PAPER – 6

FINANCIAL ACCOUNTING

CMA INTERMEDIATE

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What Our Students have to Say....

Aman Mahajan (CA AIR 19)

I really liked your classes, especially the practical linkages explained with amazing graphics. The full subject test serieshelped a lot in improving my writing speed and presentation skills.

Sundar Sri Renganathan B (AIR 33)

I took Accounting from IndigoLearn and the classes were really good. They emphasized on conceptual clarity over getting things done quickly, which is really vital to score good marks in practical papers. Other resources like Notes, Quizzes and Forum was beneficial too.

Dwarakesh

Thank you IndigoLearn team for the guidance and support throughout the past few months. I had great conceptual clarity in all the subjects and the revision classes by Suraj Sir were very helpful. Study planner and Free resources were very useful. Thank you Team IndigoLearn.

Yug Manoj Kumar Bhattad

I have cleared my CA Foundation examination with the total of 286. And this was not possible without the efforts and support of IndigoLearn. The way of teaching with utmost conceptual clarity is the best thing at Indigolearn.

Prakash Bhatt

Superb, one stop solution for All CA and Accountancy students they serve real Education at very very reasonable price

Naveen Kumar S

Good experience, unlimited views helped a lot in last one month preparation. Looking forward for

Bhagyasree Chougule

It was only because of Indigolearn that my concepts became very clear, and I was able to crack the exam. I wasn't 100% prepared I needed more practice but luckily I got through. I'm definitely choosing IndigoLearn for group 2 preparation. A big thanks!

Mohd Thayyab

Theoretical subjects made easier through story based examples and charts. Concept clarity 100%. Fully exam+practical oriented classes will help not only to retain the concepts during exams but for the longer duration.

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Indigolearn has been fantastic and brilliant. Helped me alot in my preparations. I cleared both the groups in first attempt with your brilliant classes and notes. Thanks to all the faculties, coordinators, forum admins and everyone at Indigolearn. Really grateful. Will go for CA Finals at Indigolearn For sure. Thank you so much Indigolearn.

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Abishek M

I'd like to thank IndigoLearn for all the support they've provided me with. Modules were great. They were time saving and straight to the point. I extensively used the materials provided before exams, they were so helpful. Also I'd appreciate them for providing unlimited views as I kept looking into the maths modules till the end.

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Harshita G

Thank u so much IndigoLearn for your guidance. This is only possible because of u people.... For my finals also my journey will continue with IndigoLearn.

Bharathsha PS

I purchased Economics, IT, FM, EIS and Audit from Indigolearn. All your classes are superb and anyone can easily crack the CA exams. What makes u special is your classes help us to understand the concepts very well.Special thanks to the FM faculty, I studied only 2 chapters in economics,and still managed to score excemption in the 8th paper.

Nayi Mihir kumar

This platform is very helpful in all activity like mcq practise, notes, teaching activities, revisions and the forum interaction with all students which I like the most. If anybody want to clear their exams in first attempt then IndigoLearn is the best platform for them. My all regards to IndigoLearn. Thank you so much.

Rajalaxmi
CA Inter

Can't believe I cleared.Sathya Sir, Suraj Sir, Yogita Mam ... thanks to all my faculties. Basically an Eng student with zero accounts knowledge. Thanks IndigoLearn for making me clear in first attempt.

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Naveen Kumar T

It been a great journey with indigo learn team. Thanks to all the facilities and forum friends who support me a lot.

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Note – The chapters have been arranged in a different order from the study material to ensure logical sequence and learning.

INDEX

No.	Chapter	Page No.
1	Accounting Fundamentals	1 - 49
2	Basic Accounting Procedures - Journal Entries	50 - 58
3	Ledgers	59 - 60
4	Cash Book	61 - 65
5	Subsidiary Books	66 - 69
6	Trial Balance	70 - 73
7	Bank Reconciliation Statement	74 - 86
8	Accounting for Special Transactions	87 - 118
9	Preparation of Financial Statements of Profit Oriented Organizations	119 - 138
10	Preparation of Financial Statements of Non Profit Organizations	139 - 151
11	Preparation of Statements of Incomplete Records	152 - 183
12	Partnership	184 - 243
13	Branch and Departmental Accounts	244 - 299
14	Insurance Claims for Loss of Stock and Loss of Profit	300 - 323
15	Hire Purchase and Instalment Sale Transactions	324 - 349
16	AS 1 - Disclosure of Accounting Policies	350 - 359
17	AS 10 - Property, Plant & Equipment	360 - 386
18	AS 19 - Leases	387 - 400
19	AS 11 - Foreign Exchange	401 - 412
20	AS 12 - Government Grants	413 - 427
21	AS 16 - Borrowing Cost	428 - 442
22	AS 22 - Accounting for Taxes on Income	443 - 456

Chapter 1 – Accounting Fundamentals
Unit 1 - Theoretical Framework

OBJECTIVES

The lists of topics which will be covered in this chapter are as follows:

1.1 Meaning and Scope of Accounting:

- Meaning and significance of Accounting.

- Difference between Book-Keeping and Accounting.

- Limitations of Accounting.

1.2 Accounting Concepts, Conventions and Principles:

- Understanding various accounting concepts, conventions, principles and assumptions which govern Accounting.

- Characteristics of Financial Statements.

1.3 Capital and Revenue Expenditure and Receipts:

- Capital and Revenue Expenditure

- Capital and Revenue Receipts

1.4 Contingent Assets and Contingent Liabilities:

- Contingent Liabilities

- Contingent Liabilities Vs Liabilities

- Contingent Liabilities Vs Provisions

- Contingent Assets

1.5 Accounting Policies:

- Meaning of Accounting Policies

- Selection of Accounting Policies

- Changes in Accounting Policies

1.6 Valuation Principles and Accounting Estimates:

- 4 Valuation Principles

- Accounting Estimates

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1.7 Accounting Standards:

- What are Accounting Standards

- Benefits and Limitations of Accounting Standards

1.8 Indian Accounting Standards:

- Need for Convergence towards Global Standards

- International Financial Reporting Standards

- Benefits of Convergence with IFRS

- Indian Accounting Standards (Indian AS)

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.

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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.

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.

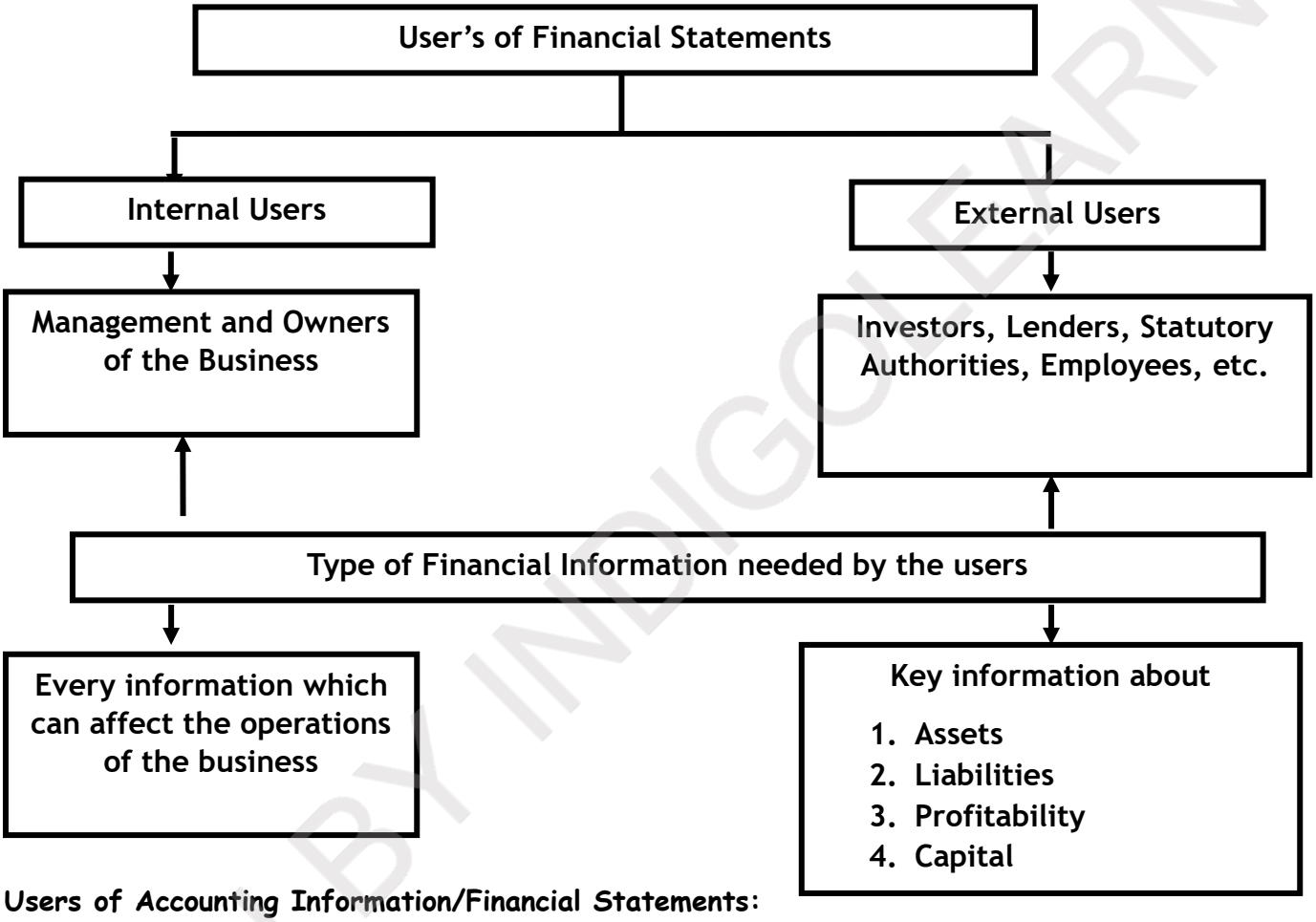
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The Financial Statements are communicated through the distribution of annual accounting reports, mandatory fillings with the various statutory authorities.

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:



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.

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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.

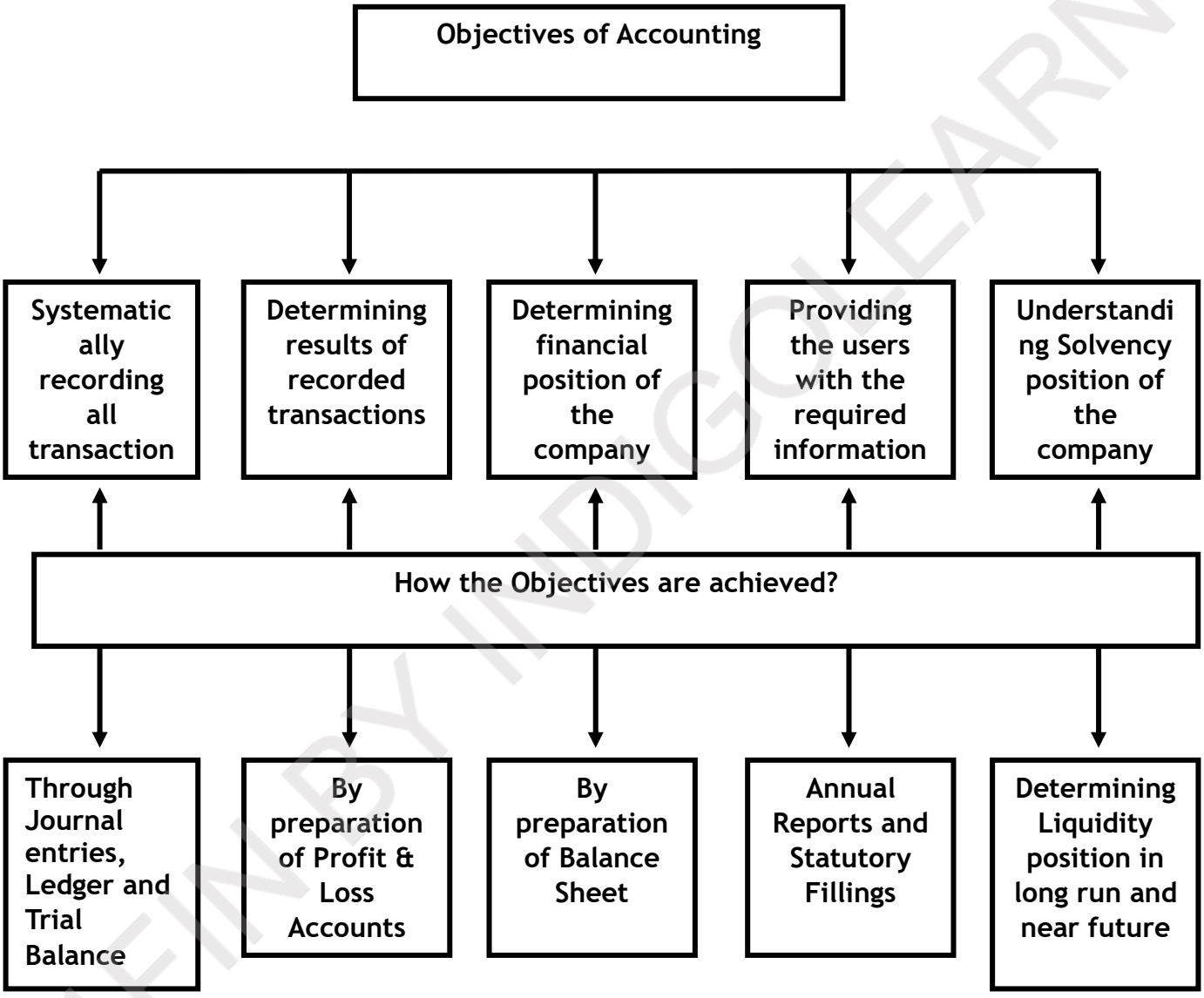
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6. **Statutory Authorities:**

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.

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:



Book-Keeping:

Book-Keeping can be stated as the process/activity to record the various transactions entered by the entity in a systematic and timely manner.

By properly recording all the transactions in an orderly manner, organizations can prepare the Financial Statements which are true and correct and useful to their users.

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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.

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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.

Relationship of Accounting with other disciplines:

i. **Accounting and Economics:**

Accounting	Economics
• It is viewed as a system, which provides data to the users to permit informed judgement and decisions. • Non-accounting data are also relevant for decision-making	It is viewed as a science of rational decision-making about the use of scarce resources.
Contributed a lot improving the management decision-making process.	economic theories influenced the development of the decision-making tools used in accounting.

At the macro-level, accounting provides the database over which the economic decision models have been developed; micro-level data arranged by the accounting system is summed up to get macro-level database.

ii. **Accounting and Statistics:**

Accounting	Statistics
Accounting information is very precise; it is exact to the last paisa	For decision-making purposes such precision is not necessary for which this is used.
All values are important individually because they relate to business transactions.	It is concerned with the typical value, behavior or trend over a period of time or

	the degree of variation over a series of observations.
It records generally take a short-term view of events and are confined to a year	It is more useful if a longer view is taken for the purpose
Several accounting and financial calculations are based on statistical formulae.	Statistical methods are helpful in developing accounting data and in their interpretation.

The functional relations showing mathematical relations of one variable with one or more other variables are based on statistical work.

iii.**Accounting and Mathematics:**

- Knowledge of arithmetic and algebra is a pre-requisite for accounting computations and measurements.
- Accounting data are also presented in ratio form.
- The fundamental accounting equation will be discussed in detail under 'Dual Aspect Concept' of this chapter.
- Since accounting is meant for providing information to the users, to be effective, accounting data should feed the information requirements of such statistical, econometric and operations research models.
- Understanding mathematics has become a must to grasp the decision models framed by statisticians, econometricians and the O.R. experts.

iv.**Accounting and Law:**

- An economic entity operates within a legal environment.
- Transactions and events are always guided by laws of the land. Very often the accounting system to be followed has been prescribed by the law.
- The legal prescription about the accounting system is the product of developments in accounting knowledge.
- Accounting influences law and is also influenced by law.

v.**Accounting and Management**

- Management is a broad occupational field, which comprises many functions and encompasses application of many disciplines.
- Accountants are well placed in the management and play a key role in the management team.
- A large portion of accounting information is prepared for management decision-making.
- So the accounting system can be molded to serve the management purpose.

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:**

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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.

   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.

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Unit-2 Accounting for Concepts, Conventions and principles

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.

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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.

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
   In one Asset, in other Asset.
   In one Asset, in Liability.

   Effect of Changes in Liability

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In one Liability, in other Liability.
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.

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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?

   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?

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Unit-3 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:**
   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.

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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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Unit 4 – Concept and Accounting of 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.
iii. To Ensure Sufficient Funds are available for replacement.
iv. To determine the true cost of production.

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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.

Example on computing the depreciable amount per annum:

For example, a machinery is purchased for Rs.5,00,000. The residual value is estimated at Rs.50,000. It is estimated that the machinery will work for 10 years. The cost to be allocated as depreciation in the accounting periods will be calculated as:

Acquisition Cost Rs.5000
00 Less: Residual Value (Rs.50000)
Depreciable Amount Rs. 450000
(÷)Estimated Useful Life 5 years

Depreciation = Depreciable Amount Rs450000 = Rs.90000/- Per Year
Estimated Useful Life 5 Years

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.

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

1. 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:

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

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

2. 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

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expected to be lower in the later years.

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

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

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

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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**

3. 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:

   (10+9+8+7+6)X (2000000-240000) = 40/55 X 1760000 = 1280000 10(10+1)/2

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.

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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

5. 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.

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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**

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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:

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

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:

Yearly Production

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

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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

1. 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 technicalestimate 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:

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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.

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.

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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.

WDV of the machine at the end of third year = 15,00,000 —

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/-

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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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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.

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.

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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:

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.

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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	
Actual repairs charged/incurred during the year ended 31.03.2016	11,50,000
31.03.2017	7,50,000
	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

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

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Unit-5 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

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.

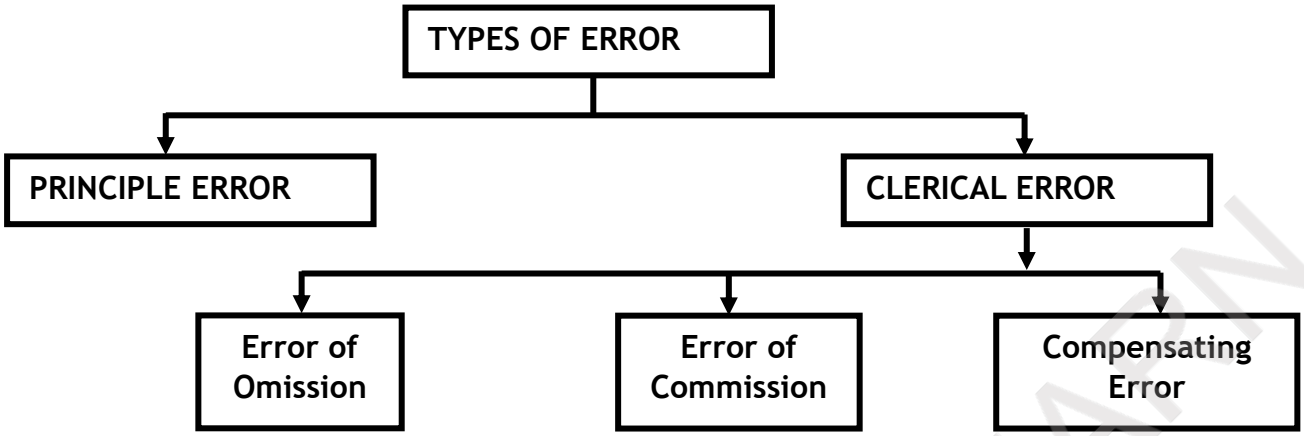
An error can occur at any stage; broadly speaking the error can occur during any of the following stages based on the flow of the process:

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

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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.

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.

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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.

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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.

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**

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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.

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.

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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)				

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Chapter 2 – Accounting Process

Journal Entries

Double Entry System:

The Double Entry System of Accounting is the most commonly used system of Accounting.

According to Double Entry System, Every transaction has two aspects a Debit and a Credit.

For every transaction entered into there will be one or more Debit and one or more Credit and the total of debit will be equal to the total of credit.

Advantages of Double Entry System:

Following are the advantages of Double Entry System due to which it is extensively used in all the countries.

i. The accuracy of the accounting can be established by the preparation of the trial balance.
ii. The result of the operations carried on during a period of time i.e. either profit or loss can be ascertained with details.
iii. The financial position of the organization can be ascertained at the end of each period through the balance sheet.
iv. The accounts can be kept in as much details as required and provides information for the purposes of control etc.
v. Result of one year may be compared with those of previous years and reasons for the change may be easily determined.

Debits and Credits:

Debits and Credits are the 2 sides of same coin. For every debit there will always be an equal and corresponding credit.

The Rules of Debit and Credit can be summarized as follow:

i. Increases in assets = debits & decrease in assets = credits.
ii. Increases in liabilities = credits & decreases in liabilities = debits.
iii. Increases in owner's capital = credits & decreases in owner's capital = debits.
iv. Increases in expenses = debits & decreases in expenses = credits.
v. Increases in revenue or incomes = credits & decreases in revenue or incomes = debits.

There are 2 methods of recording every transaction by under the Double Entry System.

Journal Entry – Traditional Approach:

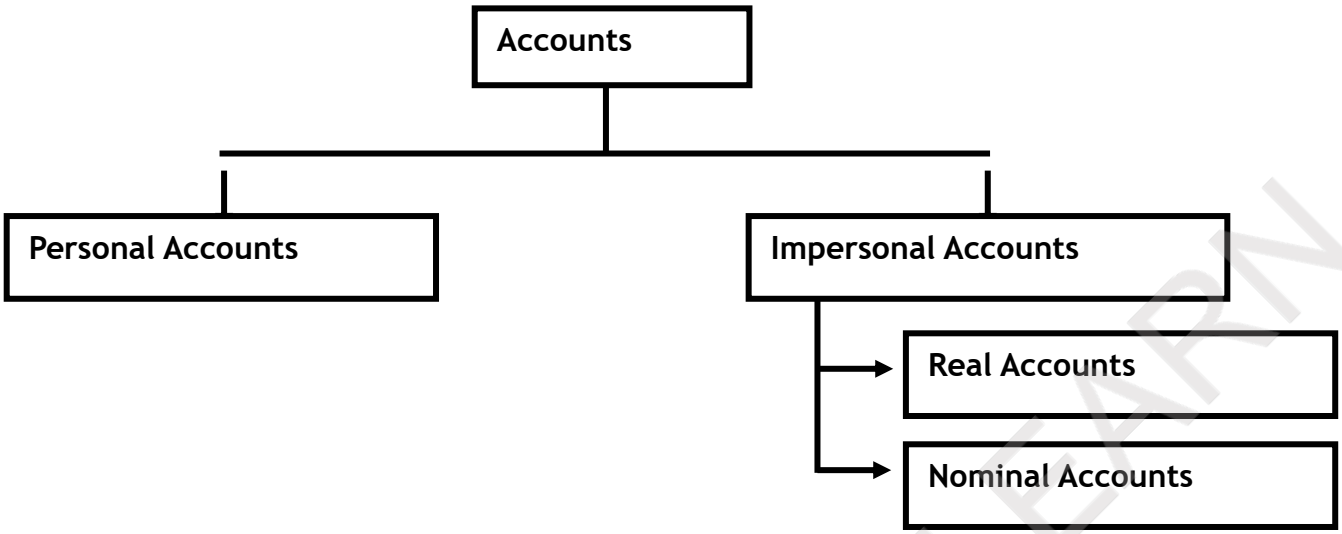
To understand the traditional approach it is important to understand 2 important factors

i. Classification of Accounts.
ii. Golden Rules of Accounting.

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Classification of Accounts:

Classification of Accounts under traditional accounts is based on Personal and Impersonal Accounts.
[GroupDrawing]



Interpretation of the Accounts:

1. **Personal Accounts:**
   These are the accounts which relate to someone who can be identified. All those accounts that have their own identity either as an individual or as a legal establishment such as Mr.A, ABC &Co, etc. are classified as Personal Accounts.

2. **Real Accounts:**
   These are the accounts which represent the assets of the firm either tangible or intangible such as Cash, Bank, Inventory, Trademark, Goodwill, etc.

3. **Nominal Accounts:**
   These are the accounts which are presented in the Profit & Loss account. This includes all the revenues, expenses, gains & Losses. The important feature of the Nominal Accounts is that they are temporary accounts and are written off by the end of the accounting period by transfer to Profit & Loss Account.

Golden Rules of Accounting:

The Golden Rules of Accounting states the rules of debit and credit for every type of accounts. The summary of Golden Rule of Accounting is as follow:

Type of Account	Debit	Credit
Personal Account	When Receiving	When Giving
Real Account	When it comes in	When it Goes out
Nominal Account	All the Expenses and Losses	All Incomes and gains

Example on Journal Entry:

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Prepare the Journal entries for the following transactions:

1. Mr. A Introduced capital of Rs.10.00 lac to start his business.
2. Purchased Machinery worth Rs.2.00 Lac by paying the entire amount.
3. Purchased goods on credit from Mr. B worth Rs. 50 Thousand.
4. Sold goods for Rs. 4.00 Lac to Mr.C and of Rs.1.00 Lac in cash.

The Journal entries for the above transaction are as follow:

Date	Particulars		Debit	Credit
	Bank A/c	Dr.	1,000,000	
	To Mr. A Capital A/c			1,000,000
	(Being capital Introduced by Mr.A)			
	Machinery A/c	Dr.	200,000	
	To Cash/Bank A/c			200,000
	(Being Machinery Purchased)			
	Purchase A/c	Dr.	50,000	
	To Mr.B A/c			50,000
	(Being Goods Purchased on Credit)			
	Mr.C A/c	Dr.	400,000	
	To Sales A/c			400,000
	(Being Goods Sold on Credit to Mr.C)			
	Cash/Bank A/c	Dr.	100,000	
	To Sales A/c			400,000
	(Being cash sales made)			

Accounting Equation – Modern Approach:

The other approach to record the transactions is the Modern Approach of accounting which is based on the Accounting Equation. The relationship among the Assets, Liabilities and Owner's equity can be expressed in terms of an Equation which is known as the "Accounting Equation."

Assets = Liabilities + Owner's Equity

The owner's equity is computed as follow:

Contributed Capital
Add: Beginning Retained Earnings (Opening balance in Profit & Loss)
Add: Profit earned during the period (Revenues – Expenses)
Less: Dividends distributed (Drawings made)

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The Modern classification of accounts can be summarized in the following table:

Account Type	Account shown a Normal Balance in	Debit when the account is to be	Credit when the account is to be
ASSET	Debit	Increase	Decrease
LIBAILITES	Credit	Decrease	Increase
CAPITAL	Credit	Decrease	Increase
REVENUE	Debit	Decrease	Increase
EXPENSES	Credit	Increase	Decrease
DRAWINGS	Debit	Increase	Decrease

Example on Modern Classification of Accounts:

Prepare the Journal entries for the following transactions:

1. Mr. A Introduced capital of Rs.10.00 lac to start his business.
2. Purchased Machinery worth Rs.2.00 Lac by paying the entire amount.
3. Purchased goods on credit from Mr. B worth Rs. 50 Thousand.
4. Sold goods for Rs. 4.00 Lac to Mr.C and of Rs.1.00 Lac in cash.

Date	Transaction	Accounts Involved	Nature of Accounts	Affected	Debit (Rs.)	Credit (Rs.)
		Bank	Asset	Increased	1,000,000	
	Capital introduced in Business	Capital	Capital	Increased		1,000,000
		Machinery	Asset	Increased	200,000	
	Machinery Purchased	Bank	Asset	Decreased		200,000
		Purchases	Expense	Increased	50,000	
	Goods Purchased on Credit	Creditor	Liability	Increased		50,000
		Debtor	Asset	Increased	400,000	
	Sold Goods on Credit	Sales	Revenue	Increased		400,000
		Bank	Asset	Increased	100,000	
	Sold Goods on Cash	Sales	Revenue	Increased		100,000

Accounting for GST

GST is a comprehensive Indirect Tax which has subsumed multiple Indirect Taxes such as Value added Tax (VAT), Excise Duty, Service Tax etc.

GST is a single tax on the supply of goods and services, right from the manufacturer to consumer.

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On introduction of GST, the tax to be levied at all stages right from the manufacture up to final consumption was a single tax-GST, with credit of taxed paid at previous stages available as setoff.

Salient features of GST

a. GST is levied on supply.
b. Tax is levied only the value added at each stage of the supply chain.
c. GST is a destination-based consumption tax.
d. There is no tax on tax or cascading of taxes under GST system.
e. There is a hormonization of laws, procedures and rates of tax across the country.

Types of Taxes under GST

a. Intra-state supply: The location of the supplier and the place of supply of goods or services are in the same state/union territory.

b. Inter-state supply: The location of the supplier and the place of supply of goods or services are in two different states or two different union territories or a state and a union territory.

1. **Central Goods and Service Tax (CGST):** Levied and collected by the centre on the Intra-state supply of goods and services.

2. **State Goods and Service Tax (SGST):** Levied and collected by the state governments on Intra State supply of goods and services.

3. **Union Territory Goods and Service Tax (UTGST):** Levied and collected by Union Territories without legislatures on Intra-state supply of goods and services.

   Union Territories – Andaman and Nicobar Islands, Lakshadweep, Ladakh, Dadra and Nagar Haveli & Daman and Diu and Chandigarh

4. **Integrated Goods and Service Tax (IGST):** Levied on the inter state supply of goods and services and is collected by centre. IGST is equivalent to the sum total of CGST and SGST.

Input and Output GST

Input tax – The tax paid by the recipient on procurement of goods/services.

Entity at each stage is permitted to avail credit of GST paid on the purchase of goods and/or availment of services and can setoff this credit against the GST payable on the goods and/or services supplied by him.

Thus, the final consumer bears the GST charged in the supply chain, with set-off benefits at all the previous stages.

Output tax – The GST charged on supply of goods or services made by the supplier.
Input tax – The credit of Input tax already paid.

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Utilisation of Input Tax Credit under GST

Tax credit of CGST, SGST and IGST can be utilized in the following manner:

Utilization of IGST credit:

a. First utilized against IGST liability
b. If any balance is still available – Utilized against CGST or/and SGST in any order and in any proportion

Utilization of CGST credit:

a. First utilized against CGST liability
b. If any balance available – Same can be utilized against IGST.
c. CGST credit cannot be utilized against SGST.

Utilisation of SGST credit

a. First utilized against SGST liability.
b. If any balance available – Same can be utilized against IGST.
c. SGST credit cannot be utilized against CGST.

	Input GST	**Output GST**
Nature	At the time of purchase of goods or services Input GST A/c is debited.	At the time of sale of goods/assets or supply of services Output GST A/c is credited.
Intra-state transaction	CGST paid is debited to Input CGST A/c SGST paid is debited to Input SGST	CGST charged is credited to output CGST A/c SGST charged is credited to Output SGST A/c
Inter-state transaction	IGST paid is debited to Input IGST A/c	IGST charged is credited to Output IGST A/c
Reversal of GST	Input GST paid at the time of purchase are reversed in following situations i. Purchase Return ii. Drawings iii. Free samples distribution iv. Goods distributed as gift v. Goods lost in fire or theft vi. Input tax credit not allowed to be availed by recipient	Reversed when the goods are returned by the purchaser.
Utilization of Input tax credit	Input GST A/c is credited when tax is paid by utilizing input tax.	

Journal entries

The Double entry book-keeping records need to show the GST values separately so that the purchases, expenses and sales are posted without the addition of GST.

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Sale of Goods or Services

Account Receivable/Debtors A/c	Dr	Gross Amount(Include GST)
To sales A/c		Net Amount
To Output GST		Ampunt of GST

Purchase of Goods or Services

Purchases A/c	Dr	Net Amount
Input GST A/c	Dr	Amount of GST
To Account payable/Creditors		Gross Amount

Utilization of Input Tax Credit towards payment of Output Tax

Output CGST A/c	Dr	Amount of GST liability
Output SGST A/c	Dr	Amount of GST liability
Output IGST A/c	Dr	Amount of GST liability
To Input CGST A/c		Amount of output GST liability paid utilizing input CGST
To Input SGST A/c		Amount of output GST liability paid utilizing input SGST
To Input IGST A/c		Amount of output GST liability paid utilizing Input IGST

Questions:

Show the effect of the following transactions using the Traditional approach as well as the Modern Approach.

i. Mr. A Introduced capital of Rs.25.00 lac to start his business.
ii. Purchased Machinery worth Rs.10.00 Lac by paying the Rs.5.00 Lac in cash and balance in credit from XYZ &Co.
iii. Purchased goods on credit from Mr. C worth Rs. 50 Thousand and in cash for Rs.1.50 Lacs
iv. Sold goods for Rs. 2.00 Lac to Mr.D and received amount of Rs.1.00 lac from him after 20 days.
v. Mr. A asked deposited amount of Rs.2.00/- Lac from his savings in Bank.

Illustration 1

Develop the accounting equation from following information available at the beginning of accounting period:

Particulars	Amount (Rs.)
Capital	51,000,000
Loan	11,500,000
Trade payables	5,700,000
Fixed Assets	12,800,000
Inventory	22,600,000
Trade receivables	17,500,000
Cash and Bank	15,300,000

At the end of the accounting period the balances appear as follows:

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Particulars	Amount (Rs.)
Capital	?
Loan	11,500,000
Trade payables	5,800,000
Fixed Assets	12,720,000
Inventory	22,900,000
Trade receivables	17,500,000
Cash and Bank	15,600,000

a. Reset the equation and find out profit.
b. Prepare Balance Sheet at the end of the accounting period.

Illustration 2

Mr. Dravid has provided following details related to his financials. Find out the missing figures-

Particulars	Amount (Rs.)
Profits carved during the year	5,000,000
Assets at the beginning of year	A
Liabilities at the beginning of year	12,000,000
Assets at the end of the year	B
Liabilities at the end of the year	C
Closing capital	35,000,000
Total liabilities including capital at the end of the year	50,000,000

Illustration 3

From the following information, state the nature of account and state which account will be Debited and which will be Credited.

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

Illustration 4

Pass journal entries for the following:

Mohan Brought in Capital of Rs. 50,00,000
Out of the above, Rs. 25,000 is withdrawn from the bank.
Furniture is purchased for Rs. 12,00,000.
Purchased goods for cash Rs. 4,00,000.
Purchased goods for Rs. 10,00,000 on credit from M/s Ram Narain Bros.
Sold goods to Ramesh on credit for Rs. 13,00,000.
Received cheque from Ramesh Rs. 13,00,000.

Illustration 5

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

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Following figures are given in ('000)
Ajith started business with capital Rs. 4,00,000
He withdrew cash for business from the Bank Rs. 2,000
He purchased goods making payment through bank Rs. 15,000
He sold goods Rs. 16,000 and received payment through bank.
He purchased furniture and paid by cheque Rs. 2,500

Illustration 6

Journalise the following transactions in the books of Mr. Rohit:
(i) Purchased goods from Sahil for ` 50,000 plus CGST and SGST @ 9% each.
(ii) Purchased goods from Sam for ` 40,000 at a trade discount of 10% plus CGST and SGST @ 9% each. ` 20,000 was paid immediately and balance payable after 3 months.
(iii) Goods costing ` 20,000 withdrawn for personal use. Such goods were purchased by paying CGST and SGST @ 9% each.
(iv) Paid rent to Gagandeep for ` 30,000 plus CGST and SGST @ 6% each.
(v) Goods costing ` 5,000 (before trade discount of 10%) returned to Sam. Such goods were purchased by paying CGST and SGST @ 9% each.
(vi) Purchased furniture for ` 44,800 including IGST @ 12%.
(vii) Purchased machinery from M/s Symphony industries for ` 1,40,000 plus CGST and SGST @ 9% each. Paid ` 1,00,000 immediately and balance to be paid after two months.

Illustration 7
Journalise the following transactions in the books of Ms. Nidhi traders July, 2022
3 Sold Goods for ` 50,000, charged CGST and SGST @ 6% each.
4 Sold goods to Surjeet for ` 28,000 including CGST and SGST @ 6% each.
5 Received ` 25,200 from Surjeet in full settlement of his account of ` 28,000.
6 Sold goods to Kapil for ` 30,000 charged IGST @ 12%. Received ` 12,000 immediately and balance to be received after one month.
10 Kapil was allowed rebate of ` 5,000 as goods supplied to him were defective. These goods were sold by charging IGST @ 12%.
12 Sold goods to Manpreet for ` 1,00,000 at trade discount of 20% and charged IGST @ 12%
13 Goods of list price ` 20,000 returned by Manpreet.
17 Received commission of ` 15,000, charged CGST and SGST @ 6% each.

Illustration 8

Record the following transactions in a Journal, assuming CGST and SGST@ 6% each.
(i) Sold goods to Mukesh at the list price of ` 50,000 less 20% trade discount.
(ii) Sold goods to Mukesh at the list price of ` 1,00,000 less 20% trade discount and 5% cash discount.
(iii) Sold goods to Mukesh at the list price of ` 1,50,000 less 20% trade discount. Out of the amount due 60% is received out of which three-fourth is received by cheque.

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Chapter 3 - Ledgers

What is a Ledger?

Once all the transactions are recorded through Journal Entries, they need to be classified and grouped by preparing the accounts. The book in which all the accounts are prepared is known as "LEDGER".

Format of LEDGER:

DR.	ACCOUNT						CR.
DATE	PARTICULARS	J.F.	AMOUNT (Rs.)	DATE	PARTICULARS	J.F.	AMOUNT (Rs.)

The process of transferring the Journal Entries in the Ledger is known as **"POSTING"**.

Important rules to be noted while posting:

1. All the Accounts which have been entered in the Journal should have Ledger Account.
2. Whenever any account is mentioned in the Debit side of the Ledger it is supposed to use the word "TO" before the name of the account
3. Whenever any account is mentioned in the Credit side of the Ledger it is supposed to use the word "BY" before the name of the account
4. At a fixed interval of time the accounts needs to be balanced. Wherein the accounts are totaled and the balance on either side is carried forward to the next period for assets and liabilities. (Refer example to understand the concept of Balancing a Ledger). The balance in income and expenses ledgers are transferred to final accounts.

Example on Ledger:

Prepare the Purchase Account for the following transactions:

1. 10/08/2018 - Purchased goods of Rs.5.00 lac on credit from Mr. A.
2. 12/08/2018 - Purchased goods of Rs.1.00 lac in cash.
3. 15/08/2018 – Returned goods of Rs.1.00 lac Purchased from Mr. A

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DR.	PURCHASE ACCOUNT						CR.
DATE	PARTICULARS	J.F.	AMOUNT (Rs.)	DATE	PARTICULARS	J.F.	AMOUNT (Rs.)
10-08-18	To Mr.A A/c		500,000	15-08-18	By Mr.A A/c		100,000
12-08-18	To Cash A/c		100,000				
				31-08-18	By Balance c/d		500,000
	TOTAL		600,000		TOTAL		600,000
01-09-18	To Balance c/d		500,000				

Note:

1. Whenever the Purchase account was debited in the Journal the corresponding credit account is mentioned on the debit side of the journal with the word "TO" before it.

2. Whenever the Purchase account was credited in the Journal the corresponding credit account is mentioned on the debit side of the journal with the word "BY" before it.

3. At the end of the month the total of both the sides is done. The deficit amount on the lower side is mentioned as Balance c/d which is known as Balancing of the Account.

Questions:

1. Prepare the Ledgers for the various transactions entered into by the company as follow:
   i. Mr. A Introduced capital of Rs.25.00 lac to start his business.
   ii. Purchased Machinery worth Rs.10.00 Lac by paying the Rs.5.00 Lac in cash and balance in credit from XYZ &Co.
   iii. Purchased goods on credit from Mr. C worth Rs. 50 Thousand and in cash for Rs.1.50 Lacs
   iv. Sold goods for Rs. 2.00 Lac to Mr.D and received amount of Rs.1.00 lac from him after 20 days.
   v. Mr. A asked deposited amount of Rs.2.00/- Lac from his savings in Bank.

(Hint – Use the Journal entries created while solving the exercise for chapter 2.1)

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Chapter 4 - Cash Books

What is CASH Book?

As discussed in the Subsidiary Books, Under Cash Book all the transactions wherein cash has been received or paid are recorded.

Cash Book plays a dual role as a Principal as well as a Subsidiary Book also.
This is because all the transactions related to payment and deposit of cash is recorded in the cash book directly. Therefore, it is treated as Subsidiary Book. But cash book also serves as a basis for preparing the trial balance thereby serving as a Ledger also. Hence, it is a principal book.

Different Kinds of Cash Book.
There are mainly 3 kinds of Cash Book.

i. Simple Cash Book
ii. Two Column Cash Book
iii. Three Column Cash Book

Some organizations also maintain another form of cash book known as Petty Cash Book.

1. **Simple Cash Book:**
   This is like a simple Cash Ledger Account. Wherein the deposits are recorded on the debit side and the payments are recorded on the credit side.

   Important points to be noted in this regard are:
   i. Only Cash receipts and payments are recorded.
   ii. The cash receipts total is always greater than cash payments total. Since payments cannot be greater than the amount of cash available.
   iii. Simple cash book is the ordinary cash ledger account.

Example on Simple Cash Book:
Record the following transactions in the simple cash book:

Date	Transaction	Amount Rs.
01-08-18	Cash in Hand	50,000
05-08-18	Received from Mr. A	5,000
07-08-18	Paid for Salaries of July 2018	30,000
08-08-18	Paid for Rent for August 18	5,000
09-08-18	Received amount due from Mr. B	25,000
15-08-18	Received amount due from Mr. D	45,000
20-08-18	Purchased Office Equipments	20,000
29-08-18	Purchased Stationery	15,000

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DR.	CASH BOOK						CR.
DATE	Receipts	L.F.	AMOUNT (Rs.)	DATE	Payments	L.F.	AMOUNT (Rs.)
01-08-18	To Balance b/d		50,000	07-08-18	By Salaries		30,000
05-08-18	To Mr.A		5,000	08-08-18	By Rent		5,000
09-08-18	To Mr. B		25,000	20-08-18	By Office Equipments		20,000
15-08-18	To Mr. D		45,000	29-08-18	By Stationery		15,000
				31-08-18	By Balance c/d		55,000
	TOTAL		125,000		TOTAL		125,000

2. **Double Column Cash Book:**
   When an additional column is added to the simple cash book which shows either discount allowed or discount received. Alternatively, the new column can also show payments made through the Bank and deposits received in the bank. It is known as a Double Column Cash Book.

   Important points to be noted in this regard are:

   i. The discount columns if prepared are not balanced. They are just totaled to reflect the total discount received and total discount given.

   ii. If the bank Column is prepared then the cash and bank column are recorded in the same manner as the simple cash book. The balancing figure of the bank balance will be the Balance in the Bank.

Example on double Column Cash Book:

Record the following transactions in the Double Column cash book preparing the discount column:

Date	Transaction	Amount Rs.
01-08-18	Cash in Hand	50,000
05-08-18	Cash Sales made to Mr.A	100,000
05-08-18	Cash Discount allowed	5,000
07-08-18	Paid for Salaries of July 2018	30,000
08-08-18	Paid for Rent for August 18	5,000
09-08-18	Received amount due from Mr. B	25,000
09-08-18	Cash Discount allowed	1,000
15-08-18	Amount paid to Mr. D	40,000
15-08-18	Cash Discount Received	2,000
20-08-18	Purchased Office Equipments	20,000
29-08-18	Purchased Stationery	15,000

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DR.	CASH BOOK								CR.
DATE	Receipts	L.F.	Discount	AMOUNT (Rs.)	DATE	Payments	L.F.	Discount	AMOUNT (Rs.)
01-08-18	To Balance b/d			50,000	07-08-18	By Salaries			30,000
05-08-18	To Mr.A		5000	100,000	08-08-18	By Rent			5,000
09-08-18	To Mr. B		1000	25,000	15-08-18	By Mr. D		2000	40,000
					20-08-18	By Office Equipments			20,000
					29-08-18	By Stationery			15,000
					31-08-18	By Balance c/d			65,000
	TOTAL		**6000**	**175,000**		**TOTAL**		**2000**	**175,000**
01-09-18	To Balance b/d			65,000					

3. **Three Column Cash Book:**

   Most of the organizations keep most of their balances in the Bank and the money can be deposited and withdrawn at any point of time as per their requirements.

   The only difference between cash in hand and money in bank is the location of the cash amount. But it is important to track the moment in both of them. That purpose is served by the three column cash book.

   Another column is added to the Cash and discount column which is the Bank Column. All the deposits and payment made in Bank are entered in the Bank Column.

   The most important factor to be noted in the three column cash book is the method of recording contra entries.

   For instance when cash is deposited in the bank the Receipt Column on the bank side is debited and the cash column on the credit side is credited. This shows the increase in the bank balance and decrease in the cash balance due to depositing cash in Bank.

Example on Three Column Cash Book:

Record the following transactions in the Three Column cash book:

Date	Transaction	Amount Rs.
01-08-18	Cash deposited in bank for commencing business	50,000
04-08-18	Cash deposited in current account	10,000
05-08-18	Cash Collected from Mr. A	40,000
05-08-18	Cash Discount allowed	2,000
10-08-18	Amount paid to Mr. D	50,000
10-08-18	Cash Discount Received	3,000
25-08-18	Amount withdrawn from Bank	10,000

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DR.	CASH BOOK										CR.
DATE	Receipts	L.F.	Discount	Cash	Bank	DATE	Payments	L.F.	Discount	Cash	Bank
01-08-18	To Capital A/c				50,000						
04-08-18	To Cash A/c	C			10,000	04-08-18	By Bank A/c	C		10000	
05-08-18	To Mr. A A/c		2000		40,000	10-08-18	By Mr. D A/c		3000		50,000
25-08-18	To Bank	C		10000		25-08-18	By Cash A/c				10,000
						31-08-18	By Balance c/d				40,000
	TOTAL		**2000**	**10000**	**100,000**		**TOTAL**		**3000**	**10000**	**100000**
01-09-18	To Balance b/d				40,000						-

IMPEREST SYSTEM OF PETTY CASH BOOK:

Sometimes business have to make a lot of petty payments in cash as a part of their operational and miscellaneous expenses.

It would be highly inconvenient for the main cashier to deal in such transactions on a daily basis. For the sake of convenience companies install the Petty Cash System.

Under the system of petty cash, a small imprest amount of cash is always maintained in the petty cash balance. The petty cashier pays all the petty expenses during the given period and at the beginning of the next period may be a week or month the petty cashier is provided the deficit to bring the petty cash balance to the originally decided amount.

For instance, if the company decides to maintain a petty cash balance of 10,000 on a weekly basis. And the petty cashier incurs an expense of Rs. 5,000 during the given week. Then at the beginning of the next week he will be reimbursed Rs.5,000 of the expenses incurred by him to bring the petty cash balance to the decided amount of Rs.10,000.

Example on Petty Cash Book:
Record the following transactions in the Petty cash book:

Record the following transactions in the Petty cash book:

Date	Transaction	Amount Rs.
01-08-18	Received Rs.1000 for Petty Cash	1,000
04-08-18	Paid to office boy for travel reimbursement	100
05-08-18	Paid for Postage & telegram	150
07-08-18	Paid for Stationery	50

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PETY CASH BOOK

Receipts	Date	V.No.	Particulars	Total	Travel	Postage	Stationery
1,000	01-08-18		To Cash				
	04-08-18		By Travel	100	100		
	05-08-18		By Postage	150		150	
	07-08-18		By Stationery	50			50
				300	100	150	50
			By Balance c/d	700			
1,000			**TOTAL**	**1,300**	**200**	**300**	**100**
700			To Balance b/d				
300	08-08-18		To CASh				

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Chapter 5 - Subsidiary Books

What is Subsidiary Book?

All the transactions incurred by business on a daily basis can be classified into few major activities which are Receipt and Payment of Cash, Sale of Goods and Purchase of Goods.

To facilitate ease of work a separate register is maintained which records all the transactions for each such class of transactions. For the entries mentioned in such registers there wouldn't be any Journal Entries. The balances from these registers in respect of the particular items will be directly posted in the Ledger.

This separate registers where the entries are first made are known as **"SUBSIDIARY BOOKS"**.

The following Subsidiary Books are commonly prepared and maintained by the businesses:

1. Cash Book:
   Records all transactions related to receipts and payments.

2. Purchase Book
   Records credit purchase of goods which are required by the entity in its daily operations.

3. Purchase Return Book
   Records the return of the goods purchased on credit.

4. Sales Book
   Records Credit sales of goods made by the entity.

5. Sales Return Book
   Records sales return made by the customers.

6. Bills Receivable & Bills Payable
   If the entity deals in promissory notes they record it in a separate subsidiary book for all the Bill Receivable and Bills Payable.

7. Journal Book
   This is the book where if any transaction cannot be recorded in the above 7 books they are recorded in this book.

Advantages of Subsidiary Book:

The following are the advantages of the Subsidiary Books:

1. **Division of Work:**
   Every Subsidiary book deals in a specific area of business. Therefore, it is possible to allocate resources on a specific of work based on the volume

2. **Specialization of Work:**
   Since the work is divided into different areas of business, it can be specialized by allocating and training resources on a particular domain.

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3. **Time Saving:**
   Since the need to maintain the Journal is eliminated for the transactions entered into the subsidiary books and there are various accountants involved for different work areas, it leads to Time Savings.

4. **Information Availability:**
   Since all the common areas of work are identified and maintained in separate books it is easy to access information about a specific area of work without going through all the different records.

5. **Easiness in Locating errors:**
   If the Trial Balance does not agree, it is easy to identify the area where there might be an issue due to the maintenance of various subsidiary books.

Difference between Principal Books and Subsidiary Books:

The book in which transactions are recorded first for further processing is called Subsidiary Books. The details entered into subsidiary books are transferred to the Ledgers and from the Ledgers to the trial balance and ultimately to the Financial Statements.

The Ledger and the Cash Book are called the Principal Books. This is because they facilitate the information needed to prepare the trial balance and financial statements.

Example on Subsidiary Book (Purchase Books):

Prepare the Purchase Book from the following transactions and post their balances in Ledger.

