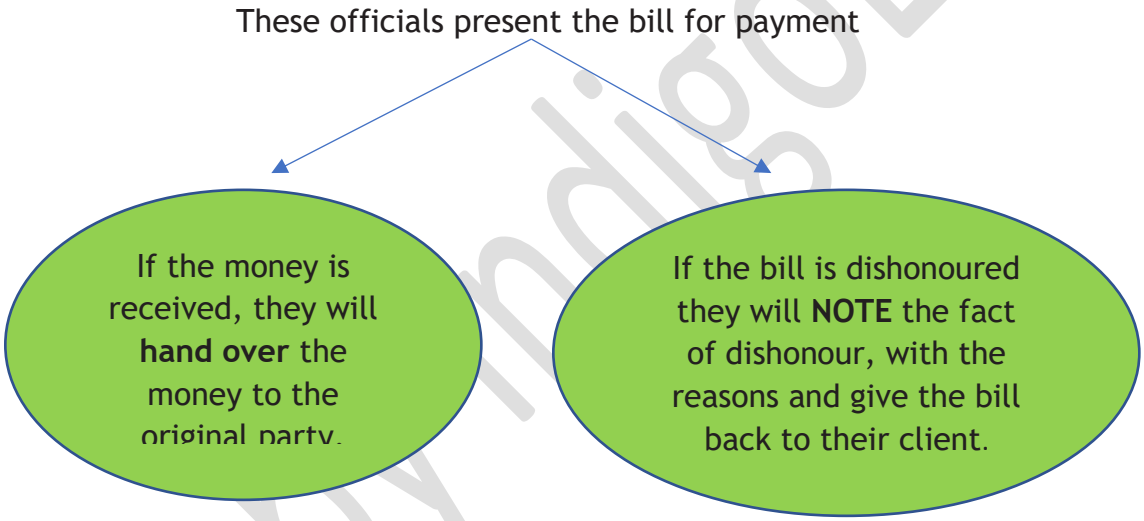
Point to be remember

1) When the bill is made payable at a stated number of months(s) after date, the **term** shall expire on that day of the month which corresponds with the day on which the bill is dated. If the month in which the period terminates has no corresponding day, the period shall be deemed to expire on the last day of such a month. For example, a bill signed on January 31st payable after 3 months will be due on April 30th.

2) The term of a **Bill after sight** commences from the date of acceptance of the bill whereas the term of a bill after date commences from the date of drawing of bill.

NOTING CHARGES

- When the acceptor denies the payment of bill then it leads to dishonor of bill.
- If there is dishonour, or fear of dishonour, the bill will be given to a public official known as ***"Notary Public"***.



- For doing this activity, the officer charges a small fee known as **noting charges.** The amount of noting charges is recoverable from the party which is responsible for dishonour.

RENEWAL OF BILL

When Acceptor is unable to pay the amount and he himself moves that he should be given extension.

In consideration, the acceptor agrees to bear interest for the extended tie period.

(Calculated from the date of renewal till the date of expected settlement).

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A new bill will be drawn, and the old bill will be cancelled.

The amount of the new bill may represent any of the following

1) Where the drawee pays nothing: Total of amount of original bill as well as the interest for the extended time period.
2) Where the drawee pays the interest amount at the time of renewal: Amount of the Original bill.
3) Where the drawee makes part payment of the original bill: that part of total of amount of original bill remain unpaid as well as the interest for the extended time period on unpaid amount.

RETIREMENT OF BILLS OF EXCHANGE AND REBATE

The acceptor has spare funds much before the maturity date of the bill of exchange accepted by him.

He approaches the payee of the bill of exchange and asks him whether the payee is prepared to accept cash before the maturity date.

The acceptor gets a certain rebate or interest or discount for premature payment.



The rebate becomes the income of the acceptor and expense of the payee.

ACCOMODATIO

- The mechanism of bill can be used to raise finance without doing any trading activity.

  For example: Sanju and Manju are two friends. Sanju needs fund for three months. . In that case he may persuade his friend Manju to accept his draft. The bill of exchange may then be taken by Sanju to his bank and get it discounted there. Thus, Sanju will be able to make use of funds.
  When the three months period expires Sanju will send the requisite amount to Manju and Manju will meet the bill.
- The same mechanism can be use when both the party needs money. In that case the proceeds divided between the drawer and drawee according to mutual concern. The discounting charges must also be borne by the two parties in the same ratio in which the proceeds are divided.
- It may so happen that the drawer is not able to remit the proceeds to drawee on the due date.

  In such a case, the drawee may draw a bill on the drawer, and get it discounted with the bank to honour the first bill.

BILL RECEIVABLE AND BILL PAYABLE BOOKS

- Bills receivable and bills payable books are **journals** (Day Books) to record in a **chronological order** the details of bills receivable and bills payable.
- When **large number** of bill transactions take place in an organization, it is convenient to maintain these books.
- Wherein any bill transaction takes place, the same is entered in the Day Books in the first instance and then the posting to respective debtor or creditor and to Bills Receivable or Bills Payable account done from the day book.
- Useful for **following up** the status of outstanding bills.

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JOURNAL ENTRIES IN BOOKS OF DRAWER

Particular	Amount
On receipt of Bill	
Bills Receivable Account Dr.	
To Drawee/Maker of the note	
On Endorsement in favour of another Party(say Z) Z A/c Dr.	
To Bills Receivable Account	
On discounting with bank Bank Account Dr. (with the amount actually received Discount Account Dr. (with the amount of loss of discount) To Bills Receivable Account	
On the date of maturity (Bill is honoured) Cash Account Dr.	
To Bills Receivable Account	
On the date of maturity (Bill is dishonoured)	
1) If the bill was kept till maturity, then	
Drawee / Maker of the note Dr.	

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To Bills Receivable Account	
2) If the bill was endorsed in favour of a creditor, the entry is:	
Drawee / Maker of the note Dr.	
To Bill payables	
3) If the bill was discounted with the bank:	
Drawee / Maker of the note Dr.	
To Bank A/c	
<u>Entry for Noting charges</u>	
1) Suppose X received from Y a bill for 1,000. On Maturity the bill is dishonoured and 10 is paid as noting charges. The entry in this case will be	
Y A/c Dr.	1,010
To Bills Receivable Account To Bank A/c	1,000 10
2) Suppose X had endorsed this bill in favour of Z	
Y A/c Dr.	1,010
To Z *This is because Z will claim 1,010 from X and X has the right of recovering 1,010 from Y.*	1,010
3) If the bill has been discounted with a bank, entry will be	
Y Dr.	1,010
To Bank A/c	1,010
<u>In case of Insolvency</u>	

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1) When drawee become insolvent	
Drawee A/c Dr.	
To Bills Receivable A/c	
2) When something received from estate	
Cash A/c Dr.	
To Drawee A/c	
3) Entry for Irrecoverable Amount	
Bad debt A/c Dr.	
To Drawee A/c	
❖ **In case of Renewal of bill**	
1) **Cancellation of original Bill**	
Entries are same as explained for dishonour of bill.	
2) **Entry for New bill**	
Bills Receivable A/c Dr.	
To Drawee A/c	
3) In case of interest charged for new period	
Bills Receivable A/c Dr.	

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To Drawee A/c To Interest Income A/c	
In case of Retirement of Bill	
Cash/ Bank A/c Dr.	
Rebate on bills account Dr.	
To Bills Receivable A/c	

JOURNAL ENTRIES IN BOOKS OF DRAWEE

Particular	Amount
On acceptance of Bill	
Drawer A/c Dr.	
To Bills Payable A/c	
On the date of maturity (Bill is honoured)	
Bills Payable A/c Dr.	
To Cash/Bank A/c	
On the date of maturity (Bill is dishonoured)	
Bills Payable A/c Dr.	
To Drawer A/c	
Entry for Noting charges	

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Legal expense A/c Dr.	
To Drawer A/c	
In case of Insolvency	
1) When drawee become insolvent	
Bills Payable A/c Dr.	
To Drawer A/c	
2) **When final settlement Made**	
Drawer A/c Dr.	
To Cash/Bank A/c	
3) Entry for short payment	
Drawer A/c Dr.	
To Deficiency A/c	
<u>In case of Renewal of bill</u>	
Cancellation of original Bill	
Bills Payable A/c Dr.	
To Drawer A/c	
Entry for New bill	
Drawer A/c Dr.	
To Bills Payable A/c	
In case of interest charged for new period	
Drawer A/c Dr.	

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Interest Charged A/c Dr.	
To Bills Payable	
In case of Retirement of Bill	
Bills Payable Dr.	
To Cash / Bank To Rebate on bill discount	

BILLS OF COLLECTION

Particular	Amount
Entries for Bills for Collection Process	
Bills for Collection Account Dr.	
To Bills Receivable Account	
When the amount is realized the entry will be	
Bank Account Dr.	
To Bills for Collection Account	
When the amount is not honoured, the entry will be	
Party (from whom the bill was received) Dr.	
To Bills for collection A/c	

Illustrations

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Illustration – 1

Vijay sold goods to Pritam on 1st September 2016 for Rs. 1,06,000. Pritam immediately accepted three months bill. On due date Pritam requested that the bill be renewed for a fresh period of two months. Vijay agrees provided interest at 9% was paid immediately in cash. To this Pritam was agreeable. The second bill was met on due date.
Give Journal entries in the books of Vijay and Pritam.

Illustration – 2

On 1st January 2016, Ankita sells goods for Rs 5,00,000 to Bhavika and draws a bill at three months for the amount. Bhavika accepts it and returns it to Ankita. On 1st March 2016, Bhavika retires her acceptance under rebate of 12% per annum.
Record these transactions in the journals of Ankita and Bhavika.

Illustration – 3

	Journalize the following transactions in K. Katrak's books
1	Katrak's acceptance to Basu for Rs 2,500 discharged by a cash payment of Rs 1,000 and a new bill for the balance plus Rs 50 for interest
2	G. Gupta's acceptance for Rs 4,000 which was endorsed by Katrak to M. Mehta was dishonored. Mehta paid Rs 20 noting charges. Bill withdrawn against cheque
3	D. Dalal retires a bill for Rs 2,000 drawn on him by Katrak for Rs 10 discount
4	Katrak's acceptance to Patel for Rs 5,000 discharged by Patel. Mody's acceptance to Katrak for a similar amount

Illustration - 4

On 1st January,2016, Vilas draws a Bill of Exchange for Rs. 10,000, due for payment after 3 months on Eknath. Eknath accepts to this bill of exchange. On 4th March,2016. Eknath retires the bill of exchange at a discount of 12% p.a.
You are asked to show the journal entries in the books of Vilas.

Illustration – 5

Mr. David draws two bills of exchange on 1.1.2016 for Rs 6,000 and Rs 10,000. The bills of exchange for Rs 6,000 is for two months while the bill of exchange for Rs 10,000 is for three months. These bills are accepted by Mr. Thomas.
On 4.3.2016, Mr. Thomas requests Mr. David to renew the first bill with interest at 18% p.a. for a period of two months. Mr. David agrees to this proposal. On 20.3.2016, Mr. Thomas retires the acceptance for Rs 10,000, the interest rebate i.e. discount being Rs 100. Before the due date of the renewed bill, Mr. Thomas becomes insolvent and only 50 paisa in a rupee could be recovered from his estate.
You are to give the journal entries in the books of Mr. David.

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Illustration – 6

Rita owed Rs. 1,00,000 to Siriman.

- On 1st October,2016, Rita accepted a bill drawn by Siriman for the amount at 3 months
- Siriman got the bill discounted with his bank for Rs. 99,000 on 3rd October,2016
- Before the due date, Rita approached Siriman for renewal of the bill.
- Siriman agreed on the conditions that Rs. 50,000 be paid immediately together with interest on the remaining amount at 12% per annum for 3 months and for the balance, Rita should accept a new bill at three months
- These arrangements were carried out
- But afterwards, Rita became insolvent and 40% of the amount could be recovered from his estate

Pass journal entries (with narration) in the books of Siriman.

Illustration - 7

On 1st July,2016 Gorge drew a bill for Rs. 1,80,000 for 3 months on Harry for mutual accommodation.

- Harry accepted the bill of exchange
- Gorge had purchased goods worth Rs. 1,81,000 from Jack
- On the same date Gorge endorsed Harry's acceptance to Jack in full settlement
- On 1st September,2016, Jack purchased goods worth Rs. 1,90,000 from Harry
- Jack endorsed the bill of exchange received from Gorge to Harry and paid Rs. 9,000 in full settlement of the amount due to Harry
- On 1st October,2016, Harry purchased goods worth Rs. 2,00,000 from Gorge
- Harry paid the amount due to Gorge by cheque

Give the necessary Journal Entries in the books of Harry and Gorge.

Illustration - 8

For the mutual accommodation of 'X' and 'Y' on 1st April,2016, 'X' drew a four month's bill on 'Y' for Rs. 4,000

- 'Y' returned the bill after acceptance of the same date
- 'X' discounts the bill from his bankers @ 6% per annum and remit 50% of the proceeds to 'Y'
- On due date 'X' is unable to send the amount due and therefore 'Y' draws a bill for Rs. 7,000, which is duly accepted by 'X'
- 'Y' discounts the bill for Rs. 6,600 and sends Rs. 1,300 to 'X'
- Before the bill is due for payment 'X' becomes insolvent. Later 25 paise in a rupee received from his estate

Record Journal entries in the books of 'X'.

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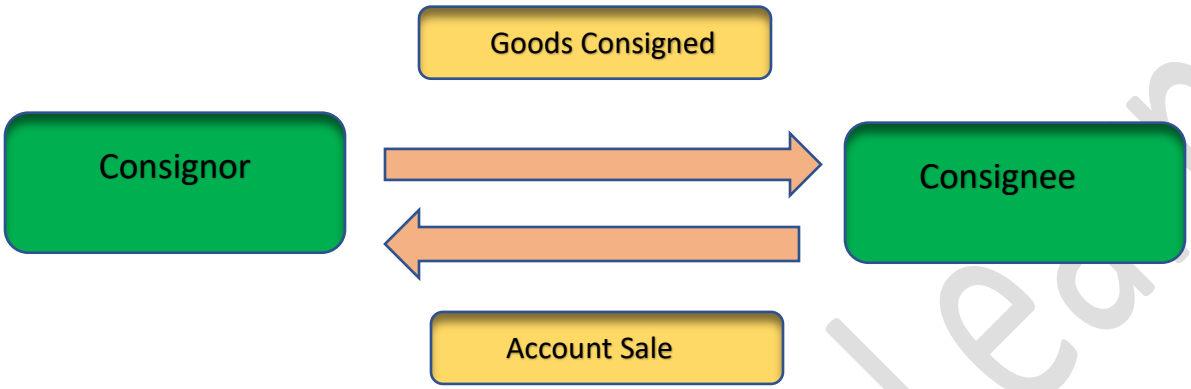
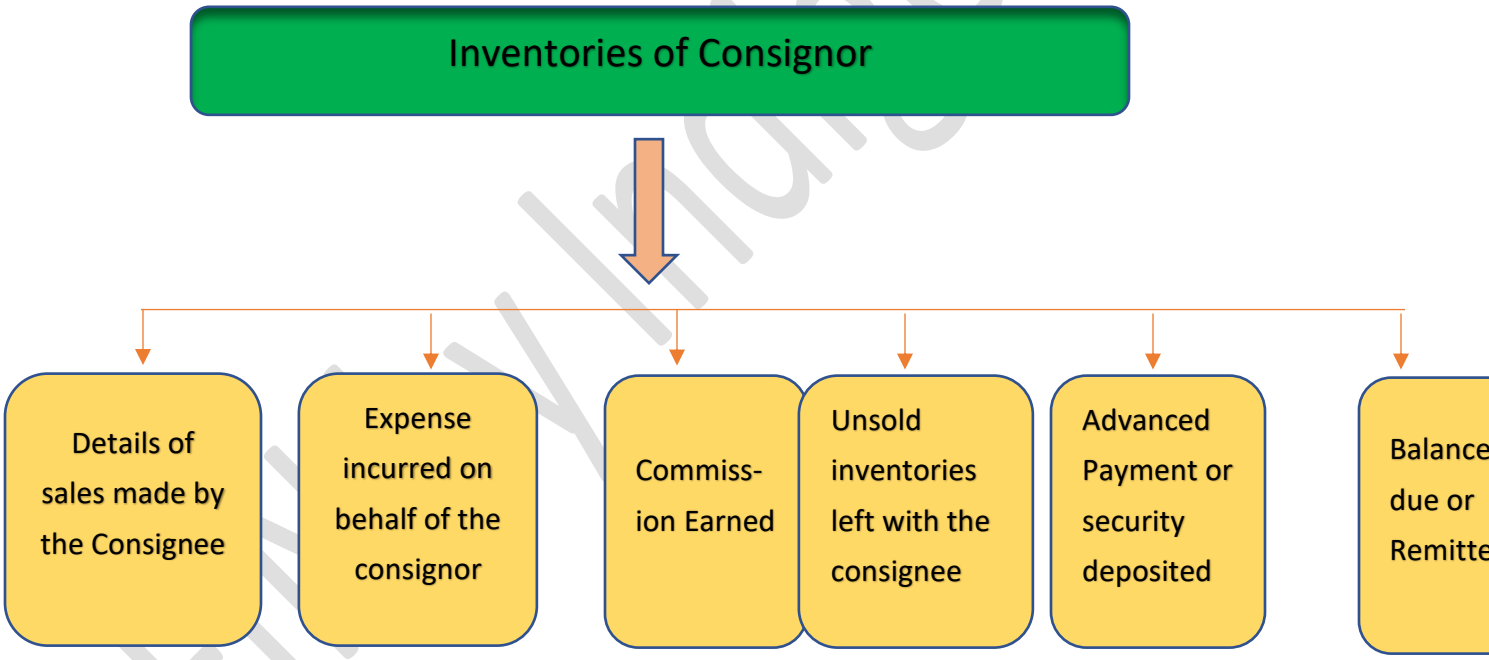
2.2 Consignment Accounting





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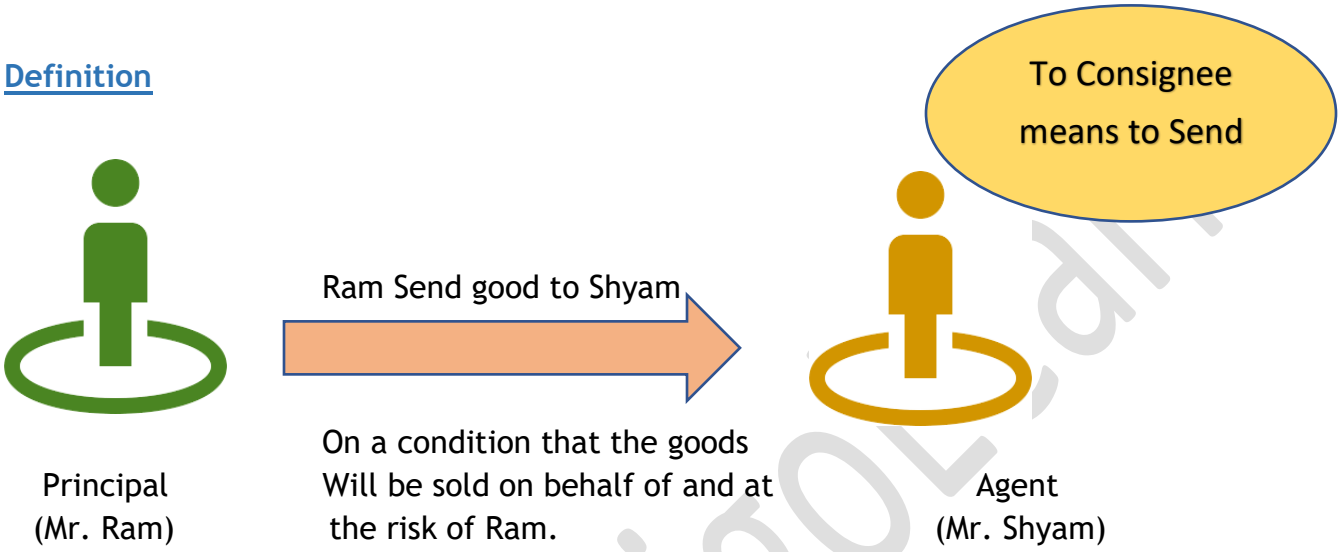
MEANING OF CONSIGNMENT ACCOUNT

❖ **Definition**



Ownership: Remains with the consignor or the **principal**.

Invoicing : Consignor does not send an invoice. He only sends a **proforma invoice**.

What is Proforma Invoice?

It is a statement conveying information to the consignee regarding **particulars of the good sent**. It looks like an invoice.

❖ **Features**

- The consignee recovers from the consignor all **expenses** incurred by him on the consignment. This however can be changed by agreement between the two parties
- It is also usual for the consignee to give an **advance to the consignor** in the form of cash or a bill of exchange.
- The consignee receives a commission calculated on the basis of **gross sale**. It is calculated on total sale and not merely on credit sale.

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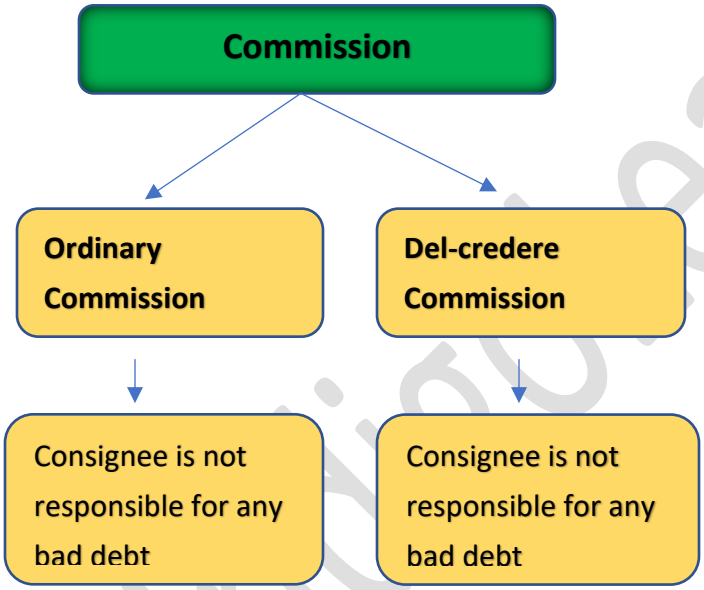

- Periodically, the consignees sends to the consignor a statement called **Account Sales**.

What is Account Sales?

- It sets out the **sales** made by the consignee
- The **expenses** incurred on behalf of the consignor
- The **commission earned** by the consignee and
- The **balance** due to the consignor.

Firms usually like to ascertain the profit or loss on each consignment or consignments to each consignee.

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DISTINCTIONS

❖ **Consignment And Sale**

S.No.	Consignment	Sale	Basis
1.	Ownership of the goods rests with the consignor till the time they are sold by the consignee, no matter the goods are transferred to the consignee.	The ownership of the goods transfers with the transfer of goods from the seller to the buyer.	**Ownership**
2.	The consignee can return the unsold goods to the consignor.	Goods sold are the property of the buyer and can be returned only if the seller agrees	**Return**
3.	Consignor bears the loss of goods held with the consignee.	It is the buyer who will bear the loss if any, after the transfer of goods.	**Onus of loss**
4.	The relationship between the consignor and the consignee is that of a principal and agent.	The relationship between the seller and the buyer is that of a creditor and a debtor.	**Relationship**
5.	Expenses done by the consignee to receive the goods and to keep it safely are borne by the consignor unless there is any other agreement.	Expenses incurred by the buyer are to be borne by the buyer itself after the transfer of goods.	**Expenses**

❖ **Commission and Discount**

	Commission	Discount
	Commission may be defined as remuneration of an employee or agent relating to services performed in connection with sales, purchases, collections or other types of business transactions and is usually based on a percentage of the amounts involved. Commission earned is accounted for as an income in the books of accounts, and commission allowed or paid is accounted for as an expense in the books of the party availing such facility or service.	The term discount refers to any reduction or rebate allowed and is used to express one of the following situations: An allowance given for the settlement of a debt before it is due i.e. cash discount. An allowance given to the whole sellers or bulk buyers on the list price or retail price, known as trade discount. A trade discount is not shown in the books of account separately and it is shown by way of deduction from cost of purchases.

ACCOUNTING IN BOOKS OF CONSIGNOR

- A separate consignment account has to be prepared for **each consignment**.
- Each consignment account is a **nominal-cum-personal account.**
- Each consignment account constitutes a **profit and loss account** in respect of the transactions to which it relates.

PARTICULAR	AMOUNT	COMMENTS
1. When goods are consigned or dispatched		The personal account of consignee is not debited and also sales account is not credited.
Consignment Account Dr.		
To Goods Sent on Consignment Account		
2. Expenses incurred by consignor		Unlike normal practice to debiting expense accounts first and then transferring to profit and loss account, expenses are directly debited to consignment account
Consignment Account Dr.		
To Supplier Account/Bank/Cash		
3. When advance is received from the consignee		The consignee may remit some advance to consignor.
Bank/Cash Account Dr.		
To Consignee's Personal Account		

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4. On receipt of account sales from the consignee			
For sales proceeds			
Consignee's Personal Account Dr.			Account sales contains details of sales made by consignee.
To Consignment Account			
For expenses incurred by consignee			
Consignment Account Dr.			expenses incurred by consignee
To Consignee's Personal Account			
5. Cash or cheque or bank draft or bill of exchange/promissory note received from the consignee as settlement			
Cash/Bank/Bills Receivable Account Dr.			
To Consignee's Personal Account			
6. For bad debts			
When del-credere commission is not paid to the consignee			
Consignment Account Dr.			Entry is for Bad debt and not for commission
To Consignee's Personal Account			
When del-credere commission is paid to the consignee			
No entry is recorded as bad debts is to be borne by consignee			

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7. For the goods taken over by the consignee		
Consignee's Personal Account Dr.		
To Consignment Account		
8. For unsold consignment stock		
Consignment Stock Account Dr.		
To Consignment Account		
9. For commission payable to consignee		
Consignment Account Dr.		
To Consignee's Personal Account		

VALUATION OF INVENTORIES

Principle: Inventories should be valued at cost or net realizable value whichever is lower.

In the case of consignment

Cost means cost of the goods to the consignor + all expenses incurred till the goods reach the premises of the consignee

Examples of expense

1) Packaging
2) Freight
3) Cartage
4) Insurance in transit
5) Octroi
6) Import duty

What is not include?

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Expenses incurred after the goods have reached the consignee's godown.

Examples: Godown rent
Insurance of godown
Delivery charges
Salesman salaries.

If the expected selling price of inventories on hand is lower than the cost, the inventories should be valued at expected net selling price only, i.e. expected selling price less delivery expenses, etc.

GOODS INVOICED ABOVE COST

Scenario: The proforma invoice is made out at a value higher than the cost.

Entries in the books of the consignor are made out on that basis.

Additional entries (before ascertaining profit) to remove the effect of loading:

PARTICULAR	AMOUNT	COMMENT
Goods sent on Consignment Account Dr.		reversed to the extent of loading in order to debit the Consignment A/c on cost basis
To Consignment Account		
Consignment Account Dr.		The amount of loading included in the value of the closing Inventories is unrealized profit – hence reserve is created by debit
To Inventory Reserve Account		

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		to the Consignment Account

NORMAL LOSS

- Normal loss would be spread over the entire consignment while valuing inventories.
- No entry is recorded for normal loss.
- Normal loss considered as an expense for valuation of remaining inventory.

Cost per unit: (total cost + normal loss)/total quantity.

ABNORMAL LOSS

- Abnormal loss is any accidental or unnecessary loss occurs.
- This amount should be credited to the Consignment Account and debited to the P&L A/c.
- Abnormal loss cannot be considered in valuing the stock.
- Abnormal loss is valued just like inventories in hand.
- For the purpose of valuation of inventory in hand, it should be noted that while normal loss is considered as part of cost of remaining goods, whereas abnormal loss is ignored.

Special case

Valuing goods lost in transit : Consignee's non-recurring expenses are not included.

Valuing goods lost in consignee's godown : Consignee's non-recurring expenses are included.

Distinction between Normal loss and abnormal loss

Basis	Normal loss	Abnormal loss

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Occurrence	Normal loss occurs due to inherent nature of the goods being shipped e.g. leakage, evaporation, loss of perishable goods etc.	Abnormal loss occurs mainly because of unforeseen events e.g. accident or natural calamity etc.
Time of Accounting	Normal loss is not accounted for immediately and is loaded on the remaining goods. It gets accounted for as cost of remaining goods as and when they are sold.	Abnormal loss is accounted for immediately in profit and loss account.
Impact on gross profit	As normal loss is added to cost of remaining goods, it impact gross profit.	Abnormal loss does not impact gross profit.
Coverage by Insurance Co.	Insurance companies generally do not cover normal loss as it is expected to be incurred on each consignment or storage of goods.	Insurance is generally available for abnormal losses.
Certainty	Normal loss is almost certain however it may vary from time to time.	Abnormal loss is because of unforeseen events and is not certain.

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❖ **Journal Entries**

PARTICULAR		AMOUNT	COMMENT
Abnormal Loss Account	Dr.		
To Consignment Account			
Insurance Company's Account	Dr.		If abnormal loss is recoverable from
To Abnormal Loss Account			

		the insurance company.
Consignee's Personal Account Dr.		If abnormal loss is recoverable from the consignee.
To Abnormal Loss Account		
Profit & Loss Account Dr.		If abnormal loss is not recoverable
To Abnormal Loss Account		

COMMISSION

- **Definition:** Commission is the remuneration paid by the consignor to the consignee for the services rendered to the former for selling the consigned goods.

Three Types of Commission

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RETURN OF GOODS FROM THE CONSIGNEE

Consigned goods can be returned by the consignee because of many reasons like

- poor quality
- not upto the specimen
- Destroyed in transit etc.

What is the value of returned goods?

Valued at the price at which it was **consigned to the consignee**.

Special Point

Expenses incurred by the consignee to send those goods back to the consignor are not taken into consideration. This is generally called secondary freight in accounting terms.

ACCOUNT SALES

❖ **Definition**: An account sale is the periodical summary statement sent by the consignee to the consignor

It contains details regarding:

1) sales made
2) Expenses incurred on behalf of the consignor.
3) Commission earned.
4) Unsold inventories left with the consignee.
5) Advance payment or security deposited with the consignor and the extent to which it has been adjusted.
6) Balance payment due or remitted.

It is a summary statement and is different from Sales Account

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PARTICULAR		AMOUNT
1. On making sales		
Cash/Bank Account/Debtors	Dr.	
To Consignor's Personal Account		
2. For expenses incurred and his commission		
Consignor's Personal Account	Dr.	
To Bank Account		
For advance paid to consignor		
Consignor's Personal Account	Dr.	
To Bank Account		
For recording bad debts		
Bad Debts Account	Dr.	
To Customer's Account		
For writing out bad debts		
When del-credere commission is not allowed		
Consignor's Personal Account	Dr.	
To Bad Debts Account		
When del-credere commission is allowed		
Commission Account	Dr.	
To Bad Debts Account		

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ACCOUNTING IN THE BOOKS OF CONSIGNEE

PARTICULAR		AMOUNT
1. On making sales		
Cash/Bank Account/Debtors	Dr.	
To Consignor's Personal Account		
2. For expenses incurred and his commission		
Consignor's Personal Account	Dr.	
To Bank Account		
For advance paid to consignor		
Consignor's Personal Account	Dr.	
To Bank Account		
For recording bad debts		
Bad Debts Account	Dr.	
To Customer's Account		
For writing out bad debts		
When del-credere commission is not allowed		
Consignor's Personal Account	Dr.	

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To Bad Debts Account		
When del-credere commission is allowed		
Commission Account	Dr.	
To Bad Debts Account		

ADVANCE BY THE CONSIGNEE VS SECURITY AGAINST CONSIGNMENT

- The consignor insist the consignee for some advance payment for the goods consigned at the time of delivery of goods.
- This advance payment is adjusted in full against the amount due by the consignee on account of the goods sold.

Special case

If the advance money deposited by the consignee is in the form of security against the goods consigned.

- Then the full amount is not adjusted against the amount due by the consignee to the consignor on account of goods sold if, **there is any unsold inventory left with the consignee.**

In that case proportionate security in respect of **unsold goods** is carried forward till the time the respective goods held with the consignee are sold.

Illustrations

Illustration - 1

Exe sent on 1st July,2019 to Wye goods costing Rs 50,000 and spent Rs1,000 on packing etc. On 3rd July,2019, Wye received the goods and sent his acceptance to Exe for Rs. 30,000, payable at 3 months. Wye spent Rs 2,000 on freight and cartage, Rs 500 on godown rent and Rs 300 on insurance. On 31st December,2019 he sent his Account Sales (along with the amount due to Exe). Showing that 4/5 of the goods had been sold for

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Rs55,000. Wye is entitled to a commission of 10%. One of the customers turned insolvent and could not pay Rs600 due from him.
Show the necessary journal entries in the books of consignor. Also prepare ledger accounts.

Illustration – 2

Miss Rakhi consigned 1,000 radio sets costing Rs.900 each to Miss Geeta, her agent on 1st July,2016. Miss Rakhi incurred the following expenditure on sending the consignment.
Freight Rs.7,650
Insurance Rs.3,250
Miss Geeta received the delivery of 950 sets. An Account sale dated 26th November 2016 showed that 750 sets were sold for Rs.9,00,000 and Miss Geeta incurred Rs.10,500 for carriage.
Miss Geeta was entitled to commission of 6% on the sales effected by her. She incurred expenses amounting to Rs.2,500 for repairing the damaged radio sets remaining in the inventory.
Miss Rakhi lodged a claim with the insurance company which was admitted at Rs.35,000.
Show the Consignment A/c and Miss Geeta's Account in the books of Miss Rakhi.

Illustration – 3

Vikram Milk Foods Co. Ltd. of Vikrampur sent to Sunder Stores, Sonepuri 5,000 kgs of baby food packed in 2,000 tins of net weight 1 kg and 6,000 packets of net weight 1/2 kg for sale on consignment basis. The consignee's commission was fixed at 5% of sale proceeds. The cost price and selling price of the product were as under

Particulars	**1 Kg. tin**	**½ Kg. packet**
Cost Price	10	6
Selling Price	15	7

The consignment was booked on freight "To Pay" basis, and freight charges came to 2% of selling value. One case containing 50 (1kg. tins) was lost in transit and the transport carrier admitted a claim of Rs. 450.
At the end of the first half-year, the following information is gathered from the "Account Sales" sent by the consignee:

1. Sale proceeds:
   a. 1,500 1Kg. tins
   b. 4,000 ½ Kg. packets
2. Store rent and insurance charges Rs. 600

Find out the value of closing inventory on consignment.
Show the Consignment A/c and the Consignee's A/c in the books of Vikram Milk Food Co. Ltd. assuming that, the consignee had paid the amount due from him.

Illustration - 4

Shri Mehta of Mumbai consigns 1,000 cases of goods costing Rs. 1,000 each to Shri Sundaram of Chennai. Shri Mehta pays the following expenses in connection with consignment:

Particulars	Amount (Rs.)
Carriage	10,000
Freight Charges	30,000
Loading Charges	10,000

Shri Sundaram sells 700 cases at Rs. 1,400 per case and incurs the following expenses:

Particulars	Amount (Rs.)
Clearing Charges	8,500
Warehousing and Storage	17,000
Packing and Selling Expenses	6,000

It is found that 50 cases have been lost in transit and 100 cases are still in transit. Shri Sundaram is entitled to a commission of 10% on gross sales. Draw up the Consignment Account and Sundaram's Account in the books of Shri Mehta.

Illustration – 5

Ajay of Mumbai consigned to Vijay of Delhi, goods to be sold at invoice price which represents 125% of cost. Vijay is entitled to a commission of 10% on sales at invoice price and 25% of any excess realised over invoice price.

1. The expenses on freight and insurance incurred by Ajay were Rs. 10,000.
2. The account sales received by Ajay shows that Vijay has affected sales amounting to Rs. 1,00,000 in respect of 75% of the consignment.
3. His selling expenses to be reimbursed were Rs. 8,000.
4. 10% of consignment goods of the value of Rs. 12,500 were destroyed in fire at the Delhi godown and the insurance company paid Rs. 12,000 net of salvage.
5. Vijay remitted the balance in favour of Ajay.

Prepare consignment account and the account of Vijay in the books of Ajay along with the necessary calculations.

Illustration – 6

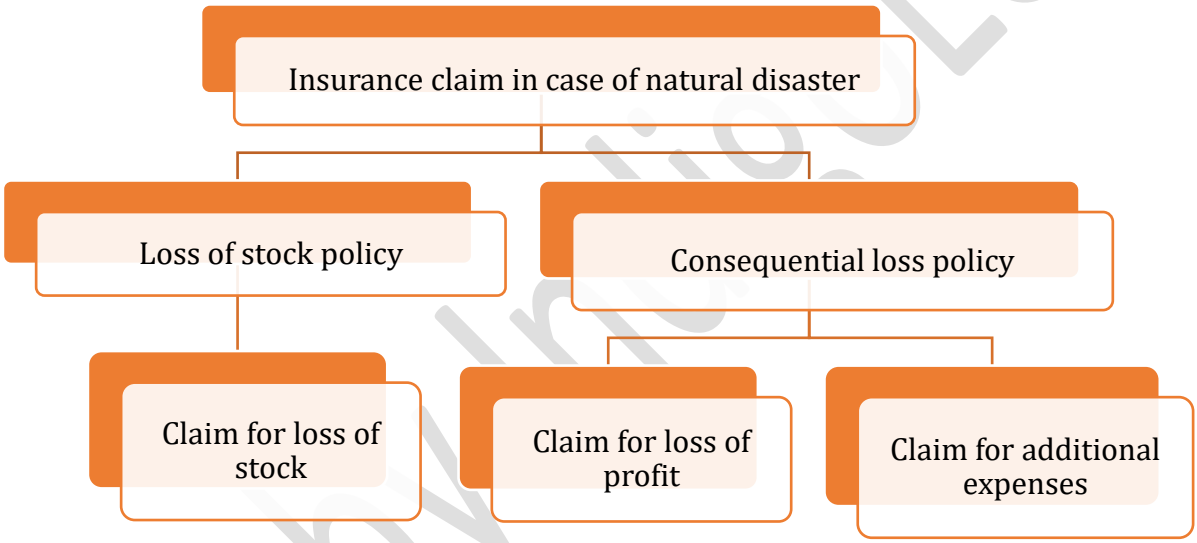
Exe sent on 1st July,2019 to Wye goods costing Rs 50,000 and spent Rs1,000 on packing etc. On 3rd July,2019, Wye received the goods and sent his acceptance to Exe for Rs. 30,000, payable at 3 months. Wye spent Rs 2,000 on freight and cartage, Rs 500 on godown rent and Rs 300 on insurance. On 31st December,2019 he sent his Account Sales (along with the amount due to Exe). Showing that 4/5 of the goods had been sold for Rs55,000. Wye is entitled to a commission of 10%. One of the customers turned insolvent and could not pay Rs. 600 due from him.
Show the necessary journal entries in the books of consignor. Also prepare ledger accounts.

2.4 Insurance Claims For Loss Of Stock And Loss Of Profit

INTRODUCTION

★ Business enterprises get insured against the loss of stock on the happening of certain events such as fire, flood, theft, earthquake etc.

★ Insurance being a contract of indemnity, the claim for loss is restricted to the actual loss of assets. Sometimes an enterprise also gets itself insured against consequential loss of profit due to decreased turnover, increased expenses etc.



MEANING OF FIRE

For purposes of insurance, fire means:

1. Fire (whether resulting from explosion or otherwise) not occasioned or happening through:

(a) Its own spontaneous fomentation or heating or it undergoing any process involving the application of heat;

(b) Earthquake, subterranean fire, riot, civil commotion, war, invasion act of foreign enemy, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, military or usurped power.

2. Lightning

3. Explosion, not occasioned or happening through any of the perils in 1 (a) above

(i) Of boilers used for domestic purposes only;

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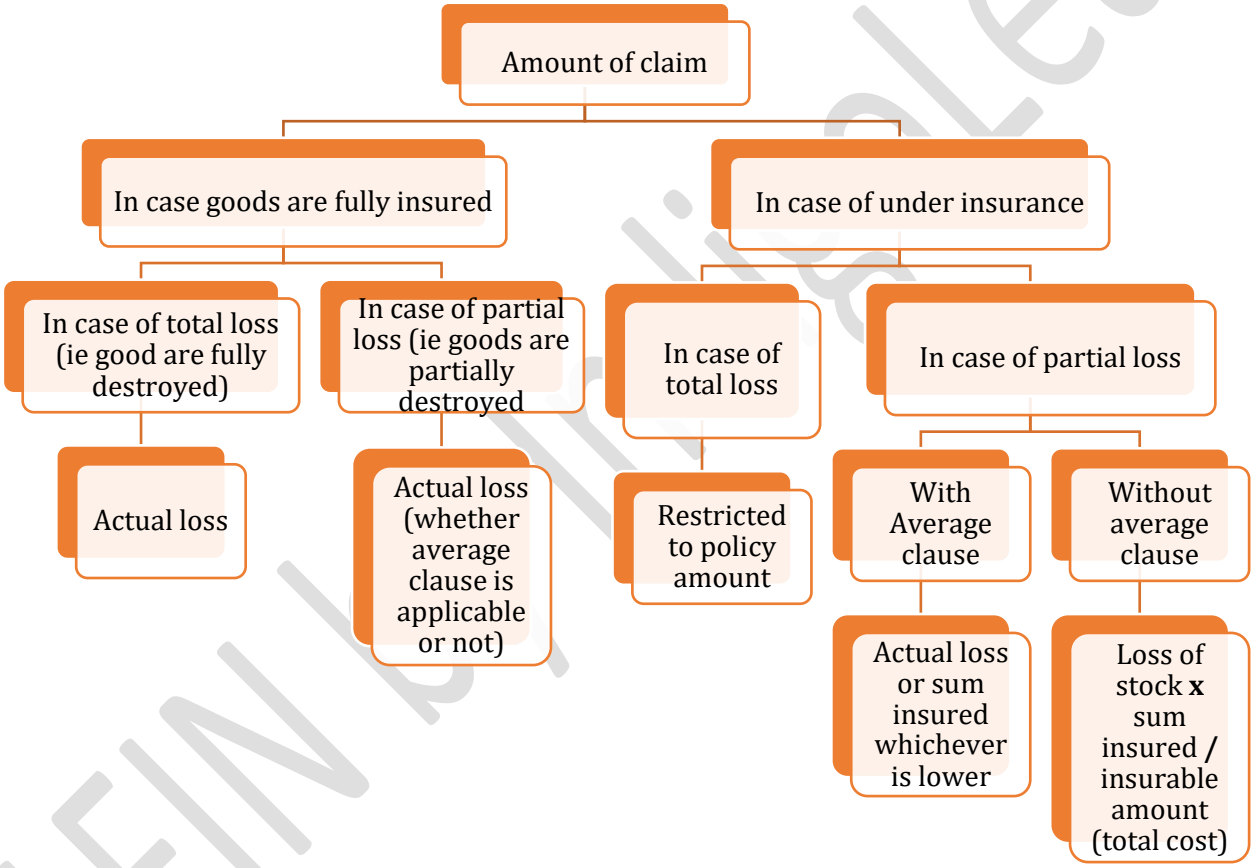
(ii) Of any other boilers or economizers on the premises;

(iii) In a building not being any part of any gas works or gas for domestic purposes or used for lighting or heating the building.

The policy of insurance can be made to cover any of the excepted perils by agreement and payment of extra premium, if any. Damage may also be covered if caused by storm or tempest, flood, escape of water, impact and break down of machinery, etc., again by agreement with the insurer.

CLAIM FOR LOSS OF STOCK



COMPUTING VALUE OF STOCK ON THE DATE OF FIRE

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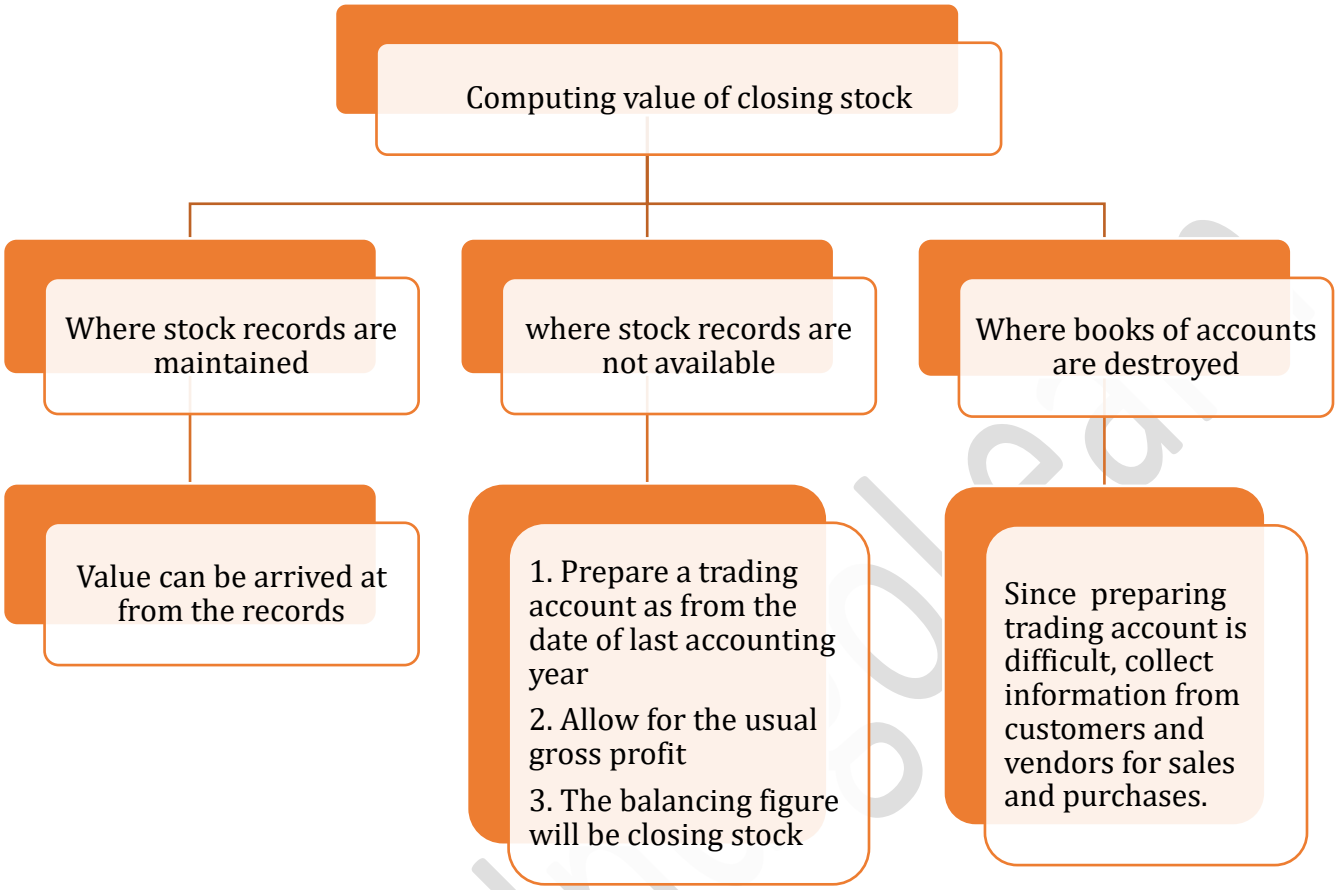


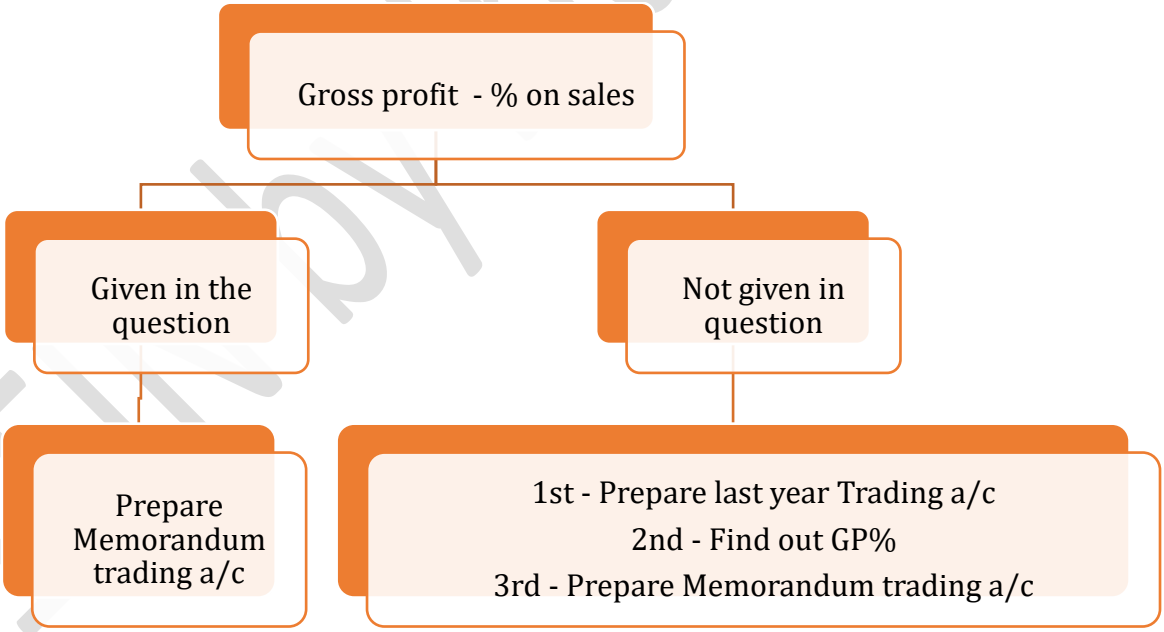
1. In determining the amount of the claim, credit is given for damaged and salvaged stock.
2. Frequently salvaged stock can be made saleable after it is reconditioned. In that case, the cost of such stock must be credited to the Trading Account and debited to a salvaged stock account. The expenses on reconditioning must be debited and the sales credited to this account, the final balance being transferred to the Profit & Loss Account.

Computation of loss of stock

Value of stock on the date of fire	xxx
Less - Value of salvaged stock	xxx
Amount of loss of stock	xxx

Amount transferred to P&L A/c	
Value of Salvages stock	xxx
Add – Expenses on re-conditioning	xxx
Less – sales	xxx
Profit / loss transferred to P&L A/c	xxx

Performa Memorandum trading account					
Date	Particulars	Amount	Date	Particulars	Amount
	Opening stock	Xxx		Sales	xxx
	Purchases	Xxx		Closing stock on date of fire (Balancing Figure)	xxx
	Gross profit	Xxx			
		Xxx			Xxx



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ADJUSTMENTS TO BE MADE IN TRADING ACCOUNT

In the given scenarios, adjustments have to be made to the trading account in order to arrive at the correct gross profit ratio.

1. Undervaluation / overvaluation of closing stock of last year
   Add back or reduce the value of Closing stock.

2. Change in price level of stocks (either +ve or -ve)
   i. If current year price level has changed over last year then 1st adjust every component of current year's Memorandum trading A/c to ensure it is at same pricing level as of last year.
   ii. Apply last year's GP ratio and arrive at the Closing stock
   iii. Adjust the closing stock with the price level change

3. Abnormal stock in the last year -
   i. Abnormal means anything which cannot be sold at normal GP ratio
   ii. If abnormal stock is in Closing stock – subtract the value at realizable price
   iii. If abnormal stock is in sales – subtract the value at selling price Correspondingly
   iv. Remove abnormal stock from opening stock / purchases in the current year – subtract the value at cost price.

CLAIM FOR LOSS OF PROFIT

★ When a fire occurs, apart from the direct loss on account of stock or other assets destroyed, there is also a consequential loss because, for some time, the business is disorganized or has to be discontinued, and during that period, the standing expenses of the business like rent, salaries etc. continue.

★ Moreover, there is loss of profit which the business would have earned during the period. This loss can be insured against by a "Loss of Profit or "Consequential Loss" policy.

★ There must be a separate policy in respect of the consequential loss, but claim will be admitted in respect of the policy only when the claim on account of fire is also admitted under other policies.

★ The Loss of Profit Policy normally covers the following items:
   - Loss of net profit
   - Any increase in the cost of working, e.g., renting of temporary premises etc.

★ A claim for loss of profit cannot arise if the claim for loss of property as a result of the fire is not admitted.

★ To measure the loss suffered by a firm due to fire, it is necessary to setup some standard expressed in such units to represent the volume of work. A comparison between the amount of the standard before and after the fire will give a reliable indication of the

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loss of profit. The most satisfactory unit of measuring profit is turnover.

★ Insurance does not cover electrical installations and the like

DEFINITIONS OF IMPORTANT TERMS

Net Profit - The net trading profit (exclusive of all capital receipts and accretion and all outlay properly chargeable to capital) resulting from the business after due provision has been made for all standing and other charges including depreciation.

Insured Standing Charges – All fixed expenses like Interest on Debentures, Mortgage Loans and Bank Overdrafts, Rent, Rates and Taxes (other than taxes which form part of net profit), Salaries of Permanent Staff and Wages to Skilled Employees, Boarding and Lodging of resident Directors and/or Manager, Directors' Fees, Unspecific Standing Charges [not exceeding 5% of the amount recoverable in respect of Specific Standing Charges].

Insured standing charges may include additional items, by agreement with the insurer.

Rate of Gross Profit - The rate of Gross Profit earned on turnover during the financial year immediately before the date of damage.

Annual Turnover – The turnover during the twelve months immediately before the date of damage.

Indemnity Period - The period beginning with the occurrence of the damage and ending not later than twelve months. i.e... Period after the fire when the business is disrupted cannot exceed 12 months.

Depending upon the nature of business, the indemnity period may extend beyond 12 months (it may be as long as 6 years). Indemnity period shall not be confused with the period of insurance which cannot be more than one year.

The insurance for Loss of Profit is limited to loss of gross profit due to

(i) Reduction in turnover, and

(ii) Increase in the cost of working.

Standard Turnover: The turnover during that period (in the twelve months immediately before the date of damage) which corresponds with the Indemnity Period.

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Standard Should be adjusted for any upward or downward trend

Short sales - Sales that could not be made due to fire

Amount of Indemnity Payable	
Gross Profit Lost	xxx
(+) Claim for increased cost of working Capital	xxx
(-) Saving in Insured standing Charges.	xxx
	xxx

COMPUTATION OF AMOUNT OF CLAIM FOR LOSS OF PROFIT

Step 1 - Reduction in Turnover (Short sales)		
Standard Turnover		xxx
+ / - Adjustment for trend		xxx
(-) Actual turnover during Indemnity period		xxx
Short sales		xxx
GP on short sales		xxx
Step 2 - Additional expenses - Lower of the following		
i. Actual expenses	xx	
ii. GP on sales generated by increase cost of working	xx	
iii. Additional expenses **x** $\frac{\text{GP on adjusted Annual Turnover}}{\text{GP on adjusted Annual Turnover + uninsured standing charges}}$	xx	
		xx

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Step 3 – Reduce savings in additional standing charges	(xx)
Amount of claim before average clause	xxx
Step 4 – Average clause Amount of claim = Amount of claim (per step 3) **x** $\frac{\text{Policy amount}}{\text{GP on Annual Turnover}}$	xxx

Note:

1. Rate of Gross profit (GP) for last year = $\frac{\text{Net proft+Insured standing charges}}{\text{Turnover for last financial year}}$ **x** 100

2. Gross Profit (GP)

   = NP + Insured standing charges **OR**

   = Insured standing charges – [net trading loss (if any) X $\frac{\text{Insured statnding charges}}{\text{Total standing charges}}$

3. Net profit means profit before income tax based on profits.

Illustrations

Illustration - 1

From the following information, ascertain the value of stock as on 31st March, 20X2:

	Rs.

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Stock as on 01-04-20X1	28,500
Purchases	1,52,500
Manufacturing Expenses	30,000
Selling Expenses	12,100
Administration Expenses	6,000
Financial Expenses	4,300
Sales	2,49,000

At the time of valuing stock as on 31st March, 20X1, a sum of Rs. 3,500 was written off on a particular item, which was originally purchased for Rs. 10,000 and was sold during the year for Rs. 9,000. Barring the transaction relating to this item, the gross profit earned during the year was 20% on sales.

Illustration – 2

On 20th October, 20X1, the godown and business premises of Aman Ltd. were affected by fire. From the salvaged accounting records, the following information is available:

	Rs.
Stock of goods @ 10% lower than cost as on 31st March, 20X1	2,16,000
Purchases less returns (1.4.20X1 to 20.10.20X1)	2,80,000
Sales less returns (1.4.20X1 to 20.10.20X1)	6,20,000

Additional information:
(1) Sales up to 20th October, 20X1 includes Rs. 80,000 for which goods had not been dispatched.
(2) Purchases up to 20th October, 20X1 did not include Rs. 40,000 for which purchase invoices had not been received from suppliers, though goods have been received in Godown.
(3) Past records show the gross profit rate of 25%.
(4) The value of goods salvaged from fire Rs. 31,000.
(5) Aman Ltd. has insured their stock for Rs. 1,00,000.

Compute the amount of claim to be lodged to the insurance company.

Illustration – 3

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On 2.6.2019 the stock of Mr. Black was destroyed by fire. However, following particulars were furnished from the records saved:

Particulars	Amount (Rs.)
Stock at cost on 1.4.2018	1,35,000
Stock at 90% of cost on 31.3.2019	1,62,000
Purchases for the year ended 31.3.2019	6,45,000
Sales for the year ended 31.3.2019	9,00,000
Purchases from 1.4.2019 to 2.6.2019	2,25,000
Sales from 1.4.2019 to 2.6.2019	4,80,000

- Sales up to 2.6.2019 includes Rs. 75,000 being the goods not dispatched to the customers. The sales (invoice) price is Rs. 75,000.
- Purchases up to 2.6.2019 includes a machinery acquired for Rs. 15,000.
- Purchases up to 2.6.2019 does not include goods worth Rs. 30,000 received from suppliers, as invoice not received up to the date of fire. These goods have remained in the godown at the time of fire.
- The insurance policy is for Rs. 1,20,000 and it is subject to average clause. Ascertain the amount of claim for loss of stock.

On 12th June, 20X2 fire occurred in the premises of N.R. Patel, a paper merchant. Most of the stocks were destroyed, cost of stock salvaged being Rs. 11,200. In addition, some stock was salvaged in a damaged condition and its value in that condition was agreed at Rs. 10,500. From the books of account, the following particulars were available:

- His stock at the close of account on December 31, 20X1 was valued at Rs. 83,500.
- His purchases from 1-1-20X2 to 12-6-20X2 amounted to Rs. 1,12,000 and his sales during that period amounted to Rs. 1,54,000.
- On the basis of his accounts for the past three years it appears that he earns on an average a gross profit of 30% of sales.
- Patel has insured his stock for Rs. R 60,000. Compute the amount of the claim.

Illustration – 4

On 1st April, 20X2 the stock of Shri Ramesh was destroyed by fire, but sufficient records were saved from which following particulars were ascertained:

Particulars	Amount (Rs.)
Stock at cost-1st January, 20X1	73,500
Stock at cost-31st December, 20X1	79,600
Purchases-year ended 31st December,20X1	3,98,000
Sales-year ended 31st December, 20X1	4,87,000

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Purchases-1-1-201X2 to 31-3-20X2	1,62,000
Sales-1-1-20X2 to 31-3-20X2	2,31,200

- In valuing the stock for the Balance Sheet at 31st December, 20X1 Rs. 2,300 had been written off on certain stock which was a poor selling line having the cost Rs. 6,900.
- A portion of these goods were sold in March, 20X2 at loss of Rs. 250 on original cost of Rs. 3,450. The remainder of this stock was now estimated to be worth its original cost.
- Subject to the above exception, gross profit had remained at a uniform rate throughout the year.
- The value of stock salvaged was Rs. 5,800. The policy was for Rs. 50,000 and was subject to the average clause. Work out the amount of the claim of loss by fire.

Illustration – 5

On 30th March, 20X2 fire occurred in the premises of M/s Suraj Brothers. The concern had taken an insurance policy of Rs. 60,000 which was subject to the average clause. From the books of accounts, the following particulars are available relating to the period 1st January to 30th March 20X2.

Stock as per Balance Sheet at 31st December, 20X1	Rs. 95,600
Purchases (including purchase of machinery costing Rs. 30,000)	Rs. 1,70,000
Wages (including wages Rs. 3,000 for installation of machinery)	Rs. 50,000
Sales (including goods sold on approval basis amounting to Rs. 49,500) No approval has been received in respect of 2/3rd of the goods sold on approval.	Rs. 2,75,000
The average rate of gross profit is 20% of sales.	
The value of the salvaged goods	Rs. 12,300

You are required to compute the amount of the claim to be lodged to the insurance company.

Illustration – 6

A fire occurred on 1st February, 20X2, in the premises of Pioneer Ltd., a retail store and business were partially disorganised up to 30th June, 20X2. The company was insured under a loss of profits for Rs. 1,25,000 with a six months period indemnity.

From the following information, compute the amount of claim under the loss of profit policy assuming entire sales during interrupted period was due to additional expenses.

	Rs.
Actual turnover from 1st February to 30th June, 20X2	80,000
Turnover from 1st February to 30th June, 20X1	2,00,000
Turnover from 1st February, 20X1 to 31st January, 20X2	4,50,000
Net Profit for last financial year	70,000
Insured standing charges for last financial year	56,000
Total standing charges for last financial year	64,000
Turnover for the last financial year	4,20,000

1. The company incurred additional expenses amounting to Rs. 6,700 which reduced the loss in turnover.
2. There was also a saving during the indemnity period of Rs. 2,450 in the insured standing charges as a result of the fire.
3. There had been a considerable increase in trade since the date of the last annual accounts and it has been agreed that an adjustment of 15% be made in respect of the upward trend in turnover.