Date	Transaction
01-08-18	Purchased from ABC & Co. 10,000 units @ Rs.10 each
	Received Trade Discount of 5% on the above purchases
	Paid Freight Charges for Rs.7000/- on the above purchases
10-08-18	Purchased from XYZ & Co. 5,000 units @ Rs.15 each
	Received Trade Discount of 10% on the above purchases
	Paid Freight Charges for Rs.1000/- on the above purchases

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The purchase book for the above transactions is as follow:

	PURCHASE BOOK					
DATE	PARTICULARS	GROSS AMOUNT	TRADE DISCOUNT	NET PRICE	FREIGHT	TOTAL
01-08-18	ABC & Co.					
	10,000 units @ Rs.10 each, Trade Discount 5%	100,000	5,000	95,000	7,000	102,000
10-08-18	XYZ & Co.					
	5,000 units @ Rs.15 each, Trade Discount 10%	75,000	7,500	67,500	1,000	68,500
	TOTAL	175,000	12,500	162,500	8,000	170,500

The ledger posting for the above transactions recorded in the Purchase Book is as Follow:

DR.	PURCHASE ACCOUNT						CR.
DATE	PARTICULARS	J.F.	AMOUNT (Rs.)	DATE	PARTICULARS	J.F.	AMOUNT (Rs.)
31-08-18	To Amt. as per Purchase Book		162,500				

DR.	FREIGHT ACCOUNT						CR.
DATE	PARTICULARS	J.F.	AMOUNT (Rs.)	DATE	PARTICULARS	J.F.	AMOUNT (Rs.)
31-08-18	To Amt. as per Purchase Book		8,000				

DR.	ABC & Co.						CR.
DATE	PARTICULARS	J.F.	AMOUNT (Rs.)	DATE	PARTICULARS	J.F.	AMOUNT (Rs.)
31-08-18				31-08-18	By Purchase A/c		95,000
				31-08-18	By Freight A/c		7,000

DR.	XYZ & Co.						CR.
DATE	PARTICULARS	J.F.	AMOUNT (Rs.)	DATE	PARTICULARS	J.F.	AMOUNT (Rs.)
31-08-18				31-08-18	By Purchase A/c		67,500
				31-08-18	By Freight A/c		1,000

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Questions:

1. Prepare the Sales Subsidiary Books for the following transactions and prepare the Ledger posting for the same.

Date	Transaction
01-08-18	Sold 20,000 units @ Rs.25 each to ABC & Co.
	Proivded Trade Discount of 2% on the above sales
10-08-18	Sold 15,000 units @ Rs.15 each for cash to XYZ & Co.
	Proivded CAsh Discount of 3% on the above sales
10-08-18	Sold old Computer for Rs.50,000 for Cash

Hint:

1. The sale of Computer is a sale of Fixed Asset and not normal sale made in the course of business.
2. The Cash Sales will be recorded in Cash Book. Only credit sales are recorded in Sales Book.

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Chapter - 6 Trial Balance

What is a Trial Balance?

After the entire ledger accounts for the various transactions which were recorded via Journal Entries is completed. The Next step is the creation of the Trial balance.

Trial Balance contains the debit and credit balance of the various ledgers. It is important to note that the total of debit column and credit column needs to be equal for the trial balance to be complete.

Objectives of Preparing a Trial Balance:

The Objectives of preparing a Trial Balance are as mentioned below:

i. Trial balance helps to establish arithmetical accuracy of the books of Accounts.
ii. Financial statements are normally prepared on the basis of agreed trial balance otherwise the work may be cumbersome. So it can be stated that the preparation of trail balance eases the preparation of Financial Statements.
iii. The trial balance serves as a summary of all the ledger balances.

LIMITATIONS OF TRIAL BALANCE:

The agreement of Trial Balance is not a final evidence of the accuracy of the trial balance. The Arithmetical accuracy shows the fact that all the debit balance equals the credit balances. However, there are certain possibilities whereby even though the trial balance is agreed upon it is still inaccurate.

It is possible that the following types of errors still exist and the trial balance is agreed upon.

i. Transaction has not been entered at all in the journal. Hence, is not entered in Ledger and not accounted for in Trial balance.
ii. A journal recorded with wrong Amount.
iii. A journal recorded with wrong Accounts.
iv. Omitting to record a Journal entry in the Ledger.
v. Posting the same journal entry twice in the ledger.

It is to be noted that the preparation of trial balance still cannot be omitted due to the above mentioned limitations.

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Format of TRIAL BALANCE:

Trial Balance as at _____

Sr.No.	Ledger Account	L.F.	Debit Amount	Credit Amount

Adjusted Trial Balance:

Sometimes it may happen that the trial balance does not agree even after entering all the amounts correctly from the Ledgers. In such situations the entities use suspense account to balance the trial balance. Wherein they transfer the difference in the suspense account and agree the trial balance. This kind of trial balance which has suspense account in it is known as Agreed Trial Balance.

Methods of preparing Trial Balance:

There are 3 different methods of preparing Trial Balance. The only difference in these 3 methods is the manner of presenting the ledger balances.

1. **TOTAL METHOD:**

Under this method, every ledger account is totaled and that total amount of debit side and credit side is transferred to trial balance. In this method, trial balance can be prepared as soon as ledger accounts are totaled. There is no need to balance the ledger Accounts.

2. **BALANCE METHOD:**

Under this method, only the ledger balances of the various ledger accounts are transferred to trial balance. This is the most commonly used method of creating trial balance. Also, it is to be noted that the Financial Statements are prepared on the basis of the Ledger Account Balances.

3. **TOTAL AND BALANCE METHOD:**

This is a combination of the above mentioned 2 methods. Under this method the trial balance shows the total columns as well as the balance columns.

Example on Trial Balance:

The Balances of the various ledgers and the total of the ledger columns are as presented below: Prepare the Trial Balance for the following Ledger Accounts as per the 3 different methods.

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Sr.No.	Account Name	Balance Amount (Rs.)	Total Amount (Rs.)
1	Cash A/c	10,000	50,000
2	Furniture A/c	25,000	25,000
3	Salaries A/c	20,000	60,000
4	Mr.A Capital A/c	100,000	370,000
5	Debtors A/c	50,000	150,000
6	Creditors A/c	80,000	100,000
7	Bank A/c	40,000	120,000
8	Sales A/c	130,000	145,000
9	Purchases A/c	155,000	200,000
10	Trade Discounts Given A/c	10,000	10,000

Note:

1. The Total Amount represents the total of the Ledger Accounts.
2. The Balance Amount represents the amounts remaining after the balancing of the respective ledgers which are carried forward.

TRIAL BALANCE AS PER TOTAL METHOD:

Table image

Note: Here we have considered only the amount from the total column.

TOTAL METHOD

Trial Balance as at _____

Sr.No.	Ledger Account	L.F.	Debit Amount	Credit Amount
1	Cash A/c		50000	
2	Furniture A/c		25000	
3	Salaries A/c		60000	
4	Mr.A Capital A/c			370000
5	Debtors A/c		150000	
6	Creditors A/c			100000
7	Bank A/c		120000	
8	Sales A/c			145000
9	Purchases A/c		200000	
10	Trade Discounts Given A/c		10000	
	TOTAL		615000	615000

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TRIAL BALANCE AS PER BALANCE METHOD:

BALANCE METHOD

Trial Balance as at _____

Sr.No.	Ledger Account	L.F.	Debit Amount	Credit Amount
1	Cash A/c		10000	
2	Furniture A/c		25000	
3	Salaries A/c		20000	
4	Mr.A Capital A/c			100000
5	Debtors A/c		50000	
6	Creditors A/c			80000
7	Bank A/c		40000	
8	Sales A/c			130000
9	Purchases A/c		155000	
10	Trade Discounts Given A/c		10000	
	TOTAL		310000	310000

Note: Here we have considered only the amount from the BALANCE column.

TRIAL BALANCE AS PER TOTAL & BALANCE METHOD:

TOTAL & BALANCE METHOD

Trial Balance as at _____

Sr.No.	Ledger Account	L.F.	Debit Total	Credit Total	Debit Balance	Credit Balance
1	Cash A/c		50000		10000	
2	Furniture A/c		25000		25000	
3	Salaries A/c		60000		20000	
4	Mr.A Capital A/c			370000		100000
5	Debtors A/c		150000		50000	
6	Creditors A/c			100000		80000
7	Bank A/c		120000		40000	
8	Sales A/c			145000		130000
9	Purchases A/c		200000		155000	
10	Trade Discounts Given A/c		10000		10000	
	TOTAL		615000	615000	310000	310000

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Chapter 7 – Bank Reconciliation System

OBJECTIVES

The lists of topics which will be covered in this chapter are as follows:

3.1 Understand Pass book

3.2 Understand the differences between cash book and bank pass book

3.3 Reconcile the difference between the cash book and bank pass book.

3.4 Intention of preparing the bank reconciliation system and its utility.

SERVICES PROVIDED BY BANK:

In the present time nearly all of the transactions of the organizations are performed through the banks whether it is a receipt or a payment at local, regional, national or international level. In Fact, it is legally necessary to carry out the transactions through bank after a certain limit.

Apart from receiving collections and making payments, the following services are also performed by the bank:

i. Discounting of promissory notes or hundies which enables the entities to receive the cash before the due date in exchange for a small charges.

ii. Allowing overdraft facilities to their credible customer which enables them to make payments even when they do not have sufficient balance in their account. These overdraft balances need to be cleared within a certain period of time.

iii. Providing loans to their customers which provide great financial assistance for their businesses.

iv. Collecting on behalf of the customer the amount of dividends, interest on securities etc.

v. Making Utility payments such as insurance premium, rent etc. on the due dates as instructed by their customers.

vi. Remitting money to another place or persons at a low cost.

vii. Providing security or guarantee for its customers whose credit is good, in return for a consideration,

viii. Issuing letter of credit or traveller's cheque which facilitates commerce as well as travel.

ix. Provides international banking services.

BANK PASS BOOK AND BANK STATEMENT:

Bank pass book and Bank Statements provides the details of the customer's account in the bank. Through the Bank Pass Book and Bank Statement the bank keeps its customers informed of the

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entries made in their account. It is the customer's duty to check the entries and immediately inform the bank of any error that he may notice.
The bank balance shown in the passbook or the statement is known as pass book balance for reconciliation purpose. The credit balance as per pass book at a particular point of time is the deposit made by the customer while debit balance as per pass book is the overdraft balance for the customer.

BANK RECONCILIATION STATEMENT:

The Bank Reconciliation Statement reconciles the difference between the Bank Pass Book and Bank Balance as per the organization record eliminating any differences arising between them.
Whenever any deposit or withdraws is made from banks, it is always recorded at two places: -
1. Bank column of the cash book and
2. Bank statement or Bank pass book

The cash book is maintained by the customer having who has the bank account and the bank statement is prepared by the bank.

The balance in both the accounts should be equal and opposite in nature ideally. For e.g. If Mr. Z deposited 1,000 in his bank account, it should be recorded as Debit entry on the cash book of Mr. Z. And the same should be recorded as Credit Entry on the Customer Account maintained by the Bank.

In an Ideal world both the accounts should always match but it does not happen in most of the cases due to several reasons.

There are many reasons for these differences in balances which are explained later. These differences are reconciled by considering the various facts and figures on the two statements.

The process of reconciling the difference and bringing the two accounts in line with each other is known as "Reconciliation", and the statement in which the reconciliation is done is known as "BANK RECONCILIATION STATEMENT".

IMPORTANCE OF BANK RECONCILIATION STATEMENT:

Bank reconciliation statement acts as a tool for internal control of cash flows by detecting if any errors, frauds and irregularities have occurred at the time of passing entries in the cash book or in the passbook, whether intentionally or unintentionally. The important features of bank reconciliation statement can be summarized as follow:

i. The reconciliation identifies any errors that may have been committed either in the cash book or in the pass book.

ii. Any unreasonable delay in the clearance of cheques will be shown up by the reconciliation

iii. A regular reconciliation discourages the accountant of the bank from embezzlement. There have been many cases when the cashiers merely made entries in the cash book but never deposited the cash in the bank they were able to get away with it only because of lack of reconciliation.

iv. It helps in finding out the actual position of the bank balance.

v. It will ensure accounting of all the financial transactions incurred by the company during a particular financial year.

CAUSES OF DIFFERENCES:

The differences between the balance as per the Bank Pass Book and the Bank Balance as per the company's cash book arise mainly due to the following reasons:

1. **Timing of recording the transactions:**
   Due to the difference in the timing of recording the transaction.
   For e.g., If M has issued a cheque on 30th March, it will be recorded in the bank column of cash book on 30th March itself, but it will be recorded by the Bank only when it is presented for clearance giving rise to the difference.

2. **Transactions:**
   Some transactions are carried out by the bank directly and the customer becomes aware of it only when they perform the reconciliation.
   For e.g. crediting the interest in the customer's account directly.

3. **Errors:**
   Any kind of Mistake or error made either by the customers or the bank results in differences.

TRANSACTIONS OR EVENTS THAT FREQUENTLY CAUSE DIFFERENCES:

The following are the transactions and events that frequently cause a difference between the balance as per the bank records and the organization records due to the difference in the timing of recording these transactions.

1. Cheques issued but not presented for payment.
2. Cheques paid into the bank but not cleared.
3. Interest allowed by bank.
4. Interest and expenses charged by the bank.
5. Interest and dividends collected by the bank.
6. Direct payments by the bank.
7. Direct payment into the bank by a customer.
8. Dishonor of a bill discounted with the bank.
9. Bills collected by the bank on behalf of the customer.
10. Errors (This is not a timing difference)

Following is the table summarizing in brief the timings of different transactions

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Sr.No.	Transaction	Time of recording in cash Book	Time of recording in pass book
1	Issue of a cheque by the account holder	When the cheque is issued	When it is presented to the bank for payment.
2	Depositing a cheque in the account	When deposited in the Bank Account	When collected from the issuing party
3	Collection of bills/cheque directly by the bank	When referring the bank pass book	When it is collected by the bank.
4	Direct payment to the account holder	When referring the bank pass book.	When the amount is made in the account
5	Dishonor of cheque/bills Receivable.	When referring the bank pass book	When the cheque is Dishonored.
6	Bank charges levied by the Bank	When referring the bank pass book	When charges are levied by the bank
7	Interest and dividend credited by the bank	When referring the bank pass book	When interest or dividend is collected by the bank.
8	Interest debited by the bank	When referring the bank pass book	When interest is charged by the bank

Example on Reconciliation of Timing Differences:

The following is the bank passbook and bank balance as per the cash book maintained by Mr. A. for the month of September 2018.

Bank Pass Book

Date	Particulars	Deposits	Withdrawls	Balance
01-09-18	By Cash	100,000	-	100,000
03-09-18	To ABC & Co.	-	10,000	90,000
05-09-18	To XYZ & Co.	-	15,000	75,000
08-09-18	By MR. D	50,000	-	125,000
15-09-18	By Cash	10,000	-	135,000
17-09-18	By Cash	5,000	-	140,000
20-09-18	To Bank Charges	-	1,000	139,000
22-09-18	By Interest	500	-	139,500
25-09-18	By Interest on Govt. Securities	750	-	140,250

Dr.	Cash Book (Bank Column)				Cr.
Date	Particulars	Amount	Date	Particulars	Amount
01-09-18	By Cash	100,000	01-09-18	To ABC & Co.	10,000
06-09-18	By Mr.D	50,000	04-09-18	To XYZ & Co.	15,000
15-09-18	By Cash	10,000			
17-09-18	By Cash	5,000	30-09-18	To Balance c/d	140,000
	TOTAL	165,000		TOTAL	165,000

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As can be noted above the balance as per the bank pass book is Rs.140250/- However, as per the Bank Column of the cash book it is Rs. 140000/-. The difference between the same is reconciled as follow:

The reconciliation can be done by 2 ways.

i. Arriving at the pass book balance from cash book or
ii. Arriving at the cash book balance from pass book.

We will reconcile the balance by arriving at the cash book balance from the pass book balance.

Particulars	Amount	Amount
Amount as per Pass Book		**140,250**
Add		
Bank Charges levied by bank	1,000	1,000
Less:		
Bank Interest credited in pass book	(500)	
Interest on Govt Securities credited in pass book	(750)	(1,250)
Amount as per Cash Book		**140,000**

Thus the balances have been reconciled.

PROCEDURE FOR RECONCILING THE CASH BOOK BALANCES WITH THE PASS BANK BALANCE:

Understanding the following debit and credit balances presented in the cash book and bank pass book is important in reconciling the differences:

Debit Balance as per Cash Book – Excess of Deposit over Withdrawals in Bank
Credit Balance as per Cash Book – Excess of Withdrawals over Deposit in Bank

Debit Balance as per Bank Pass Book – Excess of Withdrawals over Deposit in Bank
Credit Balance as per Bank Pass Book – Excess of Deposit over Withdrawals in Bank

The reconciliation can be done by using any of the four balances given in the question.

There can be 2 different kinds of reconciliation based on the details provided which can be categorized as follow:

i. When the causes of differences are known
ii. When the causes of differences are not known

When causes of differences are known the reconciliation can be done by taking any of the balance stated above and analyzing the causes and accordingly reconciling the transactions to eliminate the effects of the various differences.

If the balance of the other book is more on account of the said causes then add the amount. If the balance of the other book is less on account of the said causes then subtract the amount.

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For example, if the reconciliation is initiated with Dr. Balance as per the cash book and there is a cheque deposited in the bank but not cleared, then on account of non-clearance of the cheque, the Cr. balance of the pass book would be less. In this case, the amount of cheque should be subtracted from the cash book balance to arrive at the balance as per the pass book.

When causes of differences are not known then a comparison needs to be done of the debit entries of cash book with the credit entries of the pass-book and vice-versa.

The entries which do not tally are the causes of difference in the balances of both the books. Once the causes are located their effects on both the books are analyzed and then reconciliation statement is prepared to arrive at the actual bank balance. However, one should take care that whether opening balance of both the books tallies or not. If opening balances are not same then the reconciliation items are divided into two categories i.e., one relating to reconciliation of opening balance and other relating to reconciliation of closing balance.

METHODS OF RECONCILIATION:
There are 2 methods of reconciliation:

i. Without preparation of the Adjusted Cash-Book and
ii. With the preparation of the Adjusted Cash-Book

Without preparation of the Adjusted Cash-Book
The reconciliation under this method can be done by taking any of the four balances as the starting point and reconciling the causes of differences. The following table (Extracted from the ICAI Study Material) provides the detailed analysis of how to reconcile the difference by using the various starting point.

Causes of differences	Favorable balance (Dr.) as per cash book	Unfavorable balance (Cr.) as per cash book	Favorable balance (Cr.) as per pass book	Unfavorable balance (Dr.) as per pass book
Cheque deposited but not cleared	Subtract	Add	Add	Subtract
Cheque issued but not presented to bank	Add	Subtract	Subtract	Add
Cheque directly deposited in bank by a customer	Add	Subtract	Subtract	Add
Income (e.g., interest from UTI) directly received by bank	Add	Subtract	Subtract	Add
Expenses (e.g., telephone bills, Insurance charges) directly paid by bank on standing instructions	Subtract	Add	Add	Subtract
Bank charges levied by bank	Subtract	Add	Add	Subtract
Locker rent levied by bank	Subtract	Add	Add	Subtract
Wrong debit in the cash book	Subtract	Add	Add	Subtract
Wrong credit in the cash book	Add	Subtract	Subtract	Add

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Wrong debit in the pass book	Subtract	Add	Add	Subtract
Wrong credit in pass book	Add	Subtract	Subtract	Add
Under casting of Dr. side of bank account in the cash book	Add	Subtract	Subtract	Add
Overcastting of Dr. side of bank account in the cash book	Subtract	Add	Add	Subtract
Under casting of Cr. side of bank account in the cash book	Subtract	Add	Add	Subtract
Over casting of Cr. side of bank account the cash book	Add	Subtract	Subtract	Add
Bill receivable collected directly by bank	Add	Subtract	Subtract	Add
Interest on bank overdraft charged	Subtract	Add	Add	Subtract
Final Balance	If answer is positive then it is favorable balance as per pass book i.e. Cr. Balance as per Pass Book, if it is negative then it is Unfavorable balance i.e.. Dr. Balance as per Pass Book	If answer is positive then it is Unfavorable balance as per pass book i.e. Dr. Balance as per Pass Book, if it is negative then it is Favorable balance i.e.. Cr. Balance as per Pass Book	If answer is positive then it is Unfavorable balance as per pass book i.e. Dr. Balance as per Pass Book, if it is negative then it is Favorable balance i.e.. Cr. Balance as per Pass Book	If answer is positive then it is Unfavorable balance as per cash book i.e. Cr. Balance as per Cash Book, if it is negative then it is Favorable balance i.e.. Dr. Balance as per Cash Book

Note: The reconciliation statement can be presented as per the two methods:

i. Balance Presentation
ii. Plus-Minus Presentation

With preparation of the Adjusted Cash-Book:

Adjusted Cash Book:

When the balance in the cash book is first adjusted for certain adjustments before taking it to the bank reconciliation statement, then it is known as adjusted cash book balance. Adjusting the cash-book before preparing the bank reconciliation statement is completely optional, if reconciliation is done during different months. But if reconciliation is done at the end of the accounting year or financial year, the cash-book must be adjusted so as to reflect the correct bank balance in the balance sheet.

While adjusting the cash-book the following adjustments are considered: -

1. All the errors (like wrong amount recorded in the cash-book, entry posted twice in the cash-book, over/ under casting of the balance etc.) and omissions (like bank charges recorded in the pass-book only, interest debited by the bank, direct receipt or payment by the bank, dishonor of cheques/bills etc.) by the cash-book are taken into care

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2. Only these transactions are considered for adjusting cash book, apart from this delay in recording in the pass-book due to difference in timing (like cheque issued but not presented for payment, cheque deposited but not collected) is taken to bank reconciliation statement. This adjusted cash-book balance is taken to bank reconciliation statement.

EXAMPLE 1:

On 30th September, 2018, the bank account of Mr. A, according to the bank column of the Cash-Book, was overdrawn to the extent of Rs 10,000. On the same date the bank statement showed a debit balance of 15,000 in favor of A.

An examination of the Cash Book and Bank Statement reveals the following:

1. A cheque for Rs.50,000 deposited on 28th September, 2018 was credited by the bank only on 2nd October, 2018

2. A payment by cheque for Rs.20,000 has been entered twice in the Cash Book.

3. On 29th September, 2018, the bank credited an amount of Rs.75,000 received from a customer of A, but the advice was not received by A until 2nd October, 2018.

4. Bank charges amounting to Rs. 1500 had not been entered in the Cash Book.

5. On 6th September, 2018, the bank credited Rs.10,000 to A in error.

6. A bill of exchange for Rs.90,000 was discounted by X with his bank. This bill was dishonored on 28th September, 2018 but no entry had been made in the books of A.

7. Cheques issued up to 30th September, 2018 but not presented for payment up to that date totaled Rs.100,000.

Prepare the following details based on the above mentioned transactions:

1. Present appropriate rectifications in the Cash Book of Mr. A to arrive at the correct balance as on 30th September 2018 and
2. Bank Reconciliation Statement

Cash Book (Bank Column) of Mr. A for September 30, 2018

Dr.	Cash Book (Bank Column)				Cr.
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
Sept 30	To Customer A/c	20,000	Sept 30	By Bank Charges	1,500
	To Customer A/c	75,000		By Customer A/c	
				(Bill Dishonored)	90,000
				By Balance c/d	3,500
	TOTAL	**95,000**		**TOTAL**	**95,000**

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Bank Reconciliation Statement for September 30, 2018		
Particulars	**Amount**	**Amount**
Balance as per Cash Book		**3,500**
Add		
Cheques deposited but not collected upto 30 september 2018	50,000	50,000
Less:		
Cheques issue but not presented for payment till september 30 2018	(100,000)	(100,000)
Amount as per Bank Pass Book		**(46,500)**

EXAMPLE 2:
From the following information (as on 31.3.2018), prepare a bank reconciliation statement after making necessary amendments in the cash book

Particulars Amount Bank balances as per the cash book (Dr.) 800,000

Cheques deposited, but not yet credited 45,000

Cheques issued but not yet presented for payment 35,000

Bank charges debited by bank but not recorded in the cash-book 2,500

Dividend directly collected by the bank 20,000

Insurance premium paid by bank as per standing instruction
Not intimated 18,000

Cash sales wrongly recorded in the Bank column of the cash-book 2,00,000

Customer's cheque dishonored by bank not recorded in the cash-book 1,00,000

Wrong credit given by the bank 1,10,000

Also show the bank balance that will appear in the trial balance as on 31.3.2018.

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Dr.	Cash Book (Bank Column) - After necessary adjustements				Cr.
Date	Particulars	Amount	Date	Particulars	Amount
31-03-18	To Balance b/d	800,000	31-03-18	By Bank Charges	2,500
	To Dividend	20,000		By Insurance Premium	18,000
				By Acc. Receivable	100,000
				(Cheque Dishonored)	
				By Cash (Wrong recorded cash sales)	200,000
				By Balance c/d	499,500
	TOTAL	820,000		TOTAL	820,000

Bank Reconciliation Statement for March 31, 2018		
Particulars	Amount	Amount
Balance as per Cash Book		**499,500**
Add		
Cheques issued but not presented for payment	35,000	
Amount wrongly credited by bank	110000	145,000
		644,500
Less:		
Cheques deposited but not yet credited by bank	(45,000)	(45,000)
Amount as per Bank Pass Book		**599,500**

The balance of Rs. 499,500/- will appear on the trial balance of 31st March 2018.

Questions:

From the following information (as on 31.3.2018), prepare a bank reconciliation statement after making necessary amendments in the cash book

Particulars Amount Bank balances as per the cash book (Dr.) 600,000

Cheques deposited, but not yet credited 85,000

Cheques issued but not yet presented for payment 70,000

Bank charges debited by bank but not recorded in the cash-book 1,000

Dividend directly collected by the bank 50,000

Insurance premium paid by bank as per standing instruction
Not intimated 45,000

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Cash sales wrongly recorded in the Bank column of the cash-book 1,50,000

Customer's cheque dishonored by bank not recorded in the cash-book 3,00,000

Wrong credit given by the bank 10,000

Also show the bank balance that will appear in the trial balance as on 31.3.2018.

Illustrations

Question: 1

From the following particulars, prepare a Bank Reconciliation Statement for Jindal offset Ltd.

(1) Balance as per cash book is Rs. 2,40,000
(2) Cheques issued but not presented in the bank amounts to Rs. 1,36,000.
(3) Cheques deposited in bank but not yet cleared amounts to Rs. 90,000.
(4) Bank charges amounts to Rs. 300.
(5) Interest credited by bank amounts to Rs. 1,250.
(6) The balance as per passbook is Rs.2,86,950

Question: 2

On 31st March 2017, the Bank Pass Book of Namrata showed a balance of Rs.1,50,000 to her credit while balance as per cash book was Rs.1,12,050. On scrutiny of the two books, she ascertained the following causes of difference:

i. She has issued cheques amounting to Rs. 80,000 out of which only Rs. 32,000 were presented for payment.
ii. She received a cheque of Rs.5,000 which she recorded in her cash book but forgot to deposit in the bank.
iii. A cheque of Rs.22,000 deposited by her has not been cleared yet.
iv. Mr. Gupta deposited an amount of Rs.15,700 in her bank which has not been recorded by her in Cash Book yet.
v. Bank has credited an interest of Rs. 1,500 while charging Rs. 250 as bank charges.

Prepare a bank reconciliation statement.

Question: 3

From the following particulars ascertain the balance that would appear in the Bank Pass Book of A on 31st December 2017.

1. The bank overdraft as per Cash Book on 31st December 2017 Rs. 6,340.
2. Interest on overdraft for 6 months ending 31st December 2017 Rs. 160 is entered in Pass Book.
3. Bank charges of Rs. 400 are debited in the Pass Book only.
4. Cheques issued but not cashed prior to 31st December,2017, amounted to Rs.11,68,000.
5. Cheques paid into bank but not cleared before 31st, December 2017 were for Rs. 22,17,000.
6. Interest on investments collected by the bank and credited in the Pass Book Rs.12,00,000.

Question: 4

On 30th September 2017, the bank account of X, according to the bank column of the Cash- Book, was over drawn to the extent of Rs. 4,062. On the same date the bank statement showed a debit

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balance of Rs.20,758 in favour of X. An examination of the Cash Book and Bank Statement reveals the following:

1. A cheque for Rs.13,14,000 deposited on 29th September 2017 was credited by the bank only on 3rd October 2017
2. A payment by cheque for Rs.16,000 has been entered twice in the Cash Book.
3. On 29th September 2017, the bank credited an amount of Rs.1,17,400 received from a customer of X, but the advice was not received by X until 1st October 2017.
4. Bank charges amounting to Rs.580 had not been entered in the Cash Book.
5. On 6th September 2017, the bank credited Rs.20,000 to X in error.
6. A bill of exchange for Rs.1,40,000 was discounted by X with his bank. This bill was dishonoured on 28th September 2017, but no entry had been made in the books of X.
7. Cheques issued up to 30th September 2017 but not presented for payment up to that date totalled Rs.13,26,000.

You are required:

a. to show the appropriate rectifications required in the cash Book of X, to arrive at the correct balance on 30th September 2017. And

b. to prepare a bank reconciliation statement as on that date.

Question: 5

On 30th December 2017 the bank column of A. Philip's cash book showed a debit balance of Rs. 4,610. On examination of the cash book and bank statement you find that:

1. Cheques amounting to Rs. 6,30,000 which were issued to trade payables and entered in the cash book before 30th December 2017 were not presented for payment until that date.
2. Cheques amounting to Rs. 2,50,000 had been recorded in the cash book as having been paid into the bank on 30th December 2017 but were entered in the bank statement on1st January 2018.
3. A cheque for Rs. 73,000 had been dishonoured prior to 30th December 2017, but no record of this fact appeared in the cash book.
4. A dividend of Rs. 3,80,000, paid direct to the bank had not been recorded in the cash book.
5. Bank interest and charges amounting to Rs.4,200 had been charged in the bank statement but not entered in the cash book.
6. No entry had been made in the cash book for a trade subscription of Rs. 10,000 paid vide banker's order in November 2017.
7. A cheque for Rs.27,000 drawn by B. Philip had been charged to A. Philip's bank account by mistake in December 2017.

You are required:

a. to make appropriate adjustments in the cash book bringing down the correct balance, and

b. to prepare a statement reconciling the adjusted balance in the cash book with the balance shown in the bank statement.

Question: 6

From the following information, prepare a Bank reconciliation statement as at 31st December 2017 for Messrs New Steel Limited:

(1)	Bank overdraft as per Cash Book on 31st December, 2017	22,45,900
(2)	Interest debited by Bank on 26th December 2017, but no advice received	2,78,700

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(3)	Cheque issued before 31st December 2017 but not yet presented to Bank	6,60,000
(4)	Transport subsidy received from the State Government directly by the Bank but not advised to the company	14,25,000
(5)	Draft deposited in the Bank, but not credited till 31st December, 2017	13,50,000
(6)	Bills for collection credited by the Bank till 31st December 2017 but no advice received by the company	8,36,000
(7)	Amount wrongly debited to company account by the Bank, for which no details are available	7,40,000

Question: 7

The Cash Book of Mr. Gadbadwala shows Rs.8,36,400 as the balance at Bank as on 31st December 2017, but you find that it does not agree with the balance as per the Bank Pass Book. On scrutiny, you find the following discrepancies:

1. On 15th December 2017 the payment side of the Cash Book was undercast by Rs.10,000.
2. A cheque for Rs.1,31,000 issued on 25th December 2017 was not taken in the bank column.
3. One deposit of Rs.1,50,000 was recorded in the Cash Book as if there is no bank column therein.
4. On 18th December 2017 the debit balance of Rs.15,260 as on the previous day, was brought forward as credit balance.
5. Of the total cheques amounting to Rs.11,514 drawn in the last week of December 2017, cheques aggregating Rs.7,815 were encashed in December.
6. Dividends of Rs.25,000 collected by the Bank and subscription of Rs.1,000 paid by it were not recorded in the Cash Book.
7. One out-going Cheque of Rs.3,50,000 was recorded twice in the Cash Book.

Prepare a Reconciliation Statement

Question: 8

When Nikki & Co. received a Bank Statement showing a favourable balance of Rs.10,39,200 for the period ended on 30th June 2017, this did not agree with the balance in the cash book.

An examination of the Cash Book and Bank Statement disclosed the following:

1. A deposit of Rs.3,09,200 paid on 29th June 2017 had not been credited by the Bank until 1st July 2017.
2. On 30th March 2017 the company had entered into hire purchase agreement to pay by bank order a sum of Rs.3,00,000 on the 10th of each month, commencing from April 2017. No entries had been made in Cash Book.
3. A customer of the firm, who received a cash discount of 4% on his account of Rs.4,00,000 paid the firm a cheque on 12th June. The cashier erroneously entered the gross amount in the bank column of the Cash Book.
4. Bank charges amounting to Rs.3,000 had not been entered in Cash Book.
5. On 28th June, a customer of the company directly deposited the amount in the bank Rs. 4,00,000, but no entry had been made in the Cash Book.
6. Rs.11,200 paid into the bank had been entered twice in the Cash Book.
7. A debit of Rs. 11,00,000 appeared in the Bank Statement for an unpaid cheque, which had been returned marked 'out of date'. The cheque had been re-dated by the customer and paid into Bank again on 5th July 2017.

Prepare Bank Reconciliation Statement on 30 June 2017.

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Chapter 8 – Accounting for Special Transactions

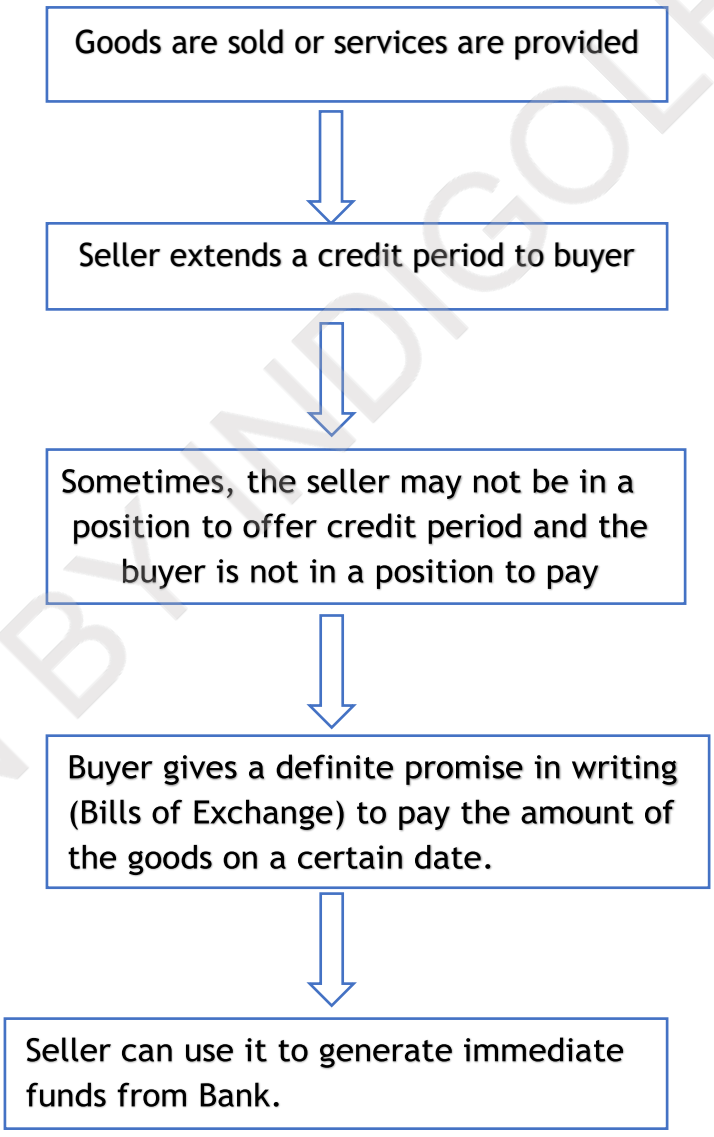
Unit 1 – Bills of Exchange and Promissory Note

1. BILLS OF EXCHANGE

❖ 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.

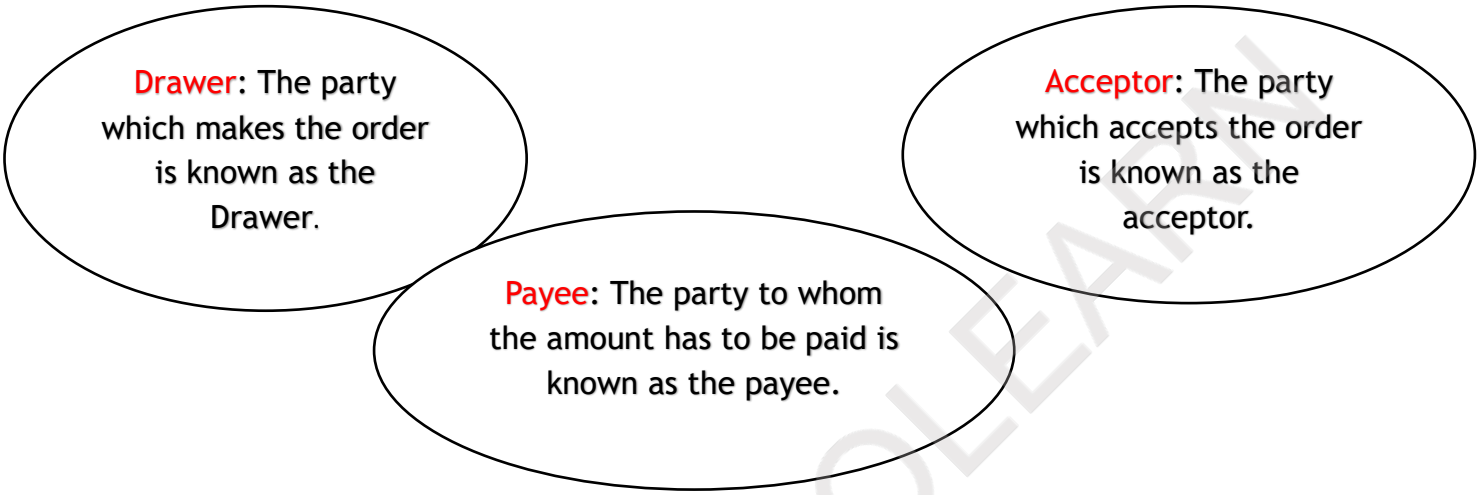
❖ Concept



- ### Characteristics
  - It must be in **writing**.
  - It must be **dated**.

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- 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.

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.

2. 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**.

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- 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**.

3. 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.

4.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.

5. EXPIRY /DUE DATE OF BILL

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

6. DAY OF GRACE

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

7. 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**.

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- 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**

8. 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 payment** 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.

9. BILL AFTER DATE

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

9. BILL AFTER DATE

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

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- on a **specific day**
- after **sight**
- on the happening of event

Which is **certain to happen**.

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- 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.

10. 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

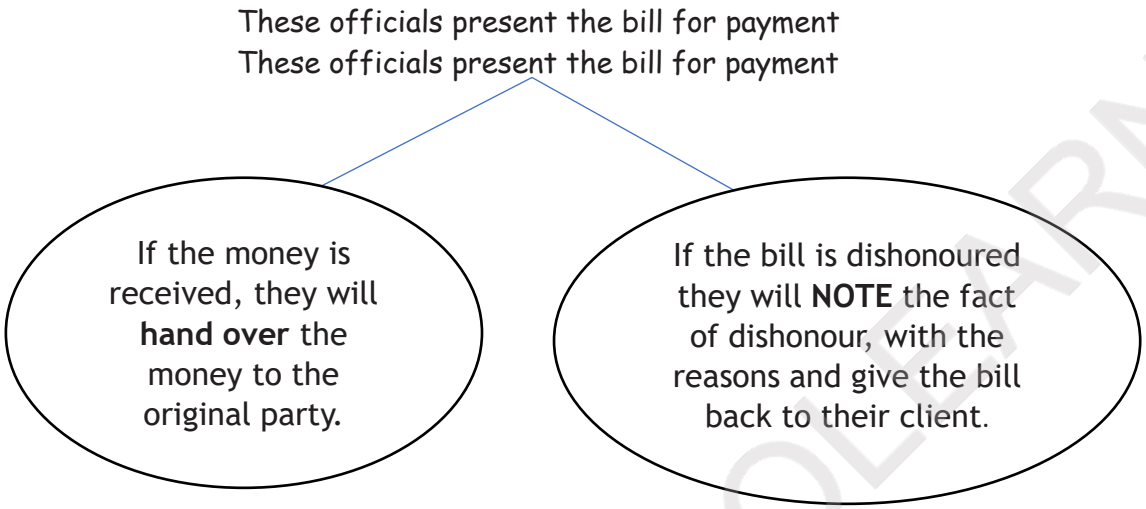
1) When the bill is made payable at a stated number of months(s) after date, the **term** shall expire on that day of the month which corresponds with the day on which the bill is dated. If the month in which the period terminates has no corresponding day, the period shall be deemed to expire on the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

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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.

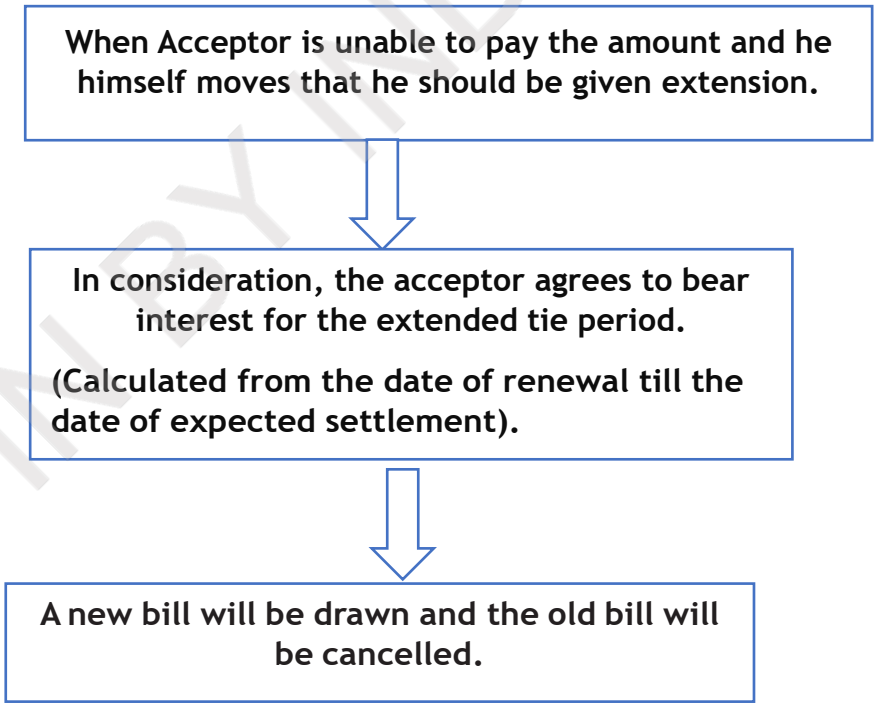
11. NOTING CHARGES

- 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.

12. RENEWAL OF BILL



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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.

13. RETRIEMENT 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.

14. ACCOMODATION BILLS

- 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.

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- 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.

15. 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.

16. 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 or 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.	
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.	

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	To Bank A/c	
Entry for Noting charges		
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		1,000
To Bank A/c		10
2. **Suppose X had endorsed this bill in favour of Z**		
Y A/c	Dr.	1,010
To Z		1,010
This is because Z will claim 1,010 from X and X has the right of recovering 1,010 from Y.		
3. **If the bill has been discounted with a bank, entry will be**		
Y	Dr.	1,010
To Bank A/c		1,010
In case of Insolvency		
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**		

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Bills Receivable A/c	Dr.	
To Drawee A/c		
3. **In case of interest charged for new period**		
Bills Receivable A/c	Dr.	
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		

17. 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		
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		

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In case of Renewal of bill	
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.	
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	

18. 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	

Question: 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.

Question: 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.

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Question: 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

Question: 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.

Question: 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.

Question: 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.

Question: 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

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- 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.

Question: 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

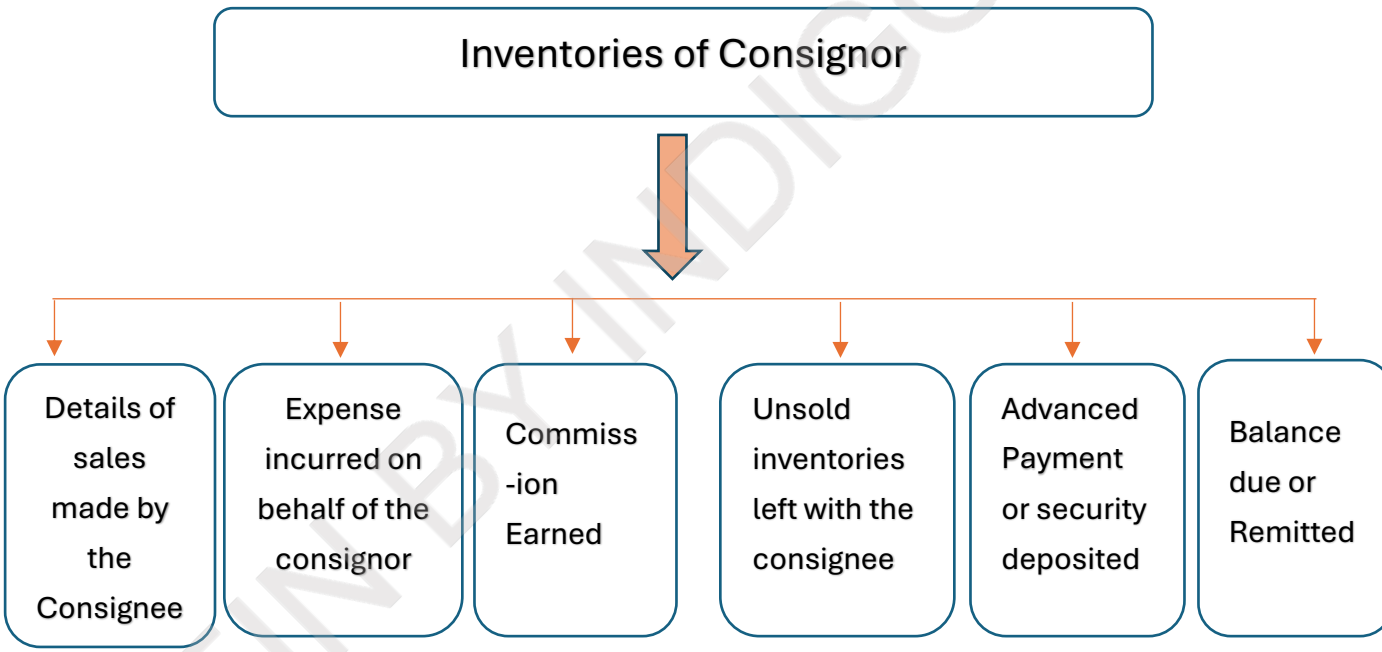
- 'Y' returned the bill after acceptance of the same date
- 'X' discounts the bill from his bankers @ 6% per annum and remit 50% of the proceeds to 'Y'
- On due date 'X' is unable to send the amount due and therefore 'Y' draws a bill for Rs. 7,000, which is duly accepted by 'X'
- 'Y' discounts the bill 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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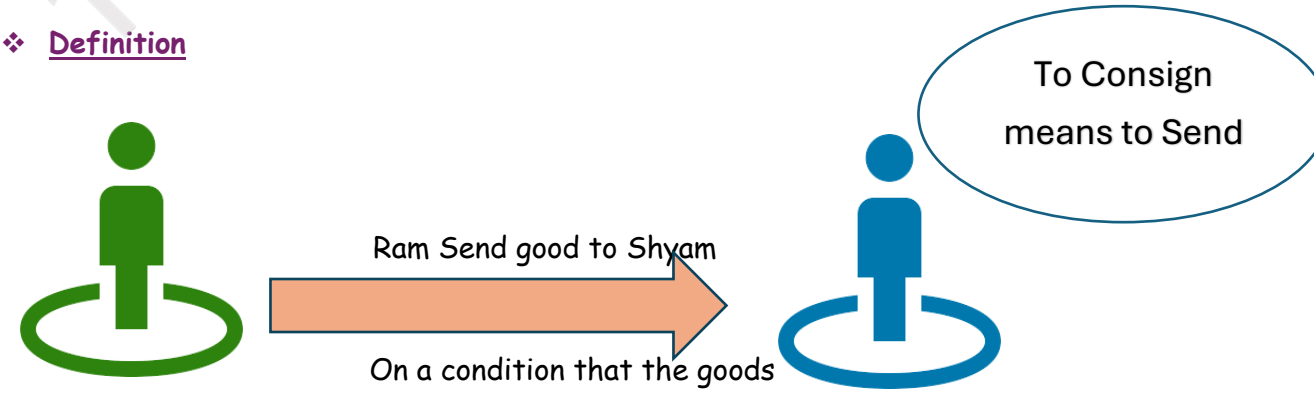
Unit – 2 Consignment





2. MEANING OF CONSIGNMENT ACCOUNT

❖ **Definition**



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Principal (Mr. Ram)	Will be sold on behalf of and at the risk of Ram.	Agent (Mr. Shyam)

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

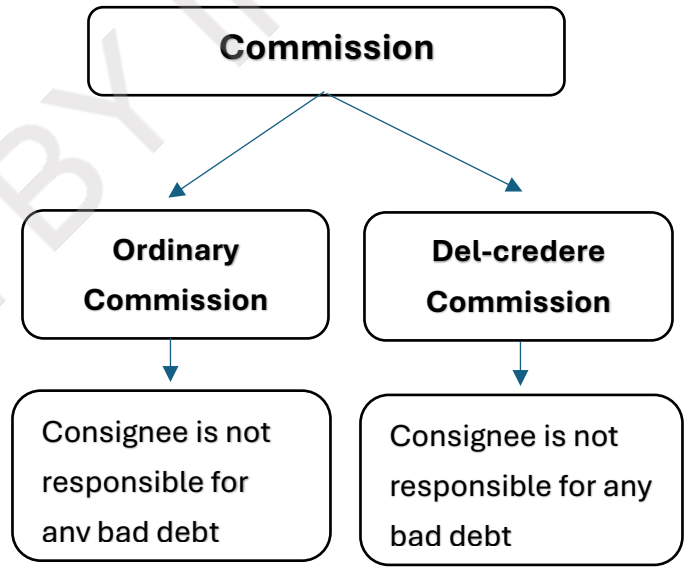
Invoicing : Consignor does not send an invoice. He only sends a **proforma invoice**.

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.



- Periodically, the consignees send 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

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- 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.

3. 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

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	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.

4. 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			

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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			
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			
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.			

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To Consignment Account		
9. For commission payable to consignee		
Consignment Account Dr.		
To Consignee's Personal Account		

5. 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?

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.

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6. 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 the Consignment Account
To Inventory Reserve Account			

7. 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.

8. 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.

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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
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.