Illustration - 7

The premises of XY Limited were partially destroyed by fire on 1st March, 20X2 and as a result, the business was practically disorganized upto 31st August, 20X2.
The company is insured under a **loss of profits policy for Rs.1,65,000** having an **indemnity period of 6 months**.
From the following information, prepare a claim under the policy:

		(Rs.)
(i)	Actual turnover during the period of dislocation (1-3-20X2 to 31-8-20X2)	80,000
(ii)	Turnover for the corresponding period (dislocation) in the 12 months immediately before the fire (1-3-20X1 to 31-8-20X1)	2,40,000
(iii)	Turnover for the 12 months immediately preceding the fire (1-3-20X1 to 28-2-20X2)	6,00,000
(iv)	Net profit for the last financial year	90,000
(v)	Insured standing charges for the last financial year	60,000
(vi)	Uninsured standing charges	5,000
(vii)	Turnover for the last financial year	5,00,000

Due to substantial increase in trade, before and up to the time of the fire, it was agreed that an adjustment of 10% should be made in respect of the upward trend in turnover.
The company incurred additional expenses amounting to Rs.9,300 immediately after the fire and but for this expenditure, the turnover during the period of dislocation would have been only Rs.55,000.

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There was also a saving during the indemnity period of Rs.2,700 in insured standing charges as a result of the fire.

Illustration - 8

From the following particulars, you are required to calculate the amount of claim for Buildwell Ltd., whose business premises was partly destroyed by fire:

Sum insured (from 31st December 20X1) Rs. 4,00,000
Period of indemnity 12 months
Date of damage 1st January, 20X2
Date on which disruption of business ceased 31st October, 20X2

The subject matter of the policy was gross profit but only net profit and insured standing charges are included.

The books of account revealed:

(a) The gross profit for the financial year 20X1 was Rs. 3,60,000.

(b) The actual turnover for financial year 20X1 was Rs.12,00,000 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 Rs.10,00,000.

During dislocation of the position, it was learnt that in November-December 20X1, there has been an upward trend in business done (compared with the figure of the previous years) and it was stated that had the loss not occurred, the trading results for 20X2 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 20X2.

The pre-damaged figures together with agreed adjustments were:

Period	Pre-damaged figures	Adjustment to be added	Adjusted standard turnover
	Rs.	Rs.	Rs.
January	90,000	10,000	1,00,000
Feb. to Oct.	9,10,000	50,000	9,60,000
Nov. to Dec.	2,00,000	10,000	2,10,000
	12,00,000	**70,000**	**12,70,000**
Gross Profit	3,60,000	46,400	4,06,400

1. Rate of Gross Profit
   - 30% (actual for 20X1),
   - 32% (adjusted for 20X2).
2. Increased cost of working amounted to Rs.1,80,000.

3. There was a clause in the policy relating to savings in insured standard charges during the indemnity period and this amounted to Rs.28,000.
4. Standing Charges not covered by insurance amounted to Rs.20,000 p.a.
5. The annual turnover for January was nil and for the period February to October 20X2 Rs.8,00,000

Illustration – 9

From the following information compute the consequential loss claim

Turnover	Rs.2,00,000
Indemnity Period	6 months
Period of interruption	1st Jul to 31st Oct
Net Profit	Rs.18,000
Standing Charges	Rs.42,000 (includes Rs.10,000 which has not been insured)
Sum assured	Rs.50,000
Standard Turnover	Rs. 65,000
Turnover in the period of interruption (Rs. 6,000 rent @ Rs.600 per month)	Rs. 25,000
Annual Turnover	Rs.2,40,000
Savings in insured standing charges	Rs.4,725 p.a

It was agreed between the insurer and insured that the business trends would lead to an increase of 10% in the turnover.
Compute the consequential claim of loss of profit.
Important Note: Calculate additional cost of working by considering gross profit on last financial year's turnover instead of adjusted annual turnover.

Illustration – 10

Sony Ltd.'s. Trading and profit and loss account for the year ended 31st December 20X1 were as follows:

Trading and Profit and Loss Account for the year ended 31.12.20X1

		Rs.			Rs.
To	Opening stock	20,000	By	Sales	10,00,000
To	Purchases	6,50,000	By	Closing stock	90,000
To	Manufacturing expenses	1,70,000			
To	Gross profit	2,50,000			
		10,90,000			**10,90,000**
To	Administrative expenses	80,000	By	Gross profit	2,50,000

To	Selling expenses	20,000			
To	Finance charges	1,00,000			
To	Net profit	50,000			
		2,50,000			**2,50,000**

The company had taken out a fire policy for Rs. 3,00,000 and a loss of profits policy for Rs.1,00,000 having an indemnity period of 6 months. A fire occurred on 1.4.20X2 at the premises and the entire stock were gutted with nil salvage value. The net quarter sales i.e. 1.4.20X2 to 30.6.20X2 was severely affected.

The following are the other information:

Particulars	Period	Rs.
Sales during the period	1.1.X2 to 31.3.X2	2,50,000
Purchases during the period	1.1.X2 to 31.3.X2	3,00,000
Manufacturing expenses	1.1.X2 to 31.3.X2	70,000
Sales during the period	1.4.X2 to 30.6.X2	87,500
Standing charges insured		50,000
Actual expense incurred after fire		60,000

The general trend of the industry shows an increase of sales by 15% and decrease in GP by 5% due to increased cost.
Ascertain the claim for stock and loss of profit.

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Study Note 3 | Preparation of Financial Statements of Profit Oriented Organizations

Financial Accounts of Non-Manufacturing Entities

What is a Non-Manufacturing Entity?
Non-manufacturing entity is the entity, which is engaged in the purchase and sale of goods at profit without processing of those goods. Non-manufacturing entities sell the goods in its original form.

To ascertain the results of the business the entity prepares the income statement i.e. the Profit & Loss Statement and financial position i.e. Balance Sheet at the end of the accounting year.

Important Principles to be followed in preparation of Final Accounts:

The important principles to be followed in the preparation of the Final Accounts are as follow:

i. Distinction should be made between capital and revenue receipts and payments.

ii. Only the Income earned, and Expense incurred in the current accounting period should be accounted for in the current accounting period.

iii. All the different items of income and expenditure should be accumulated under major heads of income and expense to disclose the sources from which capital has been raised and the liabilities, which are outstanding for payment.

iv. Distinction between Personal and Business Income should be maintained.

v. All material information needs to be disclosed which can impact the decision of the users.

Matching Principle:

As per this principle the expenses incurred to earn the revenue should be properly matched in the same accounting period. The following point's needs to be taken care while recording the revenue and expense for the current period:

i. If an item of revenue or income is recorded in the Trading or Profit and Loss Account then all the expenses relating to those revenue or income needs to be recorded in the same period Trading and Profit & Loss Account irrespective of the fact whether or not payment has been actually made.

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ii. If some expense has been incurred but the revenue for it will be received in the next year, the expense should be carried forward as an asset and shown in the Balance Sheet.
It will be debited to the Profit and Loss Account only when the relevant income will also be credited. This is the same logic based on which the depreciation on assets is charged.

iii. In the similar manner if some income has been received but the expense for the same will be incurred in the next year, the income should be recorded as liability and shown in the Balance Sheet.
It will be credited to the Profit and Loss Account only when the relevant expense is debited.

iv. Exception to the above rule is that costs which have been incurred or is expected to be incurred should only be debited to Profit and Loss Account. For example, if a fire has occurred and has damaged the firm's property the loss must be debited to the Profit and Loss Account to the extent it is not covered by insurance.

Trading Account:
Trading Account enables to compute the Gross Profit or Gross Loss occurred due to carrying out the business operations during the accounting period.

Gross Profit/Gross Loss is computed as the difference between the selling price and the Cost of Goods Sold. The Cost of Goods sold is computed using the following formula:

	Opening Stock
Add:	**Purchases**
Add:	**Direct Expenses**
Less:	**Closing Stock**
	Cost of Goods Sold

Format of Trading Account:

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Dr.	Trading Account for the year ended…….				Cr.
	Amount	Amount		Amount	Amount
To Opening Stock		XXX	By Sales	XXX	
To Purchases	XXX		Less: Sales Return	(XXX)	XXX
Less: Purchase Return	(XXX)	XXX			
			By Closing Stock		XXX
To Direct Expenses			By Gross Loss c/d (Either profit or loss)		
Freight & Carriage	XXX				
Insurance	XXX				
Wages	XXX				
Fuel	XXX				
Factory Expense	XXX				
Depreciation on Factory Equip	XXX	XXX			
By Gross Profit c/d (Either profit or loss)					
TOTAL		**XXX**	**TOTAL**		**XXX**

Accounting Entries related to Trading Account:

1. **Opening Inventory:**
   Trading A/c Dr.
   To Opening Stock

2. **Purchases:**
   Purchase A/c Dr.
   To Vendor/Cash A/c

   Trading A/c Dr.
   To Purchases

3. **Purchase Return:**
   Purchase Return A/c Dr.
   To Purchases

4. **Carriage, Freight Inwards:**
   Trading A/c Dr.
   To Carriage, Freight Inwards A/c

5. **Wages:**
   Trading A/c Dr.
   To Wages A/c

6. **Sales:**
   Debtors/Cash A/c Dr.

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To Trading A/c

Sales A/c Dr.
To Trading A/c

7. **Sales Return:**
   Trading A/c Dr.
   To Sales Return A/c

8. **Closing Inventory:**
   Closing Inventory A/c Dr.
   To Trading A/c

Note:
If Closing Stock appears in the Trial balance then the closing inventory is not recorded in the trading account, it is directly presented in the balance sheet.
This is due to the fact that the entry has already been recorded to arrive at Cost of Goods Sold.

As per the valuation principle closing inventory is recorded at cost or net realisable value whichever is less.

Profit & Loss Account:
Trading Account enables to determine the gross profit or loss derived from carrying out the trading activities in which the organization is engaged in.

All the expenses which have not been recorded in the trading account form a part of the Profit & Loss Account. All the income and gains except for sales form a part of the Profit & Loss Account.

Format of Profit & Loss Account:

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Dr.	Profit & Loss Account for the year ended.....				Cr.
	Amount	Amount		Amount	Amount
To Gross Loss b/d			**By Gross Profi t b/d**		
Management expenses			**Other Income**		
To Salaries (administrative)			By Discount Received		
To Offi ce rent, rates and taxes			By Commission Received		
To Printing and stationery					
To Telephone charges			**Non-trading Income**		
To Postage and telegrams			By Bank Interest		
To Insurance			By Rent of property let-out		
To Audit Fees			By Dividend from shares		
To Legal Charges					
To Electricity Charges			**Abnormal Gains**		
			By Profi t on sale of machinery		
Maintenance expenses			By Profi t on sale of investment		
To Repairs & renewals					
To Depreciation on:			**By Net Loss (transferred to capital A/c)**		
Office Equipment					
Office Furniture					
Office Buildings					
Selling and Distribution expenses					
To Salaries (selling staff)					
To Advertisement					
To Godown rent					
To Carriage Outward					
To Bad Debts					
To Provision for bad debts					
To Selling commission					
Financial expenses					
To Bank charges					
To Interest on loans					
To Discount on bills					
To discount allowed to customers					
Abnormal Losses					
To Loss on sale of machinery					
To Loss on sale of investment					
To loss by fi re					
To Net Profit (transferred to Capital A/c)					
TOTAL		XXX	**TOTAL**		XXX

Accounting Entries related to Profit & Loss Account:

1. **Drawings:**
   Capital A/c Dr.
   To Drawings

2. **Income Tax**
   Capital A/c Dr.
   To Income Tax A/c

3. **Discount received**
   Profit/Loss A/c Dr.
   To Discount Allowed A/c

4. **Discount allowed**
   Discount Received A/c Dr.
   To Profit/Loss A/c

5. **Bad Debts**
   Bad Debts Account Dr.
   To Debtor's Account

   Profit/Loss Account Dr.
   To Bad Debts A/c

   In case of Provision for Bad Debts is prepared then the bad debts are first recorded against the provision

   Bad Debts Account Dr.
   To Debtor's Account

   Provision for Bad Debts A/c Dr.
   To Bad Debts A/c

6. **Bad Debts Recovery**

   Bad Debts Recovered Account Dr.
   To Profit/Loss Account

Closing Entries
The journal entries that are made for transferring various account to the trading and Profit & Loss Account are known as Closing Entries.

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1. **For expenses to be recorded to Profit & Loss Account.**

   Profit and Loss Account Dr.
   To Salaries Account
   To Rent Account
   To Interest Account
   To Other Expenses Account

2. **For revenues and gains to be recorded to Profit & Loss Account.**

   Discount Received Account Dr.
   Bad debts Recovered Account Dr.
   To Profit and Loss Account

3. **Net Profit or Loss transferred to Capital Account**

   Net Profit
   Profit and Loss Account Dr.
   To Capital Account

   Net Loss
   Capital Account Dr.
   To Profit and Loss Account

Other Adjustments and their treatment:

1. **Abnormal loss of Inventory by accident or fire**

   Loss by Fire Account Dr.
   To Purchases/Trading Account

   Claim received from Insurance Company
   Profit & Loss A/c Dr.
   To Loss by Fire A/c

2. **Goods sent on Approval basis**

   Sales A/c Dr.
   To Trade receivables A/c

   Sale on approval A/c Dr.
   To Trading A/c

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3. **Goods used other than for sale**

When goods are given away as donation
` Donation A/c Dr.
To Purchases A/c

When goods are used by the proprietor for his personal use
Drawings A/c Dr.
To Purchases A/c

When goods are distributed as free samples: -
Advertisement A/c Dr.
To Purchases A/c

When goods are used in business for construction of Fixed Asset: -
Fixed Asset A/c Dr.
To Purchases A/c

When goods are used for maintenance of Fixed Asset: -
Repair & Maintenance A/c Dr.
To Purchases A/c

4. **Commission based on profit**

Sometimes organizations offer the Managers and high-level authorities a part of profit via commission as a part of their compensation. The computation involved in the computation of these commission and the journal entries to record the same are as stated below.

Commission based on Net Profit before charging such commission:

$$\text{Commission} = \text{Profit before commission} \times \frac{\text{Rate of Commission}}{100}$$

Commission based on Net Profit after charging such commission:

$$\text{Commission} = \text{Profit before commission} \times \frac{\text{Rate of Commission}}{100 + \text{Rate of Commission}}$$

Recording Commission in the Books of Accounts:

Commission A/c Dr.
To Commission Payable A/c

Profit/Loss Account Dr.
To Commission A/c

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Example:

The following is the Trial Balance of ABC Co. on 31st Dec. 2018. Prepare the Trading and Profit & Loss Account from the Trial Balance after passing the closing entries.

Particulars	Debit Rs.	Credit Rs.
Capital		1,500,000
Inventory	357,500	
Cash	55,000	
Machinery	800,000	
Purchases	800,000	
Wages	250,000	
Salaries	175,000	
Discount Received		10,000
Discount Allowed	7,500	
Office Expense	15,000	
Sales		1,000,000
Debtors	500,000	
Creditors		450,000
TOTAL	**2,960,000**	**2,960,000**

Value of Closing Inventory on December 31, 2017 was Rs.625000/-

Date	Particulars		Debit	Credit
Dec-31	Trading A/c	Dr.	1,407,500	
	To Inventory A/c			357,500
	To Purchases A/c			800,000
	To Wages A/c			250,000
	(Being balances appearing in trial balance transferred to trading account)			
Dec-31	Sales A/c	Dr.	1,000,000	
	To Trading A/c			1,000,000
	(Being Sales balance transferred to trading account)			
Dec-31	Closing Inventory A/c	Dr.	625,000	
	To Trading A/c			625,000
	(Being Closing Inventory recorded)			
Dec-31	Trading A/c	Dr.	217,500	
	To Profit & Loss A/c			217,500
	(Being gross profit transferred to Profit & Loss Account)			

Dec-31	Profit & Loss A/c	Dr.	197,500	
	To Salaries A/c			175,000
	To Discount Allowed A/c			7,500
	To Office Expenses A/c			15,000
	(Being expenses appearing in trial balance transferred to P&L account)			
Dec-31	Discount Received A/c	Dr.	10,000	
	To Profit & Loss A/c			10,000
	(Being expenses appearing in trial balance transferred to P&L account)			
Dec-31	Profit & Loss A/c		30,000	
	To Capital A/c			30,000
	(Being Profit & Loss Account Balance transferred to Capital)			

Dr.	Trading Account for the year ended December 31, 2018				Cr.
	Amount	Amount		Amount	Amount
To Opening Stock		357,500	By Sales		1,000,000
To Purchases		800,000	By Closing Stock		625,000
To Wages		250,000			
To Gross Profit c/d		217,500			
TOTAL		1,625,000	TOTAL		1,625,000

Dr.	Profit & Loss Account for the year ended December 31, 2018				Cr.
	Amount	Amount		Amount	Amount
To Salaries		175,000	By Gross Profit b/d		217,500
To Discount Allowed		7,500	By Discount Received		10,000
To Office Expenses		15,000			
To Net Profit (Transferred to Capital A/c)		30,000			
TOTAL		227,500	TOTAL		227,500

Balance Sheet:
Balance Sheet is the statement which presents an organization Assets and Liabilities position on a particular date.

Important points with regard to Balance Sheet:

1. It is valid only for a particular date and not later. For Example, if the closing inventory for December 31, 2018 was valued at Rs.1,00,000/- and the entity purchased inventory worth Rs,50,000 on 1st January 2019 the Balance Sheet on 1st January 2019 would be different as compared to 31st December 2018.

2. Balance sheet is prepared only after the preparation of the Profit and Loss Account.

Format of Balance Sheet:

	Balance Sheet as at				
Liabilities	Amount	Amount	Assets	Amount	Amount
Capital A/c			Tangible Fixed Assets		
Opening Balance	XXX		Land and Building	XXX	
Add : Net Profi t/Less: Net Loss	XXX		Plant and Machinery	XXX	
Less : Drawings	(XXX)	XXX	Furniture and Fixture	XXX	
			Vehicles	XXX	XXX
Long Term Loans					
Term Loans	XXX		Intangibles		
Other Loans	XXX	XXX	Goodwill	XXX	
			Patent Rights	XXX	
Short Term Loans			Designs and Brand Names	XXX	XXX
Cash Credit	XXX				
Overdrafts	XXX		Investments		
Other Loans	XXX	XXX	Long term investments	XXX	XXX
Current Liabilities			Current Assets		
Trade payables	XXX		Inventory in Trade	XXX	
Outstanding Expenses	XXX		Trade receivables	XXX	
Advances Taken	XXX	XXX	Short term investments	XXX	
			Prepayments	XXX	
Provision			Advances	XXX	
Provision for Bad debts	XXX		Bank Balances	XXX	XXX
Provision for Retirement Benefits	XXX	XXX			
TOTAL		XXXX	TOTAL		XXXX

CLASSIFICATION OF ASSETS AND LIABILITIES

Assets are classified into the following categories:

1. **Current Assets**
   These are the assets which are meant to be used or converted into cash as within the next operating cycle or one year whichever is longer.
   For Eg: Cash, Bank, Debtors, Closing stock, etc.

2. **Long Term Assets:** -

These are the assets which are meant for long term usage and are expected to last for more than a year or the accounting cycle whichever is longer.
Long Term Assets are classified as Intangible Assets or Tangible Assets.

Intangible Assets are those Assets which have no physical existence i.e. which cannot be touched, felt or seen. For Eg, Patents, Copyrights, etc.

Tangible Assets are those assets which have their physical existence and can be identified. For Eg, Furniture, Equipments, Machinery, etc.

Liabilities can be classified into the following categories:

1. **Current Liabilities**:
   These are the liabilities which must be settled or paid within in one year or operating cycle whichever is higher. Current Liabilities are also known as Short Term Liabilities. For Eg, Creditors, Bills Payable etc.

2. **Long Term Liabilities**:
   These are the liabilities which are to be paid or settled at least after a year or the operating cycle whichever is longer. For Eg, Long term loans, Borrowings, etc.

Example:
The following is the Trial Balance of ABC Co. on 31st Dec. 2018. Prepare the Balance Sheet.

Particulars	Debit Balance	Credit Balance
Capital A/C		1,235,000
Machinery	100,000	
Long Term Loan		50,000
Creditors		24,000
Debtors	40,000	
Cash	5,000	
Closing Stock	15,000	
Building	1,500,000	
Short Term Borrowings		175,000
Advances to Suppliers	55,000	
Profit for Current year		256,000
Drawings	25,000	
TOTAL	1,740,000	1,740,000

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	Balance Sheet as at 31st December 2018				
Liabilities	**Amount**	**Amount**	**Assets**	**Amount**	**Amount**
Capital	1,235,000		Machinery		100,000
Add: Profit	256,000		Building		1,500,000
Less: Drawings	(25,000)	1,466,000			
			Debtors		40,000
Long Term Loan		50,000	Cash		5,000
			Closing Stock		15,000
Creditors		24,000	Advance to Suppliers		55,000
Short Term Borrowings		175,000			
TOTAL		**1,715,000**	**TOTAL**		**1,715,000**

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Questions:

Question 1:
The following is the Trial Balance of ABC Co. on 31st Dec. 2018. Prepare the Trading and Profit & Loss Account from the Trial Balance after passing the closing entries.

Particulars	Debit Rs.	Credit Rs.
Capital		1,381,500
Inventory	256,500	
Cash	49,000	
Machinery	550,000	
Purchases	851,000	
Wages	355,000	
Salaries	475,000	
Discount Received		25,000
Discount Allowed	20,000	
Office Expense	150,000	
Sales		1,355,000
Debtors	400,000	
Creditors		345,000
TOTAL	**3,106,500**	**3,106,500**

Value of Closing Inventory on December 31, 2017 was Rs.89500/-

Question 2:
The following is the Trial Balance of ABC Co. on 31st Dec. 2018. Prepare the Balance Sheet.

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Particulars	Debit Rs.	Credit Rs.
Capital A/C	-	2,470,000
Machinery	200,000	-
Long Term Loan	-	100,000
Creditors	-	48,000
Debtors	80,000	-
Cash	10,000	-
Closing Stock	30,000	-
Building	3,000,000	-
Short Term Borrowings	-	350,000
Advances to Suppliers	110,000	-
Profit for Current year	-	512,000
Drawings	50,000	-
TOTAL	**3,480,000**	**3,480,000**

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Illustrations

Illustration -1

Trial Balance for financial the year (FY) ended 31st March 2017 of M/s Deepakshi shows following details:

Particulars	Debit (Rs.)	Credit (Rs.)
Purchases and sales	10,00,000	12,00,000
Debtors and Creditors	5,00,000	4,00,000
Opening Stock	2,00,000	
Closing Stock	3,00,000	
Other Expenses and Incomes	7,00,000	9,00,000
Fixed Assets and Long-term Liabilities	25,00,000	6,00,000
Capital		21,00,000
Total	**52,00,000**	**52,00,000**

Additional Information:

- Creditors balance as on 1st April 2016 is Rs. 3,00,000.
- You are required to calculate cost of goods sold and amount paid to creditors during the year.

Illustration - 2

Particulars	Amount (Rs.)
Opening Inventory	1,00,000
Purchases	6,72,000
Carriage Inwards	30,000
Wages	50,000
Sales	11,00,000
Returns inward	1,00,000
Returns outward	72,000
Closing Inventory	2,00,000

From the above information, prepare a Trading Account of M/s. ABC Traders for the year ended 31st March 2017 and Pass necessary closing entries in the journal proper of M/s. ABC Traders.

Illustration - 3

Revenue, Expenses and Gross Profit Balances of M/s ABC Traders for the year ended on 31st March 2016 were as follows:

Particulars	Amount (Rs.)
Gross Profit	4,20,000
Salaries	1,10,000
Discount (Cr.)	18,000
Discount (Dr.)	19,000

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Bad Debts	17,000
Depreciation	65,000
Legal Charges	25,000
Consultancy Fees	32,000
Audit Fees	1,000
Electricity Charges	17,000
Telephone, Postage and Telegrams	12,000
Stationery	27,000
Interest paid on Loans	70,000

Prepare Profit and Loss Account of M/s ABC Traders for the year ended on 31st March. Show necessary closing entries in the Journal Proper of M/s. ABC Traders also.

Illustration – 4

On 1st Jan. 2017 provision for Doubtful Debts existed at Rs. 40,000. Trade receivables on 31.12.2017 were Rs. 15,00,000. Bad debts totalled Rs. 1,00,000. It is required to write off the bad debts and create a provision equal to 5% of the Trade receivable's balance.

Illustration – 5

The following is the Trial Balance of C. Wanchoo on 31st Dec. 2017

Trial Balance on 31st December

Particulars	**Amount (Rs.)**	**Amount (Rs.)**
Capital Account		10,00,000
Inventory Account	2,00,000	
Cash in hand	1,44,000	
Machinery A/c	7,36,000	
Purchases A/c	18,20,000	
Wages A/c	10,00,000	
Salaries A/c	10,00,000	
Discount Allowed A/c	50,000	
Discount Received A/c		30,000
Sundry Office Expenses A/c	6,00,000	
Sales A/c		50,00,000
Sums owing by customer (Trade receivables)	8,50,000	
Trade payables (sums owing to suppliers)		3,70,000
Total	64,00,000	64,00,000

Value of Closing Inventory on 31st Dec. 2017 was Rs. 2,70,000

Prepare Trading and Profit and Loss Account.

Illustration – 6

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The balance sheet of Thapar on 1st January 2017 was as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Trade Payables	15,00,000	Plant and Machinery	30,00,000
Expenses Payable	1,50,000	Furniture and Fixture	3,00,000
Capital	50,00,000	Trade receivables	14,00,000
		Cash at Bank	6,50,000
		Inventories	13,00,000
Total	66,50,000	Total	66,50,000

During 2017, his Profit and Loss Account revealed a net profit of Rs. 15,30,000. This was after allowing for the following:
(a) Interest on capital @ 6% p.a.
(b) Depreciation on Plant and Machinery @ 10% and on Furniture and Fixtures @ 5%
(c) A provision for Doubtful Debts @ 5% of the trade receivables as at 31st December 2017
But while preparing the Profit and Loss Account he had forgotten to provide for
(1) Outstanding expenses totalling Rs. 1,80,000
(2) Prepaid insurance to the extent of Rs. 20,000
His current assets and liabilities on 31st December 2017 were:

a. Inventories Rs. 14,50,000
b. Trade receivables Rs. 20,00,000
c. Cash at Bank Rs. 10,35,000
d. Trade payables Rs. 11,40,000

During the year he withdrew Rs. 6,00,000 for domestic use.
Draw up his Balance Sheet at the end of the year.

Illustration – 7

Balance Sheet as at 31st December 2017

Capital and Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Mahindra & Sons	5,60,000	Cash in Hand	43,000
Capital	20,00,000	Cash at Bank	2,67,500
		Trade Receivables	7,49,500
		Closing Inventory	9,00,000
		Machinery and Equipment	6,00,000
Total	25,60,000	Total	25,60,000

From the above given balance sheet prepare the relevant opening entry.

Illustration – 8

Shri Mittal gives you the following Trial Balance and some other information

Trial Balances as on 31st March 2017

Particulars	Amount (Rs.) Dr.	Amount (Rs.) Cr.

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Capital		8,70,000
Purchases and Sales	6,05,000	12,10,000
Opening Inventory	72,000	
Trade receivables and Trade payables	90,000	1,70,000
14% Bank Loan (loan taken at year end)		2,00,000
Overdrafts (overdraft taken at year end)		1,12,000
Salaries	2,70,000	
Advertisements	1,10,000	
Other expenses	60,000	
Returns	40,000	30,000
Furniture	4,50,000	
Building	8,90,000	
Cash in Hand	5,000	
Total	25,92,000	25,92,000

Closing Inventory on 31st March 2017 was valued at Rs. 1,00,000.
Prepare final accounts of Shri Mittal for the year ended 31st March 2017.

Illustration - 9

Mr. Mohan gives you the following trial balance and some other information

Particulars	**Amount (Rs.)**	**Amount (Rs.)**
Capital		6,50,000
Sales		9,70,000
Purchases	4,30,000	
Opening Inventory	1,10,000	
Freight Inward	40,000	
Salaries	2,10,000	
Other Administrative Expenses	1,50,000	
Furniture	3,50,000	
Trade receivables and Trade Payables	2,10,000	1,90,000
Returns	20,000	12,000
Discounts	19,000	9,000
Bad debts	5,000	
Investments in Government Securities	1,00,000	
Cash in Hand and cash at Bank	1,87,000	
Total	18,31,000	18,31,000

Other Information:
(i) Closing Inventory was Rs. 1,80,000
(ii) Depreciate Furniture @ 10% p.a

1. Prepare Trading and Profit and Loss Account for the year ended on 31.3.2017. Balance Sheet of Mr. Mohan as on that date.

Illustration - 10

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The Balance Sheet of Mr. Popatlal, a merchant on 31st March,2017 stood as below

Capital and Liabilities	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital	2,40,000	Fixed Assets		1,25,600
Trade payables	1,64,000	Inventories		2,06,400
Bank Overdraft		Trade Receivables		
	1,46,000	**Less**	1,88,000	
		Provision		
			6,200	
		Cash		1,81,800
				36,200
Total	5,50,000	Total		5,50,000

Show opening journal entry on 1st April,2017 in the books of Mr. Popatlal.

Illustration - 11

The following is the schedule of balances as on 31.3.17 extracted from the books of Shri Gavaskar, who carries on business under the same name and style of Messrs Gavaskar Viswanath & Co., at Bombay

Particulars	Amount (Rs.) Dr.	Amount (Rs.) Cr.
Cash in Hand	14,000	
Cash at Bank	26,000	
Sundry Debtors	8,60,000	
Stock on 01.04.2016	6,20,000	
Furniture & fixtures	2,14,000	
Office equipment	1,60,000	
Buildings	6,00,000	
Motor Car	2,00,000	
Sundry Creditors		4,30,000
Loan from Viswanath		3,00,000
Provision for bad debts		30,000
Purchases	14,00,000	
Purchase Returns		26,000
Sales		23,00,000
Sales Returns	42,000	
Salaries	1,10,000	
Rent for Go down	55,000	
Interest on loan from Vishwanath	27,000	
Rates & Taxes	21,000	
Discount allowed to Debtors	24,000	
Discount Received from creditors		16,000
Freight on purchases	12,000	
Carriage Outwards	20,000	
Drawings	1,20,000	
Printing and Stationery	18,000	

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Electricity Charges	22,000	
Insurance Premium	55,000	
General office expenses	30,000	
Bad debts	20,000	
Bank Charges	16,000	
Motor car expenses	36,000	
Capital a/c		16,20,000
Total	47,22,000	47,22,000

Prepare Trading and Profit and Loss Account for the year ended 31st March 2017 and the Balance Sheet as at that date after making provision for the following:

I. Depreciate:
   (a) Building used for business by 5 %
   (b) Furniture and fixtures by 10 %:
   One steel table purchased during the year for Rs. 14,000 was sold for same price but the sale proceeds were wrongly credited to Sales Account
   (c) Office equipment by 15 %:
   Purchase of a typewriter during the year for Rs. 40,000 has been wrongly debited to purchase
   (d) Motor car by 20%

II. Value of stock at the close of the year was Rs. 4,40,000

III. Two month's rent for Go down is outstanding

IV. Interest on loan from Viswanath is payable at 12 % per annum, this loan was taken on 01.05.2016

V. Reserve for bad debts is to be maintained at 5 % of Sundry Debtors

VI. Insurance premium includes Rs. 40,000 paid towards proprietor's life insurance policy and the balance of the insurance charges cover the period from 01.04.2016 to 30.06.2017.

Illustration - 12

Crimpson Ltd.'s profit and loss account for the year ended 31st March 2016 includes the following information

Particulars	**Amt (Rs.)**
(i) Depreciation	57,500
(ii) Bad debts written off	21,000
(iii) Increase in provision for doubtful debts	18,000
(iv) Proposed dividend	15,000
(v) Retained profit for the year	20,000
(vi) Liability for tax	4,000

Required:

State which one of the items (i) to (vi) above are –

(a) transfer to provisions;

(b) transfer to reserves; and

(c) neither related to provisions nor reserves.

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Illustrations related to Final accounts of Manufacturing entities

Illustration - 1

1,00,000 units were produced in a factory Per unit material cost was Rs.10 and per unit labour cost was Rs.5. That apart it was agreed to pay royalty @ Rs.3 per unit to the Japanese collaborator who supplied technology.
Required: Calculate Manufacturing Cost.

Illustration - 2

Mr. Vimal runs a factory which produces soaps. Following details were available in respect of his manufacturing activities for year ended on
31.03.2016.

Particulars	**Amt. (Rs.)**
Opening Work-in-Process (10,000 units)	16,000
Closing Work-in-Process (12,000 units)	20,000
Opening inventory of Raw Materials	1,70,000
Closing inventory of Raw Materials	1,90,000
Purchases	8,20,000
Hire charges of machine @ Rs. 0.60 per unit manufactured	
Hire charges of factory	2,20,000
Direct wages-Contracted @ Rs.0.80 per unit manufactured and @ Rs.0.40 per unit of	
Closing W.I.P.	
Repairs and Maintenance	1,80,000
Units produced – 5,00,000 units	

Prepare a Manufacturing Account of Mr. Vimal for the year ended 31.3.2016.

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Study Note 4 | Preparation of Statements of Incomplete Records

INTRODUCTION

★ Very often small sole proprietorship and partnership businesses do not maintain double entry book keeping system. Sometimes they keep record of the cash transactions and credit transactions only. But at the end of the accounting period they want to know the performance and financial position of their businesses. So, it become imperative to complete the accounts from available incomplete records.

★ Accounts from incomplete records is also popularly known as 'Single entry system'. Under this system the task of the accountant is to establish linkage among the available information and to finalize the accounts

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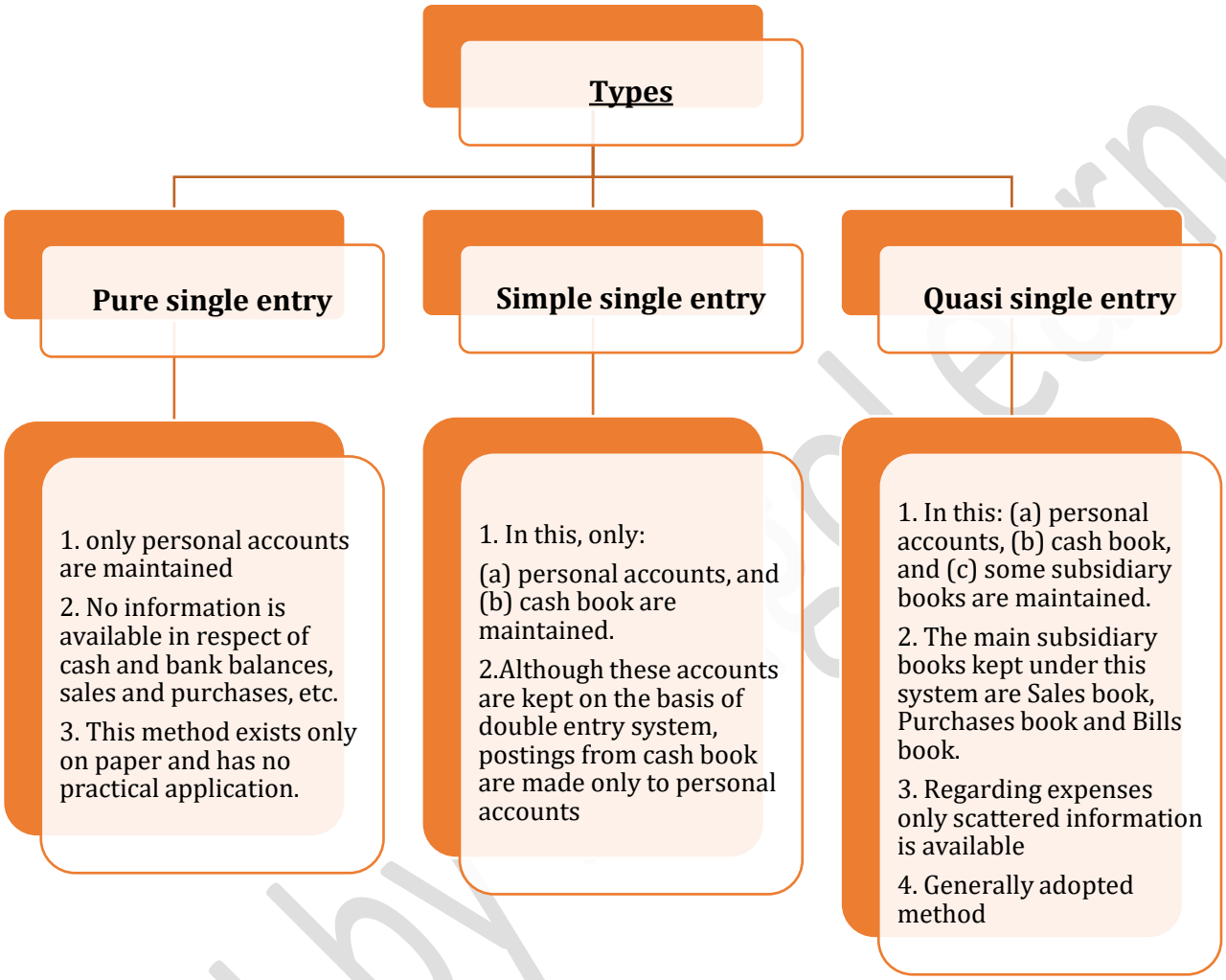
TYPES OF SINGLE-ENTRY SYSTEM



FEATURES OF SINGLE-ENTRY SYSTEM

- ★ It is an inaccurate, unscientific and unsystematic method of recording business transactions.
- ★ There is generally no record of real and personal accounts and, in most of the cases; a record is kept for cash transactions and personal accounts.
- ★ Cash book mixes up business and personal transactions of the owners.
- ★ There is no uniformity in maintaining the records and the system may differ from firm to firm depending on the requirements and convenience of each firm.
- ★ Profit under this system is only an estimate based on available information and therefore true and correct profits cannot be determined. The same is the case with the financial position in the absence of a proper balance sheet.

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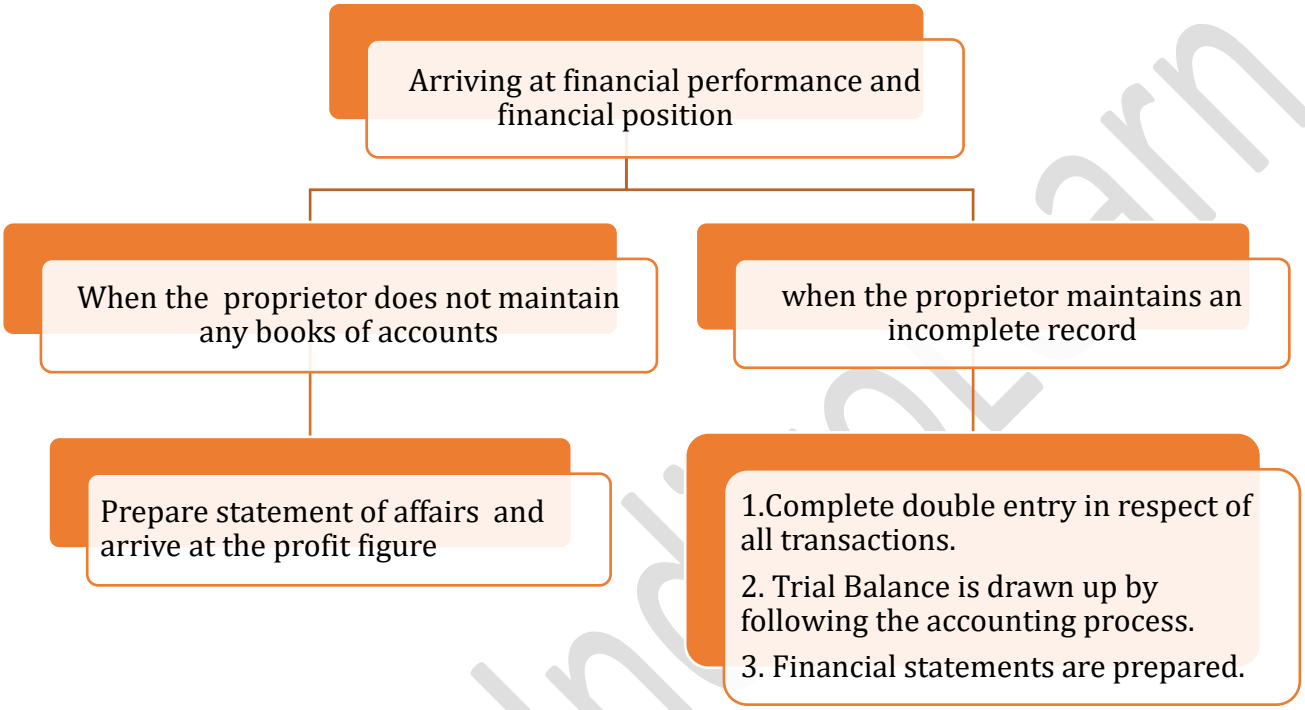
FINANCIAL PERFORMANCE AND FINANCIAL POSITION



ASCERTAINMENT OF PROFIT THROUGH STATEMENT OF AFFAIRS

If detailed information regarding revenue and expenses is not known, it becomes difficult to prepare profit and loss account. Instead by collecting information about assets and liabilities, it is easier to prepare balance sheet at two different points of time. So, while preparing accounts from incomplete records, if sufficient information is not available, it is better to follow the **method of capital comparison** to arrive at the profit figure.

This method is also known as **Net Worth method** or **Statement of Affairs Method**.

Closing Capital – Opening Capital = Profit

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The above formula can also be expanded as below:

Capital at the end (a)	xxx
Add: Drawings	xxx
Less: Fresh capital introduced	xxx
Capital at the beginning (b)	xxx
Profit (a – b)	xxx

Opening and closing capital can be determined by preparing statement of affairs at the two respective points of time.

Statement of affairs is prepared in the following format. The opening and the closing balance is a balancing figure.

Statement of affairs as on…….

Liabilities	Amount 20xx	Amount 20x1	Assets	Amount 20xx	Amount 20x1
Capital (balancing figure)	xxx	xxx	Building	xxx	xxx
Loans, Bank overdraft	xxx	xxx	Machinery	xxx	xxx
Sundry creditors	xxx	xxx	Furniture	xxx	xxx
Bills payable	xxx	xxx	Inventory	xxx	xxx
Outstanding expenses	xxx	xxx	Sundry debtors	xxx	xxx
			Cash and bank	xxx	xxx
			Prepaid expenses	xxx	xxx
	xxx	xxx		xxx	xx

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Sources of assets and liabilities: -

Item	Source of information
Cash and bank	Cash book and bank passbook
Debtors and Creditors	Personal ledger
Inventory	actual counting and valuation
Fixed assets	The proprietor would disclose the original cost and date of purchase. Reasonable amount of depreciation can be deducted from the same.
Loans, Bank overdraft	Corresponding bank documents
Prepaid and outstanding expenses	Prepaid expense – corresponding documentary proof Outstanding expense – Proprietor must provide this information.

DIFFERENCE BETWEEN STATEMENT OF AFFAIRS AND BALANCE SHEET

Basis	Statement of affairs	Balance sheet
Reliability	It is prepared based on transactions partly recorded based on double entry book keeping and partly based on single entry. Most of the assets are recorded based on estimates, assumptions, information gathered from memory rather than records.	It is based on transactions recorded strictly based on double entry book keeping; Each item in the balance sheet can be verified from the relevant subsidiary books and ledger. Hence the balance sheet is not only reliable, but also dependable.

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Capital	In this statement, capital is merely a balancing figure being excess of assets over capital. Hence assets need not be equal to liabilities.	Capital is derived from the capital account in the ledger and therefore the total of assets side will always be equal to the total of liabilities side.
Omission	Since this statement is prepared based on incomplete records, it is very difficult, to locate the assets and liabilities, if they are omitted from the books.	There is no possibility of omission of any item of asset and liability since all items are properly recorded. Moreover, it is easy to locate the missing items since the balance sheet will not agree.
Basis of Valuation	The valuation of assets is generally done in an arbitrary manner; therefore, no method of valuation is disclosed.	The valuation of assets is done on scientific basis, that is original cost in the case of new assets and depreciated amount based on cost minus depreciation to date for used assets. Any change in the method of valuation is properly disclosed.
Objects	The object of preparing this statement in the calculation of capital figures in the beginning and at the end of the accounting period respectively.	The object of preparing the balance sheet is to ascertain the financial position on a particular date.

ASCERTAINMENT OF PROFIT BY COMPLETING BOOKS OF ACCOUNTS

- ★ Where the accounts of a business are incomplete, it is advisable to convert them first to the double entry system and then to draw up the Profit and Loss Account and the Balance Sheet.
- ★ As books of accounts of different firms being incomplete in varying degrees, it is not possible to suggest a formula which could uniformly be applied for preparing final accounts there from.

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★ However, the following general rule can be followed:

1. It is essential first to start the ledger accounts with the opening balances of assets, liabilities and the capital.
2. Afterwards, each book of original entry should be separately dealt with, so as to complete the double entry by posting into the ledger such entries as have not been posted. For example, if only personal accounts have been posted from the Cash Book, debits and credits pertaining to nominal accounts and real accounts that are not posted, should be posted into the ledger.
3. Afterwards, the other subsidiary books, i.e., Purchases Day Book, Sales Day Book, Return Book and Bills Receivable and Payable, etc. should be totaled up and their totals posted into the ledger to the debit or credit of the appropriate nominal or real accounts, the personal aspect of the transactions having been posted already.
4. Once all the ledgers have been updated, prepare a trial balance to confirm the arithmetical accuracy.
5. From the trial balance, prepare the financial statements.

When an Accountant is engaged in posting the unposted items from the Cash Book and other subsidiary books, he may be confronted with a number of problems. The manner in which some of them may be dealt with is described below:

Problems encountered by Accountants	**Solutions**
1. In the Cash Book, there might be entered several receipts and payments which have no connection with the business but which belong to the proprietor, e.g., interest collected on his private investment, legacies received by him, purchase of car as gift for his son, expenses of his pleasure trip etc.	All the personal receipts should be credited to his capital account. And his personal expenses should be debited to his capital account.
2. Amounts belonging to the business after collection may have been directly utilised for acquiring business assets or for meeting certain expenses instead of being deposited into the Cash Book.	The appropriate asset or expense account should be debited and the source which had provided funds credited
3. The proprietor may have met some of the business expenses from his private resources.	The appropriate asset or expense account should be debited, and the capital account should be credited
4. Any excess or shortage in cash book for unidentified reasons	Should be adjusted with Proprietor's capital account.

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5. Where the benefit of an item of an expense is received both by the proprietor and business	It should be allocated between them on some equitable basis e.g. rent of premises when the proprietor lives in the same premises, should be allocated based on the area occupied by him for residence.
6. Analysis of cash and bank receipts and payments in detail.	Should be done in extensive manner. Prepare Cash and Bank Summary (if not available in proper form with both sides tallied). The cash and bank balance at the end should be reconciled with the cash and bank books. Having done so, the various items detailed on the Summary Statements, should be posted into the ledger. The balancing figure in the summary can be opening balance of cash, cash sales or cash purchases. This is based on other available information.
7. Analysis of sales and purchases ledger.	This should be done by considering all the information regarding credit sales, purchases, discount allowed/received, bad debts, return inwards/outwards, bills received/ dishonored, etc.
8. Analysis of nominal accounts	This should be done by considering the outstanding and prepaid expenses during the period.

Analysis of Sales Ledger

It would disclose information pertaining to the opening balance of the debtors, the goods sold to them on credit during the year, bills receivable dishonored, if any; cash received from them in the accounting period, discount, rebate or any other concession allowed to them, receipts of bills receivable, returns inwards, bad debts written off and transfers which can be shown in the following format.

OP Customer Balance	Sales	Bills Dishonored	Total Debits	Cash Recd.	Discounts Allowed	Bills Recd.	Bad debts	Sales Returns	Total credit	Balance (CL)

Journal entries must be made by debiting or crediting the impersonal accounts concerned with contra credit or debit given to total debtors account.

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From the aforementioned, it will be possible to build up information about sales and other accounts which can then be posted in totals, if so desired. It would also be possible to prepare Total Debtors.

Analysis of Purchases Ledger

A Purchases Ledger is not as commonly in existence as the Debtors Ledger for it being convenient to make entries in respect of outstanding liabilities at the time, they are paid rather than when they are incurred.

The information is available in respect of opening balance of the creditors, goods purchased on credit, bills payable dishonored; cash paid to the creditors during the year, discount and other concessions obtained, returns outwards and transfers. It is made in the similar format as the sales ledger.

Journal entries must be made by debiting or crediting the respective impersonal accounts. Contra credit or debit being given to total creditor's account.

If a proper record of return to creditors, discount allowed by them etc., has not been kept, it will not be possible to write up the Total Creditors A/c.

In such a case, net credit purchase will be ascertained as follows:

Cash paid to Creditors including on account of bills payable during the period	xxx
Closing balance of Creditors and Bills Payable	xxx
Total	xxx
Less: Opening balance of Creditors and Bills Payable	xxx
Net credit purchase during the period	xxx

Alternatively

Cash paid to Creditors during the period	xxx
Add: Bills Payable issued to them	xxx
Total	xxx
Closing balance of Creditor	xxx

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Less: Opening balance of creditors	xxx
Credit Purchases during the period	xxx

Analysis of Nominal accounts

It is quite likely that the total expenditure shown by balance of nominal account may contain items of expenditure which do not relate to the year for which accounts are being prepared and, also, there may exist certain items of expenditure incurred but not paid, which have not been included therein. On that account, each and every account should be adjusted in the following manner:

Particulars (1)	Cash payment (2)	Bank payment (3)	Outstanding payment (4)	Total paid/payable (5) = 2 +3 + 4	Pre-paid amount (6)	Expenses for the period (7) = 5 – 6
Office rent						
Salaries						

Only the amount entered as "expenses for the period" should be posted to the respective nominal accounts.
A similar adjustment of nominal accounts in respect of revenue receipt should be made.

ILLUSTRATIONS

Scan the business transactions carefully to identify the nature of payment/ receipt and classify them as drawings / fresh investments.

The following are some examples of drawings and fresh investment made by the proprietor/partner.

Drawings	Fresh investment

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Rent of premises commonly used for residential as well as business purposes	Money collected and put in the business on maturity of Life Insurance Policy of the proprietors
Common electricity and telephone bills	Interest and dividend of personal investment of the proprietors collected and put in the business.
Life insurance premiums of proprietor/partners paid from business cash.	Income from non-business property collected and put in the business
Household expenses met from business cash	Business expenses met by the proprietor from his personal bank account.
Private loan paid to friends and relatives out of business cash	Payment made to any creditor out of proprietor's personal account.
Personal gifts made to any friends and relatives out of business cash	
Goods or services taken from the business for personal consumption	
Cash withdrawals to meet family expenses	

Illustration – 1

Assets and Liabilities of Mr. X as on 31-12-2015 and 31-12-2016are as follows:

Particulars	31-12-2015	31-12-2016
	(Rs.)	(Rs.)
Assets		
Building	1,00,000	?
Furniture	50,000	?
Inventory	1,20,000	2,70,000
Sundry debtors	40,000	90,000
Cash at bank	70,000	85,000
Cash in hand	1,200	3,200
Liabilities		
Loans	1,00,000	80,000
Sundry creditors	40,000	70,000

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- Decided to depreciate building by 2.5% and furniture by 10%.
- One Life Insurance Policy of the Proprietor was matured during the period and the amount Rs. 40,000 is retained in the business.
- Proprietor took @ Rs. 2,000 p.m. for meeting family expenses.

Prepare Statement of Affairs.

Illustration - 2

The Income Tax Officer, on assessing the income of Shri Moti for the financial year 1 and year 2 feels that Shri Moti has not disclosed the full income. He gives you the following particulars of assets and liabilities of Shri Moti as on 1st Jan Yr. 1 and 1st Jan Yr. 3.

				Amount (Rs.)
1st Jan Yr. 1	Assets	:	Cash in hand	25,500
			Inventory	56,000
			Sundry debtors	41,500
			Land and Building	1,90,000
			Wife's Jewellery	75,000
	Liabilities	:	Owing to Moti's Brother	40,000
			Sundry creditors	35,000
1st Jan Yr. 2	Assets	:	Cash in hand	16,000
			Inventory	91,500
			Sundry debtors	52,500
			Land and Building	1,90,000
			Motor Car	1,25,000
			Wife's Jewellery	1,25,000
			Loan to Moti's Brother	20,000
	Liabilities	:	Sundry creditors	55,000

During the two years the domestic expenditure was Rs. 4,000 p.m. The declared income of the financial years were Rs. 1,05,000 for Yr. 1 and Rs. 1,23,000 for Yr. 2 respectively. State whether the Income-tax Officer's contention is correct. Explain by giving your workings.

Illustration – 3

A and B are in Partnership having Profit sharing ratio 2:1. The following information is available about their assets and liabilities:

Particulars	**31-3-2016**	**31-3-2017**
	Amount (Rs.)	Amount (Rs.)
Furniture	1,20,000	?
Advances	70,000	50,000
Creditors	32,000	30,000
Debtors	40,000	45,000

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Inventory	60,000	74,750
Loan	80,000	—
Cash at Bank	50,000	1,40,000

- The partners are entitled to salary @ Rs. 2,000 p.m. They contributed proportionate capital.
- Interest is paid @ 6% on capital and charged @ 10% on drawings.

Drawings of A and B

Particulars	**A**	**B**
	Amount (Rs.)	Amount (Rs.)
April 30	2,000	—
May 31	—	2,000
June 30	4,000	—
Sept. 30	—	6,000
Dec. 31	2,000	—
Feb. 28	—	8,000

- On 30th June, they took C as 1/3rd partner who contributed Rs. 75,000.
- C is entitled to share of 9 months' profit.
- The new profit ratio becomes 1:1:1.
- A withdrew his proportionate share.
- Depreciate furniture @ 10% p.a., new purchases Rs. 10,000 may be depreciated for 1/4th of a year
- Current account as on 31-3-2016:
  A Rs. 5,000 (Cr.), B Rs. 2,000 (Dr)
- Prepare Statement of Profit, Current Accounts of partners and Statement of Affairs as on 31-3-2017.

Illustration - 4

The following information relates to the business of Mr. Shiv Kumar, who requests you to prepare a Trading and Profit & Loss Account for the year ended 31st March, Year2 and a Balance Sheet as on that date:

(a)

Particulars	**Balance as on 31st March, Year1 (Rs.)**	**Balance as on 31st March, Year2 (Rs.)**
Building	3,20,000	3,60,000
Furniture	60,000	68,000
Motorcar	80,000	80,000
Inventory	?	40,000
Bills payable	28,000	16,000
Cash and bank balances	1,80,000	1,04,000
Sundry debtors	1,60,000	?
Bills receivable	32,000	28,000

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Sundry creditors	1,20,000	?

(b) Cash transactions during the year included the following besides certain other items:

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Sale of old papers and miscellaneous income	20,000	Cash purchases	48,000
Miscellaneous Trade expenses (including salaries etc.)	80,000	Payment to creditors	1,84,000
Collection from debtors	2,00,000	Cash sales	80,000

(c) **Other information:**

- Bills receivable drawn during the year amount to Rs.20,000 and Bills payable accepted Rs.16,000.
- Some items of old furniture, whose written down value on 31st March, Year1 was Rs.20,000 was sold on 30th September, Year1 for Rs.8,000. Depreciation is to be provided on Building and Furniture @ 10% p.a. and on Motorcar @ 20% p.a. Depreciation on sale of furniture to be provided for 6 months and for additions to Building for whole year.
- Of the Debtors, a sum of Rs.8,000 should be written off as Bad Debt and a reserve for doubtful debts is to be provided @ 2%.
- Mr. Shivkumar has been maintaining a steady gross profit rate of 30% on turnover.
- Outstanding salary on 31st March, Year1 was Rs.8,000 and on 31st March, Year2 was Rs.10,000. On 31st March, Year1, Profit and Loss Account had a credit balance of Rs.40,000.
- 20% of total sales and total purchases are to be treated as for cash.
- Additions in Furniture Account took place in the beginning of the year and there was no opening provision for doubtful debts.

Illustration - 5

From the following data, you are required to prepare a Trading and Profit and Loss Account for the year ended 31st March, Year 2 and a Balance Sheet as at that date. All workings should form part of your answer.

Particulars	As on 01-04-x1 (Rs.)	As on 31-03-x2 (Rs.)
Creditors	15,770	12,400

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Sundry expenses outstanding	600	330
Sundry Assets	11,610	12,040
Inventory in trade	8,040	11,120
Cash in hand and at bank	6,960	8,080
Trade debtors	?	17,870

Details relating to transactions in the year:	
Cash and discount credited to debtors	64,000
Sales return	1,450
Bad debts	420
Sales (cash and credit)	71,810
Discount allowed by trade creditors	700
Purchase returns	400
Additional capital-paid into Bank	8,500
Realisations from debtors-paid into Bank	62,500
Cash purchases	1,030
Cash expenses	9,570
Paid by cheque for machinery purchased	430
Household expenses drawn from Bank	3,180
Cash paid into Bank	5,000
Cash drawn from Bank	9,240
Cash in hand on 31-3-x2	1,200
Cheques issued to trade creditors	60,270

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Illustration – 6

Adamjee keeps his books on single entry basis. The analysis of the cash book for the year ended on 31st December, 20X1 is given below:

Receipts	Rs.	Payments	Rs.
Bank Balance as on 1st January, 20X1	2,800	Payment to Sundry Creditors	35,000
Received from Sundry Debtors	48,000	Salaries	6,500
Cash Sales	11,000	General Expenses	2,500
Capital brought during the year	6,000	Rent and Taxes	1,500
Interest on Investments	200	Drawings	3,600
		Cash Purchases	12,000
		Balance at Bank on 31st Dec, 20X1	6,400
		Cash in hand on 31st Dec., 20X1	500
	68,000		**68,000**

Particulars of other assets and liabilities are as follows:

	1st January 20X1	31st December 20X1
Sundry Debtors	14,500	17,600
Sundry Creditors	5,800	7,900
Machinery	7,500	7,500
Furniture	1,200	1,200
Inventory	3,900	5,700
Investments	5,000	5,000

Prepare final accounts for the year ending 31st December, 20X1 after providing depreciation at 10 percent on machinery and furniture and Rs. 800 against doubtful debts

Illustration – 7

Mr. Anup runs a wholesale business where in all purchases and sales are made on credit. He furnishes the following closing balances:

	1-1-20X1	31-12-20X1
Sundry Debtors	70,000	92,000
Bills Receivable	15,000	6,000
Bills Payable	12,000	14,000
Sundry Creditors	40,000	56,000
Inventory	1,10,000	1,90,000
Bank	90,000	87,000

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Cash	5,200	5,300

Summary of cash transactions during the year 20X1:

i. Deposited to bank after payment of shop expenses
- @ Rs. 600 p.m., wages
- @ Rs. 9,200 p.m. and personal expenses
- @ Rs. 1,400 p.m. Rs. 7,62,750.

i. Withdrawals Rs. 1,21,000.
ii. Cash payment to suppliers Rs. 77,200 for supplies and Rs. 25,000 for furniture.
iii. Cheques collected from customers but dishonored Rs. 5,700.
iv. Bills accepted by customers Rs. 40,000.
v. Bills endorsed Rs. 10,000.
vi. Bills discounted Rs. 20,000, discount Rs. 750 Bills matured and duly collected Rs. 16,000.
vii. Bills accepted Rs. 24,000.
viii. Paid suppliers by cheque Rs. 3,20,000.
ix. Received Rs. 20,000 on maturity of one LIC policy of the proprietor by cheque.
x. received Rs. 14,000 by cheque for the premises owned by proprietor.
xi. building was purchased on 30-11-20X1 for opening a branch for Rs. 3,50,000 and some expenses were incurred on this building, details of which are not maintained.
xii. and telephone bills paid by cash Rs. 18,700, due Rs. 2,200.

Other transactions:

i. Claim against the firm for damage Rs. 1,55,000 is under legal dispute. Legal expenses Rs. 17,000. The firm anticipates defeat in the suit.
ii. Goods returned to suppliers Rs. 4,200.
iii. Goods returned by customers Rs. 1,200.
iv. Discount offered by suppliers Rs. 2,700.
v. Discount offered to the customers Rs. 2,400.
vi. The business is carried on at the rented premises for an annual rent of Rs. 20,000 which is outstanding at the year end.

Prepare Trading and Profit & Loss Account of Mr. Anup for the year ended 31-12-20X1 and Balance Sheet as on that date.

Illustration - 8

Ms. Rashmi furnishes you with the following information relating to her business:

a. Assets and liabilities as on

	1.1. Year1	31.12. Year1
Particulars	Amount (Rs.)	Amount (Rs.)
Furniture (w.d.v)	12,000	12,700
Inventory at cost	16,000	14,000
Sundry Debtors	32,000	?
Sundry Creditors	22,000	30,000
Prepaid expenses	1,200	1,400

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Unpaid expenses	4,000	3,600
Cash in hand and at bank	2,400	1,250

b. Receipts and payments during 2016:

- Collections from debtors, after allowing discount of Rs. 3,000 amounted to Rs. 1,17,000.
- Collections on discounting of bills of exchange, after deduction of discount of Rs. 250 by the bank, totaled to Rs. 12,250.
- Creditors of Rs. 80,000 were paid Rs. 78,400 in full settlement of their dues.
- Payment for freight inwards Rs. 6,000.
- Amount withdrawn for personal use Rs. 14,000.
- Payment for office furniture Rs. 2,000.
- Investment carrying annual interest of 4% were purchased at Rs. 192 (face value Rs. 200) on 1st July,2016 and payment made there for.
- Expenses including salaries paid Rs. 29,000.
- Miscellaneous receipts Rs. 1,000

c. Bills of exchange drawn on and accepted by customers during the year amounted to Rs. 20,000. Of these, bills of exchange of Rs. 4,000 were endorsed in favour of creditors. An endorsed bill of exchange of Rs. 800 was dishonored.

d. Goods costing Rs. 1,800 were used as advertising materials.

e. Goods are invariably sold to show a gross profit of 33-1/3% on sales.

f. Difference in cash book, if any, is to be treated as further drawing or introduction of capital by Ms. Rashmi.

g. Provide at 2.5% for doubtful debts on closing debtors.

Prepare trading and profit and loss account for the year ended 31st December,2016 and the balance sheet as on that date.