❖ Journal Entries

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

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			

9. 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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ordinary commission

- It is based on fixed percentage of the gross sales proceeds made by the consignee.
- . It is given by the consignor regardless of whether the consignee is making credit sales or not.
- This type of commission does not give any protection to the consignor from bad debts and is provided on total sales.

Del-credere Commission

- To increase the sale and to encourage the consignee to make credit sales, the consignor provides an additional commission generally known as del-credere commission.
- This additional commission when provided to the consignee gives a protection to the consignor against bad debts.
- It is calculated on total sales unless there is any agreement between the consignor and the consignee to provide it on credit sales only.

Over-riding Commission

- It is an extra commission allowed by the consignor to the consignee to promote sales at higher price then specified .
- Depending on the agreement it is calculated on total sales or on the difference between actual sales and sales at invoice price or any specified price.
- In order to encourage the consignee to earn higher margins, it can also be in the form of share of additional profits made by consignee on sale of goods.

10. RETURN OF GOODS FROM THE CONSIGNEE

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

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- 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.

11. 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		
3. For advance paid to consignor		
Consignor's Personal Account	*Dr.*	
To Bank Account		
4. For recording bad debts		
Bad Debts Account	*Dr.*	
To Customer's Account		
5. For writing 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		

12. 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		
3. For advance paid to consignor		
Consignor's Personal Account	*Dr.*	
To Bank Account		
4. For recording bad debts		
Bad Debts Account	*Dr.*	

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To Customer's Account		
5. 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		

13. ADVANCE BY THE CONSIGNEE VS SECURITY AGAINST CONSIGNMENT

- The consignor insists 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.

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Unit 3 – Joint Ventures

Introduction:

Joint venture is a short term business undertaking jointly by two or more persons who share the profits and losses in an agreed ratio. Joint Venture is a temporary form of business organization. There are certain business activities or projects that may involve higher risks; higher investments and even they demand multi-skills. In such cases, an individual person may not be able to muster all resources. Hence two or more people having requisite skill sets come together to form a temporary partnership. This is called a Joint Venture. There is a Memorandum of Undertaking (MOU) signed for this purpose.

Concept

A joint venture (JV) is a business arrangement in which two or more parties agree to pool their resources for the purpose of accomplishing a specific task. This task can be a new project or any other business activity.

Characteristics

Following are the salient features of a joint venture form of business:

1. There is an agreement between two or more persons.
2. Joint venture is made for the specific execution of a business plan/project.
3. It is a temporary partnership without the use of a firm name.
4. Profit & Share are shared on the same terms and conditions agreed upon. However, in the absence of any agreement, profit & share will be divided equally.
5. The terms of the joint ventures are executed on a written agreement signed by all parties involved. This document will state that the parties are willingly assisting each other and will contain other terms as such durations, model of association, liabilities etc.
6. Joint ventures are of short duration. Such associations are temporary and comes to an end when the purpose of the agreement is served.

Parties in a Joint Venture

The parties who have agreed to undertake the joint venture are called Co-venturers or Joint venturers. It is exactly same as partnership, with the exception that it is one of the business that is to be terminated after the venture period is over, counting from the time from when it has started. Since it is to be terminated after the period of completion of the venture, the firm name is not generally used. It is a temporary partnership with or without firm name. If there is no agreement concerning the sharing of profits or losses between the co-venturers, it is shared equally by all the parties.

Difference between Joint Venture and Partnership

Partnership	Joint Venture
Always carried on with firm's name	No such firm's name is required
The persons who run the business are called as partners	The persons who agreed to take the project are called as co-venturers
Normally, a partnership is constituted for a long period	A joint venture is formed to complete a specific job/project.
Partnership is governed under the Partnership Act, 1932	There is no enactment of such kind for the joint ventures However, as a matter of fact in

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	law, a joint venture is treated as a partnership
The number of partners is limited to 10 under banking business and 20 for any other trade or business.	There is no limit specified for the numbers of co-venturers
Liability of a partner is unlimited and may extent to his business and personal estate	Liabilities of co-venturers are limited to the particular assignment or project agreed upon.

Difference between Joint Venture and Consignment

	Consignment	Joint Venture
Relationship	Relationship of a consignor and consignee is of owner and agent	The co-venturers of a Joint venture are the owners of a Joint venture
Sharing of Profits	There is no distribution of profit between a consignor and consignee, consignee only gets commission on sale made by him	The co-venturers of a joint venture share profits as per the agreed profit-sharing ratio.
Ownership of Goods	Ownership of the goods remains with the consignor. Consignor transfers only possession to the consignee	Every co-venturer of a joint venture is the co-owner of the goods/project
Contribution of Funds	Investment is done by the consignor only	Funds are contributed by all co-ventures in a certain agreed proportion.
Continuity of Business	Everything goes smooth, consignment is a continuous process.	There is no continuity of the business once project is completed

Accounting of Joint Venture

There are different methods of recording joint venture transactions. They can be broadly classified into two following methods:

1. When separate set of books are maintained
2. When separate set of books are not maintained.

Method I: When Separate Set Books are Maintained for the Joint Venture

As the business duration is short, the books of accounts are not very comprehensive. The basić purpose is to ascertain the profit or loss on account of the joint venture. Generally, under this approach, the following accounts are maintained:

a) Joint Venture account,
b) Joint Bank account; and
c) Co-venturers account.

a. **Joint Venture account:** In this account, in the debit side all expenses (paid personally by the co venturers or out of join bank) irrespective of its nature (i.e capital or revenue) are recorded. In the credit side, all sales (to outsiders as well as to the co-venturers) are recorded. It records all transactions related to the activities carried out. The net result of this account will be either profit or loss.

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b. **Joint Bank account**: To record cash/bank transactions a Joint Bank A/c is maintained. This is basically the cash book of the business. This could take a form of cash book with cash and bank column. It will record, the initial contributions made by each co-venturer, proceeds of sales, expenses and distribution of net balances among co-venturers on dissolution: of the venture All cash inflows are recorded in the debit side and the outflows are recorded in the credit side, Final settlement of the co venturers are lastly put into this account so that it tallies..

c. **Co-venturers account:** Co-Venturer's personal Accounts are maintained to record transaction related to co- venturers. It is like the capital account in the partnership business. Balance in this account refer to the claim of a co venture to/ from the business and is settled through the joint bank account.

The accounting entries are normally as follows:

1. Contribution made by the co Ventures
   Joint Bank A/c Dr.
   To, Co-Venturer Alc

2. Expenses paid through Joint Bank Account
   Joint Venture A/c Dr.
   To, Joint Bank A/c

3. Expenses paid or goods supplied by the co-venturers from private account
   Joint Venture A/C Dr.
   To Co-Venturer A/c

4. Sale proceeds or collections
   Joint Bank A/C Dr.
   To, Joint Venture A/c

5. Collections received by co-venturer
   Co-Venturer A/C Dr.
   To, Joint Venture A/C

6. Assets taken over by the co-venturer
   Co-Venturer A/c Dr.
   To, Joint Venture A/C

7. Liabilities taken over by the coventurers
   Joint Venture A/C Dr.
   To, Co-Venturer A/C

8. Profit on joint venture
   Joint Venture A/C Dr.
   To, Co-Venturer A/C

9. Loss on joint venture
   Co-Venturer A/c Dr.

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To, Joint Venture A/c

10. Final settlement made to co-venturer

Co-Venturer A/c Dr.

To, Joint Bank A/c

Method II: When Separate Set of Books are Not Maintained for the Joint Venture

The co-venturers may decide not to keep separate books of account for the venture if it is for a very short period of time. In this case, all co-venturers will have account for the transactions in their own books. Here no Joint Bank A/c is opened and the co-venturers do not contribute in cash. Goods are supplied by them from out of their stocks and expenses for the venture are also settled the same way.

Each co-venturer will prepare a Joint Venture A/c and the other Co-Venturer's A/c in his books. Naturally, the profit or loss is separately calculated by each co-venturer. Each co-venturer will take into A/c all transactions i.e. done by himself and by his co-venturer as well.

This method is generally applicable when the size of the business is small and co-venturers are operating from distant places.

(a) When each co-venturer keeps record of all transactions

Each co-venturer will prepare a Joint Venture A/c and the other Co-Venturer's A/c in his books. Naturally, the profit or loss is separately calculated by each co-venturer. Each co-venturer will take into account all transactions i.e. done by himself and by his co-venturer as well

The accounting entries (considering two co-venturers-A and B) are presented as under:

	In books of co-venturer A	In books of co-venturer B
When goods are supplied and expenses paid by A	Joint Venture A/c Dr. To, Purchases A/c To, Cash/ Bank A/c	Joint Venture A/c Dr To, A's A/c
When goods are supplied by B and expenses paid by B	Joint Venture A/c Dr To, B's A/C	Joint Venture A/c Dr. To, Purchases A/c To, Cash / Bank A/c
When advance is given by A to B or bill accepted by A	B's A/c Dr To, Cash / Bank A/c To B/P A/C	Cash/ Bank A/c Dr. To, B/R A/C To, A's A/c
When sale proceeds are received by A	Cash/ Bank A/C Dr To, Joint Venture A/c	A's A/C Dr. To, Joint Venture A/c
When sale proceeds are received by B	B's A/c Dr To, Joint Venture A/c	Cash / Bank A/C Dr. To, Joint Venture A/c
For unsold goods taken over by A	Goods A/c Dr To, Joint Venture A/c	A's A/c Dr. To, Joint Venture A/c
For unsold goods taken over by B	B's A/c Dr To, Joint Venture A/C	Goods A/C Dr. To, Joint Venture A/c
For profit on joint venture business	Joint Venture A/c Dr To, B's A/c To, P& LA/C	Joint Venture A/c Dr. To, A's A/c To, P&LA/c
For loss on joint venture business	B's A/C Dr. P&LA/C Dr. To, Joint Venture A/c	A's A/c Dr. P&LA/C Dr. To, Joint Venture A/c

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(b) When each co-venturer keeps record of its own transactions (Memorandum method)

As a variation from this system, the co-venturers may decide to maintain a separate 'Memorandum Joint Venture Al/c' in joint books. In this transactions made by each co-venturer is shown against their name, This account will reflect the profit or loss of the joint venture. The co-venturers will keep an account called"Joint venture with co-venturer A/c"wherein all transactions done by him only are recorded.

Each co-venturer sends a periodic statement of transactions effected by him for the joint venture to the other co-venturer. On the receipt of the above statement, each co-venturer prepares Memorandum Joint Venture Account for determining the profit/ loss from the joint venture. This account is not a double entry account by nature.

The journal entries which are required to be passed are as follows:

Particulars	Journal Entries
Amount received from co-venturer in cash / cheque or B/R	Cash/ Bank/ B/RA/C Dr. To, Joint Venture with Co-Venture's A/c
Discounting of Bills Receivable	Bank A/C Dr. Joint Venture with Co-venturer..A/c (Discount) Dr. To, B/RA/C
Purchase of goods	Joint Venture with Co-venturer…A/C Dr. To, Cash/ Bank Alc To, JV Creditors A/c
Making payment lo Creditors (including discount received)	JV Creditors A/c Dr. To, Cash/ Bank/ B/P A/C To, Joint Venture with Co-venturer.... A/c
Goods supplied by co-venturer from own stock	Joint Venture with Co-venturer.. A/c Dr. To, Purchases A/c/ Goods sent to JV A/c
Payment of expenses	Joint Venture with Co-venturer... A/c Dr. To, Cash/ Bank A/c
Sale of goods	Cash/ Bank/ JV Debtors A/c Dr. To, Joint Venture with Co-venturer... A/c
Collection from customer (including bad debts discount allowed)	Cash/ Bank A/C Joint Venture with Co-venturer.... A/C (Amount of bad debts and discount allowed) To, JV Debtors A/c
Taking away of unsold goods	Goods sent to JVA/C Dr. To, Joint Venture with Co-venturer....A/c
Co-venturer entitled to commission/ salary etc	Joint Venture with Co-venturer... A/c Dr. To, Commission/ Salary A/c
Share of profit on joint venture	Joint Venture with Co-venturer.... A/c Dr. To, Profit & Loss A/c
Share of loss on joint venture	Profit & Loss A/C Dr. To, Joint Venture with Co-venturer.... A/c
Settlement of balance of JV with.... A/c	In case of debit balance Cash/ Bank A/c Dr. To, Joint Venture with Co-venturer....A/c

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	In case of credit balance A Joint Venture with Co-venturer....A/c Dr. To, Cash/ Bank A/c

Points to note: The following transactions are not recorded in the books of either co-venturer: · Transactions effected by other co-venturer; and ·
Transactions not involving cash receipt or cash payment

Conversion of Consignment into Joint Venture

A variation could be that an ongoing consignment arrangement may get converted into a joint venturé arrangement. In such a case, normal accounting for consignment business is done till the conversion. Upon the conversion, the balance stock on consignment is transferred to the Joint Venture A/c and from that day onwards, accounting is done on the basis of principles followed for joint venture

Joint Ventures Running for More than One Accounting Period

If a joint venture runs for more than one accounting period, it poses a special problem of calculation of the closing stock. The stock should be valued on the basis of basic cost plus proportionate non-recurring expenses and it should be shown in the memorandum joint Venture account on the credit side at the end of the year and on the debit side of the memorandum joint venture account of the next year. The other accounts should be made in the usual manner. However, if the co-ventures are interested in an interim settlement at the end of the first year, they should bring in their proportionate share in the value of the closing stock in their respective Joint Venture with Co-Venturer Account' and finally settle their account. The share of stock should be carried forward and shown on the debit side of the Joint Venture with Co-venturer Account.

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Chapter 9 – 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.

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.

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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

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:**

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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.
   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:
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

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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.

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

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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

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**

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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

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/-

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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)			

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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:

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	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.

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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

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

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.

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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/-

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Question 2:

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

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**

Illustrations

Question: 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.

Question: 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.

Question: 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
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.

Question: 4

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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.

Question: 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.

Question: 6

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.

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Question: 7

Balance Sheet as at 31st December 2017

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

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

Question: 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.**
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.

Question: 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

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Bad debts	5,000	
Investments in Government Securities	1,00,000	
Cash in Hand and cash at Bank	1,89,000	
Input CGST	10,000	
Input SGST	10,000	
Output CGST		
Output SGST		8,000
Output IGST		8,000
		6,000
Total	18,31,000	18,31,000

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

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

Question: 10
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.

Question: 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	

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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	
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.

Question: 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

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(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.

Question 12

From the following particulars extracted from the books of Ganguli, prepare trading and profit and loss account and balance sheet as at 31st March, 2022 after making the necessary adjustments:

Particulars	Amount	Particulars	Amount
Ganguli's capital account(Cr.) as on 1.4.2021	5,40,500	Interest received	7,250
Stock on 1.4.2021	2,34,000	Cash with Traders Bank Ltd.	40,000
Sales	14,48,000	Discounts received	14,950
Sales return	43,000	Investments (at 5%) as on1.4.2021	25,000
Purchases	12,15,500	Furniture as on 1-4-2021	9,000
Purchases return	29,000	Discounts allowed	37,700
Carriage inwards	93,000	General expenses	19,600
Rent	28,500	Audit fees	3,500
Salaries	46,500	Fire insurance premium	3,000
Sundry debtors	1,20,000	Travelling expenses	11,650
Sundry creditors	74,000	Postage and telegrams	4,350
Loan from Dena Bank Ltd.(at 12%)	1,00,000	Cash in hand	1,900
Interest paid	4,500	Deposits at 10% as on1-4-2021 (Dr.)	1,50,000
Printing and stationery	17,000	Drawings	50,000
Advertisement	56,000		

Adjustments:
(1) Value of stock as on 31st March, 2022 is ` 3,93,000. This includes goods returned by customers on 31st March, 2022 to the value of ` 15,000 for which no entry has been passed in the books.
(2) Purchases include furniture purchased on 1st January, 2022 for `10,000.
(3) Depreciation should be provided on furniture at 10% per annum.

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(4) The loan account from Dena bank in the books of Ganguli appears as follows:

		Rs.			Rs.
31.3.2022	To Balance c/d	1,00,000	1.4.2021	By Balance b/d	50,000
			31.3.2022	By Bank	50,000
		1,00,000			1,00,000

(5) Sundry debtors include ` 20,000 due from Robert and sundry creditors include ` 10,000 due to him.

(6) Interest paid include ` 3,000 paid to Dena bank.
(7) Interest received represents ` 1,000 from the sundry debtors (due to delay on their part) and the balance on investments and deposits.
(8) Provide for interest payable to Dena bank and for interest receivable on investments and deposits.
(9) Make provision for doubtful debts at 5% on the balance under sundry debtors. No such provision need to be made for the deposits.

Question 13

Sengupta & Co. employs a team of eight workers who were paid ` 30,000 per month each in the year ending 31st March, 2021. At the start of financial year 2021-2022, the company raised salaries by 10% to ` 33,000 per month each.
On October 1, 2021 the company hired two trainees at salary of ` 21,000 per month each. The work force are paid salary on the first working day of every month, one month in arrears, so that the employees receive their salary for January on the first working day of February etc.
You are required to calculate:
(i) Amount of salaries which would be charged to the profit and loss for the year ended 31st March, 2022.
(ii) Amount actually paid as salaries during 2021-22
(iii) Outstanding Salaries as on 31st March, 2022.

Question 14

Mr. Kotriwal is engaged in business of selling magazines. Several of his customers pay money in advance for subscribing his magazines. Information related to year ended 31st March 2022 has been given below:
On 1.4.2021 he had a balance of ` 2,00,000 advance from customers of which ` 1,50,000 is related to year 2021-22 while remaining pertains to year 2022-23. During the year 2021-22 he made cash sales of ` 5,00,000. You are required to compute:
(i) Total income for the year 2021-22.
(ii) Total money received during the year if the closing balance in advance from customers account is ` 1,70,000.

Question 15

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Mr. Birla is a proprietor engaged in business of trading electronics. An excerpt from his Trading & P&L account is as follows:

Particulars	`	Particulars	`
To Cost of Goods Sold	45,00,000	By Sales	C
To Gross Profit c/d	D		
	F		F
To Rent A/c	26,00,000	By Gross Profit b/d	D
To Office Expenses	13,00,000	By Miscellaneous Income	E
To Selling Expenses	B		
To Commission to Manager (on Net Profit before charging such commission)	2,00,000		
To Net Profit	A		
	G		60,00,000

Commission is charged at the rate of 10%.
Selling Expenses amount to 1% of total sales. You are required to compute the missing figures.

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Chapter 10 – Financial Statements of Not-For-Profit Organizations

What is a Not-for-Profit Organization?

A Not-for-Profit Organization is an entity which is not being operated for the purpose of earning profit but for the benefit for the society. It is brought into existence with a view to serve a social cause, not to earn profits for its owners.

Following are some of the forms of Not-For-Profit Organization:

1. Public Hospitals
2. Public Educational Institutions
3. Government Clubs
4. Temples, etc.

Receipt and Payment Account:

A Receipt and Payment Account is similar to cash book except it does not include the date column. The key features of the Receipt and Payment account are as stated below:

1. It presents the summary of cash and bank transactions.
2. All the receipts and payments irrespective of the fact whether they are capital or revenue in nature are accounted for.
3. This account is not maintained as part of the double entry system of accounting.
4. Surplus for the period i.e. Excess of Income over expenditure or Deficit i.e. Excess of Expenditure over income for the period cannot be determined from this account since it excludes all non-cash transactions. This is the limitation of the Receipt and Payment Account.

Example on Receipt and Payment Account:

The receipts and payments for the ABC, NPO for the year ended March 31, 2018 were:

Particulars	**Amount (INR)**
Entrance fees	1000
Membership Fees	5000
Donation for Club Building 1	5000
Food sales	3500
Salaries and Wages	5500
Purchase of Food	2000
Construction of Club Pavilion	13000
General Expenses	1000
Rent and Taxes	500
Bank Charges	250
Opening Cash in hand Balance	5000
Closing Cash in hand Balance	1500
Opening Cash in Bank Balance	2000
Closing Cash in Bank Balance	3500

Prepare the Receipts and Payment Account.

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Receipt and Payment Account for the year ended 31st March 2018

Receipts	Amount	Payments	Amount
To Balance b/d (Op. Bal)		By Salaries and Wages	5,500
- Cash	5,000	By Purchase of Food	2,000
- Bank	2,000	By Construction of Club Building	13,000
		By General Expenses	1,000
To Entrance fees	1,000	By Rent and Taxes	500
To Membership Fees	5,000	By Bank Charges	250
To Donation for Club Building	15,000		
To Food sales	3,500	By Balance c/d	
		- Cash	3,500
		- Bank	5,750
TOTAL	**31,500**	**TOTAL**	**31,500**

Income and Expenditure Account:

Income and Expenditure account can be considered as the PROFIT AND LOSS ACCOUNT for the NPO. The key features of the Receipt and Payment account are as stated below:

1. It is the revenue account for the NPO which is prepared at the end of the accounting period of the NPO.

2. It is prepared using the Matching Principle i.e. current year revenue and expenses are recorded in the current accounting period only irrespective of the status of their payment.

3. Cash as well as Non-Cash items are taken into consideration.

4. Income and Expenses which are capital in nature are excluded.

Preparing the Income and Expenditure Account from the Receipt and Payment Account:

Income and Expenditure account and the Balance Sheet for the NPO can be prepared from the Receipt and Payment Account by making necessary adjustment with respect to the income earned and expense incurred during the current period.
The following steps needs to be followed to prepare the income and expenditure and balance sheet using the Receipt and Payment Account.

1. Prepare the Opening Balance Sheet to arrive at the opening balance of the accumulated fund.

2. Prepare Ledger Accounts for the various income and expenses through which the accruals and outstanding at the beginning and end of the period needs to be adjusted to arrive at the income and expense for the current period.
3. Post the debit and credit of the Receipt and Payment to the Credit of the Income and Expenditure Account for adjusting the accrual and outstanding.

4. Transfer the balance of the income and expenditure to the Accumulated/Capital Fund Account.

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5. Transfer the amounts which are capital in nature from the Receipt and Payment to the Balance Sheet of the NPO.

6. Prepare the Closing Balance Sheet.

Example on Computing and Preparing a particular Income Account from the Receipt and Payment information:

During 2018, Subscription received in cash is Rs. 70000.
It includes Rs.15000 for 2017 and Rs.10000 for 2019.
Also Rs.20000 has still to be received for 2018.
Prepare the Subscription Outstanding, Subscription and Advance Subscription Account for the year ended March 31, 2018.

Dr. Subscription Outstanding Account for the year ended 31st March 2018 Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2018					
Apr - 1	To Balance b/d	15,000	Mar - 31	By Subscription A/c	15,000
Mar - 31	To Subscription A/c	20,000	Mar - 31	By Balance c/d	20,000
	TOTAL	**35,000**		**TOTAL**	**35,000**
2019					
Apr - 1	To Balance b/d	20,000			

Dr. Subscription Account for the year ended 31st March 2018 Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2018					
Mar - 31	To Subscription Outstanding A/c	15,000	Mar - 31	By Cash/Bank A/c	70,000
Mar - 31	To Advance Subscription A/c	10,000	Mar - 31	By Subscriptions Outstanding A/c	20,000
Mar - 31	To Income & Expenditure A/c	65,000			
-	**TOTAL**	**90,000**		**TOTAL**	**90,000**

Dr. Advance Subscription Account for the year ended 31st March 2018 Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2018			2018		
Apr - 1	To Balance b/d	10,000	Mar - 31	By Subscription A/c	10,000
	TOTAL	**10,000**		**TOTAL**	**10,000**
			2019		
			Apr - 1	By Balance c/d	10,000

The balance in Advance Subscription Account of Rs.10000/- will appear on the liabilities side and in Outstanding subscription Account of Rs.20000/- will appear on the Asset Side.

Balance Sheet:

A Balance Sheet is the statement which presents the balance of the assets and liabilities of an accounting period at a given date. Normally it is prepared at the end of an accounting period after the Income and Expenditure Account has been prepared. In NPO Accounting, the excess of total assets over total outside liabilities is known as Capital Fund which presents the amount contributed by the Members, receipt of special donations and surplus accumulated over the years.

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Example on preparing the Income and Expenditure account and Balance Sheet from the receipt and Payment Account.

Following is the Receipt and Payment Account of Club XYZ, an NPO for the year ended March 31, 2018 along with the details of the opening and closing balance of Assets and Liabilities for the year ended.

Prepare the Income and Expenditure and Balance Sheet for the year ended March 31, 2018.

Receipt and Payment Account for the year ended 31st March 2018

Receipts	Amount	Payments	Amount
To Balance b/d (Op. Bal)	10,000	By Salaries and Wages	13,000
		By Rent	5,000
To Membership fees	25,000	By Utilities	7,000
To Miscellaneous Income	5,000	By Magazines and Periodicals	2,500
To Interest on Secured Deposit	2,500	By Miscellaneous Expenses	3,000
		By Balance c/d (Cl. Bal)	12,000
TOTAL	**42,500**	**TOTAL**	**42,500**

Particulars	31-Mar-17	31-Mar-18
Salaries outstanding	5,000	8,000
Outstanding Rent	5,000	10,000
Outstanding Utilities	500	1,000
Outstanding Magazines and Periodicals	250	500
Fixed Deposit	50,000	50,000
Accrued Interest	1,000	1,000
Fees Receivable	1,250	1,500
Prepaid Expenses (Miscellaneous)	450	600
Computers	7,000	
Equipment	4,000	
TOTAL		

Depreciation on the Computers is charged at 15% and on Equipment is charged at 10%.
The Opening Balance Sheet is as presented below:

Balance Sheet as on 31st March 2017

Liabilities	Amount	Amount	Assets	Amount	Amount
Outstanding Expenses:			Fixed Deposits		50,000
- Salaries		5,000	Accrued Interest		1,000
- Rent		5,000	Fees Receivable		1,250
- Utilites		500	Prepaid Expenses		450
- Magazines & Periodicals		250	Computers		7,000
			Equipments		4,000
Capital Fund (Bal. Fig)		52,950			
TOTAL		**63,700**	**TOTAL**		**63,700**

The Income and Expenditure Account is as presented below:

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Dr.	Income and Expenditure Account for the year ended March 31, 2018				Cr.
Particulars	**Amount**	**Amount**	**Particulars**	**Amount**	**Amount**
To Salaries and Wages		16,000	By Membership Fees		25,250
To Rent		10,000	By Miscellaneous Income		5,000
To Utilites		7,500	By Interest on Seurity Deposit		2,500
To Magazines & Periodicals		2,750			
To Misc. Expenses		2,850			
			By Excess of Expenditure over Income		7,800
To Depreciation:					
- Computers (@ 15%)	1050				
- Equipments (@ 10%)	400	1,450			
TOTAL		**40,550**	**TOTAL**		**40,550**

The computations done in arriving at the amounts mentioned in the above income and expenditure account are as follow:

Particulars	**Salaries**	**Rent**	**Utilities**	**Mag & Periodicals**	**Misc. Exp**
1. Expense Computation					
Paid during the year	13,000	5,000	7,000	2,500	3,000
Add: O/s as on 31.03.2018	8,000	10,000	1,000	500	
Add: Prepaid on 31.03.2017					450
	21,000	**15,000**	**8,000**	**3,000**	**3,450**
Less: O/s as on 31.03.2017	(5,000)	(5,000)	(500)	(250)	
Less: Prepaid on 31.03.2018					(600)
Expenditure for the Year	**16,000**	**10,000**	**7,500**	**2,750**	**2,850**

Particulars	
2. Membership Income Computation	
Received in Cash/Bank	25,000
Add: Receivable in 2018	1,500
Less: Receivable in 2017	(1,250)
Membership Income	**25,250**

The Balance Sheet is as presented below:

Club XYZ Balance Sheet as on 31st March 2018

Liabilities	**Amount**	**Amount**	**Assets**	**Amount**	**Amount**
Outstanding Expenses:			Fixed Deposits		50,000
- Salaries		8,000	Accrued Interest		1,000
- Rent		10,000	Fees Receivable		1,500
- Utilites		1,000	Prepaid Expenses		600
- Magazines & Periodicals		500	Computers	7,000	
			Less: Depreciation (@ 15%)	(1,050)	5,950
Capital Fund					
Opening Balance	62,950		Equipments	4,000	
Less: Excess of Expenditure over Income	(7,800)	55,150	Less: Depreciation (@ 10%)	(400)	3,600
			Cash in Hand/Bank		12,000
TOTAL		**74,650**	**TOTAL**		**74,650**

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Accounting treatment of some special items

Donations: These may have been raised either for meeting some revenue or capital expenditure; those intended for the first mentioned purpose are credited directly to the Income and Expenditure Account but others, if the donors have declared their specific intention, then they are credited to special fund account and in the absence thereof, to the Capital Fund Account.

If any investments are purchased out of a special fund or an asset is acquired therefrom, these are disclosed separately. Any income received from such investments or any donations collected for a special purpose are credited to an account indicating the purpose and correspondingly the expenditure incurred in carrying out the purpose of the fund is debited to this account. On no account any such expense is charged to the Income and Expenditure Account. **The term "Fund" is strictly applicable to the amounts collected for a special purpose when these are invested, e.g. Scholarship Fund, Prize Fund etc.**

Entrance and admission fees: Such fees which are payable by a member on admission to club or society are normally considered capital receipts and credited to Capital Fund. This is because these do not give rise to any special obligation towards the member who is entitled to the same privileges as others who have paid only their annual subscription. Nevertheless, where the amount is small, meant to cover expenses concerning admission, or the rules of the society provided that such fees could be treated as income of the society, these amounts may be included in the Income and Expenditure Account. The treatment depends upon the requirement of question. If the question is silent then always take it to be capital receipt.

Subscription: Subscriptions being an income should be allocated over the period of their accrual. For testing the knowledge of candidates of this important accounting principle, questions are often set in examinations wherein figures of subscription collected by a society during the year as well as those outstanding at the beginning of the year and at its close are given. If some subscriptions have been received in advance, their amount is also indicated. In such cases, it is always desirable to set up a Subscription Account for determining the amount of subscription pertaining for the period for which accounts are being prepared

Life membership fee: Fees received for life membership is a **capital receipt** as it is of non-recurring nature. It is **directly added to capital fund** or general fund.

For adjusting lump sum subscription collected from the life members, one of the following methods can be adopted:

(1) The entire amount may be carried forward in a special account until the member dies, after which the same may be transferred to the credit of the Accumulated Fund.

(2) An amount equal to the normal annual subscription may be transferred every year to the Income and Expenditure Account and balance carried forward till it is exhausted. If, however, the life member dies before the whole of the amount paid by him has been transferred in this way, the balance should be transferred to the Accumulated Fund on the date of his death.

(3) An amount, calculated according to the age and average life of the member, may annually be transferred to the credit of Income and Expenditure Account.

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Other Concepts:

1. **Donation:** it is **gift** in **cash** or **kind** from some person. It may be of two types:
   (a) **Specific Donation:** It is received for certain specific purpose like Building Donation, Library Books donation etc. It should be capitalized and shown on the liabilities side of the balance sheet.
   (b) **General Donation:** It is not received for any specific purpose and shown on the credit side of Income and Expenditure Account.
2. **Entrance Fees:** It may also be known as admission fees. **Entrance Fees should be capitalized** and added to the capital fund for all organization. If the question gives any specific treatment of Entrance fees, then it should be followed accordingly.
3. **Legacy:** It is an amount received by an organization as per the **will** of the person after the death of the person. It should be capitalised and shown on the liabilities side of the balance sheet by adding to the Capital Fund.
4. **Life Membership Fees:** It should **be capitalized** and shown on the liabilities side of the balance sheet. If the question gives any specific treatment of Life membership Fees, then it should be followed accordingly.
5. **Endowment Fund Donation:** It is a donation received and **only income from that donation is to be used for certain specific purpose**. In such cases income relating to special funds should be added to these funds on the liabilities side of the Balance sheet. All the expenses should be deducted from that fund on the liabilities side of the Balance sheet.
6. **Treatment of Sale of Old Newspaper and Periodicals:** The amount received on such sale is shown as Income on the credit side of income and expenditure account.
7. **Sale of old Fixed Assets:** The Sale proceeds of old Fixed Assets are treated as **capital receipts**. The profit or loss on sale of fixed asset is shown in the Income and Expenditure A/c
8. **Honorarium:** It is paid to someone for receiving any services from person who are **not the employees** of the Not for Profit Organisation.

Questions:

Question 1:
Following is the Receipt and Payment Account of Club ABC, an NPO for the year ended March 31, 2018 along with the details of the opening and closing balance of Assets and Liabilities for the year ended.

Prepare the Income and Expenditure and Balance Sheet for the year ended March 31, 2018.

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Receipt and Payment Account for the year ended 31st March 2018

Receipts	Amount		Payments	Amount
To Balance b/d (Op. Bal)	15,000		By Salaries and Wages	17,000
			By Rent	12,000
To Membership fees	35,000		By Utilities	7,500
To Miscellaneous Income	7,000		By Magazines and Periodicals	2,500
To Interest on Secured Deposit	4,000		By Miscellaneous Expenses	3,500
			By Balance c/d (Cl. Bal)	18,500
TOTAL	**61,000**		**TOTAL**	**61,000**

Particulars	31-Mar-17	31-Mar-18
Salaries outstanding	7,000	9,500
Outstanding Rent	5,500	7,500
Outstanding Utilities	750	500
Outstanding Magazines and Periodicals	450	150
Fixed Deposit	75,000	75,000
Accrued Interest	1,500	1,250
Fees Receivable	850	1,400
Prepaid Expenses	950	1,200
Computers	15,000	
Equipment	9,000	
TOTAL		

Depreciation on the Computers is charged at 25% and on Equipment is charged at 15%.

Illustrations

Question: 1

The receipts and payments for the Swaraj Club for the year ended March 31, 2016 were:

- Entrance fees Rs.300;
- Membership Fees Rs.3,000;
- Donation for Club Pavilion Rs.10,000,
- Foodstuff sales Rs.1,200;
- Salaries and Wages Rs.1,200
- Purchase of Foodstuff Rs.800;
- Construction of Club Pavilion Rs.11,000;
- General Expenses Rs.600;
- Rent and Taxes Rs.400;
- Bank Charges Rs.160.
- Cash in hand–April. 1st Rs.200, March. 31st Rs.350
- Cash in Bank–April. 1st Rs.400; March. 31st Rs.590

You are required to prepare Receipts and Payment Account.

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Question: 2

During 2016, subscription received in cash is Rs.42,000. It includes Rs.1,600 for 2015 and Rs.600 for 2017. Also, Rs.3,000 has still to be received for 2016.

Calculate the amount to be credited to Income and Expenditure Account in respect of subscription.

Question: 3

Suppose salaries paid during 2016 were Rs 23,000. The following further information is available:

Salaries unpaid on 31st March,2015	1,400
Salaries pre-paid on 31st March,2015	400
Salaries un-paid on 31st March,2016	1,800
Salaries pre-paid 31st March,2016	600

Required: Calculate the amount to be debited to Income and expenditure account in respect of salaries and also, show necessary ledger accounts.

Question: 4

The following was the Receipts and Payments Account of Exe Club for the year ended March. 31, 2016 (All the figures in thousands)

Receipts	**Rs**	**Payments**	**Rs**
Cash in hand	100	Groundsman's Fee	750
Balance at Bank as per Pass Book:		Moving Machine	1,500
Deposit Account	2,230	Rent of Ground	250
Current Account	600	Cost of Teas	250
Bank Interest	30	Fares	400
Donations and Subscriptions	2,600	Printing & Office Expenses	280
Receipts from teas	300	Repairs to Equipment	500
Contribution to fares	100	Honorarium to Secretary and	
Sale of Equipment	80	Treasurer of 2015	400
Net proceeds of Variety		Balance at Bank as per Pass Book:	
Entertainment	780	Deposit Account	3,090
Donation for forth coming		Current Account	150
Tournament	1,000	Cash in hand	250
	7,820		**7,820**

You are given the following additional information:

Particulars	**April.1.2015 (Rs.)**	**March.31.2016 (Rs.)**
Subscription due	150	100
Amount due for printing etc.	100	80
Cheques unpresented being payment for repairs	300	260
Estimated value of machinery and equipment	800	1,750
Interest not yet entered in the Pass book		20
Bonus to Groundsman o/s.		300

For the year ended March. 31, 2016, the honorarium to the Secretary and Treasurer are to be increased by a total of Rs 200.

Required: Prepare Income & Expenditure Account for period ending 31-03-2016 and the relevant Balance Sheet.

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Question: 5

The Income and Expenditure Account of the Youth Club for the Year 2016 is as follows:

Expenditure	Rs.	**Income**	Rs.
To Salaries	4,750	By Subscription	7,500
To General Expenses	500	By Entrance Fees	250
To Audit Fee	250	By Contribution for annual dinner	1,000
To Secretary's Honorarium	1,000	By Annual Sport meet receipts	750
To Stationery & Printing	450		
To Annual Dinner Expenses	1,500		
To Interest & Bank Charges	150		
To Depreciation	300		
To Surplus	600		
	9,500		9,500

This account had been prepared after the following adjustments:

Particulars	**Amount (Rs.)**
Subscription outstanding at the end of 2015	600
Subscription received in Advance on 31st December,2015	450
Subscription received in advance on 31st December,2016	270
Subscription outstanding on 31st December,2016	750

Salaries Outstanding at the beginning and the end of 2016 were respectively Rs.400 and Rs.450. General Expenses include insurance prepaid to the extent of Rs.60. Audit fee for 2016 is yet unpaid. During 2016 audit fee for 2015 was paid amounting to Rs.200.

The Club owned a freehold lease of ground valued at Rs.10,000. The club had sports equipment on 1st January 2016 valued at Rs.2,600. At the end of the year, after depreciation, this equipment amounted to Rs.2,700. In 2015, the Club has raised a bank loan of Rs.2,000. This was outstanding throughout 2016. On 31st December 2016 cash in hand amounted to Rs.1,600.

Required: Prepare the Receipts and Payments Account for 2016 and Balance Sheet as at the end of the year.

Question: 6

From the following Income and Expenditure Account and the Balance Sheet of a club, prepare its Receipts and Payments Account and Subscription Account for the year ended 31st March 2016:

Income & Expenditure Account for the year 2015-16

Expenditure	**Rs.**	**Income**	**Rs.**
Upkeep of Ground	10,000	By Subscriptions	17,320
Printing	1,000	By Sale of Newspapers (Old)	260
Salaries	11,000	By Lectures	1,500
Depreciation on Furniture	1,000	By Entrance Fee	1,300
Rent	600	By Misc. Income	400
		By Deficit	2,820
	23,600		23,600

Balance Sheet as at 31st March 2016

Liabilities		**Rs.**	**Assets**	**Rs.**

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Subscription in Advance (2016-17)		100	Furniture	9,000
Prize Fund: Opening Balance			Ground and Building	47,000
Add: Interest	25,000		Prize Fund Investment	
	1,000		Cash in Hand	20,000
Less: Prizes	26,000		Subscription	2,300
General Fund:	(2,000)	24,000	(outstanding) (2015-16)	
Opening Balance				
Less: Deficit	56,420			700
	(2,820)			
Add: Entrance Fee	53,600			
	1,300	54,900		
		79,000		79,000

The following adjustments have been made in the above accounts:

1. Upkeep of ground Rs.600 and Printing Rs. 240 relating to 2014-2015 were paid in 2015-16.
2. One-half of entrance fee has been capitalised by transfer to General Fund.
3. Subscription outstanding in 2014-15 was Rs.800 and for 2015-16 Rs.700.
4. Subscription received in advance in 2014-15 was Rs.200 and in 2015-16 for 2016-17 Rs. 100.

Question: 7

The Sportswriters Club gives the following Receipts and Payments Account for the year ended March 31, 2016:

Receipts and Payments Account

Receipts	**Rs.**	**Payments**	**Rs.**
To Balance b/d	4,820	By Salaries	12,000
To Subscriptions	28,600	By Rent and electricity	7,220
To Miscellaneous income	700	By Library books	1,000
To Interest on Fixed deposit	2,000	By Magazines and newspapers	2,172
		By Sundry expenses	10,278
		By Sports equipment's	1,000
		By Balance c/d	2,450
	36,120		36,120

Figures of other assets and liabilities are furnished as follows:

Particulars	**As at March 31**	
	Rs.	**Rs.**
	2015	**2016**
Salaries outstanding	710	170
Outstanding rent & electricity	864	973
Outstanding for magazines and newspapers	226	340
Fixed Deposit (10%) with bank	20,000	20,000
Interest accrued thereon	500	500
Subscription receivable	1,263	1,575

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Prepaid expenses	417	620
Furniture	9,600	
Sports equipment's	7,200	
Library books	5,000	

The closing values of furniture and sports equipment's are to be determined after charging depreciation at 10% and 20% p.a. respectively inclusive of the additions, if any, during the year. The Club's library books are revalued at the end of every year and the value at the end of March 31, 2016 was Rs. 5,250.

Required: From the above information you are required to prepare:

(a) The Club's Balance Sheet as at March 31, 2015;

(b) The Club's Income and Expenditure Account for the year ended March 31, 2016.

(c) The Club's Closing Balance Sheet as at March 31, 2016.

Question: 8

From the following balances and particulars of Republic College, prepare Income & Expenditure Account for the year ended March 2016 and a Balance Sheet as on the date:

	Rs.	Rs.
Seminars & Conference Receipts		4,80,000
Consultancy Receipts		1,28,000
Security Deposit – Students		1,50,000
Capital Fund		16,06,000
Research Fund		8,00,000
Building Fund		25,00,000
Provident Fund		5,10,000
Tuition Fee Received		8,00,000
Government Grants		5,00,000
Donations		50,000
Interest & Dividends on Investments		1,85,000
Hostel Room Rent		1,75,000
Mess Receipts (Net)		2,00,000
College Stores-Sales		7,50,000
Outstanding expenses		2,25,000
Stock of-stores and Supplies (opening)	3,00,000	
Purchases - Stores & Supplies	8,00,000	
Salaries – Teaching	8,50,000	
Research	1,20,000	
Scholarships	80,000	
Students Welfare expenses	38,000	
Repairs & Maintenance	1,12,000	
Games & Sports Expenses	50,000	
Misc. Expenses	65,000	
Research Fund Investments	8,00,000	
Other Investments	18,50,000	
Provident Fund Investment	5,10,000	
Seminar & Conference Expenses	4,50,000	
Consultancy Expenses	28,000	
Land	1,00,000	
Building	16,00,000	

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Plant and Machinery	8,50,000	
Furniture and Fittings	6,00,000	
Motor Vehicle	1,80,000	
Provision for Depreciation:		
Building		4,80,000
Plant & Equipment		5,10,000
Furniture & Fittings		3,36,000
Cash at Bank	6,42,000	
Library	3,60,000	
	1,03,85,000	**1,03,85,000**

Adjustments:

	Particulars	**Rs.**
(1)	*Materials & Supplies consumed: (From college stores)*	
	Teaching	*50,000*
	Research	*1,50,000*
	Students Welfare	*75,000*
	Games or Sports	*25,000*
(2)	Tuition fee receivable from Government for backward class Scholars	80,000
(3)	Stores selling prices are fixed to give a net profit of 10% on selling price	
(4)	Depreciation is provided on straight line basis at the following rates:	
	(1) Building	5%
	(2) Plant & Equipment	10%
	(3) Furniture & Fixtures	10%
	(4) Motor Vehicle	20%

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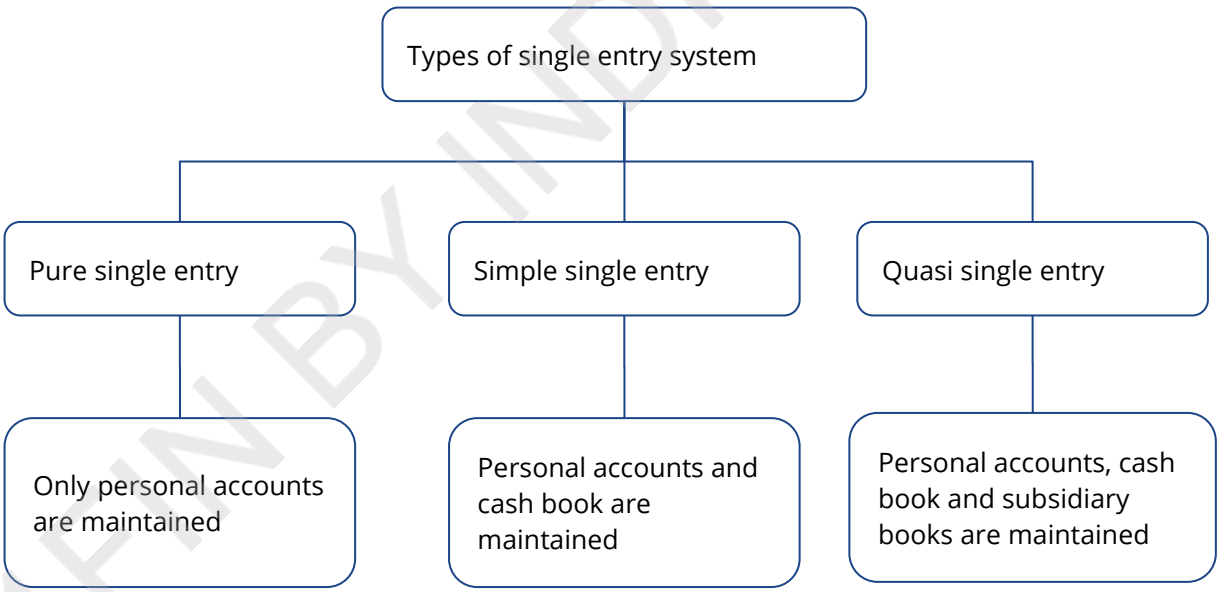
CHAPTER 11: ACCOUNTS FROM INCOMPLETE RECORDS

Introduction

Very often small sole proprietorship and partnership businesses do not maintain a double entry bookkeeping system. Sometimes they keep records 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 becomes 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.

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 books mix 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

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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.

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 a profit and loss account. Instead by collecting information about assets and liabilities, it is easier to prepare a 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**.

The above formula can also be expanded as below:

Particulars	Amount
A.Capital at the end	XXX
Add: drawings	XXX
Less: Fresh capital introduced	XXX
B. Capital at the beginning	XXX
Profit **(A-B)**	XXX

Opening and closing capital can be determined by preparing a 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 20X0	AMOUNT 20X1	ASSETS	AMOUNT 20X0	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

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			Cash at bank	xxx	xxx
			Prepaid expenses	xxx	xxx
Total	xxx	xxx	Total	xxx	xxx

Sources of assets and liabilities: -

Item	Source of information
Cash and bank	Cash book and bank pass book
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

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.
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 a scientific basis, that is the original cost in the case of new assets and the depreciated amount based on cost minus depreciation to date for used

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		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.
- 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
In the Cash Book, there might be 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.
Amounts belonging to the business after collection may have been directly utilized for	The appropriate asset or expense account should be debited and the source which had

acquiring business assets or for meeting certain expenses instead of being deposited into the Cash Book.	provided funds credited
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
Any excess or shortage in cash book for unidentified reasons	Should be adjusted with Proprietor's capital account.
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.
Analysis of cash and bank receipts and payments in detail.	Should be done in an 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 the opening balance of cash, cash sales or cash purchases. This is based on other available information.
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.
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.

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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 the total debtors account.

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 the 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
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 the balance of the 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	Prepaid 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.

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**
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 the 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	

Illustrations

Illustration – 1

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

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Particulars	31-12-2015 (Rs.)	31-12-2016 (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

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 a Statement of Affairs 31-12-2015 and 31-12-2016.
Find out profit for the year ended ended 31-12-2016

Solution

(i).Statement of affairs

Liabilities	**31-12-2015**	**31-12-2016**	**Assets**	**31-12-2015**	**31-12-2016**
	Rs.	**Rs.**		**Rs.**	**Rs.**
Capital	**2,41,200**	**4,40,000**	Building	1,00,000	97,500
Loans	1,00,000	80,000	Furniture	50,000	45,000
Sundry creditors	40,000	70,000	Inventory	1,20,000	2,70,000
			Sundry debtors	40,000	90,000
			Cash at bank	70,000	85,000

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			Cash in hand	1200	3200
	3,81,200	5,90,000		3,81,200	5,90,000

Working notes

(i) Depreciation and closing balances

	Building (Rs.)	furniture(Rs.)
Balance as on 31-12-2015	1,00,000	50,000
Less : depreciation	2500	5000
Balance as on 31-12-2016	97,500	45,000

(ii) Determination of profit by applying the method of capital comparison

Particulars	Amount (₹)
Capital balance as on 31-12-2016	4,40,700
Less : fresh capital introduced	(40,000)
	4,00,700
Add : drawings(₹2000 × 12)	24,000
	4,24,700
Less: capital balance as on 31-12-2015	(2,41,200)
Profit	1,83,500

Note :

- Closing balance is increased due to fresh capital introduction , so its deducted
- Closing capital was reduced due to withdrawal by proprietor ;so its deducted

Alternative method

Capital account can be prepared as follows

Particulars	(₹)	Particulars	(₹)
To drawings	24,000	By balance b/d	2,41,200
To balance c/d	4,40,700	By additional capital	40,000
		By net profit (bal fig)	**1,83,500**
	4,64,700		4,64,700

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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. 2.

			Amount (₹)
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 Jewelry	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.

Solution

Statement of affairs

Particulars	**01.01.year 1**		**01.01.year 2**	
	liabilities(₹)	**Assets (₹)**	**liabilities(₹)**	**Assets (₹)**
Assets				
Cash in hand		25,500		16,000
Inventory		56,000		91,500
Sundry creditors		41,500		52,500
Land and building		1,90,000		1,90,000
Wife's jewellery		75,000		1,25,000
Motor car		_		1,25,000
Loan to Moti's brother		_		20,000
		3,88,000		6,20,000
Liabilities				
Owing to Moti's brother	(40,000)		_	
Sundry creditors	(35,000)	_	(55,000)	_

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Capital		**3,13,000**		**5,60,000**

Income during the 2 years

Particulars	**Amount (₹)**	**Amount (₹)**
Closing Capital (1st jan year 1)	5,65,000	
Add : Drawings - domestic expenses for two years (Rs.4000 × 24 months)	96,000	
Less : opening capital	(3,13,000)	3,48,000
Profit for the year 1 and year 2)		
Profit disclosed Year 1 Year 2	1,05,000 1,23,000	(2,28,000)
		1,20,000

Income is disclosed less than Rs. 1,20,000
Hence, the contention of the Income tax Officer is correct.

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 (₹)**
Furniture	1,20,000	?
Advances	70,000	50,000
Creditors	32,000	30,000
Debtors	40,000	45,000
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**
April 30	2,000	—
May 31	—	2,000
June 30	4,000	—
Sept. 30	—	6,000
Dec. 31	2,000	—
Feb. 28	—	8,000

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- 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.