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Study Note 6 | Partnership

Introduction

Business carried on by all or any one of them acting for all.

If the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.

Sharing of profits and losses of the business.

The persons concerned must agree to **share the fits of the business.**

A provision for sharing of loss is not necessary.

Existence of a business.

A partnership comes into existence only when partners begin to carry on business in accordance with their agreement.

An agreement entered into by all persons concerned.

A formal or written agreement is not necessary to create a partnership.

An association of two or more persons.

Unlimited liability of all partners

❖ Why Partnership?

Due to the financial and managerial demands of the present day business world. In Partnership, two or more individuals may decide to pool their financial and non-financial resources to carry on a business

LIMITED LIABILITY PARTNERSHIP

The Limited Liability Partnership (LLP)

- Viewed as an alternative corporate business proposal that provides the benefits **of limited liability.**
- Allows its members, the flexibility of organizing their internal structure as a partnership, which is based on a **mutually arrived agreement**.

Law Definition

Section 2 of the Limited Liability Partnership (LLPs) Act, 2008 defines LLP

As a partnership formed and registered under this Act

AND

"limited liability partnership agreement" means any written agreement

1) between the partners of the limited liability partnership

2) between the limited liability partnership and its partners

Which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership.

❖ Features

- The LLP will be a separate legal entity
  - Liable to the full extent of its assets.
  - The liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature.
  - No partner would be liable on account of the independent or un-authorized actions of other partners or their misconduct.

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The liabilities of the LLP and partners who are found to have acted with intent to defraud Creditors or for any fraudulent purpose shall be unlimited for all or any of the debts or other liabilities of the LLP.

- It is **taxed as a partnership**, but has the benefits of being a corporate, or more significantly, a juristic entity with limited liability.
- The provisions of the **Indian Partnership Act, 1932** shall not apply to LLP unless stated.
- Every limited liability partnership shall have at least **two partners**.

❖ Who can become a partner in LLP?

Any **individual or body corporate** may be a partner in a LLP.

Provided that an individual shall not be capable of becoming a partner of a limited liability partnership if

- He has been found to be of unsound mind by a Court of competent jurisdiction .
- He is an undischarged insolvent.
- He has applied to be adjudicated as an insolvent and his application is pending.

❖ What happen if the number of partner reduced to one and the LLP carried business for more than 6 month.

The only partner of LLP who carries the business after 6 month and has the knowledge of the fact he is carrying the business alone, shall be liable personally for the obligations of the LLP incurred during that period.

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DISTINCTION BETWEEN ORDINARY PARTNERSHIP FIRM AND AN LLP

	Key Elements	Partnerships	LLPs
1	Applicable Law	Indian Partnership Act 1932	**The Limited Liability Partnerships Act, 2008**
2	Registration	Optional	**Compulsory with ROC**
3	Creation	Created by an Agreement	**Created by Law**
4	Body Corporate	No	**Yes**
5	Separate Legal Entity	No	**Yes**
6	Perpetual Succession	Partnerships do not have perpetual succession	**It has perpetual succession and individual partners may come and go**
7	Number of Partners	Minimum 2 and Maximum 50	**Minimum 2 but no maximum limit**
8	Ownership of Assets	Firm cannot own any assets. The partners own the assets of the firm	**The LLP as an independent entity can own assets**
9	Liability of Partners / Members	Unlimited: Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets	**Limited to the extent of their contribution towards LLP except in case of intentional fraud or wrongful act of omission or commission by a partner.**
10	**Principal Agent Relationship**	**Partners are the agents of the firm and of each other**	**Partners are agents of the firm only and not of other partners**

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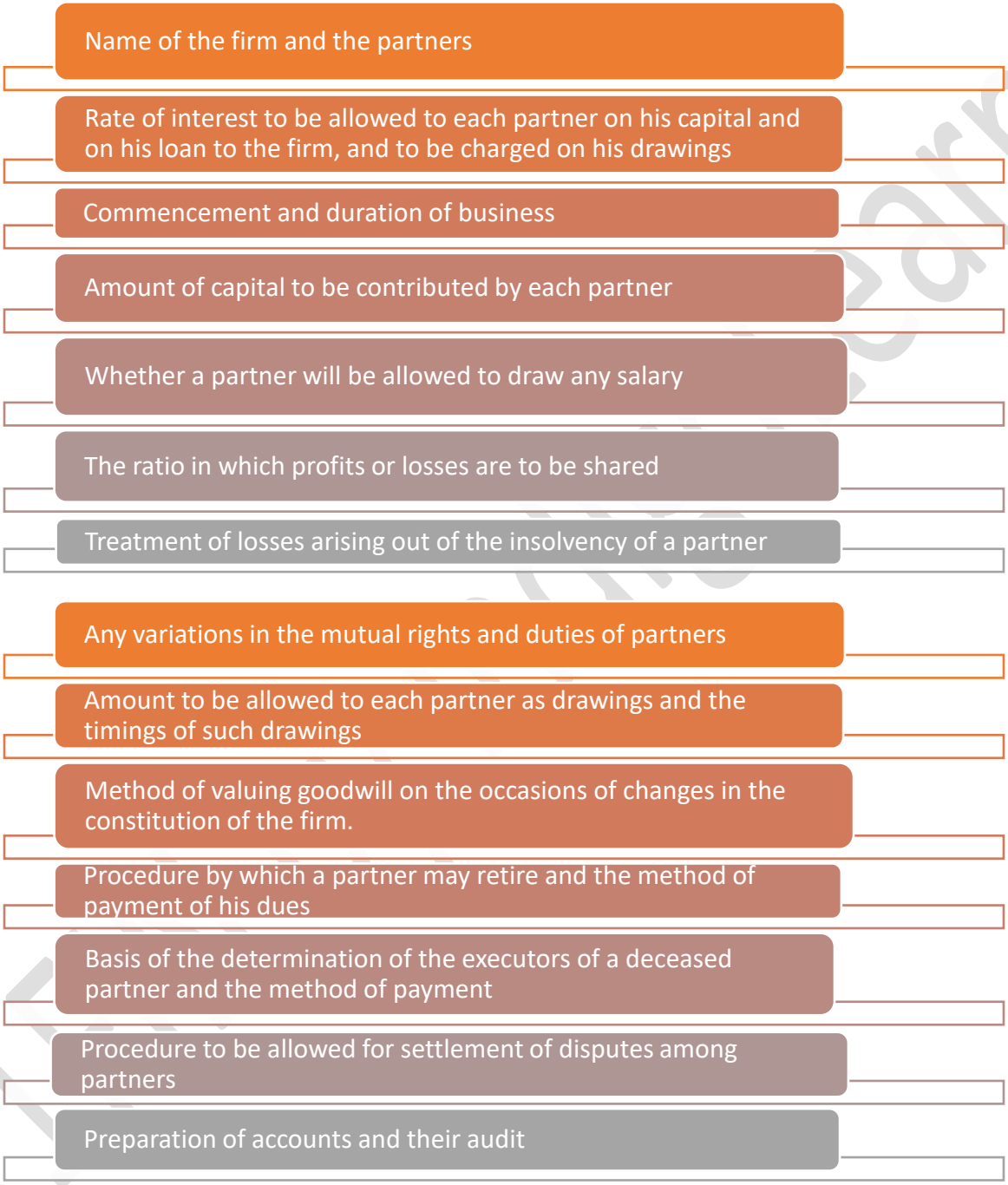
MAIN CLAUSES IN A PARTNERSHIP DEED



❖ Special Points

Registration of a deed is not compulsory.

Non registration restricts the partners or firm from taking any **legal action**.

Partnership act will apply in case of no partnership deed or the deed is silent on any point.

Rules in the absence of Partnership Deed

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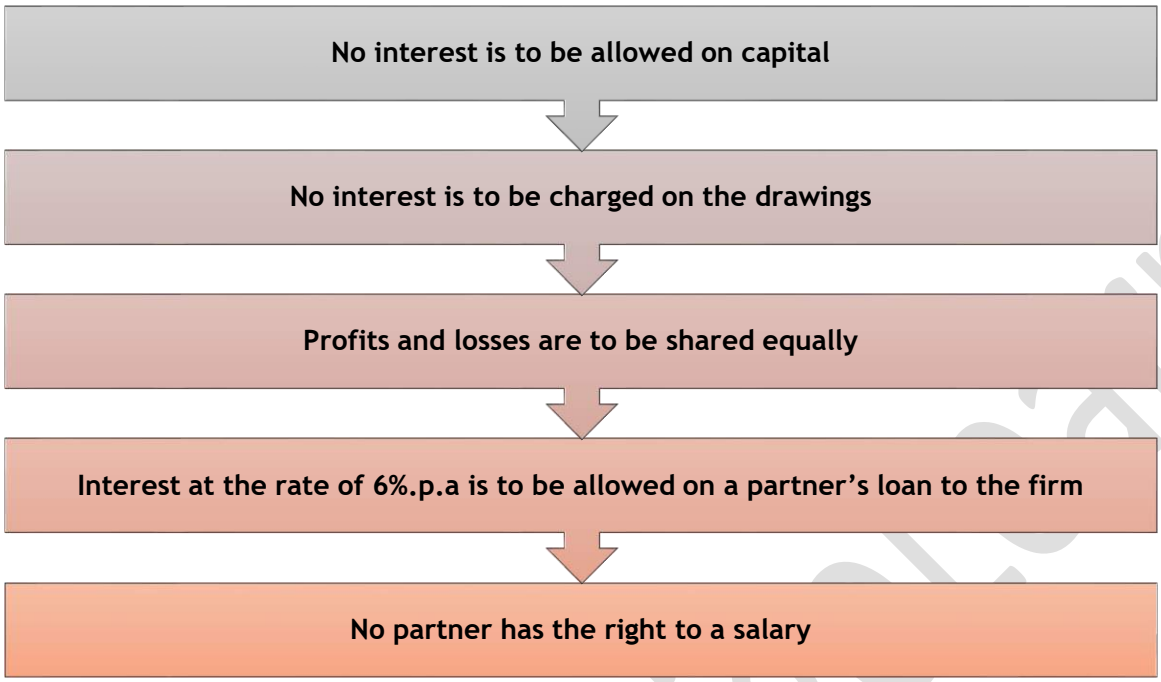


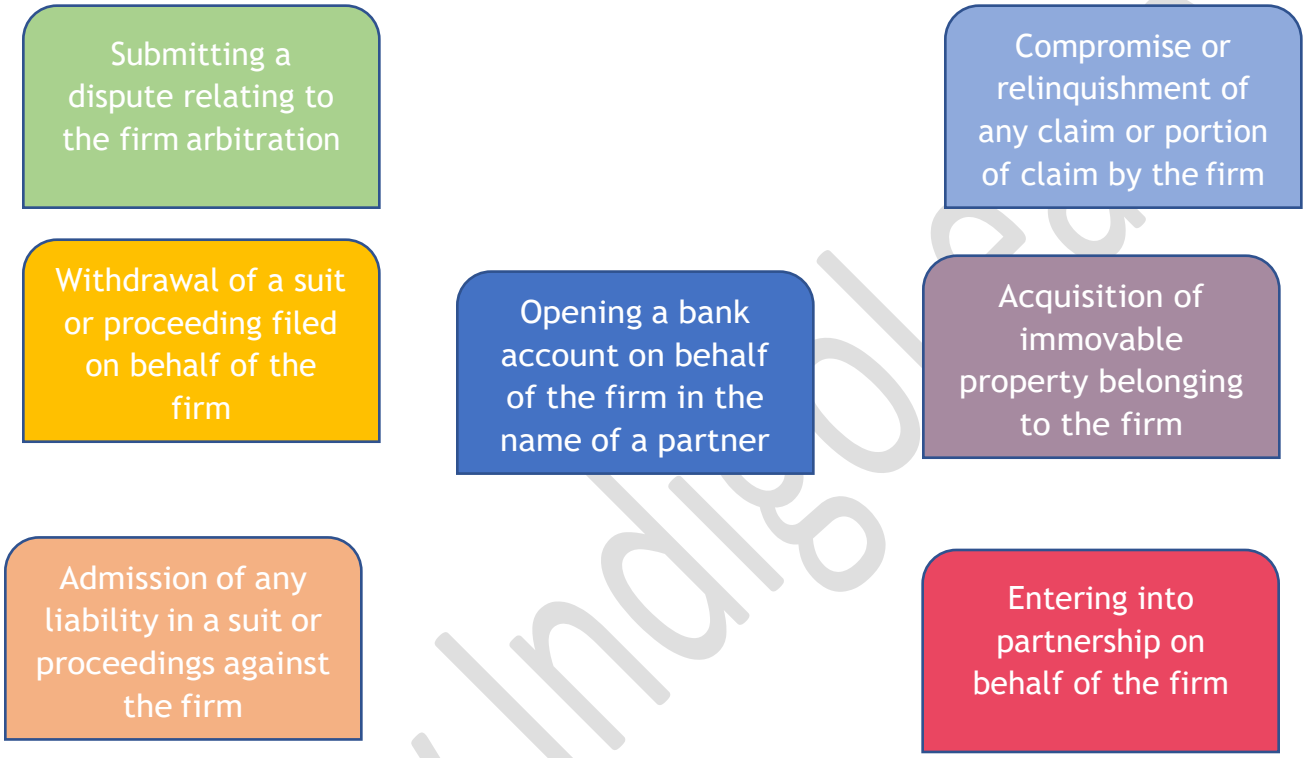
In the absence of an agreement to the contrary, the interest and salary payable to a partner will be paid only if there is profit.

MAIN CLAUSES IN A PARTNERSHIP DEED

❖ In case of a trading firm, the implied power of partners are the following

- Buying and selling of goods
- Receiving payments on behalf of the firm and giving valid receipt.
- Engaging servants for the business of the firm.
- Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm.
- Borrowing money on behalf of the firm with or without pledging the inventories-in-trade.

- **In following cases** , third parties cannot bind the firm unless all the partners have agreed



ACCOUNTS

- Partnership Act doesn't specify any **format** for preparation of accounts of Partnership Firm
- **Capital Account**
  - May be, there are multiple capital account.
  - Partner withdraw money which either can be debited to capital account or separately debited to Drawing account.
- In a Trial Balance of a partnership firm, one may find Capital Accounts of partners as well as Drawings Accounts.

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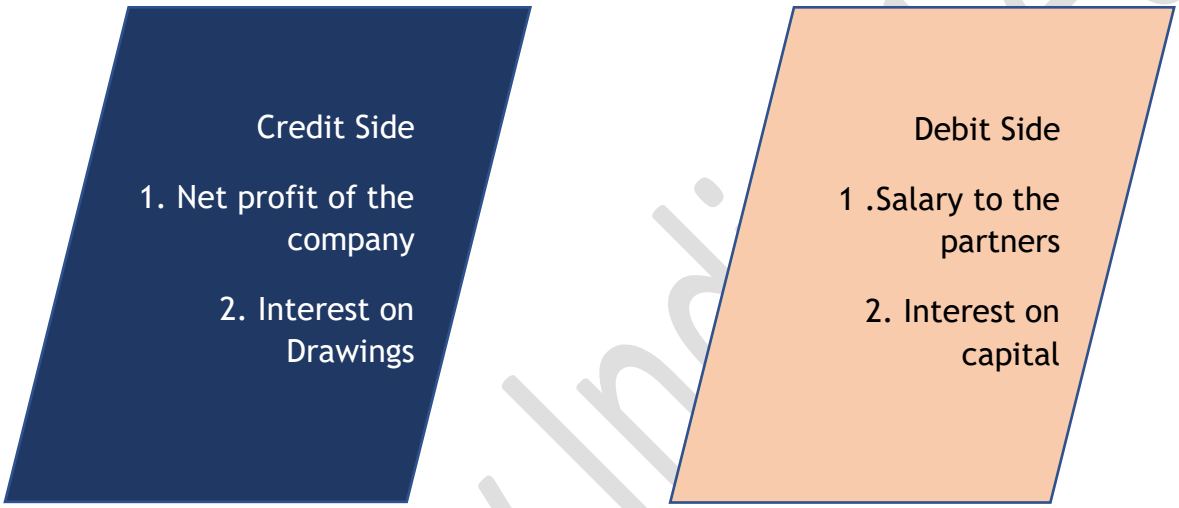
PROFIT AND LOSS APPROPRIATION

Profit has to be divided between the partners in a certain profit sharing ratio after making necessary adjustments stated in the partnership deed such as

1) **Interest on capitals**
2) **Interest on Drawings and loans**
3) **Salaries or/and commission to partners**

For above adjustments, there is an additional account is prepared known as Profit and Loss Appropriation Account.



FIXED AND FLUCTUATING CAPITAL

There are two methods of accounting

1) **Fixed capital method**
2) **Fluctuating capital method**

❖ Fixed Capital Method

There are two accounts under this method

1) **Capital account**: Initial capital contributions by the partners are credited.
2) **Current Account**: subsequent transactions and events are dealt with through current accounts.

Unless a decision is taken to change it, initial capital account balance is not changed.

❖ Fluctuating Capital method

- No current account is maintained. Only one account is maintained.
- All such transactions and events are passed through capital accounts.

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- Capital account balance fluctuates all the time.

INTEREST ON CAPITAL

- A partner get interest on capital only if there is an **agreement** for it.
- Normally, interest on capital for full year on the balance of capital at the **beginning** of the year.
- If any fresh capital introduced, then the interest for the **relevant period** of utilization is calculated.
- If any permanent withdraw of capital then the interest for the **relevant period** of utilization is calculated.
- In case of fixed capital accounts, interest is calculated on the balance of capital accounts only and **no interest** is payable / chargeable on the balance of **current accounts**.
- Subject to contract between the partners, interest on capitals is to be provided out of profits only.
- *In case of insufficient profits,* the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.

❖ What is insufficient profit?
When the interest on capital is more than the net profit.

INTEREST ON DRAWINGS

- Interest will be charged according to the time that elapses between the **taking out of the money** and the **end of the year** or till the time it was **repaid** whichever is earlier.
- If the dates on which amounts are drawn are not given, then interest for **six months** on the whole of the amount will be charged

Withdrawals are made evenly in the beginning of each Month	Interest can be calculated on whole amount for 6.5 months
Withdrawals are made at the end of each month	Interest can be calculated on whole amount for 5.5 months
Withdrawals are mode at the beginning of each quarter	Interest can be calculated on whole amount for 7.5 months
Withdrawals are mode at the beginning of each quarter	Interest can be calculated on whole amount for 4.5 months

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GUARANTEE OF MINIMUM PROFIT

- One partner can enjoy the right to have **minimum amount of profit** in a year as per the terms of the partnership agreement.

- If share of partner (who has been guaranteed minimum profit) is more than the amount of guarantee profit



Allocation of profit is done in a normal way

- If share of partner (who has been guaranteed minimum profit) is less than the amount of guarantee profit



He takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

- Deficiency can be share in following ways
  - Excess is payable by one of the **remaining partners**.
  - Excess is payable by **at least two or all the partners** in an agreed ratio.
  - Excess is payable by **remaining partners** in their mutual profit sharing ratio.

- If question silent about the nature of guarantee

  The burden of guarantee is borne by the remaining partners in their mutual profit sharing ratio.

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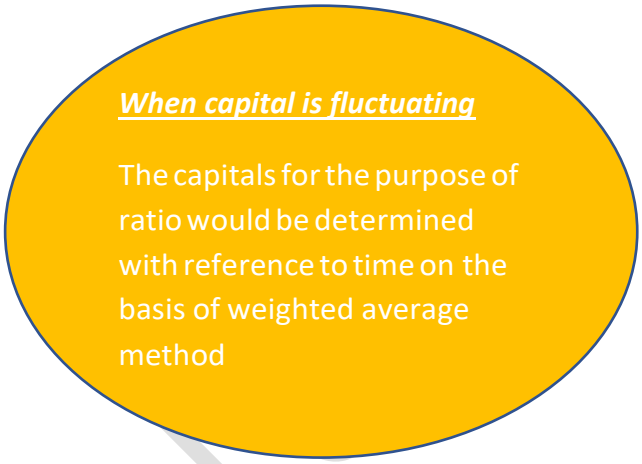
CAPITAL RATIO – For sharing profits

- When capital is fixed: **Profits will be shared in the ratio of given capitals**
- Partners may agree to share profits and losses in the capital ratio.





JOURNAL ENTRIES

PARTICULAR	AMOUNT
Introduction of capital	
Bank A/c Dr.	
To Partner's Capital A/c	
Withdrawal of capital	
Drawings A/c Dr.	
To Bank A/c	
Interest on Capital	
Interest on capital A/c Dr.	
To (Individual) Capital (or Current) Accounts of Partners	
Interest on Drawings	
(Individual) Capital (or Current) Accounts of Partners A/c	

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Dr.	
To Interest on Drawings A/c	
Salary to partners	
Salary A/c Dr.	
To (Individual) Capital (or Current) Accounts of Partners	
Sharing of profit	
Profit& Loss Appropriation A/c Dr.	
To (Individual) Capital (or Current) Accounts of Partners	
In case of Loss	
(Individual) Capital (or Current) Accounts of Partners Dr.	
To Profit& Loss Appropriation A/c	

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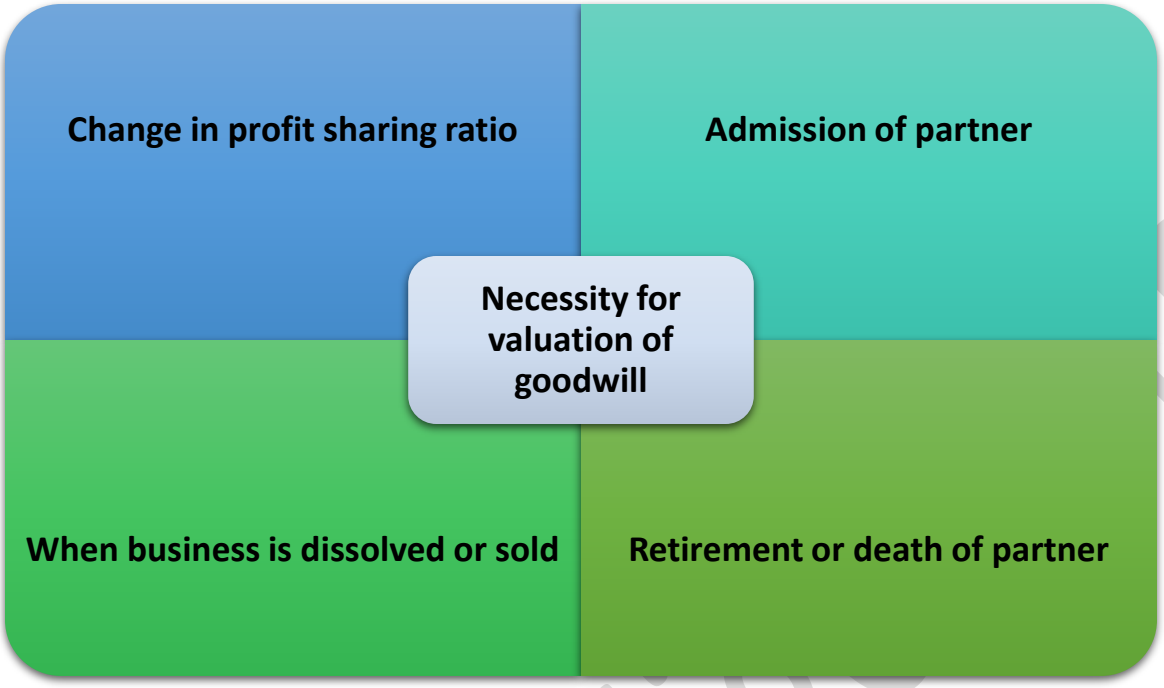
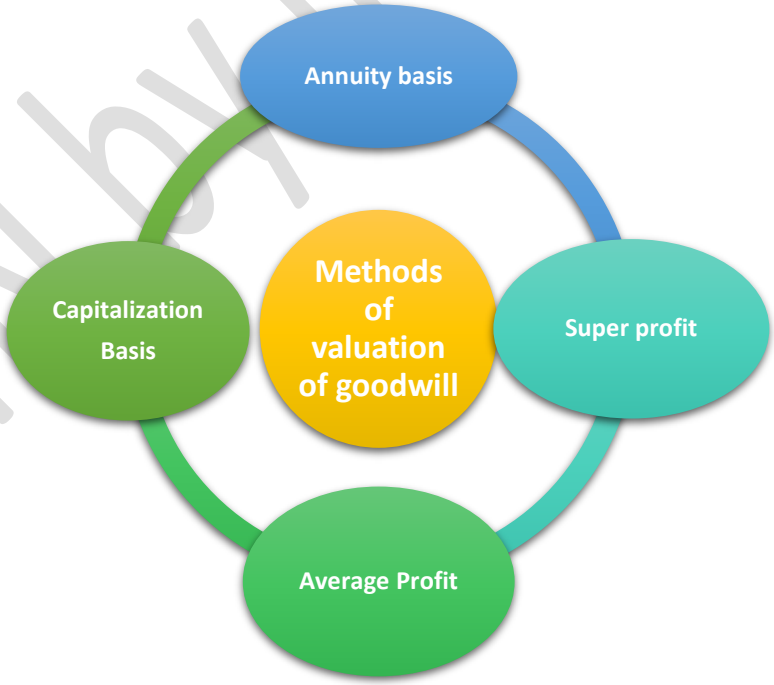
Treatment of Goodwill





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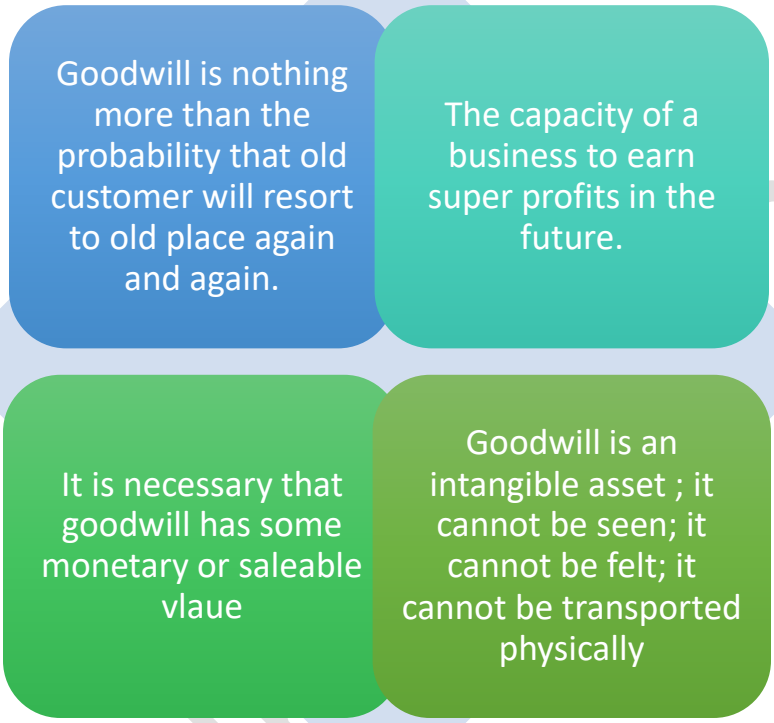
Goodwill



❖ Why Goodwill arise?

Due to

- Locational advantage
- Better customer service
- Possession of a unique patent right
- Personal reputation of the partner
- Quality of the goods sold.
- possession of near monopoly right
- Possession of trademarks and patents
- Presence of managerial skill.
- Cost of research and development.
- Possession of special contracts

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❖ Recommendation of Accounting Standard

Accounting Standards require an enterprise to recognize an intangible asset, if

An intangible asset must have the **characteristics of an asset**	• It means that it must have some **value** and must be clearly **identifiable**. • It can be sold without **disposing** other assets or future benefits flowing from other assets.
An intangible asset should be recognized only if **future probable economic benefits will flow to the business enterprise**	• Future **probable economic benefits** means it has a capacity to increased revenue from sales. • It means that management can make **reasonable estimates** of future benefits.
The cost of the intangible asset can **be measured reliably**	• The cost is objectively **verifiable**. • If the cost cannot be measured **reliably**, then it cannot be recognized as an asset.

** Internally generated goodwill or inherent goodwill will not be recognise*

Goodwill should be recorded in the books only when some consideration in money or money' worth has been paid for it. Only purchased goodwill should be recorded in the books of account.

In the event of **reconstitution of the firm due to admission, or retirement or death of a partner or even a change in the profit sharing ratio** without reconstitution

- Goodwill of the firm is evaluated.
- The value of goodwill should not be brought into books of account because it is **inherent or self-generated goodwill** since no money or money' worth has been paid for it.
- The goodwill should be adjusted through **capital accounts** of the partner(s) of the firm.

- Goodwill account **cannot be raised** in the books of account, either on the reconstitution of the firm or change in the profit sharing ratio.
- If goodwill account exists at the time of reconstitution of firm, It should be **written off** immediately whether it is internally generated or goodwill has been bought for some consideration.

METHOD FOR GOODWILL VALUATION

Three Methods

- Average profit basis,-Simple and Weighted.
- Super profit basis-Number of Year Purchase, Annuity basis, and Capitalization of Super Profit.
- Capitalization basis- Average Profits.

❖ *Average Profits Basis – Simple and weighted*

- Average profit of past years can be calculated by using Simple average or weighted average method.
- The no. of years for average profit and no. of years of purchase profit are decided on the basis of **judgment and negotiation**.
- For averaging the past profit, either simple average or weighted average may be employed depending upon the circumstances.

Weighted average profit : If there exists clear increasing or decreasing trend of profits.
Simple average profit : If there is no clear trend of profit.

❖ *Super Profit Basis*

- Goodwill is valued on the basis of super profits earned by the firm.
- Super profit can be calculated as follows:

Super Profit=Actual Profit-Normal Profit

Super Profit: Excess profit that can be earned by a firm over and above the normal

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profit usually earned by similar firms under similar circumstances.

Actual Profit: Actual Profit is average profit

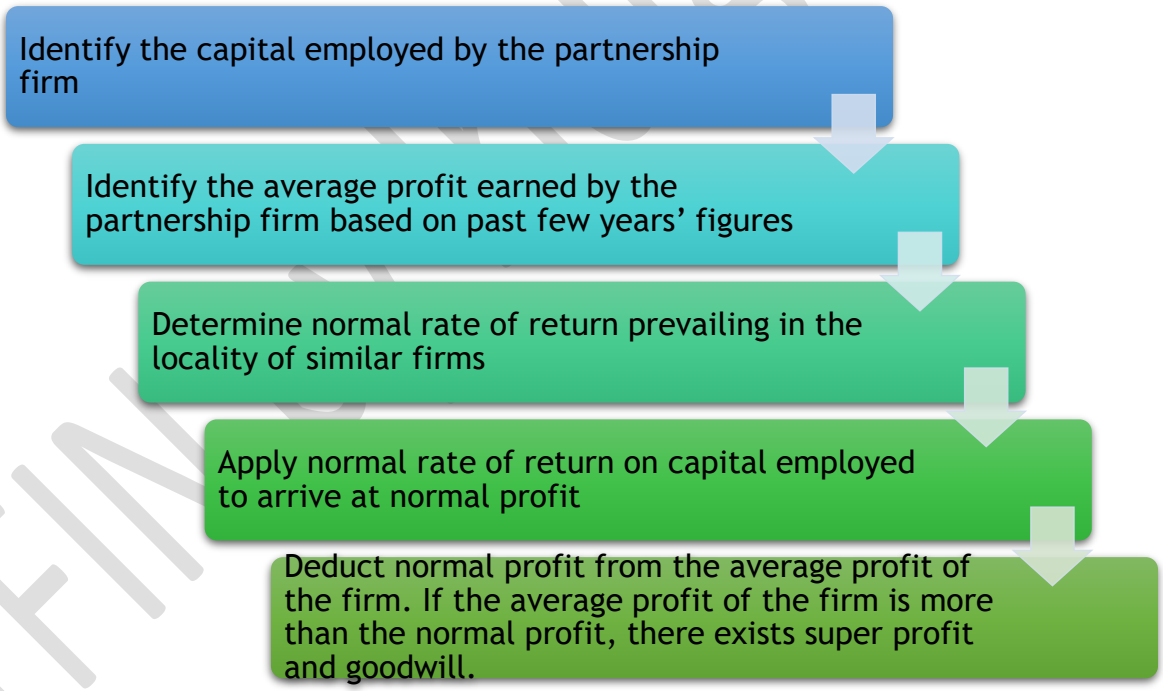
Normal Profit: Normal rate of Return (NRR) x Capital Employed

Why super profit can be use?

1) The partner who gains **excess earning** owing to reconstitution of firm should compensate to partners sacrificing their share in the reconstitution.

2) The partner who gains in terms of profit sharing ratio has to contribute only for excess profit because normal profit he can earn by joining any partnership firm.

Steps in calculation of Super profit



How Goodwill calculate using Super Profit?

(a) **Number of Years Purchase Method:**

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(i) Goodwill is generally valued by **multiplying the amount of super profit**
(ii) By **certain number of years** depending upon the expectation about the maintenance of such profit in future.

(b) **Annuity Method:**

(i) Goodwill is valued by **multiplying the amount of super profit** of every year by the **discounting factor** of every year and then adding them.

(ii) The major drawback of number of number of years purchase method is that **time value of money** is not considered and in annuity method the time of value money considered.

(c) Capitalization Basis:

(i) Value of whole business is determined applying **normal rate of return**.

(ii) Value (**arrived at by applying normal rate of return**) is higher than the capital employed in the business, then the difference is goodwill.

Steps :

1) Determine the **normal rate of return**.
2) Find out the **average profit** of the partnership firm for which goodwill is to be determined.
3) Determine the **capital employed** by the partnership firm for which goodwill is to be determined.
4) Find out **normal value of the business** by dividing average profit by normal rate of return.
5) Deduct average capital employed from the normal value of the business to arrive at **goodwill.**

Goodwill = Normal Capital-Actual Capital

Normal capital = Average Profit/NRR

NEED FOR VALUATION OF GOODWILL

Whenever there is any change in the existing relationship of the partners

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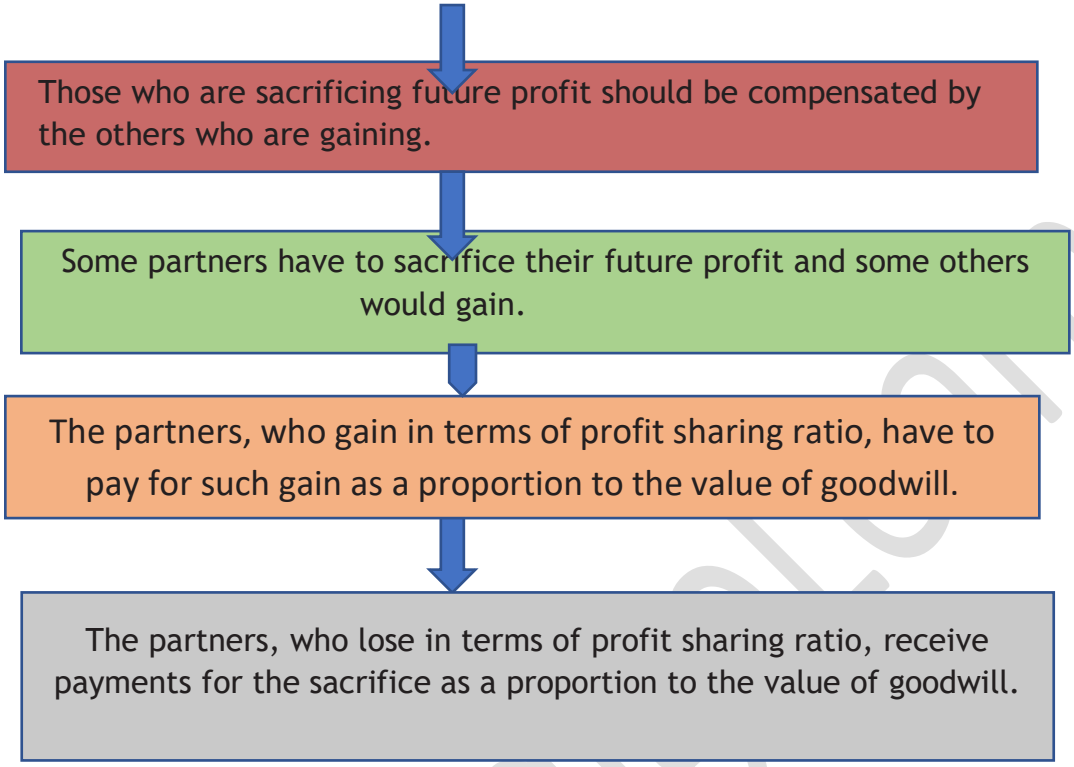

VALUATION OF GOODWILL IN CASE OF ADMISSION OF A PARTNER

When a new partner is admitted into a partnership

Certain adjustments in accounts become necessary

Because the new partner will acquire a share in the profits of the firm and because of this, the old partners will stand to lose.

For Example: A and B are partners sharing profits in the ratio of 3:2. C is admitted and given one fourth share in profits.

1) If their profits are 20,000, A will get 12,000 and B will get 8,000.
2) C got 5000 and remaining 15000 will be divided between A and B.
3) A got 9000 and B got 6000.
4) Due to C's admission, A loses 3,000 per year and B loses 2,000 per year.
5) C will have to compensate A and B for this loss.

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- The above compensation is tackled through **Goodwill**. Compensation of goodwill is done in **profit sacrificing ratio**.
- Kindly note that it is not necessary that the profit of the firm will remain 20000 after C's admission. Extra profits will arise and therefore, A and B will both get more than what they previously got.
- The additional profits will be earned by the combined efforts of all the partners A, B and C and hence no need that c compensate to A and B for extra profit in future.

As per the Accounting Standards, it is not recommended to raise goodwill account but to show the adjustment of goodwill through partners' capital accounts

ACCOUNTING TREATMENT OF GOODWILL

❖ Accounting Treatment of Goodwill in Case of Change in Profit Sharing Ratio

In case of change in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through **capital accounts** of the partners on the basis of profit sacrificing ratio.

❖ Accounting Treatment of Goodwill in Case of Retirement or Death of a partner
- When a partner retired, the continuing partners will gain in terms of **profit sharing ratio**.
- They have to pay to retiring partner for his share of goodwill in the firm in the **gaining ratio**.
- Similarly, in case of **death of the partner**, the continuing partners should bear the **share of goodwill** due to the heirs of the deceased partner.

❖ Accounting treatment of Goodwill in case of Admission of a new partner

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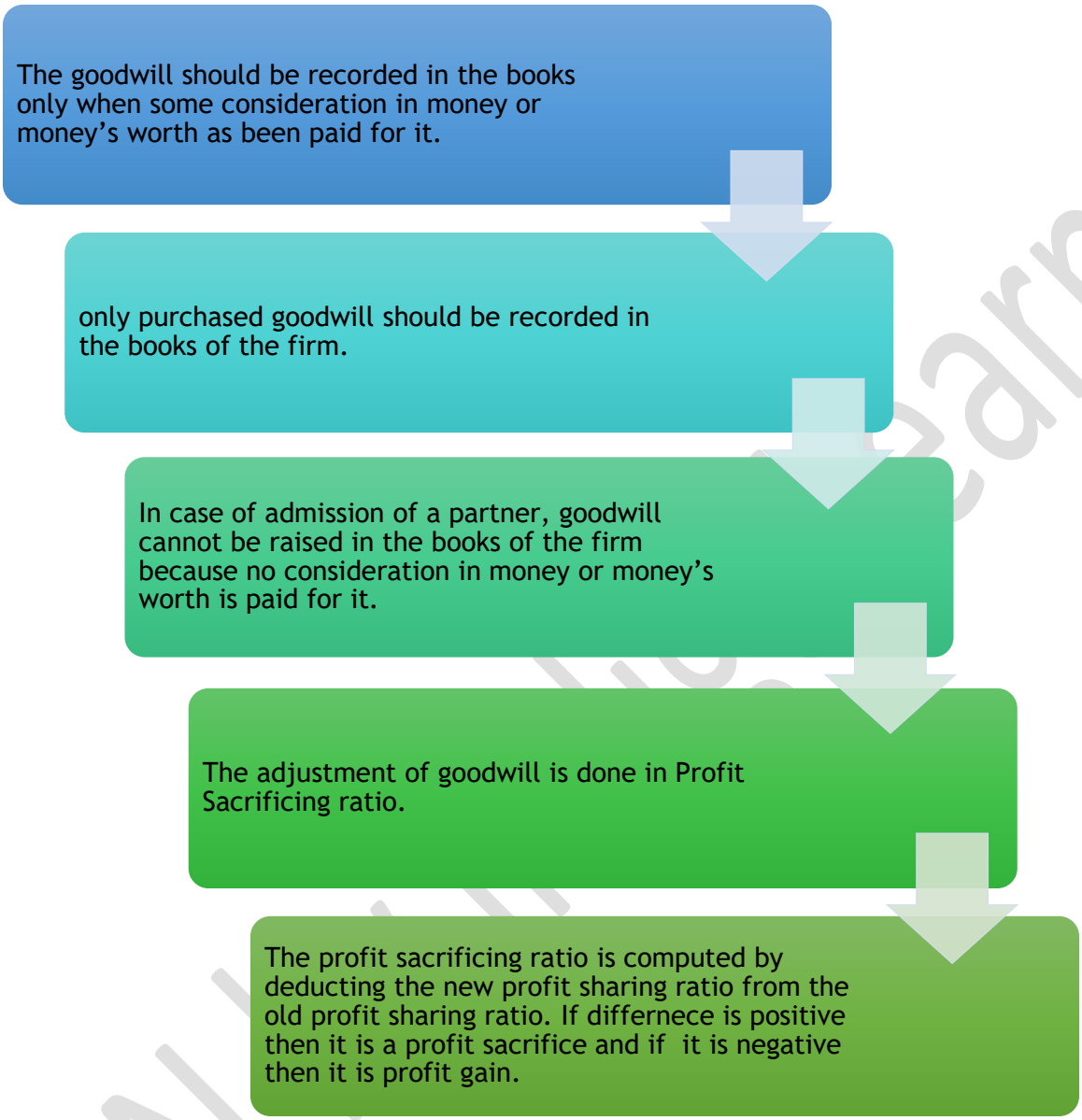
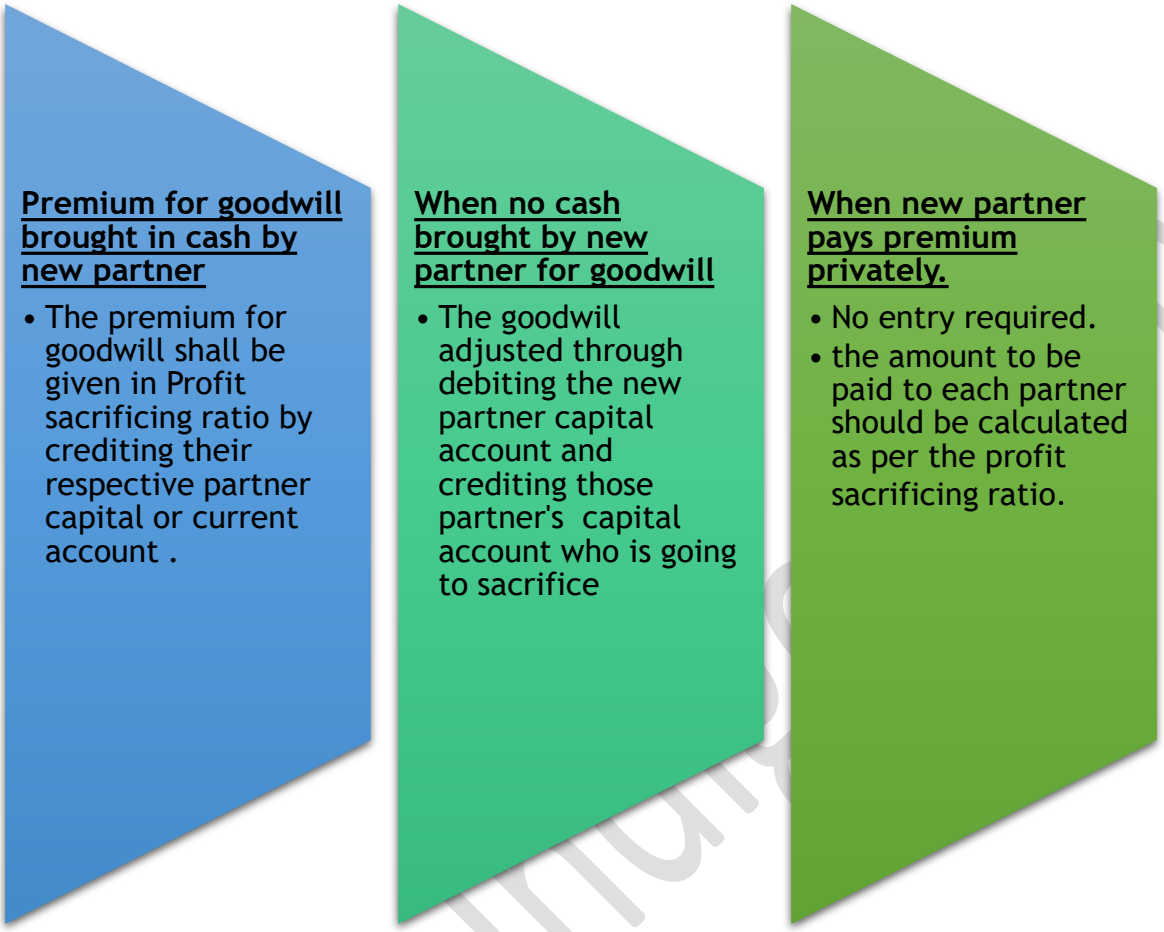

The goodwill should be recorded in the books only when some consideration in money or money's worth as been paid for it.
only purchased goodwill should be recorded in the books of the firm.
In case of admission of a partner, goodwill cannot be raised in the books of the firm because no consideration in money or money's worth is paid for it.
The adjustment of goodwill is done in Profit Sacrificing ratio.
The profit sacrificing ratio is computed by deducting the new profit sharing ratio from the old profit sharing ratio. If differnece is positive then it is a profit sacrifice and if it is negative then it is profit gain.



JOURNAL ENTRIES

PARTICULAR	AMOUNT
Accounting treatment of Goodwill at the time of Admission	
1. Premium for goodwill brought in cash by new partner	
Bank A/c Dr.	
To A Partner's Capital A/c	
To B Partner's Capital A/c	
(Goodwill adjustment in the profit sacrificing ratio)	

2. When no cash brought by new partner for goodwill	
C Partner's Capital A/c Dr.(New partner)	
To A Partner's Capital A/c (old Partner)	
To B Partner's Capital A/c (old Partner)	
(Adjustment for goodwill)	
3. When new partner pays premium privately	
No entry Required	
Accounting treatment of Goodwill at the time of change in profit sharing ratio	
C Partner's Capital A/c Dr. (gaining partner)	
To A Partner's Capital A/c (Sacrificing Partner)	
To B Partner's Capital A/c (Sacrificing Partner)	
(Adjustment for goodwill)	
Accounting Treatment of Goodwill in Case of Retirement or Death of a partner	
A Partner's Capital A/c	
B Partner's Capital A/c	
To C's Partner Capital A/c	
(C is going to retire and his share of goodwill adjusted to existing partners' capital accounts in profit gaining ratio)	

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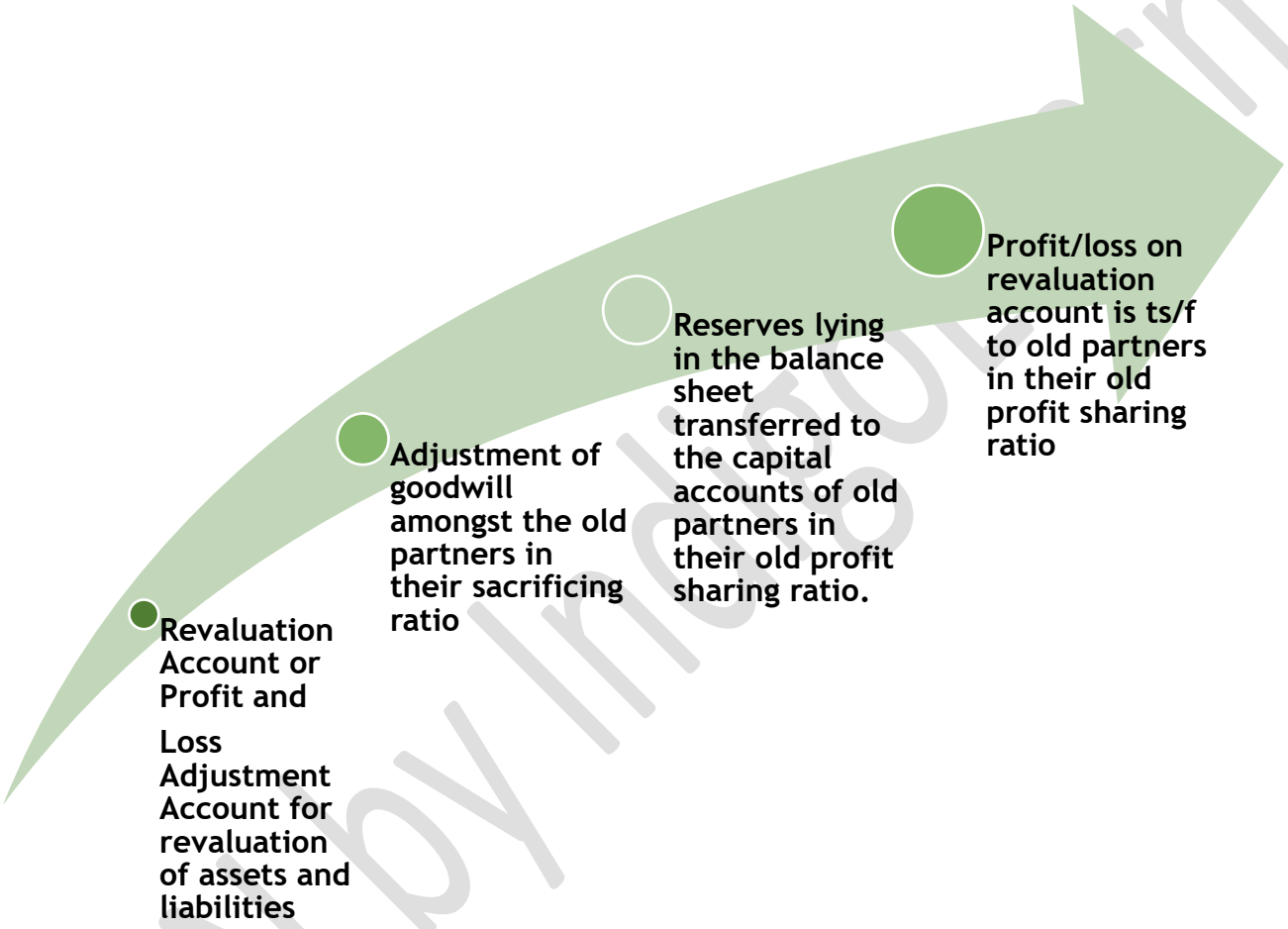
6.1 Admission of Partner



INTRODUCTION

- **Reason for admitting New Partner**
  - For increasing the **partnership capital.**
  - For strengthening the **management** of the firm.

- **Effects for admitting New partner**

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- Desirable to bring all **appreciation or reduction** in the value of assets into accounts as on the date of admission.
- **Liabilities recorded**, if not recorded.
- **Liabilities written off**, if not required to be paid.
- All profits which have **accrued but not yet brought** into books should be record.
- All losses which have **occurred but not recorded** should be recorded.
- The **value of goodwill** is to be assessed and proper accounting treatment is required to bring the value of goodwill into books of accounts.

The purpose of such entries is to make an updated Balance Sheet on the date of admission.

REVALUATION ACCOUNT OR PROFIT AND LOSS ADJUSTMENT ACCOUNT

Revaluation Account

- Revaluation account is debited with all **reduction** in the value of **assets** and **increase** in **liabilities**.
- Credited with **increase** in the value of **assets** and **decrease** in the value of **liabilities**.
- The difference in two sides of the account will show **profit or loss**.
- This is transferred to the Capital Accounts of **old partners** in the **old profit sharing ratio**.

Why Revaluation?

When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed.

Memorandum Revaluation Account

Memorandum Revaluation Account prepared when all the partners including the new partner may agree to keep the assets and liabilities at the old values even when they agree to revalue them.

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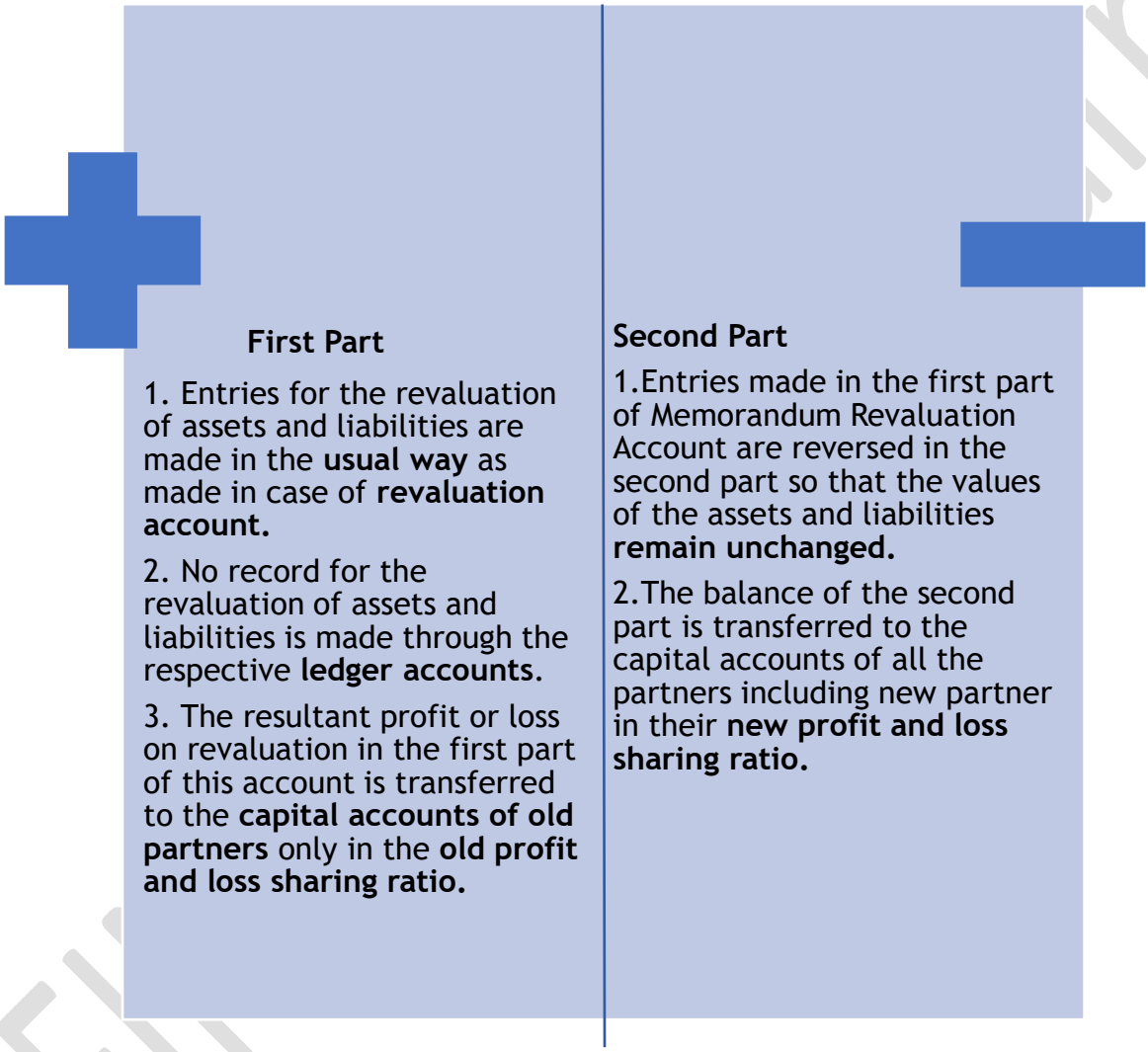
Memorandum Revaluation Account has two parts



Special Points

1. If there is a **profit** in the **first part** there will be a **loss** of the same amount in the **second part** and vice versa.

2. The result of the **first part** of Memorandum Revaluation Account is shared by **old partners** in the **old profit sharing ratio**, while the result of the **second part** is shared by all partners including the **new one** in the **new profit sharing ratio**.

❖ **Difference between Revaluation Account and Memorandum Revaluation Account**

Basis	Revaluation Account	Memorandum Revaluation Account
Asset and Liabilities	Assets and liabilities appear in the new balance sheet at the new or revalued figures.	Assets and liabilities appear in the new balance sheet at the old figures.
No. of parts	Revaluation account is not divided into two parts.	Memorandum revaluation account has two parts: first part for old partners and second part for all partners including the new partner.
Sharing of Net results	transferred to old partners' capital accounts in the old profit sharing ratio	The balance of the first part is transferred to old partner's capital accounts in the old profit sharing ratio while the balance of the second part is transferred to all partners including the new partner in the new profit sharing ratio.

COMPUTATION OF NEW PROFIT-SHARING RATIO

When new partner's share is given but the question is silent about the sacrifice made by the old partners	• It is assumed that the old partner will share the remaining share in their old profit sharing ratio.
When new partner purchases his share from old partner's in a particular ratio	• The new ratio of the old partners will be calculated by deducted the proportion given to the new partner from the shares of old partner.
When the old partners surrender a particular fraction of their share in favour of new partner	• Determine the share surrendered by the old partners. • Find the new share of the old partners by deducting share surrendered from their old share. • Calculate share of the new partner by taking the sum of surrendered share of old partners. • Calculate the new ratio.

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When the new partner acquires his share entirely from any one of partner only	• The sacrificing partner share is calculated by deducting his sacrifice from his old share.
When the new partner acquires his share from the old partners in the certain ratio	• The sacrifice of each partner is deducted from their old shares.

❖ **Some useful Definition**

1) **Sacrificing Partner:** The partners whose shares have decreased as a result of change are known as sacrificing partners.

2) **Sacrificing Ratio :** Ratio in which the old partners sacrifice their share in favor of new Partner is called sacrificing ratio.

Sacrificing ratio = Old Profit sharing ratio - New Profit sharing ratio

3) **Gaining Partners :** The partners whose shares have increased as a result of change are known as gaining partners.

4) **Gaining Ratio:** The ratio in which the partners have agreed to gain their shares in profit from the other partner or partners, is known as gaining ratio.

Gaining Ratio = New Profit sharing ratio - Old Profit sharing ratio

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PARTICULAR	AMOUNT	Remarks
Accounting treatment of Revaluation of assets and liabilities through Revaluation Account		
(a) Revaluation A/c Dr.		With the reduction in the value of the assets
To Assets A/c		
(individually which show a decrease)		
(b) Revaluation A/c Dr.		With the increase in the liabilities.
To Liabilities A/c		
(Individually which have to be increased)		
(c) Assets A/c Dr.		With the increase in the value of the of assets.
To Revaluation A/c		
(Individually which have to be increased)		
(d) Liabilities A/c Dr.		With the reduction in the amount liabilities.
To Revaluation A/c		
(individually which show a decrease)		
(e) Revaluation A/c Dr.		With the profit in the old profit sharing ratio.
To Capital A/c of the old partners		
(Sharing of Revaluation Profit)		

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Capital A/c of the old partners Dr.			**with the loss in old profit sharing ratio**
To Revaluation A/c			
(Sharing of Revaluation Loss)			
Accounting treatment of Revaluation of assets and liabilities through Memorandum Revaluation Account(Part - 1)			
A) Assets A/c Dr.			**with increase in the value of individual assets**
Liabilities A/c Dr.			**With decrease in the value of individual liabilities**
To Memorandum Revaluation A/c			
B) Memorandum Revaluation A/c Dr.			
To Assets A/c			**with increase in the value of individual assets**
To Liabilities A/c			**with decrease in the value of individual liabilities**

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Memorandum Revaluation A/c Dr			**If there is profit on revaluation.**
To Old Partners' Capital A/c			
Old Partners' Capital A/C Dr.			**If there is loss on revaluation.**
To Memorandum Revaluation A/c			
Accounting treatment of Revaluation of assets and liabilities through Memorandum Revaluation Account(Part - 2)			
REVERSE ENTRIES OF PART 1 (A &B)			
Memorandum Revolution A/c Dr.			**(New profit and loss sharing ratio)**
To All Partners' Capital A/c			
(If there is Profit)			
All Partners' Capital A/c Dr.			**(New profit and loss sharing ratio)**
To Memorandum Revaluation A/c			
(If there is loss)			
Reserves or Profit & Loss A/c Dr.			**In the old profit sharing ratio**
To Old Partners' Capital A/c			

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(Any reserve etc. lying in the Balance Sheet transferred to the Capital Accounts of the old partners)		
C's Capital A/c (Gaining Partner)		**In case of Hidden Goodwill**
To A's Capital A/c (Sacrificing Partner)		
To B's Capital A/c (Sacrificing Partner)		
(Being the share of C in the hidden goodwill adjusted through capital accounts by crediting sacrificing partners in their sacrificing ratio)		

HIDDEN GOODWILL

When the value of the goodwill of the firm is not specifically given, the value of goodwill has to be inferred

Particulars	`
Incoming partner's capital x Reciprocal of share of incoming partner	**xxx**
***Less*: Total capital after taking into consideration the capital brought in by incoming partner**	**xxx**
Value of Goodwill	**xxx**

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6.2 Retirement of Partner

When a partner retires from a firm, the treatment of various items like revaluation of assets, goodwill treatment, sacrifice/gain ratio, reserves etc., are similar to that of admission of a partner into a partnership firm. The only additional treatment which is required is to settle the amount due to outgoing partner.

Important Points:

1. The revaluation gain/loss belongs to all the partners (before retirement) and is distributed in existing profit sharing ratio.
2. The reserves are distributed to all partners in existing profit sharing ratio.
3. The goodwill is adjusted on the basis of gain ratio or sacrifice ratio. (Can be done using table adjustment)
4. The settlement to partner is done based on agreement between partners as discussed below.

Settlement

1. The final amount standing to the credit of capital account may be paid in full to the retiring partner.

    Retiring Partner Capital A/c … Dr.