Solution

Statement of affairs as on 31-03-2016 and 31-03-2017

Liabilities	**31-12-2016**	**31-12-2017**	**Assets**	**31-12-2016**	**31-12-2017**
	Rs.	**Rs.**		**Rs.**	**Rs.**
Capital a/cs			Furniture	1,20,000	1,17,500
A	1,50,000	75000	Advances	70,000	50,000
B	75,000	75000	Inventory	60,000	74,750
C		75000	Sundry debtors	40,000	45,000
Loan	_	_	Cash at bank	50,000	1,40,000
Sundry creditors	32000	30,000	Current a/c B	2,000	_
Current a/cs					
A	5,000	74,036*			
B		48,322*			
C		50,142*			
	3,42,000	**4,27,500**		**3,42,000**	**4,27,500**

***refer current A/Cs**

CURRENT ACCOUNTS

Particulars	**A**	**B**	**C**	**Particulars**	**A**	**B**	**C**
	₹	₹	₹		₹	₹	₹
To balance b/d	_	2,000	_	By balance b./d	5,000	_	_
To drawings	8,,000	16,000	_	By salary	24,000	24,000	18,000
To interest on drawings	533	534	-	By interest on capital	5635	4,500	3375
To balance b/d(b.f)	74,036	48,322	50,142	By share of profit	47,944	38,356	28,767
	82,567	48,322	50,142		82,567	48,322	50,142

STATEMENT OF PROFIT

₹

Current account balances as on 31-3-20X2			1,72,500
Less: Salary			
A Rs.2000 × 12 = 24,000			
B Rs.2000 × 12 = 24,000			
C Rs.2000 × 12 = 18,000			(66,000)
Less : interest on capital			
	A	5,625	
	B	4,500	
	C	3,375	(13,500)
Add: drawings			
	A	8,000	
	B	16,000	24,000
Add: interest on drawings			
	A	533	
	B	534	1067
			1,18,067
Less: current a/c balances as on 31-3-20X1 (5000-2000)			(3000)
Net profit for the year			1,15,067

Notes :

₹

(i) Depreciation on furniture	
10 % on Rs.1,20,0000	12000
10 % on Rs. 10,000 for 1/4th year	250
	12,250
(ii) furniture as on 31-3-20X1	1,20,000
Balance as on 31-3-20X1	10,000
Add: new purchase	1,30,000
	(12,250)
	1,17,750
(iii) total of current accounts as on 31-3-20X2	
Total of assets (1,17,750 + 50,000 + 74,750 + 45,000 + 1,40,000)	4,27,500
Less: fixed capital (75,000 + 75,000+ 75000)	(2,55,000)
	1,72,500
(iv) interest on capital	
A: 1,50,000 @ 6% for 3 months	2250
75,000 @ 6 % for 9 months	3375
	5625
B: 75,000 @ 6 % for 1 year	

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C: 75,000 @ 6 % for 9 months	4500
	3375
(v) interest on drawings	
A: 2000 @ 10% for 11 months	
4000 @ 10% for 9 months	183
6000 @ 10% for 3 months	300
	50
	533
B: 2000 @ 10% for 10 months	167
6000 @ 10% for 6 months	300
8000 @ 10 % for 1 month	67
	534
(vi) Allocation of profit	
3 months profit Rs. 1,15,067	
9 months profit Rs. 28,767	
A: 2/3 * 28,767 + 1/3 * 86,300	
B: 1/3* 1,15,067	47,944
C: 1/3 * 86,300	38,356
	28,767
	1,15,067

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, 20X2 and a Balance Sheet as on that date:

(a)

Particulars	31-3-20X0 ₹	31-3-20X1 ₹
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
Sundry creditors	1,20,000	?

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

Particulars	Amount (₹)	Particulars	Amount (₹)

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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:**

1. Bills receivable drawn during the year amount to Rs.20,000 and Bills payable accepted Rs.16,000.
2. Some items of old furniture, whose written down value on 31st March, 20X1 was Rs.20,000 was sold on 30th September, 20X1 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 the whole year.
3. 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%.
4. Mr. Shivkumar has been maintaining a steady gross profit rate of 30% on turnover.
5. 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.
6. 20% of total sales and total purchases are to be treated as for cash.
7. Additions in the Furniture Account took place in the beginning of the year and there was no opening provision for doubtful debts.

Solution

Mr. Shiv Kumar

Trading and profit and loss account of for the year ended 31st March,20X2

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To opening inventory (bal.fig)		80,000	By sales (3,20,000×100/80)		4,00,000
To purchases (1,92,000 × 100/80)		2,40,000	By closing stock		40,000
To gross profit c/d @ 30%on sales		120,000			
		4,40,000			4,40,000
To miscellaneous expenses (w.n.10)		82,000	By gross profit b/d		1,20,000
To depreciation			By miscellaneous receipts		20,000
building	36,000		By net loss transferred to capital a/c (bal.fig)		25,840
Furniture (6800 + 1000)	7800				
Motor car	16000	59,800			

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To loss on sale of furniture		11,000			
To bad debts		8,000			
To provision for doubtful debts		5040			
		1,65,840			**1,65,840**

Balance sheet as on 31st March,20X2

Liabilities	**Amount (₹)**	**Amount (₹)**	**Assets**	**Amount (₹)**	**Amount (₹)**
Capital as on 1st April,20X1		7,16,000	Building (w.n.8)		3,24,000
Profit and loss a/c	40,000		Furniture (w.n.5)		61,200
Less: loss for the year	(25,840)		Motor car(w.n.9)		80,000
		14,160	Inventory in trade		40,000
Sundry creditors		1,12,000	Sundry debtors	2,52,000	
Bills payable		16,000	Less: provision for doubtful debts @ 2%	(5040)	2,46,960
Outstanding salary		10,000	Bills receivable		28,000
			Cash in hand and at bank		1,04,000
		8,68,160			**8,68,160**

Working notes:

1.Debtors account

Particulars	**Amount (₹)**	**Particulars**	**Amount (₹)**
To balance b/d	1,60,000	By cash/bank a/c	2,00,000
To sales a/c	3,20,000	By bills receivable a/c	20,000
		By bad debts	8,000
		By balance c/d (bal.fig)	2,52,000
	4,80,000		4,80,000

2.Creditors account

Particulars	**Amount (₹)**	**Particulars**	**Amount (₹)**
To cash/bank a/c	1,84,000	By balance b/d	1,20,000
To bills payable a/c	16,000	By purchases a/c	1,92,000
To balance c/d (bal.fig)	1,12,000		
	3,12,000		3,12,000

3.Bills payable account

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Particulars	Amount (₹)	Particulars	Amount (₹)
To cash/bank a/c (bal.fig)	28,000	By balance b/d	28,000
To balance c/d	16,000	By sundry creditors a/c	16,000
	44,000		44,000

4.Bills receivable account

Particulars	Amount (₹)	Particulars	Amount (₹)
	32,000	By cash/bank a/c (b.f)	24,000
	20,000	By balance c/d	28,000
	52,00o		52,000

5. Furniture account

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	60,000	By bank/cash a/c	8,000
To bank a/c (b.f)	28,000	By depreciation	1,000
		By profit and loss a/c (loss on sale) (20,000-1000-8000)	11,000
		By depreciation a/c (68,000 ×10%)	6,800
			61,200
	88,000		88,000

6. Cash /Bank account

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	1,80,000	By miscell. Trade expensesa/c	80,000
To miscellaneous receipts a/c	20,000	By purchases a/c	48,000
To sundry debtors a/c	2,00,000	By furniture a/c	28,000
To sales a/c	80,000	By sundry creditors a/c	1,84,000
To furniture a/c (sale)	8000	By bills payable a/c	28,000
To bills receivable a/c	24,000	By building a/c (3,60,000-3,20,000)	40,000

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		By balance c/d	1,04,000
	5,12,000		5,12,000

7. Opening balance sheet as on 31.3.20X1

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital (bal.fig)	7,16,000	Building	3,20,000
Profit and loss a/c	40,000	Furniture	60,000
Sundry creditors	1,20,000	Motor car	80,000
Bills payable	28,000	Inventory in trade	80,000
Outstanding salary	8,000	Sundry debtors	1,60,000
		Bills receivable	32,000
		Cash in hand and at bank	1,80,000
	5,12,000		5,12,000

8. Building account

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	3,20,000	By depreciation a/c	36000
To cash/bank a/c	40,000	By balance c/d	3,24,000
	3,60,000		3,60,000

9. Motor car account

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	80,000	By depreciation a/c	16,000
		By balance c/d	64,000
	80,000		80,000

10.miscellaneous expenses

Miscellaneous expenses (including salaries)	80,000
Less:outstanding salary as on 31.3.20X1	(8000)
Add: oustanding salary as on 31.3.20X2	10,000

Illustration - 5

From the following data furyou are required to prepare a Trading and Profit and Loss Account for the year ended 31st March, 20X2 and a Balance Sheet as at that date. All workings should form part of your answer.

Particulars	As on	As on

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

Solution

Trading and profit and loss account of for the year ended 31st March,20X2

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To opening inventory		8,040	By sales		
To purchases (58000 + 1030)	59,030		cash	4,600	
Less: returns	(400)	58,630	credit	67,210	
To gross profit c/d		14,810	Less: returns	(1450)	70,360
			By closing inventory		11,120
		81,480			81,480
To sundry expenses (w.n.5)		9300	By gross profit b/d		14,810
To discount		1500	By discount		700
To bad debts		420			
To net profit		4290			
		15,510			**15,510**

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Balance sheet as on 31st March,20X2

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)
Capital			Sundry assets	12,040
Opening balance	26,770		Inventory in trade	11,120
Add: addition	8500		Sundry debtors	17,870
Add: net profit	4,290		Cash in hand & at bank	8,080
	39,560			
Less: drawings	(3,180)	36,380		
Sundry creditors		12,400		
Outstanding expenses		330		
		49,110		**49,110**

Working notes:

1.Cash sales

Cash and bank account

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	6,960	By sundry creditors	60,270
To sundries (contra)	5000	By sundries (contra)	5,000
To sundries (contra)	9240	By sundries (contra)	9,240
To sundry debtors	62,500	By drawings	3,180
To capital a/c	8,500	By machinery	430
To sales (balancing figure)	4,600	By sundry expenses	9,570
		By purchases	1,030
		By balance c/d	8,080
	96,800		96,800

2. Debtors account

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	16,530	By bank	62,500
To sales (71,810-4600)	67,210	By discount (64,000-62,500)	1500
		By return inward	1450
		By bad debts	420
		By balance c/d	17,870
	83,740		83,740

3. Total creditors account

Particulars	Amount (₹)	Particulars	Amount (₹)
To bank	60,270	By balance b/d	15,770
To discount	700	By purchases	58,000

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Particulars	Amount (₹)	Particulars	Amount (₹)
To return outward	400		
To balance c/d	12,400		
	73,770		73,770

4.Balance sheet as on 1st April,20X1

Liabilities	Amount (₹)	Particulars	Amount (₹)
Capital	26,770	Sundry assets	11,610
Sundry creditors	15,770	Inventory in trade	8,040
Outstanding expenses	600	Sundry debtors	16,530
		Cash in hand and at bank	6,960
	43,140		43,140

5.Calculation of sundry expenses

₹

Expenses paid in cash	9570
Add: outstanding on 31-2-20X2	330
	9900
Less: outstanding on 1-4-20X1	(600)
	9300

6.Due to lack of information, depreciation has not been provided on fixed assets.

Illustration – 6

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

Receipts	Amount (₹)	Payments	Amount (₹)
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

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		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:

Particulars	**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.

Solution

In the books of A.Adamji

Trading and profit and loss account of for the year ended 31st December,20X1

Particulars	**Amount (₹)**	**Amount (₹)**	**Particulars**	**Amount (₹)**
To opening inventory		3900	By sales	62,100
To purchases		49,100	By closing inventory	5700
To gross profit c/d (bal.fig)		14,800		
		67,800		67,800
To salaries		6,500	By gross profit c/d	14,800
To rent and taxes		1,500	By interest on investment	200
To general expenses		2,500		
To depreciation				
Machinery @ 10 %	750			
Furniture @ 10 %	120	870		
To provision for doubtful debts		800		
To net profit (carried to capital a/c)		2,830		
		15,000		**15,000**

Balance sheet as on 31st December,20X1

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Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital as on 1st April,20X1	29,100		Machinery	7,500	
Add: fresh capital	6000		Less: depreciation	(750)	6,750
Add: net profit	2830		furniture	12000	
Less: drawings	(3600)	34,330	Less: depreciation	(120)	1,080
Sundry creditors		7,900	Inventory in trade		5,700
			Sundry debtors	17,600	
			Less: provision for doubtful debts	(800)	16,800
			investment		5,000
			Cash at bank		6,400
			Cash in hand		500
		42,230			**42,230**

Working notes;

1. **Balance sheet of Mr.Adamjee as on 1st January, 20X1**

Liabilities	Amount (₹)	Assets	Amount (₹)
Adamjee's capital	29,100	Machinery	7500
Sundry creditors	5800	furniture	1200
		inventory	3900
		Sundry debtors	14,500
		investments	5,000
		Bank balance (from cash statement)	2,800
	34,900		34,900

2. **Ledger accounts**

Adamjee's capital account

Particulars	Amount (₹)	Particulars	Amount (₹)
To drawings	3,600	By balance b/d	29,100
To balance c/d (b.f)	34,330	By net profit	2,830
		By cash	6,000
	37,930		37,930

Sales account

Particulars	Amount (₹)	Particulars	Amount (₹)
To trading a/c (b.f)	62,100	By cash a/c	11,000

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		By debtors a/c	51,100
	62,100		62,100

Debtors account

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	14,500	By cash	48,000
To credit sales (b.f)	51,100	By balance c/d	17,600
	65,800		65,800

Purchase account

Particulars	Amount (₹)	Particulars	Amount (₹)
To cash a/c	12,000	By trading account (b.f)	49,100
To balance b/d	37,100		
	49,100		49,100

Creditors account

Particulars	Amount (₹)	Particulars	Amount (₹)
To cash	35,000	By balance b/d	5,800
To balance b/d	7,900	By credit purchases	37,100
	42,900		42,900

Illustration – 7

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

Particulars	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

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Bank	90,000	87,000
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.

ii. Withdrawals Rs. 1,21,000.

iii. Cash payment to suppliers Rs. 77,200 for supplies and Rs. 25,000 for furniture.

iv. Cheques collected from customers but dishonored Rs. 5,700.

v. Bills accepted by customers Rs. 40,000.

vi. Bills endorsed Rs. 10,000.

vii. Bills discounted Rs. 20,000, discount Rs. 750 Bills matured and duly collected Rs. 16,000.

viii.Bills accepted Rs. 24,000.

ix. Paid suppliers by cheque Rs. 3,20,000.

x. Received Rs. 20,000 on maturity of one LIC policy of the proprietor by cheque.

xi.Received Rs. 14,000 by cheque for the premises owned by the proprietor.

xii.The 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.

xiii.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.

Solution

Trading and profit and loss account of Mr.Anup for the year ended 31st March,20X2

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To opening inventory		1,10,000	By sales	9,59,750	
To purchases (w.n2)	4,54,100		Less : sales return	(1,200)	9,58,550
Less:purchase return	(4,200)	4,49,900	By closing inventory		1,90,000
To gross profit c/d (bal.fig)		5,88,650			
		11,48,550			11,48,550
To salary (9200 × 12)		1,10,400	By gross profit b/d		5,88,650

To electricity & Tel. charges	18,700		By discount received		2,700
	2,200	20,900			
To legal expenses		17,00			
To discount allowed :					
Debtors	2,400				
Bills	750	3150			
To shop expenses (600 × 12)		7200			
To provision for claims for damages		1,55,000			
To shop rent		20,000			
To net profit(b.f)		2,57,700			
		5,91,350			**5,91,350**

Balance sheet as on 31st March,20X2

Liabilities	**Amount (₹)**	**Amount (₹)**	**Assets**	**Amount (₹)**
Capital a/c (wn.6)	2,38,200		Building (from cash and bank a/c)	3,72,000
Add: fresh capital introduced			Furniture	25,000
Maturity value from LIC	20,000		Inventory	1,90,000
rent	14,000		Sundry debtors	92,000
Add: net profit	2,57,700		Bills receivable	6,000
	5,29,900		Cash at hand	87,000
Less : drawing (1400×12)	(16,800)	5,13,100	Cash in hand	5,300
Rent outstanding		20,000		
Sundry creditors		56,000		
Bills payable		14,000		
Outstanding expenses :				
Legal expenses	17,000			
Electricity & telephone charges	2,200	19,200		
Provision for claims for damages		1,55,000		
		7,77,300		7,77,300

Working notes :

1. **Sundry debtors A/C**

Particulars	**Amount (₹)**	**Particulars**	**Amount (₹)**
To balance b/d	70,000	By bills receivable a/c - bills accepted by customers	40,000
To bills receivable a/c - bills dishonoured	3,000	By bank a/c - cheque received	5,700

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To bank a/c - cheque dishonoured	5,700	By cash a/c (from summary cash and bank account)	8,97,150
To credit sales (bal.fig.)	9,59,750	By return inward a/c	1,200
		By discount a/c	2,400
		By balance c/d	92,000
	10,38,450		10,38,450

2. Bills receivable account

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	15,000	By sundry creditors a/c (bills endorsed)	10,000
To sundary creditors a/c (bills accepted)	40,000	By bank a/c (20,000-750)	19,250
		By discount a/c (bills discounted)	750
		By bank a/c (bills collected on maturity)	16,000
		By sundry debtors Bills dishonoured (bal.fig)	3,000
		By balance c/d	6,000
	55,000		55,000

3. Sundry creditors account

Particulars	Amount (₹)	Particulars	Amount (₹)
To bank	3,20,000	By balance c/d	40,000
To cash	77,200	By credit purchase (bal.fig.)	4,54,100
To bills payable a/c	24,000		
To bills receivable a/c	10,000		
To return outward a/c	4,200		
To discount received a/c	2,700		
To balance b/d	56,000		
	4,94,100		4,94,100

4. Bills payable account

Particulars	Amount (₹)	Particulars	Amount (₹)
To bank a/c (bal.fig)	22,000	By balance b/d	12,000

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To balance c/d	14,000		24,000
	36,000		36,000

5. Summary cash and bank a/c

Particulars	Cash (₹)	bank(₹)	Particulars	Cash (₹)	Bank (₹)
To balance b/d	5200		By bank	7,62,750	1,21,000
To sundry debtors (bal.fig)	8,97,150	90,000	By cash	7200	
To cash			By shop exp.(600 × 12)	1,10,400	
To bank	121,000	7,62,750	By salary	16,800	
To sundry debtors					22,000
To bills receivable				77,200	3,20,000
To bills receivable				25,000	
To capital(maturity value of LIC policy)		20,000			5700
To capital (rent received)		14,000		18,700	
					3,72,000
				5300	87000
	10,23,350	9,27,700		10,23,350	9,27,700

6. Statement of affairs as on 31st March 20X1

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital (bal.fig.)	**40,000**	Inventory	1,10,000
Creditors	12,000	Debtors	70,000
Bills payable	2,38,200	Bills receivable	15,000
		Cash at bank	90,000
		Cash in hand	5,200
	2,90,200		2,90,200

Illustration - 8

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

a. Assets and liabilities as on

Particulars	1.4.20X1	31.3.20X2
	Amount (Rs.)	Amount (Rs.)
Furniture (w.d.v)	12,000	12,700
Inventory at cost	16,000	14,000

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Sundry Debtors	32,000	?
Sundry Creditors	22,000	30,000
Prepaid expenses	1,200	1,400
Unpaid expenses	4,000	3,600
Cash in hand and at bank	2,400	1,250

b.Receipts and payments during 20X2:

- Collections from debtors, after allowing a 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.
- Investments 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 favor 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 books, 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 accounts for the year ended 31st March,20X2 and the balance sheet as on that date.

Solution

Trading and profit and loss account of Ms.Rashmi for the year ended 31st March,20X2

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)
To opening inventory		16000	By sales	1,46,100
To purchases (w.n2)	91,200		By closing inventory	14,000
Less: for advertising	(1800)	89,400		
To freight inwards		6,000		
To gross profit c/d @ 33-⅓%		48,700		
		1,60,100		1,60,100
To sundry expenses (w.n.6)		28,400	By gross profit b/d	48,700

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To advertisement		1800	By interest accrued on investment (200×4/100×1/2)	4
To discount allowed			By discount received	1600
Debtors	3000		By miscellaneous income	1,000
Bills receivable	250	3250		
To depreciation on furniture (12,000+2000-12,700)		1300		
To provision for doubtful debts		972		
To net profit(b.f)		15,582		
		51,304		**51,304**

Balance sheet as on 31st March,20X2

Liabilities	**Amount (₹)**	**Amount (₹)**	**Assets**	**Amount (₹)**	**Amount (₹)**
Capital as on 1.4.20X1	37,600		Furniture	12,000	
Less: drawings	(15,808)		Additions during the year	2,000	
	21,792		Less: depreciation (b.f)	(1300)	12,700
Add: net profit	15,582	37,374	Investments		192
Sundry creditors		30,000	Interest accrued (200×4/100×1/2)		4
Outstanding expenses		3,600	Closing inventory		14,000
			Sundry debtors	38,900	
			Less: provision for doubtful debts @ 2.5 %	972	37,928
			Bills receivable		3,500
			Cash in hand and at bank		1250
			Prepaid expenses		1400
		70,972			**70,974**

Working notes:

1.Capital on 1st april, 20X1

Balance sheet as on 1.4.20X1

Liabilities	**Amount (₹)**	**Assets**	**Amount (₹)**

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Capital (bal.fig.)	37,600	Furniture	12,00
Creditors	22,000	Inventory at cost	16,00
Outstanding expenses	4,000	Sundry creditors	32,00
		Cash in hand and at bank	2,400
		Prepaid expenses	1,200
	63,600		63,600

2. Purchases made during the year

Sundry creditors

Particulars	Amount (₹)	Particulars	Amount (₹)
To cash and bank a/c	78,400	By balance b/d	22,000
To discount received a/c	1,600	By sundry debtors a/c	800
To bills receivable a/c	4,000	By purchases a/c (bal.fig)	91,200
To balance b/d	30,000		
	1,14,000		1,14,000

3. Sales made during the year

Particulars	Amount (₹)	Amount (₹)
Opening inventory		16,000
Purchases (w.n2)	91,200	
Less: for advertising	(1800)	89,400
Freight inwards		6,000
Less: closing inventory		(14,000)
Cost of goods sold		97,400
Add: gross profit (@ 50 % on cost)		48,700
		1,46,100

4. Debtors on 31.3.20X2

Sundry debtors account

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	32000	By cash and bank a/c	1,17,000
To sales a/c (w.n.3)	1,46,100	By discount allowed a/c	3,000
To sundry creditors a/c (bills dishonoured)	800	By bills receivable a/c	20,000
		By balance c/d (bal.fig.)	38,900
	1,78,900		1,78,900

5. Additional drawings by Ms.Rashmi

Cash and bank a/c

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Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	2,400	By freight inwards a/c	6,000
To sundry debtors a/c	1,17,000	By furniture a/c	2,000
To bills receivable a/c	12,250	By investment a/c	192
To miscellaneous income a/c	1,000	By expenses a/c	29,000
		By drawings a/c (14,000+1808(b.f)(additional drawings)]	78,400
		By balance c/d	1250
	1,31,650		1,31,650

6. Amount of expenses debited to profit and loss a/c

Sundry expenses a/c

Particulars	Amount (₹)	Particulars	Amount (₹)
To prepaid expenses a/c (on 1.4.20X1)	1200	By outstanding expenses a/c (on 1.4.20X1)	4,000
To bank a/c	29,000	By profit and loss a/c (bal.fig)	28,400
To outstanding expenses a/c (on 31.3.20X2)	3,600	By prepaid expenses a/c	1400
	33,800		33,800

7. Bills receivable on 31st March,20X2

Bills receivable account

Particulars	Amount (₹)	Particulars	Amount (₹)
To debtors a/c	20,000	By creditors a/c	4,000
		By bank a/c	12,250
		By discount on bills receivable a/c	250
		By balance c/d (bal.fig.)	3,500
	20,000		20,000

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Chapter 12 - Partnership

Unit -1 Admission of Partner

Revaluation Account or Profit and

Loss Adjustment Account for revaluation of assets and liabilities

Adjustment of goodwill amongst the old partners in their sacrificing ratio

Reserves lying in the balance sheet transferred to the capital accounts of old partners in their old profit sharing ratio.

Profit/loss on revaluation account is ts/f to old partners in their old profit sharing ratio

INTRODUCTION

- **Reason for admitting New Partner**
  - For increasing the **partnership capital**.
  - For strengthening the **management** of the firm.

- **Effects for admitting New partner**
  - 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.

REVLAUATION 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.

Memorandum Revaluation Account has two parts

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First Part

1. Entries for the revaluation of assets and liabilities are made in the **usual way** as made in case of **revaluation account.**

2. No record for the revaluation of assets and liabilities is made through the respective **ledger accounts.**

3. The resultant profit or loss on revaluation in the first part of this account is transferred to the **capital accounts of old partners** only in the **old profit and loss sharing ratio.**

Second Part

1.Entries made in the first part of Memorandum Revaluation Account are reversed in the second part so that the values of the assets and liabilities **remain unchanged.**

2.The balance of the second part is transferred to the capital accounts of all the partners including new partner in their **new profit and loss sharing ratio.**

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.

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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.
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 terms

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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

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

JOURNAL ENTRIES

PARTICULAR		Amt	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)			

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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)		
	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**
	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		

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(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			
(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)			

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.

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Give journal entries to record the above. Also, give the Balance Sheet of the partnership firm after Shyam's admission.

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.

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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.

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 Fittings	5,000
B:28,000	65,000	Inventories	15,000
		Trade Receivables	20,000
Trade Payables	5,000	Cash in Hand	10,000
	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.

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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.

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Unit-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

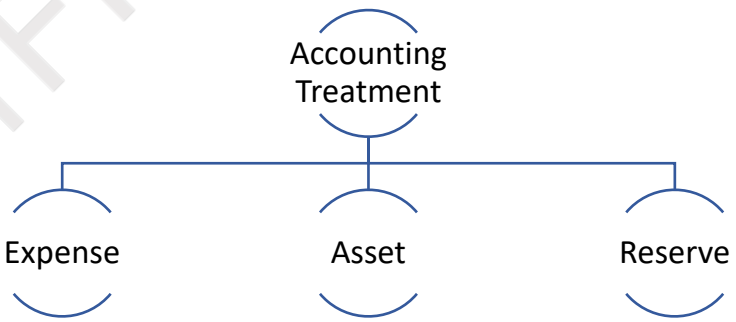
2. If the amount is not settled in full, the balance amount is transferred to loan account.

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.

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.



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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 Loss = JLP Balance – Surrender Value	Profit & Loss A/c Dr. 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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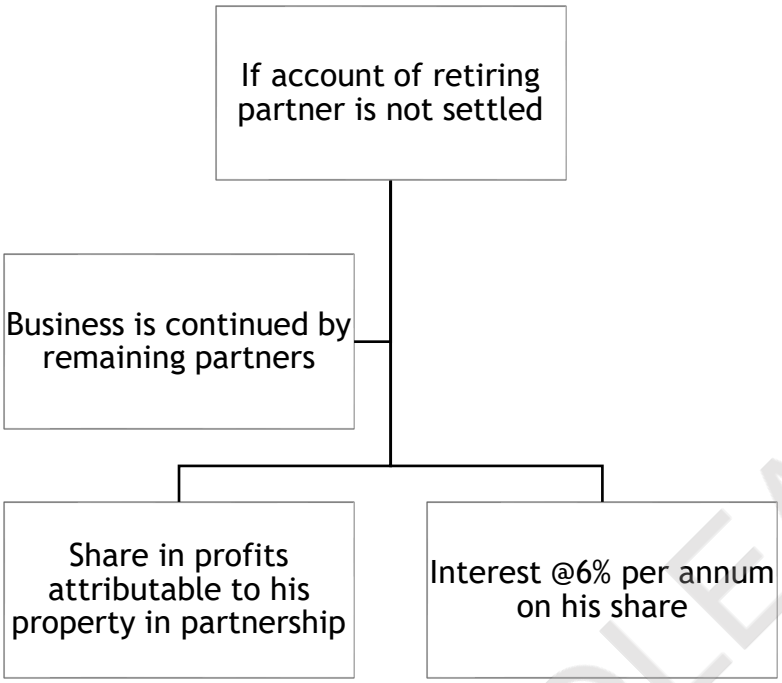


Illustration 1

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 Rs.20,000)	
Reserves	10,000	Bank	50,000
Trade Payables	50,000		
	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.

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Illustration 2

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**

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 3

Red, White and Black shared profits and losses in the ratio of 5:3:2. They took out a joint life Policy in 2018 for Rs. 50,000, a premium of Rs.3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows:

Year	Rs.
2018	nil
2019	900
2020	2,000
2021	3,600

Black retires on 15th April, 2022.

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Required

Prepare ledger accounts assuming Joint Life Policy Account is maintained on surrender value basis

Illustration 4

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		
	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 5

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.

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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%.
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 6
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.

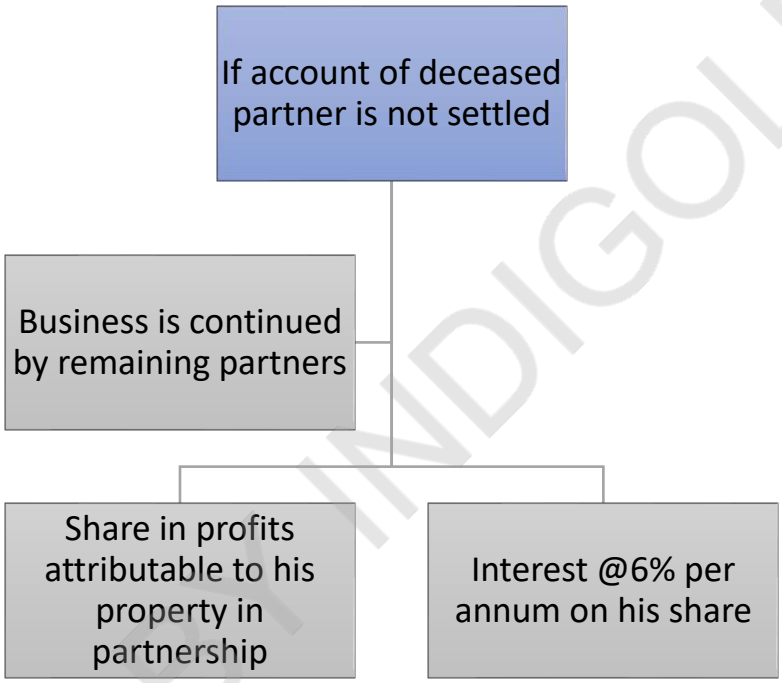
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Unit-3 Death of a Partner

The problems arising on the death of a partner are similar to those arising on retirement
Important Points:

- The revaluation gain/loss belongs to all the partners and is distributed in existing profit sharing ratio.
- The reserves are distributed to all partners in existing profit sharing ratio.
- The goodwill is adjusted on the basis of gain ratio or sacrifice ratio. (Can be done using table adjustment)
- The treatment of Joint Life Policy would be different as the firm would receive the sum assured on the policy.
- The amount due to the deceased partner would be paid to the legal heirs.
- Business may be continued by other partners (also known as reconstitution of partnership)

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

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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.

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.

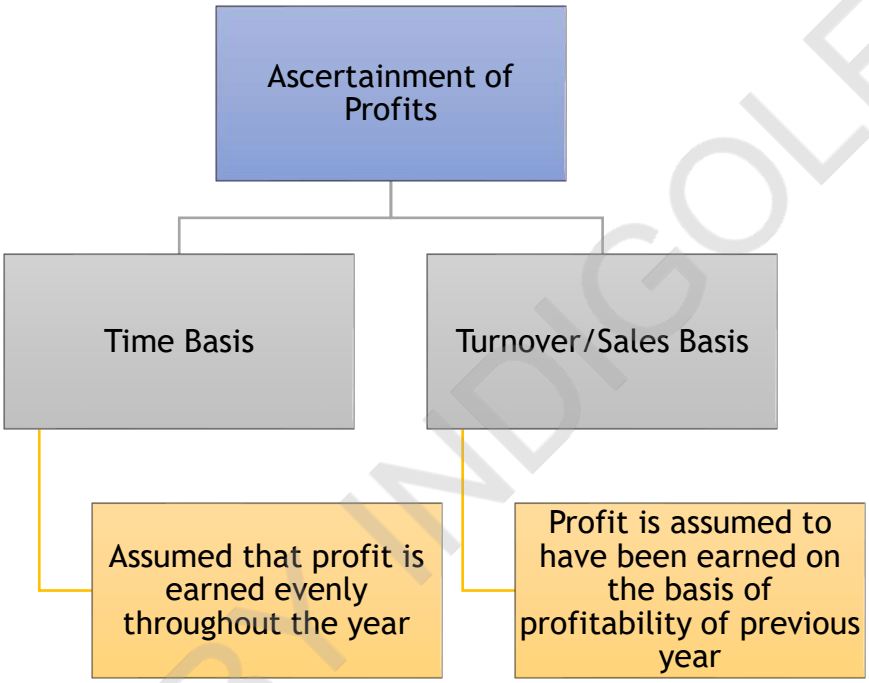
To Bank A/c

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



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

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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)

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.

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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

iii. Prepare partners' capital accounts and balance sheet of the firm Om & Co. as on 31.12.2016.

Illustration 2

The partnership agreement of a firm consisting of three partners- A, B and C (who share profits in proportion of $\frac{1}{2}$ $\frac{1}{4}$ and $\frac{1}{4}$ 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.

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Unit 4 - DISSOLUTION OF PARTNERSHIP FIRMS

1. Introduction

One of the important aspects of partnership accounts is to close books of accounts in case of dissolution.
Dissolution of partnership means the ending of the relationship between partners as in the case of admission of a partner.
Dissolution of a Partnership firm means when the business ceases to exist, and also includes dissolution of the partnership as the relation between the partners also comes to an end.
This chapter deals with the accounting for Dissolution.

2. Circumstances of Dissolution

Dissolution occurs when

- All partners agree to dissolve the firm
- All partners except one become insolvent
- The business becomes illegal
- Partner gives notice of dissolution in partnership at will.
- The court orders dissolution.
- 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.

Court orders dissolution of firm when

- A partner has become of unsound mind
- A partner suffers from permanent incapacity
- A partner is guilty of misconduct in the business
- A partner persistently disregards the partnership agreement
- A partner transfers his interest or shares to a third party
- the business cannot be carried on except at a loss; and where it appears to be just and equitable.

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3. Dissolution of Partnership Vs Partnership Firm

Basis	Dissolution Of Partnership	Dissolution Of Firm
Meaning	Discontinue the relationship between partners or reconstitution of partnership. Eg: Change in profit sharing ratio, admission of partner etc.	The entire firm and the relation between partners cease. Eg: Business becomes illegal
Continuation of Business	Partnership is reconstituted and business continues.	Business comes to an end
Power of Court	No intervention by the court	Court has the power to order the dissolution of a firm.
Economic Relationship	Economic relationship among partners may change or remain the same.	Economic relationship among partners comes to an end.
Revaluation v/s Realization	Assets and liabilities are revalued after the winding up of the existing partnership. Revaluation account is prepared	Assets and liabilities are realized and settled on winding up. Realization account is prepared.
Books of Accounts	Books of accounts are not closed	Books of accounts are closed

4. Consequences of Dissolution

4.1 Section 48 of the Partnership Act

- The assets of the firm including the goodwill are realized initially.
- The assets realized are utilized in the following manner:
  - to pay the debts of third parties
  - to settle loans and advances from partners
  - To repay partners' capital
  - Surplus if any, to be divided in the profit sharing ratio
- Losses including deficiencies of capital are paid;
  - First out of profits
  - Next out of capital
  - If necessary, by partners in their profit sharing ratio

4.2 Dissolution Before the Expiry of a Fixed Period

- Some partners enter the partnership on the condition that the firm will not be dissolved before the expiry of a certain period and pays a premium. This premium or its part is refundable if the firm dissolves earlier. This is borne by other partners in their profit sharing ratio.

- Exceptions:
  - Dissolution due to the death of a partner
  - Dissolution due to the misconduct of the partner claiming the refund

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- In pursuing an agreement with no provision of refund of premium

5. Closing of Books of the Partnership Firm

Accounts To Be Created

- Realisation A/c ;
- Partner's Loan A/c;
- Partner's capital A/c;
- Cash A/c

Realization a/c

- All assets except cash in hand or at bank are transferred to this account at book values.
- Sundry Debtors and Provisions for Bad Debts Accounts are two separate accounts and the gross amount of debtors should be separately transferred.
- Outsider's liabilities and Reserves or Provisions against Assets are also transferred to Realization A/c, which will also include Partner's spouse loan account.

- If the question is silent about the realization of an asset, it is assumed that the asset has not realized any amount. All liabilities have to be settled in full whether or not mentioned in the question
- If goodwill is already appearing in the balance sheet, it is treated like any other asset and is transferred to the realization account.

JOURNAL ENTRIES

Date	Particulars	Debit (₹)	Credit (₹)
1	**Realization A/c**		
	Transfer of assets		
	Realization A/c Dr.		
	To Asset A/c		
	Transfer of outside liabilities		
	Liabilities A/c Dr.		
	To Realization A/c		
	Amount realized from sale of an asset		
	Cash A/c Dr.		
	To Realization A/c		
	Payment of outside liabilities		
	Realization A/c Dr.		
	To Cash A/c		
	Asset taken over by the partner at agreed value		
	Partner's Capital A/c Dr.		

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	To Realization A/c **Liability taken over by the partner at agreed value** Realization A/c Dr. To Partner's Capital A/c **Payment of Dissolution Expenses or Realization expenses** Realization A/c Dr. To Cash A/c **Dissolution Expenses borne by Partner** Realization A/c Dr. To Partner's Capital A/c **In case of profit, Closing Realization A/c and transferring profit** Realization A/c Dr. To Partner's Capital A/c **In case of loss, Closing Realization A/c and transferring loss** Partner's Capital A/c Dr. To Realization A/c		

- Investment fluctuation fund is transferred to the credit side of the realization account only if investments are appearing on the asset side. Otherwise, it is credited to the partner's capital account.
- Bank Overdraft is not transferred to Realization A/c, since it should be shown as a negative balance in Bank A/C.

Partner's loan a/c

- Loan taken from a partner will be passed through cash or bank account.
- Loan given to a partner will be transferred (debited) to his capital account.
- If the current account of the partner from whom loan has been taken by the firm, shows a debit balance after all adjustments, his loan account will be transferred to the credit of his capital account to the extent of the debit balance of the capital account.

JOURNAL ENTRIES

Date	Particulars	Debit (₹)	Credit (₹)
2	**Partner's loan A/c** **Payment of Partner's Loan Account** Partner's Loan A/c Dr. To Cash A/c		

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	In case of debit balance of partner's current accounts Partner's Loan A/c Dr. To Partner's Current Account		

Partner's Capital A/c

- Apart from the realization profit or loss, undistributed profits such as General reserve, P&L account etc are transferred to the partners' capital account.
- Fictitious assets like Debit balance of the P&L account, deferred revenue expenditure etc. should not be transferred to the realization account. Such accounts are transferred to the partner's capital account

JOURNAL ENTRIES

Date	Particulars	Debit (₹)	Credit (₹)
	Transfer of reserves, undistributed profits or fictitious assets **Distribution of Undistributed Profits/ Reserves** Reserves A/c Dr. Profit and Loss A/c (Credit Balance) Dr. To Partner's Capital A/c **Transfer of fictitious assets** Partner's Capital A/c Dr. To Profit and Loss A/c (Debit Balance) To Deferred Expenditure		

Cash A/c

- The balance of the cash account at the end will be exactly equal to the balance of the capital accounts, 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

Date	Particulars	Debit (₹)	Credit(₹)
4	**BALANCE** **In case of surplus cash balance, paid toward capital** Partner's Capital A/c Dr. To Cash A/c		

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	In case of deficit cash balance, brought in by partners Cash A/c Dr. To Partner's Capital A/c		

6. Insolvency of a Partner

Any partner who is unable to pay its debts in the usual course of business and has been declared to be insolvent by the appropriate court is an insolvent. The following are the consequences of the insolvency of a partner;

- 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.

6.1 Loss arising from Insolvency of a Partner

The share of loss of an insolvent partner is to be borne by other solvent partners following the decision in the English case of **Garner vs. Murray**.

Garner v/s Murray

- normal loss on realization of assets to be borne by all partners (including insolvent partner) in the profit-sharing ratio.
- loss due to insolvency of a partner must be borne by the solvent partners in the capital ratio.

Calculation of capital ratio in different scenarios

Scenarios	Consequence
When Capitals are fixed (Fixed Capital Method)	Loss on insolvency is borne by the solvent partners in the ratio of their fixed capitals. All other adjustments are done through their current accounts, which may have a debit or credit balance

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When Capitals are not fixed (Fluctuating Capital Method)	The 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 Realization Account.
A partner has a Debit Balance in his Capital Account (Partner other than the insolvent partner)	Although he is not insolvent, he cannot be called up to bear the loss on insolvency.
When outside liabilities cannot be paid in full • out of firm's assets • out of partners' personal assets	• It is advised not to transfer creditors to Realization A/c • Creditors may be paid the amount available including the amount contributed by the partners. • The remaining portion of the creditor account is transferred to the 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.

7. Piecemeal payment

Generally, the assets sold upon dissolution of the partnership are realized only in small instalments over a period of time. In such cases, liabilities are settled gradually as cash is received rather than waiting to collect the entire sum. This is the system of Piecemeal Payments. In this system,

- Outside liabilities are settled initially, which includes creditors and thereafter loan from spouse of the partner
- In the next stage, inside liabilities which includes loans from partners are settled.
- Finally, Partners' Capitals are settled by;
    1) Maximum Loss Method OR
    2) Highest Relative Capital Method

Maximum Loss Method

Each instalment realized is considered to be the final payment i.e., outstanding assets and claims are considered worthless, and partners' accounts are adjusted on that basis each time when a distribution is made, following either Garner vs. Murray Rule or the profit-sharing ratio rule.

Highest Relative Capital Method (OR)
Proportionate capital method

The partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off.

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Methods - Stepwise

Steps	Maximum possible loss method	Highest relative capital method
Step 1	Adjust the money available with the total amount due to the partners	Ascertain capital per profit sharing unit for each partner (capital balance/ profit sharing ratio)
Step 2	Determine the maximum possible loss assuming there is no more money going to be realized	Determine the capital balance to be maintained by each partner considering the lowest per unit capital as base
Step 3	Distribute the maximum possible loss amongst the partners in their profit-sharing ratio	Determine partners with capital greater in proportion to their profit-sharing ratio and ascertain excess for each such partner
Step 4	If any partner has deficiency (negative balance), distribute the deficiency to the other partners in their capital ratio by applying Garner vs Murray Rule	Compare the excess per unit of profit for all such partners. Ascertain the partner with the largest excess capital following the above procedure
Step 5	The amount left is the value of money to be distributed to the partners from the installment	Pay the partner with the largest excess capital the value of money equivalent to excess capital
Step 6	Subtract the amount from the opening balance and arrive at the revised capital balances. Repeat the above procedure	Pay other partners who have excess capital (amounting to excess capital) until the capital of partners is reduced to their profit-sharing ratio. Distribute the balance money amongst all the partners in profit sharing ratio

NOTE: Total payment made to each partner will be the same under both methods.

8. Limited Liability Partnerships

A limited liability partnership is a body corporate formed and incorporated under the **Limited Liability Partnership Act, 2008**. It has a **separate legal entity** with **perpetual succession** and the change in the partners of a limited liability partnership does not affect the existence, rights, or liabilities of the limited liability partnership.

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8.1 Incorporation of LLP

- **Two or more persons** associated
- to carry on a **lawful** business 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 anyone who subscribed his name to the incorporation document,
- that all the requirements of the **LLP Act 2008** and the rules made thereunder have been complied with.

8.2 Important Sections

Section	Title	Law
Section 5	Members	any individual or body corporate may be a partner in an LLP provided he is not; • of unsound mind • undischarged insolvent • applied to be adjudicated insolvent
Section 6	Number Of Members	every LLP should have at least 2 partners if at any time the number of partners is reduced below 2 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 • will be liable personally for the obligations of the LLP incurred during that period.
Section 7	Designated Partners	every LLP should have at least two designated partners who are ; • individuals and • at least one should be a resident of India "resident in India" means a person who has stayed in India for **not less than 182** days during the immediately preceding year. where all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate,

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		at **least two individuals who are partners** of such LLP or **nominees of such body corporate** will act as designated partners.
Section 8	Liabilities of Designated Partners	responsible for the doing of all acts, matters, and things as are required to be done by the LLP, complying with the provisions of the act Eg: filing of any document, return etc. liable to all penalties imposed on the LLP for any contravention of those provisions.
Section 27	Limitation of liability of an LLP and its Partners	**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 **27(2)** The LLP is liable if a partner of the LLP is **liable** to any person due to wrongful or omission on his part in the course of business of the LLP or **with his authority**. **27(3)** An obligation of an LLP arising out of a contract or otherwise, will be **solely** the obligation of the LLP and liabilities met out of the properties of the LLP
Section 28		A partner is not personally liable, directly or indirectly, for an obligation referred to in Section 27 (3) above
Section 30		The liability of the LLP and the partners from **fraud** will be **unlimited** for all or any of the debts or other liabilities of the LLP.
Section 34	Financial disclosures and Returns	**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 • maintain at its registered office for the prescribed period **34(2)** within **six months** of the end of each financial year prepare a **Statement of Account and Solvency** as of the last day of the said financial year, in the prescribed form and should be **signed by the designated partners** of the LLP

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		34(3) should file within the prescribed time, the Statement of Account and Solvency with the **Registrar every year** in such form and manner and with such fee as may be prescribed **34(4)** accounts of an LLP must be audited in following such rules.
Section 35		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.
Section 55	Conversion of Firm into Limited Liability Partnership	A **firm** may convert into an LLP in accordance with the provisions of the Act and the **Second Schedule** to the Act.
Section 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.
Section 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.
Section 63	Winding up and Dissolution	an LLP may be wound up • voluntarily or • by the Tribunal • and such LLP so wound up may be dissolved
Section 64		LLP may be wound up by the Tribunal if • the LLP decides • number of partners remain less than two for more than six months • unable to pay its debts; • acted against the interests of the integrity and sovereignty of India, the security of the state or public order; • defaulted in the filing of the Statement of Account and Solvency with the Registrar for **five consecutive financial years**; • the Tribunal believes that it is just and equitable that the LLP be wound up.

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9. Summary

- Dissolution of partnership occurs when the relationship between the partners comes to an end
- Dissolution of partnership firm occurs when the business ceases to exist.

- Realization account is prepared and profit or loss is transferred to the Partners' Capitals.
- In case of Insolvency of a partner Garner vs Murray rule is followed.

Garner v/s murray

- normal loss on realization of assets to be borne by all partners (including insolvent partner) in the profit sharing ratio
- loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio.

10. Illustrations

1. Illustration

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

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Solution 1

Realisation A/c

Particulars	₹	Particulars	₹
To Fixed Assets	5,00,000	By Creditors	3,20,000
To Stock in trade	3,00,000	By Cash	5,20,000
To Sundry debtors	5,00,000	By cash	4,40,000
To Cash A/c	3,04,000	By Partner's capital A/c	2,50,000
To Cash A/c	60,000	By loss (transferred to Partner's capital A/c in 4:3:2)	80,000
	16,10,000		16,10,000

Particulars	X	Y	Z	Particulars	X	Y	Z
To Realisation A/c	35,555	25,000 26,667	17,778	By Balance B/d	4,00,000 40,000	3,00,000 30,000	2,00,000 20,000
To Realisation A/c	4,04,445	53,333	2,02,222	By General reserve [90,000 in 4:3:2]			
[80,000 loss in 4:3:2] To Cash A/c	4,40,000	3,30,000	2,20,000		4,40,000	3,30,000	2,20,000

Partners Capital Account

Cash A/c

Particulars	₹	Particulars	₹
To Balance B/d	10,000	By Realisation A/c	3,04,000
To Realisation A/c	5,20,000	[95% of 3,20,000]	6,000
To Realisation A/c	4,40,000	By Realisation A/c	4,04,445
		By X's Capital A/c	53,333
		By Y's Capital A/c	2,02,222
		By Z's Capital A/c	
	9,70,000		9,70,000

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2. Illustration

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		FreeholdProperty	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	TradeDebtors 2,000	
Trade Creditors		12,400	Less: Provision (100)	1,900
			Cash at Bank	200
			Miscellaneouslosses	
			R's CurrentAccount	400
			Profit and LossAccount	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 CapitalAccounts (after transferring Current Accounts' balances).

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Solution 2

Realisation A/c

Particulars	₹	Particulars	₹
To Goodwill	40,000	By Loan from P	8,000
To Freehold property	8,000	By Trade Creditors	12,400
To Plant & Equipment	12,800	By Provisions	100
To Motor vehicle	700	By Q's Capital A/c	500
To Stock	3,900	By Cash/Bank A/c (Asset sale)	16,600
To Trade Debtors	2,000	By Loss (B.F)	51,000
To Cash/Bank A/c (Creditors)	11,700	(Transferred to Partner's Capitals)	
To Cash/Bank A/c (Expenses)	1,500		
To Cash/Bank A/c (P's Loan)	8,000		
	88,600		**88,600**

Garner vs Murray Rule

- **Realisation Loss**: Divide in Profit sharing ratio as given in the Deed. Solvent Partners to get their share in cash.
- **Deficiency**: Divide amongst other partners in ratio of Capitals after few adjustments.