        To Bank A/c

2. If the amount is not settled in full, the balance amount is transferred to loan account.

    Retiring Partner Capital A/c … Dr.

        To Bank A/c

        To Retiring Partner's Loan A/c

The loan is repaid as per the terms of retirement and entries will be passed accordingly.

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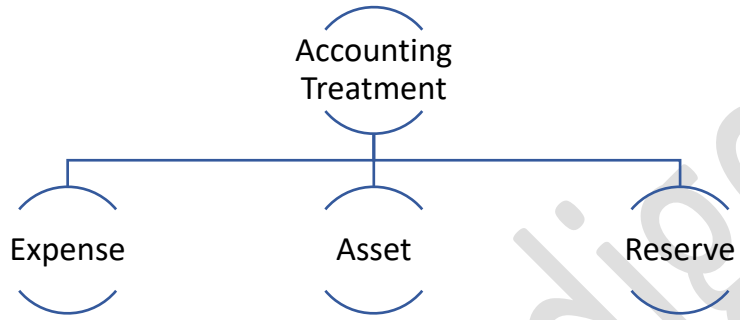
Joint Life Policy

- A partnership firm may decide to take a Joint Life Insurance Policy on the lives of all partners.
- The firm pays the premium and the amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier.
- The objective of taking such a policy is to minimize the financial hardships to the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.



1. When JLP is treated as expense

Payment of JLP premium	JLP Premium A/c Dr. To Bank A/c
Transfer of JLP to P&L	Profit & Loss A/c Dr. To JLP Premium A/c
On Maturity of Policy	Bank A/c Dr. To Partners Capital A/c (in PSR)

2. When JLP is treated as Asset

Payment of JLP premium	Joint Life Policy A/c Dr. To Bank A/c
Year End – Check with Surrender Value	Profit & Loss A/c Dr.

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Loss = JLP Balance – Surrender Value	To Joint Life Policy A/c
On Maturity of Policy	Bank A/c Dr. To Joint Life Policy A/c To Partner's Capital A/c (In case of gain)

3. Creation of JLP Reserve

Payment of JLP premium	Joint Life Policy A/c Dr. To Bank A/c
Year End Creation of Reserve	Profit & Loss Appropriation A/c Dr. To JLP Reserve A/c
Year End – Check with Surrender Value Loss = JLP Balance – Surrender Value	JLP Reserve Dr. To Joint Life Policy A/c
On Maturity of Policy	JLP Reserve A/c To Joint Life Policy A/c
Balance in JLP A/c	Transferred to Partners

Joint Life Policy – Individual

- All the partners may take individual life policies for each of them by paying the premium from the firm.
- In the event of retirement, the retired partner is entitled for the surrender value of the life policies of all the partners.

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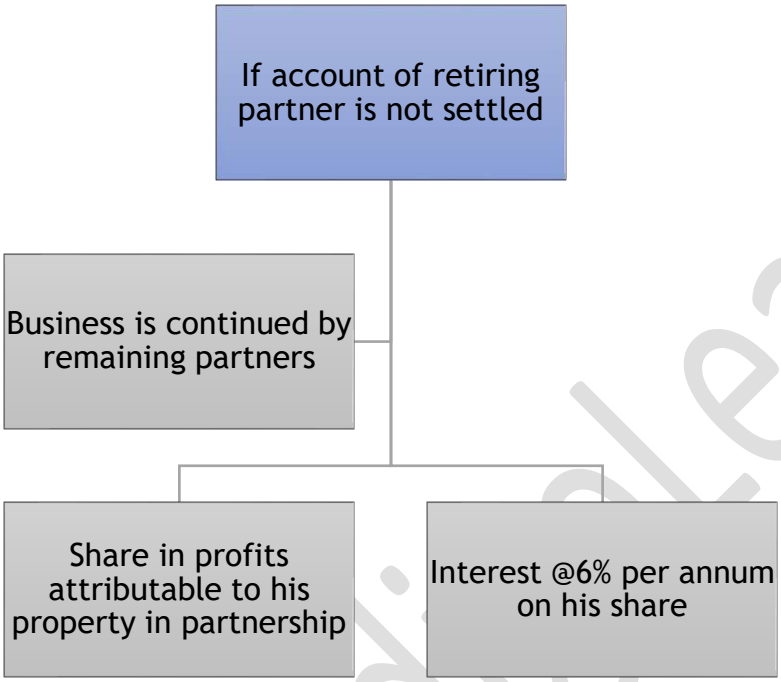
Right in subsequent profits



6.3 Death of a Partner

The problems arising on the death of a partner are similar to those arising on retirement

Important Points:

1. The revaluation gain/loss belongs to all the partners and is distributed in existing profit sharing ratio.
2. The reserves are distributed to all partners in existing profit sharing ratio.
3. The goodwill is adjusted on the basis of gain ratio or sacrifice ratio. (Can be done using table adjustment)
4. The treatment of Joint Life Policy would be different as the firm would receive the sum assured on the policy.
5. The amount due to the deceased partner would be paid to the legal heirs.
6. Business may be continued by other partners (also known as reconstitution of partnership)

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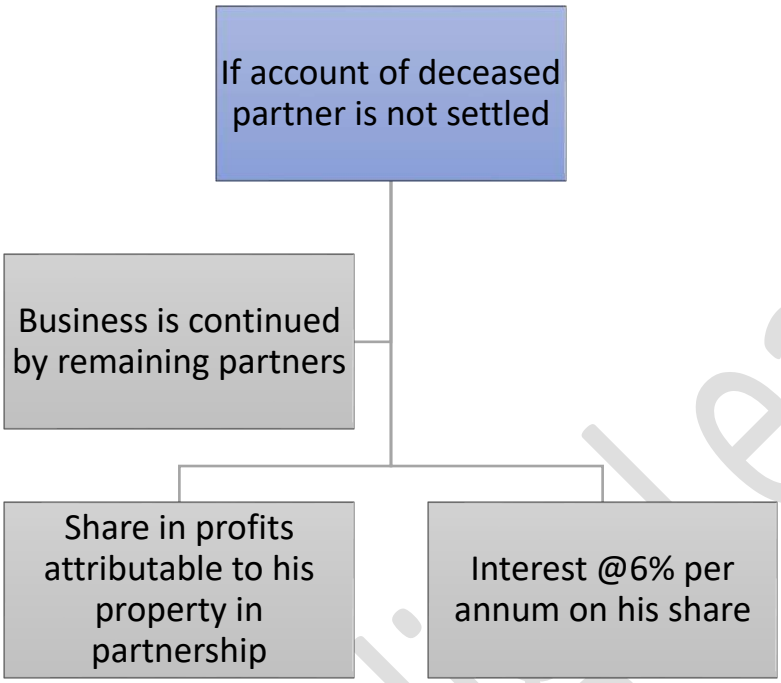
Right in subsequent profits



Amount payable to legal representatives

1. The amount standing to the credit to the capital account of the deceased partner
2. Interest on capital, if provided in the partnership deed up to the date of death
3. Share of goodwill of the firm;
4. Share of undistributed profit or reserves;
5. Share of profit on the revaluation of assets and liabilities;
6. Share of profit up to the date of death;
7. Share of Joint Life Policy.
8. Share in profits after death if account is not settled

The following amounts will be deducted

1. Drawings
2. Interest on drawings
3. Share of loss on revaluation of assets and liabilities
4. Share of loss up to the date of death

Settlement

3. The final amount standing to the credit of capital account may be paid in full to the retiring partner.

Retiring Partner Capital A/c … Dr.

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To Bank A/c

4. If the amount is not settled in full, the balance amount is transferred to loan account.

Retiring Partner Capital A/c … Dr.

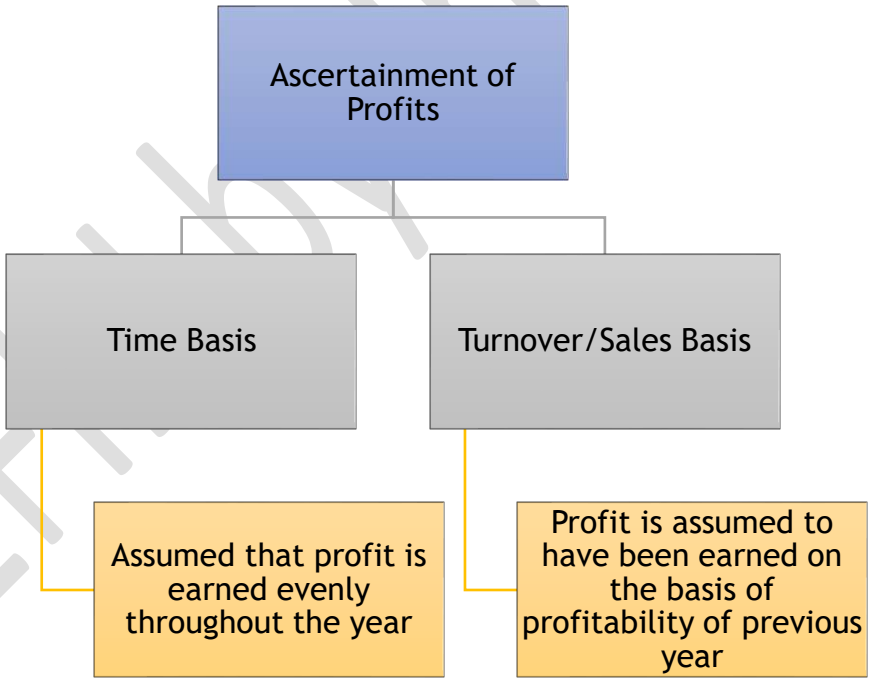
To Bank A/c

To Retiring Partner's Loan A/c

The loan is repaid as per the terms of retirement and entries will be passed accordingly.

Calculation of profits up to the death of a partner

- Profit is calculated through P&L Suspense account.
- Amount due to the deceased partner, it should be credited to his Executor's Account.
- The representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death.



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Joint Life Policy

- The firm will receive the sum assured on joint life policy
- The gain on joint life policy will be credited to the partners in profit sharing ratio
- The joint life policy reserve will be credited to the partners in profit sharing ratio

Entry at time of receipt of amount from Joint Life Policy

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

Entry to transfer gain on Joint Life Policy (balance in JLP)

Joint Life Policy A/c Dr. (Balance Figure)
To Partner's capital A/c (PSR)

Entry to transfer Joint Life Policy (JLP) reserve

Joint Life Policy Reserve A/c
To Partner's Capital A/c (PSR)

Joint Life Policy – Separate Policy

If the firm has taken separate policy for each partner, then at the time of death of partner,

- The firm will receive sum assured on the policy of deceased partner
- The policy of other partners will be valued at surrender value.

Any gain on account of above will be credited to the continuing partners and executor (legal representative)

Bank A/c Dr.
To Separate Life Policy of Deceased partner A/c

(Policy value received on death of a partner)

Separate Life Policy of Deceased Partner A/c Dr. (Sum Assured)
Separate Life Policy of Remaining Partners A/c Dr. (Surrender Value)
To Executor's A/c
To Remaining partners A/c
(Distribution of balances)

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Illustrations

Introduction to Partnership Accounting

Illustration 1 & 2
A and B start business on 1st January 2016, with capitals of Rs. 30,000 and Rs.20,000. According to the Partnership Deed, B is entitled to salary of Rs.500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2016 the firm earned a profit, before charging salary to B and interest on capital amounting to Rs.25,000. During the year A withdraw Rs.8,000 and B withdrew Rs.10,000 for domestic purposes.
Give Journal entries relating to division of profit.

Illustration – 3
Ram, Rahim and Karim are partners in a firm. They have no agreement in respect of profit-sharing ratio, interest on capital, interest on loan advanced by partners and remuneration payable to partners. In a matter of Distribution of profits, they have put forward the following claims:

i) Ram, who has contributed maximum capital demands interest on capital at 10% p.a. and share of profit in the capital ratio. But Rahim and Karim do not agree
ii) Rahim has devoted full time for running the business and demands salary at the rate of Rs.500 p.a. But Ram and Karim do not agree.

Karim demands interest on loan of Rs.2,000 advanced by him at the market rate of interest which is 12% p.a.
How shall you settle the dispute and prepare Profit and Loss Appropriation after transferring 10% of the divisible profits to Reserve? Net profit before taking into account any of the above claims amounted Rs.45,000 at the end of the first year of their business.

Illustration – 4
A and B start business on 1st January,2016 with capitals of Rs.30,000 and Rs.20,000. According to the Partnership Deed, B is entitled to a salary of Rs. 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2016, the firm earned a profit, before charging salary to B and interest on capital amounting to Rs.25,000. During the year A withdrew Rs.8,000 and B withdrew Rs.10,000 for domestic purposes.
Prepare Profit and Loss Appropriation Account.

Illustration 5
Prepare Partner's capital account for Illustration – 4

Illustration – 6
A and B are partners sharing profits and losses in the ratio of their effective capital.

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They had Rs.1,00,000 and Rs. 60,000 respectively in their Capital Accounts as on 1st January 2016. A introduced a further capital of Rs.10,000 on 1st April 2016 and another Rs.5,000on 1st July 2016. On 30th September 2016 A withdrew Rs.40,000.
On 1st July 2016, B introduced further capital of Rs.30,000. The partners drew the following amounts in anticipation of profit.
A drew Rs.1,000 per month at the end of each month beginning from January 2016.
B drew Rs.1,000 on 30th June and Rs.500 on 30th September 2016. 12% p.a. interest on capital is allowed and 10% p.a. interest on drawings is chargeable.
Date of closing 31.12.2016.
Calculate:

- profit sharing ratio
- interest on capital and
- interest on drawings

Illustration 7
A and B were partners in a firm sharing profits and losses in the ratio of 3:2. They admit C for 1/6th share in profits and guaranteed that his share of profits will not be less than Rs.2,50,00,000. Total profits of the firm for the year ended 31st March 2017 were Rs.9,00,000.
Calculate share of profits for each partner when:

1. Guarantee is given by firm
2. Guarantee is given by A
3. Guarantee is given by A and B equally

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Goodwill

Illustration – 1

Lee and Lawson are equal partnership. They agreed to take Hicks as one- fourth partner. For this it was decided to find out the value of goodwill. M/s. Lee and Lawson earned profits during 2013-2016 as follows:

Year	Profits
2013	1,20,000
2014	1,25,000
2015	1,30,000
2016	1,50,000

On 31.12.2016 capital employed by M/s. Lee and Lawson was Rs.5,00,000. Rate of normal profit id 20%. Find out the value of goodwill following various methods.

Illustration – 2

The following particulars are available in respect of the business carried on by Rathore

S.No.	Particulars	Rs.
1)	Capital invested	1,50,000
2)	Trading Results	
	2013 profit	40,000
	2014 profit	36,000
	2015 loss	6,000
	2016 profit	50,000
3)	Market Rate of interest on investment 10%	
4)	Rate of risk return on capital invested in business 2%	
5)	Remuneration from alternative Employment of the proprietor Rs.6,000 per annum (if not engaged in business)	

You are required to compute the value of goodwill on the basis of 5 years purchase of super profit of the business calculated on the average profits of the last four years.

Illustration – 3

The following is the balance Sheet of Yellow and Green as at 31st December 2016:

Liabilities	Rs.	Assets	Rs.

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Trade payables	20,000	Cash at Bank	10,000
Capital:		Sundry Assets	55,000
Yellow	25,000		
Green			
	20,000		
	65,000		65,000

The partners shared profits and losses in the ratio 3:2. On the above date, Black was admitted as partner on the condition that he would pay Rs.20,000 as capital. Goodwill was to be valued at 3 years purchase of the average of four years profits which were:

	Rs.		Rs.
2012	9,000	2014	12,000
2013	14,000	2105	13,000

The new profit-sharing ratio is 6:5:5.
Give journal entries and Balance Sheet if goodwill is adjusted through partner's capital accounts.

Illustration – 4

With the information given in illustration 3, give Journal Entries assuming that goodwill is brought in cash.

Illustration – 5

With the information given in illustration 3, assuming that goodwill is paid privately.

Illustration – 6

A, B and C are equal partners. They wanted to change the profit-sharing ratio into 4:3:2. Make the necessary journal entries. Goodwill of the firm is valued at Rs.90,000.

Illustration – 7

A, B and C are partners sharing profits and losses in the ratio of 4:3:3.
They decided to change the profit-sharing ratio to 7:7:6. Goodwill of the firm is valued at Rs.20,000. Calculate the sacrifice/gain by the partners and make necessary journal entry.

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Admission of a Partner

Illustration 1

The following is the Balance Sheet of Ram and Mohan, who share Profit in the ratio of 3:2 as on 1st January 2016:

Liabilities	Rs.	Assets	Rs.
Trade Payables	15,000	Buildings	18,000
Ram's Capital	20,000	Plant and Machinery	15,000
Mohan's Capital	25,000	Inventories	12,000
		Trade Receivables	10,000
		Bank	5,000
	60,000		**60,000**

On this date Shyam was Admitted on the following:

1. He is to pay Rs.25,000as his capital and Rs.10,000as his share of goodwill for one fifth share in profits.
2. The new profits sharing ratio will be 5:3:2
3. The assets are to be revalued as under:

	Rs.
Building	25,000
Machinery	12,000
Inventories	12,000
Trade receivables (Because of Doubtful debts)	9,500

4. It was found that there was a Lability for Rs.1,500 for goods received but not recorded in books.

Give journal entries to record the above. Also, give the Balance Sheet of the partnership firm after Shyam's admission.

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Illustration 2

A and B are partners sharing profits and losses in the ratio of 3:2. The Balance Sheet as on 31.3.2016 is given below:

Liabilities	Rs.	Assets	Rs.
Trade Payables	50,000	Freehold premises	2,00,000
Capital A/c		Plant	40,000
A	2,00,000	Furniture	20,000
B	1,00,000	Office equipment	25,000
		Inventories	30,000
		Trade Receivables	25,000
		Bank	10,000
	3,50,000		**3,50,000**

On 1.4.2016 they admit C on the following terms:

1. C will bring Rs.50,000 as a capital and Rs.10,000 for goodwill for 1/5 share;
2. Provision for doubtful debts is to be made on trade receivables @2%
3. Inventory to written down by 10%
4. Freehold premises are to be revalued at Rs.2,40,000, plant at Rs.35,000 furniture Rs.25,000 and office equipment Rs.27,500.
5. Partners agreed that the values of the assets and liabilities remain the same and as such, there should not be any change in the book values as a result of the above-mentioned adjustments.

You are required to make necessary adjustments in the capital Accounts of the partners and show the Balance Sheet of the New Firm.

Illustration 3

Dalal, Banerji and Mallick are partners in a firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March 2016 is as below:

Liabilities	Rs.	Assets	Rs.
Trade payables	12,850	Land and Buildings	25,000
Outstanding Liabilities	1,500	Furniture	6,500
General Reserves	6,500	Inventory of goods	11,750
Capital Account:		Trade receivables	5,500
Mr. Dalal – 12,000		Cash in Hand	140
Mr. Banerji – 12,000		Cash at Bank	960
Mr. Mallick - 5,000	29,000		

	49850		**49850**

The partners have agreed to take Mr. Mistri as a partner with effect from 1st April 2016 on the following terms:

1) Mr. Mistri shall bring Rs.5,000 towards his capital.
2) The value of Inventory should be increased by Rs.2,500 and furniture should be depreciated by 10%.
3) Reserves for bad and doubtful debts should be provided at 10% of the Trade receivables.
4) The value of land and buildings should be enhanced by 20% and the value of the goodwill be fixed at Rs.15,000.
5) The value of the goodwill be fixed at Rs.15,000.
6) General Reserve will be transferred to the partner's Capital Accounts.
7) The new profit- sharing ratio shall be: Mr. Dalal 5/15, Mr. Banerji 3/15, and Mr. Mistri 2/15.
   The outstanding liabilities include Rs.1,000 due to Mr. Sen which has been paid by Mr. Dalal. Necessary entries were not made in the books.

Prepare i) Revaluation Account, ii) The Capital Accounts of the partners, iii) Balance Sheet of the firm after admission of Mr. Mistri

Illustration 4

A and B are in a partnership sharing profits and losses in the proportion of three- fourth respectively. Their Balance Sheet as on 31st March 2016 was as follows:

Cash Rs.1,000: trade receivable Rs.25,000; inventory Rs.22,000; plant and machinery Rs.4,000; trade payables Rs.12,000; bank overdraft Rs.15,000; A's Capital Rs.15,000; B's Capital Rs.10,000.

1) C to purchase one-third of the goodwill for Rs.20,000 and provide Rs.10,000 as capital. Goodwill not to appear in books.
2) Further profits and losses are to share by A B and C equally.
3) Plant and machinery is to be reduced by 10% and Rs.500 is to provide for estimated bad debts. Inventory is to be taken at a valuation of Rs.24,940.
4) By brining in or withdrawing cash and capitals of A and B are to be made proportionate to that of C on their profit-sharing basis.

Set out entries to the above arrangement in the firm's journal and give the partners'capital accounts in tabular from.

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Illustration 5

A and B are partners of X & Co. sharing profits and losses in 3:2 ratio between themselves. On 31st March 2016, the Balance Sheet of the firm was as follows:

Liabilities	Rs.	Assets	Rs.
Capital A/cs:		Plant and Machinery	20,000
A:37,000		Furniture and	5,000
B:28,000	65,000	Fittings	15,000
		Inventories	20,000
Trade Payables	5,000	Trade Receivables	10,000
		Cash in Hand	
	70,000		**70,000**

X agrees to join the business on the following conditions as and from 1.4.2016:

a) He will introduce Rs.25,000 as his capital and pay Rs.15,000 to the partners as premium for goodwill for 1/3rd share of the future profits of the firm.
b) A revaluation of assets of the firm will be made by reducing the value of plant and machinery to Rs.15,000, inventory by 10%, furniture and fittings by Rs.1,000 and by making a provision of bad and doubtful debts at Rs.750 on trade receivables.

Prepare profit and losses adjustment account, capital accounts of partners including partner X assuming that the relative ratios of the old partners will be in equal proportion after admission.

Illustration 6

A and B are in partnership sharing profits and losses equally. The Balance Sheet M/s. A and B as on 31.12.2016, was as follows:

Liabilities	Rs.	Assets	Rs.
Capital A/cs:		Sundry fixed assets	60,000
A	45,000	Inventories	30,000
B	45,000	Bank	20,000
Trade Payables	20,000		
	1,10,000		**1,10,000**

On 1.1.2017 they agreed to take C as 1/3rd partner to increase the capital base to Rs.1,35,000. C agrees to pay Rs.60,000. Show the necessary journal entries and prepare partner's capital accounts.

Retirement of Partner

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Illustration 1

F, G and K were partners sharing profits and losses at the 2:2:1. K wants to retire on 31.12.2015. given below is the Balance Sheet of the Partnership as well as other information:

Balance Sheet as on 31.12.2015

Liabilities	Rs.	Assets	Rs.
Capital A/cs:		Sundry Fixed Assets	1,50,000
F	1,20,000	Inventories	50,000
K	80,000	Trade Receivables	70,000
G	60,000	(including Bills Receivables	
Reserves	10,000	Rs.20,000)	50,000
Trade Payables	50,000	Bank	
	3,20,000		**3,20,000**

F and G agrees to share profits and losses at the ratio of 3:2 in future. Value of Goodwill is taken to be Rs.50,000. Sundry fixed Assets are revalued upward by Rs.30,000 and inventories by Rs.10,000. Bills Receivable dishonoured Rs.5,000 on 31.12.2015 but not recorded in the books. Dishonour of bill was due to insolvency of the customer. F and G agree to bring sufficient cash to discharge claim of K and to make their capital proportionate. Also, they wanted to maintain Rs. 75,000 bank balance for working capital.

Required:

Pass necessary journal entries and draft the balance Sheet of M/s F & G. Also prepare capital accounts of partners and the Balance Sheet of M/s F& G after K's retirement.

Illustration 2

K, L & M are partners- sharing profits and losses in the ratio 5:3:2. Due to illness, L wanted to retire from the firm on 31.12.2015 and admit his son N in his place.

Balance Sheet of K, L and M as on 31.3.2015

Liabilities	Rs.	Assets	Rs.

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Capital A/cs:		Goodwill	30,000
F: 40,000		Furniture	20,000
K: 60,000		Trade receivables	50,000
G: 30,000	1,30,000	Inventory in trade	50,000
		Cash and bank	50,000
Reserves	50,000	balance	
Trade Payables	20,000		
	2,00,000		**2,00,000**

On the retirement of L assets were revalued: Goodwill Rs.50,000, furniture Rs.10,000 and inventory in trade Rs.30,000. 50% of the amount due to L was paid off in cash and the balance was retained in the firm as capital of N. On admission of the new partner, goodwill has been written off. M is paid off his extra balance to make capital proportionate.

You are required to give:

i) Necessary journal entries
ii) Balance Sheet of M/s K, M and N

Capital Accounts of partners

Illustration 3
Dowell & Co. is a partnership firm with partners Mr. A, Mr. B and Mr. C, sharing profits and losses in the ratio of 10:6:4. The Balance Sheet of the firm as at 31st March 2015 is as under:

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital A/cs:		Land	10,000
Mr. A:80,000		Buildings	2,00,000
Mr. B:20,000		Plant and Machinery	1,30,000
Mr. C: 30,000	1,30,000	Furniture	43,000
Reserves		Investment	12,000
(inappropriate profit)	50,000	Inventories	1,30,000
Long term Debt	3,00,000	Trade Receivables	1,39,000
Bank O/D	44,000		
Trade Payables	1,70,000		
	6,64,000		**6,64,000**

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It was mutually agreed that Mr. B will retire from the partnership and in his place Mr. D will be admitted as a partner with effect from 1st April 2015. For this purpose, the following adjustments are to be made:

a) Goodwill is to be valued at 1 lakh but the same will not appear as an asset in the books of the reconstituted firm.
b) Building and plant and machinery are to be depreciated by 5% and 20% respectively. Investments are to be taken over by the retiring partner at Rs.15,000. Provision of 20% is to be made on trade receivables to cover doubtful debts.
c) In the reconstituted firm, the total capital will be Rs.2 lakhs which will be contributed by Mr. A, Mr.C and Mr. D in their new profit- sharing ratio, which is 2:2:1.
    1) The surplus funds, if any will be used for repaying bank O/D.
    2) The amount due to retiring partner shall be transferred to his loan account.

Required:
Prepare i) Revaluation account
ii) Partners capital accounts:
iii)Bank account and
iv)Balance Sheet of the reconstituted firm as on 1st April 2015.

Illustration 4
Red, White and Black shared profits and losses in the ratio of 5:3:2. They took out a joint life policy in 2011 for Rs.50,000, a premium of Rs.3,000 being paid annually on the 10th June.
The surrender value of the policy on 31st December of various years was as follows: 2011 nil;
2012 Rs.900;
2013 Rs.2,000;
2014 Rs.3,600.
Black retires on 15th April 2015.
Required
Prepare ledger accounts assuming no Joint Life Policy Account is Maintained.

Illustration 5

A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. The balance sheet of the firm on 31.12.2015 was as follows:

Balance Sheet

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital A/cs :		Sundry Fixed Assets	80,000
A	50,000	Inventories	50,000
B	40,000	Trade receivables	30,000
C	30,000	Joint Life Policy	20,000
Bank loan	40,000	Bank	10,000
Trade payables	30,000		

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	1,90,000		**1,90,000**

On 1.1.2016 A wants to retire B and C agreed to continue at 2:1. Joint Life Policy was taken on 1.1.2010 for Rs.1,00,000 and its surrender value as on 31.12.2015 was Rs.25,000. For the purpose of A's retirement goodwill was raised for Rs.1,00,000.
Sundry Fixed Assets was revalued for Rs.1,10,000. But B and C did not prefer to show such increase in assets in the Balance Sheet.
Also, they agreed to bring necessary cash to discharge 50% of the A's claim, to make the bank balance Rs25,000and to make their capital proportionate.
Required:
Prepare necessary journal entries.

Illustration 6

A, B & C were in partnership sharing profits in the proportions of 5:4:3. The balance sheet of the firm as on 31st March 2015 was as under:

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital accounts:		Goodwill	40,000
A	1,35,930	Fixtures	8,200
B	95,120	Inventories	1,57,300
C	61,170	Trade receivables	93,500
Trade payables	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 as on 31st March 2015, the terms of which were as follows:

1. The profit and loss account for the year ended 31st March 2015 which showed a net profit of Rs 48,000 was to be re-opened. B was to be credited with Rs 4,000 as bonus, in consideration of the extra work which had devolved upon him during the year. The profit sharing was to be revised as from 1st April 2014 as 3:4:4
2. Goodwill was to be valued at two years' purchase of the average profits of the preceding five years. The fixtures were to be valued 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.

The valuations arising out of the above agreement were goodwill Rs 56,800 and fixtures Rs 10,980.
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 the revised value, and to increase the provision for doubtful debts to 6%.

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You are required to submit the journal entries necessary to give effect to the above arrangements and to draw up the capital account of the partners after carrying out all adjusting entries as stated above.

Illustration 7
K, L & M are partners sharing profits and losses in the ratio 5:3:2

- Due to illness, L wanted to retire from the firm on 31.03.2015 and admit his son N in his place

Balance Sheet of K, L and M as on 31.3.2015

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)
Capital			Goodwill	30,000
K	40,000		Furniture	20,000
L	60,000			
M	30,000		Trade Receivables	50,000
		1,30,000		
Reserve		50,000	Inventory in Trade	50,000
Trade Payable		20,000		
			Cash and Bank Balances	50,000
		2,00,000		**2,00,000**

On Retirement of L assets were revalued –

- Goodwill Rs. 50,000
- Furniture Rs. 10,000
- Inventory in Trade Rs. 30,000
- 50% of the amount due to L was paid off in cash and the balance was retained in the firm as capital of N

On admission of the new partner, goodwill has been written off
M is paid off his extra balance to make capital proportionate
Required

i. Necessary journal entries
ii. Balance sheet of M/s K, M and N as on 01.04.2015

Capital accounts of partners.

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Death of Partner

Illustration 1

The following was the Balance Sheet of Om & Co. in which X, Y, Z were partners sharing profits and losses in the ratio of 1:2:2 as on 31.3.2016. Mr. Z died on 31st December 2016. His account has to be settled under the following terms.

Balance Sheet of Om & Co. as on 31.3.2016

Liabilities	Rs.	Assets	Rs.
Trade payables	20,000	Goodwill	30,000
Bank Loan	50,000	Building	1,20,000
General reserve	30,000	Computers	80,000
Capital accounts:		Inventories	20,000
X: 40,000		Trade receivables	20,000
Y: 80,000		Cash at bank	20,000
Z:80,000	2,00,000	Investments	10,000
	3,00,000		3,00,000

Goodwill is to be calculated at the rate of two years purchase on the basis of average of three years profits and losses. The profits and losses for three years were detailed as below:

Year ending on	Profits/loss
31.3.2016	30,000
31.3.2015	20,000
31.3.2014	(10,000) loss

Profit for the period from 1.4.2016 to 31.12.2016 shall be ascertained proportionately on the basis of average profits and losses of the preceding three years. During the year ending on 31.3.2016 a car costing Rs.40,000 was purchased on 1.4.2015 and debited to traveling expenses account on which depreciation is to be calculated at 20% p.a. this asset is to be brought into account at the depreciated value.

Other values of assets were agreed as follows:

Inventory at Rs.16,000, Building at Rs.1,40,000, Computers at Rs. 50,00; investments at Rs.6,000. Trade receivables were considered good.

Required

i) Calculate goodwill and Z's share in the profits of the firm for the period 1.4.2016 to 31.12.2016

ii) Prepare revaluation account assuming that other items of assets and liabilities remained the same

Prepare partners' capital accounts and balance sheet of the firm Om & Co. as on 31.12.2016.

Illustration 2

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The partnership agreement of a firm consisting of three partners- A, B and C (who share profits in proportion of ½ ¼ and ¼ and whose fixed capitals are Rs.10,000; Rs.6,000 and Rs.4,000 respectively) provides as follows:

a) That partners be allowed interest at 10 per cent per annum on their fixed capitals, but no interest be allowed on undrawn profits or charged drawings.
b) That upon the death of a partner, the goodwill of the firm be valued at two years' purchase of the average net profits (after charging interest on capital) for the three years to 31st December preceding the death of a partner.

That an insurance policy of Rs.10,000 each to be taken in individual names of each partner, the premium is to be charged against the profit of the firm.

a) Upon the death of a partner, he is to be credited with his share of the profits, interest on capitals etc. calculated upon 31st December following his death.
b) That the share of the partnership policy and goodwill be credited to a deceased partner as on 31st December following his death.
c) That the partnership books be closed annually on 31st December.

A died-on 30th September 2016, the amount standing to the credit of his current account on 31st December 2015 was Rs.450 and from that date to the date of death he had withdrawn Rs.3,000 from the business.
An unrecorded liability of Rs.2,000 was discovered on 30th September 2016. It was decided to record it and be immediately paid off.
The trading result of the firm (before charging interest on capital) had been as follows: 2013 profit Rs.9,640; 2014 profit Rs.6,720; Loss Rs.640; 2016 Profit Rs.3,670
Assuming the surrender value of the policy to be 20 percent of the sum assured.
Required
Prepare an account showing the amount due to A's legal representative as on 31st December 2016.

6.4 Dissolution of Firms

INTRODUCTION

One of the important aspects of partnership accounts is to close books of accounts in case of dissolution. Indian Partnership Act makes a distinction between dissolution of partnership and dissolution of partnership firm.

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Dissolution of Partnership – refers to termination of the old partnership agreement and a reconstruction of the firm due to admission, retirement, and death of a partner. The remaining partners may agree to carry on the business under a new agreement.

Dissolution of partnership firm – refers to closing down of business. The assets of the firm are sold and liabilities are paid off, the remaining amount is settled off among partners.

Basis of distinction	Dissolution of Partnership	Dissolution of firm
1. Meaning	It refers to a change in the existing agreement between partners.	It refers to the dissolution of partnership between all the partners of the firm.
2. continuation of business	The firm continues its business	The firm does not continue its business.
3. Books of accounts	Profit sharing ratio changes but the books of accounts are not closed.	Books of accounts are necessarily closed.
4. Effect	Dissolution of Partnership does not necessarily mean the dissolution of firm	This necessarily means dissolution of Partnership also.
5. Nature	It is voluntary	It may be both voluntary and compulsory.

CIRCUMSTANCES LEADING TO DISSOLUTION OF PARTNERSHIP

★ **Mutual agreement** –
- When all the partners agree for its dissolution.

★ **On happening of an event** –
- The expiry of the term for which it was formed
- The completion of the venture for which it was entered into;
- Death of a partner
- Insolvency of a partner.

However, the partners or remaining partners (in case of death or insolvency) may continue to do the business. In such case there will be a new partnership but the firm will continue.

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★ **Compulsory dissolution** –

- All partners or all except one become insolvent;
- The business becomes illegal;

★ **The court orders dissolution -**

The court has the option to order dissolution of a firm in the following circumstances :

- Where a partner has become of unsound mind;
- Where a partner suffers from permanent incapacity;
- Where a partner is guilty of misconduct of the business;
- Where a partner persistently disregards the partnership agreement;
- Where a partner transfers his interest or share to a third party;
- Where the business cannot be carried on except at a loss; and
- Where it appears to be just and equitable.

CONSEQUENCES OF DISSOLUTION – [Sec 48 of Partnership Act]

★ Firstly, assets of the firm, including goodwill, are realised.

★ Amount realised, is applied towards repayment of

- 1st - Liabilities to outsiders
- 2nd - Loans taken from partners
- 3rd - Capital contributed by partners
- Lastly, if there is still surplus - it is distributed among the partners in their profit-sharing ratio
- In case the amount is insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit- sharing ratio

★ Losses including deficiencies of capital are paid,

- first out of profits,
- next out of capital and,
- lastly, if necessary, by the partners individually in the proportion in which they are entitled to share profits

Private debt – refers to the debts payable by a partner in his personal capacity. Amount realized from the sale of private estate of partner is first used to pay his personal debts and if there is any surplus, it is used to pay firm's debt.

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DISSOLUTION BEFORE EXPIRY OF A FIXED TERM

★ A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund of premium or of such part as may be reasonable, if the firm is dissolved before the term has expired.

★ The amount to be repaid will be such as is reasonable having regard to the terms upon which the admission was made and to the length of period agreed upon and that already expired.

★ Any amount that becomes due will be borne by other partners in their profit- sharing ratio.

★ No claim in this respect will arise if:

- the firm is dissolved due to the death of a partner.
- the dissolution is mainly due to the partner's (claiming refund) own misconduct; and
- the dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

CLOSING OF PARTNERSHIP BOOKS

★ In order to close the books of the firm on dissolution the following accounts are opened in the order given below:

1. Realisation account
2. Partner's loan account
3. Partner's capital account
4. Cash or bank account

⇐ Accounts have to be created in this order only.

★ **Realisation account** – It is a nominal account. It is opened for disposing off all assets of the firm and making payment to all creditors. The objective is to find the profit or loss on realization of assets and payment to creditors which is distributed amount partners in their profit sharing ratio.

★ **Partner's loan account** – This is not transferred to realization account. It is separately prepared and paid off through cash/bank, because it is to be paid after payment to outside liabilities but before payment to partner's capital.

★ **Partner's capital account** – Apart from realization profit or loss, undistributed profits such as General reserve, P&L account etc are transferred to partner's capital account.

The Capital Accounts of partners will show how much amount is due to them or from them. The partner owing money to the firm will pay. Money owing to a partner will be paid to him.

If the capital account of a partner is in debit, after his share of loss or profit has been adjusted therein, the firm will not have sufficient cash or assets to pay off the amounts due to the other partners, until

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the amount is repaid by the partner whose account is in debit. If however, the partner is insolvent, the amount will not be realised. In such a case, the deficiency may be borne by the solvent partners in their profit-sharing ratio or according to the principle settled in the well known case of Garner vs. Murray. In the latter case, the deficiency would be borne by the solvent partners in proportion to their capitals and not in the proportion in which they share profits and losses.

★ **Cash account –** The balance of the cash account at the end will be exactly equal to the balance of capital account, provided they are in credit; credit cash and debit the partners' capital account with the amount payable to them to close their accounts.

Journal entries
For closing the assets account Realisation A/c Dr. To Fixed assets A/c To current assets A/c
Note - 1) All assets **except cash in hand or at bank** are transferred to this account at **book values.** 2) Sundry Debtors and **Provisions for Bad Debts Accounts** are two separate accounts and the gross amount of debtors should be transferred. 3) **Fictitious assets** like Debit balance of P&L account, deferred revenue expenditure etc. should not be transferred to realization account. Such accounts are transferred to **partner's capital account.** 4) **If the question is silent about the realization of an asset, it is assumed that the asset has not realized any amount** 5) If goodwill is already appearing in the balance sheet, it is treated like any other asset and is transferred to realization account.
For transferring fictitious assets Partner's capital A/c Dr. To Deferred revenue expenditure A/c To P&L A/c
For transferring outside liabilities

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Sundry Creditors A/c Dr. Provision for bad debts A/c Dr. Bank /Outsider's loan A/c Dr. To Realisation A/c **Note:** Bank overdraft is not to be transferred to realization account. It is a negative bank balance to be shown on the credit side of the bank account.
For accounting the actual amount realized by sale of assets Cash A/c Dr. To Realisation A/c
If a partner takes over an asset Partner's Capital A/c Dr. To realisation A/c **Note** – This entry is made at the **values agreed upon**
If a partner takes over a liability Realisation A/c Dr. To Partner's capital A/c **Note** – This is also accounted at the **amount agreed upon.**
Expenses of dissolution or realisation of assets Realisation A/c Dr. To cash A/c
When expenses of dissolution are paid by a partner on behalf of the firm Realisation A/c Dr. To Partner capital A/c
The actual amount paid to creditors or towards settlement of outside liabilities Realisation A/c Dr. To cash A/c **Note – If the question is silent about the payment of any liability, it has to be paid out in full.**
Transferring realization profit to Partner's capital account Realisation A/c Dr. To Partner's capital A/c
Transferring realization loss to partner's capital accont Partner's Capital A/c Dr. To Realisation A/c

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Payment of Partner's loan account Partner's loan A/c To Cash A/c	Dr.
Transfer of undistributed profits General reserve A/c Profit & Loss A/c To Partner's capital A/c Note: Investment fluctuation fund is transferred to credit side of realization account only if investments are appearing on the asset side. Otherwise it is credited to partner's capital account.	Dr. Dr.
In case of surplus cash available to be paid towards capital Partner's Capital A/c To Cash A/c **Note:** - The above entry will be reversed if a partner has to bring in cash. This will close the Capital Accounts as well as the Cash Account	Dr.

- Loan taken from partner will be passed through cash or bank account.
- Loan given to a partner will be transferred (debited) to his capital account.
- Outsider's loan account will include Partner's spouse loan account which is transferred to realization a/c.
- If the current account of the partner from whom loan has been taken by the firm, shows a debit balance after all adjustment, his loan account will be transferred to the credit of his capital account to the extent of debit balance of capital account.

6.5 Insolvency of Partner

CONSEQUENCES OF INSOLVENCY OF PARTNER

If a partner goes insolvent, then the following are the consequences:

- The partner adjudicated as insolvent ceases to be a partner on the date on which the order of adjudication is made.

- The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.
- The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication, and
- The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.

LOSS ARISING FROM INSOLVENCY OF A PARTNER

When a partner is unable to pay his debt due to the firm he is said to be insolvent and the share of loss is to be borne by other solvent partners in accordance with the decision in the English case of **Garner vs. Murray.**

According to this decision, solvent partners have to bear the loss due to insolvency of a partner and have to categorically put that the normal loss on realisation of assets to be borne by all partners (including insolvent partner) in the profit sharing ratio but a **loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio.**

> The provisions of the Indian Partnership Act are not contrary to Garner vs. Murray rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per deed should be applied.

The determination of capital ratio for this has been explained below.

Capital Ratio on Insolvency

- The partners are free to have either fixed or fluctuating capitals in the firm.

Scenario	Consequence
If capitals are fixed	➢ All adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary etc. are done through Current Accounts, which may have debit or credit balances and ➢ Insolvency loss is distributed in the ratio of fixed capitals.

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If capitals are not fixed	➢ All transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts and ➢ Capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and on drawings to the date of dissolution **but before adjusting profit or loss on Realisation Account**.
If some partner is having a debit balance in his Capital Account	➢ Although he is not insolvent, he cannot be called upon to bear loss on account of the insolvency of other partner.
When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners	➢ All the partners of the firm are said to be insolvent. ➢ Under such circumstances it is better not to transfer the amount of creditors to Realisation Account ➢ Creditors may be paid the amount available including the amount contributed by the partners. ➢ The unsatisfied portion of creditor account is transferred to Capital Accounts of the partners in the profit sharing ratio, then Capital Accounts are closed. In doing so first close the Partners' Capital Account which is having the worst position. The last account will be automatically closed.

PIECEMEAL PAYMENTS

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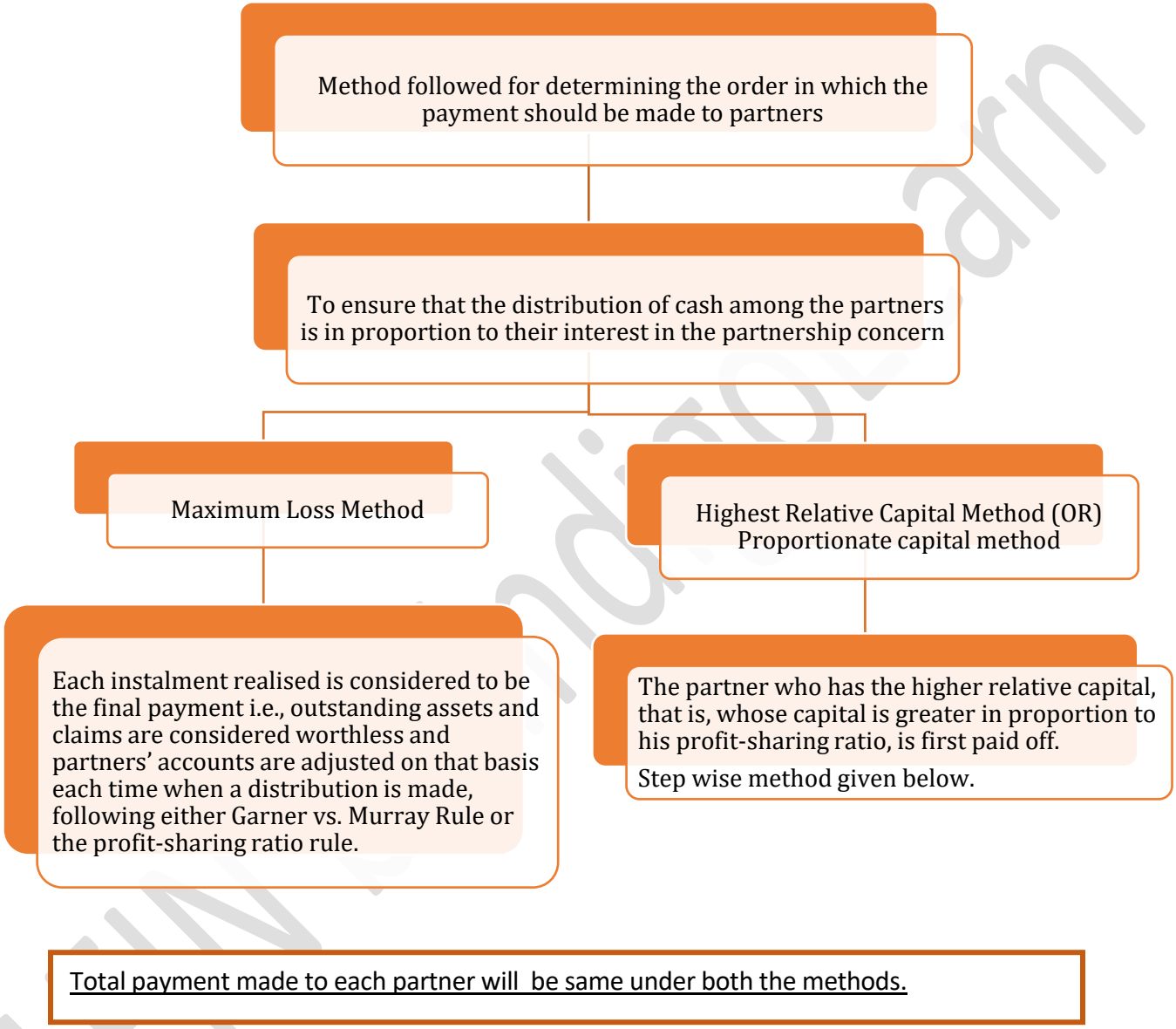
Generally, the assets sold upon dissolution of partnership are realised only in small instalments over a period of time. In such circumstances, usually whatever is collected is distributed instead of waiting till the whole amount is collected.



Highest Relative Capital Method

Step wise method:

1. For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit- sharing ratio;
2. The smallest quotient will indicate the basic capital. Having ascertained the partner

who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called as their hypothetical capitals.

3. The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital; the resultant figure will be the amount of excess capital held by him.
4. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained.
5. The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

ISSUES RELATED TO ACCOUNTING IN LIMITED LIABILITY PARTNERSHIPS

The Limited Liability Partnerships (LLPs) in India were introduced by Limited Liability Partnership Act, 2008 which lay down the law for the formation and regulation of Limited Liability Partnerships.

Definitions **Section 2 of the Limited Liability Partnership (LLPs) Act, 2008 defines the following terms**	
Limited liability partnership	Means a partnership formed and registered under this Act
Limited liability partnership agreement	Means any written agreement between the partners of the limited liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership
Foreign limited liability partnership	Means a limited liability partnership formed, incorporated or registered outside India which establishes a place of business within India
Business	Includes every trade, profession, service and occupation
Designated partner	Means any partner designated as such pursuant to section 7 of the Act
Partner	Means any person who becomes a partner in the limited liability partnership in accordance with the limited liability partnership agreement

NATURE OF LIMITED LIABILITY PARTNERSHIP (LLP)

★ **Separate legal entity** - A LLP is a body corporate formed and incorporated under this Act and is a

legal entity separate from that of its partners.

★ **Perpetual succession** – A LLP has a perpetual succession. Any change in the partners of a limited liability partnership should not affect the existence, rights or liabilities of the LLP.

★ **Non-applicability of the Indian Partnership Act, 1932 -** Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 should not apply to a LLP.

★ **Minimum number of partners** - As per section 6 of the LLP Act, every limited liability partnership should have at least two partners.

- If at any time the number of partners is reduced below two
- and the LLP carries on business for more than six months,
- the person, who is the only partner during such six months and
- has the knowledge of the fact that it is carrying on business with him alone,
- will be liable personally for the obligations of the LLP incurred during that period.

★ **Membership** - As per section 5 of the LLP Act, any individual or body corporate may be a partner. Provided that an individual should not be capable of becoming a partner of a LLP, if-

(a) he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force;

(b) he is an undischarged insolvent; or

(c) he has applied to be adjudicated as an insolvent and his application is pending

DISTINCTION BETWEEN AN ORDINARY PARTNERSHIP FIRM AND AN LLP

	Basis of difference	Partnerships	LLPs
1	Applicable Law	Indian Partnership Act 1932	The Limited Liability Partnerships Act, 2008
2	Registration	Optional	Compulsory with ROC
3	Creation	Created by an Agreement	Created by Law
4	Body Corporate	No	Yes
5	Separate Legal Entity	No	Yes
6	Perpetual Succession	Partnerships do not have perpetual succession	It has perpetual succession and individual partners may come and go

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7	Number of Partners	Minimum 2 and Maximum 20 (subject to 10 for banks)	Minimum 2 but no maximum Limit
8	Ownership of Assets	Firm cannot own any assets. The partners own the assets of the firm	The LLP as an independent entity can own assets
9	Liability of Partners / Members	Unlimited: Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets	Limited to the extent of their contribution towards LLP except in case of intentional fraud or wrongful act of omission or commission by a partner.
10	Principal Agent Relationship	Partners are the agents of the firm and of each other	Partners are agents of the firm only and not of other partners

OTHER IMPORTANT PROVISIONS OF LIMITED LIABILITY PARTNERSHIP ACT, 2008

DESIGNATED PARTNERS

SEC 7

1) Every limited liability partnership should have
   - at least two designated partners who are individuals and
   - at least one of them should be a resident in India:
2) Provided that in case of a LLP in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such limited liability partnership or nominees of such bodies corporate will act as designated partners.
3) For the purposes of this section, the term "resident in India" means a person who has stayed in India for a period of not less 182 days during the immediately preceding one year.
4) If the incorporation document-
   - specifies who are to be designated partners, such persons should be designated partners on incorporation; or
   - states that each of the partners from time to time of LLP is to be designated partner, every such partner will be a designated partner;
5) Any partner may become a designated partner by and in accordance with the LLP agreement and a partner may cease to be a designated partner in accordance with LLP agreement.
6) An individual will not become a designated partner in any LLP unless he has given his prior consent

to act as such in such form and manner as may be prescribed.

7) Every LLP should file with the registrar the particulars of every individual who has given his consent to act as designated partner in such form and manner as may be prescribed within thirty days of his appointment.
8) An individual eligible to be a designated partner should satisfy such conditions and requirements as may be prescribed.

LIABILITIES OF DESIGNATED PARTNERS

Sec 8

Unless expressly provided otherwise in this Act, a designated partner should be-

- responsible for the doing of all acts, matters and things as are required to be done by the LLP in respect of compliance of the provisions of this Act including filing of any document, return, statement and the like report pursuant to the provisions of this Act and as may be specified in the limited liability partnership agreement; and .
- liable to all penalties imposed on the LLP for any contravention of those provisions.

CHANGES IN DESIGNATED PARTNERS

A limited liability partnership may appoint a designated partner within thirty days of a vacancy arising for any reason and provisions of sub-section (4) and sub-section (5) of section 7 will apply in respect of such new designated partner:

Provided that if no designated partner is appointed, or if at any time there is only one designated partner, each partner will be deemed to be a designated partner

FORMATION OF LLP

Two or more persons associated for the purpose of carrying on a lawful business with a view to earn profits may subscribe their names to an incorporation document and file the same with the Registrar of the state in which the Registered Office of the LLP is to be situated, in such manner with such fees as may be prescribed along with a statement in the prescribed form made either by an advocate, a company secretary or a chartered accountant or a cost accountant, who is engaged in the formation of LLP and by any one who subscribed his name to incorporation document, that all the requirements of the LLP Act 2008 and the rules made there under have been complied with.

LIMITATION OF LIABILITY OF AN LLP AND ITS PARTNERS

SEC 27(1)

A LLP is not bound by anything done by a partner in dealing with a person, if:

- The partner does not have the authority to act on behalf of the LLP in doing a particular act; and
- The other person knows that the partner has no authority or does not know or

believe him to be a partner in the LLP

SEC 27(2)

The LLP is liable if a partner of LLP is liable to any person as a result of wrongful or omission on his part in the course of business of the LLP or with his authority.

SEC 27(3)

An obligation of an LLP arising out of a contract or otherwise, will be solely the obligation of the LLP;

The Liabilities of an LLP should be met out of the properties of the LLP

SEC 28(1)

A partner is not personally liable, directly or indirectly, for an obligation referred to in Section 27 (3) above, solely by reason of being a partner in the LLP

SEC 30(1)

The liability of the LLP and the partners perpetrating fraudulent dealings will be unlimited for all or any of the debts or other liabilities of the LLP.

FINANCIAL DISCLOSURES & RETURNS

SEC 34(1)

Every LLP should maintain such proper books of accounts as may be prescribed relating to its affairs for each year of its existence on cash basis or accrual basis and according to the double entry system of accounting and should maintain the same at its registered office for such period as may be prescribed;

SEC 34(2)

Every LLP should within six months of the end of each financial year prepare a Statement of Account and Solvency for the said financial year as at the last day of the said financial year, in such form as may be prescribed, and such statement should be signed by the designated partners of the LLP

SEC 34(3)

Every LLP should file within the prescribed time, the Statement of Account and Solvency with the Registrar every year in such form and manner and accompanied by such fee as may be prescribed

SEC 34(4)

The accounts of an LLP must be audited in accordance with such rules as may be prescribed.

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SEC 35(1)

Every LLP is required to file an Annual Return which is duly authenticated with the registrar within sixty days of the closure of its financial year in such form and manner and with such fees as may be prescribed.

ASSIGNMENT AND TRANSFER OF PARTNERSHIP RIGHTS

- The rights of a partner to the share of profits and losses of an LLP and to receive distribution in accordance with the LLP Agreement are transferable wholly or in part.
- The transfer of any right by a partner as above does not by itself cause the disassociation of the partner or a dissolution or winding up of the LLP;
- Similarly, the transfer of the right as above does not entitle the transferee to participate in the management or the conduct of activities of the LLP, or give access to any information concerning the transactions of the LLP.

CONVERSION OF FIRM INTO LIMITED LIABILITY PARTNERSHIP

SEC 55

A firm may convert into a LLP in accordance with the provisions of the Act and the Second Schedule to the Act.

SEC 56

A private limited company may convert into an LLP in accordance with the provisions of the Act and the Third Schedule to the Act.

SEC 57

An unlisted public limited company may convert into an LLP in accordance with the provisions of the Act and the Fourth Schedule to the Act.

WINDING UP AND DISSOLUTION

SEC 63

An LLP may be wound up voluntarily or by the Tribunal and such LLP so wound up may be dissolved.

SEC 64

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LLP may be wound up by the Tribunal:

1) If the LLP decides that it should be wound up by the Tribunal;
2) If for a period of more than six months, the number of partners of the LLP is reduced below two;
3) If the LLP is unable to pay its debts;
4) If the LLP has acted against the interests of the integrity and sovereignty of India, the security of the state or public order;
5) If the LLP has defaulted in the filing of the Statement of Account and Solvency with the Registrar for five consecutive financial years;
6) If the Tribunal is of the opinion that it is just and equitable that the LLP be wound up.

Illustrations

Illustration – 1

X, Y and Z are partners of the firm XYZ and Co., sharing Profits and Losses in the ratio of 4 : 3 : 2. Following is the Balance Sheet of the firm as at 31st March, 20X1:

Balance Sheet as at 31st March, 20X1

Liabilities	Rs.	Assets	Rs.
Partners' Capitals:		Fixed Assets	5,00,000
X	4,00,000	Stock in trade	3,00,000
Y	3,00,000	Sundry debtors	5,00,000
Z	2,00,000	Cash in hand	10,000
General Reserve	90,000		
Sundry Creditors	3,20,000		
	13,10,000		**13,10,000**

1. Partners of the firm decided to dissolve the firm on the above said date.
2. Fixed assets realised Rs. 5,20,000 and book debts Rs. 4,40,000.
3. Stocks were valued at Rs. 2,50,000 and it was taken over by partner Y.
4. Creditors allowed discount of 5% and the expenses of realisation amounted to Rs. 6,000.

You are required to prepare:

(i) Realisation account;
(ii) Partners capital account; and
(iii) Cash account.

Illustration - 2

P, Q and R were partners sharing profits and losses in the ratio of 3 : 2 : 1, no partnership salary or interest on capital being allowed. Their balance sheet on 30th June, 20X1 is as follows:

Liabilities		**Rs.**	**Assets**	**Rs.**

Fixed Capital			Fixed assets :	
P	20,000		Goodwill	40,000
Q	20,000		Freehold Property	8,000
R	10,000	50,000	Plant and Equipment	12,800
Current Accounts:			Motor Vehicle	700
P	500		Current Assets	
Q	9,000	9,500	Stock	3,900
Loan from P		8,000	Trade Debtors 2,000	
Trade Creditors		12,400	Less : Provision (100)	1,900
			Cash at Bank	200
			Miscellaneous losses	
			R's Current Account	400
			Profit and Loss Account	12,000
		79,900		79,900

On 1st July, 20X1 the partnership was dissolved. Motor Vehicle was taken over by Q at a value of Rs. 500 but no cash passed specifically in respect of this transaction.

Sale of other assets realised the following amounts:

	Rs.
Goodwill	*nil*
Freehold Property	*7,000*
Plant and Equipment	*5,000*
Stock	*3,000*
Trade Debtors	*1,600*

Trade Creditors were paid Rs. 11,700 in full settlement of their debts.
The costs of dissolution amounted to Rs. 1,500.
The loan from P was repaid, P and Q were both fully solvent and able to bring in any cash required but R was forced into bankruptcy and was only able to bring 1/3 of the amount due.
You are required to show:
(a) Cash and Bank Account,
(b) Realisation Account, and
(c) Partners Fixed Capital Accounts (after transferring Current Accounts' balances).

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Illustration - 3

Amal and Bimal are in equal partnership. Their Balance Sheet stood as under on 31st March, 20X1 when the firm was dissolved:

Liabilities	Rs.	Assets	Rs.
Creditors A/c	4,800	Plant & Machinery	2,500
Amal's Capital A/c	750	Furniture	500
		Debtors	1,000
		Stock	800
		Cash	200
		Bimal's drawings	550
	5,550		**5,550**

The assets realised as under:

Asset	Rs.
Plant & Machinery	1,250
Furniture	150
Debtors	400
Stock	500

The expenses of realisation amounted to Rs. 175. Amal's private estate is not sufficient even to pay his private debts, whereas Bimal's private estate has a surplus of Rs. 200 only.
Show necessary ledger accounts to close the books of the firm

Illustration – 4

M/s X, Y and Z who were in partnership sharing profits and losses in the ratio of 2:2:1 respectively, had the following Balance Sheet as at December 31, 20X1:

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital :X	29,200		Fixed Assets		40,000
Y	10,800		Stock		25,000
Z	10,000	50,000	Book Debts	25,000	
Z's Loan		5,000	Less : Provision	(5,000)	20,000
Loan from Mrs. X		10,000	Cash		1,000
Sundry Trade Creditors		25,000	Advance to Y		4,000
		90,000			**90,000**

The firm was dissolved on the date mentioned above due to continued losses.

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- After drawing up the balance sheet given above, it was discovered that goods amounting to Rs. 4,000 have been purchased in November, 20X1 and had been received but the purchase was not recorded in books.
- Fixed assets realised Rs. 20,000; Stock Rs. 21,000 and Book Debt Rs. 20,500.
- Similarly, the creditors allowed a discount of 2% on the average.
- The expenses of realisation come to Rs. 1,080.
- X agreed to take over the loan of Mrs. X.
- Y is insolvent, and his estate is unable to contribute anything.

Give accounts to close the books; work according to the decision in Garner vs. Murray.

Illustration – 5 & 6

The following is the Balance Sheet of A, B, C on 31st December, 20X1 when they decided to dissolve the partnership:

Liabilities	Rs.	Assets	Rs.
Creditors	2,000	Sundry Assets	48,500
A's Loan	5,000	Cash	500
Capital Accounts:			
A	15,000		
B	18,000		
	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	20,100
	34,000

The expenses of realisation were expected to be Rs.500 but ultimately amounted to Rs.400 only. Show how at each stage the cash received should be distributed between partners. They share profits in the ratio of 2:2:1.

Illustration – 7

Ajay Enterprises, a Partnership firm in which A,B and C are three partners sharing profits and losses in the ratio of 4 : 3 : 3. the balance sheet of the firm as on 31st December, 20X1 is as below:

Liabilities	Rs.	Assets	Rs.

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A' s Capital	15,000	Factory Building	24,160
B' s Capital	7,500	Plant & Machinery	16,275
C' s Capital	15,000	Debtors	5,400
B' s Loan	4,500	Stock	12,390
Sundry Creditors	16,500	Cash at Bank	275
	58,500		**58,500**

On balance sheet date all the three partners have decided to dissolve their partnership. Since the realisation of assets was protracted, they decided to distribute amounts as and when feasible and for this purpose they appoint C who was to get as his remunerations 1% of the value of the assets realised other than cash at Bank and 10% of the amount distributed to the partners.

Assets were realised piecemeal as under:

First instalment	Rs. 18,650
Second instalment	Rs. 17,320
Third instalment	Rs. 10,000
Last instilment	Rs. 7,000
Dissolution expenses were provided for estimated amount of	Rs. 3,000
The creditors were settled finally for	Rs. 15,900

Prepare a statement showing distribution of cash amongst the partners by 'Higher Relative Capital Method'

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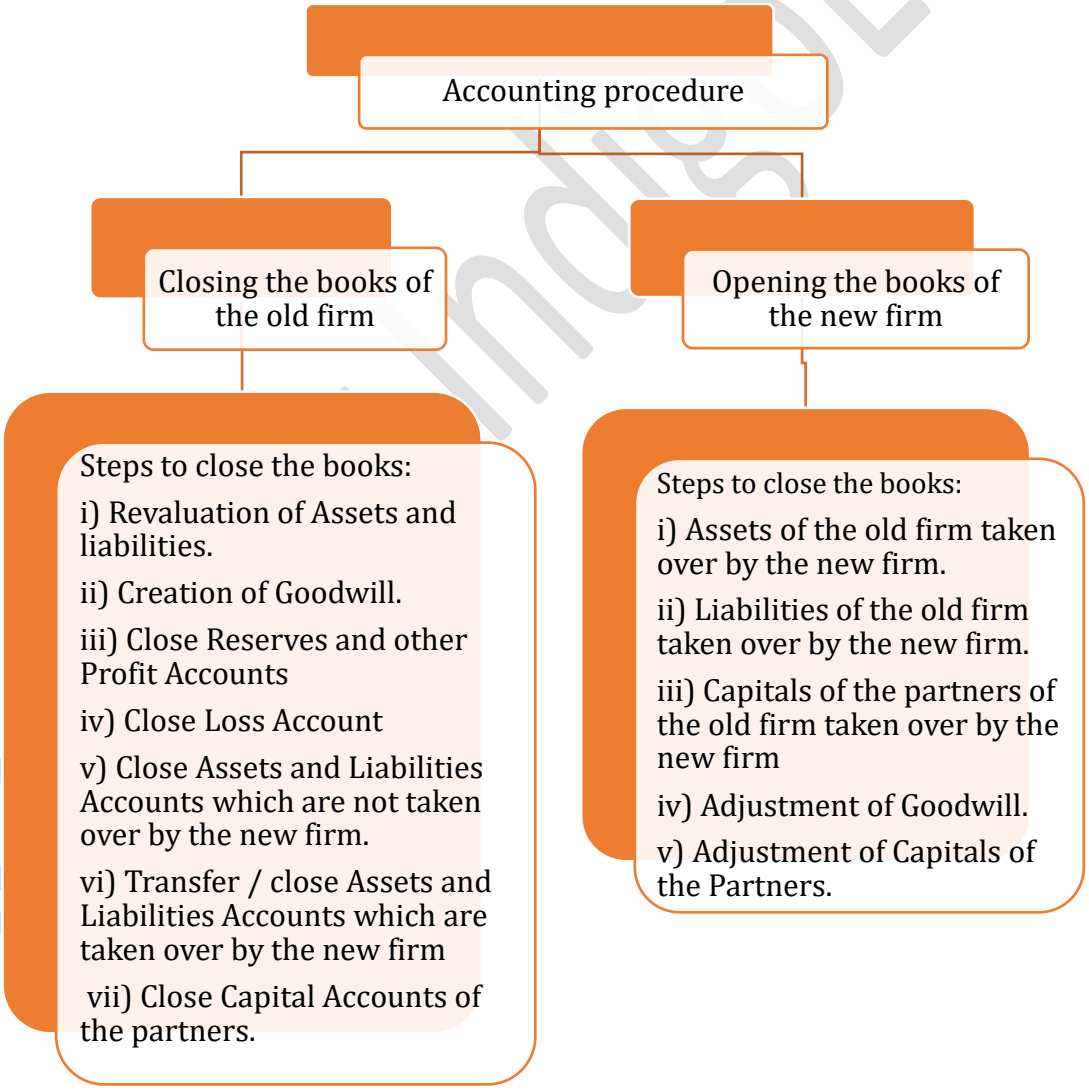
6.6 Amalgamation, Conversion and Sale

INTRODUCTION

Amalgamation means to merge or to combine two or more business units carrying on same type of business and form a new business unit.
Amalgamation of partnership firms means merger of two or more partnership firms with one another and form a new partnership firm.

ACCOUNTING PROCEDURE



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OBJECTIVES OF AMALGMATION

Amalgamation of partnership firm is done to achive the following objectives :

i) To avoid the cut-throat competition.
ii) To minimize the common expenses of business.
iii) To get advantage of large scale business.
iv) To strengthen the capital position.
v) To get advantage of expertise of different people, etc.

ACCOUNTING PROCEDURE

Closing Journal entries in the books of old firm	
For increase in the value of asset and decrease in the value of Liability, which shows revaluation profit Particular Asset / Liability A/c To Revaluation A/c	Dr.
For decrease in the value of asset and increase in the value of liability which shows revaluation loss Revaluation A/c To Particular Asset / Liability A/c	Dr.
For closing the Revaluation A/c and transferring profit Revaluation A/c To Partner's Capital A/c **Note**: -1. **This transfer is in Partner's profit sharing ratio** 2. In case of loss the entry will be reverse	Dr.
For Creation of Goodwill Goodwill A/c	Dr.

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To Partner's Capital A/c	
For closing Reserves and Profit Accounts Reserves A/c Dr. Profit & Loss A/c (Cr. Balance) Dr. To Partner's Capital A/c	
For closing Loss Account Partner's Capital A/c Dr. To Profit & Loss A/c	
For closing Assets and Liabilities A/C s which are not taken over by the New Firm - Those assets and Liabilities which are not taken over by the new firm will be either sold away / paid off by the old firm or transferred to Partner / Partner's Capital A/C s in the capital ratio. The profit or loss on such transaction will be transferred directly to Partner's Capital A/Cs in the old profit sharing ratio. a) If an asset is sold away for cash Cash / Bank A/c Dr. To Particular Asset A/c b) If an asset is taken over by the partner / partners Partner/s Capital A/c Dr. To Particular Asset A/c c) If a liability is paid off	

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Particular Liability A/c	Dr.
To Cash / Bank A/c	
d) If a liability is taken over by the partner/ partners	
Particular Liability A/c	Dr.
To Partner/s Capital A/c	
For closing Assets and Liabilities which are taken over by the New Firm : The accounts of assets and liabilities which are taken over by the new firm will be closed by transferring them to the New Firm A/c at agreed values	
a) For closing Assets	
New Firm A/c	Dr.
To Assets A/c	
b) For closing Liabilities	
Liabilities A/c	Dr.
To New Firm A/c	
For closing Partner's Capital A/Cs Partner's Capital A/cs of the old firm are to be closed with the net balance by transferring them to the New Firm A/c	
Partner's Capital A/c	Dr.

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To New Firm A/c

Opening Journal entries in the books of New firm

For Assets, Liabilities and Capitals of the Partners of the old firm taken over by the New Firm.

Assets A/c Dr.

To Liabilities A/c

To Partner's capital A/c

Note - Assets and liabilities are transferred at agreed values and partner's capital is shown at the transferred balance.

For Adjustment of Goodwill

The good will transferred from the old firm to the new firm may be maintained as it is or may be written off or may be reduced by the New Firm. If the goodwill is written off, the entry is

All Partner's Capital A/c Dr.

To Goodwill A/c

Note - All partner's capital A/c are debited in the new profit sharing ratio

For setting of Inter firm transactions

When the two firms which are merging, have transactions among themselves before merger, the resultant debtor/ creditor and stock reserve appearing in the unsold stock has to be nullified.

For eliminating the mutual debtor & creditor appearing in each other's books

Creditor A/c

To Debtor A/C Dr.

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For Adjustment of Capitals -

If the capitals of the partners in the new firm are changed as per the new profit sharing ratio or as per the agreement, there is a need to pass journal entries for the adjustment of capitals. The adjustments of capital may be made in cash or through current A/Cs.

a) For cash brought in or through current A/c for adjustment of shortage of capital

Cash / Bank A/c		Dr.
Particular Partner Current A/c		Dr.
To Particular Partner Capital A/c		

b) For cash paid or through current a/c for adjustment of excess capital

Particular Partner Capital A/c		Dr.
To Cash / Bank A/c		
To Particular Partner Current A/c		

Ledger Accounts in the Books of the Old Firms	Ledger Accounts in the Books of New Firm
i) Revaluation A/c ii) Partner's Capital A/Cs iii) New Firm A/c iv) Good will A/c v) Partner's Current A/c, etc.	i) Opening Balance Sheet of the new firm ii) Partner's capital A/Cs iii) Cash/Bank A/c

SALE OR CONVERSION OF PARTNERSHIP FIRM

Sometimes partnership firm is either purchased by a company or it is converted into a company. This also results in the dissolution of the firm.
When a partnership firm is converted into a company, the financial statements of the new company will be prepared according to Schedule III of Companies Act 2013.

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PROCEDURE OF THE ACCOUNTING IN THE BOOKS OF DISSOLVING FIRM

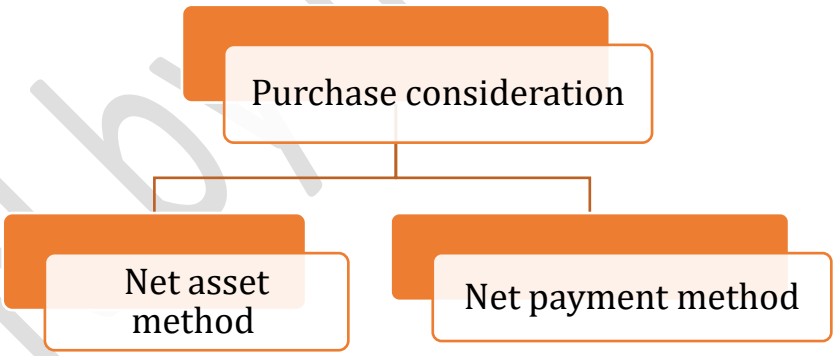
The accounting procedure is not much different to the amalgamation discussed above. We need to the close the books of the dissolving firm and open the books of the company.

Ledger Accounts to be prepared in the Books of the dissolving Firm	Ledger Accounts to be prepared for the new company.
i) Realisation A/c ii) Partner's Capital A/Cs iii) Purchasing company A/c iv) Cash A/c (if required)	i) Opening Balance Sheet of the new firm ii) Partner's capital A/Cs iii) Cash/Bank A/c

Step 1 - First, we need to prepare a Realisation A/c which is of nominal nature for the purpose of finding out profit or loss on dissolution.

Step 2 – Find out purchase consideration. Purchase consideration can be in the form of cash, shares of the buying company or Debentures.

Step 3 – Distribute the purchase consideration among partners.



Net asset method	
All assets taken over (at agreed values*)	xxx
(-) All liabilities taken over (at agreed value*)	(xx)
Purchase consideration (PC)	**xxx**

Note: *Agreed value can be more than or lesser than the book value. Only assets and liabilities that are taken over should be considered.

Net payment method

Lumpsum consideration is decided between the parties instead of valuing each asset and liability.

No. of shares x Agreed value per share	xxx
(+)Cash	xxx
(+)Debentures (No. of debentures x agreed value)	xxx
Purchase consideration (PC)	**xxx**

Closing Journal entries in the books of dissolving firm

Transfer all assets to Realisation account (assets that are taken over by the purchasing company)

Realisation A/c		Dr.
	To All Assets A/c	

Transfer all liabilities to realization account (those that have been taken over by the Purchasing company)

All liabilities A/c		Dr.
	To Realisation A/c	

Note:

1) All assets and liabilities are transferred **at book value.**
2) All assets may **include cash and bank** also **if the same is taken** the purchasing company.
3) All liabilities may include **partner's loan account** also if the **same is taken** over by the purchasing company.
4) If any asset or liability is not taken over by the purchasing company then that is not considered.
5) If it is mentioned in the question that ' business is taken over' then it mean all assets and liabilities have been taken over.

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For recording purchase consideration Purchasing company A/c Dr. To Realisation A/c **Note**: -1. PC can be computed in any of the two methods mentioned above.	
For receipt of purchase consideration Cash A/c Dr. Shares in purchasing company A/c Dr. Debenture of purchasing company A/c Dr. To Purchasing company A/c	
For recording of sale of assets that are not taken over by the purchasing company Cash A/c Dr. To Realisation A/c	
For recording of assets taken over by the partner Partner's capital A/c Dr. To Realisation A/c **Note –** This will also be at agreed value	
For payment of liabilities not taken over by the purchasing company Realisation A/c Dr. To Liability A/c	

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Note - Same entry will come even in case of unrecorded liability. All liabilities not taken over have to be paid through cash.

In case any liability is taken over by the partner

Realisation A/c		Dr.
To Partner's capital A/c		

For recording dissolution expenses

Realisation A/c		Dr.
To Cash A/c		

Any profit or loss on realization account is distributed among partners in their profit sharing ratio

a) In case of profit

Realisation A/c		Dr.
To Partner's Capital A/c		

b) In case of loss

Partner's capital A/c		Dr.
To Realisation A/c		

For transferring the Reserves and surplus to partner's account in profit sharing ratio

Reserves and surplus A/c		Dr.

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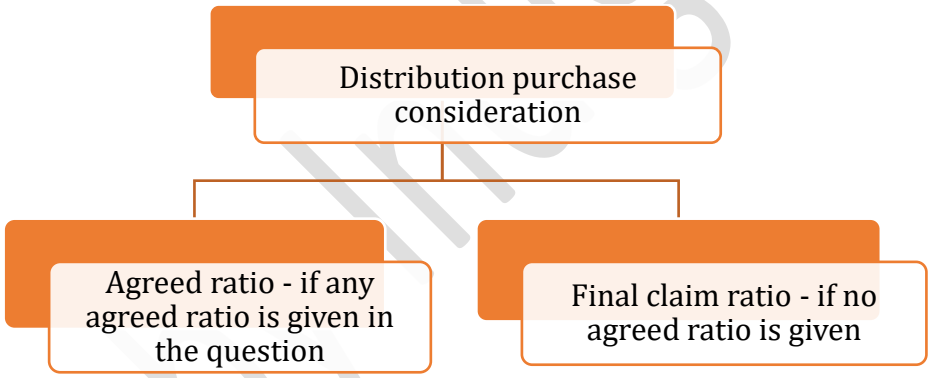
To Partner's capital A/c **Note -** In case of any accumulated losses the above entry will be reversed.
For distributing the purchase consideration among partners Partner's capital A/c Dr. To Cash To Shares of purchasing company To debentures of purchasing company



Final claim ratio - The ratio in which the final balances of the partner's capital appear, after adjusting all reserves and realization profit or loss.

Agreed ratio -Any excess or shortfall in capital, will be adjusted through Cash. ie it will either be bought in by the partner whose capital is showing a debit balance and will be given to the partner whose account is showing a credit balance.

PROCEDURE OF THE ACCOUNTING IN THE BOOKS OF PURCHASING COMPANY

Incorporating Journal entries in the books of purchasing company

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For recording business purchase

Business purchase A/c		Dr.
To Partnership firm A/c		

Note – Show purchase consideration in the amount column

For incorporating all assets and liabilities

All Assets A/c	(@ Agreed values)	Dr.
Goodwill A/c	(Balancing Figure)	Dr.
To Liabilities A/c	(@ Agreed values)	
To business purchase A/c	(Purchase consideration)	
To Capital reserve	(Balancing figure)	

Note - Net assets taken over (NA)= Total assets – Total liabilities

If Purchase consideration **>** Net assets taken over, then **PC – NA = Goodwill**

If purchase consideration**<** Net assets, then **NA – PC = Capital reserve**

For payment of purchase consideration

Partnership firm A/c		Dr.
To Cash A/c		
To Equity share capital A/c		
To Securities premium		

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Note: - Whenever shares are issued at a premium (value in excess of face value), securities premium should be credited.If debentures are issued as consideration, then that should be credited.

For recording take over expenses

	Goodwill A/c	Dr.
OR	Capital reserve A/c	Dr.
	To Cash A/c	

Note – If there is goodwill in the second entry then goodwill is debited or else capital reserve is debited

For recording Preliminary expenses

	Preliminary expenses A/c	Dr.
	To Bank A/c	

Some important points to remember:

1. In case the goodwill is given separately in the question (not being part of balance sheet),
   Purchase consideration = Net assets + Goodwill
2. In case the sale/ conversion happens during the year and the Balance sheet as at the beginning of the year is given (instead of the balance sheet on the date of conversion)-
   a. We need to find the profit for the intermittent period.
   b. And draw the balance sheet as on the date of conversion / sale
   Profit for the intermittent period = Closing net assets – Opening capital
3. In case of retirement / death of any partner
   a. Find out the new profit sharing ratio and the gaining ratio.

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Illustrations

Illustration – 1

B & S are partners of S & Co. sharing profits and losses in the ratio of 3:1. S and T are partners of T & Co. sharing profits and losses in the ratio of 2:1.

Their Balance sheets on that date were as under:					
Liabilities	S & Co.	T & Co.	Assets	S & Co.	T & Co.
Due to X & Co.	40,000	-	Cash in hand	10,000	5,000
Due to S & Co.	-	50,000	Cash in bank	15,000	20,000
Other Creditors	60,000	58,000	Due from T & Co.	50,000	-
Reserves	25,000	50,000	Due from X&Co.	-	30,000
Capitals			Other Debtors	80,000	1,00,000
B	1,20,000	-			
S	80,000	1,00,000			
T	-	50,000			
			Stock	60,000	70,000
			Furniture	10,000	3,000
			Vehicles	-	80,000
			Machinery	75,000	-
			Building	25,000	-
	3,25,000	**3,08,000**		**3,25,000**	**3,08,000**

On 31st October, 20X1, they have decided to amalgamate and form a new firm M/s BST & Co. wherein B, S and T would be partners sharing profits and losses in the ratio 3:2:1.

The amalgamated firm took over the business on the following terms:

1. Goodwill of S & Co. was worth Rs.60,000 and that of T & Co. Rs.5,000. Goodwill account was not to be opened in the books of the new firm; the adjustments being recorded through capital accounts of the partners.
2. Building , machinery and vehicles were taken over at Rs.50,000, Rs.90,000 and Rs.1,00,000 respectively
3. Provision for doubtful debts has to be carried forward at Rs.4,000 in respect of debtors of S & Co. and Rs.5,000 in respect of debtors of T & Co

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You are required to:

1. Compute the adjustments necessary for goodwill
2. Pass the journal entries in the books of BST & Co. assuming that excess / deficit capital (taking T's Capital as base) with reference to share in profits are to be transferred to current accounts.

Illustration – 2

Firm X & Co. consists of partners A and B sharing Profits and Losses in the ratio of 3 : 2.

The firm Y & Co. consists of partners B and C sharing Profits and Losses in the ratio of 5 : 3.

On 31st March, 20X1 it was decided to amalgamate both the firms and form a new firm XY & Co., wherein A, B and C would be partners sharing Profits and Losses in the ratio of 4:5:1.

Balance Sheet as at 31.3.20X1

Liabilities	X & Co.	Y & Co.	Assets	X & Co.	Y & Co.
	Rs.	Rs.		Rs.	Rs.
Capital:			Cash in hand/bank	40,000	30,000
A	1,50,000	---	Debtors	60,000	80,000
B	1,00,000	75,000	Stock	50,000	20,000
C	---	50,000	Vehicles	---	90,000
Reserve	50,000	40,000	Machinery	1,20,000	---
Creditors	1,20,000	55,000	Building	1,50,000	---
	4,20,000	2,20,000		4,20,000	2,20,000

The following were the terms of amalgamation:

1. Goodwill of X & Co. was valued at Rs. 75,000. Goodwill of Y & Co. was valued at Rs.40,000. Goodwill account not to be opened in the books of the new firm but adjusted through the Capital accounts of the partners.
2. Building, Machinery and Vehicles are to be taken over at Rs. 2,00,000, Rs. 1,00,000 and Rs.74,000 respectively.

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3. Provision for doubtful debts at Rs.5,000 in respect of X & Co. and Rs. 4,000 in respect of Y & Co. are to be provided

You are required to:

(i) Show, how the Goodwill value is adjusted amongst the partners.

(ii) Prepare the Balance Sheet of XY & Co. as at 31.3.20X1 by keeping partners capital in their profit sharing ratio by taking capital of 'B' as the basis. The excess or deficiency to be kept in the respective Partners' Current accounts.

Illustration – 3

On 31st March 20X2, Sri Raman acquires on payment of Rs.80,000 the business of M/s Gupta and Singh taking over at book values the following assets and liabilities:

Assets & Liabilities	Rs.
Debtors	35,000
Furniture	3,000
Stock	46,000
Creditors	10,000

There was no change between 1st January 20X2 to 31st March 20X2 in the book value of the assets and liabilities not taken over.

The same set of books has been continued after the acquisition and no entries of the acquisition have been passed except for the payment of Rs.80,000 made by Sri Raman.

From the following balance sheet and trial balance prepare Business Purchase Account, Profit and Loss Account for the year ended 31st December, 20X2 and Balance Sheet at that date.

Balance Sheet as at December 20X1

Liabilities	Rs.	Rs.	Assets	Rs.
Capital Accounts Sri Gupta Sri Singh	30,000 20,000	50,000	Furniture	3,000
			Investments	5,000
			Insurance Policy	2,000
Bank Loan		18,000	Stock	40,000
Creditors		12,000	Debtors	30,000

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		80,000		**80,000**

From the following balance sheet and trial balance prepare

1. Business Purchase Account,
2. Profit and Loss Account for the year ended 31st December, 20X2 and
3. Balance Sheet at that date

Illustration – 4

Hari, Lal and Jay have been in partnership for a number of years, sharing profits/losses in the ratio of 2:2:1 as wholesale stationers trading under the name 'Hari Brothers'. They decide to convert their partnership into a limited company (with effect from 1st January, 20X2) to be known as Hari Ltd.

Immediately prior to this conversion the balance sheet of partnership as at 31st December 20X1 was as follows:

Balance Sheet
As on 31st December 20X1

Liabilities	Rs.	Rs.	Assets	Rs.
Capital accounts			Fixed assets (at written down value)	
Hari	70,000		Land & Buildings	50,000
Lal	30,000		Plant & Machinery	30,000
Jay	20,000	1,20,000	Motor vehicles	20,000
Current accounts			Current Assets:	
Hari	7,000		Inventories	60,000
Lal	5,000		Debtors	25,000
Jay	3,000	15,000	Axis Bank account	5,000
Current liabilities				
Creditors	25,000			
Dena Bank account	20,000	45,000		
Long-term liabilities				
Loan-Hari	3,000			
Loan-Gopi Ltd.	7,000	10,000		
		1,90,000		1,90,000

The terms of conversion are that Hari Ltd. is to take over the assets and liabilities of Hari Brothers as follows:

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Particulars	Valuation for take-over (Rs.)
Land and Building	96,000
Plant and Machinery	28,000
Motor vehicles	15,000
Inventories	60,000
Debtors	24,000
Creditors	25,000
Goodwill	10,000

The closing balance in Axis Bank account is to be transferred to Dena Bank account before all the other dissolution entries are effected in the partnership ledgers.

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Lal took over one of the motor vehicles at an agreed amount of ` 2,000. All other liabilities were paid from the Dena Bank account.

The purchase consideration is discharged by an issue at par of ` 60,000 10% Debentures (fully paid) to the partners in their capital account proportions as shown in the above balance sheet plus equity shares in Hari Ltd. of ` 1 each (fully paid to make up the balance due to each partner).

You are required to

1. prepare (a) Realisation Account (b) Partners' Capital Accounts (c) Bank account of Axis Bank and Dena Bank in the books of Hari Brothers;
2. 'Business purchase account' and 'Hari Brothers' account in Hari Ltd.'s books.

Illustration – 5

A and B were carrying on business sharing profits and losses equally. The firm's Balance Sheet as at 31.12.20X1 was:

Liabilities		Amount (Rs.)	**Assets**	Amount (Rs.)
Sundry Creditors		60,000	Stock	60,000
Bank overdraft		35,000	Machinery	1,50,000
Capital A/cs:			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	26,000
			Drawing Account:	
			10,000	
			6,000	16,000
		3,65,000		3,65,000

The business was carried on till 30.6.20X2. The partners withdrew in equal amounts half

Page Break

the amount of profits made during the period of six months after charging depreciation at 10% p.a. on machinery and after writing off 5% on leasehold premises.
In the half year, sundry creditors were reduced by Rs. 10,000 and bank overdraft by Rs. 15,000.
On 30.06.20X2, stock was valued at Rs. 75,000 and Debtors at Rs. 60,000; the Joint Life Policy had been surrendered for Rs. 9,000 before 30.06.20X2 and other items remained the same as at 31.12.20X1.
On 30.06.20X2, the firm sold the business to a Limited Company. The value of goodwill was fixed at Rs. 1,00,000 and the rest of the assets were valued on the basis of the Balance Sheet as at 30.6.20X2. The company paid the purchase consideration in Equity Shares of Rs. 10 each.
You are required to prepare:
(a) Balance Sheet of the firm as at 30.6.20X2;
(b) The Realisation Account;
(c) Partners' Capital Accounts showing the final settlement between them.

Illustration – 6

Prabhu & Co. is a partnership firm consisting of Mr. Prabhu, Mr. Bhola and Mr. Shiv who share profits and losses in the ratio of 2:2:1 and Bhagwan Ltd. is a company doing similar business.
Following is the Balance sheet of the firm and that of the company as at 31.3.20X1:

Liabilities	Prabhu & Co. (Rs.)	Bhagwan Ltd. (Rs.)	Assets	Prabhu & Co. (Rs.)	Bhagwan Ltd. (Rs.)
Equity share Capital:			Plant & machinery	2,50,000	8,00,000
Equity shares of Rs.10 each		10,00,000			
Partners' capital:			Furniture & fixture	25,000	1,12,500
Prabhu	1,00,000				
Bhola	1,50,000				
Shiv	50,000				
General reserve	50,000	3,50,000	Stock in Trade	1,00,000	4,25,000
Sundry creditors	1,50,000	6,50,000	Sundry debtors	1,00,000	4,12,500
			Cash at bank	5,000	2,00,000
			Cash in hand	20,000	50,000
TOTAL	**5,00,000**	**20,00,000**		**5,00,000**	**20,00,000**

It was decided that the firm Prabhu & Co. be dissolved and all the assets (except cash in hand and cash at bank) and all the liabilities of the firm be taken over by Bhagwan Ltd. By issuing 25,000 shares of Rs.10 each at a premium of Rs.2 per share.
Partners of Prabhu & Co. agreed to divide the shares issued by Bhagwan Ltd. In the profit-sharing ratio and bring necessary cash for settlement of their capital.

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The creditors of Prabhu & Co. include Rs.50,000 payable to Bhagwan Ltd. An unrecorded liability of Rs.12,500 of Prabhu & Co. must also be taken over by Bhagwan Ltd.
Prepare:

1. Realisation account, Partners' capital accounts and Cash in hand/Bank account in the books of Prabhu & Co.
2. Pass journal entries in the books of Bhagwan Ltd. For acquisition of Prabhu & Co.

Illustration – 7

The following is the Balance Sheet of Messers A and B as on 31st March 20X5:

Liabilities	Rs.	Assets	Rs.
Capital A's 40,000 B's 50,000	90,000	Land & Buildings	50,000
A's Loan	10,000	Stock	30,000
General Reserve	20,000	Debtors	20,000
Liabilities	20,000	Investments 6% Debentures in X Ltd	20,000
		Cash	10,000
	1,30,000		**1,30,000**

- It was agreed that Mr. C is to be admitted for a fifth share in the future profits from 1st April 20X5.

- He is required to contribute cash towards goodwill and Rs. 10,000 towards capital.

The following further information is furnished:

(i) The partners A and B shared the profit in the ratio 3:2.
(ii) Mr. A was receiving a salary of Rs. 500 p.m. from the very inception of the firm in 20YY in addition to share of profit

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(iii) The future profit ratio between A, B and C will be 3:1:1. Mr. A will not get any salary after the admission of Mr. C

(a) The goodwill of the firm shall be determined on the basis of 2 years' purchases of the average profits from business of the last 5 years.

(b) The particulars of the profits are as under

Year Ended	Profit /Loss	Rs.
31-3-X1	Profit	20,000
31-3-X2	Loss	10,000
31-3-X3	Profit	20,000
31-3-X4	Profit	25,000
31-3-X5	Profit	30,000

The above profits and losses are after charging the salary of Mr. A. The profit of the year ended 31st March 20X1 included an extraneous profit of Rs.30,000 and the loss of the year 31st March 20X2 was on account of loss by strike to the extent of Rs. 20,000.

(c) It was agreed that the value of the goodwill of the firm shall appear in the books of the firm.

(d) The trading profit for the year ended 31st March, 20X6 was Rs. 40,000 before depreciation.

(e) The partners had drawn each Rs. 1,000 p.m. as drawings.

(f) The value of the other assets and liabilities as on 31st March 20X6 were as under:

Building (before depreciation)	Rs.60,000
Stock	Rs.40,000
Debentures	Nil
Investment	Rs.20,000
Liabilities	Nil

(iv) Provide depreciation at 5% on land and buildings on the closing Balance and interest at 6% on A's Loan.

(v) They applied for conversion of the firm into a Private Limited Company i.e. ABC Private Limited. Certificate received on 1-4-20X6. They decided to convert Capitals A/cs

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of the partners into share capital in the ratio of 3:1:1 on the basis of total Capital as on 31-3-20X6. If necessary, partners have to subscribe to fresh capital or withdraw.

Prepare the profit and loss account for the year ended 31st March, 20X6 and the Balance Sheet of the company

Illustration - 8

Yash, Tanish and Ruchika were partners sharing Profit & Loss in ratio of 3:2:1. Balance Sheet of the firm is as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Fixed Capital:		Fixed Assets	45,000
- Yash	50,000	Investments	15,000
- Tanish	20,000	Current Assets:	
- Ruchika	10,000	- Stock	10,000
Current Accounts:		- Debtors	27,500
- Yash	6,000	- Cash & Bank	12,500
- Ruchika	4,000	Current Account:	
Unsecured Loans	15,000	- Tanish	10,000
Current Liabilities	15,000		-
	1,20,000		**1,20,000**

On 1st April, 20X1 all the partners agreed to form a new company YTR Pvt. Ltd., which will take over the firm as going concern including goodwill but excluding cash and bank balances.

The following matters were also agreed upon:

1. Goodwill should be valued at 3 years' purchase of super profits.
2. Actual profit for the purpose of goodwill valuation will be Rs. 20,000.
3. The normal rate of return will be 17.50% per annum of Fixed Capital.
4. All other Assets and Liabilities will be taken over at book value.
5. The purchase consideration will be paid partly in share of Rs. 1 each and partly in cash. Yash and Tanish to acquire interest in new company in the ratio of 3:2 at face value. Ruchika agreed to retire after taking her share in cash.
6. Realisation expenses amounted to Rs. 5,000.

Prepare Realisation Account, Cash and Bank Account, YTR Private Limited Account and Capital Accounts of the partners.

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Study Note 7 | Self-Balancing Ledger

Introduction

One ledger is maintained for all accounts when the volume of transactions of business is small and number of accounts is limited. But for a big business, with rise in the number of transactions, size of the ledger becomes hefty due to large number of accounts. When large number of ledgers is kept by a concern and if their balances do not tally, the accountant would have to face great difficulty in tracing book-keeping errors, responsible for the non-agreement of the trial balance. In order to reduce to a minimum the trouble and time involved in locating the errors, sometimes the system of multiple ledgers (self-balancing or sectional balancing) is employed.

Self-Balancing Ledger System implies a system of ledger keeping which classifies ledgers as per nature of transactions, namely, Sales ledger, bought ledger, General ledger, etc. and also makes them to balance independently. The objective of this system is to identify errors and to facilitate their quick detection with the minimum efforts. In order to make each ledger selfbalancing, an extra account called general ledger adjustment account is opened in each of the sales ledger and bought ledger.

A self-balancing ledger system implies a system of ledger keeping which classifies ledgers as per nature of transactions namely Sales Ledger, Bought Ledger, General Ledger etc. and also make them to balance independently. In order to make each ledger self-balancing, an extra account called General Ledger Adjustment Account is opened in each of the sales ledger and bought ledger. Normally, the accounts of individual debtors are maintained recording credit sales, cash collections, discount, bad debts etc, in Debtors Ledger or Sales Ledger. The General Ledger Adjustment account in the Sales Ledger gives a summary of all these transactions in a reverse manner. Similarly in Bought ledger, General Ledger Adjustment account gives a summary of all transactions of the Bought Ledger in a reverse manner. Against these ledger adjustment accounts, two other adjustment accounts are maintained in the General Ledger to complete the double entry.

These adjustment accounts are known as Control Accounts. The correctness of individual balances in each ledger would be verified by extracting its balances and agreeing them with the balance of the Control Account. The object of the system is to identify errors and to facilitate their quick detection with the minimum effort.

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Difference between Self balancing and Sectional Balancing ledgers

Basis	Self-Balancing	Sectional Balancing
Classification of Ledgers	Separate ledger is maintained for different type of transactions.	Only total account for each of the subsidiary ledgers is opened in the general ledger.
Double entry	Under this system, a general ledger adjustment account is prepared in the debtors' ledger as well as in creditors' ledger to complete double entry.	A separate trial balance can't be made from these ledger as double entry is not completed.
Accuracy of Accounts	Correctness of individual account balances in each ledger will be verified by extracting its balances by agreeing them with balance of control accounts.	Accuracy of individual customer's/supplier's account can be checked by comparing the total of their balances with balances of total debtors' /creditors' account in general ledger.

Journal entries relating to Trade Debtors

Transactions	Usual Entry	Self-balancing Entry
For credit sales	**Individual customers A/c Dr** **To Sales A/c**	**Debtors Ledger Adjustment A/c (in General ledger)** **To General Adjustment A/c (in debtors ledger)**
For cash/cheques received from customers	**Cash A/c Dr** **To individual customers A/c**	**General Ledger Adjustment A/c Dr (in Debtors ledger)** **To Debtors Ledger Adjustment A/c (in General ledger)**
For Discount allowed/	**Discount allowed A/c Dr** **To Individual customers A/c**	**General Ledger Adjustment A/c Dr (in Debtors ledger)**

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allowances to customers		**To Debtors Ledger Adjustment A/c (in General ledger)**
For Bad debts	**Bad debts A/c Dr** **To Individual customers A/c**	**General Ledger Adjustment A/c Dr (in Debtors ledger)** **To Debtors Ledger Adjustment A/c (in General ledger)**
For Bills receivable received from customers	**Bills receivable A/c Dr** **To Individual customers A/c**	**General Ledger Adjustment A/c Dr (in Debtors ledger)** **To Debtors Ledger Adjustment A/c (in General ledger)**
For Return inwards	**Return inwards A/c Dr** **To Individual customers A/c**	**General Ledger Adjustment A/c Dr (in Debtors ledger)** **To Debtors Ledger Adjustment A/c (in General ledger)**
For Bills / Cheques received/ dishonoured	**Individual customers A/c Dr** **To Bills receivable A/c**	**Debtors Ledger Adjustment A/c (in General ledger)** **To General Adjustment A/c (in debtors ledger)**
For Interest on customers overdue account or cost of carriage charged to customers	**Individual customers A/c Dr** **To Interest/charges A/c**	**Debtors Ledger Adjustment A/c (in General ledger)** **To General Adjustment A/c (in debtors ledger)**

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In General Ledger

Debtors Ledger Adjustment Account

Dr. Date	Particulars	Amount	Date	Particulars	Amount Cr.
2012		Rs.	2010		Rs.
Jan. 1	To Balance b/d		Jan. 1	By Balance b/d *(if any)*	
	" General Ledger Adjustment A/c :			" General Ledger	
	Credit Sales	* *		Adjustment A/c :	
Dec. 31	" Carriage and Sundry Charges			" Cash/Cheques received	* *
	debited to customer—			" Bad Debts	* *
	" Bills Receivable Dishonoured	* *		" Returns Inward	* *
	" Cheque Received and Dishonoured	* *		" Discount Allowed	* *
	" Interest and Charges etc.	* *		" Other Allowances	* *
	" Refund–Cash paid to customers	* *		" Bills Receivable	* *
	" B/R discounted and dishonoured	* *		" Transfer to or from	
	" B/R endorsed and dishonoured	* *		other Ledgers	* *
	Interest charged to overdue account			" Balance c/d	* *
	" Balance c/d *(if any)*	* *			
		* *			* *

In the Debtors Ledger

General Ledger Adjustment Account

Dr. Date	Particulars	Amount	Date	Particulars	Amount Cr.
2012		Rs.	2012		Rs.
Jan. 1	To Balance b/d (if any)	***	Jan. 1	By Balance b/d	***
	" Debtors/Sold Ledger			" Debtors/Sold Ledger	
	Adjustment A/c	***		Adjustment A/c—	
	" —Cost and Cheque			" Debtors/Sold Ledger	
	Received	***		Adjustment A/c—	
	—Bad Debts	***			
	—Returns Inward	***		" Carrying and Sundry	
	—Discount Allowed	***		Charges	***
	—Other Allowances	***		" Bills Receivable Dishonoured	***
	—Bills Receivable	***		" Cheque Rec. and Dishonoured	***
	—Transfer to or from	***		" Interest and Charges	***
	other Ledger	***		" Refund-cash paid to	
	" Balance C/d	***		Customers	***
				" B/R Discounted and Dishonoured	
				" B/R endorsed and Dishonoured	***
				" Interest Charges on	
				Overdue A/c	
				" Balance c/d (if any)	***
		***			***

Journal entries relating to Trade Creditors

Transactions	Usual Entry	Self-balancing Entry
For credit purchases	Purchase A/c Dr To Creditors A/c	General Ledger Adjustment A/c Dr (in Creditors ledger) To Creditors Ledger Adjustment A/c (in General ledger)

For cash paid to customers	Creditors A/c Dr To Cash A/c	Creditors Ledger Adjustment A/c (in General ledger) To General Ledger Adjustment A/c Dr (in Creditors ledger)
For Discount received from creditors	Creditors A/c Dr To Discount received A/c	Creditors Ledger Adjustment A/c (in General ledger) To General Ledger Adjustment A/c Dr (in Creditors ledger)
For Bills accepted in favour of creditors	Creditors A/c Dr To Bills payable A/c	Creditors Ledger Adjustment A/c (in General ledger) To General Ledger Adjustment A/c Dr (in Creditors ledger)
For Return outwards	Creditors A/c Dr To Return outwards A/c	Creditors Ledger Adjustment A/c (in General ledger) To General Ledger Adjustment A/c Dr (in Creditors ledger)
For Bills payable dishonoured	Bills payable A/c Dr To Creditors A/c	General Ledger Adjustment A/c Dr (in Creditors ledger) To Creditors Ledger Adjustment A/c (in General ledger)
For Interest carriage charged by creditors	Interest/charges A/c Dr To creditors A/c	General Ledger Adjustment A/c Dr (in Creditors ledger) To Creditors Ledger Adjustment A/c (in General ledger)

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In General Ledger

Dr. Creditors Ledger Adjustment Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2012 Jan. 1	To Balance b/d (*if any*)	* *	2012 Jan. 1	By Balance b/d	* *
	" General Ledger Adjustment Account :			" General Ledger Adjustment Account :	
Dec. 31	Cash Paid	* *	Dec. 31	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
2012		Rs.	2012		Rs.
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 Purchase	***		" Cash paid	***
	—Bills Payable Dishonoured	***		Bills Payable Accepted	***
	—Interest and Charges	***		" Discount Received	***
	" Balance c/d (if any)	***		" Returns Outward	***
				" Balance c/d	***
		***			***

The following items will not affect the Self balancing Ledger

1. **Any cash sale/purchase of goods**
2. **Bills receivable discounted**
3. **Recovery of Bad debts**
4. **Trade Discount**
5. **Bills receivable endorsed**
6. **Bills receivable honoured**
7. **Any sort of provision on Debtors/creditors etc**

Illustrations

Illustration – 1

Dinesh & Co. have three ledgers in use viz, a Debtors Ledger, a Creditors Ledger and a Normal Ledger which are all kept on the system of self-balancing. From the following particulars prepare the adjustments account that would appear in each of these ledgers.

2015	Particulars	Rs.
Jan 1	Balance of Sundry Debtors	16,000
	Balance of Sundry Creditors	18,500
Jan 31	Credit Purchases	4,500
	Credit Sales	9,800
	Cash Sales	1,500
	Paid to Creditors	9,875
	Discount allowed by them	325
	Cash received from debtors	7,800
	Allowed them discount	200
	Bills payable accepted	1,500
	Bills receivable received	3,000
	Returns inwards	875
	Returns outwards	600
	Rebates allowed to debtors	275
	Rebates allowed by creditors	150
	Provision for Doubtful Debts	320
	Bad Debts	450
	Bills Receivable dishonoured	375

Illustration - 2

From the following particulars as extracted from the books of Messrs Kulkarni Brothers, who keep a Debtors' Ledger, a Creditors Ledger and a General Ledger on the self-balancing system, show how the General Ledger Adjustment Account will appear in the Debtor's Ledger and the creditors' Ledger.

Particulars	Rs.
Debtors' Balance on 1st January 2014	91,500
Creditors' Balance on 1st January 2014	1,09,800
Transactions for the year 2014:	
Credit purchases	41,000
Credit sales	45,400
Returns Inwards	800

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Returns Outwards	1,200
Cash received from customers	51,000
Discount allowed to customers	900
Cash paid to creditors	61,400
Discount received	1,340
Acceptances received	17,000
Acceptances given	24,000
Bills Receivable dishonoured	2,400
Bills Payable dishonoured	6,000
Bad debts written off	5,000
Sundry charges debited to customers	690
Allowances from creditors	550
Transfer from Debtors Ledger	1,290

Illustration – 3

M. Govind keeps self-balancing ledgers. Record the following transactions in the General Ledger Adjustment Account in the Sales Ledger:

Date	Particulars
1.4.2015	Received Rs.475 from Mr. X in full settlement. He was allowed a discount of Rs.25.
2.4.2015	Received Rs.2,000 from Mr. Y towards his dues in full.
3.4.2015	Goods supplied to Mr. T Rs.700 and received Rs.300 after adjustment of the advance of Rs.400.
4.4.2015	Bad debts recovered from Mr. Q Rs.1,000
5.4.2015	Goods sold to the following: Mr A Rs.1,000 Mr B Rs.1,500 Mr C Rs.2,000
15.4.2015	Mr. P paid Rs.750 towards dues. Balance thereafter due was Rs.250
25.4.2015	Amount received from the following: Mr A Rs.750 Mr B Rs.1,000 Mr C Rs.2,000
30.04.2015	Advance received from Mr R for supply Rs.2,000

Illustration – 4

The following information is available from the book of a trader from January 1 to March 31, 2013:

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1. Total sales amounted to Rs. 60,000 including the sale of old furniture for Rs. 1,200 (book value Rs. 3,500). The total cash sales were 80% less than the total credit sales.
2. Cash collection from debtors amounted to 60% of the aggregate of the opening debtors and credit sales for the period. Debtors were allowed cash discount for Rs. 2,600.
3. Bills Receivable drawn during three months totalled Rs. 6,000 of which bills amounting to
    a. Rs. 3,000 were endorsed in favour of suppliers. Out of these endorsed B/R, a B/R for
    b. Rs. 600 was dishonoured for non-payment, as the party became insolvent, his estate realising nothing.
4. Purchases totalled Rs. 16,000 of which 10% was for cash.
5. A cheque received from a customer for Rs. 6,000 was dishonoured; a sum of Rs. 500 is irrecoverable: Bad Debts written off in the earlier years realised Rs. 2,500.
6. Sundry debtors, as on 1st January 2013 stood at Rs. 40,000

You are required to show the Debtors' Ledger Adjustment Account in the General Ledger.

Illustration - 5

From the following particulars, prepare the relevant adjustment account as would appear in the General Ledger of Mr. Vasu for the month of March, 2015:

Date	Particulars
1	Purchase from Mr. X Rs. 2,000
2	Paid Rs. 1,600 after adjusting the initial advance in full to Mr. X.
13	Paid Rs. 1,000 to Mr. R towards the purchases made in February in full.
13	Paid advance to Mr. Y Rs. 3,000
14	Purchased goods from Mr. A Rs. 4,000
25	Returned goods worth Rs. 500 to Mr. A.
26	Settled the balance due to A at a discount of 10 per cent.
27	Goods purchased from Mr. Y Rs. 2,500 against advance paid on 13th.
28	Received at bank the advance from Mr. P paid on 28 February, 2015 Rs. 2,000.
29	Purchased from B Rs. 2,000.
30	Goods returned to Q Rs. 750.

Illustration – 6

The following particulars are obtained from books of a Self Ltd. for the year ended 31st March, 2015:

	Rs.		Rs.
Cash Sales	25,000	Bills Receivable dishonoured	2,500

Credit Purchases	2,80,000	Return Inward	8,500
Collection from Debtors	4,25,000	Payments to creditors	1,62,000
Bills Receivable drawn	20,000	Discount allowed	3,000
Discount Received	2,500	Debtors' cheque returned dishonured	7,500
Cash Purchases	12,000	Credit Sales	4,90,000
Bills Payable paid	6,500	Bills Receivables collected	10,000
Recovery of Bad Debts	1,500	Return outward	3,700
Bills Receivable discounted with Bank	8,000	Bills Receivable endorsed to creditors	7,900
Interest charged on overdue Customer's Accounts	1,200	Over-payments refunded by suppliers	600
Endorsed Bills Receivable dishonoured (noting charges Rs.75)	5,500	Bad Debts	1,000
Bills Payable accepted	16,000	Opening Balances • Sundry Debtors • Sundry Creditors	 78,000 85,000

You are required to prepare the Total Debtors Account and Total Creditors Account.

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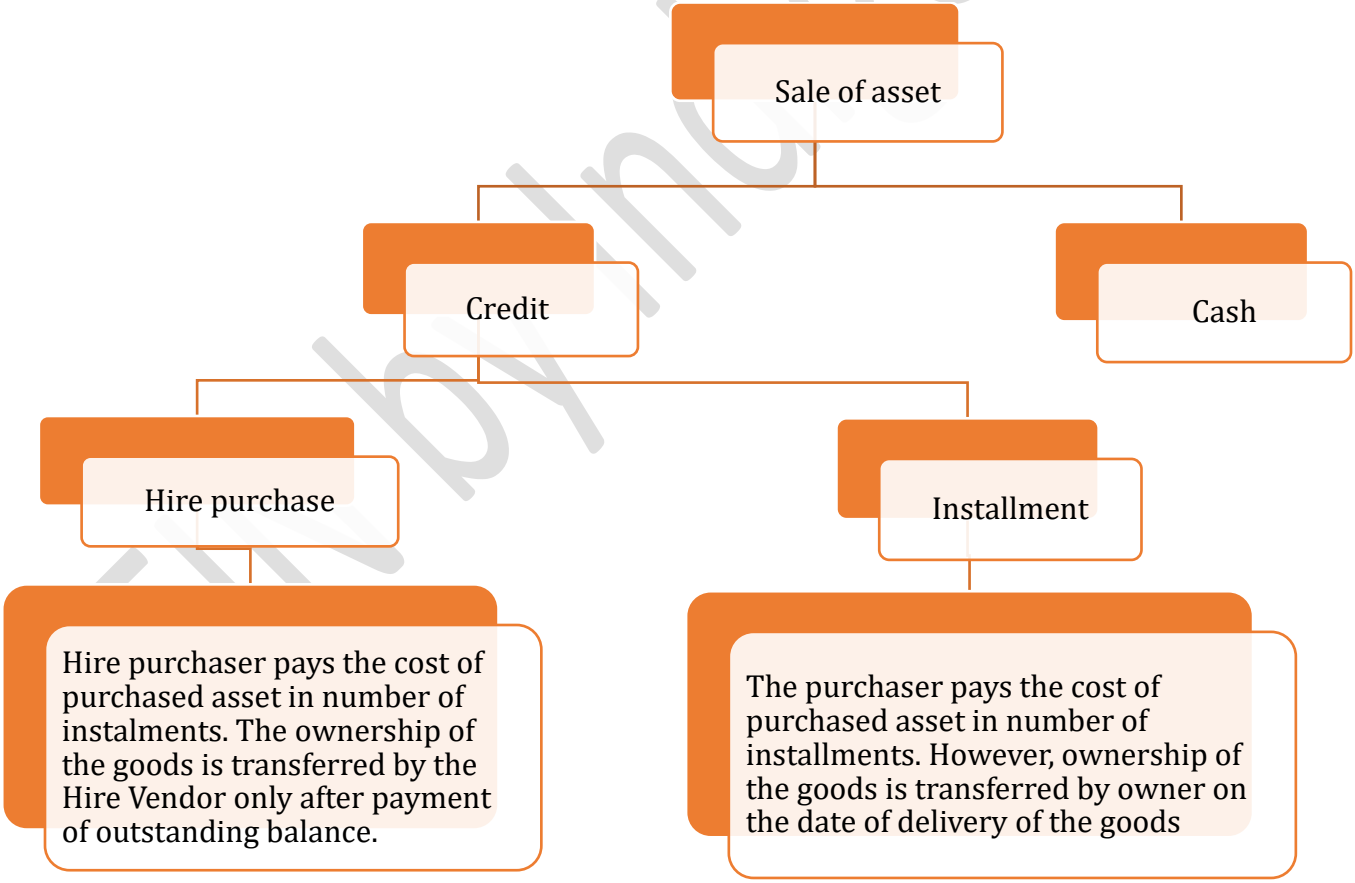
Study Note 9 | Hire Purchase and Installment System

INTRODUCTION

- ★ When a person wants to acquire an asset, but is unable to make the payment immediately, he may pay in instalments if the vendor agrees. This enables the purchaser to use the asset while paying for it in instalments over an agreed period of time.
- ★ The agreed instalments include interest on the assets given on credit to the purchaser. Therefore, the total amount (being paid in instalments over a period of time) is certainly higher than the cash down price of the asset because of interest charges.
- ★ Both the parties gain in the bargain. By virtue of this,
  - ➢ The purchaser - gets the right of immediate use of the asset without making immediate payment for the asset, by this, he gets both credit and product from the same seller.
  - ➢ The seller - derives the benefits by way of increase in sales and, he recovers his own cost of credit.



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FEATURES OF HIRE PURCHASE TRANSACTIONS

- ★ **Possession**: The hire vendor transfers only possession of the goods to the hire purchaser immediately after the contract for hire purchase is made.
- ★ **Installments**: The goods are delivered by the hire vendor on the condition that a hire purchaser should pay the amount in periodical instalments.
- ★ The total amount (being paid in instalments over a period) is certainly higher than the cash down price of the asset because of interest charges.
- ★ **Down Payment:** The hire purchaser generally makes a down payment, i.e., an amount on signing the agreement.
- ★ **Constituents of Hire purchase instalments**: Each instalment consists of two elements- Finance charge (interest on unpaid amount) and Capital payment.
- ★ **Ownership**: The property in goods is to pass to the hire purchaser on the payment of the last instalment and exercising the option conferred upon him under the agreement.
- ★ **Repossession**: In case of default in respect of payment of even the last instalment, the hire vendor has the right to take the goods back without making any compensation. i.e., the hire vendor is not going to pay back a part or whole of the amount received through instalments till the date of default from the buyer

FEATURES OF INSTALLMENT BASIS TRANSACTIONS

- ★ **Ownership** - In instalment payment system, the ownership of the goods is passed immediately to the buyer on the signing the agreement.
- ★ **Other features similar to Hire purchase are**
  - ➢ Possession,
  - ➢ Installments
  - ➢ Down payment and
  - ➢ Constituents of Instalments.
- ★ **Court proceedings** – In the event of default by the purchaser, the seller cannot repossess the goods. He can only sue the purchase and allow the court to take action.

TERMS USED

- ★ **Hire Vendor**: He is a person who delivers the goods along with its possession to the hire purchaser under a hire purchase agreement.
- ★ **Hire Purchaser**: He is a person who obtains the goods and rights to use the same from hire vendor under a hire purchase agreement.
- ★ **Cash Price**: Cash price is the amount to be paid by the buyer on outright purchase in

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cash.

- ★ **Down Payment**: Down payment is the initial payment made to the hire vendor by the hire purchaser at the time of entering into a hire purchase agreement.
- ★ **Hire Purchase Instalment**: Hire purchase instalment is the amount which the hire purchaser must pay after a regular interval up to certain period as specified in the agreement to obtain the ownership of the asset purchased (on payment of the last installment) under a hire purchase agreement. It comprises of principal amount and the interest on the unpaid amount.
- ★ **Hire purchase price**: It means the total sum payable by the hire purchaser to obtain the ownership of the asset purchased under hire purchase agreement.

  HP price = Cash price (+) Interest on outstanding balances

DISTINCTION BETWEEN HIRE PURCHASE AND INSTALMENT SYSTEM

Basis of distinction	Hire Purchase	Instalment System
Governing Act	It is governed by Hire Purchase Act, 1972.	It is governed by the Sale of Goods Act, 1930.
Nature of contract	It is an agreement of hiring.	It is an agreement of sale.
Passing of Title (ownership)	The title to goods passes on last payment.	The title to goods passes immediately as in the case of usual sale.
Right to Return goods	The hirer may return goods without further payment except for accrued instalments.	Unless seller defaults, goods are not returnable.
Seller's right to repossess	The seller may take possession of the goods if hirer is defaults, in whatever condition they are at that time. A separate charge on this account cannot be made.	The seller can sue for price if the buyer is in default. He cannot take possession of the goods.

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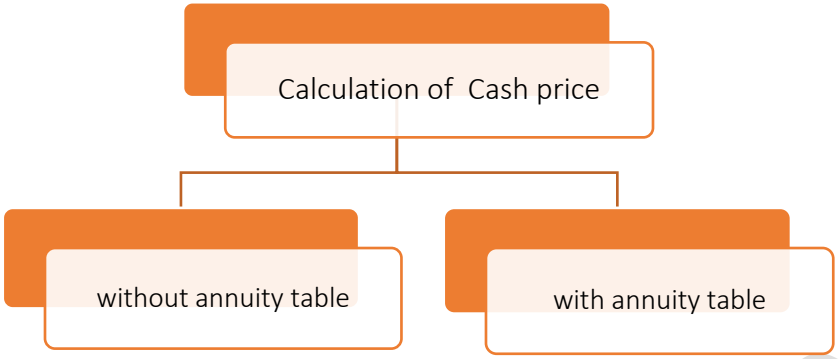
Right of Disposal	Hirer cannot hire outsell, pledge or assign entitling transferee to retain possession as against the hire vendor.	The buyer may dispose off the goods and give good title to the bona fide purchaser.
Responsibility for Risk of Loss.	The hirer is not responsible for risk of loss of goods if he has taken reasonable precaution because the ownership has not yet transferred.	The buyer is responsible for risk of loss of goods because of the ownership has transferred.
Name of Parties involved	The parties involved are called Hirer and Hire vendor	The parties involved are called buyer and seller.
Component other than cash price.	Component other than Cash Price included in installment is called Hire charges.	Component other than Cash Price included in Installment is called Interest.
Conditions When goods are sold on HP and when on Instalment	1.When goods cannot be destroyed easily. 2. when goods can be insured 3. when goods have resale value. E.g. Car, Bike, House etc.	If the conditions of HP and not satisfied, they will be sold on installment basis. For E.g. Household goods – TV, Fridge, AC etc.

Key points to be kept in mind while solving the problems

1. Down payment does not include any interest.
2. Interest is always calculated on total amount outstanding at the time of payment of installment.
3. Though the instalments of a hire purchase agreement may be equal, the interest element in each instalment is not the same.
4. Interest element in the 1st installment is > interest in 2nd installment. So on and so forth.
5. Total interest = HP price – Cash price

COMPUTING HIRE PURCHASE DETAILS

I. ASCERTAINMENT OF TOTAL CASH PRICE



I.(a) Calculation of Total Cash Price without using Annuity Table

In this method, the interest included in the last instalment is to be calculated first with the help of the appropriate formula

For example, in a hire purchase transaction, apart from down payment, four other instalments are payable. The interest will be calculated first on the 4th instalment, then on the 3rd instalment, then on the 2nd instalment and lastly on the 1st instalment. Interest on down payment will be nil.

The amount of interest will go on increasing from the 4th instalment to the 3rd instalment, so on and so forth.

We need to calculate the interest with the help of the total amount due on hire purchase price since the cash price is not known. The following steps should be followed:

Step 1	Calculate the ratio between interest and the amount due Ratio of interest and amount due = $\frac{\text{Rate of interest}}{100 + \text{Rate of interest}}$
Step 2	Calculate the interest included in the last instalment Interest = Total amount due at the time of instalment **x** Ratio of interest and amount due (as calculated in step 1)
Step 3	Amount of outstanding cash price at the time of last instalment = Last instalment – Interest (as calculated in step 2)

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Step 4	Amount due at the time of previous installment = Cash price (computed in Step 3) + Amount of instalment due at the end the previous year.
Step 5	Calculate the interest on the entire sum. Amount due (computed in step 4) X Ratio arrived at step 1
Step 6	Outstanding cash price at the time of that instalment = Total amount due at the end of that year (Step 4) - Interest (step 5)
Step 7	Repeat steps 4 to 6, to reach at 1st installment. Compute Amount due at the time of previous installment. Calculate the interest on the entire sum. Compute Outstanding cash price at the time of that instalment
Step 10	Total cash price = Cash price (computed in Step 7) + Amount of down payment, if any.

I.(b) Calculation of Total Cash Price with the help of Annuity Table

Cash price = Down payment + Present value of instalments

1. If present value of an annuity of Rs. 1 for a given period, at given rate of interest, is given

Present value of instalments = Annual instalments **x** Present value of an annuity of Rs. 1 for a given period at given rate of interest

$$= \text{Annual instalments} \times \frac{(1 + r)^n - 1}{r\,(1 + r)^n}$$

2. If annuity to recover Rs. 1 during a given period at given rate of interest is given,

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Present value of instalments = Annual instalments **x** $\frac{(1 + r)^n - 1}{r(1 + r)^n - 1}$

II. ASCERTAINMENT OF INTEREST

2 Possible situations may arise:

II.(a) - When the cash price, rate of interest and the amount of instalments are given.

Step 1 Calculate the total amount of interest: - Interest = Hire purchase price – Cash price Now the amount of interest involved in each instalment is to be calculated.			
Particulars	Total	Interest in each instalment	Cash price in each instalment
Step 2			
Cash price Less: down payment Balance due after down payment (a) Interest Cash price in 1st instalment	Xxxx (xxx) Xxxx	Balance x rate of interest	Instalment - Interest
Step 3			
Cash price in 1st instalment (b) Balance due after 1st Instalment (a-b) = (c)	(xxx) Xxxx		

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Interest Cash price in 2nd instalment		Balance x rate of interest	 Instalment - Interest
Step 4			
Cash price in 2nd instalment (d) Balance due after 1st Instalment (c-d) = (e) Interest Cash price in 3rd instalment	(xxx) Xxxx	 Balance x rate of interest	 Instalment - Interest
Step 5 Repeat the above steps till the last instalment is paid		This gives the total interest paid	This gives the hire purchase price.

II. (b) - When the cash price and the amount of instalments are given, but the rate of interest is not given.

Method 1

When the rate of interest is not given, but the cash price and the amount of installments are given, we have to find interest rate implicit in the transaction by bifurcating the installments between reduction in liability and finance charges (interest).

Step 1

Calculate the total amount of interest: - Interest = Hire purchase price – Cash price

Step 2

Bifurcate the interest in the ratio of amount outstanding.

Method 2

Use IRR.

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Internal rate of return (IRR) is the discount rate that equates the present value of the expected net cash outflows (amount of down-payment and installments) with the cash price. When the net cash flows are not uniform over the life of the investment, the determination of the discount rate can involve trial and error and interpolation between interest rates.

In case of hire purchase, Internal Rate of Return Method (IRR) method considers the time value of money, the cash price, and all cash outflows (amount of down-payment and installments) relating to the purchase of the asset on hire purchase basis.

IRR method does not use the desired rate of return but estimates the discount rate that makes the present value of subsequent net cash outflows equal to the cash price.

Step 1	Compute NPV at an initial guess rate (say L1) Aggregate of Cash flow of each year x Discounting factor @ L1 of each year = Present Value
Step 2	Compute NPV at second guess rate (say L2) Aggregate of Cash flow of each year x Discounting factor @ L2 of each year = Present Value
Step 3	Compute IRR through Linear intrapoliation IRR = L1 + $\frac{\text{NPV of L1}}{\text{NPV of L1} - \text{NPV of L2}}$ x (L2-L1)

METHOD OF ACCOUNTING

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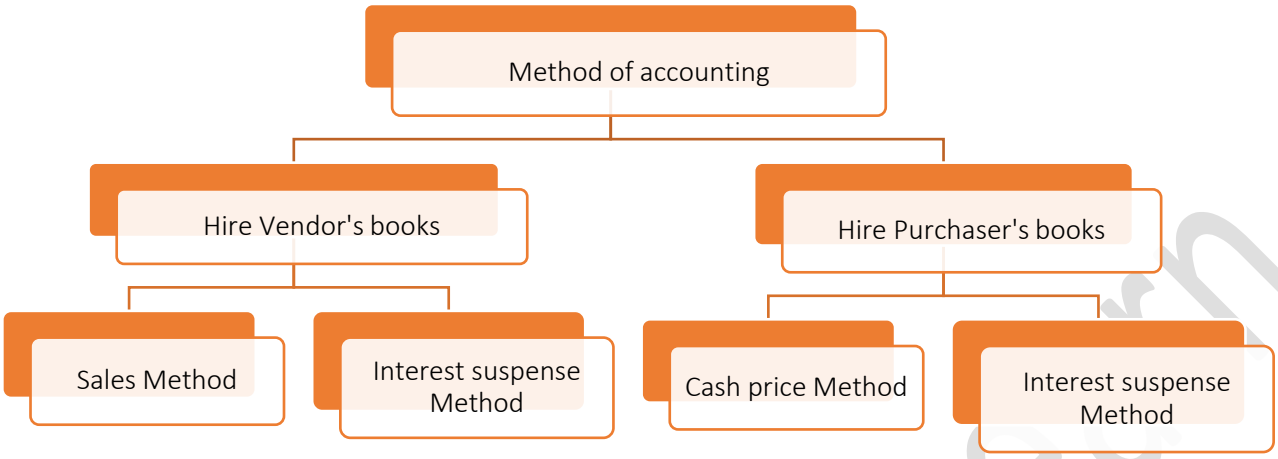

IN THE BOOKS OF HIRE PURCHASER

To have proper accounting record, one should know the following:

(1) Date of purchase of the asset;
(2) Cash price of the asset;
(3) Hire purchase price of the asset;
(4) The amount of down payment;
(5) Number and amount of each instalment;
(6) Rate of interest;
(7) Method and rate of depreciation;
(8) Date of payment of every instalment; and
(9) Date of closing the books of account.