Cash A/c

Particulars	₹	Particulars	₹
To Balance B/d	200	By Realisation A/c (Creditors Paid)	11,700
To Realisation A/c (Asset sale) [7,000 + 5,000 + 3,000 + 1,600]	16,600 25,500	By Realisation A/c (Expenses)	1,500
		By Realisation A/c (P's Loan)	8,000
To P's Capital A/c	17,000	By P's Capital A/c	14,200
To Q's Capital A/c	300	By Q's Capital A/c	24,200
To R's Capital A/c			
	9,70,000		9,70,000

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Working Note: 1

		Partner's Capital Account					
Particulars	**P**	**Q**	**R**	**Particulars**	**P**	**Q**	**R**
To Current A/c			400	By Balance B/d	20,000	20,000	10,000
To Profit and loss A/c	6,000	4,000	2,000	By Current A/c	500	9,000	
[12,000 in 3:2:1]	25,500	17,000	8,500	By Cash/Bank A/c	25,500	17,000	
To Realisation A/c		500		By Cash/Bank A/c			300
To Realisation Loss [3:2:1]	300	300		By P's Capital A/c (W.N:1)			300
To R's Capital A/c	14,200	24,200		By Q's Capital A/c (W.N:1)			300
To Cash A/c (B.F)	46,000	46,000	10,900		46,000	46,000	10,900

Bal. Fig in R's Capital -> 900	
1/3	2/3
Cash = 300	Deficiency = 600
	In the Ratio of Fixed Capital A/c (20,000:20,000) = (1:1)

P	Q
₹300	₹300

3. Illustration

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

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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.

Particulars	Amal	Bimal	Particulars	Amal	Bimal
To Balance B/d		550	By Balance B/d	750	
To Realisation A/c [2,675 in 1:1]	1,337	1,338	By cash A/c		200
			By Deficiency A/c (Bal.Fig)	587	1.688
	1,337	1,888		1,337	1,888

Solution 3

Realisation A/c

Particulars	₹	Particulars	₹
To Plant & Machinery	2,500	By Cash (1,250+150+400+500)	2,300
To Furniture	500	By Partner's Capital (Bal.Fig)	2,675
To Debtors	1,000	[Realisation loss]	
To Stock	800		
To Cash (Expenses)	175		
	4,975		4,975

Cash A/c

Particulars	₹	Particulars	₹
To Balance B/d	200	By Realisation A/c	175
To Realisation A/c	2,300	By Creditors A/c (Bal.Fig)	2,525
To Bimal's Capital A/c	200		
	2,700		2,700

Partner's Capital Account

Sundry Creditors A/c

Particulars	₹	Particulars	₹
To Cash A/c	2,525	By Balance B/d	4,800
To Deficiency A/c (Bal.Fig)	2,275		
	4,800		4,800

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Deficiency A/c

Particulars	₹	Particulars	₹
To Amal's Capital A/c TO Bimal's Capital A/c	587 1,688	By Sundry creditors A/c	2,275
	2,275		2,275

4. Illustration

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

- 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 Garnervs. Murray.

Solution 4

Realisation A/c

Particulars	₹	Particulars	₹
To Fixed Assets	40,000	By Z's Loan	5,000
To Stock	25,000	By Sundry Creditors	25,000
To Book Debts	25,000	By Provision	5,000
To Cash	28,420	By Sundry Creditors –	4,000
To Cash	1,080	(Unrecorded liability)	
To Cash (Z's Loan)	5,000	By Cash (20,000 + 21,000 + 20,500	61,500

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		Partner's Capital Account					
Particulars	**X**	**Y**	**Z**	**Particulars**	**X**	**Y**	**Z**
To Y's Advance	-	- 4,000		By balance	29,200	10,800	10,000
To Creditors Unrecorded	1,600	1,600	800	B/d	10,000		-
[4,000 in 2 : 2 : 1]	9,600	9,600	4,800	By Mrs X's loan	9,600	- 3,300	4,800
To Realisation Loss {2:2:1)	3,300	-	1,100	By Cash		1,100	
To Y's Capital	34,300		8,100	By X's Capital			
To Cash	48,800	15,200	14,800	BY Z's Capital	48,800	15,200	14,800
				By Loss – Transferred to Partners Capital (Bal. Fig)			24,000
		1,24,500					1,24,500

Cash A/c

Particulars	₹	Particulars	₹
To Balance B/d	1,000	By Realisation A/c	28,420
To Realisation A/c	61,500	By Realisation A/c	1,080
To X's Capital A/c [Cash for loss]	9,600	By Realisation A/c	5,000
To Y's Capital A/c [Cash for loss]	4,800	By X's Capital A/c	34,300
		BY Z's Capital A/c	8,100
	76,900		76,900

Working Note: 1

Purchases – Unrecorded

Trading ,Profit and loss A/c	Dr	4,000	
To Creditors A/c			4,000

- ₹ 4,000 will reduce profits, it should be debited to Partner's Capital A/c => 4,000 (in 2 : 2 :1 ratio).
- Creditors increased by ₹ 4,000.

Working Note: 2

Creditors

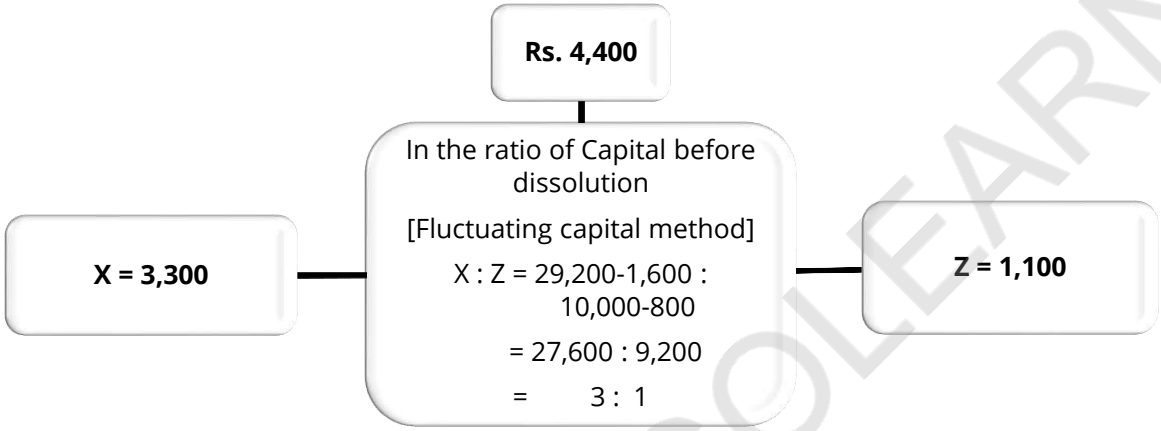
Creditors	25,000
(+) Unrecorded Creditors	4,000

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	29,000
(98% of 29,000) – Cash paid	28,420

Working note: 3

⇨ Y's Deficiency [after all adjustment] => 16,000 + 4,000 + 9,600 = ₹4,400



5. 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:

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Solution 5

Maximum Loss Method

- **Statement showing Realisation and Distribution**

Particulars	Amount Realised	Creditors	Partner's (A's) Loan	Partner's Capital
Balance payable (Due)	-	2,000	5,000	42,000
1st Instalment	1,000	(1,000)	-	-
		1,000	**5,000**	**42,000**
2nd Instalment	3,000	(1,000)	(2,000)	-
		0	**3,000**	**42,000**
3rd Instalment	3,900	-	(3,000)	(900)
		-	**0**	**41,100**
4th Instalment	6,000	-	-	(6,000)
		-	**-**	**35,100**
5th Instalment	20,100	-	-	(20,100)
Deficiency / Loss	**-**	**-**	**-**	**15,000**

** Includes savings in expenses i.e. Rs.100 (Rs.500-Rs.400)*

- **Statements showing Realisation and Distribution of cash to Partners**

❖ **Distribution of ₹900 (3rd Instalment)**

Particulars	Amount	A	B	C
Balance payable (Due)	42,000	15,000	18,000	9,000
Balance from 3rd instalment	(900)			
Maximum possible loss (Divided into 2 :2 :1)	**41,100**	(16,440)	(16,440)	(8,220)
		(1,440)	**+ 1,560**	**+780**
A's Deficiency split between B&C in their capital ratio of 18 : 9 as per Garner vs Murray		+ 1,440	(960)	(480)
Actual pay out (Balance available and to be distributed)		0	600	300
Closing Capital after 3rd Instalment	**41,100**	**15,000**	[18,000-600] **17,400**	[9,000-300] **8,700**

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❖ **Distribution of ₹6,000 (4th Instalment)**

Particulars	Amount	A	B	C
Capital balance	41,100	15,000	17,400	8,700
4th instalment	(6,000)			
Maximum possible loss (Divided into 2 :2 :1)	**35,100**	(14,040)	(14,040)	(7,020)
Actual pay out (Balance available and to be distributed)		**960**	**3,360**	**1,680**
Closing Capital after 4th Instalment	**35,100**	=15,000-900 **=14,040**	=17,400-3,360 **=14,040**	=8,700-1,680 **=7,020**

❖ **Distribution of ₹20,000 (5th Instalment)**

Particulars	Amount	A	B	C
Capital balance	35,100	14,040	14.040	7,020
5th instalment	(20,100)			
Maximum possible loss (Divided into 2 :2 :1)	**15,000**	(6,000)	(6,000)	(3,000)
Actual pay out (Balance available and to be distributed)		**8,040**	**8,040**	**4,020**
Closing Capital after 4th Instalment	**15,000**	**=14,040-8,040 =6,000**	**=14,040-8,040 =6,000**	**=7,020-4,020 =3,000**

Summary

Particulars	Amount Realised	Creditors	Partner's (A's) Loan	A	B	C
Opening balance	-	2,000	5,000	15,000	18,000	9,000
• 1st Instalment	1,000	(1,000)	-	-	-	-
• 2nd Instalment	3,000	(1,000)	(2,000)	-	-	-
• 3rd Instalment	3,900	-	(3,000)		(600)	(300)
• 4th Instalment	6,000	-	-	**(960)**	**(3,360)**	**(1,680)**

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• 5th Instalment	20,100	-	-	**(8,040)**	**(8,040)**	**(4,020)**
Deficiency / Loss	**-**	**-**	**-**	**6,000**	**6,000**	**3,000**

6. Illustration (Same as 5th)

Solution 6

Highest Relative Capital Mthod

Statement showing Realisation and Distribution

Particulars	Amount Realised	Creditors	Partner's (A's) Loan	Partner's Capital
Balance payable (Due)	-	2,000	5,000	42,000
1st Instalment	1,000	(1,000)	-	-
		1,000	**5,000**	**42,000**
2nd Instalment	3,000	(1,000)	(2,000)	**-**
		0	**3,000**	**42,000**
3rd Instalment	3,900	-	(3,000)	(900)
		-	**0**	**41,100**
4th Instalment	6,000	-	-	(6,000)
		-	**-**	**35,100**
5th Instalment	20,100	-	-	(20,100)
Deficiency / Loss	**-**	**-**	**-**	**15,000**

Statement showing basis for calculation of distribution of cash

Particulars	A	B	C
a) Capital	15,000	18,000	9,000
b) PSR	2	2	1
c) Capital per unit of profit (a) ÷ (b)	7,500*	9,000	9,000
d) Taking A's Capital as base [7,500 x (b)] (i.e. Lowest capital)*	15,000	15,000	7,500
e) Excess (a) – (d)	**0**	**3,000**	**1,500**
f) PSR	2	2	1
g) Excess per unit of profit (e) ÷ (f)	**-**	**1,500**	**1,500**

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Conclusion

1) 3,000 + 1,500 = 4,500. => 1st 4,500 towards Partner's capital will be divided among B:C in 2:1 ratio.
2) Subsequent amount will be divided among A : B : C in 2 : 2 : 1 ratio.

Statement showing distribution of cash to partners

Particulars	Amount	A	B	C
3rd Instalment B : C => 2 : 1	900	-	600	300
4th Instalment • 4,500 - 900 = 3,600 (B:C=>2:1) • 6,000 - 3,600 = 2,400 (2 :2 :1)	6,000	- 960	2,400 960	1,200 480
5th instalment (2 : 2 : 1)	20,100	8,040	8,040	4,020
Total Pay out	**27,000**	**9,000**	**12,000**	**6,000**

7. Illustration

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.
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

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Last instilment	Rs. 7,000
Dissolution expenses were provided for estimatedamount 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'

Solution 7

- **Statement showing Distribution of Cash**

Particulars	Amount Realised	Expenses	Commission on sale of assets	Creditors
Balance payable (Due)	-	N/A	N/A	16,500
1st Instalment **(WN: 1)**	18,925	3,000	187	(15,738)
2nd Instalment **(WN: 2 & 5)**	17,320	-	173	**(162)**
3rd Instalment **(WN : 3 & 6)**	10,000	-	100	-
4th Instalment **(WN: 4)**	7,000	-	70	-
Closing balance	-	N/A	N/A	600*

⇨ *600 is a gain transferred to P & L A/c

Partner's Loan	Commission from Payment to Partners	A	B	C
4,500	N/A	15,000	7,500	15,000
-	-	-	-	-
(4,500)	1,135	(4,343)	-	**(7,007)** [3,750 + 3,257]
-	900	(3,797) [657 + 3,140]	(2355)	(2,848) [493 + 2,355]
-	630	(2,520)	(1,890)	(1,890)
0	N/A	4,340	3,255	3,255

➔ Loss suffered by Partners : A = 4,340
B = 3,255
C = 3,255

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Highest Relative Capital method

Statement showing basis for calculation of distribution of cash to Partners

Particulars	A	B	C
a) Capital	15,000	7,500	15,000
b) PSR	4	3	3
c) Capital per unit of profit (a) – (b)	3,750	2,500	5,000
d) Revised capital taking B's capital as base [2,500 x (b)]	10,000	7,500	7,500
e) Excess (a) – (d)	**5,000**	**-**	**7,500**
f) Excess per unit of profit (e) ÷ (b)	1,250	-	2,500
g) Excess consideration taking A's excess as base	1,250 x 4 = 5,000	-	1,250 x 3 =3,750
h) C's excess over A (e) – (g)	**-**	**-**	**3,750**

Conclusions:

1) 1st 3,750 to C only
2) Next 5,000 + (7,500 – 3,750) = 8,750 to A & C in 4 : 3
3) Balance will be paid to A : B : C in 4 : 3 : 3

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Working note: 1

1st installment

Sale amount = 18,650

(+) cash balance = 275

= 18,925

- 3,000 expenses
- 18,650 x 1% = 187 [Remuneration or Commision on sale of asset]
- Balance = 18,925 - 3,000 - 187 = 15,738
  (-) Creditors = (15,738) = 0
  Balance payable to Creditors (15,900 - 15,738) is Rs. 162

Working note: 2

2nd Instalment : 17,320

- 17,320 x 1% = 173 [Remuneration or Commision on sale of asset]
- Sundry Creditors = 162 **(WN: 1)**
- Balance = 17,320 - 173 - 162 = 16,985
  (-) Partners Loan = (4,500)
  =12,485
  - a) 12,485 x (10/110) = 1,135 (commission)
  - b) 12,485 x (100/110) = 11,350 (Partners payment)

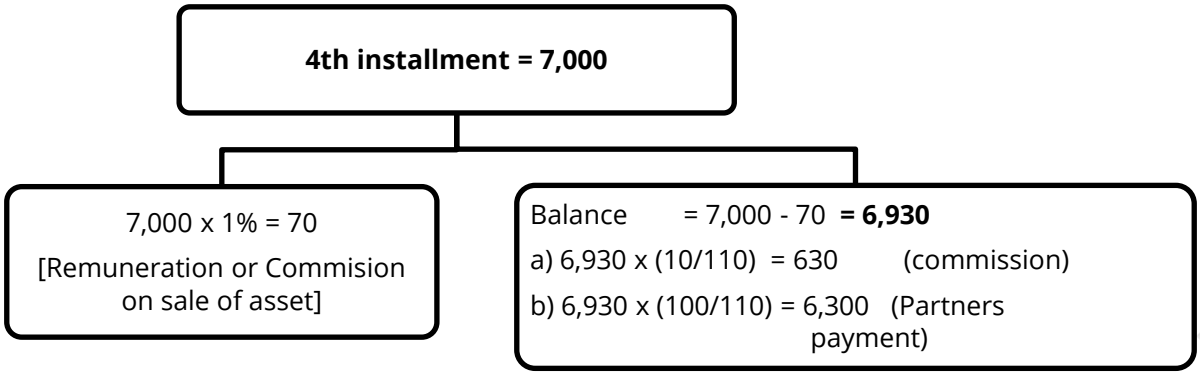
Working note: 3

3rd installment = 10,000

- 10,000 x 1% = 100 [Remuneration or Commision on sale of asset]
- Balance = 10,000 - 100 **= 9,900**
  a) 9,900 x (10/110) = 900 (commission)
  b) 9,900 x (100/110) = 9,000 (Partners payment)

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Working note: 4



Working Note: 5

Particulars	₹
Total 2nd Instalment	17,320
Less : Commission and B's Loan	(5,970)
Balance after Commission and B's loan	**11,350**
Less : First payment from balance to C (as per conclusion 1)	(3,750)
Balance available after payment to C	**7,600**

- This 7,600 will be split in 4 : 3 ration to A & C as per conclusion (2)
- A = 7,600 x 4/7 = 4,343
- C = 7,600 x 3/7 = 3,257

Working Note: 6

Particulars	₹
3rd Instalment	10,000
Less: Remuneration	**(1,000)**
Balance available	9,000
Less: Balance of ₹1,150 [(8,750 – 7,600) as per conclusion (2)] split among A & C in 4 : 3	(1,150)
Balance available	7,850

- The balance ₹7,850 will be split among A & B & C on 4 : 3 : 3 [3,140 : 2,355 : 2,355]

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8. Illustration

The partners A, B and C have called you to assist them in winding up the affairs of their partnership on 30th June 20X1. Their Balance Sheet as on that date is given below:

Liabilities	Amount (₹)	Assets	Amount (₹)
Sundry Creditors	17,000	Cash at Bank	6,000
Capital Accounts		Sundry Debtors	22,000
A	67,000	Stock in trade	14,000
B	45,000	Plant and Equipment	99,000
C	31,500	Loan-A	12,000
		Loan-B	7,500
	1,60,500		**1,60,500**

(1) The partners share profit and losses in the ratio of 5:3:2
(2) Cash is distributed to the partners at the end of each month
(3) A summary of liquidation transactions are as follows:

- **July 20X1**
  - ₹ 16,500 collected from Debtors, balance is uncollectable.
  - ₹ 10,000 received from sale of entire stock.
  - ₹ 1,000 liquidation expenses paid.
  - ₹ 8,000 cash retained in the business at the end of the month.

- **August 20X1**
  - ₹ 1,500 liquidation expenses paid.
  - As part payment of his Capital, C accepted a piece of equipment for ₹ 10,000 (book value ₹ 4,000).
  - ₹ 2,500 cash retained in the business at the end of the month.

- **September 20X1**
  - ₹ 75,000 received on sale of remaining plant and equipment.
  - ₹ 1,000 liquidation expenses paid. No cash retained in the business.

Required : Prepare a schedule of cash payments as of September 30, showing how the cash was distributed under 'Highest Relative Capital Method'

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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.

1. Building , machinery and vehicles were taken over at Rs.50,000, Rs.90,000 and Rs.1,00,000 respectively

2. 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

You are required to:

1. Compute the adjustments necessary for goodwill

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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.

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 Sr iGupta 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
		80,000		**80,000**

On 31st December 20X2 the trial balance is

Particulars	Amount (Rs.)	Amount (Rs.)
Stock	40,000	
Furniture	3,000	

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Investment	5,000	
Insurance policy	2,000	
Business purchase account	80,000	
Bank loan		18,000
Capital:		
Gupta		30,000
Singh		20,000
Raman		30,000
Bank	3,000	
Debtors	48,000	
Creditors		15,000
Purchases	3,20,000	
Expenses	12,000	
Sales		4,00,000
	5,13,000	**5,13,000**
Closing Stock Rs. 50,000		

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 ofpartnership as at 31st December 20X1 was as follows:

Balance Sheet As on 31st December 20X1

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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 andliabilities of Hari Brothers as follows:

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

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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.

Lal took over one of the motor vehicles at an agreed amount of Rs. 2,000. All other liabilities were paid from the Dena Bank account.

The purchase consideration is discharged by an issue at par of Rs. 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 Rs. 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 LifePolicy	9,000
B	1,30,000	2,70,000	Leasehold Premises	34,000
			Profit & Loss A/c	26,000
			Drawing Account:	16,000
			10,000	
			6,000	
		3,65,000		**3,65,000**

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The business was carried on till 30.6.20X2. The partners withdrew in equal amounts half the amount of profits made during the period of six months after charging depreciation at 10% p.a. on machinery and after writing off 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: Equity shares of Rs.10 each		10,00,000	Plant & machinery	2,50,000	8,00,000
Partners' capital:			Furniture & fixture	25,000	1,12,500
Prabhu	1,00,000				

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Bhola Shiv	1,50,000 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 atbank	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.

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

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Liabilities	20,000	Investments6% Debenturesin 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

(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

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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 of the partners into sharecapital 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 incash.
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.

Illustration 9

Mohit, Neel and Om were sharing Profits and losses in the ratio of 5:3:2 respectively. The trial balance of the firm on 31st March 2019 was the following

Particulars	**Amount (₹)**	**Amount (₹)**
Machinery at cost	2,00,000	
Inventory	1,37,400	
Trade receivables	1,24,000	
Trade payables		1,69,400
Capital a/c's		
Mohit		1,36,000
Neel		90,000
Om		46,000
Drawing a/c's		
Mohit	50,000	
Neel	46,000	
Om	34,000	
Depreciation on machinery		80,000
Profit for the year ended 31st March		2,48,600
Cash at Bank	1,78,600	
	7,70,000	**7,70,000**

Interest on Capital Accounts at 10% p.a. on the amount standing to the credit of Partners' Capital Account at the beginning of the year, was not provided before preparing the above Trial Balance. On the above date, they formed a MNO Private Limited Company with an

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Authorized Share Capital of 2,00,000 shares of 10 each to be divided in different classes to take over the business of Partnership firm.

You are provided the following information:

- Machinery is to be transferred at ₹1,40,000.
- Shares in the Company are to be issued to the partners, at par, in such numbers, and in such classes as will give the partners, by reason of their shareholdings alone, the same rights as regards interest on capital and the sharing of profit and losses as they had in the partnership.
- Before transferring the business, the partners wish to draw from the partnership profits to such an extent that the bank balance is reduced to₹1,00,000. For this purpose, sufficient profits of the year are to be retained in profit-sharing ratio
- Assets and liabilities except Machinery and Bank, are to be transferred at their book value as on the above date.

You are required to prepare:

Statement showing the workings of the Number of Shares of each class to be issued by the company, to each partner.

Capital Accounts showing all adjustments required to dissolve the Partnership.

Balance Sheet of the Company immediately after acquiring the business of the Partnership and Issuing of Shares.

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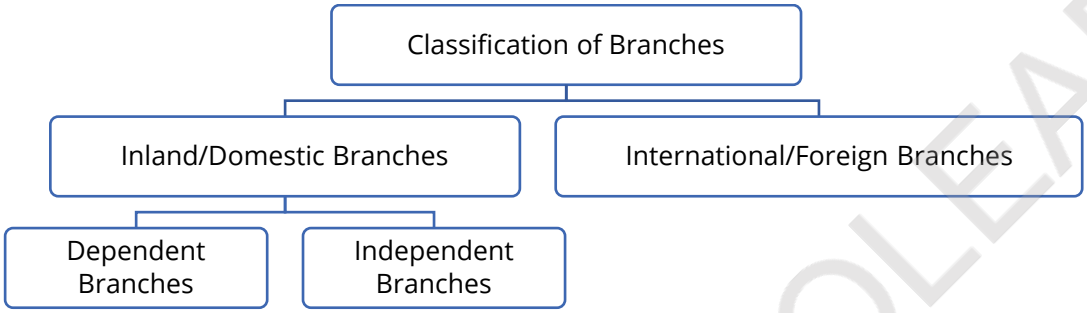
ACCOUNTING FOR BRANCHES INCLUDING FOREIGN BRANCHES

1 Introduction

1.1 Branch

Establishment at location different from head office to carry either same or substantially same activity as carried on by head office.

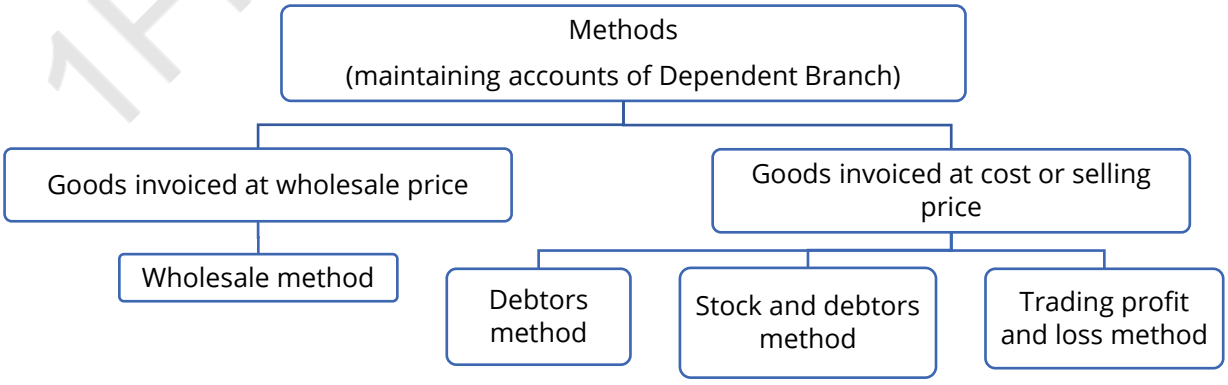
Classification of Branches



- **Dependent Branches** - whole accounting records are kept at Head office
  Head office will decide the branch operations, for example:
  - To sell goods at specific
  - Money is to be paid back to head office as soon as the goods are sold
  - To sell the goods sent by head office only
  - **Independent Branches** - maintain independent accounting records. Branch office will decide their own operations, For eg:
  - At which Price?
  - Where to Buy?
  - From whom to raise loan?

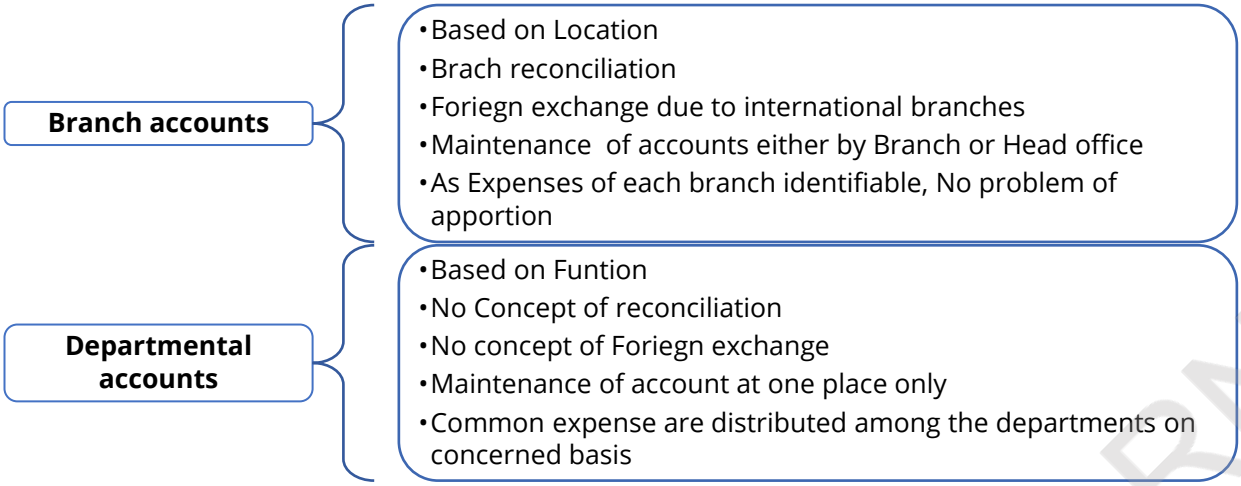
1.2 Methods of charging Goods to branches

Goods are transferred from HO to branches, accounting of the same as following methods



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1.3 Distinguish between Branch accounts and Departmental accounts



2 Accounting for Dependent Branch

2.1 When goods are invoiced at cost

When Goods are transferred at cost, from Head Office to Branch office.

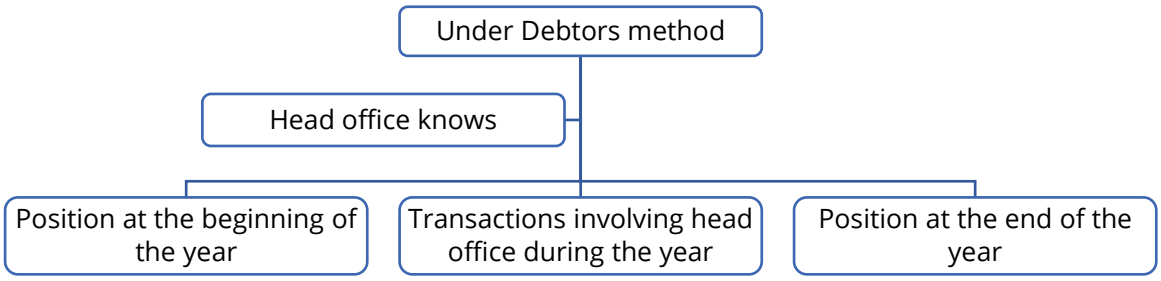
Debtors Method

- Suitable for small sized branches
- Separate Branch account is maintained for each branch to compute profit or loss made by each branch.

Proforma Branch account

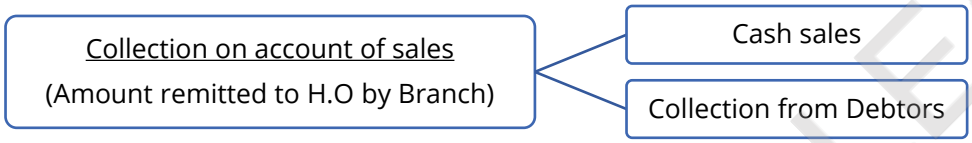
Particulars	Amount	Particulars	Amount
To Opening balance b/d: Furniture Stock Cash Debtors To goods sent to branch To Bank A/c Salaries Rent Sundry Expense To Profit & Loss – Profit (If credit side is larger)		By Bank A/c (Cash remitted) By Return to H.O By Balance c/d Cash Stock Debtors Petty cash Fixed Assets Prepaid Expense To Profit & Loss – Loss (If Debit side is larger)	

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Note:

- Transactions happened in Branch, which involves Head office – will be recorded in the books of H.O in Branch account
- Closing balance of Asset of Branch is missing à H.O will prepare those asset accounts as if they were Branch accountant



Recorded in the books of H.O

> Cash sales - Remitted to H.O
> Expenses directly paid by H.O
> Goods/Cash sent to Branch from H.O
> Cash remitted to H.O by Branch, but received by H.O
> Cash remitted to H.O, but not received by H.O, as Cash-in-transit
> Opening & Closing Balance of Assets

Not recorded in the books of H.O

> Cash sales - not transfered to H.O
> Expenses paid by Branch
> Credit Sales
> Good returns from customer
> Bad debts
> Discount to customer

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Trading Profit and loss method (Final Accounts method)

- In this method, Trading and profit & loss account are prepared considering each branch as separate entity
- Branch Trading and profit & loss account is merely a memorandum account and therefore, the entries made à do not have double entry effect.

Branch Trading and profit & loss account Proforma

Particulars	Amount	Particulars	Amount
To Opening Stock To goods sent from HO Less: Returns from HO To Gross profit c/d (If credit side is larger)		By Sales: Cash Credit Less: returns By Closing Stock By Gross loss c/d (If debit side is larger)	
By Gross loss b/d To Salaries & wages To Rent & Rates To Sundry Exp. To Petty cash Exp. To Allowance to Customers To Discount To Bad debts To Net Profit (If credit side is larger)		By Gross profit b/d By Net Loss (If debit side is larger)	

Stock and debtors' method



Following accounts are maintained by HO under this method

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Branch Debtors Account	•To get Closing balance of debtors
Branch Stock Account or Branch Trading Account	•To find Shortage or Surplus
Branch Expense Account	•To know the total of Branch expenses
Goods sent to Branch Account	•To know the cost of Goods sent by H.O to Branch
Branch Cash/Bank Account	•To know about cash flow at branch
Branch Fixed Asset Account	•Control over branch Fixed asset
Branch P&L Account	•To find Branch Net profit/loss

The manner in which entries are recorded in the above method is shown below:

Transaction	Entry
Cost of Goods sent by HO to branch	Branch Stock a/c Dr To Goods sent to branch a/c
Cost of Goods Returned from branch to HO	Goods sent to branch a/c Dr To Branch Stock a/c
Cash sales	Bank or Branch Cash a/c Dr To Branch stock a/c
Credit sales	Branch debtor a/c Dr To Branch stock a/c
Goods returned from Customer to Branch	Branch Stock a/c Dr To Branch Debtor a/c
Cost of Goods lost	Goods lost a/c Dr To Branch Stock a/c Branch P&L a/c Dr To Goods lost
Remittance for expense	Branch cash a/c Dr To Cash a/c
Any asset (Eg: Furniture) provided by HO	Branch Asset (Furniture) a/c Dr To Asset a/c
Cash paid by debtors	Branch cash a/c Dr To Branch Debtor a/c
Discount & allowance to debtors, bad debts	Branch Expense a/c Dr To Branch Debtors a/c
Remittance to HO	Cash a/c Dr To Branch Cash a/c
Branch expense directly paid by HO	Branch Expense a/c Dr To cash a/c
Expense met by Branch	Branch Expense a/c Dr To Branch cash a/c

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Note:

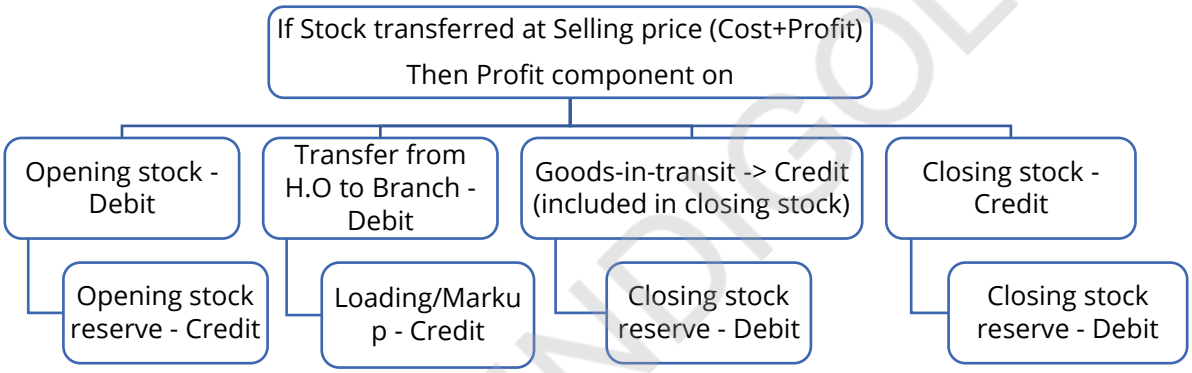
- Under 3 methods, Same net profit will arrive
- Dependant Branch accounting has to be prepared, when Branch expense direct from HO & remit all cash received to HO (Found any hints in the question that HO controls operations of branch)

2.2 When goods are invoiced at Selling price

When goods transferred at Selling price (cost + profit @Mark-up), from HO to Branch

Debtors Method

Under Debtors method, if goods are transferred at selling price Then in Branch accounts	
Profit component in debit item	Credit the profit component
Profit component in credit item	Debit the profit component



Note:

- For Eg: Rs.20 profit included in the opening stock Rs.120 & Rs.50 profit included in the closing stock

Branch account

Particulars	Amount	Particulars	Amount
To Opening stock	120	By Opening stock reserve (Profit on opening stock)	20
To Closing stock reserve (Profit on Closing stock)	50	By Closing Stock	250

- Profit component on Transfer/sales by HO to branch à Loading/Mark-up
- Profit component on Transfer/sales by branch to customer à Profit of Branch

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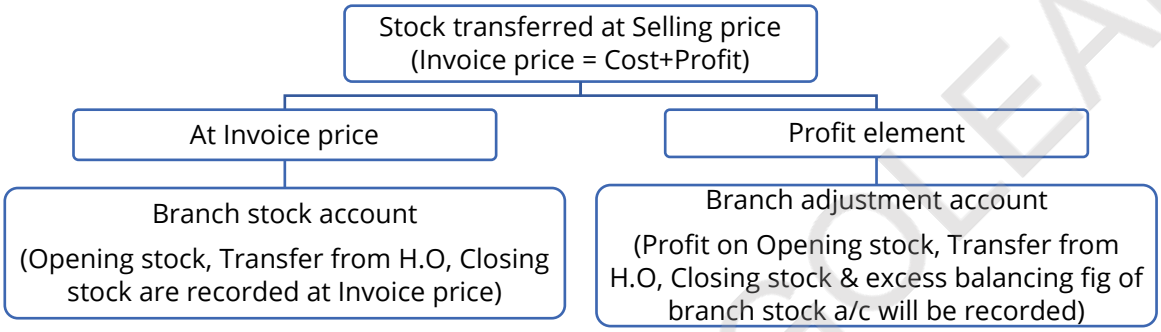
Trading Profit and loss method (Final Accounts method)

- All items of Memorandum Branch Trading and Profit and loss account are to be converted into cost price if the goods are invoiced to branch at selling price.
- Remaining will be same as if goods are invoiced at cost.

Stock and debtors' method

Accounts maintained under Stock and debtors' method

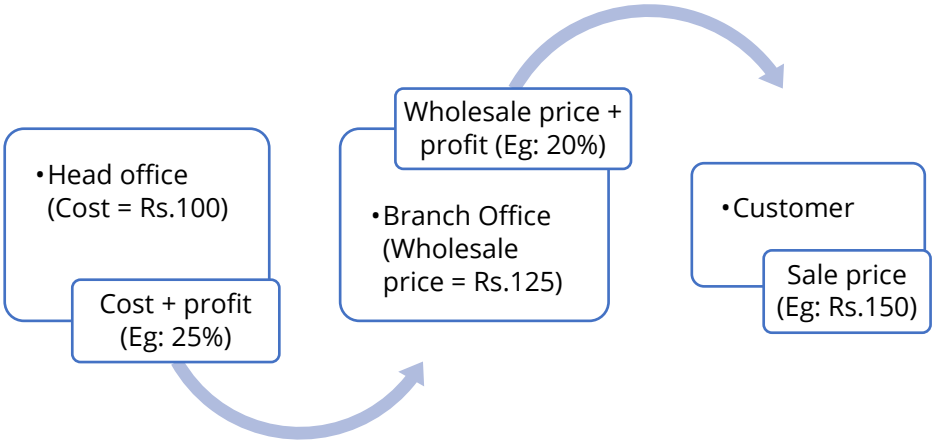
- Stock Account
- Debtors Account
- Profit and Loss Account & Other Account



Transaction	Journal Entry	Debit	Credit
Goods sent by HO to branch at Invoice price (Cost 100 + Profit 10 = 110)	Branch Stock a/c Dr To Branch Adjustment a/c To Goods sent to branch a/c	110	 10 100
Goods Returned from branch to HO	Branch Adjustment a/c Dr Goods sent to branch a/c Dr To Branch Stock a/c	10 100	 110
Goods lost at Invoice price (Cost 100 + Profit 10 = 110)	Goods lost a/c Dr Branch Adjustment a/c Dr To Branch Stock a/c	100 10	 110
	Branch P&L a/c Dr To Goods lost	100	 100

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2.3 Wholesale Branch method



- $Profit\ of\ Branch = (Sale\ proceeds\ at\ shop - Wholesale\ Price\ of\ goods\ sold)$

Principles for accounting under wholesale branch method

Opening stock & Goods sent to branch will be debited to Branch Stock or Trading account @ Wholesale price

Sales, Closing stock & Goods lost will be credit to to Branch Stock or Trading account @ Wholesale price

Branch Stock or Trading account will reveal the Gross Profit or Loss --> transfer to Branch P&L

After debited with expense, Branch P&L will disclose Net profit/Loss

As Closing stock valued @ wholesale price,

Create Stock reserve --> Difference between Wholesale price and its cost

> By debiting to HO P&L

> Stock reserve carried forward to next year and then transfer to credit of HO P&L

3 Accounting in the Books of Independent Branch

3.1 Salient features of accounting system of an independent system are as follows:

- Branch accounting - Double entry system
- Record all transaction between Branch and HO
  - Branch account in Head Office books &
  - Head office in Branch account
- Branch prepares its
  - Trail balance and profit and loss account at the end of the accounting period and
  - sends copies of these statements to HO for incorporation
- After receiving the final statement from branch, HO reconciles between
  - Branch account in HO books &
  - Head office in Branch account

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- HO passes necessary journal entries to incorporate branch trail balance in its books

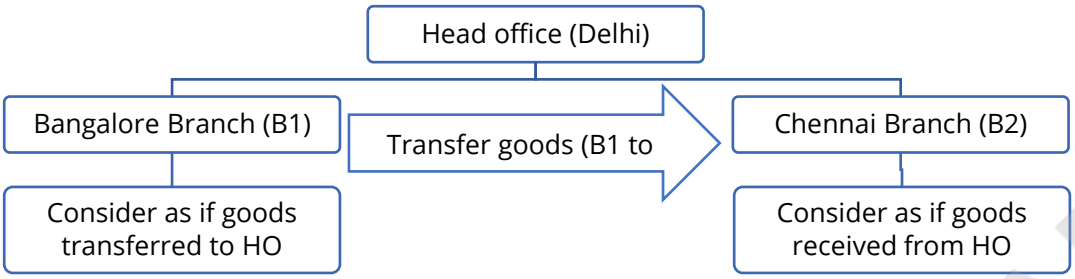
3.2 Journal entries

Transaction	Journal Entry in books of HO	Journal Entry in books of Branch
HO sent goods to Branch	Branch office a/c Dr To Goods sent to branch a/c	Goods received from HO a/c Dr To Head office a/c
Goods returned from branch to HO	Goods sent to branch a/c Dr To Branch office a/c	HO a/c Dr To Goods received from HO a/c
Branch pay its Expenses	No Entry	BO Expense a/c Dr To Cash/Bank a/c
Branch expense paid by HO	Branch a/c Dr To Bank a/c	Branch Expense a/c Dr To HO a/c
Branch made outside purchases	No Entry	Purchases a/c Dr To Cash/Bank a/c To Creditor a/c
Branch sales	No Entry	Cash/Bank a/c Dr Debtor a/c Dr To Sales a/c
Branch collected from Debtors	No Entry	Cash/Bank a/c Dr To Debtors a/c
Branch debtors collection made by HO	Cash/Bank a/c Dr To Branch a/c	HO a/c Dr To Debtors a/c
Payment made by Branch to Creditors for goods purchased	No Entry	Creditors a/c Dr To Cash/Bank a/c
Payment made by HO to Branch creditor	Branch a/c Dr To Cash/Bank a/c	Creditors a/c Dr To HO a/c
Purchase of Assets by Branch	No Entry	Asset a/c Dr To Cash/Bank a/c
Purchase of Assets for Branch, payment by HO	Branch a/c Dr To Cash/Bank a/c	Asset a/c Dr To HO a/c
Depreciation Entry for the above asset		Depreciation a/c Dr To Asset a/c P&L a/c Dr To Depreciation a/c
Asset purchased by Branch & retained in HO books	Asset a/c Dr To Branch a/c	HO a/c Dr To Cash/Bank a/c
Depreciation Entry for the retained asset	Branch a/c Dr To Asset a/c	Depreciation a/c Dr To HO a/c
Funds remittance by branch to HO	Cash/Bank a/c Dr To Branch a/c	HO a/c Dr To Cash/Bank a/c

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Transaction	Journal Entry in books of HO	Journal Entry in books of Branch
Funds remittance by HO to branch	Branch a/c Dr To Cash/Bank a/c	Cash/Bank a/c Dr To HO a/c

3.3 Inter Branch transfer of Goods

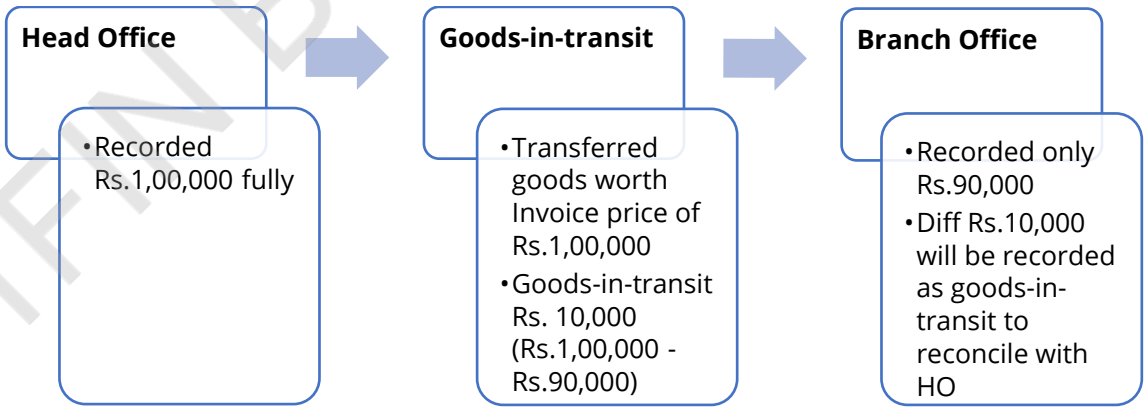


Journal Entry in books of B1	Journal Entry in books of HO	Journal Entry in books of B2
Delhi HO a/c Dr To Goods sent to Delhi a/c	Goods from branch a/c Dr To Bangalore Branch a/c	No Entry
No Entry	Chennai branch a/c Dr Goods sent to Branch a/c	Goods from HO a/c Dr To HO a/c

3.4 Goods-in-transit & Cash-in-transit

Steps to be considered for Goods-in-transit:

1. Check whether number of HO & Branch being compared/reconciled have a common base (i.e., Either it can be Invoice price or cost to HO)
2. Example:



Goods-in-transit	Journal entry in HO	Journal entry in Branch
Goods-in-transit from HO to Branch	Already journal entry passed	Goods-in-transit a/c Dr To HO a/c
Goods-in-transit from Branch to HO	Goods-in-transit a/c Dr To Branch office a/c	Already journal entry passed

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Cash-in-transit	Journal entry in HO	Journal entry in Branch
Cash-in-transit from HO to Branch	Already journal entry passed	Cash-in-transit a/c Dr To HO a/c
Cash-in-transit from Branch to HO	Cash-in-transit a/c Dr To Branch office a/c	Already journal entry passed

4 Incorporation of balances in HO

Journal entries in the books of HO and Branch for incorporation of balances in HO

Particulars	Journal entry in HO	Journal entry in Branch
Asset transferred from Branch to HO	Assets a/c Dr To BO a/c	HO a/c Dr To Assets a/c
Liabilities transferred from Branch to HO	BO a/c Dr To Liabilities a/c	Liabilities a/c Dr To HO a/c
Expenses transferred from Branch to HO	Expenses a/c Dr To BO a/c	HO a/c Dr To Expenses a/c
Sales transferred from Branch to HO	BO a/c Dr To Sales a/c	Sales a/c Dr To HO a/c

5 Foreign Branches

5.1 Foreign Operation



5.2 Integral Operations

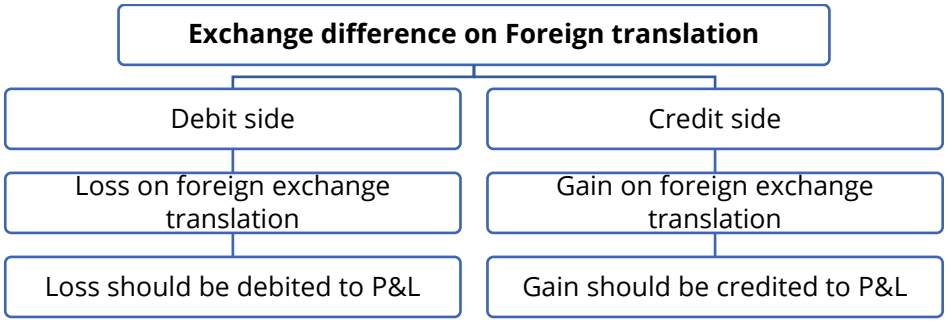
Principles for translating Integral Foreign Operations:

- Take the Trail Balance Foreign Operation/Branch which Foreign currency is denominated and tallied (Generally given in the question)
- Convert those number into local currency using the following conversion rates

S.No	Particulars	Conversion rates
1	Opening stock	Opening rate
2	Closing stock; all monetary items	Closing rate
3	Purchases; Sales etc	Average rate
4	Fixed assets	Actual

- Exchange difference in Trail balance à Transferred to P&L account

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5.3 Non-Integral Foreign Operations

Principles for translating Non-Integral Foreign Operations:

- Convert those number into local currency using the following conversion rates

S.No	Particulars	Conversion rates
1	All balance sheet items	Closing rate
2	All P&L items	Actual rate/Average rate

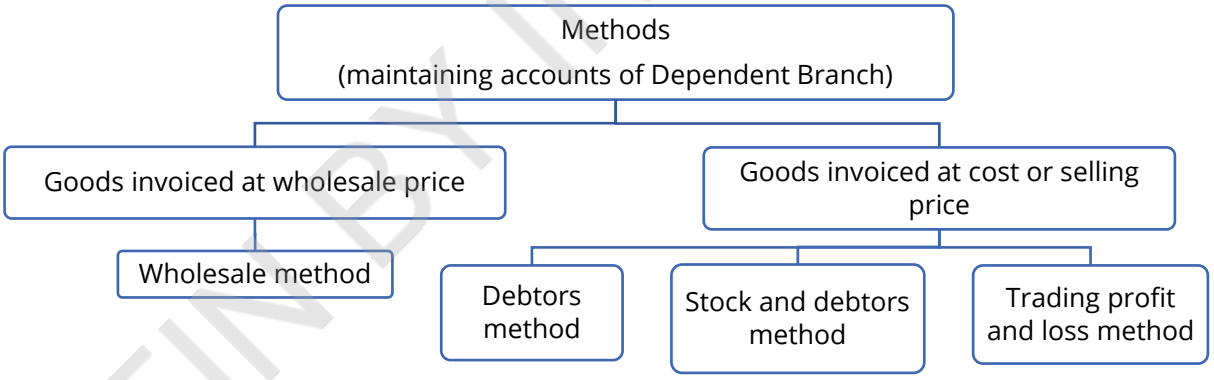
- Exchange difference in Trail balance à Transferred to Foreign Currency Translation Reserve (FCTR)

Note:

FCTR balance will be carried forward in the balance sheet till the concerned branch operations are shutdown/closed.

6 Summary

Classification of Branches: Domestic (Dependent & Independent) & Foreign Branches





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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

a. Debtors method
b. Final accounts method
c. stock and debtors method

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Opening balance (1-1-20X1)		Bad Debts	1,000
Imprest Cash	2,000	Discount to Customers	2,000
Sundry Debtors	25,000	Remittances to H.O. (recd.	1,65,000
Stock: Transferred from	24,000	by H.O.)	
H.O.	16,000	Remittances to H.O. (not	5,000
Direct Purchases		recd. by H.O. so far)	30,000
	45,000	Branch Exp. directly paid by	
Cash Sales	1,30,000	H.O.	10,000
Credit Sales	45,000	Closing Balance (31-12-20X1)	15,000
Direct Purchases		Stock:	
	3,000	Direct Purchase Transfer	?
Returns from Customers		from H.O.	?
Goods sent to branch from	60,000	Debtors	4,000
H.O.	4,000	Imprest Cash	
Transfer from H.O. for		Petty Cash expenses	
Petty Cash expenses			

Solution

a. **Debtors method**

In the books of Buckingham bros, Bombay

Nagpur branch account

Particulars	₹	Particulars	₹	₹
To opening branch assets		By bank -remittances received from branch		
Stock (24,000+16,000)	40,000	cash	45,000	
Debtors	25,000	Cash from debtors	1,20,000	
Imprest cash	2000	Cash in transit	5000	1,70,000
To goods sent to branch a/c	60,000	By closing branch assets		
To creditors (direct purchases)	45,000	Stock (15,000+10,000)		25000
To bank (sundry expenses)	30,000	Debtors (w.n 1)		24000
To bank (petty cash expenses)	4000	Imprest cash (w.n 2)		2000
To net profit (transferred to general profit and loss a/c)	**15,000**			
	2,21,000			2,21,000

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Working notes:

1. Memorandum debtors a/c

Particulars	₹	Particulars	₹
To balance b/d	25,000	By sales return	3000
To sales	1,30,000	By bad debts	1,000
		By discount	2,000
		By cash (w.n 3)	125,000
		By balance c/d	24,000
	1,55,000		1,55,000

2. Memorandum petty cash

Particulars	₹	Particulars	₹
To balance b/d	2,000	By expenses (met by branch)	4,000
To transfer from H. O	4,000	By balance c/d	2,000
	6,000		6,000

3. Collection from debtors = total remittances – cash sales
   = 1,70,000(1,65,000+5000) – 45,000
   = 125,000

b. **Final accounts method**

In the books of Buckingham bros, Bombay

Nagpur branch trading and profit and loss account for the year ending 31st December,20X1

Particulars	₹	Particulars	₹	₹
To opening stock	40,000	By sales		
To goods transferred from head office	60,000	Cash	45,000	
To purchases	45,000	Credit	1,30,000	
To gross profit c/d	52,000		1,75,000	
		Less: returns	(3000)	1,72,000
		By closing stock		25,000
	1,97,000			1,97,000
To sundry expenses	30,000	By gross profit b/d		52,000
To discounts	2,000			
To bad debts	1,000			
To petty cash expenses	4,000			
To net profit (transferred to general profit and loss a/c)	**15,000**			
	52,000			52,000

c. **stock and debtors method**

In the books of Buckingham bros, Bombay

Branch stock account

Particulars	₹	Particulars	₹	₹
To opening stock	40,000	By sales		

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To goods transferred from head office	60,000	Cash	45,000	
To purchases	45,000	Credit	1,30,000	
To gross profit c/d	52,000		1,75,000	
		Less: returns	(3000)	1,72,000
		By closing stock		25,000
	1,97,000			1,97,000

Branch expenses a/c

Particulars	₹	Particulars	₹
To bad debts a/c	1000	By branch profit and loss account	37,000
To discount allowed	2000		
To petty cash expenses	4000		
To sundry expenses	30,000		
	37,000		37,000

Branch profit and loss account

Particulars	₹	Particulars	₹
To branch expenses	37,000	By branch stock a/c	52,000
	15,000		
	52,000		52,000

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	500
Debtors	12,600	customers	6,200
Petty Cash	200	Salaries & Wages	1,200
Goods sent from H.O.	26,000	Rent & rates	8,00
Goods returned to H.O.	1,000	Sundry Expenses	
Cash sales	17,500	Cash received (from Sundry	2,800
Credit sales	28,400	Debtors)	
Allowances to customers	200	Balances as on 31.12.20X1:	6,500
Discount to customers	1,400	Stock	9,800
		Debtors	100
		Petty Cash	

Prepare:

(a) Branch Account (Debtors Method),

(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

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Solution

a. **Debtors method**

Branch account for the period 31st December, 20X1

Particulars	₹	₹	Particulars	₹	₹
To opening branch assets:			By bank		
Stock	7,000		Cash	17,500	
Debtors	12,600		Cash received from debtors	28,500	46,000
Petty cash	200	19,800	By goods sent to branch a/c		
To goods sent to branch a/c		26,000	(Returns to H.O)		1000
To bank:			By closing branch assets		
Salaries and wages	6200		Stock	6500	
	1200		Debtors	9800	
	800	8200	Petty cash	100	16,400
To net profit transferred to general profit and loss a/c		**9400**			
		63,400			63,400

(b) stock and debtors method

Delhi Branch stock account

Particulars	₹	Particulars	₹	₹
To balance b/d-		By sales:		
Opening stock	7000	Cash	17,500	
To goods sent to branch a/c	26,000	Credit	28,400	
To branch profit and loss a/c	19,900	Less: return	(500)	45,400
		By goods sent to branch a/c – return		1000
		By balance c/d – closing stock		6500
	52,900			52,900

Delhi branch debtors account

Particulars	₹	Particulars	₹
To balance b/d	12,600	By cash	28,500
To sales	28,400	By returns	500
		By allowances	200
		By discounts	1400
		By bad debts	600
		By balance c/d	9800
	41,000		41,000

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Delhi branch expenses account

Particulars	₹	Particulars	₹
To salaries and wages	6200	By branch profit and loss a/c	10,500
To rent and rates	1200		
To sundry expenses	800		
To petty cash expenses (200-100)	100		
To allowance to customer	200		
To discount	1400		
To bad debts	600		
	10,500		10,500

Delhi branch profit and loss account

Particulars	₹	Particulars	₹
To branch expenses a/c	10,500	By gross profit b/d (branch stock a/c)	19,900
To net profit transferred to general profit and loss a/c	9400		
	19,900		19,900

(c) branch trading and profit and loss account

Particulars	₹	₹	Particulars	₹	₹
To stock		7000	By sales:		
To goods sent from H. O	26,000		Cash	17,500	
Less: returns	(1000)	25,000	Credit	28,400	
To gross profit c/d		19,900	Less: returns	(500)	45,400
			By closing stock		6500
		51,900			51,900
To salaries and wages		6200	By gross profit b/d		19,900
To rent and rates		1200			
To sundry expenses		800			
To petty cash expenses		100			
To allowances to customers		200			
To discounts		1400			
To bad debts		600			
To net profit		**9400**			
		19,900			19,900

Illustration – 3 (a)

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:

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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.

Solution

In the books of Harrison

Branch stock account

Particulars	₹	Particulars	₹
To balance b/d – opening stock	30,000	By branch debtors (sales)	165,000
To goods sent to branch a/c	2,40,000	By branch cash	59,000
To branch adjustment a/c (balancing figure – excess of sale over invoice price)	2000	By balance c/d:	
		Goods in transit	20,000
		Closing stock at branch	28,000
	2,72,000		2,72,000

Branch debtors account

Particulars	₹	Particulars	₹
To balance b/d	32,750	By bad debts written off	750
To branch stock a/c (sales)	165,000	By branch cash (balancing figure)	1,71,000
		By balance c/d	26,000
	1,97,750		1,97,750

Branch cash account

Particulars	₹	Particulars	₹
To balance b/d	5,000	By bank remittance to H. O	2,22,500
To branch stock a/c	59,000	By branch expenses (met by branch -bal.fig.)	10,000
To branch debtors	1,71,000	By balance c/d	2,500
	2,35,000		2,35,000

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Branch adjustment account

Particulars	₹	Particulars	₹
To branch profit and loss a/c - gross profit (bal.fig)	**39,000**	By stock reserve -opening balance (25000 × 20 %)	5000
To stock reserve (48,000 × 1/6)	8,000	By goods sent to branch a/c	40,000
		By branch stock a/c	
	47,000		47,000

Branch expenses

Particulars	₹	Particulars	₹
To cash (H.O)	12,000	By branch profit and loss a/c	22,000
To branch cash	10,000		
	22,000		22,000

Branch profit and loss account

Particulars	₹	Particulars	₹
To branch expenses	22,000	By gross profit (from branch adjustment a/c)	39,000
To branch debtors (bad debts)	750		
To net profit	**16,250**		
	39,000		39,000

Goods sent to branch account

Particulars	₹	Particulars	₹
To branch adjustment a/c	40,000	By branch stock a/c	2,40,000
To purchase a/c – transfer	2,00,000		
	2,40,000		2,40,000

Illustration 3 (b)

Take figures from illustration 3 (a) and prepare branch account following debtors method.

Solution

In the books of Harrison

New Delhi Branch account

Particulars	₹	Particulars	₹	₹
To opening branch assets:		By stock reserve		5000
Stock	30,000	By goods sent to branch a/c		40,000
Debtors	32,750	By cash - remittance from branch:		
Cash	5000	Cash sales	59,000	
To goods sent to branch a/c (2,00,000 + 20 %)	2,40,000	Debtors (WN1)	1,63,500	2,22,500
To cash (expenses paid by H.O)	12,000	By balance c/d		
To net profit transferred to general profit and loss a/c)	**16,250**	Debtors		26,000

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To stock reserve (48,000 × 20/120)	8000	Stock (including transit – WN 2)		48,000 2500
	3,44,000			**3,44,000**

Working notes:

1. Collection from debtors = total cash remitted – cash sales
   = ₹ 2,25,000 - ₹ 59,000
   = ₹ 1,63,500
2. Closing stock = stock at branch + stock in transit (goods sent by HO – goods Received by branch)
   = ₹28,000 + ₹ 20,000 (2,40,000 – 2,20,000) = ₹ 48,000

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

i.The profit earned by the branch during the year.
ii.branch stock reserve in respect of unrealized profit.

Solution

In the books of Jammu branch
Trading and profit and loss account

Particulars	**₹**	**Particulars**	**₹**
To opening stock	2,20,000	By sales	12,00,000
To goods received by HO	1,10,000	By closing stock (refer W.N)	3,60,000
To expenses	45,000		
To net profit (bal.fig)	**1,95,000**		
	15,60,000		15,60,000

(II) Stock reserve in respect of unrealized profit

= ₹3,60,000 × 20/120 = ₹ 60,000

Working note:

	₹
Cost price	100
Invoice price	120
Sales price	150
Calculation of closing stock at invoice price	
Opening stock at invoice price	2,20,000

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Goods received during the year at invoice price	11,00,000
	13,20,000
Less: cost of goods sold at invoice price [12,00,000 × (120/150)]	(9,60,000)
Closing stock	3,60,000

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:

	Jan 20X1 ₹	Feb 20X1 ₹	March 20X1 ₹
Goods sent to branch (purchase price)	40,000	50,000	60,000
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)	1200	600	2400

The stock of goods held by the branch on March 31, 20X1 amounted to Rs. 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.

Solution

In the books of sell well

Branch account

Particulars	₹	Particulars	₹	₹
To goods sent to branch a/c (1,50,000 + 10 %)	1,65,000	By goods sent to branch – loading		15,000
To goods sent to branch a/c (4200 × 10/110)	382	By goods sent to branch – returns		4200
To stock reserve (53,400 × 10 /110)	4855	By bank a/c		1,06,000
To net profit (balancing figure – transferred to general P&L a/c)	37,363	By balance c/d		
		Stock	53,400	
		Debtors	29,000	82,400
	2,07,600			2,07,600

Working note:

Memorandum branch debtors account

Particulars	₹	Particulars	₹
To balance b/d	---	By cash / bank a/c	1,06,000
To sales	1,35,000	By balance c/d	29,000
	1,35,000		1,35,000

Goods sent to branch account

Particulars	₹	Particulars	₹
To branch a/c – loading	15,000	By branch a/c	1,65,000

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To branch a/c – returns	4,200	By branch a/c – loading on returns	382
To purchases a/c	1,46,182		
	1,65,382		1,65,382

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
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.

Solution,

In the books of Hindustan industries, Mumbai

Cochin branch stock account

Particulars	₹	Particulars	₹
To balance b/d – opening stock	60,000	By bank a/c – cash sales	2,00,0000
To branch debtors a/c – sales return	8,000	By branch debtors a/c – credit sales	3,60,000
To goods sent to branch a/c	6,00,000		12,000
To branch adjustment a/c (excess of selling price over invoice price)	24,000		1,20,000
	6,92,000		6,92,000

Cochin branch stock account

Particulars	₹	Particulars	₹
To goods sent to branch a/c (1/5 of ₹1,20,000 – on returns)	2400	By balance b/d (1/5 of ₹ 60,000)	12,000

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To branch P&L a/c (profit on sale) – balancing figure	1,29,600	By goods sent to branch to branch a/c (1/5 of ₹ 6,00,000)	1,20,000
To balance c/d (1/5 of ₹ 1,20,000)	24,000	By branch stock	24,000
	1,56,000		1,56,000

Goods sent to branch account

Particulars	₹	Particulars	₹
To cochin branch stock adjustment a/c	1,20,000	By cochin branch stock a/c	6,00,000
To cochin branch stock a/c (returns)	12,000	By cochin branch stock adjustment a/c	2,400
To purchases a/c	4,70,400		
	6,02,400		6,02,400

Branch debtors a/c

Particulars	₹	Particulars	₹
To balance b/d	72,000	By bank a/c	3,20,000
To branch stock a/c	3,60,000	By branch P&L a/c - discount	6,000
		By branch P&L a/c – bad debts	4,000
		By branch stock – sales return	8,000
		By balance c/d	94,000
	4,32,000		4,32,000

Branch expenses a/c

Particulars	₹	Particulars	₹
To bank a/c (rent, rates &taxes)	18,000	By branch profit & loss a/c	84,000
To bank a/c (salaries & wages)	60,000		
To bank a/c (office expenses)	6,000		
	84,000		84,000

Branch profit & loss account for the year ending 31st December 20X1

Particulars	₹	Particulars	₹
To branch expenses a/c	84,000	By branch stock adjustment a/c	1,29,600
To branch debtors a/c – discount	6,000		
To branch debtors a/c – bad debts	4,000		
To net profit transferred to P&L a/c	35,600		
	1,29,600		1,29,600

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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 year ended 31.3.20X2:

1. Outlet Stock Account.
2. Outlet Profit & Loss Account.
3. Stock Reserve Account.

Solution

Outlet stock account

Particulars	₹	Particulars	₹
To balance b/d	30,000	By sales (W.N.1)	3,60,000
To goods sent to outlet	3,24,000	By goods lost by fire (bal.fig)	18,000
To gross profit c/d	60,000	By balance c/d	36,000
	4,14,000		4,14,000

Outlet profit and loss account

Particulars	₹	Particulars	₹
To expenses	20,000	By gross profit b/d	60,000
To goods lost by fire (W.N.2)	18,000		
TO Profit transferred	22,000		
	60,000		60,000

Stock reserve account

Particulars	₹	Particulars	₹
To HO P&L a/c -transfer	6,000	By balance b/d	6,000
To balance c/d (stock reserve)	7,200	By HO P&L a/c	7,200
	13,200		13,200

Working notes:

(1)

	₹
Wholesale price 100 + 25	125
Retail price 125 +20%	150
Gross profit at the outlet	
Wholesale price – retail price (150 -125)	25
Retail sales value = 60,000 × 150/25	3,60,000

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(2) **goods lost by fire**

Opening stock + goods sent + gross profit – sales – closing stock

30,000 + 3,24,000 + 60,000 – 3,60,000 – 36,000 = ₹ 18,000

(3) **stock reserve**

Opening stock = 30,000 × 25/125 = ₹ 6,000

Closing stock = 36,000 × 25/125 = ₹ 7200

Illustration - 8

Messrs Ram Chand & 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 (₹)	Credit	Amount (₹)
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 (H.O. goods at invoice prices)	4,000	Sundry Creditors	3,000
Opening Stock of other goods	500		
Salaries	7,000		
Rent	3,000		
Office expenditure	2,000		
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.

Solution,

In the books of M/s. Ram Chand & Co.

Delhi branch trading and profit and loss account for the year ending 31st December 20X1

Particulars	₹	₹	Particulars	₹	₹
To opening stock:			By sales		1,00,000
Head office goods (4000 × 80%)	3200		By goods received from branch		3000

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Others	500	3700	By closing stock:		
To goods sent to branch (50,000 × 80%)		40,000	Head office goods (3000 × 80%)	2400	
To purchases		20,000	Others	1000	3400
To gross profit c/d		42,700			
		1,06,400			**1,06,400**
To salaries		7,000	By gross profit b/d		42,700
To rent		3,000			
To office expenses		2,000			
To depreciation on furniture @ 10%		500			
To net profit		30,200			
		42,700			**42,700**

Branch fixed assets account

Particulars	₹	Particulars	₹
To balance b/d	5,000	By Delhi branch a/c (depreciation)	500
		By balance c/d	4500
	5,000		5000

Note: furniture a/c is maintained in head office books; it is not a part of either opening or closing balance.

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	
Branch Current Account	1,33,710	
	9,99,410	**9,99,410**

Branch Trial Balance

Particulars	**Debit (Rs.)**	**Credit (Rs.)**
PPE (Property, plant & Equipment)	95,000	
Profit for 20X1		31,700
Stock	50,460	
Debtors and Creditors	19,100	10,400
Cash Balance	6,550	

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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:

a. Cash remitted by the Branch on 31st December, 20X1, but received by the Head Office on 1st January 20X2 – Rs. 3,000.

b. 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.

Solution

The balance current in the head office books [1,33,710] and head office current account in the branch books [1,29,010] do show the same balances. Its results in difference of Rs.4700

Therefore, in order to reconcile them, the following journal entries will be passed in the head office books:

Journal entries

		Dr (₹)	Cr. (₹)
20X1 Dec.,31	Cash in transit a/c Dr To branch current a/c (cash sent by the branch on 31st dec.,20X1 but received at H.O. on 1st Jan., 20X2)	3000	3000
	Loss by theft a/c Dr To branch a/c (stock lost in transit from H.O to branch)	1,700	1,700

The following journal entries passed in H.O books, given branch trail balance drawn up after preparing the branch profit and loss a/c

		Dr (₹)	Cr. (₹)
20X1 Dec.,31	Branch current a/c Dr To profit and loss a/c (branch profit for the year)	31,700	31,700
	Branch fixed assets Dr Branch stock a/c Dr Branch debtors a/c Dr Branch cash a/c Dr To branch current a/c	95,000 50,460 19,100 6,550	1,71,110
	Branch current a/c Dr	10,400	10,400

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	To branch creditors (branch creditors brought into H.O Books)		

Branch current account

Particulars	₹	Particulars	₹
To balance b/d	1,33,710	By cash in transit	3,000
	31,700	By loss of theft	1,700
	10,400	By sundry branch assets	1,71,110
	1,75,810		1,75,810

Profit and loss account for 20X1

Particulars	₹	Particulars	₹
To loss by theft	1,700	By balance b/d	25,310
To balance c/d	1,07,510	By year's profit: H.O.	52,200
		Branch	31,700
	1,09,210		1,09,210

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.

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 (₹)	Credit (₹)	Debit (₹)	Credit (₹)
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 & selling overheads	12,500		2,300	
Inter-unit accounts	5,000			2,000
Capital		50,000		

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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.

Solution,

In the books of KP

Trading and profit & loss account for the year ending 31st December,20X1

Particulars	H.O (₹)	Branch (₹)	Total (₹)	Particulars	H.O (₹)	Branch (₹)	Total (₹)
To opening stock	13,000	9200	22,200	By sales	2,00,000	65,600	2,65,200
To material consumed (W.N.1)	34,500	_	34,500	By goods sent to branch	46,000	-	-
To wages	1,08,500	-	1,08,500	By closing stock including transit (W.N.2)	15,000	**9,560** (bal.fig)	24,560
To factory overheads	39,000	-	39,000				
To goods from H.O.		46,000					
To gross profit c/d (W.N.3)	**66,000** (Bal.fig)	19,560	85,560				
	2,61,000	74,760	2,89,760		2,61,000	74,760	2,89,760
To Admn salaries	13,900	4,000	17,900	By gross profit b/d	66,000	19,560	85,560
To salesmen salaries	22,500	6,200	28,700				
To other Admn & Selling overheads	12,500	2,300	14,800				

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To stock reserve (W.N 4)	47	-	47				
To bonus to staff	-	156	156				
To net profit	**17,053**	**6,904**	**23,957**				
	66,000	19,560	85,560		66,000	19,560	85,560

Balance sheet as on 31st December., 20X1

Particulars	**H.O (₹)**	**Branch (₹)**	**Total (₹)**	**Particulars**	**H.O (₹)**	**Branch (₹)**	**Total (₹)**
Capital	50,000	_	50,000	Fixed assets	-	-	-
Profit:				Current assets:			
H.O 17,053				Raw material	2300		2300
Branch 6,904	23,957	-	23,957	Finished goods	15,000	9,560	**23,313**
Trade creditors		13,000	13,000	[24,560 –			
Bonus payable		156		1247(stock			
H.O account		10,404		reserve)]	37,000	-	37,000
Stock reserve				Debtors	22,000	1,000	23,000
(W.N.4)	1,247			Cash	1500	-	1500
				Cash in transit	10,404		
				Branch a/c (W.N.5)			
	88,204	10,560	87,113		88,204	10,560	87,113

Working notes:

1.Material consumed = Opening raw material + raw material consumed – Closing raw material

= 1,800 + 35,000 – 2,300 = 34,500

2.Closing stock at head office

Particulars	**₹**	**₹**
Opening stock		13,000
Total factory cost		
Material consumed	34,500	
Wages	1,08,500	
Factory overhead	39,000	1,82,000
Cost of goods sold		
Sales	2,00,000	
Less: gross profit (30% on sales)	60,000	(1,40,000)
Stock transferred to branch	46,000*100/115	(40,000)
Closing stock		15,000

3.Gross profit of branch = sales × 30% = 19,560

4.closing stock reserve = 9,560 × 15/115 = 1,247

Charge to profit and loss account = 1247 – 1200 (existing) = 47

5.branch account

Branch profit + inter unit account = 6904 + 5000 = 10,404

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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 in ₹	Amount in ₹
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.

Solution,

In the books of English firm (head office in New York)

Chennai branch profit and loss account for the year ended 31st December,20X2

Particulars	$	Particulars	$
To opening stock	4,500	By sales	46,875
To purchases a/c	31,250	By closing stock (6,37,500/51)	12,500
To gross profit c/d	23,625		
	59,375		59,375
To salaries	2,000	To gross profit c/d	23,625
To rent, rates and taxes	2125		
To exchange translation loss	2,000		
To net profit c/d	17,500		
	23,625		23,625

Balance sheet of Chennai Branch as on 31st December,20X2

Liabilities	$	$	Assets	$
Head office a/c	13,400		Furniture	1,750
Add: net profit	17,500	30,900	Closing stock	12,500
Trade creditors		10,000	Trade debtors	15,000
Bills payable		3,500	Bills receivable	4000
			Cash at bank	11,150
		44,400		44,400

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Working note:

Calculation of exchange translation loss

Chennai branch trial balance (converted in $) as on 31st December,20X2

Particulars	Dr. ₹	Cr. ₹	Conversion principle	Conversion rate	Dr. $	Cr. $
Stock on 1st Jan ,20X2	2,34,000		Opening	52	4500	
Purchases & sales	15,62,500	23,43,750	Average	50	31,250	46,875
Debtors and creditors	7,65,000	5,10,000	Closing	51	15,000	10,000
Bills receivable and bills payable	2,04,000	1,78,500	Closing	51	4,000	3,500
Salaries and wages	1,00,000		Average	50	2000	
Rent, rates and taxes	1,06,250		Average	50	2125	
Furniture	91,000		Actual	-	1750	
Bank a/c	5,68,650		Closing	51	11,150	
New York account		5,99,150				13,400
Exchange translation loss (bal.fig)					2000	
	36,31,400	36,31,400			73,775	73,775

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:

Particulars	Bombay In ₹ (000)		Sydney In Australian 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	-
Managing Director's salary	30	-	-	-
Wages & Salaries	75	-	45	-
Rent	-	-	12	-
Office Expenses	25	-	18	-
Commission Receipts	-	256	-	100

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Branch / H.O. Current A/c	120 **4,880**	- **4,880**	- **390**	7 **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

Solution

In the books of S&M Ltd.
Sydney branch trail balance (in rupees) as on 31st march ,20X2

Particulars	**Australian dollars ('000)**		**Conversion principle**	**Conversion rate**	**INR ₹ (000)**	
	Dr.	Cr.		**1 A $ = Rs.**	Dr.	Cr.
Plant and machinery (cost)	200	-	Fixed asset	18	3600	-
Plant and machinery depreciation reserve	-	130	Fixed asset	18	-	2340
Debtors /creditors	60	30	Closing	24	1440	720
Stock (1.4.20X1)	20	-	Opening	20	400	
Cash and bank balances	10	-	Closing	24	240	
Purchases/sales	20	-	Average	22	440	2706
Goods received from H. O	5	-	Actual	-	100	
Wages / salaries	45	-	Average	22	990	
Rent	12	-	Average	22	264	
Office expenses	18	-	Average	22	396	
Commission receipts	-	100	Average	22		2200
H.O. current a//c		7	Actual	-		120
	390	390			7870	8086
Exchange loss (bal.fig)	-				216	
					8086	8086

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.
Mumbai branch furnishes you with its trial balance as on 31st March, 20X2 and the additional information given thereafter:

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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 $

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.

Solution

In the books of M/S. Carlin

Mumbai branch trial balance in (US $) as on 31st march ,20X2

Particulars	US $		Conversion principle	Conversion rate	INR ₹	
	Dr.	Cr.		1 A $ = Rs.	Dr.	Cr.
Stock on 1.4.20X1	3,00,000	-	Opening	40	7500	-
Purchases and sales	8,00,000	12,00,000	Average	41	19,512.20	29,268.29
Sundry debtors and creditors	4,00,000	3,00,000	Closing rate	42	9523.81	7142.86
Bills of exchange	1,20,000	2,40,000	Closing	42	2857.14	5714.29
Wages and	5,60,000	-	Average	41	13,658.54	-
salaries	3,60,000	-	Average	41	8780.49	-
Rent, rates and	1,60,000	-	Average	41	3902.44	-
taxes	2,40,000	-	Actual	-	6000.00	-
Sundry charges	4,20,000	-	Closing	42	10,000.00	-
Computers	-	16,20,000	Actual	-	-	39,609.18

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Bank balance New York Office a/c						
	33,60,000	33,60,000			81.734.62	81,734.62

Trading and profit & loss account for the year ended 31st March ,20X2

Particulars	US $	Particulars	US $
To opening stock	7500.00	By sales	29,268.29
To purchases	19,512.20	By closing stock	10,000.00
To wages and salaries	13,658.54	By gross loss c/d	1402.45
	40,670.74		40,670.74
To gross loss c/d	1402.45	By net loss	17,685.38
To sundry charges	8780.49		
To depreciation on computers (US $6000 ×× 0.6)	3600.00		
	17,685.38		17,685.38

Balance sheet of Mumbai branch as on 31st March, 20X2

Liabilities	US $	US $	Assets	US $	US $
New York office a/c	39,609.18		Computers	6000.00	
Less: net loss	(17,685.38)	21,923.80	Less: depreciation	(3600.00)	2400.00
Sundry creditors		7142.86	Closing stock		10,000.00
Bills payable		5714.29	Sundry debtors		9523.81
			Bank balance		10,000.00
			Bills receivable		2857.14
		34,780.95			34,780.95

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DEPARTMENTAL ACCOUNTS

1 Introduction

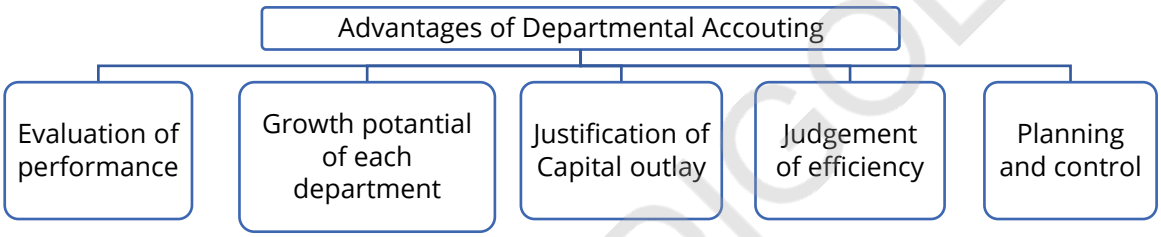
1.1 Departmental Accounting

When organisation with business consisting of independent activities or is divided into various departments with exclusive functions, the management of such organisations require accounts of such independent activities or departments to review their efficiencies and performance. Department accounting fulfils this objective.

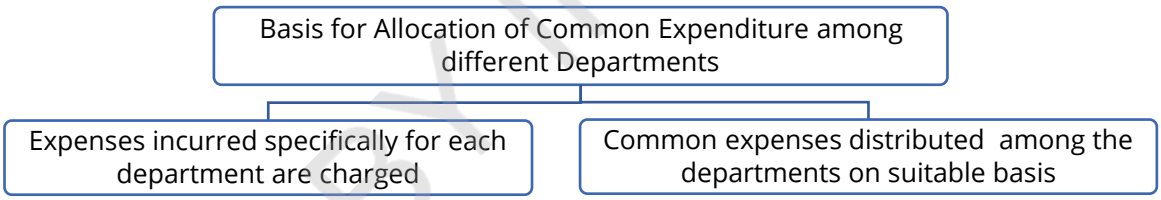
- Departmental Accounting are Internal performance measures
- Performance analysis of each department based on
  - Expense allocated and
  - Incomes attributed

  Will help management in deciding the economic viability of the department

1.2 Advantages of Departmental Accounting



2 Basis for allocating Expenses



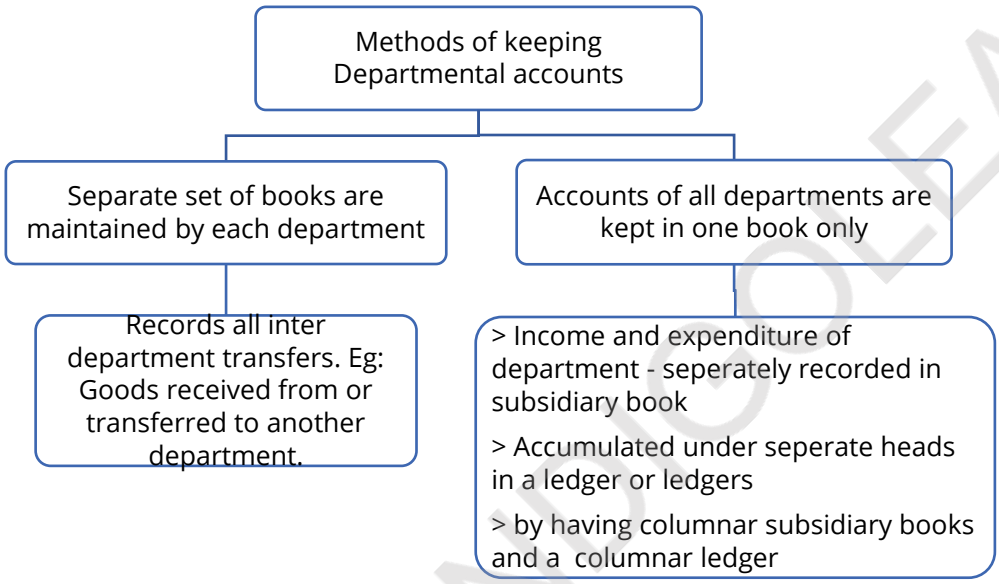
S.No	Expense	Basis of Allocation
1	Rent	Area/Floor space occupied
2	Property Taxes	Area occupied
3	Repairs to buildings & Insurance	Area Occupied
4	Lighting & Power Expense Electricity	Power (Units) Consumed by each department
5	Selling Expense	Proportionate to Sales of each department
6	Carriage Inwards / Discount received	Purchase made by each department
7	Wages & Salaries (Common)	Time spent by employees in each department

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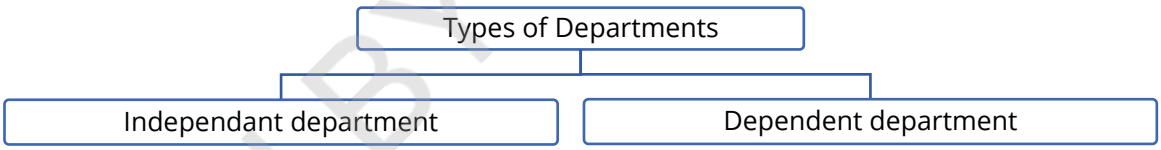
8	Depreciation, Insurance & Maintenance on/of assets	Asset value in each department or time spent by asset in each department	Note:
9	Administration Expenses	Equally or any other appropriate basis	
10	Labour welfare Expense	No. of employees working in the department	
11	PF, ESI, Gratuity, etc	Wage cost of each department	
12	Carriage Outwards	Sales made by each department	

- Certain Expenses and Income, cannot be apportioned on a suitable basis → Recognised in combined Profit and loss Account
  Eg: Interest on loan, profit/loss on sale of investment etc (Most being of financial nature)

3 Methods of Departmental Accounting



4 Types of Departments



4.1 Independent Department

Department which works independently of each other and have negligible inter-department transfers → Independent Department

4.2 Dependant Department

Department which transfers goods from one department to other department for further processing → Dependant department

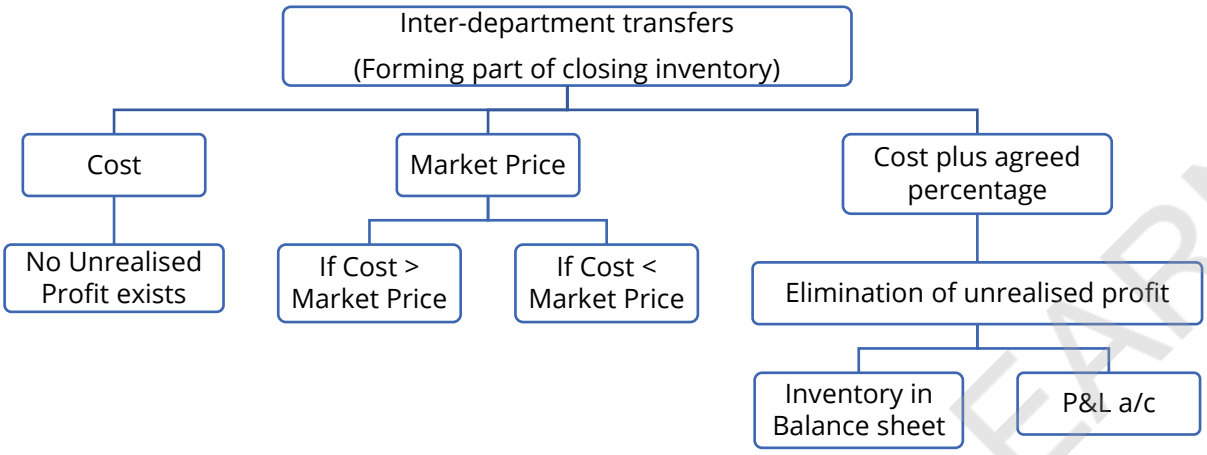
- Output of one department becomes Input for the other department
- Transfer can be done at Cost or Pre-decided Selling price

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5 Inter-Departmental Transfers

5.1 Different Inter-departmental transfer

Goods & services transfer are charged by one department to another as follows:



5.2 Stock Reserve

Stock Reserve → Profit made on inter-departmental transfer

$$Stock\ Reserve\ = \frac{Transfer\ price\ of\ unsold\ stock\ \times\ Profit\ included\ in\ transfer\ price}{Transfer\ Price}$$

Journal Entry:

Period	Particulars	Entry
At the end of accounting year	For elimination of Unrealised profit included in Closing stock	Profit and loss a/c Dr To Stock Reserve a/c
In the beginning of next accounting year	To reverse Provision of unrealised profit	Stock Reserve a/c Dr To Profit and loss a/c

Disclosure in Balance sheet:

- Under Current assets
  Stock
  Less: Stock reserve

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6 Memorandum Stock and Memorandum Mark-up Account Methods

- This Method used to have an appropriate control on stock movement of various department
- Memorandum account → Control accounts

6.1 Memorandum Stock Account

- Records all stock movement @ Selling price
- I.e., Opening stock, purchases, stock transfer, shortages and sales by adding the mark-up

6.2 Memorandum Mark-up Account

- Prepared for loading or mark-up on cost in Memorandum Stock Account

$$Mark\ up = (Selling\ price - Cost)$$

6.3 Various accounting adjustment that are required to be made under this method

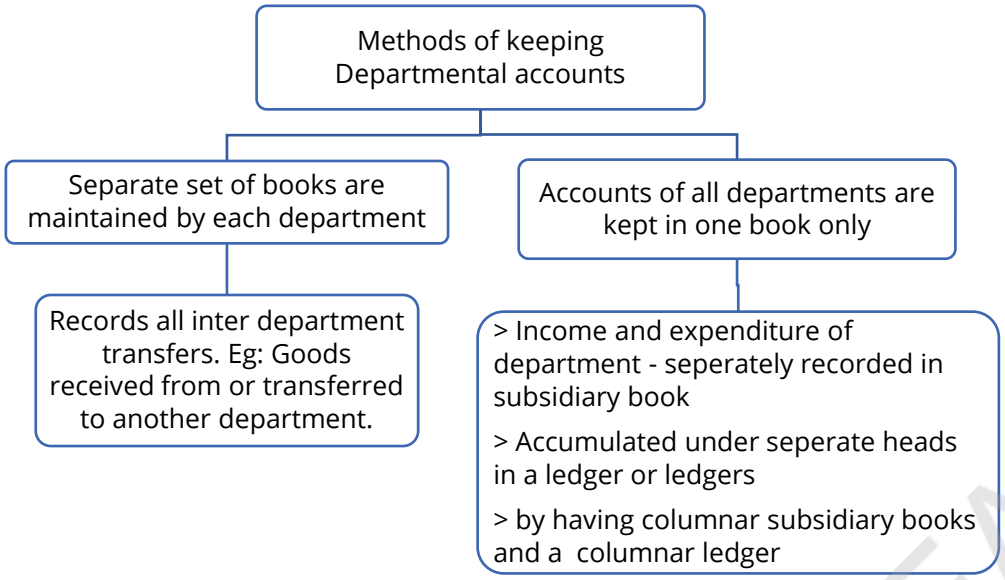
Particulars		Memorandum Stock Account (Selling price)	Particulars	Memorandum Mark-up Account (Mark-up / Mark-down)
		Debit/Credit		Debit/Credit
Opening Stock		Debit	Its Mark-up	Credit
Purchases/ Stock Transfer		Debit	Its Mark-up	Credit
Sales		Credit	No Mark-up	-
Any theft / Shortage / Loss of stock		Credit	Mark-up	Debit
If Selling price of any goods reduced below its normal selling price	On Debit Items	Debit	Its Mark-down	Debit
	On Credit Items	Credit	Its Mark-down	Debit
Closing Stock		Credit	Its Mark-up	Debit

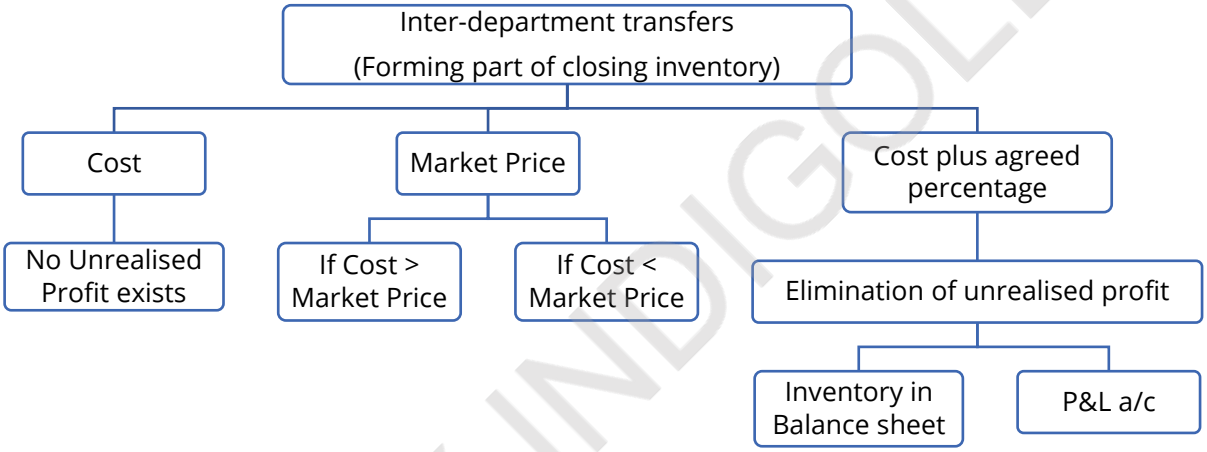
Note:

Balance remaining in Mark-Up Account should reflect profit or loss for the period (Cross verified by calculating the mark-up % on Sales)

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7 Summary





$$Stock\ Reserve\ = \frac{Transfer\ price\ of\ unsold\ stock\ \times\ Profit\ included\ in\ transfer\ price}{Transfer\ Price}$$

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Illustrations

Illustration 1 (Concept of Stock Reserve)

Goods are transferred from Department P to Department Q at a price 50% above cost. If closing stock of Department Q is ₹27,000 compute the amount of stock reserve.

Solution: Illustration 1

If cost = 100

Add: Profit = 50

Selling Price/Selling Price to Department P = 150

The same 150 is Cost to Department Q, Closing stock Will be @ cost

→In 150 of Closing stock 50 is Profit

→How Much in 27,000 =?

⇒Stock Reserve/Unrealised Profit = 27,000 × $\frac{50}{150}$ = ₹9,000

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.

Solution: Illustration 2

Departmental Trading Account for the year ended on 31st March, 20X1

Particulars	**A (₹)**	**B (₹)**	**C (₹)**	**Particulars**	**A (₹)**	**B (₹)**	**C (₹)**
To Opening Stock (WN1) & (WN2)	11,520 (720 x 16)	8,640 (480 x 18)	12,240 (612 x 20)	By Sales	2,44,800 (6120 x 40)	5,18,400 (11,520 x 45)	7,48,800 (14,976 x 50)
To Purchases (WN3)	96,000 (6,000 x 16)	2,16,000 (12,000 × 18)	2,88,000 (14,400 × 20)	By Closing Stock	9,600 (600 x 16)	17,280 (960 x 18)	720 (36 x 20)

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To Gross Profit (WN1)	1,46,880	3,11,040	4,49,280				
	2,54,400	5,35,680	7,49,520		2,54,400	5,35,680	7,49,520

Working Notes:

1. Gross Profit %

Purchases			
Departments	**Units**	**Rate**	**Amount**
A	6,000		
B	12,000		
C	14,400		
		Cost	**6,00,000**

Assume all the units are sold			
Departments	**Units**	**Rate**	**Amount**
A	6,000	40	2,40,000
B	12,000	45	5,40,000
C	14,400	50	7,20,000
		Sales	**15,00,000**

Therefore, Profit = 15,00,000 – 6,00,000 = 9,00,000

Profit % = $\frac{₹9,00,000}{₹15,00,000}$ × 60%

2. Stock Quantity

Particulars	**A**	**B**	**C**	**Particulars**	**A**	**B**	**C**
In Qty.							
To Opening Stock (Bal. Fig.)	720	480	612	By Sales	6,120	11,520	14,976
Purchases	6,000	12,000	14,400	By Closing Stock	600	960	36
	6,720	**12,480**	**15,012**		**6,720**	**12,480**	**15,012**

3. Opening stock Value

If 100 is Selling Price

Profit = 60

Cost = 50

Departments	**Selling Price**	**Profit**	**Cost**
A	40	24 $(\frac{₹40×60}{₹100})$	16 $(\frac{₹40×40}{₹100})$
B	45	27 $(\frac{₹45×60}{₹100})$	18 $(\frac{₹45×40}{₹100})$

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C	50	30 $(\frac{₹50\times60}{₹100})$	20 $(\frac{₹50\times60}{₹100})$

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 ₹		
	X	Y	Z
Opening Stock	36,000	24,000	20,000
Purchases	1,32,000	88,000	44,000
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:

	₹
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

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%.

Solution: Illustration 3

In the Books of M/s Omega Departmental Trading and Profit and Loss Account

articulars	Dept.X (₹)	Dept.Y (₹)	Dept.Z (₹)	Total (₹)	Particulars	Dept.X (₹)	Dept.Y (₹)	Dept.Z (₹)	Total (₹)
o Opening tock	36,000	24,000	20,000	80,000	By Sales	1,80,00 0	1,35,000	90,000	4,05,00
o urchases	1,32,000	88,000	44,000	2,64,000	By Stock (Closing)	45,000	17,500	21,000	83,500
o Carriage nwards WN1)	1,500	1,000	500	3,000					

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o Gross rofit c/d .f)	55,500	39,500	46,500	1,41,50 0					
	2,25,000	**1,52,500**	**1,11,000**	**4,88,500**		**2,25,000**	**1,52,50 0**	**1,11,000**	**4,88,50**
o Carriage WN1)	1,200	900	600	2,700	By Gross Profit b/d	55,500	39,500	46,500	1,41,50
alaries WN1)	20,000	16,000	12,000	48,000	By Discount received	900	600	300	1,800
ent, Rates nd Taxes	3,000	2,500	2,000	7,500					
epreciation	400	400	200	1,000					
o ectricity	1,500	1,000	500	3,000					
o Labour elfare xpenses	1,000	800	600	2,400					
o Provision or Bad ebts	750	500	500	1,750					
o Net rofit (b.f	26,350	16,350	29,300	72,000					
	56,400	**40,100**	**46,800**	**1,43,300**		**56,400**	**40,100**	**46,800**	**1,43,30**

for the year ended 31st March, 20X1

Working Notes:

Particulars	Total	Basis of Allocation	Ratio	Dept. X	Dept. Y	Dept. Z
Carriage Inwards (WN1)	3,000	Purchases	132:88:44	$\frac{₹3,000\times132}{264}$ = 1,500	$\frac{₹3,000\times88}{264}$ = ₹1,000	$\frac{₹3,000\times44}{264}$ = ₹500
Carriage Outwards (WN1)	2,700	Sales	180:135:90	$\frac{₹2,700\times180}{405}$ = ₹1,200	$\frac{₹2,700\times135}{405}$ = ₹900	$\frac{₹2,700\times90}{405}$ = ₹600
Salaries (WN1)	48,000	No. of Employees	5:4:3	$\frac{₹48,000\times5}{12}$ = ₹20,000	$\frac{₹48,000\times4}{12}$ = ₹16,000	$\frac{₹48,000\times3}{12}$ = ₹12,000
Advertisement (WN1)	2,700	Sales	180:135:90	$\frac{₹2,700\times180}{405}$ = ₹1,200	$\frac{₹2,700\times135}{405}$ = ₹900	$\frac{₹2,700\times90}{405}$ = ₹600
Discount allowed (WN1)	2,250	Sales	180:135:90	$\frac{₹2,250\times180}{405}$ = 1,000	$\frac{₹2,250\times135}{405}$ = 750	$\frac{₹2,250\times90}{405}$ = 500
Discount received (WN1)	1,800	Purchases	132:88:44	$\frac{₹1,800\times132}{264}$ = 900	$\frac{₹1,800\times88}{264}$ = 800	$\frac{₹1,800\times44}{264}$ = 300

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Rent, Rates and Taxes (WN1)	7,500	Floor Space	30:25:20	$\frac{₹7,500\times30}{75}$ = 3,000	$\frac{₹7,500\times25}{75}$ = 2,500	$\frac{₹7,500\times20}{75}$ = 2,000
Depreciation on Furniture (WN1)	1,000	Value of furniture	2:2:1	$\frac{₹1,000\times2}{5}$ = 400	$\frac{₹1,000\times2}{5}$ = 400	$\frac{₹1,000\times1}{5}$ = 200
Electricity expense (WN1)	3,000	Units consumed	3:2:1	$\frac{₹3,000\times1}{6}$ = 1,500	$\frac{₹3,000\times2}{6}$ = 1,000	$\frac{₹3,000\times1}{6}$ = 500
Labour welfare expenses	2,400	No. of Employees	5:4:3	$\frac{₹2,400\times5}{12}$ = ₹1,000	$\frac{₹2,400\times4}{12}$ = ₹800	$\frac{₹2,400\times3}{12}$ = ₹600
Provision for bad debts (WN1)	1,750	5% of Debtors at end	-	15,000 × 5% = 750	10,000 × 5% = 500	10,000 × 5% = 500

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 (₹)	B (₹)
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	4,500	24,000
2. Finished goods	6,000	14,000
Purchased goods transferred:		
• by B to A	10,000	
• by A to B		8,000
Finished goods transferred:		
• by A to B 35,000	35,000	
• by B to A 40,000		40,000
Return of finished goods:		
• by A to B 10,000	10,000	
• by B to A 7,000		7,000

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

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Solution: Illustration 4

Departmental Trading A/c

for the year ending 31st December, 20X1

	Dept. A (₹)	**Dept. B. (₹)**		**Dept. A (₹)**	**Dept. B. (₹)**
To Opening Stock	20,000	12,000	By Sales	1,40,000	1,12,000
To Purchases	92,000	68,000	By Purchased Goods transferred	8,000	10,000
To Wages	12,000	8,000	By Finished goods transferred	35,000	40,000
To Carriage	2,000	2,000	Return of finished goods	10,000	7,000
To Purchased Goods (Received)	10,000	8,000			
To F.G. transferred (Received)	40,000	35,000	By Closing Stock:		
To Ret. Of finished Goods	7,000	10,000	- Purchased Goods	4,500	6,000
			- Finished Goods	24,000	14,000
To Gross profit c/d (b.f.)	38,500	46,000			
	2,21,500	**1,89,000**		**2,21,500**	**1,89,000**

Consolidated Trading Account for the year ending 31st December, 20X1

To Opening Stock	32,000	By Sales	2,52,000
To Purchases	1,60,000	By Closing Stock:	
To Wages	20,000	- Purchased Goods	10,500
To Carriage	4,000	- Finished Goods	38,000
To Stock Reserve (642 + 1,555)	2,197		
To Gross Profit c/d	82,303		
	3,00,499		**3,00,499**

Working Notes:

1. Profit on Transfer of Finished Goods:

Net Sales of **A** (Sales which include profit margin) = 1,40,000 + 35,000 + 7,000 = ₹1,68,000

Gross Profit of Dept. A = ₹38,500

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Gross Profit % = $\frac{₹38,500 \times 100}{1,68,000}$ = 22.92%

Net Sales of **B** = (1,12,000 + 40,000 – 10,000) = ₹1,42,000

Gross Profit on Sale = ₹46,000

Gross Profit % = $\frac{₹46,000 \times 100}{1,42,000}$ = 32.39%

2. Calculation of Unrealised Profit

	Dept. A (₹)	**Dept. B (₹)**
Closing Stock out of transfer from other Departments (20% of Finished closing stock)	4,800 (20% of 24,000)	2,800 (20% of 14,000)
Unrealised Profit	4,800 × 32.39% = ₹1,555 (Profit made by B in the closing stock of A)	2,800 × 22.92% = ₹642 (Profit made by A in the closing stock of B)

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.
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:

	₹
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 (₹)	Q (₹)	S (₹)
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.