Disclosure requirement

- Disclose assets taken on hire purchase basis by classifying it as "Asset on Hire Purchase".
- Amount due to the hire vendor should also be shown as a liability—"Hire Purchase Creditors" with additional such classifications of amount of 'hire purchase instalment due' and 'amount of hire purchase instalment not yet due'.
- Asset is shown at cost (cash price) less depreciation.

CASH METHOD

Under this method, at the time of payment of instalment, Interest Account is debited, and Hire Vendor Account is credited (with the interest on outstanding balance). At the end of the year interest is transferred to Profit and Loss Account.

Journal Entries

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1.	At the time of entering into the agreement Asset Account Dr. To Hire Vendor Account	[Full cash price]
2.	When down payment is made Hire Vendor Account Dr. To Cash/Bank Account	[Down payment]
3.	When an instalment becomes due Interest Account Dr. To Hire Vendor Account	[Interest on outstanding balance]
4.	When an instalment is paid Hire Vendor Account Dr. To Bank Account	[Amount of instalment]
5.	When depreciation is charged on the asset Depreciation Account Dr. To Asset Account	[Calculated on cash price]
6.	For closing interest and depreciation account Profit and Loss Account Dr. To Interest Account To Depreciation Account	

INTEREST SUSPENSE METHOD

Under this method, at the time of transfer of possession of asset, the total interest unaccrued is transferred to interest suspense account. At later years, as and when interest becomes due, interest account is debited, and interest suspense account is credited.

Journal Entries

1.	When the asset is acquired on hire purchase Dr.	[Full cash price]

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	Asset Account To Hire Vendor Account		
2.	For total interest payment H.P. Interest Suspense Account To Hire Vendor Account	Dr.	[Total interest]
3.	When down payment is made Hire Vendor Account To Bank Account	Dr.	
4.	For Interest of the relevant period Interest Account To H.P. Interest Suspense Account		Dr. [Interest of the relevant period]
5.	When an instalment is paid Hire Vendor Account To Bank Account	Dr.	
6.	When depreciation is charged Depreciation Account To Asset Account		Dr. [Calculated on cash price]
7.	For closing interest and depreciation Profit and Loss Account To Interest Account To Depreciation Account	Dr.	

IN THE BOOKS OF HIRE VENDOR

Out of the two method (i.e. sales method and interest suspense method) the selection of the method is based on the type and value of goods sold, volume of transactions, the length of the period of purchase, etc.

The entire profit on sale under hire purchase agreement is credited to the Profit and Loss account of the year in which the sale has taken place.

Interest pertaining to each accounting period is credited to the P&L A/c of the respective year.

Sales method

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	Journal Entries	
1.	When goods are sold and delivered under hire purchase Hire Purchaser Account Dr. To H.P. Sales Account	[Full cash price]
2.	When the down payment is received Bank Account Dr. To Hire Purchaser Account	
3.	When an instalment becomes due Hire Purchaser Account Dr. To Interest Account	
4.	When the amount of instalment is received Bank Account Dr. To Hire Purchaser Account	
5.	For closing interest Account Interest Account Dr. To Profit and Loss Account	.
6.	For closing Hire Purchase Sales Account H.P. Sales Account Dr. To Trading Account	

Interest Suspense Method		
	Journal Entries	
1.	When goods are sold and delivered under hire purchase Hire Purchaser Account Dr. To H.P. Sales Account To Interest suspense account	[Full cash price + total interest] [Full cash price] [Total interest]
2.	When the down payment is received Bank Account Dr. To Hire Purchaser Account	
3.		

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	For interest of relevant accounting period Interest suspense Account Dr. To Interest Account	
4.	When the amount of instalment is received Bank Account Dr. To Hire Purchaser Account	
5.	For closing interest Account Interest Account Dr. To Profit and Loss Account	.
6.	For closing Hire Purchase Sales Account H.P. Sales Account Dr. To Trading Account	

The disclosure in balance sheet of the respective parties will be:

Balance Sheet of Hire Purchaser	Balance Sheet of Vendor
Assets	Assets
Fixed assets:	Current assets:
Asset on Hire purchase Less: Depreciation	Hire purchase debtors Less: Balance in Interest suspense A/c
Liabilities	Liabilities
Amount payable to Vendor Less: Balance in Interest Suspense A/c	

ACCOUNTING UNDER INSTALMENT PAYMENT SYSTEM

In instalment payment system, the ownership of the goods is passed immediately to the buyer on the signing the agreement. The accounting entries under instalment payment system are similar to those passed under the hire-purchase system. The scheme of entries is as under:

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Journal entries in the books of Buyer	
For Purchase of asset Asset A/c Interest suspense A/c To Vendor's A/c	 Dr. (with full cash price) Dr. (with difference between full cash price & installment price (With full installment price)
Upon interest becoming due Interest A/c To Interest suspense A/c	 Dr.
Every year interest account is debited, and interest suspense account is credited with the interest of current year.	
Upon payment of Installment Vendor's A/c To Cash A/c	 Dr.
At the end of the year P&L A/c To Interest A/c	 Dr.
Note: The balance of vendor account should be shown in the balance sheet after deducting amount in interest suspense account. Vendor is paid the instalment due to him and entry for the depreciation is passed in the usual way.	

Journal entries in the books of Seller

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For Sale of asset Buyer's A/c To Sales A/c To Interest suspense A/c	Dr. (with full Installment price) (with full cash price) (with difference between full cash price & installment price
Upon interest becoming due Interest suspense A/c To Interest A/c	Dr.
Every year this entry is passed with the interest of current year.	
Upon receipt of Installment Cash A/c To Purchaser A/c	Dr.
At the end of the year Interest A/c To P&L A/c	Dr.

REPOSSESSION

- ★ If the hire purchaser fails to pay any of the instalments, the hire vendor takes the asset back in its actual form without any refund of the earlier payments to the hire purchaser.
- ★ The amounts received from the hire purchaser through down payment and instalments are treated as the hire charges by the hire vendor.
- ★ This act of recovery of possession of the asset is termed as repossession.
- ★ Repossessed assets are resold to any other customer after repairing or reconditioning (if necessary).

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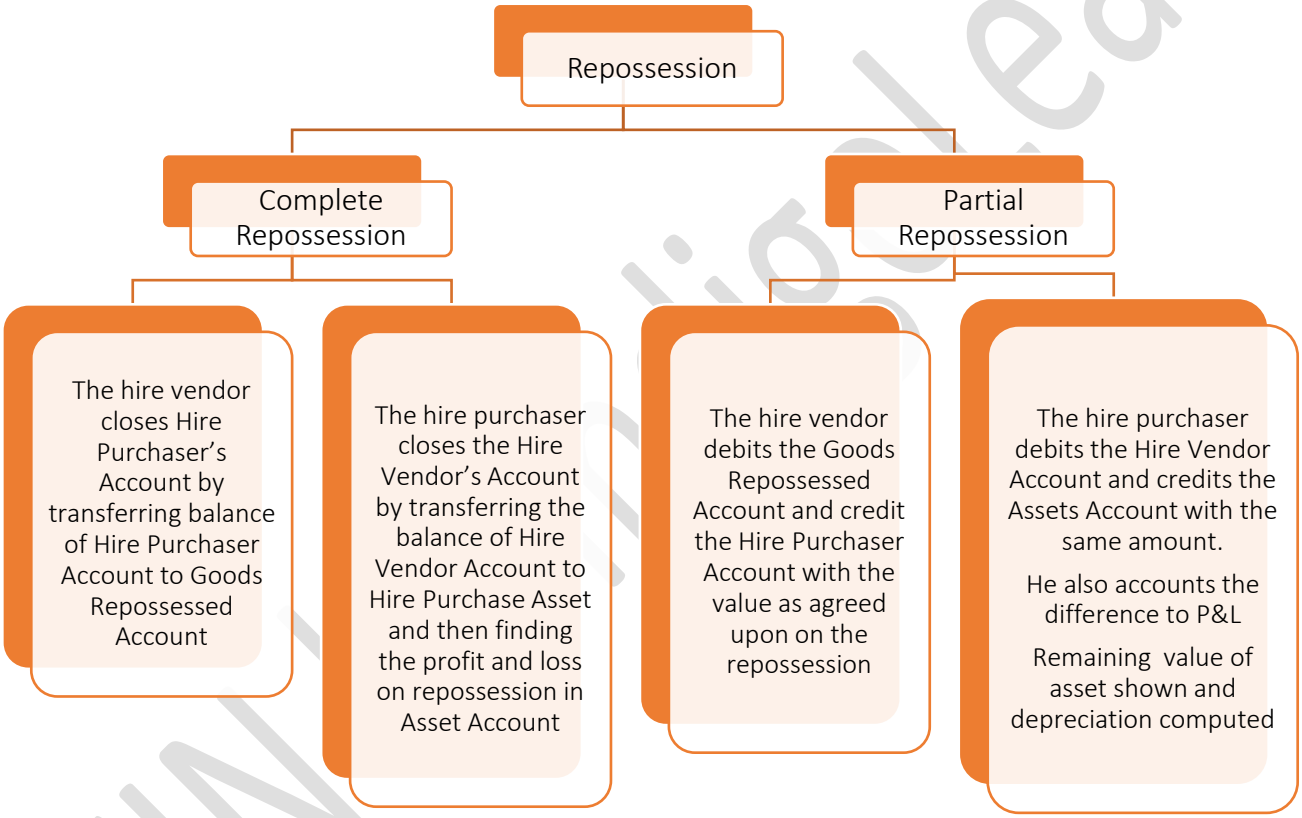
- ★ Accounting figures relating to repossessed assets are segregated from the normal hire purchase entries. Repossessions are then accounted for in a separate "Goods Repossessed Account".
- ★ In case of a partial repossession, only a part of the asset is taken back by the hire vendor and other part is left with the hire purchaser.
- ★ Assets are repossessed at a mutually agreed value (based on agreed rate of depreciation which is an enhanced rate).



COMPLETE REPOSSESSION
Journal entries in the books of hire purchaser
For purchases Asset A/c Dr. To Hire vendor A/c

Upon payment of instalment Hire vendor A/c Dr. To Cash A/c
Upon payment of interest Interest A/c Dr. To Hire vendor A/c
Upon repossession Hire vendor A/c Dr. To Asset A/c

COMPLETE REPOSSESSION
Journal entries in the books of hire Vendor
For sales made Hire purchase A/c Dr. To Sales A/c
Upon receipt of instalment Cash A/c Dr. To Hire purchaser A/c
Upon receipt of interest Hire purchaser A/c Dr. To Interest A/c
Upon repossession Goods repossessed A/c Dr. To Hire purchaser A/c

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Illustrations

Illustration - 1

A acquired on 1st January, 20X1 a machine under a Hire-Purchase agreement which provides for 5 half-yearly instalments of Rs.6,000 each, the first instalment being due on 1st July, 20X1. Assuming that the applicable rate of interest is 10 per cent per annum, calculate the cash value of the machine. All workings should form part of the answer.

Illustration -2

On 1st April, 20X1 a manufacturing company buys on Hire-purchase system a machinery for Rs.90,000 payable by three equal annual instalments combining principal and interest, the rate of interest was 5% per annum. Calculate the amount of cash price and interest. Assume that the present value of an annuity of one rupee for three years at 5% interest is Rs.2.723.

Illustration - 3

Om Ltd. purchased a machine on hire purchase basis from Kumar Machinery Co. Ltd. on the following terms:
(a) Cash price Rs.80,000
(b) Down payment at the time of signing the agreement on 1.1.20X1 Rs.21,622.
(c) 5 annual instalments of Rs.15,400, the first to commence at the end of twelve months from the date of down payment.
(d) Rate of interest is 10% p.a.
You are required to calculate the total interest and interest included in cash instalment.

Illustration - 4
A acquired on 1st January, 20X1 a machine under a Hire-Purchase agreement which provides for 5 half-yearly instalments of Rs.6,000 each, the first instalment being due on 1st July, 20X1. Assuming that the applicable rate of interest is 10 per cent per annum, calculate the cash value of the machine. All workings should form part of the answer.
Illustration:
A Happy Valley Florists Ltd. acquired a delivery van on hire purchase on 01.04.20X1 from Ganesh Enterprises. The terms were as follows:

Particulars	Amount (Rs.)
Hire Purchase Price	180,000
Down Payment	30,000
1st installment payable after 1 year	50,000
2nd installment after 2 years	50,000

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3rd installment after 3 years	30,000
4th installment after 4 years	20,000

Cash price of van Rs.150,000 You are required to calculate Total Interest and Interest included in each instalment.

Illustration - 5

On January 1, 20X1 HP M/s acquired a Pick-up Van on hire purchase from FM M/s. The terms of the contract were as follows:

1. The cash price of the van was Rs.1,00,000.
2. Rs.40,000 were to be paid on signing of the contract.
3. The balance was to be paid in annual instalments of Rs.20,000 plus interest.
4. Interest chargeable on the outstanding balance was 6% p.a.
5. Depreciation at 10% p.a. is to be written-off using the straight-line method.

You are required to:

a. Give Journal Entries and show the relevant accounts in the books of HP M/s from January 1, 20X1 to December 31, 20X3; and

b. Show the relevant items in the Balance Sheet of the purchaser as on December 31, 20X1 to 20X3.

Illustration - 6

On January 1, 20X1 HP M/s acquired a Pick-up Van on hire purchase from FM M/s. The terms of the contract were as follows:

1. The cash price of the van was Rs.1,00,000.
2. Rs.40,000 were to be paid on signing of the contract.
3. The balance was to be paid in annual instalments of Rs.20,000 plus interest.
4. Interest chargeable on the outstanding balance was 6% p.a.
5. Depreciation at 10% p.a. is to be written-off using the straight-line method.

Assume that the hire purchaser adopted the interest suspense method for recording his hire purchase transactions. On this basis, prepare Hire Purchase Interest Suspense Account, Interest Account and FM M/s Accounts and Balance Sheets in the books of hire purchaser.

Illustration - 7

X Ltd. purchased 3 milk vans from Super Motors costing Rs.75,000 each on hire purchase system.

Payment was to be made: Rs.45,000 down and the remainder in 3 equal instalments together with interest @ 9%. X Ltd. writes off depreciation @ 20% on the diminishing balance. It paid the instalment at the end of the 1st year but could not pay the next. Super Motor agreed to leave one milk van with the purchaser, adjusting the value of the other

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two milk vans against the amount due. The milk vans were valued on the basis of 30% depreciation annually on written down value basis. X Ltd. settled the seller's dues after three months.
You are required to give necessary journal entries and the relevant accounts in the books of X Ltd.

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Study Notes 10 | Branch and Departmental Accounts

10.1 Branch Accounts

INTRODUCTION

BRANCH - Any establishment carrying on either the same or substantially the same activity as that carried on by head office of the company and located at a place or places different from the head office.
HEAD OFFICE - The principal place of business.

NEED TO LEARN BRANCH ACCOUNTS

1. Ascertain its performance
2. It is an integral part of the entity and hence its financial transactions have to be clubbed with head office.
3. Helps to obtain operational and financial control and decision making

For finding out the trading results of branch, it is assumed that the branch is an entity separate from the head office.

DISTINCTION BETWEEN BRANCH ACCOUNTS AND DEPARTMENTAL ACCOUNTS

Basis	Branch	Department
Definition	Any establishment carrying on either the same or substantially the same activity as that carried on by head office and located at different places. For e.g. SBI and its branches.	An entity usually classified based on functionality which is part of the company. It need not be located at various places. For e.g. Production department, Purchase department etc.
Maintenance of accounts	Branch accounts may be maintained either at branch or at head office	Departmental accounts are maintained at one place only.

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Allocation of common expenses	expenses in respect of each branch can be identified so no question of allocation	Common expenses are distributed among the departments concerned on some equitable basis considered suitable in the case.
Reconciliation	Reconciliation of head office and branch accounts is necessary in case of independent branch accounting at the end of the accounting year.	No question of reconciliation
Conversion of foreign currency figures	At the time of finalization of accounts, conversion of figures of foreign branch is necessary.	No such conversion is needed

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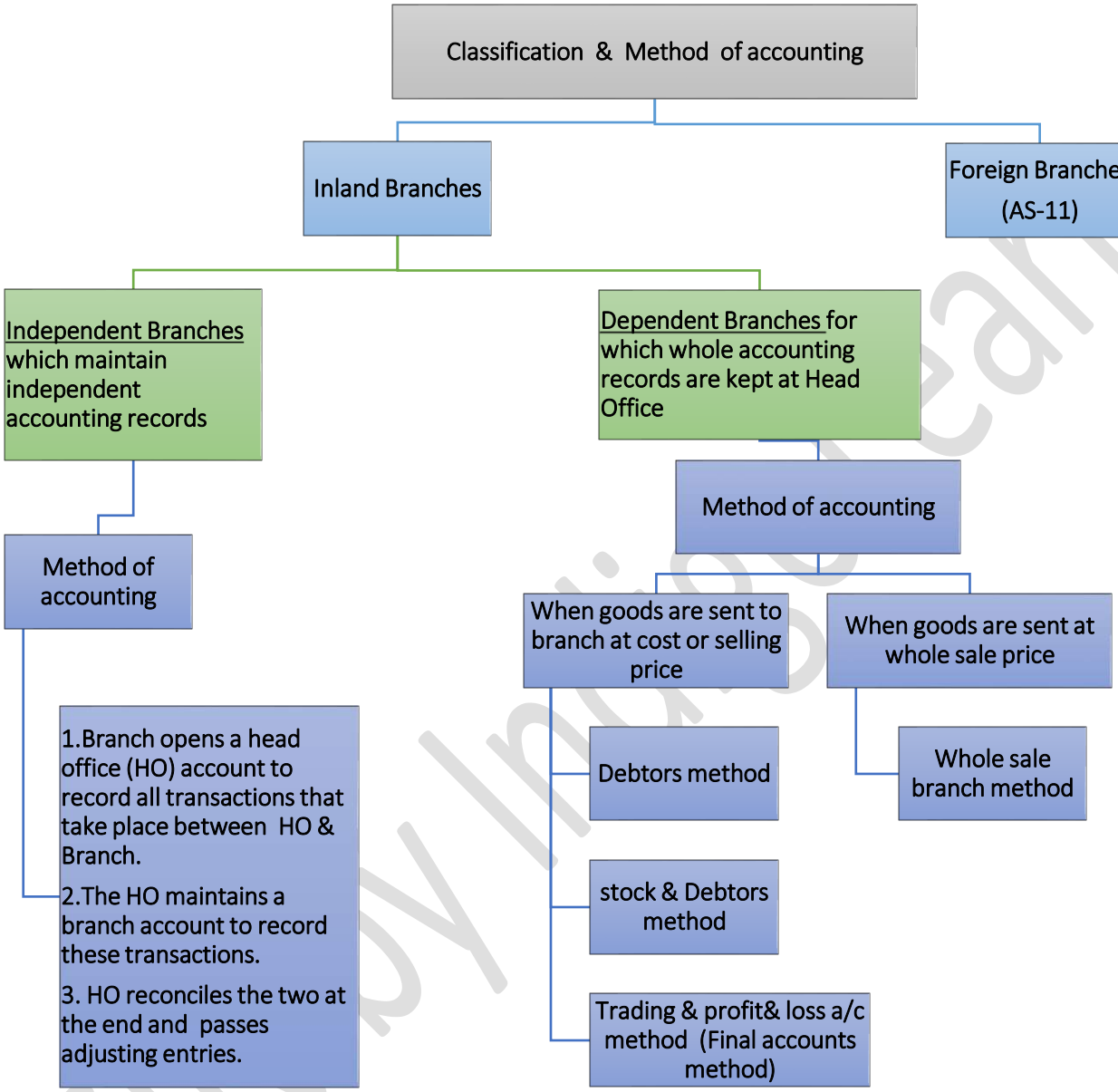
CLASSIFICATION OF BRANCHES & METHODS OF ACCOUNTING



DEPENDENT BRANCHES

- The business policies and the administration of a branch are wholly controlled by the head office
- Branch accounts, in such a case, are maintained at the head office out of reports and returns received from the branch
- Some examples of such branches are:
  - A branch set up merely for booking orders that are executed by the head office

- A branch established at a commercial center for the sale of goods supplied by the head office, and under its direction all collections are made by the H.O
- A branch for the retail sale of goods, supplied by the head office

- In first two cases, only a record of expenses incurred at the branch must be maintained.
- In case of retail branch, it sells goods supplied by the head office for cash or on credit to approved customers. Cash collected is deposited into a local bank to the credit of the HO and the HO issues cheques thereon for meeting the expenses of the branch. Further branch is provided imprest money. If, however, the branch also sells certain lines of goods, directly purchased by it, the branch retains a part of the sale proceeds to pay for the goods so purchased.

ACCOUNTING FOR DEPENDENT BRANCHES

DEBTORS METHOD

- suitable for small sized branches
- separate branch account is maintained for each branch to compute profit or loss made by each branch.
- For finding out the trading results of branch, it is assumed that the branch is an entity separate from the head office. On the basis, a Branch Account is stated in the head office books to which the price of goods or services provided, or expenses paid out are debited and correspondingly, the value of benefits and cash received from the branch are credited.

WHEN GOODS ARE INVOICED AT COST

Performa branch account (in the books of HO)

Particulars	Amount	Particulars	Amount
To Balance b/d Cash Stock Debtors Petty Cash Fixed Assets Prepaid Expenses To Goods sent to Branch		By Opening liabilities By Bank A/c (Cash remitted) By Return to H.O. By Balance c/d Cash Stock Debtors Petty Cash Fixed Assets	

To Bank A/c (Exp paid by HO) Salaries Rent Sundry Expenses To Closing liabilities To Profit & Loss A/c–Profit (if credit side is Greater)		Prepaid Expenses By Profit and Loss, A/c – Loss (if debit side is greater)	

The following are not considered in the account-

- Cash and Credit sales made by branch.
- Expenses paid by branch (as they get adjusted with cash balances)
- Discount or allowances made to debtors
- Non-cash expenses like depreciation (also gets adjusted with opening and closing balance of assets)

The accuracy of the trading results as disclosed by the Branch Account, so maintained, if considered necessary, can be proved by preparing a Memorandum Branch Trading and Profit & Loss Account, in the usual way, from the balances of various items of income and expenses contained in the Branch Account.

WHEN GOODS ARE INVOICED AT SELLING PRICE

- The value of unsold stock at the branch at the end of the year needs to be adjusted with the following, before it is incorporated in the HO accounts:
  - The change in selling price.
  - The amount of anticipatory profit included in the value of unsold stock with the branch at the close of the year will have to be eliminated before the accounts of the branch are incorporated with that of the head office. This will be done by creating a reserve.
  - Physical losses of stock due to either pilferage or wastages which may have occurred during the year. This is done by debiting the cost of the goods to Goods Lost Account and the amount of loading (included in the lost goods), to the Branch Adjustment Account.

- The stock reserve portion has to be reversed from all the components – Opening balance, goods sent to Branch, goods returned, and closing stock. And thus, two additional accounts must be prepared:

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- The Goods Sent to Branch Account; and
- The Stock Reserve Account.

Journal entries	
Goods sent to the Branch at selling price	
Branch A/c	Dr.
To Goods sent to Branch A/c	
Adjustment of loading (difference between the cost and selling price)	
Goods sent to branch A/c	Dr.
To Branch A/c	
Goods returned to HO at selling price	
Goods sent to branch A/c	Dr.
To Branch A/c	
Adjustment of loading in respect of goods returned	
Branch A/c	Dr.
To Goods sent to Branch A/c	
Loading included in the opening stock (to be reduced)	
Stock Reserve A/c	Dr.
To Branch A/c	
Closing stock at selling price	
Branch Stock A/c	Dr.
To Branch A/c	
Loading included in closing stock to reduce it to cost	
Branch A/c	Dr.
To Stock reserve A/c	

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Notes:

- In respect of closing stock at branch for the purpose of disclosure in the Balance Sheet, the credit balance in the 'Stock Reserve Account' at the end of the year will be deducted from the value of the closing stock, so as to reduce it to close; it will be carried forward as a separate balance to the following year, for being transferred to the credit of the Branch A/c

STOCK AND DEBTORS METHOD

- Useful when it is desired to exercise a more detailed control over the working of a branch.
- According to this method, the following accounts are maintained by the H O:

Account	Purpose and Treatment
Branch Stock Account (or Branch Trading Account)	Ascertainment of shortage or surplus i.e. Gross profit or loss. The balance is transferred to branch P&L. Closing stock is credited at cost.
Branch Profit and Loss Account	Calculation of net profit or loss. All expenses of branch (whether paid by Branch or paid by HO or non-cash expenses) are debited in this account. The balance is transferred to HO P&L account.
Branch Debtors account	Ascertainment of closing balance of debtors. This is prepared only if goods are sold on credit
Branch expense account	Ascertainment of total expenses incurred This is optional. Transfer the balance to Branch P&L account.

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Goods sent to branch account	Ascertainment of cost of goods sent to branch. The credit balance in this Account is afterwards transferred to the Head Office Purchase Account or Trading Account
Branch cash account	Ascertainment of cash balance. This is prepared if the branch has purchased goods locally and incurred expenses out of its cash collections.
Branch Assets account	Ascertainment of Assets balance. Optional, If the branch has spent on it.
Branch Adjustment account (This is prepared, along with other accounts, only when goods are sent at selling price)	Ascertain stock reserve/unrealized profit. We eliminate the profit element from each and every item of branch stock account except sales and sales returns. This is done by crediting this account. The balance in this account, at the end of year consists of Gross Profit earned on sale by the branch. Hence, it will be transferred to the Branch Profit and Loss Account.

WHEN GOODS ARE INVOICED AT COST

Journal entries	
Cost of goods sent to the Branch	
Branch Stock A/c	Dr.
To Goods sent to Branch A/c	
Remittances for expenses	
Branch Cash A/c	Dr.
To (HO) Cash A/c	

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Any assets (e.g. furniture) provided by H.O.		
Branch Asset (Furniture) A/c		Dr.
To (HO) Cash A/c	or	
To Vendor's A/c	or	
To (HO) Furniture A/c		
Cost of goods returned by the branch		
Goods sent to Branch A/c		Dr.
To Branch Stock A/c		
Cash Sales / Credit Sales at the Branch		
Branch Cash A/c	or	Dr.
Branch Debtors A/c		Dr.
To Branch Stock A/c		
Return of goods by debtors to the Branch		
Branch Stock A/c		Dr.
To Branch Debtors A/c		
Cash paid by debtors		
Branch Cash A/c		Dr.
To Branch Debtors A/c		
Discount & allowance to debtors, bad debts		
Branch Expenses A/c		Dr.
To Branch Debtors A/c		
Remittances to H.O.		
(H.O.) Cash A/c		Dr.
To Branch Cash A/c		

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Expenses met by H.O. Branch Expenses A/c Dr. To (HO) Cash A/c
Notes: ➢ Credit the Branch Stock Account with the value of closing stock at cost. It will be carried down as opening balance (debit) for the next accounting period. The Balance of the Branch Stock Account, (after adjustment therein the value of closing stock), if in credit, will represent the gross profit on sales and vice versa.

WHEN GOODS ARE INVOICED AT SELLING PRICE

❖ The following points should be kept in mind under this method:

Journal entries
Goods sent to the Branch at selling price Branch stock A/c (@Selling price) Dr. To Goods sent to Branch A/c (@cost) To Branch adjustment A/c (Loading)
Goods returned to HO at selling price Goods sent to branch A/c (@cost) Dr. Branch Adjustment A/c (Loading) Dr. To Branch Stock A/c (@Selling price)
Cash sales at the Branch

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Bank / Cash A/c Dr. To Branch stock A/c	
Credit Sales at the Branch Branch Debtors A/c Dr. To Branch stock A/c	
Goods returned to Branch by customers Branch Stock A/c Dr. To Branch Debtors A/c (@Selling price)	
Goods lost in transit or stolen Goods lost in transit / Goods stolen A/c (@Cost) Dr. Branch Adjustment A/c (Loading) Dr. To Branch Stock A/c	
Rebates and allowances allowed to customers Branch Adjustment A/c Dr. To Branch stock A/c (in case of cash sales) To Branch debtor's A/c (in case of credit sales)	
Notes: ➢ The value of stock actually held at the branch is either more or less than the balance of the Branch Stock Account. Branch Stock Account is increased or reduced by debit or credit to Goods Lost Account (at cost price of goods) and Branch Adjustment Account (with the loading). ➢ Closing stock - The discrepancy in the amount of balance in the Branch Stock Account and the value of stock actually in hand, valued at sale price, may be the result of one or more of the under-mentioned factors: • An error in applying the percentage of loading.	

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- Goods having been sold either below or above the established selling price.
- A Commission to adjust returns or allowances.
- Physical loss of stock due to natural causes or pilferage.
- Errors in Stock-taking.

➢ The above-mentioned losses must be accounted at cost and the profit element in them is debited to branch adjustment account.

➢ ***An alternate method*** - Where the gross profit of each branch is not required to be ascertained separately, although the selling price is uniform, the amount of goods sent to the branch is recorded only in two accounts namely - Branch Stock Account and Goods Sent to Branch A/c.

In this method, at the end of the year the Branch Stock Account is closed by transfer of the balance representing the value of closing stock, at sale price, to the Goods Sent to Branch Account. This has the effect of altogether eliminating from the books the value of stock at the branch. The balance of Goods sent to Branch Account is afterwards transferred to the Trading Account representing the net sale price of goods sold at the branch. In that case, the value of closing stock at the branch at cost will be subsequently introduced in the Trading Account together with that of closing stock at the head office.

BRANCH TRADING AND PROFIT AND LOSS ACCOUNT (FINAL ACCOUNTS METHOD)

- ❖ In this method, Trading and P&L accounts are prepared considering each branch as a separate entity.
- ❖ Easy to prepare and understand.
- ❖ Gives complete information of all transactions which are ignored in the other methods.

WHEN GOODS ARE INVOICED AT COST PRICE

- ❖ Branch Trading and P&L account is merely a memorandum account and therefore, the entries made there in do does not have double entry effect.
- ❖ Gross Profit and Net Profit earned by the branch are ascertainable.
- ❖ Evaluating the performance of the branch is very much easier

WHEN GOODS ARE INVOICED AT SELLING PRICE

- ❖ All items of memorandum Branch Trading and Profit and Loss Account are to be converted into cost price.

- Other points will remain same as mentioned above if goods are invoiced at cost.

WHOLESALE BRANCH METHOD

WHEN GOODS INVOICED AT WHOLESALE PRICE TO RETAIL BRANCHES

- Under this method, the Head Office (particularly, the manufacturing concern) supplies goods to its retail branches at wholesale price which is cost plus wholesale profit.
- Profit attributable to such branches = Sale proceeds - wholesale price of the goods sold.
- The accounts prepared maintained are:
  - Branch stock account / Branch Trading account
  - Branch P&L account
  - Stock reserve account

Proforma Branch stock account

Particulars	Amount	Particulars	Amount
To Opening stock	xxx	By Sales	xxx
To Goods sent to branch	xxx	By Goods lost in transit	xxx
To Gross profit	xxx	By Closing stock	xxx
	xxx		xxx

Note:

- All the above amounts are in wholesale price, except sales which is at retail price.
- Since the closing stock at the branch is valued at wholesale price, a stock reserve is created, equal to the difference between its wholesale price and its cost (to HO) by debiting the amount in the HO P&L A/c. This Stock Reserve is carried down to the next year and then transferred to the credit of the HO P&L A/c.

Branch P&L account

Particulars	Amount	Particulars	Amount
To Goods lost in transit	xxx	By Gross profit	xxx
To Branch expenses	xxx		xxx

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To Net profit transferred	xxx		
	xxx		xxx

Stock reserve A/c

Particulars	Amount	Particulars	Amount
To HO P&L A/c (transferred) To Balance c/d (stock reserve required)	xxx xxx	By Balance b/d (Loading on opening stock) By HO P&L A/c (Loading on Closing stock)	Xxx Xxx
	xxx		Xxx

ACCOUNTING FOR INDEPENDENT BRANCHES

- When the size of the business is big, the branch maintains complete records of its transactions. These branches are called independent branches.
- Accounting happens as follows:
  1) Branch maintains its entire books of account under double entry system.
  2) Branch opens in its books a Head Office account to record all transactions that take place between Head Office and branch. The Head Office maintains a Branch account to record these transactions.
     The branch A/c and the Head office A/c are converse of each other.
  3) Branch prepares its Trial Balance, Trading and profit and loss Account at the end of the accounting period and sends copies of these statements to Head Office for incorporation.
  4) Inter-branch transactions are usually adjusted as if they were entered only with the head office.
  5) After receiving the final statements from branch, Head Office reconciles between the two – Branch account in Head Office books and Head Office account in Branch books.
     A consolidated reconciliation statement is prepared passing necessary rectification entries (either in the HO books or Branch books or both as the case may be)
     Some common reasons for difference are:
     - Goods in transit (either sent by HO or returned by Branch)

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- Cash in transit (either remitted by HO or by branch)
- Cash directly collected by HO from Branch debtors
- Payment made directly to the vendors by HO on behalf of branch.

6) Head office passes necessary journal entries to incorporate branch trial balance in its books.
7) The result of these adjustments will be that so far as the Head Office is concerned, the branch will be looked upon either as a debtor or creditor. As a debtor if the amount of its assets is in excess of its liabilities and as a creditor if the position is reverse.
8) when accounts of the branch and head office are consolidated both the Branch and Head Office Accounts will be eliminated.
9) Incorporation of branch balance in head office books – 2 Options exists
   a. Prepare separate P&L Account and Balance Sheet of the branch and the HO.
      - The amount of profit or loss shown by the Branch P&L A/c only will be transferred to Head office Account in the branch books and a converse entry will be passed in the Head Office books.
      - The branch Balance Sheet would show the amount advanced by the head office to it, as capital. In the head office Balance Sheet, the same amount would be shown as an advance to the branch.

   b. Prepare consolidated statement of account of both branch and head office.
      - Individual balances of all the revenue accounts would be separately transferred to the Head Office Account by debit or credit in the branch books and the converse entries would be passed in the head office books.
      - Transfer the balance of assets and liabilities of the branch to the head office and pass converse entries in the books of HO.
      - At the beginning of next year, the entries are reversed.
10) If it is desired that profitability of the branch should be kept secret from the branch staff, the head office would hold back some key information from the branch, e.g., amount of opening stock, cost of goods sent to the branch, etc. The head office, in such a case would maintain a record of goods sent to the branch by passing the entry:

    Goods Supplied to the Branch Account Dr.
    To Purchases Account

    The value of the closing stock will also be adjusted only in head office books. In such a case, for closing its books at the end of the year, the branch will simply transfer various revenue accounts to the head office without drawing up a Trading and Profit & Loss Account. The HO will construct the Trading and Profit & Loss Account of the branch.

Transactions	**Head office Books**	**Branch Books**

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Dispatch of goods to branch by H.O.	Branch A/c Dr. To Good sent to Branch A/c	Goods received from H.O. A/c Dr. To Head Office A/c
When goods are returned by branch	Goods sent to Branch A/c Dr. To Branch A/c	Head Office A/c Dr. To Goods received from H.O. A/c
Branch Expenses paid by branch	No Entry	Expenses A/c Dr. To Bank or Cash A/c
Branch Expenses paid by HO	Branch A/c Dr. To Bank or cash	Expenses A/c Dr. To Head Office A/c
Outside purchases made by branch	No Entry	Purchases A/c Dr. To Bank A/c(or) To Creditors A/c
Sales effected by branch	No Entry	Cash or Debtors A/c Dr. To Sales
Collection from Branch debtors received by HO	Cash or Bank A/c Dr. To Branch A/c	Head office A/c Dr. To Sundry Debtors A/c
Payment by H.O. for purchase made by Branch	Branch A/c Dr. To Bank A/c	Purchases/Creditors A/c Dr. To Head Office
Purchase of Asset by branch	No Entry	Sundry Assets A/c Dr. To Bank A/c (or) To Liability A/c
Asset purchased by the Branch, but Asset A/c retained at H.O. books	Branch Asset A/c Dr. To Branch A/c	Head office Dr. To Bank (or) Liability
Depreciation on above	Branch A/c Dr. To Branch Asset	Depreciation A/c Dr. To Head Office A/c
Remittance of funds by HO to branch	Branch A/c Dr. To Bank	Bank A/c Dr. To Head Office
Remittance of funds by	Reverse the above entry	Reverse the above entry

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Branch to H. O		
Goods sent by HO are in transit	No entry	Goods in transit A/c Dr. To Head office A/c
Allocation of expenses by HO	Branch A/c Dr. To expense A/c	Expense A/c Dr. To Head office A/c
Transfer of goods from one branch to another branch	Recipient branch A/c Dr. To Supplying branch	Supplying branch: Head Office A/c Dr. To Goods received from Head Office A/c Recipient branch: Dr. Goods received from HO A/c To Head Office A/c

FOREIGN BRANCHES

- Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate.
- Thus, problems of incorporating balances of foreign branches relate mainly to translation of foreign currency into Indian rupees. This is because exchange rate of Indian rupee is not stable in relation to foreign currencies due to international demand and supply effects on various currencies.
- The accounting principles which apply to inland branches also apply to a foreign branch after converting the trial balance of the foreign branch in the Indian currency.

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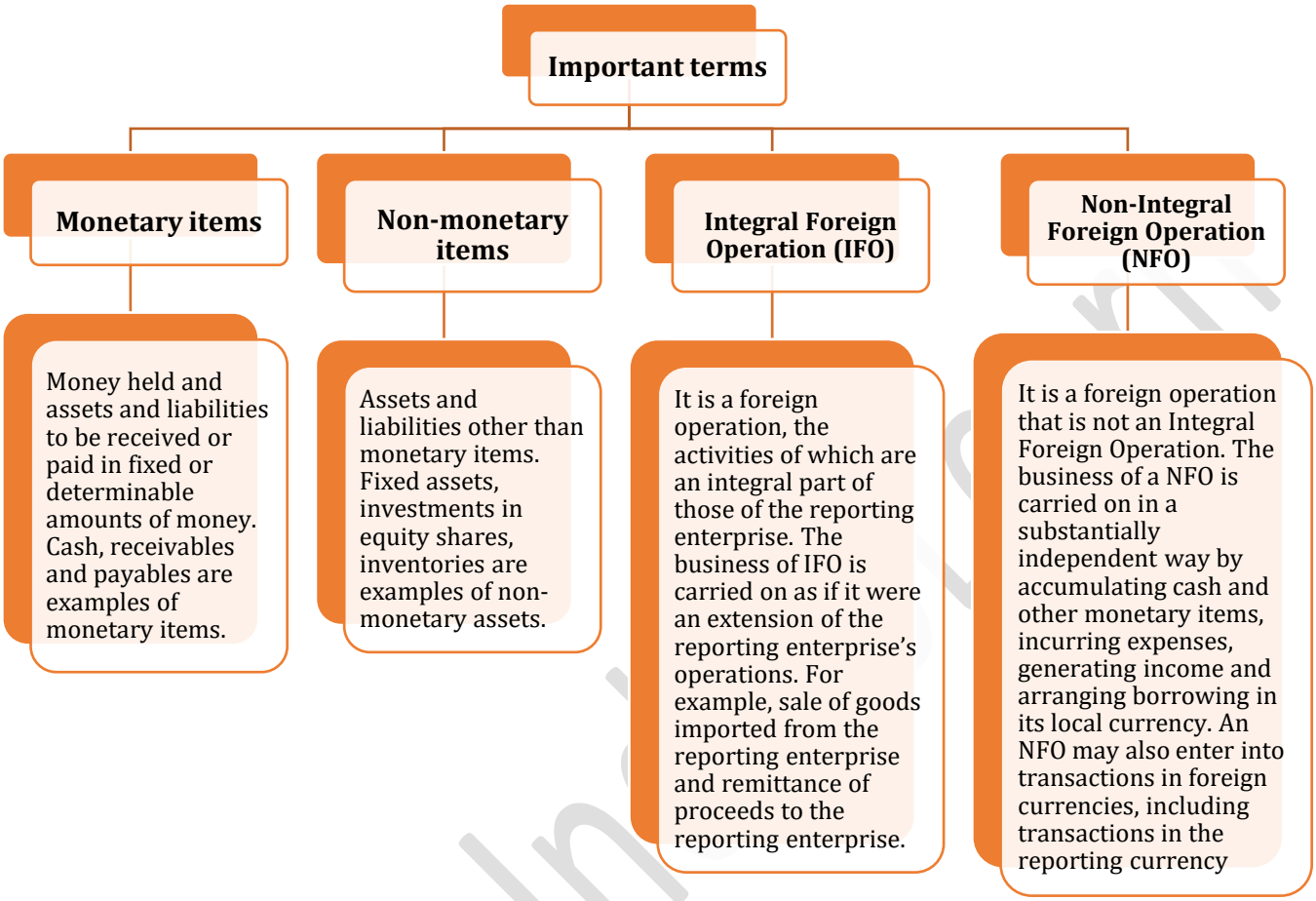

- If the Question is silent always assume it is integral otherwise it will be specifically mentioned.
- The following are the indicators of Non- Integral Foreign Operation
  - Control by reporting enterprises - While the reporting enterprise may control the foreign operation, the activities of foreign operation are carried independently without much dependence on 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.
  - Foreign operation sales are mainly in currencies other than reporting currency.
  - Day-to-day cash flow of the reporting enterprises is independent of the foreign enterprises cash flows.
- Subsidiary, Associates, joint ventures and branches classified as independent for the purpose of accounting are non-integral foreign operation.

TECHNIQUES FOR FOREIGN CURRENCY TRANSLATION

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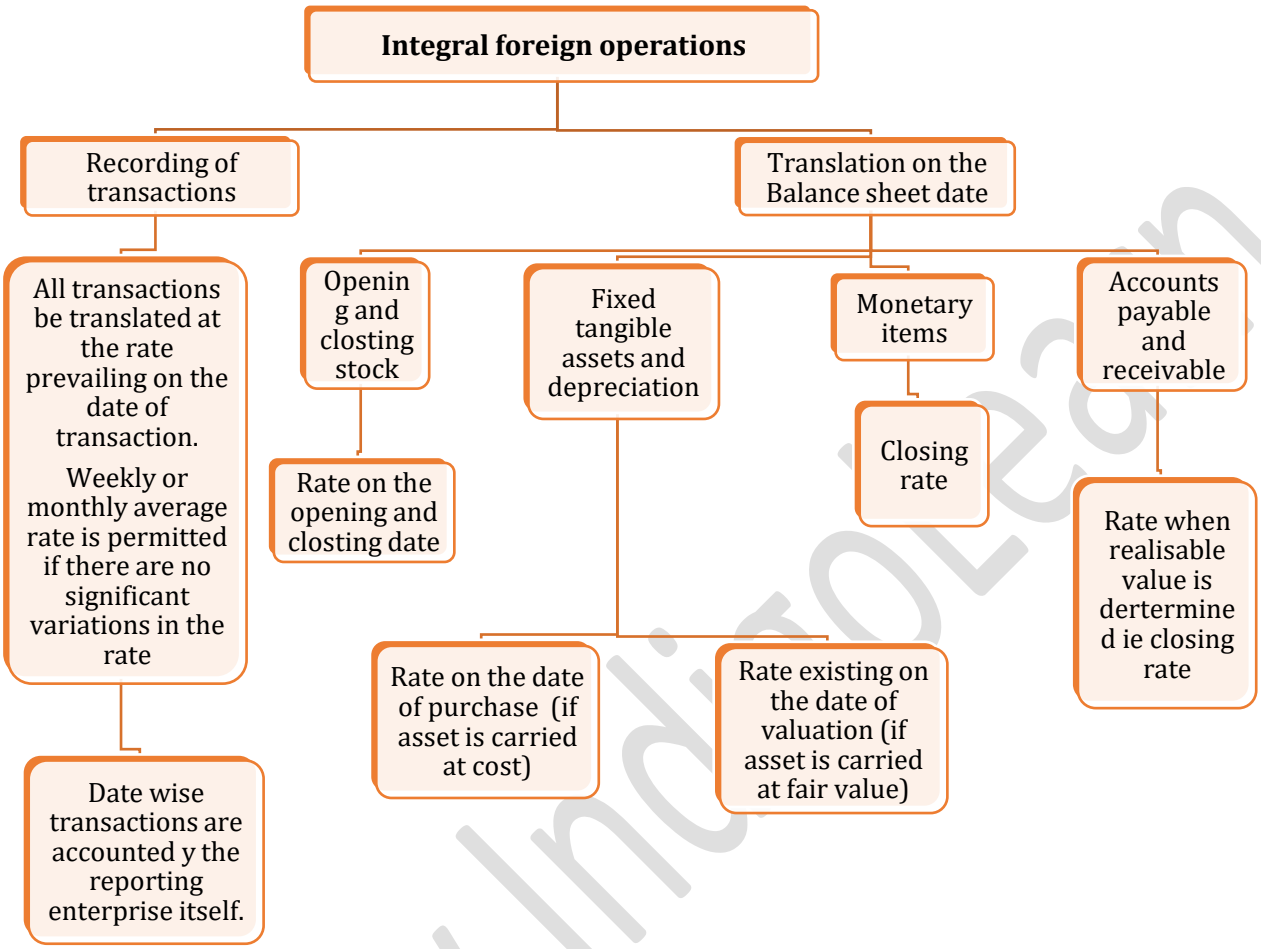

Integral foreign operations – After converting all the items of Trial balance as per above norms the difference will represent forex gain or loss which is transferred to P&L account.

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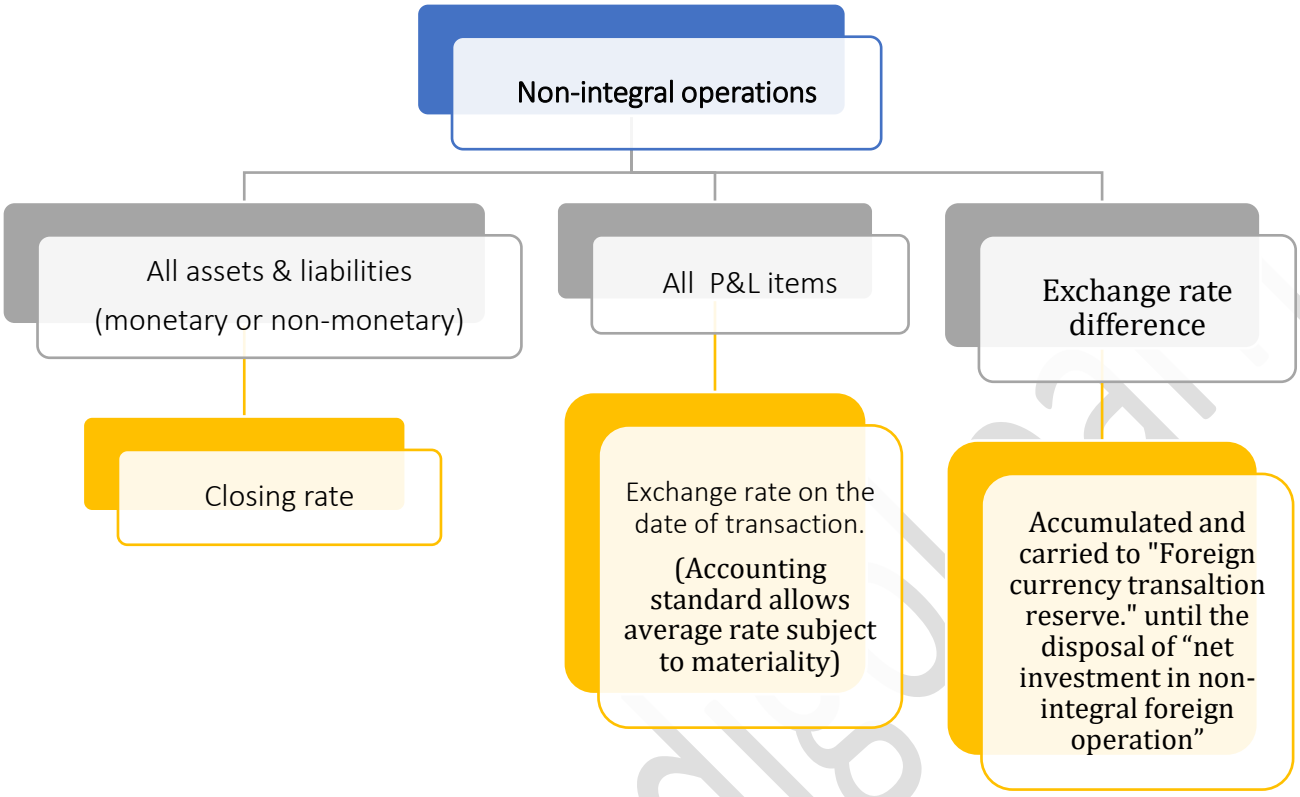

CHANGE IN CLASSIFICATION

When there is a change in classification, 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.

- **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 is 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.

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ILLUSTRATIONS

Illustration – 1

Buckingham Bros, Bombay have a branch at Nagpur. They send goods at cost to their branch at Nagpur. 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 Nagpur branch account in the books of head office by

Debtors method:

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Opening balance (1-1-20X1) Imprest Cash	2,000	Bad Debts	1,000
Sundry Debtors	25,000	Discount to Customers	2,000
Stock: Transferred from H.O.	24,000	Remittances to H.O. (recd. by H.O.)	1,65,000
Direct Purchases	16,000		
	45,000		
Cash Sales	1,30,000	Remittances to H.O. (not recd. by H.O. so far)	5,000
Credit Sales			30,000
Direct Purchases	45,000		
		Branch Exp. directly paid by H.O.	
Returns from Customers	3,000		
	60,000	Closing Balance (31-12-20X1) Stock:	10,000
Goods sent to branch from H.O.	4,000	Direct Purchase	15,000
		Transfer from H.O.	
Transfer from H.O. for Petty Cash expenses		Debtors	?
		Imprest Cash	?
			4,000

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		Petty Cash expenses	

Illustration - 2

The Bombay Traders invoiced goods to its Delhi branch at cost. Head Office paid all the branch expenses from its bank account, except petty cash expenses which were met by the Branch. All the cash collected by the branch was banked on the same day to the credit of the Head Office. The following is a summary of the transactions entered at the branch during the year ended December 31, 20X1.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Balances as on 1.1.20X1:		Bad Debts	600
Stock	7,000	Goods returned by customers	500
Debtors	12,600	Salaries & Wages	6,200
Petty Cash	200	Rent & rates	1,200
Goods sent from H.O.	26,000	Sundry Expenses	8,00
Goods returned to H.O.	1,000	Cash received (from Sundry Debtors)	2,800
Cash sales		Balances as on 31.12.20X1:	
Credit sales	17,500	Stock	6,500
Allowances to customers	28,400	Debtors	9,800
Discount to customers	200	Petty Cash	100
	1,400		

Prepare:

(a) Branch Account (Debtors Method),

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(b) Branch Stock Account, Branch Profit & Loss Account, Branch Debtors and Branch Expenses Account by adopting the Stock and Debtors Method and

(c) Branch Trading and Profit & Loss Account to prove the results as disclosed by the Branch Accounts

Illustration – 3

Harrison of Chennai has a branch at New Delhi to which goods are sent @ 20% above cost. The branch makes both cash and credit sales. Branch expenses are met partly from H.O. and partly by the branch. The statement of expenses incurred by the branch every month is sent to head office for recording. Following further details are given for the year ended 31st December, 20X1:

Particulars	Amount (Rs.)
Cost of goods sent to Branch at cost	2,00,000
Goods received by Branch till 31-12-20X1 at invoice price	2,20,000
Credit Sales for the year @ invoice price	1,65,000
Cash Sales for the year @ invoice price	59,000
Cash Remitted to head office	2,22,500
Expenses paid by H.O.	12,000
Bad Debts written off	750

Particulars	Amount (Rs.)	Amount (Rs.)
Balances as on	1-1-20X1	31-12-20X1
Stock	25,000 (Cost)	28,000 (invoice price)
Debtors	32,750	26,000
Cash in Hand	5,000	2,500

Show necessary ledger accounts in the books of the head office and determine the Profit and Loss of the Branch for the year ended 31st December, 20X1.

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Illustration – 4

Following is the information of the Jammu branch of Best New Delhi for the year ending 31st March, 20X2 from the following:

1. Goods are invoiced to the branch at cost plus 20%.
2. The sale price is cost plus 50%.
3. Other information:

Particulars	Amount (Rs.)
Stock as on 01.04.20X1(invoice price)	2,20,000
Goods sent during the year (invoice price)	11,00,000
Sales during the year	12,00,000
Expenses incurred at the branch	45,000

Ascertain

1. the profit earned by the branch during the year.
2. branch stock reserve in respect of unrealized profit.

Illustration - 5

Sell Well who carried on a retail business opened a branch X on January 1st, 20X1 where all sales were on credit basis. All goods required by the branch were supplied from the Head Office and were invoiced to the branch at 10% above cost.

The following were the transactions:

Particulars	Jan. 20X1 Amount (Rs.)	Feb. 20X1 Amount (Rs.)	March 20X1 Amount (Rs.)
Goods sent to Branch (Purchase Price)	40,000	50,000	60,000

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Sales as shown by the branch monthly report	38,000	42,000	55,000
Cash received from Debtors and remitted to H.O.	20,000	51,000	35,000
Returns to H.O. (Invoice price to Branch)	1,200	600	2,400

The stock of goods held by the branch on March 31, 20X1 amounted to ` 53,400 at invoice to branch.

Record these transactions in the Head Office books, showing balances as on 31st March, 20X1 and the branch gross profit for the three months ended on that date.

All workings should form part of your solution.

Illustration - 6

Hindustan Industries Mumbai has a branch in Cochin to which office goods are invoiced at cost plus 25%. The branch sells both for cash and on credit. Branch Expenses are paid direct from head office, and the Branch must remit all cash received into the Head Office Bank Account.

From the following details, relating to calendar year 20X1, prepare the accounts in the Head Office Ledger and ascertain the Branch Profit. Branch does not maintain any books of account, but sends weekly returns to the Head Office:

Particulars	**Amount (Rs.)**
Goods received from Head Office at invoice price	6,00,000
Returns to Head Office at invoice price	12,000
Stock at Cochin as on 1st Jan., 20X1	60,000
Sales in the year - Cash	2,00,000
Credit	3,60,000

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Sundry Debtors at Cochin as on 1st Jan. 20X1	72,000
Cash received from Debtors	3,20,000
Discount allowed to Debtors	6,000
Bad debts in the year	4,000
Sales returns at Cochin Branch	8,000
Rent, Rates, Taxes at Branch	18,000
Salaries, Wages, Bonus at Branch	60,000
Office Expenses	6,000
Stock at Branch on 31st Dec. 20X1 at invoice price	1,20,000

Prepare Branch accounts in books of head office by Stock and debtors' method.

Illustration – 7

M/s Rahul operates a number of retail outlets to which goods are invoiced at wholesale price which is cost plus 25%. These outlets sell the goods at the retail price which is wholesale price plus 20%.

Following is the information regarding one of the outlets for the year ended 31.3.20X2:

Particulars	Amount (Rs.)
Stock at the outlet 1.4.20X1	30,000
Goods invoiced to the outlet during the year	3,24,000
Gross profit made by the outlet	60,000
Goods lost by fire	?
Expenses of the outlet for the year	20,000
Stock at the outlet 31.3.20X2	36,000

You are required to prepare the following accounts in the books of Rahul Limited for the

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year ended 31.3.20X2:

1. Outlet Stock Account.
2. Outlet Profit & Loss Account.
3. Stock Reserve Account.

Illustration - 8

Messrs Ramchand & Co., Hyderabad have a branch in Delhi. The Delhi Branch deals not only in the goods from Head Office but also buys some auxiliary goods and deals in them. They, however, do not prepare any Profit & Loss Account but close all accounts to the Head Office at the end of the year and open them afresh on the basis of advice from their Head Office. The fixed assets accounts are also maintained at the Head Office. The goods from the Head Office are invoiced at selling prices to give a profit of 20 per cent on the sale price. The goods sent from the branch to Head Office are at cost. From the following, prepare Branch Trading and Profit & Loss Account and Branch Assets Account in the Head Office Books.

Debit	**Amount (Rs.)**	**Credit**	**Amount (Rs.)**
Head office opening balance on 1-1-16	15,000	Sales	1,00,000
Goods from H.O.	50,000	Goods to H.O.	3,000
Purchases	20,000	Head Office Current A/c	15,000
Opening Stock		Sundry Creditors	3,000
(H.O. goods at invoice prices)	4,000		
Opening Stock of other goods	500		
Salaries	7,000		
Rent	3,000		
Office expenditure	2,000		

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Cash on Hand	500		
Cash at Bank	4,000		
Sundry Debtors	15,000		
	1,21,000		**1,21,000**

The Branch balances as on 1st January, 20X1, were as under: Furniture Rs. 5,000; Sundry Debtors Rs. 9,500; Cash Rs. 1,000, Creditors Rs. 30,000. The closing stock at branch of the head office goods at invoice price is Rs. 3,000 and that of purchased goods at cost is Rs. 1,000. Depreciation is to be provided at 10 % on branch assets.

Illustration - 9

Ring Bell Ltd. Delhi has a Branch at Bombay where a separate set of books is used. The following is the trial balance extracted on 31st December, 20X1.

Head Office Trial Balance

Particulars	**Debit (Rs.)**	**Credit (Rs.)**
Share Capital (Authorised: 10,000 Equity Shares of Rs. 100 each):		
Issued: 8,000 Equity Shares		8,00,000
Profit & Loss Account - 1-1-20X1		25,310
General Reserve		1,00,000
Fixed Assets	5,30,000	
Stock	2,22,470	
Debtors and Creditors	50,500	21,900
Profit for 20X1		52,200
Cash Balance	62,730	

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Branch Current Account	1,33,710	
	9,99,410	**9,99,410**

Branch Trial Balance

Particulars	**Debit (Rs.)**	**Credit (Rs.)**
Fixed Assets	95,000	
Profit for 20X1		31,700
Stock	50,460	
Debtors and Creditors	19,100	10,400
Cash Balance	6,550	
Head Office Current Account		1,29,010
	1,71,110	**1,71,110**

The difference between the balances of the Current Account in the two sets of books is accounted for as follows:

1. Cash remitted by the Branch on 31st December, 20X1, but received by the Head Office on 1st January 20X2 – Rs. 3,000.
2. Stock stolen in transit from Head Office and charged to Branch by the Head Office, but not credited to Head Office in the Branch books as the Branch Manager declined to admit any liability (not covered by insurance) – Rs. 1,700.

Give the Branch Current Account in Head Office books after incorporating Branch Trial Balance through journal.

Illustration - 10

KP manufactures a range of goods which it sells to wholesale customers only from its head office. In addition, the H.O. transfers goods to a newly opened branch at factory cost plus 15%. The branch then sells these goods to the general public on only cash basis. The selling price to wholesale customers is designed to give a factory profit which amounts to 30% of the sales value. The selling price to the general public is designed to give a gross margin (i.e., selling price less cost of goods from H.O.) of 30% of the sales value.

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KP operates from rented premises and leases all other types of fixed assets. The rent and hire charges for these are included in the overhead costs shown in the trial balances.

From the information given below, you are required to prepare for the year ended 31st Dec., 20X1 in columnar form.

1. A Profit & Loss account for (i) H.O. (ii) the branch (iii) the entire business.
2. Balance Sheet as on 31st Dec., 20X1 for the entire business.

Particulars	**Head Office**		**Branch Office**	
	Debit (Rs.)	Credit (Rs.)	Debit (Rs.)	Credit (Rs.)
Raw materials purchased	35,000			
Direct wages	1,08,500			
Factory overheads	39,000			
Stock on 1-1-20X1				
Raw materials	1,800			
Finished goods	13,000		9,200	
Debtors	37,000			
Cash	22,000		1,000	
Administrative Salaries	13,900		4,000	
Salesmen Salaries	22,500		6,200	
Other administrative	12,500		2,300	

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& selling overheads				
Inter-unit accounts	5,000			2,000
Capital		50,000		
Sundry Creditors		13,000		
Provision for unrealized profit in stock		1,200		
Sales		2,00,000		65,200
Goods sent to Branch		46,000		
Goods received from H.O.			44,500	
	3,10,200	3,10,200	67,200	67,200

1. On 28th Dec., 20X1 the branch remitted Rs.1,500 to the H.O. and this has not yet been recorded in the H.O. books. Also, on the same date, the H.O. dispatched goods to the branch invoiced at Rs. 1,500 and these too have not yet been entered the branch books. It is the company's policy to adjust items in transit in the books of the recipient.
2. The stock of raw materials held at the H.O. on 31st Dec., 20X1 was valued at Rs. 2,300.
3. You are advised that:
    a. there were no stock losses incurred at the H.O. or at the branch.
    b. it is KP's practice to value finished goods stock at the H.O. at factory cost.
    c. there was no opening or closing stock of work-in-progress.
    d. Branch employees are entitled to a bonus of Rs.156 under a bilateral agreement.

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Illustration - 11

On 31st December, 20X2 the following balances appeared in the books of Chennai

Branch of an English firm having its HO office in New York:

Particulars	**Amount (Rs.)**	**Amount (Rs.)**
Stock on 1st Jan., 20X2	2,34,000	
Purchases and Sales	15,62,500	23,43,750
Debtors and Creditors	7,65,000	5,10,000
Bills Receivable and Payable	2,04,000	1,78,500
Salaries and Wages	1,00,000	-
Rent, Rates and Taxes	1,06,250	-
Furniture	91,000	-
Bank A/c	5,68,650	
New York Account	-	5,99,150
	36,31,400	**36,31,400**

Stock on 31st December, 20X2 was Rs. 6,37,500.

Branch account in New York books showed a debit balance of $ 13,400 on 31st December, 20X2 and Furniture appeared in the Head Office books at $ 1,750.

The rate of exchange for 1 $ on 31st December, 20X1 was Rs. 52 and on 31st December, 20X2 was Rs. 51. The average rate for the year was Rs. 50.

Prepare in the Head Office books the Profit and Loss A/c and the Balance Sheet of the Branch assuming integral foreign operation.

Illustration - 12

S & M Ltd., Bombay, have a branch in Sydney, Australia. Sydney branch is an integral foreign operation of S & M Ltd.

At the end of 31st March, 20X2, the following ledger balances have been extracted from the books of the Bombay Office and the Sydney Office:

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Particulars	Bombay Rupees (`000)		Sydney Austr. Dollars ('000)	
	Debit	**Credit**	**Debit**	**Credit**
Share Capital	-	2,000	-	-
Reserves & Surplus	-	1,000	-	-
Land	500	-	-	-
Buildings (Cost)	1,000	-	-	-
Buildings Dep. Reserve	-	200	-	-
Plant & Machinery (Cost)	2,500	-	200	-
Plant & Machinery Dep. Reserve	-	600	-	130
Debtors / Creditors	280	200	60	30
Stock (1.4.20X1)	100	-	20	-
Branch Stock Reserve	-	4	-	-
Cash & Bank Balances	10	-	10	-
Purchases / Sales	240	520	20	123
Goods sent to Branch	-	100	5	-

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Managing Director's salary	30	-	-	-
Wages & Salaries	75	-	45	-
Rent	-	-	12	-
Office Expenses	25	-	18	-
Commission Receipts	-	256	-	100
Branch / H.O. Current A/c	120	-	-	7
	4,880	4,880	390	390

The following information is also available:

Stock as at 31.3.20X2: Bombay Rs. 1,50,000; Sydney A $ 3,125

You are required to convert the Sydney Branch Trial Balance into rupees;

use the following rates of exchange:

Particulars	1 A $ = Rs.	Applicability
Opening rate	20	Opening stock
Closing rate	24	Closing stock; all monetary items
Average rate	22	Purchases; Sales; Etc.,
For Fixed Assets	18	Fixed assets

Illustration - 13

M/s Carlin has head office at New York (U.S.A.) and branch at Mumbai (India). Mumbai branch is an integral foreign operation of Carlin & Co.

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Mumbai branch furnishes you with its trial balance as on 31st March, 20X2 and the additional information given thereafter:

Particulars	**Dr.**	**Cr.**
	Rupees in thousands	
Stock on 1st April, 20X1	300	-
Purchases and sales	800	1,200
Sundry Debtors and creditors	400	300
Bills of exchange	120	240
Wages and salaries	560	-
Rent, rates and taxes	360	-
Sundry charges	160	-
Computers	240	
Bank balance	420	-
New York office a/c	-	1,620
	3,360	3,360

Additional information:

1. Computers were acquired from a remittance of US $ 6,000 received from New York head office and paid to the suppliers. Depreciate computers at 60% for the year.
2. Unsold stock of Mumbai branch was worth Rs. 4,20,000 on 31st March, 20X2.
3. The rates of exchange may be taken as follows:

(i) on 1.4.20X1 @ Rs. 40 per US $
(ii) on 31.3.20X2 @ Rs. 42 per US $
(iii) average exchange rate for the year @ Rs. 41 per US $
(iv) conversion in $ shall be made upto two decimal accuracy.

You are asked to prepare in US dollars the revenue statement for the year ended 31st March, 20X2 and the balance sheet as on that date of Mumbai branch as would appear in the books of New York head office of Carlin & Co. You are informed that Mumbai branch account showed a debit balance of US $ 39609.18 on 31.3.20X2 in New York books and there were no items pending reconciliation.

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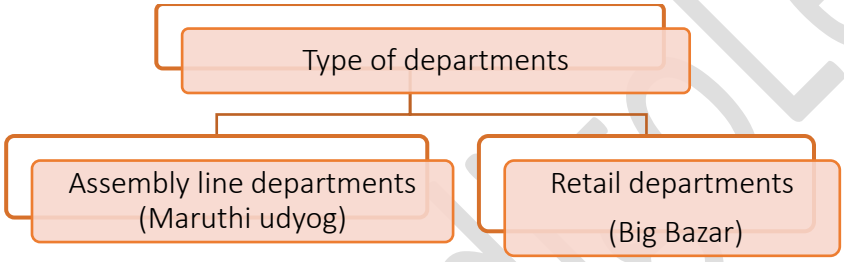
10.2 Departmental Accounts

INTRODUCTION

If a business consists of several independent activities, or is divided into several departments, for carrying on separate functions, its management is usually interested in finding out the working results of each department to ascertain their relative efficiencies. Thus, departmental accounts are prepared.
An organization usually divides the work in various departments, which is done on the principle of division of labour.



OBJECTIVE

- Calculate profit for each department. Columnar Trading and P&L account is prepared where each column represents a department.
- Readily identify wastage of material and wastage of money
- Identify inefficiencies in each department and work towards its improvement.

ADVANTAGES OF DEPARTMENTAL ACCOUNTING

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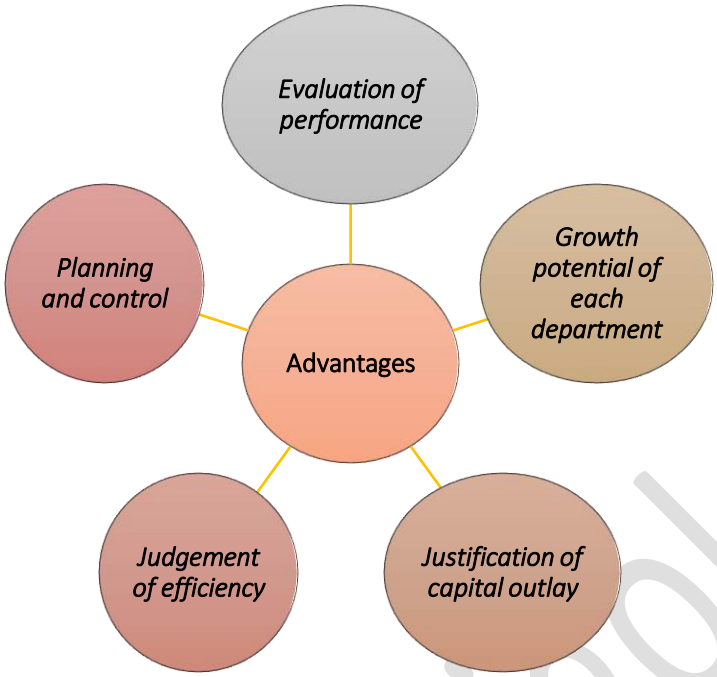
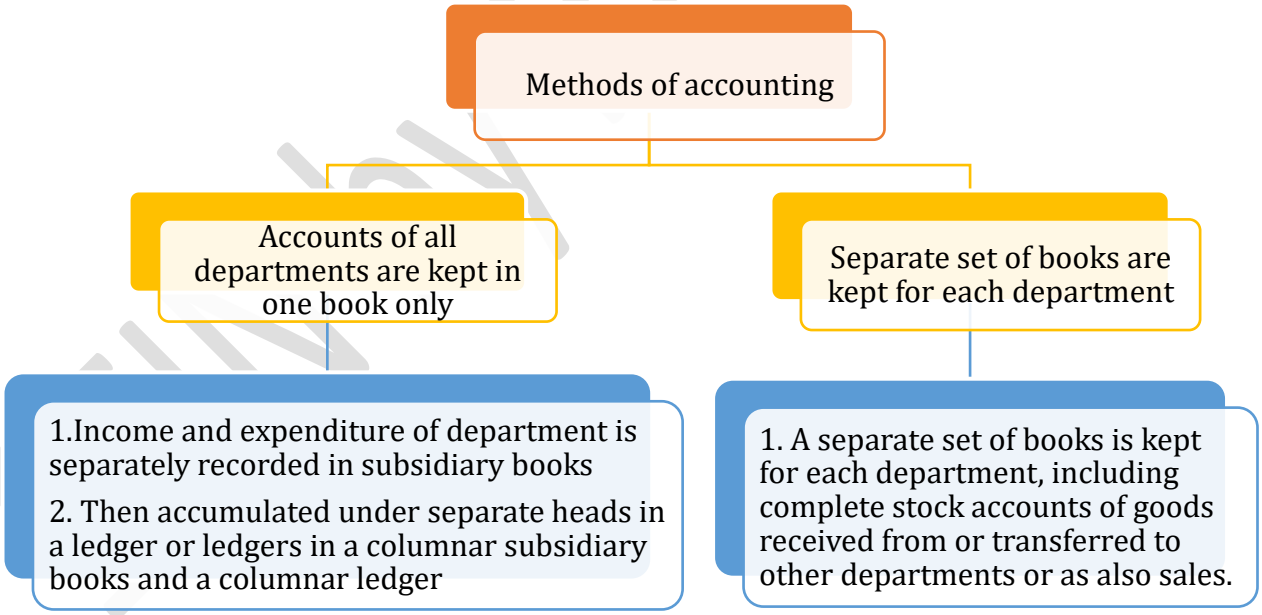


METHODS OF ACCOUNTING



BASIS OF ALLOCATION OF COMMON EXPENDITURE AMONG DIFFERENTDEPARTMENTS

Individual Identifiable Expenses: Expenses incurred specially for a particular department

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are charged directly there to e.g. insurance charges of stock held by the department.

Common Expenses: Common expenses, the benefit of which is shared by all the departments and which are capable of precise allocation are distributed among the departments concerned on some equitable basis considered suitable in the circumstances of the case.

Sr.No.	Expenses	Basis
1.	Rent, rates and taxes, repairs and maintenance, insurance of building	Floor are occupied by each department (if given) otherwise on time basis
2.	Lighting and heating expenses (e.g.: energy expenses)	Consumption of energy by each department.
3.	Selling expenses, e.g. ,discount, bad debts, selling commission, freight outward, travelling sales manager's salary and other costs	Sales of each department
4.	Carriage inward/ Discount received	Purchases of each department
5.	Wages/Salaries	Time devoted to each department
6.	Depreciation, insurance, repairs and maintenance of capital assets.	Value of assets of each department otherwise on time basis.
7.	Administrative and other expenses, e.g., salaries of managers, directors, common advertisement expenses, etc.	Time basis or equally among all departments.
8.	Labour welfare expenses	Number of employees in each department
9.	PF/ESI contributions	Wages and salaries of each department
10	Expenses and income, of financial nature, for example, interest on loan, profit/loss on sale of investment, etc.	Cannot be apportioned on a suitable basis; therefore they are recognised in the combined Profit and Loss Account

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TYPES OF DEPARTMENTS

Independent Department

Departments which work independently of each other and have negligible inter-department transfers

Dependent Department

Departments which transfer goods from one department to another department for further processing .

The output of one department becomes the input for the other department

INTER-DEPARTMENTALTRANSFERS

- Whenever goods or services are provided by one department to another, their cost should be separately recorded and charged to the department benefiting there by and credited to that providing the goods or services.
- The totals of such benefits are disclosed in the departmental Profit and Loss Account, to distinguish them from other items of expenditure.
- The price at which this is done is known as transfer price.
- In case of dependent departments, unloading is required if the transfer price is having a profit element, i.e... the unrealized profit called the stock reserve should be eliminated.

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Basis of Inter-Departmental Transfers

- Goods and services may be charged by one department to another usually on either of the following three bases:
  - 1. Cost
  - 2. Current market price
  - 3. Cost + agreed % of profit

Elimination of Unrealised Profit

- When profit is added in inter-departmental transfers the loading included in the unsold inventory at the end of the year is to be excluded before the final accounts are prepared so as to eliminate any anticipatory (internal) profit included therein.

Stock reserve

- Unrealised profit included in unsold stock at the end of accounting period is eliminated by creating an appropriate stock reserve by debiting the combined Profit and Loss Account
- In the beginning of the subsequent accounting year, the entry is reversed.
- Stock reserve is shown as a deduction from Closing stock in the balance sheet.
- Stock reserve = $\frac{\text{TP of unsold stock} \times \text{Profit included in TP}}{\text{TP}}$
- TP = Transfer price

Journal entries
At the end of the accounting year, the following journal entry will be passed for elimination of unrealized profit (creation of stock reserve): Profit and Loss Account Dr. To Stock Reserve (Being a provision made for unrealized profit included in closing stock)
In the beginning of the next accounting year, the aforesaid journal entry will be reversed as under Stock Reserve Dr. To Profit and Loss Account (Being provision for unrealized profit reversed)

Disclosure in Balance Sheet	
The unsold closing stock acquired from another department will appear on the assets side of the balance sheet as under:	
(An extract of the assets side of the balance sheet)	
Current assets	xxx
Stock	xxx
Less – Stock reserve	(xx)
	xxx

MEMORANDUM STOCK AND MEMORANDUM MARK UP ACCOUNT METHOD

- Under this method, goods supplied to each department are debited to a Memorandum Departmental Stock account at cost plus a 'mark up' (loading) to give the normal selling price of the goods.
- The sale proceeds of the department are credited in Memorandum Departmental Stock account and amount of 'Mark up' is credited to the Departmental Mark up Account.
- When it is necessary to reduce the selling price below the normal selling price, i.e., cost

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plus mark up, the reduction (mark down) is entered in the Memorandum Stock account as well as in the Mark up account.

- This method helps to achieve effective control of stock movements of various departments.

Illustrations

Illustration 1

Goods are transferred from Department P to Department Q at a price 50% above cost. If closing stock of Department Q is Rs. 27,000 compute the amount of stock reserve.

Illustration 2

Z Ltd. has three departments and submits the following information for the year ending on 31st March 2011:

	A	B	C	Total
Purchases (units)	6,000	12,000	14,400	
Purchases (Rs.)	-	-	-	6,00,000
Sales (units)	6,120	11,520	14,976	
Selling Price (per unit)	40	45	50	
Closing Stock	600	960	36	

You are required to prepare departmental trading account of Z Ltd., assuming that the rate of profit on sales is uniform in each case.

Illustration 3

M/s Omega is a departmental store having three departments X, Y and Z. The information regarding three departments for the year ended 31st March, 20X1 are given below:

	Amount in Rs.		
	X	Y	Z
Opening Stock	36,000	24,000	20,000
Purchases	1,32,000	88,000	44,000

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Debtors at end	15,000	10,000	10,000
Sales	1,80,000	1,35,000	90,000
Closing Stock	45,000	17,500	21,000
Value of furniture	20,000	20,000	10,000
Floor Space occupied (in sq. ft.)	3,000	2,500	2,000
No. of employees	25	20	15
Electricity Consumed (in units)	300	200	100

The balances of other revenue items in the books for the year are given below:

	Rs.
Carriage Inwards	3,000
Carriage Outwards	2,700
Salaries	48,000
Advertisement	2,700
Discount Allowed	2,250
Discount Received	1,800
Rent, Rates and Taxes	7,500
Depreciation on Furniture	1,000
Electricity Expenses	3,000
Labour Welfare Expenses	2,400

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You are required to prepare Departmental Trading and Profit and Loss Account for the year ended 31st March 20X1 after providing for provision for Bad Debts at 5%.

Illustration 4

M/s X has two departments, A and B. From the following particulars prepare the consolidated Trading Account and Departmental Trading Account for the year ending 31st December, 20X1

	A (Rs.)	B (Rs.)
Opening Stock	20,000	12,000
Purchases	92,000	68,000
Sales	1,40,000	1,12,000
Wages	12,000	8,000
Carriage	2,000	2,000
Closing Stock 1. Purchased goods 2. Finished goods	4,500 6,000	24,000 14,000
Purchased goods transferred: • by B to A • by A to B	10,000	8,000
Finished goods transferred: • by A to B 35,000 • by B to A 40,000	35,000	40,000
Return of finished goods: • by A to B 10,000 • by B to A 7,000	10,000	7,000

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You are informed that purchased goods have been transferred mutually at their respective departmental purchase cost and finished goods at departmental market price and that 20% of the finished stock (closing) at each department represented finished goods received from the other department

Illustration 5

Department P sells goods to Department S at a profit of 25% on cost and to Department Q at a profit of 15% on cost. Department S sells goods to P and Q at a profit of 20% and 30% on sales respectively. Department Q sells goods to P and S at 20% and 10% profit on cost respectively.

Departmental Managers are entitled to 10% commission on net profit subject to unrealized profit on departmental sales being eliminated.

Departmental profits after charging Manager's commission, but before adjustment of unrealized profits are as below:

	Rs.
Department P	90,000
Department Q	60,000
Department S	45,000

Stock-lying at different Departments at the end of the year are as below:

	Departments		
	P (Rs.)	**Q (Rs.)**	**S (Rs.)**
Transfer from P	-	18,000	14,000
Transfer from S	48,000	-	38,000
Transfer from Q	12,000	8,000	-

Find out correct Departmental Profits after charging Managers' Commission.

Illustration 6

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M/s Suman Enterprises has two departments, Finished Leather and Shoes. Shoes are made by the Firm itself out of leather supplied by the Leather Department at its usual selling price. From the following figures, prepare Departmental Trading Account for the year ended 31st March, 20X3:

	Finished Leather Department (Rs.)	**Shoes Department (Rs.)**
Opening Stock (as on 01.04.20X2)	30,20,000	4,30,000
Purchases	1,50,00,000	2,60,000
Sales	1,80,00,000	45,20,000
Transfer to Shoes Department	30,00,000	-
Manufacturing Expenses	-	5,00,000
Selling Expenses	1,50,000	60,000
Rent & warehousing	5,00,000	3,00,000
Stock on 31.03.20X3	12,20,000	5,00,000

The following further information is available for necessary consideration:

1. The stock in Shoes Department may be considered as consisting of 75% of leather and 25% of other expenses
2. The Finished Leather Department earned a Gross Profit @ 15% in 20X1-20X2.
3. General Expenses of the business as a whole amount to Rs.8,50,000

Illustration 7

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Gram Udyog, a retail store, has two departments, 'Khadi and Silks' for each of which stock account and memorandum 'markup' accounts are kept.

All the goods supplied to each department are debited to the stock account at cost plus a 'markup', which together make-up the selling-price of the goods and in the account of the sale proceeds of the goods are credited. The amount of 'mark-up' is credited to the Departmental Markup Account.

If the selling price of any goods is reduced below its normal selling price, the reduction 'marked down' is adjusted both in the Stock Account and the Departmental 'Markup' Account.

The rate of 'Mark-up' for Khadi Department is 331/3% of the cost and for Silks Department it is 50% of the cost.

The following figures have been taken from the books for the year ended December 31, 20X1:

	Khadi Dept	**Silks Dept**
	Rs.	**Rs.**
Stock as on January 1st at cost	10,500	18,600
Purchases	75,900	93,400
Sales	95,600	1,25,000

1. The stock of Khadi on January 1, 20X1 included goods the selling price of which had been marked down by Rs. 1,260. These goods were sold during the year at the reduced prices.
2. Certain stock of the value of Rs. 6,900 purchased for the Khadi Department were later in the year transferred to the Silks department and sold for Rs.10,350. As a result, though cost of the goods is included in the Khadi Department the sale proceeds have been credited to the Silks Department.
3. During the year 20X1 to promote sales the goods were marked down as follows:

	Cost	**Marked down**
	Rs.	**Rs.**
Khadi	5,600	360

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Silk	10,000	2,000

At the time of stock-taking on December 31, 20X1 it was discovered that Khadi cloth of the cost of Rs. 390 was missing and it was decided that the amount be written off.

You are required to prepare for both the departments for the year 2012.

(a) The Memorandum Stock Account;

(b) The Memorandum Mark-up Account

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Study Note 12 | Accounting Standards

12.1 AS-1 Disclosure of Accounting Policies

1.1: Objective of AS 1: This statement deals with the disclosure of significant accounting policies followed in preparing & presenting financial statements. The purpose of this statement is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

1.2: Fundamentals Accounting Assumptions: There are certain accounting concepts, which are very fundamental to the process of preparation of Financial Statements. Since, these concepts are very basic and widely accepted; it is assumed that Financial Statements are prepared by adhering to these concepts.

AS-1 identifies such fundamental Accounting Assumptions

a) Going concern
b) Accrual
c) Consistency

These three concepts are so fundamental that their acceptance and use are assumed in the preparation of financial statements. If above fundamental accounting assumptions are not followed, the fact should be disclosed clearly in the financial statements together with reasons.

Accounting assumptions are explained in the paragraphs that follow:

a) Going Concern: The enterprise is normally viewed as a going concern. It is assumed that enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations. Joint venture is an exception. Going concern concept is not followed in the context of Joint Venture. If an enterprise is not going concern, valuation of its assets and liabilities on historical cost becomes irrelevant and as a consequence it's profit or loss may not give reliable information.

b) **Accrual:** Revenue and costs are recognized and recorded in the books of accounts as they are earned or incurred. (And not as money is received of paid). Thus, all revenues and costs for the period are to be recorded even if cash is not actually received or paid. This concept is the core of mercantile system of accounting.

c) Consistency: The investors require such information that enables them to compare the performance of various companies, particularly, the companies in the same

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industry. Other users like banker, creditor, Govt. value comparability of the statements. For ensuring the quality of comparability, it is necessary that there should be consistency in using accounting policy.
Consistency has its virtues but situations may develop needing a change of accounting measurement adopted earlier, so as to reflect result. In such a situation, a departure from this concept is permissible only by making a full disclosure about the change and the monetary effect of the change on the financial statements.

1.3: Nature of Accounting Policies:

1. The accounting policies refer to the specific accounting principles and the method of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.
2. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and method of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgment by the management of the enterprise.

An Illustrative list of Accounting Policies is given below:

i. Accounting conventions followed.
ii. Basic of accounting – Historical or Current cost.
iii. Valuation of inventory
iv. Valuation of Investments.
v. Valuation of fixed assets including revaluation.
vi. Policies relating to depreciation of fixed assets.
vii. Translation of foreign currency transactions or items.
viii. Treatment of Government grants.
ix. Treatment of goodwill.
x. Recognition of a liability for retirement benefits.
xi. Recognition of profit on long-term contracts.
xii. Absorption of costs incurred on research and development.
xiii. Treatment of preliminary or capital issue expenses.
xiv. Treatment of Lease rental income or lease rental payment.
xv. Treatment of expenditure during construction.
xvi. Treatment of contingent liabilities.
xvii.

1.4: Selection of Appropriate Accounting Policies: Selection of accounting policies is guided by "TRUE AND FAIR" concept. In other words accounting policies adopted by the organization should ensure that Financial Statements do give true view of financial position and performance. AS – 1 identifies following "there major considerations" for selecting

accounting policies.

a) **Prudence:** Prudence is inclusion of a degree of caution while making estimates required under the conditions of uncertainty. The prudence concept implies that profits are not to be accounted on estimated basis. Profits are recognized only when they are realized in cash or a third party has legally become liable to pay the amount. However all anticipated losses are to be accounted for. ***Example: Inventory is value at cost or NRV whichever is lower***.
b) **Substance Over Form:** If financial statements are to represent faithfully, the transactions and events, it is essential that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
    E.g. In a finance lease, though lessor continuous to be legal owner of the asset, he is transferring the risk and reward incidental (attached) to the ownership of the asset. Lessee is using asset for generating revenue, and hence asset is recognized in his books. Thus, Balance sheet of lessee reflects, Assets taken on lease and corresponding liability towards the lessor on account of lease payments. Depreciation on such asset is debited to lessee's P & L Account.
c) **Materiality:** AS-1 states that financial statements should disclose all material items.

Material items are those, the knowledge of which might influence the decisions of the user of the financial statements. Materiality is a relative term. It is not possible to lay down precisely either in term of specific accounts or in terms of amounts of the items, which could be considered as material in another. Therefore, the decision to judge the materiality of the item shall depend upon the judgment of the individual.

1.5: Disclosure requirements: All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

1. 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.
2. 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.
3. If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

Share Capital

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The information relating to share capital can be disclosed in the balance sheet or statement of changes in equity as part of balance sheet or in notes. A description of nature and purpose of each reserve within equity should be disclosed.

For each class of share capital (different classes of preference shares to be treated separately), following disclosures are required to be made:

a) Number of shares authorized

b) Number of shares issued and fully paid and issued but not fully paid

c) Par value per share or shares that have no par value

d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

e) the rights, preferences and restrictions attaching to each class of shares;

f) shares in the company held by itself or its subsidiaries or associates;

g) Shares reserved for issue under options and contracts for sale of shares

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Illustrations

Q1: Which of the following are not parts of the term financial statements?

1. Profit and Loss Account
2. Balance Sheet
3. Cash Flow Statement
4. Notes to Financial Statements
5. **MD&A**
6. **Directors Report**
7. **Auditors' Report**

Q2: Choose the correct answer / answers for the statement made below:

As per AS 1, every entity whether a corporate / individual / government / non-governmental organization or any other body of person should follow the 3 fundamental accounting assumptions without exception.

1. Yes, these are common for all entities and no one should violate them
2. Only Companies and other Bodies of persons are expected to follow these assumptions. Sole proprietors / partnerships need not follow these assumptions.
3. **All of form of organizations / Bodies of persons / individuals are expected to disclose if they are following these assumptions.**
4. Other than accrual, which need not be followed by government / individuals other two assumptions must always be followed by all others

Feedback: AS 1 is a disclosure based standard. It prescribes the disclosures that an entity should make with respect to fundamental accounting assumptions and accounting policies. It does not differentiate between constitutions of business. Specific rules for different constitution of business / organizations are set by respective statutory bodies if any and not by AS1. According to AS 1, the 3 fundamental accounting assumptions are assumed in all financial statements unless a specific disclosure is made that they have not been follow. Eg Going concern: If an entity is on the verge of bankruptcy, it is expected to disclose such a matter in its financial statements.

Q3: What are the 3 fundamental accounting assumptions? Choose the right option

a. Going concern, Materiality, Prudence
b. Prudence, Substance over form, Materiality

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c. **Consistency, Accrual, Going Concern**
d. Accrual, Prudence, Consistency

Feedback: Consistency, Accrual & Going Concern are three fundamental accounting assumptions

12.2 AS – 2 Valuation of Inventories

Objective:

The objective of this chapter is to prescribe the accounting treatment for inventories. Inventories constitute a major portion of current assets of an entity. A primary issue in accounting for inventories is the amount of cost to be recognized as an asset and carried forward until the related revenues are recognized.

Valuation of inventory is major issue in preparation of financial statements. The value at which inventories are carried in the financial statements, affects the profit and the financial position. AS – 2 deals with the method of valuation of inventories in order to ascertain the correct profit and depict the true state of affair of the enterprise.

Scope: This Statement should be applied in accounting for inventories other than:

a) Work in progress arising under construction contracts, including directly related service contracts [see Accounting Standard (AS) 7, Accounting for Construction Contracts];
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; and
d) ***Producers' inventories*** of livestock, agricultural and forest products, and mineral oils, ores and gases ***to the extent that they are measured at net realizable value*** in accordance with well-established practices in those industries.

The inventories referred to in (d) above are measured at net realizable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assumed under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Statement.

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KEY DEFINITIONS

INVENTORY

Inventory comprises of three components:

a) held for sale in the ordinary course of business – i.e., finished goods held for sale by manufacturing entity and goods held by trading entity;
b) in the process of production for such sale – i.e., work in progress; or
c) In the form of materials or supplies to be consumed in the production process or in the rendering of services – i.e., raw material.

NET REALISABLE VALUE (NRV)

NRV 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. The estimates are to be based on reliable evidence after taking into consideration price fluctuation or costs directly relating to events after the end of the period to the extent they conform to conditions existing at the end of the period. Contingent losses are to be provided for.

COST OF PURCHASE

Cost of purchase is calculated as follows:

Particulars	**Amount (INR)**
Purchase price	xxx
Add:	
Import Duties and other taxes (e.g. GST) (*to the extent they are not recoverable from the taxing authorities)*	xxx
Freight inwards	xxx
Transport and handling costs and other costs directly attributable to the procurement of goods, material and services	xxx
Less:	
Trade discounts and rebates	(xxx)
Duties and taxes that are subsequently recovered by the enterprise from the taxing authorities	(xxx)

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Duty drawbacks and	(xxx)
Other similar items	(xxx)
COST OF PURCHASE	XXX

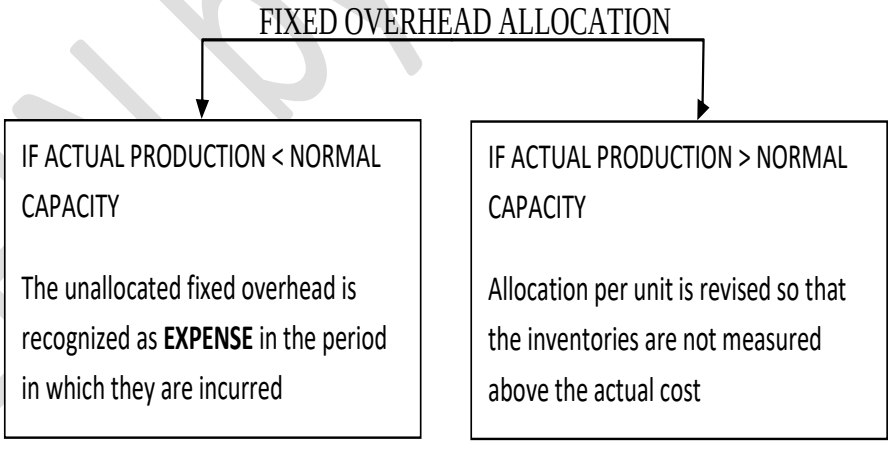
CONVERSION COST

Conversion cost includes 3 major components:

1. Costs directly related to the units of production, such as direct labour, direct material and direct expenses
2. Variable overheads – costs that directly or nearly directly vary with the production e.g., indirect labour and indirect material. These are systematically allocated based on **actual rate per unit**
3. Fixed overheads – the indirect costs which remain relatively constant regardless of the production e.g., depreciation of machinery and factory buildings, insurance of machinery and factory buildings, etc. These are systematically allocated based on **normal capacity.**

   Normal capacity is the production expected to be achieved on an average over number of periods or seasons under normal circumstances taking into account loss of capacity resulting from planned maintenance.

   Since the actual production is not necessarily equal to normal production level, the issue of under and over absorption of overheads needs to be addressed. Two scenarios may arise during the end of each reporting period:



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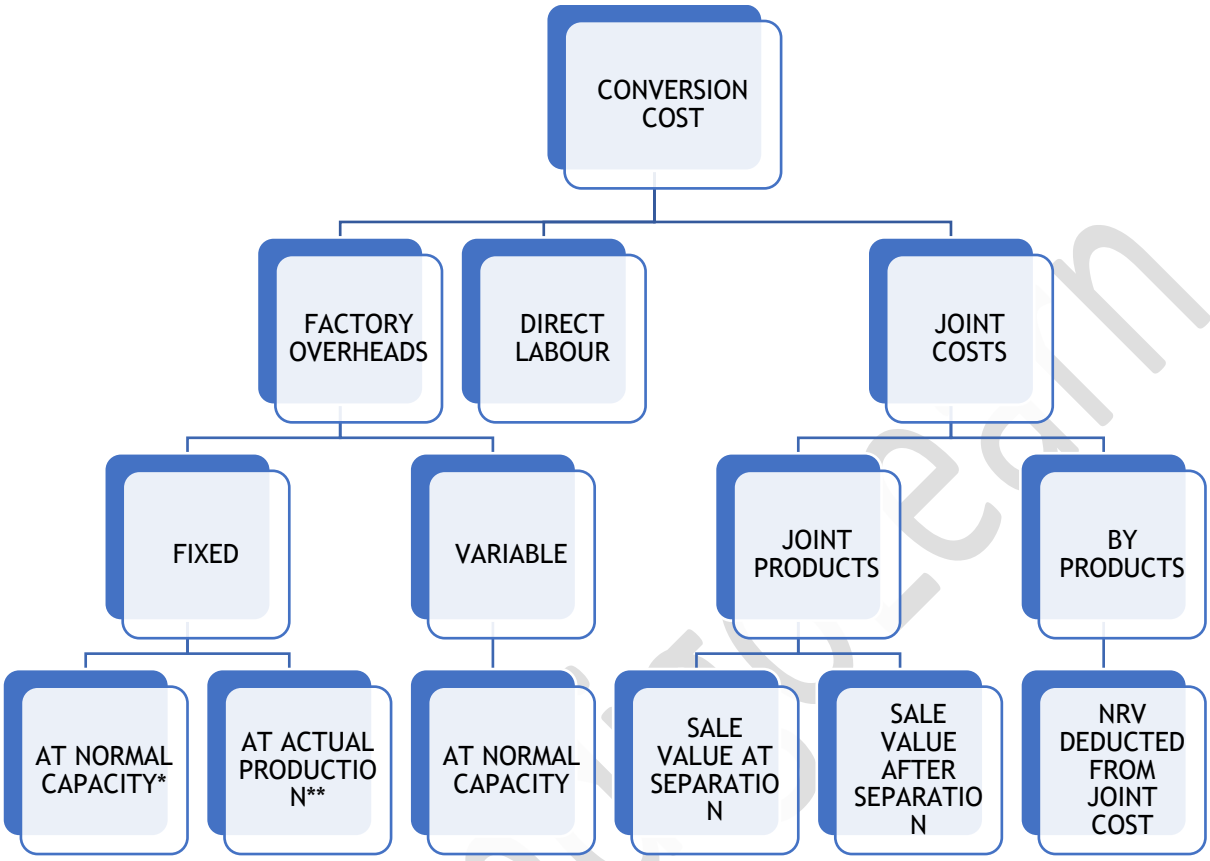

Illustration 1:

Normal level of production 1, 00,000 Units.
Fixed production overheads Rs. 5,00,000 Units.
Actual Production
Case 1 1,00,000 Units.
Case 2 80,000 Units.
Case 3 1,25,000 Units

Discuss how the fixed production overheads will be allocated to inventory.

Fixed overheads recovery rate = $\frac{\text{Total Fixed Production Overheads}}{\text{Normal level of Production}}$

$= \frac{\text{Rs. 500000}}{100000} = \text{Rs. 5 per unit}$

Case	Normal Recovery rate	Recovery rate to be used as per Ind AS 2	Overheads recovered	Overheads treated as period expense	Total overheads
	Rs.	Rs.	Rs.	Rs.	Rs.
1	5	5	5,00,000	Nil	5,00,000
2	5	5	4,00,000	1,00,000	5,00,000

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3	5	4 { 500000 / 125000 }	5,00,000	Nil	5,00,000

In case of joint products, when the costs of conversion of each product are not separately identifiable, they are to be allocated between the products on a rational and consistent basis, e.g., on the basis of relative sales value at split-off point.

Illustration 2:

In a production process, product A and B are jointly produced. A total expenditure Rs.17,50,000 lakhs is incurred as costs of conversion of 50,000 units of A and 25,000 units of B. If the sales value at split-off point is Rs. 50 and Rs. 40 respectively for product A and B, discuss how the cost of conversion will be allocated to products A and B assuming the two products are not separately identifiable.

In case of joint products, if the costs of conversion of each product are not separately identifiable, then such costs should be allocated on some rational basis. Relative sales value at split off point is one such basis. Accordingly, the relative sales value of product A and B works but to be Rs.25 lakhs and Rs.10 lakhs for products A and B respectively. Based on this, the cost of conversion will be allocated between product A and B in the following manner:

Total cost of conversion Rs. 17,50,000

Total sales value at split-off point Rs. 35,00,000

Cost of conversion allocated to Product A

= Relative sales value of product A at split off point x Total cost of conversion

Total sales value at split off point (A and b together)

Rs. 2500000 x Rs. 17,50,000

Rs. 3500000

= Rs. 12,50,000

Per unit of conversion = Cost of conversion allocated to product A

No. of units produced (of A)

(Rs. 1250000 / 50,000) = Rs. 25

Cost of conversion allocated to product B

*(*Rs. 1000000 / Rs. 3500000) x Rs.17,50,000 = Rs. 5,00,000

Per unit cost of conversion= (Rs. 500000 / 25,000) = Rs. 20

A. MEASUREMENT AND PRINCIPLES FOR VALUATION OF INVENTORY

FUNDAMENTAL PRINCIPLE OF AS 2 AND IND AS 2: Inventories are required to be stated at the lower of cost and NRV

Therefore, inventory valuation is a three step process:

Step 1 Determine the cost of inventories.

Step 2 Determine the NRV of inventories.

Step 3 Compare the values calculated in step 1 and 2 above.

Lower of the two values is the value of inventories.

STEP 1 – DETERMINE THE COST OF INVENTORIES

Cost of inventories comprise of the following *(REFER DEFINITIONS)***:**

a) All costs of purchase.
b) Costs of conversion.
c) Other costs incurred in bringing the inventories to their present condition and location.

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STEP 2 – Determine the NRV of inventories

- **Example**

	Rs.
Estimated selling price of inventory	10lakhs
Estimated costs of completion	1 lakh
Expenditure required to carry out sale	1.5 lakhs
Calculate NRV	

Net Realisable value will be calculated as follows:

	Rs.	Rs.
Estimated selling price	10 lakhs	
Less: Estimated costs of completion	1 lakh	
Expenditure required to carry out sale	1.5 lakhs	2.5 lakhs
Net realizable Value (NRV)	7.5 lakhs	

INVENTORY COSTS DO NOT INCLUDE THE FOLLOWING:

- Abnormal waste
- Storage costs
- Administrative overheads unrelated to production
- Selling costs
- Foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
- Interest cost when inventories are purchased with deferred settlement terms

Interest element vs. cost of inventory: The Standards provides the interest and other borrowing costs are **usually not included.** Under AS 16, interest can be added to the cost of inventories only if specific conditions are fulfilled.

CENVAT Credit & Excise duty vs. cost of inventory: Excise duty paid or payable is an element of cost, and should be included in valuation. However, any amount recoverable from tax authorities by way of Convert credit will have to be considered in the valuation of finished goods items.

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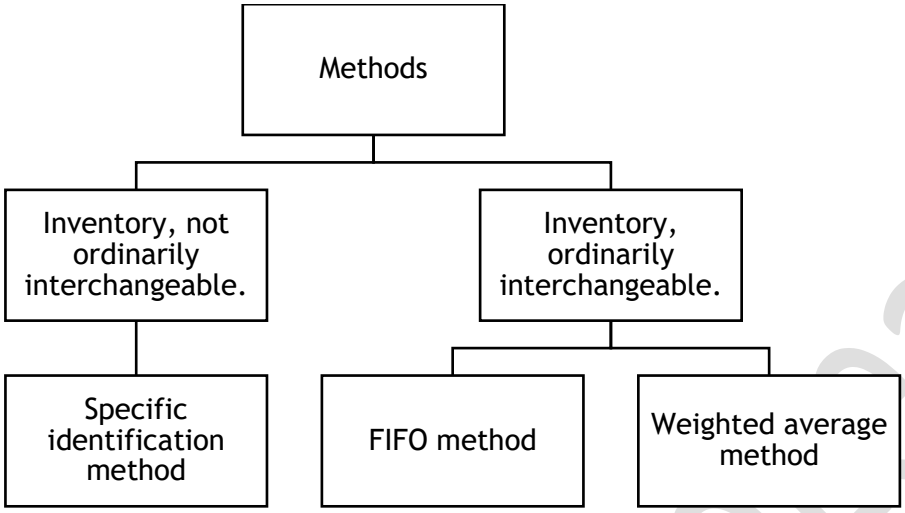
What cost formulas can be used to determine the cost of inventories



AS 2 allows cost of inventories to be determined on the basis of following cost formulas:

- Specific identification method.
- FIFO.
- Weighted Average.
- Standard Cost
- Retail Method.

a) **Specific Identification Method:** The method is also known as Specific Price method, Identifiable cost method, etc. This is also known as actual cost method because the specific job bears the actual cost of material bought for the job. When using this method, units in inventory are specifically identified and each unit cost is identified with a particular invoice. In other words, this method tracks the actual physical flow of goods available whether for sale of for production.
Cost of item forming part of inventory, that is **not ordinarily interchangeable as** also for goods or services produced and segregated **for specific projects,** should be assigned by specific identification of their individual costs. This cost formula is particularly suited for automobiles, expensive Jewellery, antique shops or custom made merchandise. This formula has to be applied whenever materials are purchased and set aside for specific job or work order.

b) **First in First out Method:** The method is based on the assumption that the material, which are purchased first, are issued first. Issue of materials is priced in the sequence of incoming order of purchases. The flow of cost of materials should be in the same order. Issues are priced on the same basis until the first lot received is exhausted, after which the price of the next lot received becomes the basis of cost of issues. Thus, the materials issued are priced at the cost pertaining to the earliest lot, and as a corollary the inventory in hand is valued at a price representing recent purchases.

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The use of the FIFO does not necessary mean that materials, which were held longest in stock, are physically exhausted first. It merely denotes that cost incurred for the "earliest purchase" is first used for accounting purpose. It is a common practice for most business houses to sell or issue oldest merchandise or materials first so that when FIFO is used for inventory valuation, there is agreement between cost flow assumption and the physical flow of goods. The ending inventory thus would consist of goods recently produced or purchased.

The FIFO method is most successfully used when:

- Size of raw materials is very large and cost is high
- Materials are easily identified as belonging to a particular purchase lot
- Not more than two or three different receipts are on material card at one time
- Price of material does not fluctuate widely, so that clerical labour involved is minimized.
- Materials are subject to deterioration and obsolescence.

c) Weighted Average Cost (WAC) Method : WAC is calculated by dividing the total **cost** of material in stock by total **quantity** of material in stock. Under this method, costs are averaged after weighing (i.e., multiplying) by their quantities. The weighted average cost is determined, either at periodical intervals, or each time when fresh materials arrive on purchase. The average cost at any time is, thus, the balance value figure divided by the balance units figure. This method evens out the effect of widely varying prices of different lots of purchases, which make up the stock. There will be no profit or loss arising out of pricing issues.

Application of Rule of Cost or net Realizable Value: This rule can be applied in any of the following ways:

- **Item by item method:** Under this method cost and net realizable value of each and every item is considered individually, and the lower figure is taken for the purpose of inventory valuation.
- **Group method:** (Also known as global method) Under this method similar or related items are grouped into categories and the lower of cost and net realizable value is applied to **each category,** instead of every item forming part of a category. Such a method is adopted **ONLY** in cases of items of inventory relating to the same product line that have similar end-users and are produced and marketed in the same geographical area and cannot be otherwise evaluated separately from other items in that product line.

➢ **Example**

X Ltd. provides you the following list of transactions relating to one of its inventory item PEE. Ascertain the value of inventory of PEE on March 31, 2009:

March, 2009	Particulars	

1	Opening Balance	100 units @ Rs. 25 each
2	Purchased	50 units @ Rs. 30 each
5	Purchased	100 units @ Rs. 28 each
10	Issued	125 units
20	Purchased	150 units @ Rs. 35 each
25	Issued	75 nits

1. Computation of Cost of Closing Stock of PEE Using FIFO

Date March 2009	Receipts			Issues			Balance		
	Qty.	Rate Rs.	Amount Rs.	Qty.	Rate Rs.	Amount Rs.	Qty.	Rate Rs.	Amount Rs.
1	Opening Balance						100	25	2,500
2	50	30	1,500				100 50	25 30	2,500 1,500
5	100	28	2,800				100 50	25 30	2,500 1,500
10				100 25	25 30	2,500 750	25 100	30 28	750 2,800
20	150	35	5,250				25 100 150	30 28 35	750 2,800 5,250
25				25 50	30 28	750 1,400	50 150	28 35	1,400 5,250

Closing Value of Inventory Rs. 6,650

2. Computation of Cost of Closing Stock of Pee using Weighted Average

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Date March 2009	Receipts			Issues			Balance		
	Qty.	Rate Rs.	Amount Rs.	Qty.	Rate Rs.	Amount Rs.	Qty.	Rate Rs.	Amount Rs.
1	Opening Balance						100	25.00	2,500
2	50	30	1,500				150	26.67	4,000
5	100	28	2,800				250	27.20	6,800
10				125	27.20	3,400	125	27.20	3,400
20	150	35	5,250				275	31.45	8,650
25				75	34.45	2,360	200	31.45	6,290

Closing Value of Inventory Rs. 6,290

TECHNIQUES FOR MEASUREMENT OF COST

When the cost of inventories cannot be calculated by applying the cost formulas discussed above, then the following two methods can also be used if the results approximate the actual cost.

- **Standard cost method** is used for normal levels of consumption for a given volume of output. It is a pre-determined cost. This method takes into account normal levels of consumption of materials and supplies, labor, efficiency and capacity utilization. These parameters should be regularly reviewed and revised, it necessary, having regard to current conditions.

- The **retail inventory method** is used where the inventories are generally large and volatile. In the retail method, the cost of inventory is determined as under:

  Ascertain sales value of the inventory

  Deduct: Appropriate percentage gross margin

These are typically for valuation of in-process and manufactured items.

For this purpose, the percentage used takes into consideration, inventory which has been marked down to below its selling price. Under this method, an average percentage for each retail department is used.

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How is NRV determined?

NRV is calculated as under:

Ascertain estimated selling price in the ordinary cause of business.

Deduct: (a) Estimated cost of completion;

(b) Estimated cost necessary to make the sale.

Inventories should usually be written down to NRV on an item by item basis. However, when the circumstances so require, it may be valued on group basis also.

Estimates of net realizable value should be based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realize. These estimated should take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

The purpose for which the inventory is held should also be considered, e.g., the net realizable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less inventory is based on general selling prices.

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 realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.

NRV should be estimated at each balance sheet date.

What are the disclosure requirements under AS 2?

a) The accounting policies adopted in measuring inventories, including the cost formula used.
b) the total carrying amount of inventories and its classification appropriate to the enterprise, e.g., raw material and components, work-in-progress, finished goods, stores and spares and loose tools.
c) By virtue of AS 1, an enterprise also need to disclose any change in the accounting

policies, adopted in measuring inventories, which has a material effect in the current period or later period(s) along with its impact on the items of financial statements. Where such impact is not ascertainable, whether wholly or in part, the fact should be disclosed.

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ILLUSTRATION

Illustration – 1

USA limited purchased raw material at Rs. 400 per Kg. The company does not sell material but uses in production of finished goods. Finished goods in which the raw material is expected to be used are expected to be sold at below cost.

At the end of accounting year, the company is having 10,000 Kgs of raw material in stock. As the company doesn't sell raw material, it doesn't know the selling price of raw material and hence cannot calculate realizable value of material for valuation of inventory. However, replacement cost of raw material is Rs. 300 per kg.

How will you value inventory of raw material?

Solution

According to AS-2, Raw Material is generally valued at Cost. However, if the Finished goods in which raw material are incorporated are expected to be sold below cost, the raw materials are valued at net realisable value. Replacement cost is a measure of realisable value. Hence in this case, Raw Material is valued at realisable value.

Raw Material Inventory

= Rs. 300 X 10,000

= Rs. 30,00,000

Illustration 2

Can PT limited, a wire netting company, while valuing its finished goods at the year end, include interest on bank overdraft as an element of cost for the reason that overdraft has been taken specifically for the purpose of financing current asset like inventory and working capital expenses?

Solution

As per AS-2 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 PT limited cannot include interest on bank overdraft as an element of cost.

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However, if interest in relation to inventory which is a qualifying asset as per AS-16, interest cost can form part of cost of inventory.

Illustration 3

Knight Limited sells beers to customers. Some of the customers consume the beer in the bar run by Knight Limited. While leaving the bars, consumers leave empty bottle in the bar and the company takes possession of these empty bottles.

The company has laid down a detailed internal control procedure for accounting for these empty bottles which are sold by the company by calling for tenders.

Keeping this in view, decide whether stock of empty bottle is an asset of the company.

If so, whether stock of empty bottles existing as on date of balance sheet is considered to be inventory and is valued as per AS-2 or to be treated as scrap and shown at realisable value with corresponding credit to other income?

Solution

Empty Bottles, generally, would be scrap and valued at Realisable value.

In the given case, Empty Bottles

- have internal control procedure
- Are sold through tenders
- Revenue is important component of revenue

Hence, Empty bottles in this case can be considered as Inventory because of the significance of revenue from these bottles.

Thus, the inventory should be valued at Net Realisable Value.

Illustration 4

Anil Pharma Limited ordered 16,000 Kgs of certain material at Rs. 160 per unit. The purchase price includes excise duty in respect of which full CENVAT credit is admissible.

- Freight incurred amounted to Rs. 140,160.

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- Normal Transit Loss is 2%.

The company actually received 15,500 units. The company consumed 13,600 units of material.

Compute cost of inventory under AS-2 and amount of abnormal loss.

Solution

Working Notes

1. Since the price already includes excise duty which is adjustable, the excise duty component would be deducted to arrive at cost of inventory.

2. Freight Inward will form part of cost of inventory

3. Normal Transit Loss – 2% of 16,000 units – 320 units

4. Expected receipt – 16,000 – 320 = 15,680 units

5. Abnormal loss = 15,680 – 15,500 = 180 units.

Particulars	Amount (Rs)
Purchase cost (16,000 X 160)	25,60,000
Less : Cenvat (16,000 X 10)	1,60,000
Add : Freight	1,40,160
Total Cost	**25,40,160**
Expected Units (16,000 – 2% of 16,000)	15,680 units
Cost per unit	25,40,160 15,680 = Rs. 162 per unit
Units in Inventory	15,500 – 13,600 = 1,900
Value of Inventory	= 1,900 x Rs. 162 = Rs. 3,07,800
Abnormal Loss (180 units X Rs. 162)	Rs. 29,160

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Illustration 5

In a manufacturing process of Vijay Ltd, one by-product BP emerges besides two main products – MP1 and MP2 apart from scrap. Details of cost of production process are hereunder:

Particulars	**Amount (Rs.)**
Raw Material : 15,000 units	1,60,000
Wages	82,000
Fixed Overheads	58,000
Variable Overheads	40,000

Product	**Production Units**	**Closing Stock 31.03.2012**
MP1	6,250	800
MP2	5,000	200
BP	1,600	

Average Market Price of MP1 and MP2 is Rs 80 per unit and Rs. 50 per unit respectively.

By-Product is sold at Rs. 25 per unit. There is a profit of Rs. 5,000 on sale of by-product after incurring separate processing charge of Rs. 4,000 and packing charges of Rs. 6,000.

Rs. 6,000 is realised from sale of scrap.

Calculate the value of closing stock MP1 and MP2 as on 31st March 2012.

Solution

Hint for Exam –

Joint Cost	**Raw Material + Wages + Overheads**

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Less:	**NRV of By-product and Scrap**
	Net Joint Cost

Allocate the net joint cost between MP1 and MP2

Particulars	**Amount (Rs.)**
Raw Material Cost	1,60,000
Wages	82,000
Fixed Overhead	58,000
Variable Overhead	40,000
Total Joint Cost	3,40,000
(Less): NRV of by-product [1600X Rs. 25 – Rs. 4000 – Rs. 6000] [40,000-4,000-6,000]	30,000
(Less): NRV of Scrap	6,000
Net Joint Cost	3,04,000

The joint cost of Rs. 3,04,000 must be split between MP1 and MP2 on a reasonable basis. In this case the joint cost can be allocated on relative sale price.

Computation of Sale Value

Product	**Qty**	**Sale Price (Rs.)**	**Sale Value (Rs.)**
MP1	6,250	80	5,00,000
MP2	5,000	50	2,50,000

Allocation of Joint Cost

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Joint Cost	Unit Cost
MP1 : Rs. 3,04,000 X 2/3 = Rs. 2,02,667	Rs. 2,02,667/6,250 = Rs. 32.42
MP2 : Rs. 3,04,000 X 1/3 = Rs. 1,01,333	Rs. 1,01,333/5,000 = Rs. 20.26

Closing Stock:
MP1 = Rs. 32.42 X 800 = Rs. 25,944/-
MP2 = Rs. 20.26 X 200 = Rs. 4,054/-

Illustration 6

Cost of a **partly finished unit** at the end of 2016-17 is Rs. 150. The unit can be finished next year by a **further expenditure** of Rs. 100. Finished unit can be sold at Rs. 250 per unit subject to payment of **4% brokerage on selling price**. Value of inventory is to be determined.

Solution

Workings
1. Brokerage: 4% of Rs. 250 = Rs. 10
2. Net Proceeds from Sale = Rs. 250-Rs. 10 = Rs. 240

Cost of Partly finished unit = Rs. 150
Selling Price = Rs. 250 (-) Estimated Cost of Completion = Rs. 100 (-) Selling Cost (Brokerage) = Rs. 10 **Net Realisable Value = Rs. 140**
Inventory will be valued at Rs. 140 (Lower of cost and NRV)

According to AS-2, Inventory will be valued at lower of cost and net realisable value. 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.

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Illustration 7

ABC limited has a plant with a **capacity to produce 1,00,000 units** of a product per annum and the expected **fixed overheads is Rs. 18,00,000**. Determine the amount of overheads to be allocated to the inventory in the following cases.

(i) Actual Production is 1,00,000 units
(ii) Actual Production is 90,000 units
(iii) Actual Production is 1,20,000 units

Solution

Explanation

1. Pre-determined Fixed Overhead Recovery Rate

= Rs. 18,00,000/1,00,000

= Rs.18 per unit

2. Case i – Actual Production: 1,00,000 units

If actual production is equal to estimate, pre-determined recovery rate is used.

Overheads allocated = 1,00,000 x Rs. 18 = Rs. 18,00,000

3. Case ii – Actual Production: 90,000 units

If actual production is lower, the recovery rate is not revised.

Overheads allocated = 90,000 X Rs. 18 = Rs. 16,20,000

Rs. 1,80,000 will be charged to P&L

4. Case iii – Actual Production: 1,20,000 units

If actual production is higher, the recovery rate is revised.

Revised overhead recovery rate: Rs.18,00,000/1,20,000 = Rs. 15 per unit

Overheads allocated = Rs. 15 x 1,20,000 = Rs. 18,00,000

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Illustration 7

The cost and net realisable value of two items that a company has in its inventory are given below.

Item	Cost (Rs.)	Net Realisable Value (Rs.)
I	50,000	45,000
II	20,000	24,000
Total	**70,000**	**69,000**

Compute the value of inventory.

Solution

Inventory is valued at lower of cost or net realisable value (NRV). Inventory should not be valued on a global basis but on item by item basis.

Item I: Lower of Cost or NRV is Rs. 45,000.

Item II: Lower of Cost or NRV is Rs. 20,000

Total Value of Inventory: Rs. 45,000 + Rs. 20,000 = Rs. 65,000

Illustration 8

X Co. Ltd purchased goods at a **cost of Rs. 40 lakhs** in October 2016. Till March 2017, **75% of the stock was sold.** Company wants to disclose closing stock at Rs. 10 lakhs. Expected **sales value is Rs. 11 lakhs and a commission of 10% is payable** to the agent. Compute the value of Inventory.

Solution

According to AS-2, Inventory will be valued at lower of cost and net realisable value. 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.

Selling Price = Rs. 11 lakhs
(-) Selling expenses: 10% of Rs. 11 lakhs = Rs. 11 lakhs
Net Realisable Value = Rs. 9.9 lakhs

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The cost of inventory is Rs. 10 lakhs. Hence, the inventory will be valued at Rs. 9.9 lakhs.

Illustration 9

In a production process **normal waste is 5% input**. 5,000 MT of input was put in process resulting in wastage **of 300 MT.** The cost per MT of input is Rs. 1,000. Entire quantity of waste is on stock at year end. With reference to Accounting Standard, How will you value inventories in this case?

Solution:

Normal Wastage: 5,000 X 5% = 250 units
Actual Wastage : 300 units
Abnormal Wastage: 50 Units
Total Cost: Rs. 1,000 X 5000 = Rs. 50,00,000
Allocable units : 5000-250 = 4750 units.
Cost per MT = Rs. 50,00,000/4,750 = Rs. 1052.63 per unit.
Inventory at Hand = 5000-300 = 4700 units
Value of Inventory = 4700 X Rs. 1052.63 = **Rs. 49,47,368/-**
Abnormal Loss = 50 X Rs. 1052.63 = **Rs. 52,632**

Question 10

You are required to value inventory per Kg of finished goods.
Material: Rs. 200 per kg
Direct Labour: Rs. 40 per kg
Direct Variable Overhead: Rs. 20 per kg
Fixed production charges for the year on normal working capacity of 2,00,000 Kgs is Rs. 20,00,000.

Solution

Material Cost: Rs. 200
Labour Cost: Rs. 40
Variable Overhead: Rs. 20
Total Variable Cost: Rs. 260

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Fixed Overhead: Rs. 10

Cost Per KG: Rs. 270

Working:
Fixed Overhead Recovery Rate: Rs. 20,00,000/2,00,000 = Rs. 10 per Kg

12.3 AS – 7 CONSTRUCTION CONTRACTS

Objective:

The primary issue in accounting for construction contracts is the allocation of revenue and costs attributable to contract activity, to the accounting periods in which construction work is performed. AS –7 prescribes appropriate accounting treatment in this regard and lays down appropriate criteria for recognition of these components in the statement of profit and loss. Besides AS –7 also provides practical guidance on the application of such criteria, while preparing Financial Statements, of contractors.

Scope and Applicability:

AS –7 is mandatory in nature. It comes into effect in respect of all contracts entered on or after 1st April 2003. It requires to be applied in accounting for construction contract in the financial statement of contractors.

Definition of Key Term "Construction Contract":
Construction contract MEANS contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or inter-dependent, in terms of their design technology aria function or their ultimate purpose or use.

Construction contract also **INCLUDES** the following:

a) Those involving rendering of services relating to construction of assets. Example: Contracts involving project management or providing architectural services.
b) Those involving destruction of assets. Example: ship-breaking, demolition of building.
c) And, those involving restoration of assets, or restoration of environment following demolition assets. Example: Removal of debris, grading, leveling and landscaping (of land).

Types of Construction Contracts: AS - 7 classifies construction contracts into two types.

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A. Fixed price contracts, are those in which:

i. Parties agree to a fixed price or

ii. Parties agree to a fixed rate per unit of output, which in some cases is subject to escalation clauses

B. Cost plus contracts are those, in which contract price involves 2 elements:

i. Reimbursement of allowable, or defined costs, AND, in addition

ii. Either a percentage of such costs or a fixed fee

Cost plus contracts involving a maximum ceiling would bear the characteristics of both the above types.

Highlights of AS — 7:

Unique feature of construction contract is that, it is carried out during more than one accounting year. Fundamental issue is — **"how do you allocate Cost and Revenue to different accounting periods. This done based on single contract by following Matching and Conservatism concept."**

Hence, following are to be understood properly:

- Construction Costs
- Construction Revenue
- Concept of single contract
- Allocation of costs and revenue by following matching and conservatism concept.

These are explained in the paragraphs that follow:

Construction Costs include.

1. Direct Costs i.e. Direct Material, Direct Labor and Direct Expenses.
2. Overheads identifiable with construction Activity but excluding general administration. Selling. Costs.
3. Specific costs- chargeable to the customer as per terms of contract.
4. **Interest Component:** As provided in Paragraph 17 of Revised Standard, it is safe to assume that, in cases where all the criteria laid down in AS 16 for capitalization of borrowing costs are met, interest costs can be included as a part of cost of construction contracts.

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In order to take advantage of bulk or volume discounts on purchase of construction materials, such as steel or cement, contractors sometimes buy significant quantities of those items and stock them at a site where a big construction contract is in progress. The costs of such material are future costs because these are not meant for immediate consumption at the site where they are stored. Such costs qualify for the treatment explained above in case of future costs. At year-end they may need to be estimated in order to report them on the balance sheet as "contract work in progress."

Construction contract Revenues include:

1. Basic price
2. Adjustment in contract price due to variations in contract work.
3. Incentives for early completion.
4. Sale of obsolete Assets which otherwise not fit for use at end of contract period.

On account of inherent uncertainties involved, as also likelihood of variations in contract price, timing of recognition of each of these items is critical, these areas need to be enquired into, evaluated, and revenues recognized based on skilful use of judgment.

Variation – A variation is an instruction by the customer for a change in the scope of the work. A variation may lead to increase or decrease in contract revenue. A variation is included in contract revenue when –

- It is probable that the customer will approve the variation and the amount of revenue arising from the variation &
- The amount of revenue can be reliably measured

Claim – A claim is an amount that the contractor seeks to collect from the customer as reimbursement for costs not included in contract price. A claim is included in contract revenue when –

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- Negotiations have reached an advanced stage such that it is probable that the customer will accept the claim &
- The amount can be measured reliably.

Incentive Payments - Incentives payments are additional amounts payable to the contractor if specified performance standard is met or exceeded. Incentives payments are included in contract revenue when –

- The contract is sufficiently advanced that it is probable that the performance standards will be met or exceeded and
- The amount of incentive payments can be measured reliably.

Concepts of a single contract: The fundamental issue aptly brought out in AS-7 is the allocation of contract revenue and contract costs to accounting periods in which construction work is performed. For purposes of recognizing costs and revenues,

a) In built provisions in the contracts should be evaluated "on a contract by contract basis" and
b) Prescriptions in AS-7 should be applied for each contract separately, and individually.

For this purpose, it is necessary to determine what constitutes a “single contract"

Principles for recognition of contract costs and revenue. [Matching and conservatism Principles]

1. When the outcome of the contract can be estimated reliably, contract revenue and related costs should be recognized as revenue and expenses**, by reference to the stage of completion of the contract activity, at the balance sheet data. [Matching]**

2. Any expected loss should be recognized immediately as expense**. [conservatism]**

Contract revenue & Contract Costs shall be reorganized based on "Percentage Completion Method" AS – 7 further states that when the stage of completion is determined by reference **to the contract costs incurred to the "reporting date"**, only those contract costs that reflect work performed are included in costs incurred to date.