Solution: Illustration 5

	Department P	**Department S**	**Department Q**
Departmental Profits (WN2)	1,00,000	66,667	50,000
Less: Unrealised profit on Stock (WN3)	(5,426)	(21,000)	(2,727)
Profit Before Manager's Commission	94,574	45,667	47,273
Less: Manager's Commission 10%	(9,457)	(4,567)	(4,727)

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Correct Profit after Manager's Commission	**85,117**	**41,100**	**42,546**

Working Notes:

1. Profit Grid

Sale By:	**Sale To:**		
	Department P	**Department S**	**Department Q**
Department P	--	25% on Cost	15% On Cost
Department S	20% on Sales	--	30% on Sales
Department Q	20% on Cost	10% on Cost	--

2. Departmental Profits (Before Manager's Commission and unrealised Profit)

	Department P	**Department S**	**Department Q**
Profit after charging Manager's Commission	90,000	60,000	45,000
Add: Manager's Commission (1/9)	10,000	6,667	5,000
	1,00,000	**66,667**	**50,000**

3. Unrealised Profit

	Stocks Lying with:			
Unrealised Profit of:	**Department P (₹)**	**Department S (₹)**	**Department Q (₹)**	**Total (₹)**
Department P	--	25/125×18,000 = ₹3,600 25% on Cost	15/115×14,000 = ₹1,826 15% On Cost	5,426
Department S	20/100×48,000 =₹9,600 20% on Sales	--	30/100×38,000 =₹11,400 30% on Sales	21,000
Department Q	20/120×12,000 =₹2,000 20% on Cost	10/110×8,000 =₹727 10% on Cost	--	2,727

Illustration 6

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 (₹)	**Shoes Department (₹)**
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

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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 ₹8,50,000

Solution: Illustration 6

Departmental Trading and Profit and Loss Account for the year ended 31st March, 20X3

	Finished leather (₹)	**Shoes (₹)**		**Finished leather (₹)**	**Shoes (₹)**
To Opening Stock	30,20,000	4,30,000	By Sales	1,80,00,000	45,20,000
To Purchases	1,50,00,000	2,60,000	By Transfer to shoes Deptt.	30,00,000	-
To Transfer from Leather	-	30,00,000			
To Manufacturing expenses	-	5,00,000			
To Gross profit c/d (b.f.)	42,00,000	8,30,000			
	2,22,20,000	**50,20,000**		**2,22,20,000**	**50,20,000**
To Selling expenses	1,50,000	60,000	By Gross profit b/d	42,00,000	8,30,000
To Rent &warehousing	5,00,000	3,00,000			
To Net profit (b.f.)	35,50,000	4,70,000			
	42,00,000	**8,30,000**		**42,00,000**	**8,30,000**

General Profit and Loss Account

Particulars	**₹**	**Particulars**	**₹**
To General expenses	8,50,000	By Net profit - Leather 35,50,000 - Shoes 4,70,000	40,20,000
To Unrealised profit (Refer W.N.)			
To General net profit (Bal. fig.)	31,43,375		
	40,20,000		**40,20,000**

Working Note:

Calculation of Stock Reserve

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Rate of Gross Profit of Finished leather Department, for the year 20X2-X3

$= \frac{\text{Gross Profit}}{\text{Total Sales}} \times 100 =$

= [(42,00,000)/ (1,80,00,000 + 30,00,000)] x100 = 20%

Closing Stock of Finished leather in Shoes Department = 75% i.e. ₹5,00,000 x 75% = ₹3,75,000

Stock Reserve required for unrealised profit @ 20% on closing stock ₹3,75,000 x 20% = ₹75,000

Stock reserve for unrealised profit included in opening stock of Shoes dept. @ 15% i.e. (₹4,30,000 x 75% x 15%) = ₹48,375

Additional Stock Reserve required during the year = ₹75,000 – ₹48,375 = ₹26,625

Illustration 7

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
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 ₹1,260. These goods were sold during the year at the reduced prices.
2. Certain stock of the value of ₹6,900 purchased for the Khadi Department were later in the year transferred to the Silks department and sold for ₹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 (₹)
Khadi	5,600	360
Silk	10,000	2,000

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Solution: Illustration 7

Khadi Stock Account

To Balance b/d (Opening Stock) WN1	12,740	By Sales	95,600
To Purchases (WN3)	1,01,200	By Silk Deptt. (WN4)	
		By Khadi Mark up (Mark Down) (WN5)	360
		By P & L (goods Lost) WN7	390
		By Khadi Mark – up WN7 (Reversal of Profits because of goods are lost)	130
		By Balance c/d	8,260
	1,13,940		**1,13,940**

Khadi Mark-up Account

To Khadi – Stock (Markup on Transfer) WN4	2,300	By Balance b/d (Mark – up opening Stock) WN1	2,240
To Khadi – Stock (WN5)	360	By Khadi Stock A/c (Mark – up on purchases) WN3	25,300
To Khadi – Stock (WN7)	130		
To P&L (Actual profit on sales) WN8	22,685		
To balance c/d (Profit on Closing Stock) WN8	2,065		
	27,540		**27,540**

Silk Stock Account

To Balance b/d (Opening stock) WN2	27,900	By Sales	1,25,000
To Purchases (WN3)	1,40,100	By Silk Mark-up A/c (WN5)	2,000
To Khadi A/c (Transfers) (WN4)	10,350	By Balance c/d (b.f.)	51,350
	1,78,350		**1,78,350**

Silk Mark-up Account

To Silk Stock A/c (Mark Down) WN5	2,000	By Balance b/d	9,300

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		(Mark – up on opening) WN2	
To Profit & Loss A/c (b.f.) (Actual Profit on Sales - WN6)	41,000	By Silk Stock A/c (Mark – up on purchases) WN3	46,700
To Balance c/d (Mark – up in Closing Stock (WN6)	16,450	By Silk Stock A/c (Mark – up on Transfer) WN4	3,450
	59,450		**59,450**

Working Notes:

1. Mark- up on opening Stock (Khadi)

Cost value of Opening Stock	10,500
Add: Mark – up @33 - 1/3rd × 10,500	3,500
Sale value of opening stock	14,000
Less: Mark – Down Value	(1,260)
Revised Sales Value of Opening Stock	12,740
Profit Portion (12,740 – 10,500)	2,240

2. Cost Value of Opening Stock (Silk – dept.)

Cost value of Opening Stock	18,600
Add: Mark – up @ 50% × 18,600	9,300
Sale value of opening stock	27,900

3. Purchases

	Khadi Deptt.	**Silks Deptt.**
Cost Value of Purchases	75,900	93,400
Mark – up on Cost	33 1/3%	50%
Sales Value of Purchases	1,01,200	1,40,100

4. Transfer Entry

	Khadi Deptt.	**Silks Deptt.**
Cost of Goods transferred	6,900	6,900
Departmental Mark - up	33 1/3%	50%
Mark – up Amount	2,300	3,450
Transfer Price	9,200	10,350

5. Mark – Down - Sales Promotion

Opening Stock and purchases were brought to their sales value, Debited to stock Account and profit credited to Mark – up account. When actual profit is lesser than the standard profit, Such reduction is now debited to Mark – up account

6. Splitting Silk Mark – Up Balance

Profit on Goods Sold

Sales	1,25,000

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Add : Mark down in goods sold	1,000
	1,26,000
Gross Profit 1/3	42,000
Less : Mark down	(1,000)
Gross profit as per books	41,000

Therefore, Profit /Mark – up on Closing Stock = ₹16,450 (Bal. Figure)

7. Missing Stock (Khadi)

Cost of material missing	390
Mark – up 33 1/3% × 390	130
	520

8. Splitting of Profit of Khadi Dept.

Out of total profits of ₹24,750

- Profit on sales % = $\frac{33\frac{1}{3}\%}{133\frac{1}{3}\%}$ × 100 = 25%

  Actual Sales = 95,600
  Add: Opening Stock = 1,260
  Add: Current year = 360
  Sales at normal value = 97,220
  Therefore, Profit (Normal) = 25% × 97,220 = 24,305
  Less: Opening Stock = 1,260
  Less: Current year = 360
  Correct Profit of Khadi Dept. =23,685
- Therefore, Profit on closing stock = (24,750 – 22,685) ₹2,065 (Bal. figure)

Illustration 8

M/s Complex has 3 departments, A, B, C. The following information is provided:

Particulars	**A (₹)**	**B (₹)**	**C (₹)**
Opening Stock	3,000	4,000	6,000
Consumption of direct materials	8,000	12,000	-
Wages	5,000	10,000	-
Closing Stock	4,000	14,000	8,000
Sales	-	-	34,000

Stock of each department is valued at cost to the department concerned, Stocks of A department are transferred to B at a margin of 50% above departmental cost, Stocks of B department are transferred to C department at a margin of 10% above departmental cost

Other expenses were:

Particulars	**Amount (₹)**
Salaries	2,000
Printing and Stationery	1,000
Rent	6,000
Interest Paid	4,000
Depreciation	3,000

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Allocate expenses in the ratio of departmental gross profit. Opening figures of reserves for unrealised profits on departmental stock were:

- Department B 1,000
- Department C 2,000

Prepare Departmental Trading and Profit & Loss Accounts for the year ending March 31, 2013 considering that closing stock of each department consists of only finished goods.

Solution: Illustration 8

M/s Complex: Departmental Trading, P&L account for the year ended 31-03-2013

Particulars	**Dept. A**	**Dept. B**	**Dept. C**	**Total**	**Particulars**	**Dept. A**	**Dept. B**	**Dept. C**	**Total**
	(₹)	**(₹)**	**(₹)**	**(₹)**		**(₹)**	**(₹)**	**(₹)**	**(₹)**
To Opening Stock	3,000	4,000	6,000	13,000	By Sales	-	-	34,000	34,000
To Direct Material	8,000	12,000	-	20,000	By Inter – Department Transfer (WN1,2)	18,000	33,000	-	51,000
To Wages	5,000	10,000	-	15,000					
To Inter Department Transfer	-	18,000	33,000	51,000					
To Gross Profit c/d (b.f)	6,000	3,000	3,000	12,000	By Closing Stock (Finished)	4,000	14,000	8,000	26,000
	2,25,000	**47,000**	**42,000**	**4,88,500**		**22,000**	**47,000**	**42,000**	**4,88,500**
To Salaries	1,000	500	500	2,000	**By** Gross Profit b/d	6,000	3,000	3,000	12,000
To Printing & Stationery	500	250	250	1,000	By Net Loss (Bal. Figure) Before unrealised profit adjustments	2,000	1,000	1,000	4,000
To Rent	3,000	1,500	1,500	6,000					
To Interest	2,000	1,000	1,000	4,000					
To Depreciation	1,500	750	750	3,000					
	8,000	**4,000**	**4,000**	**16,000**		**8,000**	**4,000**	**4,000**	**16,000**
To Net Loss To Reserve for				4,000 3,918	By Reserve for unrealised Profit on				3,000 4,918

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unrealised profit in closing stock (WN3)					opening stock By Balance (Transferred to P&l)				
	7,918								**7,918**

Gross Profit Ratio = 6:3:3 ⇒2:1:1

Working Notes:

1. Transfer: Department A to B

Cost of Dept. A: 3,000 + 8,000 + 5,000 – 4,000 = 12,000

Margin = 50% above cost = 6,000

Transfer Price from Department A to B = 18,000

2. Transfer: Department B to C

Cost of Dept. B: 4,000 + 12,000 + 10,000 + 18,000 -14,000 = 30,000

Margin 10% above cost = 3,000

Transfer Price from Department B to C = 33,000

3. Closing Stock Reserve

Closing Stock of B is 14,000

Assume FIFO ⇒ Opening Stock is not in Closing Stock, It is already sold or transferred

⇒ Closing Stock of B comprises:

- Direct Material (12/40)
- Wages (10/40)
- Inter Departmental transfer from A (18/40)

In 14,000 Portion attributable to inter departmental transfers From Dept. A = 14,000 × $\frac{18}{40}$

= 6,300 (Cost to B)

In this A made Profit , at Departmental level ,evethough this is considered as profit, at the company/entity level. This is not a realised profit, As the goods are still in the ownership of the entity.

⇒ Such profits are included in departmental closing stock, now eliminated at the overall entity level as closing stock should be valued as per As – 2 at the lower of cost or Net Realisable value.

Unrealised Profits made in the closing stock of B, By A = $\frac{50}{150}$ × 6,300 = ₹2,100

Unrealised Profit in the closing stock of C

Closing stock of C = 8,000

Assuming FIFO

As C has no other costs, entire closing stock is attributable to transfer from B to C.

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Unrealised Profit made in closing stock of C earned by B = $\frac{10}{110}$ × 3,000 = ₹727

⇒8,000 -727 = 7,273 is the cost of B .

In cost of B there are three component

⇒ $\frac{10}{110}$ × 7,273 = ₹3,273 transfer price from A to B, In this A made profit

Unrealised Profit made by A on transfer to B, which got transferred to C. And lying in the closing stock of C = $\frac{50}{150}$ × 3,273 = 1,091

Therefore, Total closing stock reserve = 2,100 + 1,091 + 729 = 3,918

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CHAPTER 15 - INSURANCE CLAIMS FOR LOSS OF STOCK AND LOSS OF PROFIT

1 Introduction

Insurance

- Getting Compensation for loss due to Risks beyond control (Eg: Theft, Earthquake, Fire, Flood etc) by charging premium for the same → Insurance
- Insurance is based on probability of occurrence of event which causes loss
- Insurance can be studied under 2 parts as under:
  - Claim for loss of stock
  - Claim for loss of profit

2 Meaning of Fire

For the Purpose of Insurance, Fire means

- Exclude - Its own spontaneous fomentation or heating or its undergoing any process involving the application of heat
- Exclude - Earthquake, subterraneous fire, riot, civil commotion, war, invasion, act of foriegn enemy, hostilities, civil war, rebellion, revolution, insurrection, military or unsurped power
- Includes - Lightning
- Includes - Explosion:
  - i) of boilers used for domestic purpose only,
  - ii) of any other boiler or economizers on the premises,
  - iii) in a building not being any part of any gas works or gas for domestic purpose or used for lightning or heating the building

Note: Exclusions can be covered by paying extra premium

3 Claim for Loss of Stock

3.1 Average Clause

Average clause applies only where the insured value is less than the total cost and not when goods are fully insured.

- Value of Insurance taken (Eg:Rs.7Cr) > Actual Value of Goods (Eg:Rs.5Cr) → Adequately Insured
- Value of Insurance taken (Eg:Rs.5Cr) = Actual Value of Goods (Eg:Rs.5Cr) → Par Insurance
- Value of Insurance taken (Eg:Rs.7Cr) < Actual Value of Goods (Eg:Rs.5Cr) → Under Insurance, Where Average clause applied

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Calculation of Claim amount, if Average clause applies

$$Amount\ of\ claim = loss\ of\ stock \times \frac{sum\ insured}{Insurable\ amount\ (Total\ cost)}$$

Note:

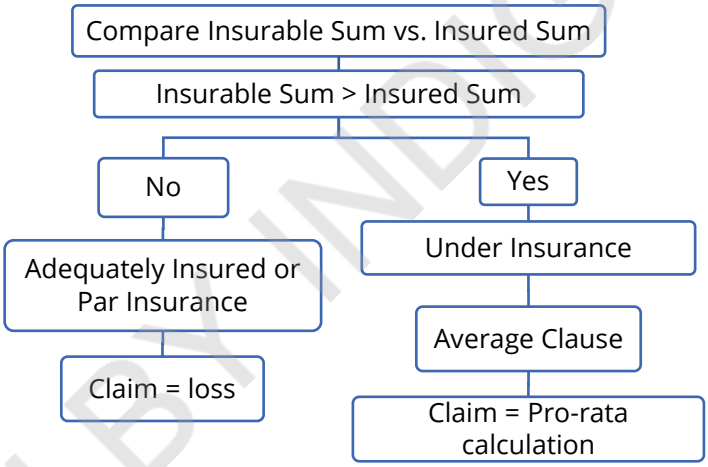
- In case of under insurance, Average clause comparison:
  Policy amount ←→ Stock in the premises, but not the overall stock.

3.2 Insurable Sum

Insurable Sum (Under Loss of stock) → The value of the stock on the date of fire/accident in godown

S.No	Particulars	Amount
1	Total Closing Stock	XXXX
2	Less: Stock outside premises (Eg: With Customers pending approval)	XXX
3	Value of Stock on the date of Fire/accident in go down	XXXX

3.3 Amount of Claim



3.4 Proforma for calculating Claim for loss of stock

S.No	Particulars	Amount (Rs.)
A	Closing stock on the date of Fire/accident in go down Normal = XXX Abnormal = XXX	XXXX
B	Less: Salvage	XXX
C	Loss of Stock (A – B)	XXXX
D	Policy Amount	XXXX

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Claim amount:

- (A > D) → Under Insurance, Apply Average Clause.
  Claim Amount → Pro-rata
- Otherwise, Claim amount → Loss of stock

4 Claim for Loss of Profit

4.1 Insurable Sum

Insurable Sum (Under Loss of profit) → Gross profit on Adjusted annual turnover

Example:

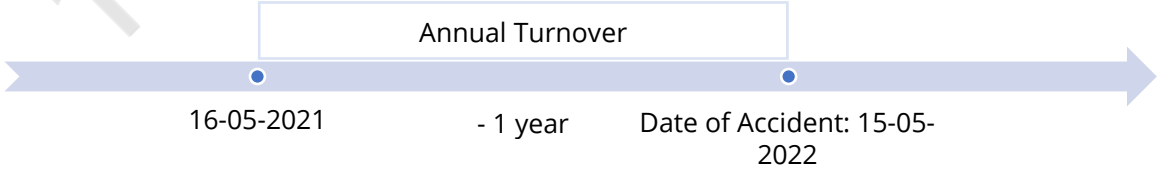
S.No	Particulars	Amount (Rs.)
A	Annual Turnover	6,00,000
B	Increasing Trend	10%
C	Gross profit ratio	30%
D	Adjusted Annual Turnover (A+B)	6,60,000
E	Insurable Sum (D×E)	1,98,000
F	Policy Value	1,50,000
G	Under Insurance	48,000

Note:

Method	Insurable sum	Insured Sum
Loss of Stock	Value of stock on the date of Accident in go down	Actual Policy Amount
Loss of Profit	Gross profit on Adjusted annual turnover	

Annual Turnover

Annual turnover → Turn over for 12 months immediately before the date of fire or damage



Adjusted Annual Turnover

Adjusted Annual Turnover → Annual turnover adjusted for trends (Which can be increase or decrease)

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Trend → It is an indication of Sales pattern of an organisation over specified period. It will help in estimation of future expected sales.

Eg: If Annual Turnover = 20 lakhs & Increase trend = 10%
then Adjusted Annual turnover = 22 lakhs

Gross Profit rate or Ratio:

$$Gross\ profit\ rate\ or\ Ratio = \frac{Gross\ profit\ amount}{Turnover} \times 100$$

In above Formulae

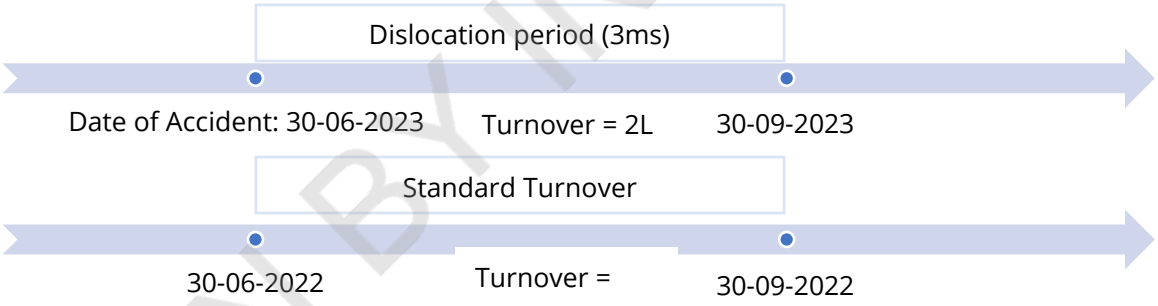
- $Gross\ profit\ amount = Gross\ profit - Uninsured\ standard\ charges\ OR$
  $Gross\ profit\ amount = Net\ profit + Insured\ standard\ charges$
- Turnover = Turnover during the financial year immediately before the date of damage plus/ minus adjustment for current year changes in price value
- Indirect Expense → Standing Charges = (Insured Standing Charges + Uninsured Standing Charges)

4.2 Loss of profit due to Reduction in turnover

Standard Turnover:

Standard Turnover → Turnover earned in the previous financial year corresponding to the period of dislocation

Example:



Adjusted Standard Turnover:

Adjusted Standard Turnover → Standard Turnover adjusted with (+/-) trend

Reduction in Turnover:

$$Redution\ in\ Turnover = Standard\ Turnover - Actual\ turnover\ in\ the\ dislocation\ period$$

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Example:

Without trend	
Particulars	**Amount (Rs)**
Standard TO (from 30-06-2022 to 30-09-2022)	10,00,000
Actual TO in Dislocation period (from 30-06-2023 to 30-09-2023)	2,00,000
Reduction in TO (10,00,000 – 2,00,000)	8,00,000

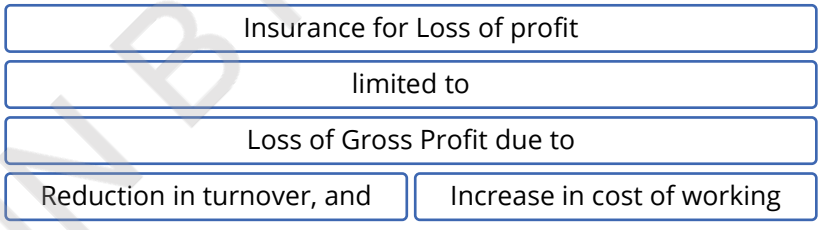
Increasing Trend	
Particulars	**Amount (Rs)**
Standard TO (from 30-06-2022 to 30-09-2022)	10,00,000
Increasing trend	10%
Adjusted Annual Turnover (10,00,000 + 10%)	11,00,000
Actual TO in Dislocation period (from 30-06-2023 to 30-09-2023)	2,00,000

4.3 Increase in the cost of Working

Allowable amount is the least of

- $Actual\ Additional\ Expense$
- $Additional\ Expense \times \frac{Gross\ profit}{Gross\ profit + Uninsured\ Expense}$
  - Where, $Gross\ Profit = Net\ profit + Insured\ Standing\ charges$
- $Reduction\ in\ Turnover\ avoided\ by\ incurring\ additional\ expenses \times Gross\ profit\ Ratio$

4.4 Amount of Claim



4.5 Proforma for calculating Claim for loss of profit

S.No	Claim:	Amount
1	Loss of profit due to reduction in turnover (Reduction in TO × Adjusted Gross Profit rate)	XXX
2	Add: Loss of profit due to increased cost	XXX
	Total	XXX
3	Less: Saving in Insured Standing Charges during Dislocation (Generally given in the Question)	XXX
4	Amount of Loss (Subject to Average Clause)	XXX

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Note:

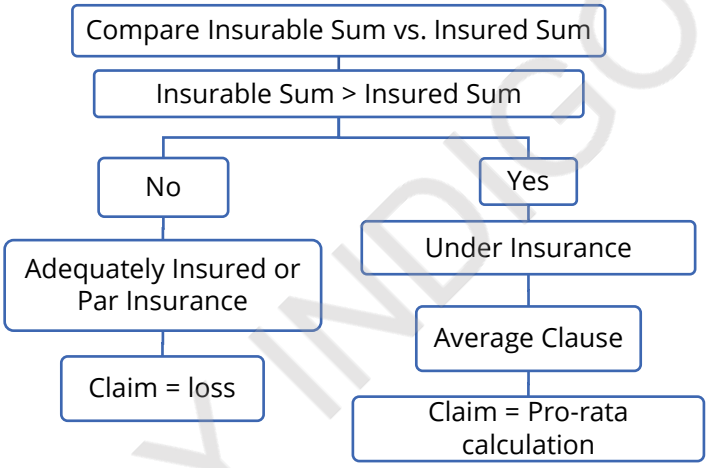
- Insurable Sum (Gross profit on Adjusted annual turnover > Insured Sum (Actual Policy amount) → Under Insurance, Apply Average Clause.
    - Claim Amount → Pro-rata
    - Otherwise, Claim amount → Loss of profit
- Indemnity Period – The maximum period for which risk of loss of profit is covered

5 Summary

Average clause applies only where the insured value is less than the total cost and not when goods are fully insured.

Amount of Claim

$$Amount\ of\ claim = loss\ of\ stock \times \frac{sum\ insured}{Insurable\ amount\ (Total\ cost)}$$



Gross Profit rate or Ratio:

$$Gross\ profit\ rate\ or\ Ratio = \frac{Gross\ profit\ amount}{Turnover} \times 100$$

Adjusted Annual Turnover

Adjusted Annual Turnover is the annual turnover adjusted for trends (Which can be increase or decrease)

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Illustration

Illustration - 1

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

	Rs.
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.

Solution: Illustration 1

Trading A/c For the Year Ended 31.3.20X2

(Normal Goods)

Particulars	**₹**	**Particulars**	**₹**
To Opening Stock (WN1)	22,000	By Sales (WN2)	2,40,000
To Purchase	1,52,500	By Closing Stock	12,500
To Manufacturing expenses	30,000		
To Gross Profit (WN2)	48,000		
	2,52,500		**2,52,500**

Trading a/c of Damaged or Abnormal Goods, For The Year Ended 31st March, 20X2

Particulars	**₹**	**Particulars**	**₹**
To Opening Stock	6,500	By Sales	9,000
To Gross Profit	2,500		
	9,000		**9,000**

Therefore, Value of stock as on 31.03.X2

Normal Goods = 12,500

Defective/Abnormal Goods = 0

Working Notes:

1. Normal Stock as on 01.04.20X1

Stock as on 01.04.20X1 = 28,500

Less: Book value of abnormal stock (₹10,000 – ₹3,500) = 6,500

Value of Normal Stock as on 01.04.20X1= 22,000

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2. Normal Sales and Gross Profit

Total Sales = ₹2,49,000

Less: Sale of abnormal or defective stock = (9,000)

Normal Sales = 2,40,000

Therefore, Normal Gross Profit = Normal Sales × Gross Profit Ratio*

= 2,40,000 × 20% = 48,000

*There is no Normal abnormal bifurcation on Gross Profit Ratio. Gross Profit Ratio is same for all

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.

Solution: Illustration 2

Memorandum Trading A/c (1.4.20X1 to 20.10.20X1)

Particulars	**₹**	**Particulars**	**₹**
To Opening stock (WN1)	2,40,000	By Sales (₹6,20,000 – ₹80,000)	5,40,000
To Purchases (₹2,80,000 + ₹40,000)	3,20,000		
To Gross profit (₹5,40,000 x 25%*)	1,35,000	By Closing stock (Bal. fig.)	1,55,000
	6,95,000		**6,95,000**

Claim Calculation:

	₹
Stock on the date of fire (i.e. on 20.10.20X1)	1,55,000
Less: Stock salvaged	(31,000)
Loss Value (Stock destroyed by fire)	1,24,000

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Had Stock Insurance = ₹1,55,000→ Claim = ₹1,24,000

But for ₹1,00,000 Stock Insurance → Claim =?

Therefore, Admissible Insurance claim after applying average clause on account of under insurance is = ₹1,00,000 × $\frac{₹1,24,000}{₹1,55,000}$ = ₹80,000

Working Notes:

1. Stock as on 1.4.20X1

Actual Value of Stock = $\frac{₹2,16,000}{90}$ × 100 = 2,40,000

2. Purchase and sales should be recognised based on transfer of risk and reward. Assumed that risk and reward transfer on:

1) Purchases happened on Delivery.
2) Sales happened on delivery.

Illustration – 3

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.

Solution: Illustration 3

Loss due to fire:

	₹
Stock on the date of fire (i.e.on 2.6.2019)	1,50,000
Less: Stock salvaged	0
Loss Value (Stock destroyed by fire)	1,50,000

Policy Amount = ₹1,20,000

As Stock on the date of fire is greater than policy amount, There is under insurance

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Average clause:

Had ₹1,50,000 been Policy Amount → Entire ₹1,50,000 of loss would be claimed
But ₹1,20,000 be Policy amount → Claim will be ₹1,20,000 only

Working Notes:

Trading Account for the year ended 31.3.2019

Particulars	₹	Particulars	₹
To Opening Stock	1,35,000	By Sales	9,00,000
To Purchases	6,45,000	By Closing Stock at cost ($\frac{₹1,62,000}{90\%}$)	1,80,000
To Gross Profit (Bal. figure)	3,00,000		
	10,80,000		**10,80,000**

Gross Profit Ratio = $\frac{\text{Gross Profit}}{\text{Sales}} \times 100$

= $\frac{₹3,00,000}{₹9,00,000} \times 100 = 33.\ ⅓\ \%$

2.

Memorandum Trading A/c for the period from 1.4.2019 to 02.06.2019

Particulars	₹	Particulars	₹
To Opening Stock	1,80,000	By Sales 4,80,000	
To Purchases 2,25,000		Less: Goods not dispatched 75,000	4,05,000
Add: Goods received but invoice not received 30,000			
Less: Machinery 15,000	2,40,000		
To Gross Profit (33. ⅓ % × ₹4,05,000)	1,35,000	By Closing Stock (Balancing figure)	1,50,000
	5,55,000		**5,55,000**

Illustration 4

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.

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- 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.

Solution: Illustration 4

	₹
Stock on the date of fire	87,700
Less: Stock salvaged (11,200 + 10,500)	(21,700)
Loss Value (Stock destroyed by fire)	66,000

Policy Amount = ₹60,000

As Stock on the date of fire is greater than policy amount, There is under insurance

Had Stock Insurance = ₹87,700→ Claim = ₹60,000

But for ₹60,000 Stock Insurance → Claim =?

Therefore, Admissible **Insurance claim** after applying average clause on account of under insurance is = ₹60,000 × $\frac{₹66,000}{₹87,700}$ = ₹45,154

Working Notes:

1.

Trading A/c for the period from 1.1.X2 to 12.06.X2

Particulars	**₹**	**Particulars**	**₹**
To Opening Stock	83,500	By Sales	1,54,000
To Purchases	1,12,000		
To Gross Profit (30% of Sales=1,54,000×30%)	46,200	By Closing Stock (Balancing figure)	87,700
	2,41,700		**2,41,700**

Illustration – 5

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

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- 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.

Solution: Illustration 5

Claim Calculation:

Stock on 1.4.X2

- Normal = ₹5,46,000
- Abnormal = 3,450

Value of Stock on the date of fire = 58,050

Less: Salvage (5,800)

Loss of stock = 52,250

Policy Amount = 50,000

As Stock on the date of fire is greater than policy amount, There is under insurance

Had Stock Insurance = ₹58,050→ Claim = ₹52,250

But for ₹50,000 Stock Insurance → Claim =?

Therefore, Admissible **Insurance claim** after applying average clause on account of under insurance is = ₹50,000 × $\frac{₹52,250}{₹58,050}$ = ₹45,004

Working Notes:

1.

Shri Ramesh Trading Account for 20X1 (to determine the rate of gross profit)

Particulars	**₹**	**Particulars**	**₹**
To Opening Stock	73,500	By Sales	4,87,000
To Purchases 3,98,000		By Closing Stock 79,600	
Less: Damaged Goods (6,900)	3,91,100	Less: Damaged Goods (4,600)	75,000
To Gross Profit (Bal. figure)	97,400		
	5,62,000		**5,62,000**

Gross Profit Ratio = $\frac{₹4,87,000}{₹97,400}$ × 100 = 20%

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2.

Memorandum Trading Account upto March 31, 20X2 (Normal)

Particulars	₹	Particulars	₹
To Opening Stock (WN1)	75,000	By Sales 2,31,200	
To Purchases	1,62,000	Less: Damaged Goods (3450 – 250) 3,200	2,28,000
Less: Damaged Goods (6,900)	3,91,100		
To Gross Profit (20% × ₹2,28,000)	45,600	By Closing Stock ((bal. fig.))	54,600
	2,82,600		**2,82,600**

3.

Memorandum Trading Account upto March 31, 20X2 (Abnormal/Damaged Items)

Particulars	₹	Particulars	₹
To Opening Stock	6,900	By Sales	3,200
To Purchases	0	By Closing Stock (bal. fig.)	3,450
		By Loss	250
	6,900		**6,900**

Illustration – 6

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.

Solution: Illustration 6

Closing Stock in Premises = 62,600

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Less: Salvage = 12,300

Loss of Stock = 50,300

Policy Amount = ₹60,000

As Stock on the date of fire is greater than policy amount, There is under insurance

Had Stock Insurance = ₹62,600→ Claim = ₹50,300

But for ₹60,000 Stock Insurance → Claim =?

Therefore, Admissible **Insurance claim** after applying average clause on account of under insurance is = ₹60,000 × $\frac{₹50,300}{₹62,600}$ = ₹48,211

Working Notes:

1. Calculation of closing stock as on 30th March,2012

Memorandum Trading Account for (from 1st January, 20X2 to 30th March, 20X2)

Particulars	**₹**	**Particulars**	**₹**
To Opening Stock	95,600	By Sales (2,75,000 - ⅔ rd of 49,500)	2,42,000
To Purchases (1,70,000 – 30,000)	1,40,000	By Closing Stock (WN2) (62,600 + 26,400)	89,000
To Wages (50,000 – 3,000)	47,000		
To Gross profit (20% on sales)	48,400		
	3,31,000		**3,31,000**

2. Closing Stock

Closing Stock:

- In our Premises = ₹62,600
- With Customers Pending approval = 33,000 (selling Price)
  Therefore cost = 33,000 × = ₹26,400

Illustration – 7

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

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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.

Solution: Illustration 7

	₹
1. Reduction in Turnover (WN1) × Gross Profit % (WN2) (1,50,000 × 30%)	45,000
2. Loss of profits due to Increased Costs (WN3)	6,372
3. Savings in Insured standing charges	2,450
4. Loss of Profits (Net) (1) + (2) – (3)	48,922
5. Average Clause application & Claim Amount (WN4)	**39,390**

Working Notes:

1.Reduction in Turnover

	₹
Standard Turnover from 1st Feb, 20X1 to 30th June, 20X1	2,00,000
Add: 15% increasing trend	30,000
Adjusted Standard Turnover	2,30,000
Less: Actual Turnover from 1st feb, 20X2 to 30 th June 20X2	(80,000)
Reduction in Turnover	1,50,000

2. Gross Profit %

Gross Profit % = $\frac{\text{Gross Profit Amount}}{\text{Turnover}} \times 100$

= Gross Profit = Net Profit + Insured standing Charges

= 70,000 + 56,000 = 1,26,000

Turnover (Last financial year Turnover) = ₹4,20,000

Therefore, Gross Profit % = $\frac{1,26,000}{4,20,000} \times 100 = 30\%$

3. **Loss of profits due to Increased cost (Lower of the following)**

(i) Actual Expense = 6,700

(ii) Gross profit on sales due to additional expenditure

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Actual Expense × $\frac{*\text{Gross Profit on adjusted Annual Turnover}}{\text{Gross Profit+Uninsured Standing Charges}}$ =

= 6,700 × $\frac{1,55,250}{1,55,250+8,000}$ = ₹6,372

*Gross Profit = GP Ratio × adjusted Annual Turnover

= 30% × (4,50,000 × 115%)

= ₹1,55,250

(iii) Reduction in Turnover Avoided × GP Ratio

= 80,000 × 30%

= ₹24,000

Allowable Increased cost = ₹6,372

4. Average Clause

Insurable Sum = GP % × Adjusted annual Turnover = 1,55,250 (WN3)

Insured Sum (Policy amount) = 1,25,000

= $\frac{₹1,25,000 \times ₹48,922}{₹1,55,250}$ = ₹39,390

Illustration - 8

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.

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

Solution: Illustration 8

	₹
1. Reduction in Turnover (WN1) × Gross Profit % (WN2) (1,84,000 × 30%)	55,200
2. Loss of profits due to Increased Costs (WN3)	7,500
3. Savings in Insured standing charges	2,700
4. Loss of Profits (Net) (1) + (2) – (3)	60,000
5. Average Clause application & Claim Amount (WN4)	50,000

Working Notes:

1. Reduction in Turnover (Short Sales)

	₹
Standard Turnover	2,40,000
Add: 10% increasing trend	24,000
	2,64,000
Less: Turnover during the dislocation period (which is at par with the indemnity period of 6 months)	(80,000)
Annual (Adjusted) Turnover:	1,84,000

2. Gross Profit Ratio

	₹
Net profit for the last financial year	2,40,000
Add: Insured standing charges	60,000
Gross Profit	1,50,000
Turnover for the last financial year	5,00,000
Rate = $\frac{1,50,000}{5,00,000}$ × 100 = 30%	

3. Loss Due to Increased Costs (Least of the Following)

(i) Actual Expenditure = ₹9,300

Adjusted Annual Turnover:

- Annual Turnover (1-3-20X1 to 23-2-20X2) = 6,00,000
- Add: 10% increasing trend= 60,000

= ₹6,60,000

Gross profit @ 30% on Adjusted Annual Turnover = 6,60,000 × 30% = 1,98,000

(ii) Gross profit on sales due to additional expenditure

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Actual Expense × $\frac{*\text{Gross Profit on adjusted Annual Turnover}}{\text{Gross Profit+Uninsured Standing Charges}}$ =

= 9,300 × $\frac{1,98,000}{1,98,000+5,000}$ = 9,071

(iii) Reduction in Turnover Avoided × GP Ratio = 25,000 × 30%

= ₹7,500

4. Average Clause

Insurable Sum = GP % × Adjusted annual Turnover = 1,98,000 (WN3)

Insured Sum (Policy amount) = 1,65,000

= $\frac{₹65,000 \times ₹1,65,000}{₹1,98,000}$ = ₹50,000

Illustration - 9

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.

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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

Solution: Illustration 9

	₹
1. Reduction in Turnover (WN1) × Gross Profit % (2,60,000 × 30.43%)	79,118
2. Loss of profits due to Increased Costs (WN2)	1,71,143
3. Less: Savings in Insured standing charges	(28,000)
4. Loss of Profits (Net) 1 + 2 – 3	2,22,261
5. Claim Amount (WN3)	2,22,261

Working Notes:

1. Reduction in Turnover (Short Sales)

	₹
Adjusted Standard Turnover (1,00,000 + 9,60,000)	10,60,000
Less: actual Turnover (Turnover during the dislocation period)	8,00,000
Reduction in Turnover	2,60,000

Gross profit ratio for the purpose of insurance claim on loss of profit

$$= \frac{\text{Net profit} - \text{Insured Standing Charges}}{\text{Adjusted Annual Turnover}}$$

$$= \frac{₹\ 4,06,400 - ₹20,000}{₹12,70,000} \times 100 = 30.43\%$$

2. Amount allowable in respect of additional expenses

Least of the following:

(i) Actual expenses = 1,80,000

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(ii) Actual Expense × $\frac{*\text{Gross Profit on adjusted Annual Turnover}}{\text{Gross Profit + Uninsured Standing Charges}}$

= 1,80,000 × $\frac{30.43\% \times 12,70,000}{30.43\% \times 12,70,000 + 20,000}$

= 1,80,000 × $\frac{₹3,86,461}{₹4,06,461}$ = ₹1,71,143

(iii) Reduction in Turnover Avoided × GP Ratio = ₹8,00,000 × 30.43% = ₹2,43,440

Least i.e. = ₹1,71,143 is admissible

3. Average Clause

Insurable Sum = GP % × Adjusted annual Turnover = ₹3,86,461 (WN2)

Insured Sum (Policy amount) = 4,00,000

On the amount of final claim, the average clause will not apply since the amount of the policy ₹4,00,000 is higher than gross profit on annual adjusted turnover ₹3,86,461.

Therefore, insurance claim will be ₹2,22,261.

Illustration – 10

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.

Solution: Illustration 10

	₹
1. Reduction in Turnover (WN1) × Gross Profit % (WN2) (46,500 × 25%)	11,625

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2. Loss of profits due to Increased Costs (WN3)	1,500
3. Less: Savings in Insured standing charges (4,725 × $\frac{2}{12}$)	(1,575)
4. Loss of Profits (Net) 1 + 2 – 3	11,550
5. Average Clause & Claim Amount (WN4)	**8,750**

Working Notes:

1. Reduction in Turnover (Short Sales)

	₹
Standard Turnover (1,00,000 + 9,60,000)	65,000
Add: 10% Trend	6,500
Adjusted Standard Turnover	71,500
Less: actual Turnover (Turnover during the dislocation period)	(25,000)
Reduction in Turnover	46,500

2. Gross Profit Ratio

	₹
Net profit for the last financial year	18,000
Add: Insured standing charges (42,000 – 10,000)	32,000
Gross Profit	50,000
Turnover for the last financial year	2,00,000
Rate = $\frac{50,000}{2,00,000}$ × 100 = 25%	

3. Loss Due to Increased Costs (Least of the Following)

(i) Actual = (600 × 4) = ₹2,400

(ii) Actual Expenses × $\frac{\text{Gross Profit on adjusted Annual Turnover}}{\text{Gross Profit+Uninsured Standing Charges}}$

= 2,400 × $\frac{₹50,000}{(₹50,000 + ₹10,000)}$ = ₹2,000

(iii) Reduction in Turnover Avoided × GP % = 6,000 × 25% = 1,500

Least i.e. = ₹1,500 is admissible

4. Average Clause

Insurable Sum = (Annual Turnover + Trend 10%) × GP Ratio

= 2,64,000 × 25% = 66,000

Insured Sum (Policy amount) = 50,000

= $\frac{₹11,550 \times 50,000}{₹66,000}$ = ₹8,750

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Illustration – 11

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.

Solution: Illustration 11

I. Loss of Stock Policy

Loss of stock:

Stock on the date of fire = 2,60,000 (WN1)

Less: Salvage Value = 0

Loss of stock = 2,60,000

Policy Amount = 3,00,000

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As the value of stock destroyed by fire is less than the policy value, the entire claim will be admitted.

Working Notes:

1.

Trading A/c for the period 1.1.20X2 to 31.3.20X2

Particulars	**₹**	**Particulars**	**₹**
To Opening Stock	90,000	By Sales	2,50,000
To Purchase	3,00,000	By Closing Stock (balancing figure)	2,60,000
To Manufacturing expenses	70,000		
To Gross Profit (20% of 2,50,000) (W.N.2)	50,000		
	5,10,000		**5,10,000**

2. Gross Profit

$= \frac{\text{Gross Profit}}{\text{Sales}} \times 100 = \frac{2,50,000}{10,00,000} \times 100 = 25\%$

Less: Trend of 5% =5%

Gross Profit Rate for 20X2 = 20%

II. Loss of Profit

	₹
1. Reduction in Turnover (WN1) × Gross Profit % (WN2) (₹2,12,500 × 5%)	10,625
2. Loss of profits due to Increased Costs (WN3)	4,375
3. Less: Savings in Insured standing charges	-
4. Loss of Profits (Net) 1 + 2 – 3	15,000
5. Claim Amount (WN4)	**15,000**

Working Notes:

1. Standard Turnover

	₹
Assuming that equal Revenue is earned over 3 Quarters Standard Turnover = (₹7,82,610/3)	2,60,870
Add: Increasing trend of sales (15%)	39,130
Adjusted Standard Turnover	3,00,000
Less: actual Turnover (Turnover during the dislocation period)	(87,500)
Reduction in Turnover (Short sales)	2,12,500

Break up of sales for the year 20X1:	

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Sales of the first quarter of 20X1	
(₹2,50,000 x 100/115)	2,17,390* (approx.)
Sales for the remaining three quarters of 20X1 ₹ (10,00,000 -2,17,390)	7,82,610

* Sales for the first quarter of 20X1 is computed on the basis of sales of the first quarter of 20X2.

2.Gross Profit

	₹
Net profit for the last financial year	50,000
Add: Insured standing charges	50,000
Gross Profit	1,00,000
Turnover for the last financial year	10,00,000
Rate = $\frac{1,00,000}{10,00,000}$ × 100 = 10%	
Less: Decreasing trend in G. P = 5%	
Gross Profit % for loss of Profit = 5%	

3. **Loss Due to Increased Costs (Least of the Following)**

(i) Actual Expense = ₹60,000

(ii) Actual Expenses × $\frac{\text{Gross Profit on}*\text{adjusted Annual Turnover}}{\text{Gross Profit+Uninsured Standing Charges}}$

= ₹60,000 × $\frac{5\%\times 11,50,000}{57,500+1,50,000}$ = ₹18,400

***Adjusted Annual Turnover = (7,82,610 + 1.15) + 2,50,000 = 9,00,000 + 2,50,000 = 11,50,000

(iii) G.P. on sales generated by additional expenses 5% of ₹87,500 = ₹4,375

least i.e. ₹4,375 is admissible

4. Average Clause

Insurable Sum = ₹57,500

Insured Sum (Policy amount) = 1,00,000

As the gross profit on annual turnover (₹57,500) is less than policy value (₹1,00,000), average clause is not applicable

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CHAPTER 16 - HIRE PURCHASE AND INSTALMENT SALE TRANSACTIONS

1 Introduction

1.1 Hire Purchase

- When a person wants to acquire an asset, but he is not affordable for cash down price.
- Then he may pay in instalments (Either Monthly or Quarterly or Annually) if vendor agrees. This enables the purchaser to use the asset while paying instalment. This type of a business deal is known as Hire purchase transaction.

1.2 Risk and Rewards under Hire purchase

Risk and rewards of the asset will be transferred at the end of the transaction (Once the last instalment is paid)

But for Accounting purpose (Substance over legal form (Reality over legality))

- From seller's point of view, treated as sale, when the transaction is entered into
- From Buyer's point of view, treated as if it is asset purchased, when the transaction is entered into

Even though Ownership is transferred after the tenure period

2 Special Features of Hire purchase

Possession

•Transfers only possession immediately after entering the contract

Instalment

•Goods delivered on condition that Payment will be on periodic instalments

Down payment

•Down payment made on signing the agreement

Constituents of Hire purchase instalment

•Two elements – Finance charge (Interest on unpaid amount) and capital payment

Ownership

•Legal ownership of the asset gets transferred after last instalment payment

Repossession

•Seller taking back the asset on default of any of the instalment (even the last one)
•without any compensation of instalment paid

3 Difference of Hire Purchase Agreement and Instalment Payment Agreement

S.No	Basis of Distinction	Hire Purchase	Instalment System
1	Nature of Contract	Agreement of Hiring	Agreement of sale

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2	Passing of Title (Ownership)	Passes on last payment	Passes immediately as in the case of usual sale
3	Right to Return good by Hirer/Buyer	May return goods without further payment except for accrued instalments	Unless seller defaults, goods are not returnable
4	Seller's right to repossess	Repossess goods if hirer is in default	Seller can sue for price if the buyer is in default. He cannot take possession of the goods
5	Right of Disposal by Hirer/Buyer	Cannot hire out, sell, pledge or Only retain possession	May dispose off the goods
6	Responsibility of Risk of loss by Hirer/Buyer	Not responsible for risk of loss if he has taken reasonable precaution because the ownership has not yet transferred	Responsible for risk of loss of goods because of the ownership has transferred
7	Name of the Parties involved	Hire Purchaser Hire vendor	Buyer Seller
8	Component other than cash price (Including in Instalment)	Hire Charges	Interest

4 Terms used in Hire purchase agreement

Down payment: The initial payment made to vendor by the hire purchaser at the time of entering into a hire purchase agreement

Hire purchase instalment: The amount which the hire purchaser has to pay after a regular interval up to certain period as specified in the agreement to obtain the ownership of the asset purchased under a hire purchase agreement.

Hire purchase price: Total sum payable by the hire purchaser to obtain the ownership of the asset purchased under hire purchase agreement.

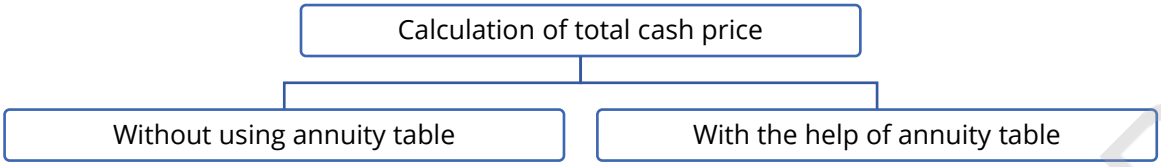
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5 Ascertainment of Cash Price

5.1 Cash price

Cash Price: Amount to be paid to get ownership of the asset

5.2 Calculation of Cash price



5.3 Calculation of Cash price - Without using annuity table:

(Let's take an example of 4 Instalments)

Step 1: Calculate ratio between Interest and the amount due

$$Ratio\ of\ Interest\ and\ amount\ due = \frac{Rate\ of\ Interest}{100 * Rate\ of\ Interest}$$

Step 2: Calculate the interest included in the last instalment

$$Interest = Total\ amt\ due\ at\ the\ time\ of\ last\ instalment * Ratio\ of\ interest\ and\ amt\ due\ (as\ calculated\ in\ step\ 1)$$

Step 3: Calculate amount of outstanding cash price at the time of last instalment

$$Amount\ of outstanding\ cash\ price\ @\ last\ instalment = last\ instalment - Interest\ (as\ calculated\ in\ step\ 2)$$

Step 4: Add Cash price calculated in Step 3 to the amount of instalment due at the end of 3rd year

Step 5: Calculate the Interest on entire amt calculated on Step 4 by using formulae of Step 1.

Step 6: Calculate amount of outstanding cash price at the time of 3rd instalment

$$Amount of outstanding\ cash\ price\ @\ 3rd\ instalment = Total\ amt\ due\ at\ the\ end\ of\ 3rd\ year - Interest\ (as\ calculated\ in\ step\ 5)$$

Step 7: Add Cash price calculated in Step 6 to the amount of instalment due at the end of 2nd year

Step 8: Calculate the Interest on entire amt calculated on Step 7 by using formulae of Step 1.