Consider the following:

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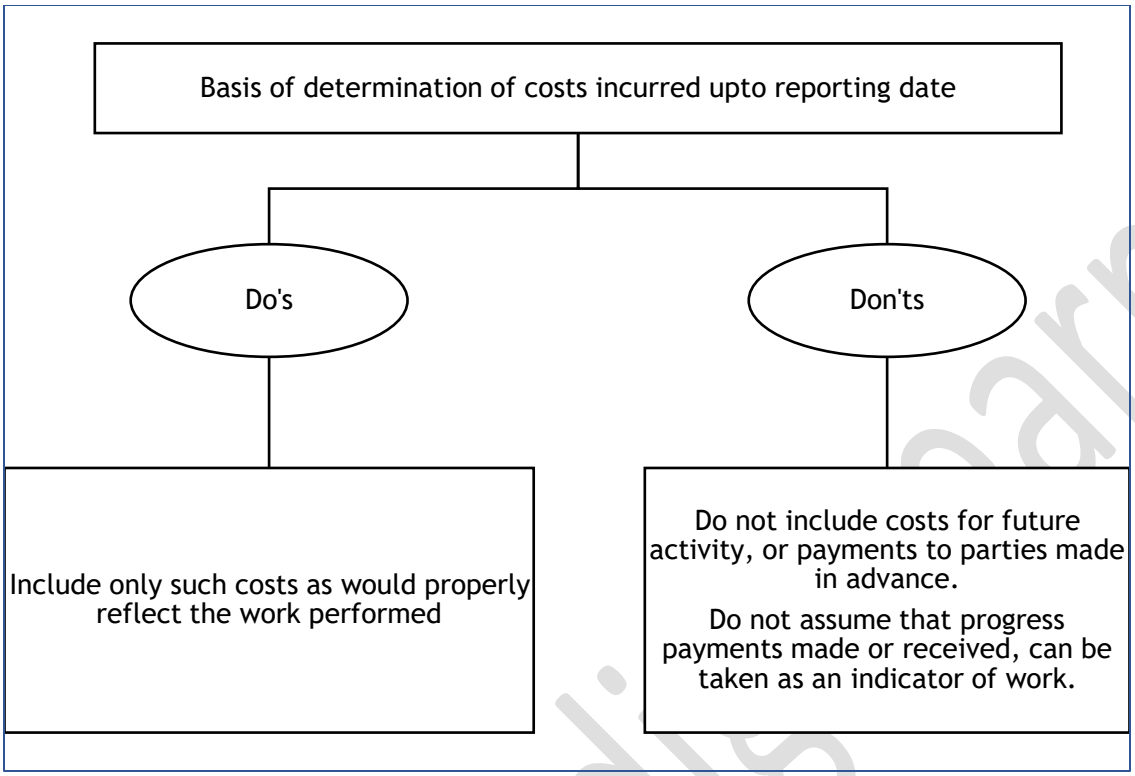

Recognition of expected loss:

Overriding principle: When it is probable that total contract costs will exceed total contract revenue, expected loss should be recognized as an expense immediately. This should be done irrespective of —

- Whether or not work has commenced
- The stage of completion
- The likelihood of profits in certain other contracts not treated as a single contract as per this Standard.

Percentage completion method is applied on a "cumulative basis" from year to year, with reference to "annually reviewed current estimate of revenue, and actual costs incurred: Changes in estimates should be accounted for as per AS — 5.

Stage of Completion = $\frac{\textit{Total contract costs incurred till date}}{\textit{Total expected cost of the contract}}$

Cost Incurred	XXX
Add: Profits recognized till date	XXX

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Amount due to/from customers

Less: Loss recognized till date	XXX
Less: Progress Billings	XXX
Amount due from / (due to) customers	Due from if +ve Due to if -ve

Disclosure Requirements:

A. An Enterprise should disclose:
- Amount of revenue recognized
- Methods used to determine amount of revenue recognized
- Methods used to determine stage of completion

B. An Enterprise should disclose the following for contracts in progress at the reporting date
- The aggregate amount of costs incurred and recognized profits (less recognized losses reporting date;
- The amount of advances received (it is the amount received before the related work completed); &
- The amount of retentions.

C. An Enterprise should present:
- The gross amount due from customers for contract work as an asset &
- The gross amount due to customers for contract work as liability.

Illustrations

Illustration 1

Mr. 'X' as a contractor has just entered a contract with a local municipal body for building a flyover. As per the contract terms, 'X' will receive an additional Rs. 2

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crores if the construction of the flyover were to be finished within a period of two years of the commencement of the contract. Mr. X wants to recognize this revenue since in the past he has been able to meet similar targets very easily.

Is X correct in his proposal? Discuss.

Solution

Mr. X wants to Recognize incentive related income before the project is completed because based on experience, such projects have been completed on time.

According to AS 7, Revenue on account of incentive should not be recognized -

- **If the contract has not made sufficient amount of progress (**is not at an advanced stage of completion) **and**
- **unless there is certainty that incentive would be received,**

The contract has not even begun and hence the contractor (Mr. X) should not recognize any revenue on account of incentive.

Illustration 2

PRZ & Sons Ltd. are Heavy Engineering contractors specializing in construction of dams. From the records of the company, the following data is available pertaining to year ended 31st March 2017.

Using this data and applying the relevant Accounting Standard you are required to:

(i) Compute the amount of profit/loss for the year ended 31st March 2017.

(ii) Arrive at the contract work in progress as at the end of financial year 2016-17.

(iii) Determine the amount of revenue to be recognized out of the total contract value.

(iv) Work out the amount due from/to customers as at year end.

(v) List down relevant disclosures with figures as per relevant Account Standard

(Amount in Crores)

Total Contract Price	2,400
Work Certified	1,250
Work pending certification	250

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Estimated further cost to completion	1,750
Stage wise payments received	1,100
Progress payments in pipeline	300

Solution:

i. & ii. Contract Profit/Loss & Contract Work in Progress

Work Certified	1,250
Work pending certification	250
Contract Work in Progress	1,500
Estimated further cost to completion	1,750
Total Cost of Contract [A]	**3,250**
Contract Revenue [B]	**2,400**
Expected Loss [A-B]	**850**

Entire anticipated loss must be provided for fully and immediately. Rs. 850 crores must be charged off to profit and loss account as loss.

iii. Revenue to be recognized

Percentage of Completion (Amount in Crores)
Total Cost Incurred: Rs. 1,250 +Rs. 250 = Rs. 1,500
Total Estimated Cost: Rs 1,250 + Rs. 250 + Rs. 1,750 = Rs. 3,250
Percentage of Completion = $\frac{1,500 \text{ x } 100\%}{3,250} = 46.15\%$
Revenue to be recognized = 46.15% of Rs. 2,400 crores = Rs. 1,107.6 crores

iv. Amount Payable/Due

= Cost Incurred + Profits - Progress Payments received/receivable – Losses
= Rs. (1,500 + 0 – 1,400 – 850) Crores
= Rs 750 Crores payable

v. Disclosures

1. Contract Revenue: Rs. 1,107.6
2. Contract Expenses: Rs. 1,500
3. Loss: Rs. 850

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4. Progress Billing: Rs. 1,400
5. Progress Billing (Not yet received): Rs. 300
6. Gross amount due to customers: Rs. 750

12.4 AS – 9 REVENUE RECOGNITION

Scope:

AS —9 highlights a fact that Revenue Recognition is concerned with the "timing of recognition" in the Statement of Profit and Loss. It lays down criteria for recognition of revenue most suited to prepare of financial statements of enterprises engaged in varied activities. The pronouncements under AS 9 are in close alignment with IAS 18.

Coverage under AS —9 excluded:

Applicability of the Standard has been excluded from events or transactions, generating revenue from

- Construction contracts (covered under AS 7 — R)
- Lease agreements (covered under AS — 19)
- Government grants or other similar subsidies (covered under AS —12)

Revenue Defined:

Revenue means the gross inflow of cash, receivables or other consideration from sale of goods, from the rendering of services and from the use by others of the resource's enterprise yielding interest royalties and dividends.

Revenue does not include

Certain transactions or events that result in unrealized or realized gains, namely,

a) unrealized gains from
   - Holding of non-current assets, holding of current assets,
   - Natural increases in herds and agricultural or forest products, or
   - Restatement of carrying amount of an obligation.

b) Realized gains from
   - Disposal of fixed assets
   - Discharge of an obligation at less than carrying amount

c) Realized or unrealized gains from

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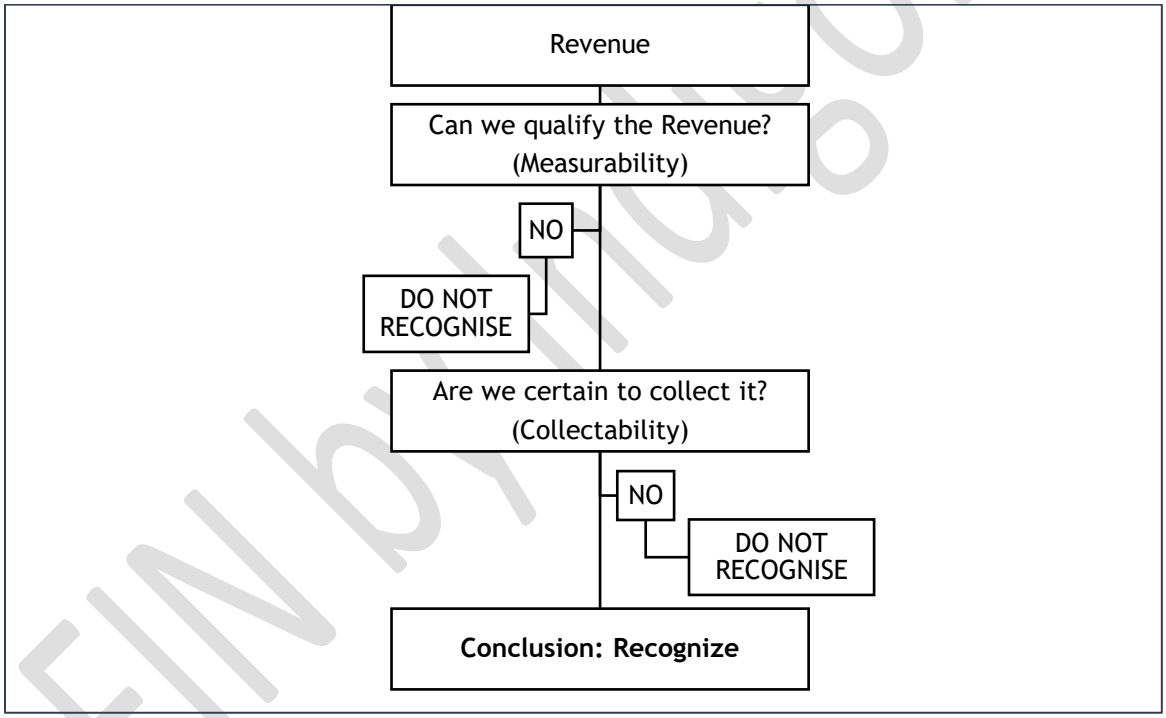
- Changes in foreign exchange rates and adjustments arising on translation of foreign financial statements.

'Revenue' should be distinguished from 'gains'. Revenue arises from an entity's or activities. Gains, however, include such items as the profit on disposal of non-current assets. Re-translating balances in foreign currencies, or fair value adjustments to financial and financial assets.

General Rule for Revenue Recognition in the books of Accounts:

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, the revenue recognition is postponed to the extent of uncertainty involved. In such case, the revenue recognized only when it is reasonably certain that ultimate collection will be made:



Following Points are Noteworthy:

a) **Consideration is not measurable postpone recognition:** Consideration receivable for sale of goods or for rendering of services should be determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

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b) **Collectability is uncertain-now-postpone recognition:** e.g. export incentives, escalation of price.

c) **Effect of postponement:** When recognition of revenue is postponed because of uncertainties, the amount is considered as revenue of the period in which it is certain to receive.

d) **Uncertainty arises later- make a provision (do not adjust revenue):** When a transaction was concluded initially, the collectability was certain. Revenue, therefore, stood recognized. (Admittedly, future is always unpredictable). Subsequent to sale or rendering of the services, and at a much later date, the collectability of consideration is rendered uncertain. In such a situation, it is more appropriate to make a separate provision to reflect the uncertainty e.g. RDD.

Specific Rules for Revenue Recognition in case of Sale of goods: 1.

1. **Transfer of Property:** The seller has transferred either property in the goods or all significant risks and rewards of ownership to the buyer.

AND

2. **Control over the goods lies with Buyer:** The seller retains no effective control over the goods transferred, to a degree usually associated with ownership.

Comment:

The general rule is that when property in an asset is transferred, risks and rewards attributable to the asset also get transferred. Yet, both these may not coincide. For example, where delivery has been delayed due to the fault of either the buyer or the seller the goods are at the risk of the party committing default as regards loss, which loss would not have occurred but for such default. At times, parties concerned may agree that the risk will pass at a time earlier or later than the time when ownership passes.

Specific Rule for Revenue Recognition in case of rendering of services Revenue shall be recognized only when **services are performed,** the performance may consist of execution of one or more acts over a period of more than one financial year. In such case revenue shall be measured by using either:

a) Completed Service Contract Method

OR

b) Proportionate Completion Method

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a) **Completed Service Contract Method:** This method is applied when performance consists of execution of single act. e.g. installation of a machine, organizing an event. In such situation, revenue is recorded only when sole or final act takes place and services become chargeable.
b) **Proportionate Completion Method:** This method is to be applied when performance consists of execution of more than one act. Revenue is to be recognized proportionately by reference to performance of each act. Consideration governing recognition are, contract values, associated number of acts or other such suitable basis. Where the number of acts is indeterminate, revenue may be recognized on a straight-line basis over a specific period, unless there is some other method is more representative of the pattern of performance. e.g.: maintenance contract, Tuition fees (educational training services).

   [Note: Where consultancy services are rendered in connection with a project or construction of a percentage completion method alone will apply, as per AS 7 (Revised)**]**

Specific Rule for recognition of revenue from use of enterprise resources by others: The resources of the enterprise by others would be yielding revenues. Revenue recognition rules are form of interest, royalties, or dividends.

i. **Interest** recognized on time proportion basis considering the amount outstanding and the applicable.
ii. **Royalties** are the charges for the use of such assets as know-how, patents, trademarks or copyrights. Revenue is recognized on **accrual basis in accordance with the terms of the relevant agreement.**

Dividends are recognized only **when the owner's right to receive payment is established.** Normally once the dividend is approved in annual general body meeting, the right to dividend is established for the shareholders.

Note: Exception to key criteria: When interest, royalties and dividends are receivable from other countries which require exchange permission and uncertainty in remittance is anticipated, revenue recognition must be on cash basis.

Disclosure Requirements: AS — 1 requires disclosure of accounting policies of the enterprise. Many companies disclose their policy of revenue recognition especially when they are engaged in special types of business such as financial services, information technology, management consultancy, etc.

In addition to such policy disclosures, an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

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Some examples of different practical commercial situations and the method of revenue recognition therefore are listed below:

Group – I Sale of Goods	
Situation	**Suggested method**
Buyer requests delivery, but takes title and accepts billing	Recognize revenue even if delivery is not made, ensuring that the item is held in stock ready for delivery.
Goods sold subject to installation and inspection	Recognize revenue only when customer accepts delivery and installation is complete (consumer durable items can be exceptions).
Sale on approval	Recognize revenue only (a) when buyer accepts goods, or (b) time period, if any, for rejection, has elapsed or a reasonable time has elapsed (subjectivity involved).
Guaranteed sales (unlimited warranty)	Enquire into the substance of the agreement. If there is a 'money back' clause Recognize revenue at the time of sale, but make a provision based on experience of claims
General warranties	Revenue on sale is recognized, and provision is made based on experience
Consignment sale	Recognize revenue only when consignee reports sale to third parties
Cash on delivery	Revenue should not be recognized until cash is received by seller or his agent
Series of instalment payments by buyer, lading to delivery only when final instalment is paid	• Recognize revenue only when goods are delivered • Subject to past trends, revenue may be recognized when significant payments received indicate that sale will be consummated.
Special order shipments	Revenues are not recognized until goods are manufactured, identified and made ready for delivery to seller or his agent.
Sale and repurchase agreements	Examine 'substance over form'. Where a seller concurrently agrees to repurchase the same goods later, it would be tantamount to financing agreement. The

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	cash flow is not an item falling within the ambit of 'Revenue'.
Sale to intermediate parties	• Where the intermediate party is an agent, recognize revenue when sale is made to third party (till then, consignment sales). • Recognize revenue, where significant risks and rewards pass to the buyer.
Instalment sales	Segregate interest element from cash price element. Recognize cash price as revenue. Recognize interest proportion to unpaid sue to seller.
Subscribed for publications	• Normally revenue is allocated and Recognize different periods on SLM basis • Where the value of sales varies from period, recognition is based on sales value of item delivered, in relation total sales value of all items covered by subscription
Trade discounts and rebates	This is not an item of revenue. These are accounted for as deductions from Revenue
Group II — Rendering of Services	
Situation	**Suggested method**
Advertising agency, **a)** Media commission **b)** Production commission	**a)** Recognize media commission as revenue when the "ad" appears in the designated media **b)** Production commission is recognized when project completed
Insurance agency commission	Recognize as revenue on the effective date of issue, or renewal of policies
Financial services commission	Determine (a) if the service is one-off basis, or continue (b) incidence of costs, and (c) likely certainty of payments If one off basis, apply critical event concept. If continuous, apply accrual concept.
Commission for granting loans	Recognize revenue when a binding obligation emerges
Loan syndication fees	Loan syndication fees

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Admission fees	Recognize revenue on "critical event concept basis" (banquets, artistic performance, etc.)

Illustrations

Illustration 1

Arjun Ltd Sold its Farm equipment through its dealers. One of the conditions at the time of the sale is that payment of consideration in 14 days and in the event of delay, interest is payable @15% p.a.

The Company has not realized interest from dealers in the past. However, for the year ended 31.3.2015 it wants to recognize interest due on the balances due from the dealers. The amount is ascertained at Rs.9 lacs. Decide, whether the income by way of interest from dealers is eligible for recognition as per AS 9.

Solution

AS 9 prescribes recognition of revenue only when the mount is measurable and collectible.

In the current case though the amount of interest is measurable, experience indicates very low probability of collection. Hence, the Company should recognize revenue of Rs.9 lacs only when the amount is collected

Illustration 2

The Board of Directors of X Limited decided on 31.3.2015 to increase sale price of certain items of goods sold, retrospectively from 1st Jan 2015.

As a result of this decision, the Company must receive Rs.5 lacs from its customers in respect if sales made from 1.1.2015 to 31.3.2015. But the Company's accountant was reluctant to make up his mind. You are asked to offer your suggestion.

Solution

Once a sale is made, a customer may not easily accept revision of that sale price.

Unless, customer agrees to make such a payment collectability of such an amount is not reasonably certain.

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Hence, Revenue recognition should be postponed till the money is collected

Illustration 3

A ltd, entered a contract with B Ltd to dispatch goods, valuing Rs.25,000 every month for 4 months upon receipt of entire payment.

B Limited accordingly made a payment of Rs.1 lac and A ltd started dispatching the goods. In the 3rd month, due to a natural calamity, B Ltd asked A ltd to not dispatch goods until further notice, though A Ltd is holding entire goods worth Rs.50,000 ready for dispatch.

A Ltd accounted Rs.50,000 as sales and transferred the balance to Advance received against Sales. Comment upon the treatment of balance amount with reference to the provisions of the Accounting Standards

Solution

Risk and Reward of the goods has already been transferred and Delivery is postponed at the request of the buyer. A Ltd can recognize sales to the extent of entire Rs.1 lac

Illustration 4

M/S. Moon Ltd sold goods worth Rs.6.5 lacs to Mr. Star. Mr. Star asked for a trade discount amounting to Rs.53,000 and the same was agreed upon by M/S. Moon Ltd. The sale was affected, and goods were dispatched. On receipt of goods, Mr. Star has found that goods worthRs.67,000 are defective. Mr. Star returned defective goods and made payment of Rs.5.3 Lacs to M/S. Moon ltd. The Accountant of M/S. Moon Ltd booked the sale for Rs.5.3 Lacs. Discuss the contention of the accountant with reference to AS 9.

Solution

If trade discount is in the normal course of business, then the sale should be recorded by M/S. Moon limited at Rs.6.5 lacs – Rs.53,000 = Rs.5.97 lacs – (This is generally assumed) If not, the sale should be recorded at Rs.6.5 lacs.

Defective goods returned should be treated as sales returns and not netted off against sales

Sales should be shown at Rs.5.97 lacs even though the payment is made only for Rs.5.3 Lacs if the discount was in ordinary course of business. If the discount was not in ordinary course of business, sales should have been shown at Rs.6.5 Lacs

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Illustration 5

Saritha Publications Ltd publishes a monthly magazine on 15th of every month. It sells advertising space in the magazine to advertisers on the terms of 80% sale value payable in advance and the balance within 30 days of release of publication.

The sale of space for the March 2014 issue was made in Feb 2014. The magazine was published on its schedule date. It received Rs.2.4 lacs on 10.3.2014 and Rs.60,000 on 10.4.2014 for the March 2014 issue.

Discuss in context of AS 9 the amount of revenue to be recognized and the treatment of the amount received from advertisers for the year ending 31st March 2014.

What will be the treatment if the publication is delayed till 2.4.2014?

Solution

In the first scenario, as per AS 9 the entire sale value needs to be recorded.

In the second scenario, revenue should be booked in the month of April 2014 and the sum of Rs.2.4 lacs will be shown as advance received.

Illustration 6

SM company has taken a Transit Insurance Policy. Suddenly in the year 2016-17 the percentage of accident has gone up to 7% and the company wants to recognize insurance claim as revenue in 2016-17 in accordance with relevant Accounting Standards. Do you agree? Explain in brief as per the relevant Accounting Standards.

Solution

Scope of AS 9 does not cover treatment of insurance claims received.

A disproportionate increase in insurance claims cannot mean they can be recognized as revenue. Such inflows must be adjusted with the loss

Insurance Claim money can be recognized in books of accounts only when such a claim is accepted by the Insurance Company

Illustration 7

Bottom Ltd. entered 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 view with reasons.

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Solution

Registration could be just a formality and sale are substantially complete on entering into a sale agreement / deed. In such a case, gain could be recognized in the period in which such a deed was entered. Else the sale and gain are recognized only in the period when the property is registered

Illustration 8

Golden Eagle Ltd. has been successful jewellers for the past 100 years and sales are against cash only. The company diversified into apparels. A young senior executive was put in charge of apparels business and sales increased 5 times. One of the conditions for sales was that dealers can return the unsold stocks within one month of the end of season. Sales return for the year was 25% of sales. Suggest a suitable Revenue Recognition Policy with reference to AS-9.

Solution

As per AS 9 revenue should be recognized when there is certainty about measurability and collectability

In the Jewellery business there are NO concerns regarding measurability as well as collectability. Hence Revenue should be recognized in this business, immediately on sale, in-line with principles outlined in AS 9

In the apparels business, Sales should be recognized only to the extent of 75% of items shipped at the time of shipping and balance 25% should be recognized when there is greater certainty.

12.5 AS – 10 PROPERTY, PLANT AND EQUIPMENT

What is Property, Plant and Equipment (PPE)?

Property, Plant and Equipment (PPE) are also generally known as fixed assets; these fixed assets are tangible property in contrast to the intangible property which is dealt by AS-26.

PPE is tangible items that are:

- held for use in production or supply of goods and services, for rental to others, or for administrative purposes and
- Expected to be used during more than a period of twelve months.

PPE are not held for sale in the normal course of business. Some examples of Property, Plant and Equipment (PPE) are land, building, plant and machinery, furniture and fitting and office equipment etc.

Scope:

This Standard prescribes the accounting for PPE except when another AS permits different accounting treatments. For example, AS-19 prescribes a different treatment of assets under Finance Lease.

This Standard does not apply to:

(a) Biological assets related to agricultural activity other than bearer plants. This Standard applies to bearer plants, but it does not apply to the produce on bearer plants.
(b) Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

However, this Standard applies to items of property, plant and equipment used to develop or maintain the assets described in (a) and (b) above.

Biological asset, Agriculture activity, Agriculture produce and bearer plant

- Biological Asset is a living animal or plant and is core income producing asset of agricultural activity.
- Agricultural activity is the management by an enterprise of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.
- Agricultural Produce is the harvested product of biological assets of the enterprise.
- Bearer plant is a plant that:

  (a) Is used in the production or supply of agricultural produce.

  (b) Is expected to bear produce for more than a period of twelve months; and

  (c) Has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

  The following are not bearer plants:

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1. Plants cultivated to be harvested as agricultural produce (for example, trees grown for use as lumber).
2. Plants cultivated to produce agricultural produce when there is more than a remote likelihood that the entity will also harvest and sell the plant as agricultural produce, other than as incidental scrap sales (for example, trees that are cultivated both for their fruit and their lumber); and
3. Annual crops (for example, maize and wheat). When bearer plants are no longer used to bear, produce they might be cut down and sold as scrap, for example, for use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a bearer plant.

   Example: Mango tree is a bearer plant and it covered by AS-10 PPE, however mango grown in tree is a produce of bearer plant and is not covered by this Standard. Further in wheat crop the plant of the wheat is not a bearer plant because it is cut down and sold as scrap.

Investment property is an investment in land or buildings that are not intended to be occupied substantially for use in the operations of the investing enterprise. The investment property is not PPE. However, it should be accounted for only in accordance with the cost model prescribed in this Standard.

Recognition of assets

Criteria for Recognition - The cost of an item of PPE should be recognized as an asset if and only if:

- It is probable that future economic benefits associated with the asset will flow to the entity and,
- The cost of the item can be measured reliably.

The degree of certainty attached to the flow of future economic benefits must be assessed. This should be based on the evidence available at the date of initial recognition (usually the date of purchase). The entity should thus be assured that it will receive the rewards attached to the asset and it will incur the associated risks, which will only generally be the case when the rewards and risks have passed to the entity. Until then, the asset should not be recognized.

Example: A plant and machinery is purchased for Rs. 20 lakhs. It satisfied the recognition criteria: future economic benefits will flow to the entity in the form of the capability to produce goods using the machinery, sell them and earn profits. Similarly,

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its cost can be measured reliably from the purchase invoice. Therefore, it qualifies to be recognized as property, plant and equipment (PPE).

Spare parts which do not meet the criteria of recognition of PPE are usually treated as inventory and recognized in the profit or loss as and when consumed.

Example: Small spare parts for machinery are purchased at a cost of Rs. 1.25 lakhs and stored by the entity. These are regularly issued whenever required by the maintenance department.

The balance of the spares on hand at the Balance Sheet date was worth Rs. 70,000. The consumed part of Rs. 55,000 should be shown as an expense in the Statement of Profit and loss. The balance of Rs. 70,000 should be carried forward as inventory it is accounting should be as per AS-2.

Major spare parts and standby equipment are treated as property, plant and equipment when they are expected to be used over more than one period. They are included in non-current assets from the date the cost is incurred.

Example: Induna Ltd purchased an item of machinery for Rs. 2 lakhs, together with major spare parts worth Rs. 25,000 not readily available in the market. It should Recognize the total of Rs. 2.25 lakhs as PPE

Those which can be used exclusively with an item of PPE are accounted for as PPE.

Example: Z Ltd purchases a 'made to order' machine for Rs. 5 lakhs and alongside also purchased spare parts worth Rs. 60,000 which can be used only on this machinery and not any machinery elsewhere. Advise Z Ltd on the accounting treatment of spare parts.

Along with the cost of machinery, the cost of spares also, should be capitalised i.e., recognized in the carrying value, thus, the total carrying value is Rs. 5.60 lakhs

Any expenditure incurred that meets the recognition criteria of PPE must be accounted for as an asset (PPE). The Standard refers to individually insignificant items that can be aggregated and accounted as a single item of PPE.

However, very often, in practice, entities adopt an accounting policy to expense items that are below a predetermined minimum level in order to avoid undue cost in maintaining the relevant records, which includes tracking the whereabouts of the asset.

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The definition and recognition criteria can also be applied to spare parts, although these are often carried as inventory and expensed as and when utilized. However, major spare parts are usually recognized PPE when an entity expects to use them during more than one period.

Safety and environmental equipment

- The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any existing item of PPE, may be necessary for an entity to obtain the future economic benefits from its other assets.
- Such items of PPE qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognized as an asset because without them the entity is unable to manufacture and sell chemicals.

Initial measurement

An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.

What is cost of PPE?

The cost of items of PPE comprises of:

- Purchase price, including import duties, non-refundable purchase taxes, less trade discounts and rebates.
- Costs directly attributable to bringing the asset to the location and condition **necessary for it to be used in a manner intended by management.**
- **Initial estimates of cost of dismantling/decommissioning, removing, and site restoration at present value** if the entity has an obligation that it incurs on acquisition of the asset or as a result of using the asset other than to produce inventories.

AS-29 prescribes the discounting of such provisions and provision is made at present value by applying pre-tax discount rate.

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Directly attributable costs include:

- Employee benefits of those involved in the construction or acquisition of an asset
- Cost of site preparation
- Initial delivery and handling costs
- Installation and assembly costs
- Costs of testing, less the net proceeds from the sale of any product arising from test production
- Borrowing costs to the extent permitted by AS-16, Borrowing Costs
- Professional fees

Examples of costs that are not directly attributable costs and therefore must be expensed in the income statement include:

- Costs of opening a new facility (often referred to as preoperative expenses)
- Costs of introducing a new product or service including advertising and promotional costs
- Costs of conducting business in a new location or with a new class of customer
- Training costs
- Administration and other general overheads
- Costs incurred while an asset, capable of being used as intended, is yet to be brought into use, is left idle, or is operating at below full capacity
- Initial operating losses
- Costs of relocating or reorganizing part or all an entity's operations

The income and related expenses of operation that are incidental to the construction or development of an item of PPE should be recognized in the income statement.

For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognized in profit or loss and included in their respective classifications of income and expense.

Cost of dismantling/decommissioning

- The elements of cost to be incorporated in the initial recognition of an asset are to include the estimated costs of its eventual dismantlement ('decommissioning cost').

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That is, the cost of the asset is "grossed up" for these estimated terminal costs, with the offsetting credit being posted to a liability account.

It is important to stress that recognition of a liability can only be affected when all the criteria set forth in AS-29 for the recognition in provisions are met.

- It seems odd to capitalize decommissioning costs that are not going to emerge until later in the asset's life. However, if there is an obligation as a direct consequence of acquiring or constructing property, plant and equipment to incur further costs in the future that cannot be avoided.
- A provision is recognized in accordance with AS-29. Therefore, the decommissioning costs at the end of the asset's life are just as much a cost of acquiring or constructing the asset as the costs incurred at the start of the asset's life. Decommissioning or similar costs such as dismantling expenditure can often arise in connection with operating leases and leasehold improvements.

For example, the terms of an operating lease may allow the tenant to tailor the property to meet their specific needs by, say, building an additional internal wall, but on condition that the tenant returns the property at the end of the lease in its original state, this will entail dismantling the internal wall.

On building the internal wall, the tenant creates an obligation to remove the wall, which it cannot avoid, therefore, must recognize a provision for that obligation in accordance with AS-29. The cost to the tenant, therefore, of the leasehold improvement is not only the cost of building the wall, but also the cost of restoring the property at the end of the lease by dismantling the internal wall. As such, both costs are capitalized when the internal wall is built and will be recognized in the profit and loss account over the useful life of the asset (generally the expected lease term) as part of the depreciation charge.

Examples of decommissioning costs that may be capitalised as part of the cost of the asset typically arise in oil and gas and electricity industries where environmental damage is caused by, say the construction and commissioning of the facility (for example, the oil platform, as in the example referred to above, or nuclear plant).

Similar costs are incurred in other industries such as: abandonment costs in the mining and extractive industries; clean up and restoration costs of landfill sites and environmental; clean-up costs in the number of industries.

The present value of decommissioning costs will be added to the value of PPE with a corresponding credit to provisions as per AS-29.

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Cost of self-constructed asset

The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (AS-2). ***Therefore, any internal profits are eliminated in arriving at such costs***.

The cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset. AS-16 Borrowing Costs establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

Exchange of assets

AS-10 specifies that exchange of items of PPE, regardless of whether the assets are similar, are measured at fair value, unless:

1. The exchange transaction lacks commercial substance, or
2. The fair value of neither the asset given up and nor the asset acquired can be measured reliably.

If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

Whether an exchange transaction has commercial substance depends on the extent to which the reporting entity's future cash flows are expected to change as a result of the transaction. If the expected cash flows after the exchange of assets are different from what would have been without the exchange, the exchange has commercial substance and is to be accounted for at fair value.

If the transaction does not have commercial substance, or the fair value of neither the asset received nor the asset given up can be measured reliably, then the asset acquired is valued at the carrying amount of the asset given up less settle-up paid or received in cash or a cash equivalent.

Measurement of cost

The cost of an item of PPE is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash

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price equivalent and the total payment is recognized as interest over the period of credit unless such interest is capitalised in accordance with AS-16.

The cost of an item of PPE held by a lessee under a finance lease is determined in accordance with AS-19.

Cost of Bearer Plants

Bearer plants are accounted for in the same way as self-constructed items of property, plant and equipment before they are in the location and condition necessary to be capable of operating in the manner intended by management. **"Construction"** should be read as covering activities that are necessary to cultivate the bearer plants before they are in the location and condition necessary to be capable of operating in the manner intended by management.

Subsequent costs

- ✓ The issue is whether subsequent expenditure is capital expenditure (i.e., to the Balance Sheet) or revenue expenditure (i.e., profit or loss statement.
- ✓ The cost of the day-to-day servicing of an item PPE is not recognized as cost of PPE. These costs are recognized in statement of profit and loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables and may include the cost of small parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment.
- ✓ To qualify for capitalization, cost must be associated with incremental benefit for example, modification to the asset made to extend its useful life or to increase its capacity would be capitalised. Similarly, if the expenditure results in an improve quality of output or results in saving the cost it will qualify for capitalization.

Part replacement

- Some items (e.g. aircraft, ships, gas, turbine etc.) are series of linked parts which require regular replacement at different intervals and so have different useful lives.
- The cost of such regular replacement is capitalised, if the recognition criteria are met.
- The carrying amount of replaced parts (old parts) is derecognized (i.e., treated as a disposal)

Major inspection/ overhaul costs

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- Performing regular major inspections for faults, regardless of whether parts of the item are replaced, may be a condition of continuing to operate an item of PPE (e.g. an aircraft).
- The cost of each major inspection performed is recognized in the carrying amount (capitalised), as a replacement, if the recognition criteria are satisfied.
- Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognized.

Subsequent Measurement

An entity may choose between the cost model and the revaluation model for subsequent measurement of items of PPE. However, the same policy must be applied to entire class of PPE.

The following are examples of separate classes of PPE:

- ✓ Land.
- ✓ Land and buildings.
- ✓ Machinery.
- ✓ Ships.
- ✓ Aircraft.
- ✓ Motor vehicles.
- ✓ Furniture and fixtures.
- ✓ Office equipment; and
- ✓ Bearer plants.

Cost Model

An item of PPE is carried at cost less any accumulated depreciation and any accumulated impairment losses.

Revaluation Model

At item of PPE is carried at a revalued amount, being fair value at the date of the revaluation less any subsequent accumulated depreciation and any accumulated impairment losses. An enterprise should apply this model only if fair value can be measured reliably.

How is fair value determined?

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The fair value of items of property, plant and equipment is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified values.

If there is no market-based evidence of fair value (e.g. because items are of a specialized nature or rarely sold), fair value is estimated using depreciated replacement cost; or an income approach (based on discounted future cash flows).

What is the frequency of revaluation?

- Revaluations should be made with enough regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.
- Frequency depends on movements in fair values. When fair value differs materially from carrying amount, a further revaluation is necessary.
- Items within a class may be revalued on a rolling basis within short period of time provided revaluations are kept up to date.

At the date of revaluation, the asset is treated in one of the following ways:

- Gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset

E.g. The PPE is recorded at cost of Rs. 1000 and has an accumulated depreciation of Rs. 400 on the date of revaluation. The PPE is considered to have a fair value of Rs. 1,500 on the date of revaluation. *In this case the revaluation gain is Rs. 900 which is proportionately adjusted against gross carrying amount and depreciation.*

If Rs. 600 (net carrying amount on date of revaluation) is to be restated as 1,500 then the gross carrying amount becomes Rs.1,500/600 X 1000 = Rs. 2,500. The accumulated depreciation is shown at Rs. 1,000 so that the net carrying amount after revaluation becomes Rs. 1,500

- Accumulated depreciation is eliminated against gross carrying amount of the asset.

In the above example, the revaluation gain of Rs. 900 would be first adjusted against accumulated depreciation. The accumulated depreciation of Rs. 400

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will be shown at Nil. The balance of Rs. 500 will be added to gross carrying amount. The gross carrying amount would be shown at Rs. 1,500.

Increase/decrease due to revaluation

On an asset by asset basis:

- Increase should be credited directly to owners' interests under the heading of **Revaluation Surplus** in the Balance Sheet. However, a revaluation increase must be recognized in profit and loss to the extent that it reverses a revaluation decrease of the asset that was previously recognized as an expense.
- Decrease should be recognized as an expense in profit and loss. However, a revaluation decrease must be charged directly against any related revaluation surplus, to the extent that it is covered by that surplus.
- The revaluation surplus may be transferred directly to retained earnings when the surplus is realized (e.g., on disposal of the asset or during the asset's remaining useful life)

Changes in existing Decommissioning, Restoration and Other Liabilities

The cost of property, plant and equipment may undergo changes subsequent to its acquisition or construction on account of:

- Changes in liabilities
- Price adjustments,
- Changes in duties,
- Changes in initial estimates of amounts provided for dismantling, removing, restoration and similar factors and included in the cost of asset.

If the related asset is measured using the cost model:

- Changes in the liability should be added to, or deducted from, the cost of the related asset in the current period.
- The amount deducted from the cost of the asset cannot exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess should be recognized immediately in the statement of profit and loss.
- If the adjustment results in an addition to the cost of an asset, the enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with AS 28

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If the related asset is measured using the revaluation model:

Changes in the liability alter the revaluation surplus or deficit previously recognized on that asset.

(a) Any decrease in liability is credited to Revaluation Surplus. However, if a revaluation deficit was recognized earlier, the decrease in liability will be credited to profit and loss account.
(b) An increase in the liability should be debited in statement of profit and loss. If revaluation surplus exists on that asset it should be debited to revaluation surplus to the extent of upward revaluation earlier.

If a decrease in the liability exceeds the carrying amount that would have been recognized had the asset been carried under the cost model, the excess should be recognized immediately in the statement of profit and loss.

Depreciation

- Depreciable amount should be allocated on a systematic basis over useful life.
- Useful life and residual value must be reviewed at least at each financial year end. If expectations differ from previous estimates the changes are to be accounted for as a change in an accounting estimate. In accordance with AS-5 “Net profit or loss for the period, Prior Period Items and Changes in Accounting Policies" (i.e., adjusting depreciation charge for current and future periods).
- Depreciation method should reflect the pattern in which the asset's economic benefits are consumed.
- Depreciation charge for each period should be recognized as an expense unless it is included in the carrying amount of another asset.
- AS-10 does not specify a method to be used.

AS-10 requires that each part of an item of PPE that has a cost that is significant when compared to the total cost of the item should be depreciated separately:

- For example, it may be appropriate to depreciate separately airframe and engines of an aircraft.
- Where one significant part has a useful life and a depreciation method that is the same as those of another part of the same item of PPE, the two parts may be grouped together for depreciation purpose.
- Standard allows separate depreciation on remaining parts that are not significant individually in terms of their cost compared to the total cost of an item.

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Depreciable amount

The Depreciable amount of an Asset shall be allocated on a systematic basis over its useful life.

Factors to be considered:

- Expected usage assessed by reference to expected capacity or physical output.
- Expected physical wear and tear (depends on operational factors e.g. number of shifts, repair and maintenance programme, etc.)
- Technical obsolescence arising from changes or improvements in production; or changes in market demand for product or service output.
- Legal or similar limits on the use (e.g., expiry dates of related leases).
- Repair and maintenance policies may also affect useful life (e.g., by extending it or increasing residual value) but do not negate the need for depreciation.

Residual value

The residual value of an asset is the estimated amount that an enterprise would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. In other words, it is value which would be obtained presently assuming the asset at end of life would be sold today.

Depreciable amount is net of residual value. Residual value is often insignificant and immaterial to the calculation of the depreciable amount.

Depreciation is always recognized, even if fair value exceeds carrying amount, except when residual value is greater than carrying amount (in which case the depreciation charge is zero).

Depreciation period

- Depreciation commences when an asset is available for use.
- Depreciation ceases at the earlier of the date the asset is:
  - retired from active use
  - held for disposal
- Depreciation does not cease when an asset is idle or retired from use for sale (unless it is fully depreciated). However, depreciation may be zero under the “units of production method”.

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Land and buildings

- These are separable assets and are separately accounted for, even when they are acquired together:
- Land normally has an unlimited useful life and is therefore not depreciated. Buildings normally have a limited useful life and are depreciable asset.
- Where land has a limited useful life (e.g., a landfill site, mine, quarry) it is depreciated.

Depreciation methods

Straight line - a constant charge over useful life

Diminishing balance - a decreasing charge over useful life

Sum of the units - charge based on expected use or output.

Review of depreciation method –

The depreciation method is reviewed periodically and, if significant, the method is changed to reflect a change in pattern of consumption of future benefits. A change in method of depreciation is accounted for as a change in accounting estimate according to AS-5.

The depreciation method should also be reviewed at least of each financial year end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits from those assets, the method should be changed to suit this changed pattern. When such a change in depreciation takes place, the change should be accounted for as a change in accounting estimate and the depreciation charge for the current and future periods should be adjusted.

Depreciation as per Schedule II of the Companies Act, 2013 and Guidance Note thereon:

- As per Schedule II of the Companies Act, 2013, depreciation to be charged based on useful life of asset. Revised AS-10, Property, Plant and Equipment (PPE) also prescribe the same principle of useful life.
- The Schedule II prescribes that the useful life of an asset shall not ordinarily be different from the useful life specified in the Schedule and the residual value of an asset shall not be more than 5% of the original cost of the asset.
- Where a company adopts a useful life different from what is specified in the Schedule or uses a residual value different from the limit specified above, the

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financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice.

Component Accounting

- As per note 4 Schedule II to the Companies Act, 2013 - “Useful life specified in Part C of the Schedule is for whole of the asset.
- Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.
- The above requirement is commonly known as 'component accounting’. Companies will need to identify and depreciate significant components with different useful lives separately. The revised AS-10, Property, Plant and Equipment (PPE) also prescribe the component accounting.
- The determination as to whether a part of an asset is significant requires a careful assessment of the facts and circumstances. This assessment would include at a minimum:

    - comparison of the cost allocated to the item to the total cost of the aggregated property, plant and equipment; and
    - Consideration of potential impact of componentization on the depreciation expense.

  Component accounting requires a company to identify and depreciate significant components with different useful lives separately. The application of component accounting is likely to cause significant change in the measurement of depreciation.

  As component accounting was hitherto not mandatory in India, it is possible that the separate cost of each significant component of an asset is not available in the books of account. In order to determine the cost of such component following criteria can be used:

  1. Break up cost provided by the vendor
  2. Cost break up given by internal/external technical expert
  3. Current replacement cost of component of the related asset and applying the same basis on the historical cost of asset

  The first step is to identify key components requiring separate depreciation. Schedule II requires separate depreciation only for parts of an item of tangible fixed asset having:

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- Significant cost, and
- Different useful lives from remaining parts of the asset.

The company must split the fixed asset into various identifiable parts to the extent possible. The identified parts should be grouped together if they have the same or similar useful life for the purpose of separate depreciation. Insignificant parts may be combined in the remainder of the asset or with the principal asset.

For instance:

(a) A Building may be split up into the following components:

- Structural design
- Elevators
- Heating system
- Water system
- Electrical system

(b) A Ship may be bifurcated into the following components:

- Hull
- Kee
- Engine
- Navigation system
- Major overhaul/inspections
- Other fit out assets

Identification of significant parts is a matter of judgment and decided on case-to- case basis. Identification of separate parts of an asset and determination of their useful life is not merely an accounting exercise; rather, it involves technical expertise. Hence, it may be necessary to involve technical experts to determine the parts of an asset.

A company needs to identify only material/significant components separately for depreciation. Materiality is a matter of judgment and needs to be decided on the facts of each case. For example, a component having original cost equal to or less than 5% of the original cost of an asset may not be material. Similarly, a component having original cost equal to 25% or more of the original cost of complete asset may be material. The Company may consider 10% of original cost of the asset as a threshold to determine whether a component is material /significant.

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In addition, a company also needs to consider impact on retained earnings, current year profit or loss and future profit or loss (say, when part will be replaced) to decide materiality. If a component may have material impact from either perspective, the said component will be material and require separate identification.

Each significant component of the asset having useful life, which is different from the useful life of the remaining asset, should be depreciated separately. If the useful life of the component is lower than the useful life of the principal asset as per Schedule II, such lower useful should be used. On the other hand, if the useful life of the component is higher than the useful life of the principal asset as per Schedule II, the company has a choice of using either the higher or lower useful life. However, higher useful life for a component can be used only when management intends to use the component even after expiry of useful life for the principal asset.

To illustrate, assume that the useful life of an asset as envisaged under the Schedule II is 10 years. The management has also estimated that the useful life of the principal asset is 10 years. If a component of the asset has useful life of 8 years, AS-10 requires the company to depreciate the component using 8 year life only.

However, if the component has 12-year life, the company may depreciate the component using either 10-year life as prescribed in the Schedule I

Impairment

- ✓ to determine whether an item of PPE is impaired an entity applies AS-28, Impairment of Assets.
- ✓ Impairment losses are accounted for accordance with AS-28.
- ✓ In certain circumstances a third party will compensate an entity for an impairment loss. For example, insurance for fire damage or compensation for compulsory purchase of land for a motorway. Such compensation must be included in profit or loss when it becomes receivable.
- ✓ Recognizing the compensation as deferred income or deducting it from the impairment loss or from the cost of a new asset is not appropriate.

De-recognition: Accounting treatment

- In Balance Sheet: Eliminate on disposal or when no future economic benefits are expected from use (“retirement”) or disposal.

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- Statement of Profit and Loss: Recognize gain or loss (difference between estimated net disposal proceeds and carrying amount) in profit or loss unless a sale and leaseback (AS-19).

- Gains are not classified as revenue.

De-recognition date

The revenue recognition principle in AS - 9 Revenue Recognition, for sales of goods applies also to sales of items of PPE only to determine the date of sale.

Disclosure

For each class

- Measurement bases used for determining gross carrying amount.
- Depreciation method used.
- Useful lives or the depreciation rates used.
- Gross carrying amount and accumulated depreciation at beginning and end of period. Accumulated impairment losses are aggregated with accumulated depreciation.
- A reconciliation of carrying amount at beginning and end of period showing:
  - Additions (i.e., capital expenditure).
  - Assets retired from active use and classified as held for sale and other disposals.
  - Acquisitions through business combinations.
  - Increase/decrease resulting from revaluations.
  - Impairment losses (i.e., reductions in carrying amount).
  - Reversal of impairment losses.
  - Depreciation.
  - Net exchange differences arising on translation of functional currency into reporting currency.
  - Other movements, in case of translation of a foreign operation.
  - Others

Other Disclosures

- Existence and amounts of restrictions on title, and PPE pledged as security
- Expenditures on account of PPE in course of construction.
- Contractual commitment for the acquisition of PPE.

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- Compensation from third parties for items impaired, lost or given up that is included in profit or loss, if not disclosed separately in the statement of Profit and Loss.

Items stated at revalued amounts

- Effective date of revaluation.
- Whether an independent value was involved.
- Methods and significant assumptions applied to estimate fair values.
- The extent to which fair values were
  - determined directly (i.e., by reference to observable prices in an active market or recent market transactions on arm's length terms) or
  - Estimated using other valuation techniques. For example, indices may be used to determine replacement cost.
- Carrying amount of each class of PPE that would have been included in the financial statements had the assets been carried under the cost model.
- Revaluation surplus, indicating movement for period and any restrictions on distribution of balance to shareholders.

Disclosure encouraged

- Carrying amount of temporarily idle PPE.
- Gross carrying amount of any fully depreciated PPE that is still in use.
- Carrying amount of PPE retired from active use and not classified as held for sale.
- When the cost model is used, the fair value of PPE when this is materially different from the carrying amount.

Transitional Provisions

- Where an entity has in past recognized expenditure in the statement of profit and loss which is eligible to be included as a part of the cost of a project for construction of property, plant and equipment in accordance with AS-10 (Revised), it may do so retrospectively for such a project. The effect of such retrospective application of this requirement should be recognized net-of-tax in revenue reserves.
- The requirements regarding the initial measurement of an item of PPE acquired in an exchange of assets transaction should be applied prospectively only to transactions entered into after this Standard becomes mandatory.
- On the date of this Standard becoming mandatory, the spare parts, which hitherto were being treated as inventory under AS-2, Valuation of Inventories, and are now required to be capitalised in accordance with the requirements of this Standard, should be capitalised at their respective carrying amounts. The spare parts so

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capitalised should be depreciated over their remaining useful lives prospectively as per the requirements of this Standard.

- The requirements regarding the revaluation model should be applied prospectively. In case, on the date of this Standard becoming mandatory, an enterprise does not adopt the revaluation model as its accounting policy but the carrying amount of item(s) of PPE reflects any previous revaluation it should adjust the amount outstanding in the revaluation reserve against the carrying amount of that item. However, the carrying amount of that item should never be less than residual value. Any excess of the amount outstanding as revaluation reserve over the carrying amount of that item should be adjusted in revenue reserves.

Illustrations

Illustration 1

Entity A, a supermarket chain, is renovating one of its major stores. The store will have more available space for in store promotion outlets after the renovation and will include a restaurant. Management is preparing the budgets for the year after the store reopens, which include the cost of re-modelling and the expectation of a 15% increase in sales resulting from the store renovations, which will attract new customers. State whether the re-modelling cost will be capitalized or not.

Solution

The cost of an item of PPE should be recognized as an asset if, and only if:

(a) It is probable that future economic benefits associated with the item will flow to the enterprise, and

(b) The cost of the item can be measured reliably.

The expenditure in re-modelling the store will create future economic benefits (in the form of 15% of increase in sales) and the cost of re-modelling can be measured reliably, therefore, it should be capitalized.

Illustration 2

What happens if the cost of the previous part / inspection was / was not identified in the transaction in which the item was acquired / constructed?

Solution

When each major inspection is performed, its cost is recognized in the carrying amount of the item of PPE as a replacement, if the recognition criteria are satisfied. Any

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remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognized.

De-recognition of the carrying amount occurs regardless of whether the cost of the previous part/inspection was identified in the transaction in which the item was acquired or constructed.

Illustration 3

Entity A has an existing freehold factory property, which it intends to knock down and redevelop. During the redevelopment period the company will move its production facilities to another (temporary) site. The following incremental costs will be incurred –

1. Setup costs of Rs.5,00,000 to install machinery in the new location.
2. Rent of Rs.15,00,000
3. Removal costs of Rs.3,00,000 to transport the machinery from the old location to the temporary location.

Can these costs be capitalized into the cost of the new building?

Solution

Any costs directly attributable to bringing the asset to the 'location and condition' necessary for it to be capable of operating in the manner intended by management.

The costs to be incurred by the company are in the nature of costs of relocating or reorganizing operations of the company and are not necessary for bring the asset to the location and condition as intended by management. The costs to be incurred by the company are in the nature of costs of relocating or reorganizing operations of the company and do not meet the requirement of AS 10 (Revised) and therefore, cannot be capitalized.

Illustration 4

Entity A, which operates a major chain of supermarkets, has acquired a new store location. The new location requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the supermarket will be closed. Management has prepared the budget for this period including expenditure related to construction and re-modelling costs, salaries of staff who will be preparing the store before its opening and related utilities costs. What will be the treatment of such expenditures?

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Solution

Management should capitalise the costs of construction and remodelling the supermarket, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management. The supermarket cannot be opened without incurring the remodelling expenditure, and thus the expenditure should be considered part of the asset.

However, if the cost of salaries, utilities and storage of goods are in the nature of operating expenditure that would be incurred if the supermarket was open, then these costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

Illustration 5

An amusement park has a 'soft' opening to the public, to trial run its attractions. Tickets are sold at a 50% discount during this period and the operating capacity is 80%. The official opening day of the amusement park is three months later. Management claims that the soft opening is a trial run necessary for the amusement park to be in the condition capable of operating in the intended manner. Accordingly, the net operating costs incurred should be capitalized. Comment.

Solution

Any costs directly attributable to bringing the asset to the 'location and condition' necessary for it to be capable of operating in the manner intended by management should be capitalised. Costs incurred after the asset is ready to use are not capitalised.

Even though it is running at less than full operating capacity (in this case 80% of operating capacity), there is sufficient evidence that the amusement park is capable of operating in the manner intended by management. Therefore, these costs are should be expensed as incurred.

Illustration 6

Entity A exchanges surplus land with a book value of Rs.10,00,000 for cash of Rs.20,00,000 and plant and machinery valued at Rs.25,00,000. What will be the measurement cost of the assets received?

Solution

When Property, Plant & Equipment is acquired in exchange of another asset and the transaction has a commercial substance, the PPE acquired is measured at fair value.

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The plant and machinery acquired in this case will be measured at Rs. 25,00,000.

**The value of land realized in this case is Rs. 45,00,000 [Plant and Machinery Rs. 25,00,000 and Cash Rs. 20,00,000]*

Illustration 7

Entity A exchanges car X with a book value of Rs.13,00,000 and a fair value of Rs.13,25,000 for cash of Rs.15,000 and car Y which has a fair value of Rs.13,10,000. The transaction lacks commercial substance as the company's cash flows are not expected to change as a result of the exchange. It is in the same position as it was before the transaction. What will be the measurement cost of the assets received?

Solution

When Property, Plant & Equipment is acquired in exchange of another asset and the transaction has a commercial substance, the PPE acquired is measured at fair value. If the transaction lacks commercial substance, the acquired items are measured at book value of assets given up.

Book Value of Car X – Rs. 13,00,000

Less: Cash Received- Rs. 15,000

Value of Car Y = Rs. 12,85,000

Illustration 8

Entity A is a large manufacturing group. It owns a number of industrial buildings, such as factories and warehouses and office buildings in several capital cities. The industrial buildings are located in industry special zones, whereas the office buildings are in central business districts of the cities. Entity A's management want to apply the revaluation model as per AS 10 (Revised) to the subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings. State whether this is acceptable under AS 10 (Revised) or not with reasons?

Solution

A company can choose to apply cost model or revaluation model to measure PPE and must apply a single policy to a class of PPE. A class of PPE is a grouping of assets of a similar nature and use in operations of an enterprise.

The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location.AS 10 (Revised) permits assets to be revalued on a class by class basis.

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The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can, therefore, be applied to these classes for subsequent measurement. Hence, Entity A's management can apply the revaluation model only to the office buildings.

However, all properties within the class of office buildings must be carried at revalued amount.

Illustration 9

Entity A has a policy of not providing for depreciation on PPE capitalized in the year until the following year but provides for a full year's depreciation in the year of disposal of an asset. Is this acceptable?

Solution

The depreciable amount of a tangible fixed asset should be allocated on a systematic basis over its useful life. The depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

Useful life means the period over which the asset is expected to be available for use by the entity. Depreciation should commence as soon as the asset is acquired and is available for use. Thus, the policy of Entity A is not acceptable.

Illustration 10

Entity A purchased an asset on 1st January 2013 for Rs.1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil. On 1st January 2017, the directors review the estimated life and decide that the asset will probably be useful for a further 4 years. Calculate the amount of depreciation for each year, if company charges depreciation on Straight Line basis.

Solution

Particulars	Amount in Rs
Depreciation for years 1-4	Rs.10000 x 4 = Rs.40,000
WDV at beginning of year 5	Rs.1,00,000- Rs.40,000 = Rs.60,000
Balance useful life	4 years
Depreciation for balance useful life	Rs.60,000 / 4 = Rs.15,000 per year

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Illustration 11

Entity B constructs a machine for its own use. Construction is completed on 1st November 2016, but the company does not begin using the machine until 1st March 2017. Comment when should the entity start charging depreciation.

Solution

The entity should begin charging depreciation from the date the machine is ready for use - that is, 1st November 2016.The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.

Illustration 12

A property costing Rs.10,00,000 is bought in 2016. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years. The estimated residual value in 20 years' time, based on 2016 prices, is:

Case (a) Rs.10,00,000 Case (b) Rs.9,00,000.

Calculate the amount of depreciation.

Solution

Case A	
Cost of Property	Rs. 10,00,000
Less: Estimated Salvage Value	Rs. 10,00,000
Depreciable Amount	Nil
Depreciation	Nil
Case B	
Cost of Property	Rs. 10,00,000
Less: Estimated Salvage Value	Rs. 9,00,000
Depreciable Amount	Rs. 1,00,000
Useful Life	20 Years
Depreciation	Rs. 1,00,000 / 20

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	= Rs. 5,000

Illustration 13

Entity A carried plant and machinery in its books at Rs.2,00,000. These were destroyed in a fire. The assets were insured 'New for old' and were replaced by the insurance company with new machines that cost Rs.20,00,000. The machines were acquired by the insurance company and the company did not receive the Rs.20,00,000 as cash compensation. State, how Entity A should account for the same.

Solution

Entity A should account for a loss in the Statement of Profit and Loss on de-recognition of the carrying value of plant and machinery in accordance with AS 10 (Revised).

Entity A should separately recognize a receivable and a gain in the income statement resulting from the insurance proceeds under AS 29 (Revised) once receipt is virtually certain. The receivable should be measured at the fair value of assets that will be provided by the insurer.

Particulars	Debit	Credit
Profit & Loss Account Dr. To Plant & Machinery Account (Being loss on account of fire)	2,00,000	 2,00,000
Insurance Company Account Dr. To Profit & Loss Account (Being claim settlement by insurance company)	20,00,000	 20,00,000
Plant & Machinery Account Dr To Insurance Company Account (Being plant received from insurance company)	20,00,000	 20,00,000

Illustration 14

ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

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#	Particulars	Amount(Rs.)
1	**Cost of the plant (cost per supplier's invoice plus taxes)**	25,00,000
2	**Initial delivery and handling costs**	2,00,000
3	**Cost of site preparation**	6,00,000
4	**Consultants used for advice on the acquisition of the plant**	7,00,000
5	**Interest charges paid to supplier of plant for deferred credit**	2,00,000
6	**Present Value Estimated dismantling costs to be incurred after 7 years**	3,00,000
7	**Operating losses before commercial production**	4,00,000

Please advise ABC Ltd. on the costs that can be capitalized in accordance with AS 10 (Revised).

Solution

According to AS-10 (Revised), the cost of an item of property, plant & equipment comprises its purchase price, all taxes (other than those refundable or eligible as input tax credit) and any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. The initial estimates of dismantling costs must be capitalized at their present values. Initial operating losses do not form part of cost of property, plant and equipment.

S.No.	Particulars	Capitalization	Amt (Rs.)
1	Cost of the plant (cost per supplier's invoice plus taxes)	**Yes**	25,00,000
2	Initial delivery and handling costs	**Yes**	2,00,000
3	Cost of site preparation	**Yes**	6,00,000

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4	Consultants used for advice on the acquisition of the plant	**Yes**	7,00,000
5	Present Value Estimated dismantling costs to be incurred after 7 years	**Yes**	3,00,000
	Total Cost to be capitalized		43,00,000

Interest charges paid to suppliers will not be capitalized unless the asset is a qualifying asset as defined by AS-16.

Illustration 15

A Ltd. has an item of plant with an initial cost of Rs.1,00,000. At the date of revaluation, accumulated depreciation amounted to Rs.55,000. The fair value of the asset, by reference to transactions in similar assets, is assessed to be Rs. 65,000. Pass Journal Entries with regard to Revaluation.

Particulars	**Debit Amount**	**Credit Amount**
Accumulated depreciation A/c **Dr.** **To Asset A/c** (Being elimination of accumulated depreciation against the cost of the asset)	55,000	 55,000
Asset A/c **Dr.** **To Revaluation Surplus A/c** (Being increase of net asset value to Fair value)	20,000	 20,000

Illustration 16

B Ltd. owns an asset with an original cost of Rs. 2,00,000. On acquisition, management determined that the useful life was 10 years and the residual value would be Rs 20,000. The asset is now 8 years old, and during this time there have been no revisions to the assessed residual value.
At the end of year 8, management has reviewed the useful life and residual value and

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has determined that the useful life can be extended to 12 years in view of the maintenance program adopted by the company. As a result, the residual value will reduce to Rs.10,000.
How would the above changes in estimates be made by B Ltd?

Solution

Particulars	Workings	Amount (Rs.)
Depreciable amount	2,00,000 - 20,000	1,80,000
Annual Depreciation Amount	$\frac{1,80,000}{10}$	18,000
Total Deprecation Debited	18,000 x 8	1,44,000
Carrying Amount of Asset at end of 8 Years	2,00,000 - 1,44,000	56,000

Asset can be used for 4 more years.

Revised Depreciation $= \frac{56,000 - 10,000}{4}$

$=11,500$

Illustration 17

An entity bought a plot of land for development of office buildings. Development of the land was scheduled into six phases. The land scheduled for development in phases five and six was leased to another entity on a short-term basis as a parking lot for heavy vehicles.
What is the treatment of rental income from car parking lot?

Solution

Some operations occur in connection with the construction or development of an item of PPE but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management.

In the given case the land scheduled for development was leased on a short-term basis as a parking lot for heavy vehicles. The car park activity is incidental to the entity`s principal activity of property development. The income and related expenses of incidental operations are recognized in the Statement of Profit and Loss for the period.

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Illustration 18

An entity acquires the right to use an underground cave for gas storage purposes for a period of 50 years. The cave is filled with gas, but a substantial part of that gas will only be used to keep the cave under pressure in order to be able to get gas out of the cave. It is not possible to distinguish the gas that will be used to keep the cave under pressure and the rest of the gas. Evaluate whether AS 10 would apply or AS 2.

Solution

The total volume of gas must be virtually split into

(i) Gas held for sale, and

(ii) Gas held to keep the cave under pressure.

> The former must be accounted for under AS 2 as Inventories. The latter must be accounted for as PPE under AS 10 and depreciated over the period the cave is expected to be used.

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