Step 9: Calculate amount of outstanding cash price at the time of 2nd instalment

$$Amount of outstanding\ cash\ price\ @\ 2nd\ instalment = Total\ amt\ due\ at\ the\ end\ of\ 2nd\ year - Interest\ (as\ calculated\ in\ step\ 8)$$

Step 10: Add Cash price calculated in Step 9 to the amount of instalment due at the end of 1st year

Step 11: Calculate the Interest on entire amt calculated on Step 10 by using formulae of Step 1.

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Step 12: Calculate amount of outstanding cash price at the time of 1st instalment

$$Amount\ of outstanding\ cash\ price\ @\ 1st\ instalment = Total\ amt\ due\ at\ the\ end\ of\ 1st\ year - Interest\ (as\ calculated\ in\ step\ 11)$$

Step 13: Add Cash price calculated in Step 12 to the amount of down payment, if any.

The sum so obtained will be the cash price.

Note:

- First 4 steps will be Standard, remaining step will repetitive nature and can be more or less based on no. of instalments

.

5.4 Calculation of Cash price - With the help of Annuity table:

- $Cash\ price = Down\ payment + Present\ value\ of\ instalment$
- $Present\ value\ of\ instalment = Annual\ instalment \times PVAF$

Note:

- Present Value Annuity Factor (PVAF) is used → Only when Instalment are equal
- $Interest = Total\ amount\ paid - Cash\ price$
- $PVAF = \frac{(1+r)^n - 1}{r(1+r)^n}$

6 Ascertainment of Interest

Two Situations may arise at the time of calculating interest

1. When Cash price, amount of instalment and rate of interest are given and
2. When Cash price and amount of instalment are given, but rate of interest is not given

6.1 When Rate of Interest is given:

Step 1: Deduct down payment from the Cash price

Step 2: Calculate Amount of Interest included in 1st Instalment.

$$Interest\ included\ in\ 1st\ Instalment = Remaining\ Balance\ (Calculated\ in\ Step\ 1) \times Rate\ of\ Interest$$

Step 3: Calculate Cash Price included 1st instalment

$$Cash\ Price\ included\ in\ 1st\ instalment = 1st\ instalment\ amount - Interest\ (as\ calculated\ in\ step\ 2)$$

Step 4: Calculate Amount outstanding after 1st Instalment is paid

$$Amount\ outstanding\ after\ 1st\ instalment = Balance\ due\ after\ down\ payment - Cash\ price\ (as\ calculated\ in\ Step\ 3)$$

Step 5: Calculate Interest amount @ given rate on the balance due after 1st instalment (Step)

Step 6: Calculate Cash Price included 2nd instalment

$$Cash\ Price\ included\ in\ 2nd\ instalment = 2nd\ instalment\ amount - Interest\ (as\ calculated\ in\ step\ 5)$$

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Step 7: Calculate Amount outstanding after 2nd Instalment is paid

$$Amount\ outstanding\ after\ 2nd\ instalment = Balance\ due\ after\ 1st\ Instalment - Cash\ price\ (as\ calculated\ in\ Step\ 6)$$

Repeat the above steps till the last instalment is paid

6.2 When Rate of Interest is not given:

- Find the interest rate implicit in the transaction by bifurcating the instalment between reduction in liability and Finance charges → By using IRR.

> **Interest Rate of Return (IRR):** Discount rate that equates the present value of the expected cash outflows (amount of down-payment and instalment) with Cash price.

- If Net cash flow are not uniform → Use trial and error method & interpolation between interest rates.

7 Accounting of Hire purchase transaction in the books of Hire purchaser

> **Hire Purchaser:** A person who obtains the goods and rights to use the same from hire vendor under a hire purchase agreement

Hire Purchaser plays dual role in Hire Purchase.

- Act like Buyer – For Cash price
- Act like Borrower – For Interest portion

Methods used for Hire purchase accounting in books of Hire Purchaser:

1. Cash price Method &
2. Interest suspense method

Note:

- Net impact of two methods on balance sheet and P&L will be same
- $Asset\ purchase\ price = Cash\ price + (Cash\ price - Down\ payment) \times Interest\%$

7.1 Cash price Method

- Recognize the Asset at the cash price of the asset
- Interest accrued will be recorded and received along with the instalment at the end of every accounting period

Cash price method – Journal Entries	
Entry	**Amount (Rs.)**
At the time entering into the agreement	
Fixed Asset A/c Dr To Hire Vendor A/c	Cash Price of the Asset
When Down Payment is made	

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Hire Vendor A/c Dr To Cash/Bank A/c	Down payment amt
When instalment becomes due (Interest accrued for the period)	
Interest Expense A/c Dr To Hire vendor A/c	Interest of the relevant period
Instalment payment (Interest + Principle repayment)	
Hire Vendor A/c Dr To Cash/ Bank A/c	Amount of Instalment
When depreciation charged to asset	
Depreciation A/c Dr To Fixed Asset A/c	Depreciation Amt (calculated on cash price)
For closing interest and Depreciation account	
P&L A/c Dr To Depreciation A/c To Interest Exp A/c	Closing balance

7.2 Interest Suspense Method

- At the time of possession of asset, Interest income will be recognized upfront in the interest suspense A/c
- Every year proportionate interest income will be transferred from interest suspense A/c to P&L A/c

Interest Suspense method – Journal Entries	
Entry	**Amount (Rs.)**
At the time entering into the agreement	
Fixed Asset A/c Dr To Hire Vendor A/c	Cash Price of the Asset
For Total interest payment	
H.P Interest Suspense A/c Dr To Hire Vendor A/c	Total Interest
When Down Payment is made	
Hire Vendor A/c Dr To Cash/Bank A/c	Down payment amt
When instalment becomes due (Interest accrued for the period)	
Interest Expense A/c Dr To H.P Interest Suspense A/c	Interest of the relevant period
Instalment payment (Interest + Principle repayment)	
Hire Vendor A/c Dr To Cash/ Bank A/c	Amount of Instalment
When depreciation charged to asset	
Depreciation A/c Dr To Fixed Asset A/c	Depreciation Amt (calculated on cash price)
Entry	**Amount (Rs.)**
For closing interest and Depreciation account	
P&L A/c Dr To Depreciation A/c	Closing balance

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To Interest Exp A/c	

7.3 Cash Price Method Vs. Interest Suspense Method

S.No	Cash Price Method – Ledger A/c	Interest Suspense Method – Ledger A/c
1	Fixed Asset – same	Fixed Asset – Same
2	Hire vendor A/c - Interest is accrued periodically and then transferred to P&L a/c	Hire Vendor A/c Dr - Interest recognized upfront and periodically transferred to P&L A/c
3	Interest Expense A/c - Interest Expense A/c Dr To Hire Vendor A/c	Interest Expense A/c - Interest Expense A/c Dr To Interest Suspense A/c
4	Depreciation A/c – Same	Depreciation A/c - Same
5	No Interest Suspense A/c	Interest Suspense A/c - Interest is recognized upfront and periodically transferred to P&L A/c

7.4 Disclosure in Balance sheet

Balance Sheet					
Liabilities			**Assets**		
Particulars	**Rs**	**Rs**	**Particulars**	**Rs**	**Rs**
Hire Vendor	Cash Price	Net Amount	Fixed Assets	Cash Price	Net value
	Less: Principle instalment (Excluding interest)			Less: Depreciation	

Note: Hire Vendor = Cash Price + Interest – Instalment (Principle + Interest)

= Cash price + ~~Interest~~ – Instalment Principle amt – ~~Instalment interest amt~~

= Cash price – Instalment principle amt

8 Accounting of Hire purchase transaction in the books of Hire Vendor

Hire Vendor: A person who delivers the goods along with its possession to the hire purchaser under a hire purchase agreement

Hire Vendor plays dual role in Hire Purchase.

- Act like Seller – For Cash price
- Act like Lender/Banker – For Interest portion

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Methods used for Hire purchase accounting in books of Hire Vendor:

1. Sales Method &
2. Interest suspense method

Note:

- Net impact of two methods on balance sheet and P&L will be same

8.1 Sale price Method

- Recognize the sale at the cash price of the asset
- Interest accrued will be recorded and received along with the instalment at the end of every accounting period
- Hire purchase treated as a Credit sale

Sale price method – Journal Entries	
Entry	**Amount (Rs.)**
At the time entering into the agreement	
Hire Purchaser A/c Dr To H.P Sales A/c	Full Cash Price
When Down Payment is received	
Cash/Bank A/c Dr To Hire Purchaser A/c	Down payment amt
When instalment becomes due (Interest accrued for the period)	
Hire Purchaser A/c Dr To Interest Expense A/c	Interest of the relevant period
Instalment payment (Interest + Principle repayment)	
Cash/Bank A/c Dr To Hire Purchaser A/c	Amount of Instalment
For closing interest account	
P&L A/c Dr To Interest Exp A/c	Closing balance
For closing Hire purchase Sales Account	
H.P Sales A/c Dr To Trading A/c	Closing balance

8.2 Interest Suspense Method

- Interest income will be recognized upfront in the interest suspense A/c
- Every year proportionate interest income will be transferred from interest suspense A/c to P&L A/c
- Entire profit on sale under hire purchase agreement is credited to P&L A/c for the year in which the sale has taken place

Interest Suspense method – Journal Entries	
Entry	**Amount (Rs.)**
At the time entering into the agreement	

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Hire Purchaser A/c Dr To H.P Sales A/c To Interest Suspense A/c	Full Cash Price + Total Interest Full Cash Price Total Interest
When Down Payment is received	
Cash/Bank A/c Dr To Hire Purchaser A/c	Down payment amt
When instalment becomes due (Interest accrued for the period)	
Interest Suspense A/c Dr To Interest Expense A/c	Interest of the relevant period
Instalment payment (Interest + Principle repayment)	
Cash/Bank A/c Dr To Hire Purchaser A/c	Amount of Instalment
For closing interest account	
P&L A/c Dr To Interest Exp A/c	Closing balance
For closing Hire purchase Sales Account	
H.P Sales A/c Dr To Trading A/c	Closing balance

8.3 Disclosure in Balance sheet

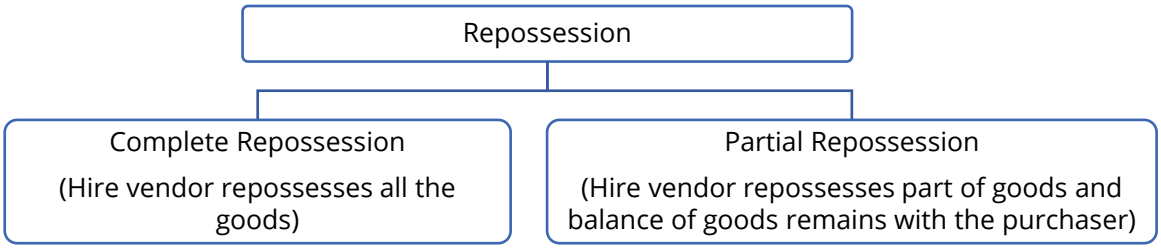
Balance Sheet		
Assets		
Particulars		**Rs**
Current Assets:	Hire Purchase Debtor Less: Balance in Interest Suspense A/c	Amount

9 Repossession

The Act of Recovery of possession of the asset by the Hire Vendor, on default of payment of Hire Purchaser is termed as **Repossession**

- Repossession takes place without any compensation of instalment paid, even default of last instalment.
- The amount received from Hire Purchaser (Down payment + Instalment) → treated as Hire charges by the Hire vendor.
- Repossessed Asset can be resold to any other customer after repairing or reconditioning (if necessary) & accounted in Separate account → "Goods Repossessed Account"

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9.1 Complete Repossession

Entry on Repossession		
Particulars	**Books of Hire purchaser**	**Books of Hire vendor**
Repossession	Hire Vendor A/c Dr To Asset a/c	Goods Repossession A/c Dr To Hire purchaser A/c

Note:

In Books of Hire Purchaser

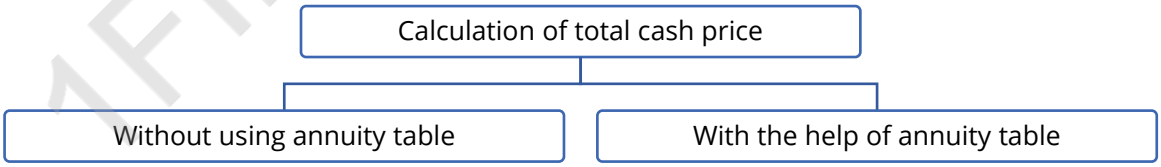
- Balance in Hire Purchase Asset → Profit/Loss on Repossession.

9.2 Partial Repossession

- In Partial Repossession → Only part of asset is taken by Hire vendor
  → Other part left with the Hire purchaser
- Entries are same as in the case of Complete Repossession
- But amount will be as agreed upon on repossession
- Neither party closes the account of the other in their respective books, as a portion of the asset is still left with Hire purchaser.
- In Books of Hire Purchaser
  - If Repossession value is less than the book of the asset which is repossessed,
  - Then Difference → Charged to P&L as "Loss on Surender"

10 Summary

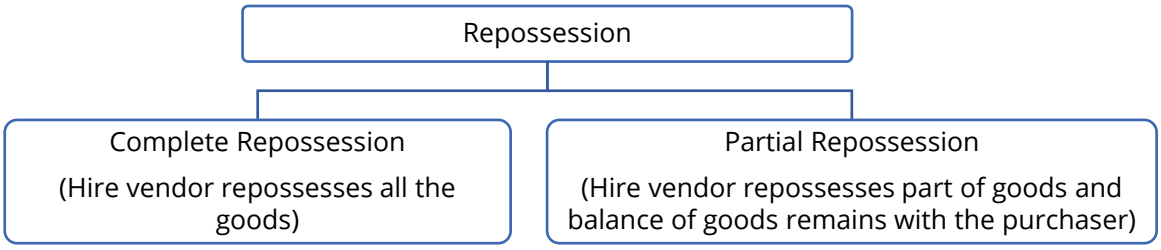
Cash Price: Amount to be paid to get ownership of the asset



Methods used for Hire purchase accounting in books of Hire Vendor:

1. Sales Method &
2. Interest suspense method

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Illustrations

Illustration - 1

Asha purchased a truck on hire purchase system. As per terms he is required to pay Rs.70,000 down, Rs.53,000 at the end of first year, Rs.49,000 at the end of second year and Rs.55,000 at the end of third year. Interest is charged @ 10% p.a. You are required to calculate the total cash price of the truck and the interest paid with each instalment.

Solution: Illustration 1

- Total cash price = ₹1,30,000 + ₹70,000 (down payment) = ₹2,00,000
- Interest = 0 + 13,000 + 9,000 + 5,000 = ₹27,000

Working Notes:

Breakdown of Interest and Cash Price

No. of instalments	Amount due at the time of instalment	Interest	Cash price
3rd	55,000	10/110 of ₹55,000 = ₹5,000	50,000
2nd	*99,000	10/110 of ₹99,000 = ₹9,000	90,000
1st	**1,43,000	10/110 of ₹1,43,000 = ₹13,000	1,30,000

*₹50,000 + 2nd instalment of ₹49,000 = ₹99,000.

** ₹90,000 + 1st instalment of ₹53,000 = ₹1,43,000.

Illustration - 2

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.

Solution: Illustration 2

Working Notes:

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	Instalment Amount	Interest @ 5% half yearly (10% p.a.) = 5/105 (in each instalment)	Principal Amount (in each instalment)
	₹	₹	₹
5th Instalment	6,000	286	5,714
Less: Interest	(286)	-	-
	5,714		
Add: 4th Instalment	6,000		
	11,714	558	5,442 (6,000 – 558)
Less: Interest	(558)		
	11,156		
Add: 3rd instalment	6,000		
	17,156	817	5,183 (6,000 – 817)
Less: Interest	(817)		
	16,339		
Add: 2nd instalment	6,000		
	22,339	1,063	4,937 (6,000 - 1,063)
Less: Interest	(1,063)		
	21,276		
Add: 1st instalment	6,000		
	27,276	1,299	4,701 (6,000 - 1,299)
Less: Interest	(1,299)		
	25,977	**4,023**	**25,977**

Illustration – 2 (Alternate method)

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.

Alternate Method

Year	Opening Balance	Interest @ 5%	Instalment (Year End)	Principal Repaid	Closing Balance
	A	B	C	D = C - B	E = A - D
1.	25,977	1,299	6,000	4,701	21,276
2.	21,276	1,063	6,000	4,937	16,339

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3.	16,339	817	6,000	5,183	11,156
4.	11,156	558	6,000	5,442	5,714
5.	5,714	286	6,000	5,714	0
		4,023			

Illustration -3

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.

Solution: Illustration 3

Calculation of Cash Price – The present value of an annuity of Re. 1 paid for 3 year @ 5% = ₹ 2.723. Hence, the present value of ₹30,000 for 3 years = 2.723 x 30,000 = ₹81,690. Thus, Cash Price will be computed as ₹81,690

Cash price may also be calculated using the annuity formula discussed above: Cash price = 30,000 x [(1 + 0.05)3 – 1]/ 0.05 (1 + 0.05)3 = ₹81,697

Note- The difference in cash price of ₹7 is on account of approximation.

Illustration - 4

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.

Solution: Illustration 4

Year	**Opening Balance**	**Interest @ 10%**	**Instalment (Year End)**	**Principal Repaid**	**Closing Balance**
	A	**B**	**C**	**D = C - B**	**E = A - D**
1.	58,378	5,838	15,400	9,562	48,816
2.	48,816	4,882	15,400	10,518	38,298
3.	38,298	3,830	15,400	11,570	26,728
4.	26,728	2,673	15,400	12,727	14,001
5.	14,001	1,400	15,400	14,000	0
		18,623			

Total interest can also be calculated as follow:

(Down payment + instalments) – Cash Price = ₹ [21,622 +(15400 x 5)] – ₹80,000 = ₹18,622

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Illustration – 5

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
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.

Solution: Illustration 5

Calculation of total Interest and Interest included in each installment.

Hire Purchase Price (HPP) = Down Payment + instalments

= 30,000 + 50,000 + 50,000 + 30,000 + 20,000 = 1,80,000

Total Interest = 1,80,000 – 1,50,000 = 30,000

Computation of IRR (considering two guessed rates of 10% and 12%)

Year	Cash Flow	DF @10%	Present Value	DF @12%	Present Value
0	30,000	1.00	30,000	1.00	30,000
1	30,000	0.91	45,500	0.89	44,500
2	30,000	0.83	41,500	0.80	40,000
3	30,000	0.75	22,500	0.71	21,300
4	30,000	0.68	13,600	0.64	12,800
		NPV	**1,53,100**	**NPV**	**1,48,600**

Interest rate implicit on lease is computed below by interpolation:

Interest rate implicit on lease = 1,400 × 2/4,500 = 0.62

12%-0.62%=11.38%

Year	Opening Balance	Interest @ 11.38%	Instalment (Year End)	Principal Repaid	Closing Balance
	A	**B**	**C**	**D = C - B**	**E = A - D**
1.	1,20,000 (1,50,000 - 30,000)	5,838	50,000	36,344	83,656

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2.	83,656	9,520	50,000	40,480	43,176
3.	43,176	4,913	30,000	25,086	18,089
4.	18,089	2,059	20,000	17,941	147*

*This difference is due to approximation.

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:

- The cash price of the van was Rs.1,00,000.
- Rs.40,000 were to be paid on signing of the contract.
- The balance was to be paid in annual instalments of Rs.20,000 plus interest.
- Interest chargeable on the outstanding balance was 6% p.a.
- Depreciation at 10% p.a. is to be written-off using the straight-line method.

You are required to:

- Give Journal Entries and show the relevant accounts in the books of HP M/s from January 1, 20X1 to December 31, 20X3; and
- Show the relevant items in the Balance Sheet of the purchaser as on December 31, 20X1 to 20X3.

Solution: Illustration 6

Loan Repayment Schedule:

Year	**Opening Balance**	**Interest @ 6% Per annum**	**Instalment (Year End)**	**Principal Repaid**	**Closing Balance**
	A	**B**	**C**	**D = C – B**	**E = A – D**
0.	1,00,000	-	-	40,000	60,000
1.	60,000	3,600	23,600	20,000	40,000
2.	40,000	2,400	22,400	20,000	20,000
3.	20,000	1,200	21,200	20,000	-

In the books of HP M/s Journal Entries

Date	**Particulars**		**Dr.**	**Cr.**
20X1 Jan. 1	Pick-up Van A/c To FM M/s A/c (Being the purchase of a pick-up van on hire purchase from FMM/s)	Dr.	1,00,000	1,00,000
	FM M/s A/c To Bank A/c (Being the Down Payment made)	Dr.	40,000	40,000
Dec. 31	Interest Expense A/c To FM M/s A/c (Being interest accrued)	Dr.	3,600	3,600
	FM M/s A/c (₹20,000+ ₹3,600) To Bank A/c	Dr.	23,600	23,600

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	(Being instalment paid)			
	Profit & Loss A/c To Interest Expense A/c (Being Interest Expense Charged – Off)	Dr.	3,600	3,600
	Depreciation A/c To Pick-up Van A/c (Being the depreciation charged @ 10% p.a. on ₹1,00,000)	Dr.	10,000	10,000
	Profit & Loss A/c To Depreciation A/c (Being Depreciation Charged – Off)	Dr.	10,000	10,000
20X2 Dec. 31	Interest Expense A/c To FM M/s A/c (Being interest accrued)	Dr.	2,400	2,400
	FM M/s A/c (₹20,000 + ₹2,400) To Bank A/c (Being the payment of 2ndinstalment along with interest)	Dr.	22,400	22,400
	Depreciation A/c To Pick-up Van A/c (Being the depreciation charged @ 10% p.a.)	Dr.	10,000	10,000
	Profit & Loss A/c Depreciation A/c (Being Depreciation Charged – Off)	Dr.	10,000	10,000
20X3 Dec. 31	Interest Expense A/c To FM M/s A/c (Being interest accrued)	Dr.	1,200	1,200
	FM M/s A/c (₹20,000 + ₹1,200) To Bank A/c (Being the payment of final instalment along with interest)	Dr.	21,200	21,200
	Depreciation A/c To Pick-up Van A/c (Being the depreciation charged @ 10% p.a.)	Dr.	10,000	10,000
	Profit & Loss A/c To Depreciation A/c (Being Depreciation Charged – off)	Dr.	10,000	10,000

Ledgers in the books of HP M/s

Pick-up Van Account

Date	Particulars	₹	Date	Particulars	₹
1.1.20X1	To FM M/s A/c	1,00,000	31.12.20X1	By Depreciation A/c	10,000
			31.12.20X1	By Balance c/d	90,000
		1,00,000			**1,00,000**
1.1.20X2	To Balance b/d	90,000	31.12.20X2	By Depreciation A/c	10,000

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			31.12.20X2	By Balance c/d	80,000
		90,000			**90,000**
1.1.20X3	To Balance b/d	80,000	31.12.20X3	By Depreciation A/c	10,000
				By Balance c/d	70,000
		80,000			**80,000**

FM M/s Account

Date	Particulars	₹	Date	Particulars	₹
1.1.20X1	To Bank A/c	40,000	1.1.20X1	By Pick-up Van A/c	1,00,000
31.12.20X1	To Bank A/c		31.12.20X1	By Interest Expense c/d	3,600
		1,03,600			**1,03,600**
31.12.20X2	To Bank A/c	22,400	1.1.20X2	By Balance b/d	40,000
31.12.20X2	To Balance c/d	20,000	31.12.20X2	By Interest Expense a/c	2,400
		42,400			**42,400**
31.12.20X3	To Bank A/c	21,200	1.1.20X3	By Balance b/d	20,000
			31.12.20X3	By Interest Expense a/c	1,200
		21,200			**21,200**

Depreciation Account

Date	Particulars	₹	Date	Particulars	₹
31.12.20X1	To Pick-up Van A/c	10,000	31.12.20X1	By Profit & Loss A/c	10,000
31.12.20X2	To Pick-up Van A/c	10,000	31.12.20X1	By Profit & Loss A/c	10,000
31.12.20X3	To Pick-up Van A/c	10,000	31.12.20X3	By Profit & Loss A/c	10,000

Interest Expense Account

Date	Particulars	₹	Date	Particulars	₹
31.12.20X1	To FM M/s A/c	3,600	31.12.20X1	By Profit & Loss A/c	3,600
31.12.20X2	To FM M/s A/c	2,400	31.12.20X1	By Profit & Loss A/c	2,400
31.12.20X3	To FM M/s A/c	1,200	31.12.20X3	By Profit & Loss A/c	1,200

Balance Sheet (Extract) of HP M/s as at 31st December,20X1

Liabilities	₹	₹	Assets	₹	₹
FM M/s Payable		40,000	Pick-up Van	1,00,000	
			Less: Depreciation	10,000	90,000

Balance Sheet (Extract) of HP M/s as at 31st December,20X2

Liabilities	₹	₹	Assets	₹	₹
FM M/s Payable		20,000	Pick-up Van	90,000	
			Less: Depreciation	10,000	80,000

Balance Sheet (Extract) of HP M/s as at 31st December,20X3

Liabilities	₹	₹	Assets	₹	₹
FM M/s Payable		10,000	Pick-up Van	80,000	
			Less: Depreciation	10,000	7 70,000

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Illustration - 7

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:

- The cash price of the van was Rs.1,00,000.
- Rs.40,000 were to be paid on signing of the contract.
- The balance was to be paid in annual instalments of Rs.20,000 plus interest.
- Interest chargeable on the outstanding balance was 6% p.a.
- 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.

Solution: Illustration 7

Interest suspense method

H.P. Interest Suspense Account

Date	Particulars	₹	Date	Particulars	₹
1.1.20X1	To FM M/s A/c	7,200	31.12.20X1	By Interest A/c	3,600
			31.12.20X1	By Balance c/d	3,600
		7,200			**7,200**
1.1.20X2	To Balance b/d	3,600	31.12.20X2	By Interest A/c	2,400
			1.1.20X2	By Balance c/d	1,200
		3,600			**3,600**
1.1.20X3	To Balance b/d	**1,200**	31.12.20X2	By Interest a/c	**1,200**

Interest Account

Date	Particulars	₹	Date	Particulars	₹
31.12.20X1	To H.P. Interest Suspense A/c	3,600	31.12.20X1	By Profit & Loss A/c	3,600
31.12.20X2	To H.P. Interest Suspense a/c	2,400	31.12.20X2	By Profit & Loss A/c	2,400
31.12.20X3	To H.P. Interest Suspense A/c	1,200	31.12.20X3	By Profit & Loss A/c	1,200

FM M/s Account

Date	Particulars	₹	Date	Particulars	₹
1.1.20X1	To Bank A/c	40,000	1.1.20X1	By Pick-up Van A/c	1,00,000
31.12.20X1	To Bank A/c	23,600	1.1.20X1	By H.P. Interest Suspense A/c	7,200
31.12.20X1	To Balance c/d	43,600			
		1,07,200			**1,07,200**
31.12.20X2	To Bank A/c	22,400	1.1.20X2	By Balance b/d	43,600

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31.12.20X2	To Balance c/d	21,200			
		43,600			**43,600**
31.12.20X3	To Bank A/c	**21,200**	1.1.20X3	By Balance b/d	**21,200**

Balance Sheet of HP M/s as at 31st December,20X1

Liabilities	**₹**	**₹**	**Assets**	**₹**	**₹**
FM M/s Payable	43,600		Pick-up Van	1,00,000	
Less: H.P. Interest Suspense	(3,600)	40,000	Less: Depreciation	(10,000)	90,000

Balance Sheet of HP M/s as at 31st December,20X2

Liabilities	**₹**	**₹**	**Assets**	**₹**	**₹**
FM M/s Payable	21,200		Pick-up Van	90,000	
Less: H.P. Interest Suspense	(1,200)	20,000	Less: Depreciation	(10,000)	80,000

Balance Sheet of HP M/s as at 31st December,20X3

Liabilities	**₹**	**₹**	**Assets**	**₹**	**₹**
			Pick-up Van	80,000	
			Less: Depreciation	(10,000)	70,000

Working Note:

Total Interest = ₹3,600 + ₹2,400 + ₹1,200 = ₹7,200

Illustration - 8

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 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.

Solution: Illustration 8

Journal Entries

In the Books of X Ltd (Hire Purchaser)

	Particulars		**Dr.**	**Cr.**
I Year	Milk Vans A/c	Dr.	2,25,000	
	To Vendor A/c			2,25,000
	(Being 3 Milk vans @₹75,000 each acquired)			

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	Super Motors (Vendor) a/c To Bank (Being down payment made)	Dr.	45,000	 45,000
I Year end	Interest Expense A/c (₹1,80,000 @ 9%) To Super Motors a/c (Being the Interest Expense for the year Accounted)	Dr.	16,200	 16,200
	Super Motors a/c To Bank A/c (₹1,80,000/3 + ₹16,200) (Being instalment paid for year 1)	Dr.	76,200	 76,200
	Profit & Loss A/c To Interest Expense A/c (Being Interest Expense Charged off)	Dr.	16,200	 16,200
	Depreciation A/c To Milk Vans A/c (2,25,000 × 20% WDV) (Being Year 1 Depreciation accounted)	Dr.	45,00	 45,000
	Profit & Loss A/c To Depreciation (Being Year 1 depreciation Charged off to P&L)	Dr.	45,000	 45,000
II Year end	Interest Expense A/c (₹1,20,000 @ 9%) To Super Motors a/c (Being Year 2 Interest Accounted)	Dr.	10,800	 10,800
	Depreciation A/c To Milk Vans A/c (2,25,000 – 45,000 × 20%) (Being Year II Depreciation Accounted)	Dr.	36,000	 36,000
	Super Motors A/c Profit/Loss A/c (b.f.) To Milk Vans A/c (Being Repossession recorded) (WN1)	Dr. Dr.	73,500 22,500	 96,000
	Profit/Loss A/c To Loss on Repossession To Interest To Depreciation (Being transfer of Nominal a/c to P&L)	Dr.	69,300	 22,500 10,800 36,000
IIIrd Year (3 months from the end of 2nd year)	Super Motors A/c To Bank (Being full & final settlement made at the end of Year II, Paid 3 months later in Year III. So, No Further interest gets accrued for this 3 month period)	Dr.	57,300	 57,300
	Depreciation A/c	Dr.	9,600	

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	To Milk Vans A/c (1,44,000 × ⅓ (WN1) × 20%) (Being Depreciation of Year III accounted)			9,600

Milk Vans Account

Year	Particulars	₹	Year	Particulars	₹
1	To Super Motors A/c	2,25,000	1 end	By Depreciation A/c	45,000
			"	By Balance c/d	1,80,000
		2,25,000			2,25,000
2	To Balance b/d	1,80,000	2 end	By Depreciation By Super Motors (value of 2 vans after depreciation for2 years @ 30%)	36,000 73,500
				By P & L A/c (balancing figure)	22,500
				By Balance c/d ((one van less depreciation for 2 years) @ 20%)	48,000
		1,80,000			**1,80,000**

Super Motors Account

Year	Particulars	₹	Year	Particulars	₹
1	To Bank A/c	45,000	1	By Milk Vans A/c	2,25,000
	To Bank A/c	76,200		By Interest Expense @ 9% on ₹1,80,000	16,200
	To Balance c/d	1,20,000			
		2,41,200			**2,41,200**
2	To Milk Van A/c	73,500	2	By Balance b/d	1,20,000
	To Balance c/d	57,300		By Interest A/c	10,800
		1,30,800			**1,30,800**
3	To Bank A/c	57,300	3	By Balance b/d	57,300

Working Notes:

1.Repossession 22,500

Asset Going Out:

- Cost = 2,25,000
- Year 1 Depreciation = 45,000
- Year 2 Depreciation = 36,000

WDV of 3 Vans = 1,44,000

Therefore, 2 Vans = ₹1,44,000 × ⅔ = ₹96,000 (Net Book Value of asset going out)

Settlement Value:

- Cost = 2,25,000

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Less: Year 1 Depreciation @ 30% = (67,500)
WDV @ Year 1 = ₹1,10,250
Less: Year 2 Depreciation @ 30% = (47,250)
WDV @ Year for 3 Vans = 1,10,250
Therefore, 2 Vans = 1,10,250 × ⅔ = 73,500 (Settlement Value)

There is a Repossession Loss, i.e. Net book value – Settlement Value (96,000 – 73,500) = ₹22,500 is charged off to P & L A/c.

Illustration - 9

X Transport Ltd. purchased from Delhi Motors 3 Tempos costing Rs. 50,000 each on the hire purchase system on 1-1-20X1.

Payment was to be made Rs. 30,000 down and the remainder in 3 equal annual instalments payable on 31-12-20X1, 31-12-20X2 and 31-12-20X3 together with interest @ 9%.

X Transport Ltd. write off depreciation at the rate of 20% on the diminishing balance.

It paid the instalment due at the end of the first year i.e. 31-12-20X1 but could not pay the next on 31-12-20X2.

Delhi Motors agreed to leave one Tempo with the purchaser on 1-1-20X3 adjusting the value of the other 2 Tempos against the amount due on 31-12-20X2.

The Tempos were valued on the basis of 30% depreciation annually.

Show the necessary accounts in the books of X Transport Ltd. for the years 20X1, 20X2 and 20X3.

Solution: Illustration 9

X Transport Ltd, Tempo Account

Date	Particulars	₹	Date	Particulars	₹
20X1 Jan. 1	To Delhi Motors	1,50,000	Dec. 31	By Depreciation A/c (20% on1,50,000)	30,000
				By Balance c/d	1,20,000
		1,50,000			**1,50,000**
20X2 Jan 1	To Balance b/d	1,20,000	20X2 Dec.31	By Depreciation A/c	24,000
				By Delhi Motors A/c (Value of 2 tempos taken away) (WN2)	49,000
				By Profit and Loss A/c (WN2)	15,000
				By Balance c/d (Value of one tempo)	32,000
		1,20,000			**1,20,000**

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20X3 Jan. 1	To Balance b/d	32,000	20X3 Dec.31	By Depreciation A/c	6,400
				By Balance b/d (WN1)	25,600
		32,000			**32,000**

Delhi Motors Account

Date	Particulars	₹	Date	Particulars	₹
20X1 Jan. 1	To Bank (Down Payment)	30,000	Jan. 1	By Tempos A/c	1,50,000
Dec. 31	To Bank	50,800	Dec. 31	By interest (9% on ₹1,20,000)	10,800
	To Balance c/d	80,000			
		1,60,800			**1,60,800**
20X2 Jan. 1	To Tempo	49,000	20X2 Jan. 1	By Balance b/d	80,000
Dec. 31	To Balance c/d	38,200	Dec. 31	By Interest (9% on ₹80,000)	7,200
		87,200			**87,200**
20X3 Dec. 31	To Bank	41,638	20X3 Jan. 1	By Balance b/d	38,200
			Dec. 31	By Interest (9% on ₹38,200)	3,438
		41,638			**41,638**

(1) Value of a Tempo left with the X Transport buyer:

	Computations	**₹**
Cost	50,000 × 1	50,000
Depreciation:		
- Year 20X1	50,000 × 20%	10,000
- Year 20X2	(50,000 – 10,000) × 20%	8,000
- Year 20X3	(40,000 – 10,000) × 20%	6,400
WDV		**25,600**

(2) book Value of Tempos taken away by the seller

	Book Value of Tempos taken away by the seller		**Settlement Value of Tempos**	
	Computations	**₹**	**Computations**	**₹**
Cost	1,00,000 × 1	1,00,000	50,000 × 2	1,00,000
Depreciation:				
- Year 20X1	1,00,000 × 20%	20,000	1,00,000 × 30%	30,000
- Year 20X2	(1,00,000 – 10,000) × 20%	16,000	(1,00,000 – 30,000) × 30%	21,000

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WDV		**64,000**		**49,000**

Loss Due to repossession = (Book Value – settlement Value) = 64,000 – 49,000 = ₹15,000

Illustration – 10

A firm acquired two tractors under hire purchase agreements, details of which were as follows:

Date of Purchase	Tractor A 1st April, 20X1(Rs.)	Tractor B 1st Oct., 20X1(Rs.)
Cash price	14,000	19,000

Both agreements provided for payment to be made in twenty-four monthly instalments (of Rs. 600 each for Tractor A and Rs. 800 each for Tractor B), commencing on the last day of the month following purchase, all instalments being paid on due dates.

On 30th June, 20X2, Tractor B was completely destroyed by fire. In full settlement, on 10th July, 20X2 an insurance company paid Rs. 15,000 under a comprehensive policy. Any balance on the hire purchase company's account in respect of these transactions was to be written off.

The firm prepared accounts annually to 31st December and provided depreciation on tractors on a straight-line basis at a rate of 20 % p.a. rounded off to nearest ten rupees, apportioned as from the date of purchase and up to the date of disposal

You are required to record these transactions in the following accounts, carrying down the balances on 31st December, 20X1 and 31st December, 20X2:

(a) Tractors on hire purchase.
(b) Provision for depreciation of tractors.
(c) Disposal of tractors.

Solution: Illustration 10

Hire Purchase accounts in the buyer's books

Tractors on Hire Purchase Account

Date	Particulars	₹	Date	Particulars	₹
20X1 Apr. 1	To HP Co - Cash price Tractor A	14,000	Dec. 31	By Balance c/d - Tractor A 14,000 - Tractor B 19,000	33,000
Oct. 1	HP Co. Cash price Tractor B	19,000			
		33,000			**33,000**
20X2 Jan. 1	To Balance b/d - Tractor A 14,000 - Tractor B 19,000	33,000	20X2 June 30	By Disposal of Tractor A/c	19,000
			Dec.31	By Transfer Balance c/d	14,000

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		33,000			**33,000**
20X3 Jan. 1	To Balance b/d	14,000			

Provision for Depreciation of Tractors Account

Date	Particulars	₹	Date	Particulars	₹
20X1 Dec. 31	To Balance c/d	3,050	Dec. 31	By Balance c/d - Tractor A 2,100* - Tractor B 950**	3,050
		3,050			**3,050**

* 14,000 x 20% x 9/12 = 2,100

** 19,000 x 20% x 3/12 = 950

Date	Particulars	₹	Date	Particulars	₹
20X2 June30	To Disposal of Tractor account (950 + 1,900)	2,850	Dec. 31	By Balance c/d	3,050
Dec. 31	To Balance c/d	4,900	Jun. 30	By P & L A/c (Depn. for Tractor B) (19,000 x 20% x 6/12)	1,900
			Dec. 31	By P & L A/c (Depn. for Tractor A) (14,000 x 20%)	2,800
		7,750			**7,750**
			20X3 Jan 1	By Balance b/d	4,900

Disposal of Tractor Account

Date	Particulars	₹	Date	Particulars	₹
20X2 June30	To Tractors on hire Purchase - Tractor B	19,000	20X2 June30	By Provision for Depn. of Tractors A/c	2,850
			July 10	By Cash: Insurance	15,000
			Dec 31	By P & L A/c: Loss (b.f.)	1,150
		19,000			**19,000**

Illustration – 11

A machinery is sold on hire purchase. The terms of payment is four annual instalments of Rs. 6,000 at the end of each year commencing from the date of agreement. Interest is charged @ 20% and is included in the annual payment of Rs. 6,000.

Show Machinery Account and Hire Vendor Account in the books of the purchaser who defaulted in the payment of the third yearly payment whereupon the vendor re-possessed the machinery.

The purchaser provides depreciation on the machinery @ 10% per annum on WDV basis. All workings should form part of your answers.

Solution: Illustration 11

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Machinery Account

Year	Particulars	₹	Year	Particulars	₹
1	To Hire Vendor A/c (W.N.1)	15,533	1	By Depreciation A/c	1,553
				By Balance c/d	13,980
		15,533			**15,533**
2	To Balance b/d	13,980	2	By Depreciation A/c*	1,398
				By Balance c/d	12,582
		13,980			**13,980**
3	To Balance b/d	12,582	**3**	By Depreciation A/c*	1,258
				By Hire Vendor	11,000
				By Profit & Loss A/c (Loss on Surrender) Bal.fig.	324
		12,582			**12,582**

Hire Vendor Account

Year	Particulars	₹	Year	Particulars	₹
1	To Bank A/c	6,000	1	By Machinery A/c	15,533
	To Balance c/d	12,639		By Interest A/c	3,106
		18,639			**18,639**
2	To Bank A/c	6,000	2	By Balance b/d	12,639
	To Balance c/d	9,167		By Interest A/c	2,528
		15,167			**15,167**
3	To Machinery A/c (transfer)	11,000	3	By Balance b/d	9,167
				By Interest A/c	1,833
		11,000			**11,000**

Woking Note

1.

Year	Opening Balance	Interest @ 20% Per annum	Instalment (Year End)	Principal Repaid	Closing Balance
	A	**B**	**C**	**D = C - B**	**E = A - D**
1.	15,533	3,106	6,000	2,894	12,639
2.	12,639	2,528	6,000	3,472	9,167
3.	9,167	1,833	6,000	4,167	5,000
4.	5,000	1,000	6,000	5,000	-

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AS - 1
Disclosure of Accounting Policies

1 Introduction

1.1 Importance

Irrespective of extent of standardisation, diversity in accounting policies is unavoidable for two reasons:

- Accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard.
- Since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all times. The accounting standards permit more than one policy even in areas covered by it.

Differences in accounting policies lead to differences in information even if underlying transactions are the same. The qualitative characteristic of comparability of financial statements suffers due to diversity of accounting policies.

1.2 Requirements:

Enterprises must disclose

- Significant accounting policies adopted by them in the preparation & presentation of their financial statements.
- Changes in accounting policies such that the users can compare financial statements of the same enterprise for different accounting periods.

1.3 Purpose of AS – 1

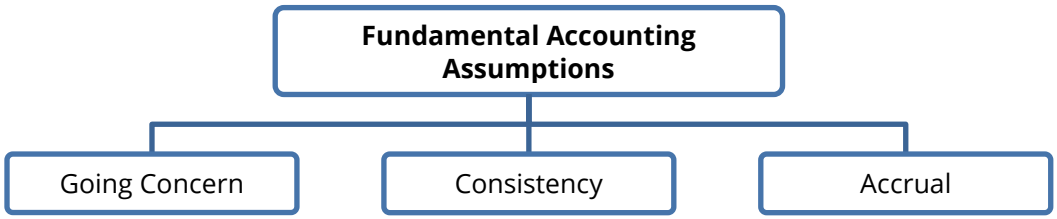
- Promote better understanding of financial statements by requiring disclosure of significant accounting policies in an orderly manner.
- To bring uniformity in the disclosure of accounting policies by different enterprises and ensure standards in the nature and degree of disclosure.
- Such disclosures facilitate more meaningful comparison between financial statements of different enterprises for the same accounting periods.

2. Fundamental Accounting Assumptions

There are certain accounting concepts, which are very fundamental to the process of preparation of Financial Statements

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AS-1 identifies three such Fundamental Accounting Assumptions:



2.1 Going Concern:

The enterprise is normally viewed as a going concern. The financial statements are normally prepared on the assumption that an enterprise will continue its operations in the foreseeable future and:

- Neither there is **intention,**
- Nor is there **a need**

of liquidation or of curtailing materially the scale of its operations.

Financial statements prepared on Going concern basis recognise:

- the need for sufficient retention of profit to replace assets consumed in operation, and
- for making adequate provision for settlement of its liabilities.

- If an enterprise is not a going concern, valuation of its assets and liabilities on historical cost becomes irrelevant and consequently it's profit or loss may not give reliable information.

Example:

The book value of 10% loan as on 31st March, 20X1 is Rs. 35,000. There is an early repayment penalty for the loan Rs. 2,500.

(i) Assuming Going Concern:

Liabilities will continue to be valued at book value only, Rs. 35,000.

(ii) Not Assuming Going Concern:

Liabilities will be valued at the settlement amount. So, the 10% loan will be shown in the Balance sheet at Rs. 37,500 (Rs. 35000 plus Rs. 2500 penalty for early repayment).

Example:

The cost and net realisable value of stock on 31st March, 20X1 were Rs. 32,000 and Rs. 40,000 respectively.

(i) Assuming Going Concern:

Stock will be valued at the valuation principle of "Cost or Net Realisable Value, whichever is lower". So, the stock will be shown in the Balance sheet at Rs. 32,000.

(ii) Not Assuming Going Concern:

Since, the entity is not a going concern, its assets will be valued at realisable value, Rs. 40,000.

2.2 Consistency:

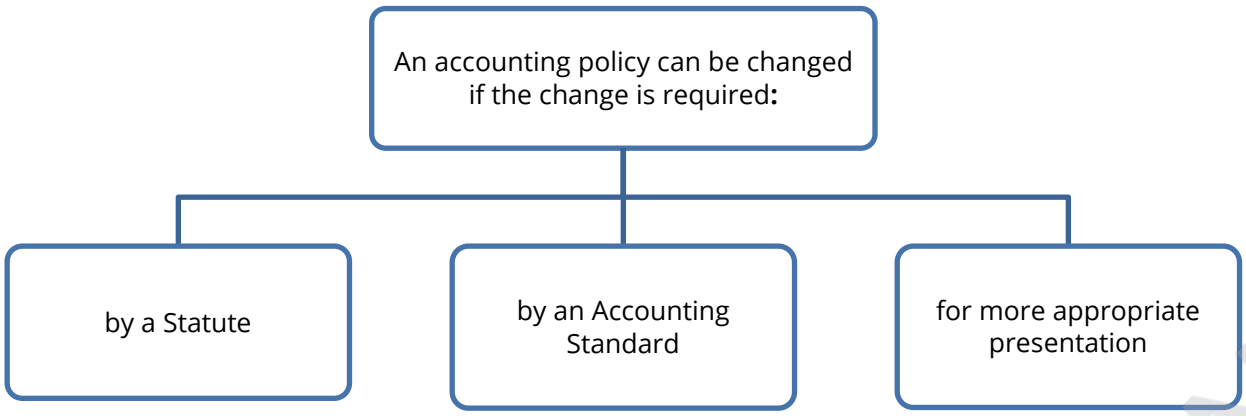
For ensuring comparability for the benefit of bankers, creditors, Govt. and other users of financial information, it is necessary that there should be consistency in using accounting policy, i.e., using the same accounting policy for similar transactions.

2.2.1 Change in Accounting Policy

Situations may develop needing a change of accounting measurement adopted earlier. In such a situation, a departure from an accounting concept is permissible only by making a full disclosure about the:

- Change, and
- Monetary effect of the change on the financial statements.

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2.3 Accrual basis of accounting:

This concept is the core of the mercantile system of accounting. Under this basis of accounting, transactions are recognised as soon as they occur, whether cash or cash equivalent is actually received or paid.

Advantages of using Accrual Basis of Accounting:

- Ensures better matching between revenue and cost.
- Profit / Loss reflects activities of the enterprise during an accounting period, rather than cash flows generated by it.

Limitation of using Accrual Basis of Accounting:

While accrual basis is a more logical approach to profit determination than the cash basis of accounting, it exposes an enterprise to the risk of

- recognising an income before actual receipt
- overstating the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital i.e. dividens may be paid even if profits is not realised in cash.

For this reason, accounting standards require that no revenue should be recognised unless:

- the amount of consideration and
- actual realisation of the consideration

is reasonably certain.

Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting. Section 128(1)(iii) of the Companies Act, 2013 makes it mandatory for companies to maintain accounts on accrual basis only.

It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated subject to the materiality of the item.

Example:

(a) A trader purchased article A on credit in period 1 for Rs. 50,000.
(b) He also purchased article B in period 1 for Rs. 2,000 cash.
(c) The trader sold article A in period 1 for Rs. 60,000 in cash.
(d) He also sold article B in period 1 for Rs. 2,500 on credit.

(i) Cash basis of accounting:

Cash purchase of article B and cash sale of article A is recognised in period 1 while purchase of article A on payment and sale of article B on receipt is recognised in period 2.

(ii) Accrual basis of accounting:

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Credit purchase of article A and cash purchase of article B and cash sale of article A and credit sale of article B is recognised in period 1 only.

3 Accounting Policies

3.1 Meaning:

The accounting policies refer to the:

- specific accounting principles and
- the methods of applying those principles

adopted by the enterprise in the preparation and presentation of financial statements.

3.2 Accountant's role:

For every item right from valuation of assets and liabilities to recognition of revenue, providing for expected losses, for each event, accountants need to:

- form principles
- and evolve a method to adopt those principles.

This method of forming and applying accounting principles is known as accounting policies.

3.3 Different Accounting Policies:

There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate make alternative accounting principles acceptable.

3.4 Examples:

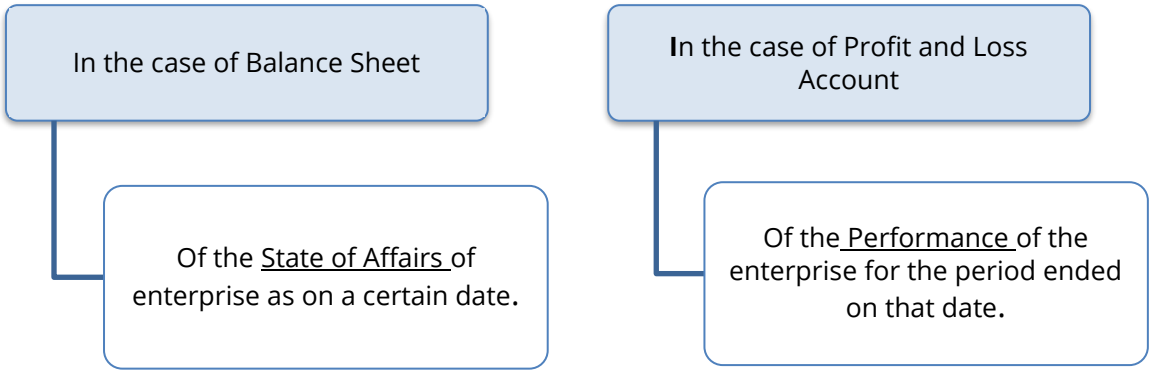
Items to be disclosed	Method of disclosure or valuation
Inventories	FIFO, Weighted Average etc.
Cash Flow Statement	Direct Method, Indirect Method
Depreciation	Straight Line Method, Reducing Balance Method, Units of Production Method etc.
Valuation of Investments	Current Investments: At Cost or Market Value, lower Non-Current Investments: At Cost
Valuation of Fixed Assets	Cost Model, Revaluation Model.
Government Grants	Income Approach or Capital Approach

4 Selection of Accounting Policy

4.1 Primary Consideration:

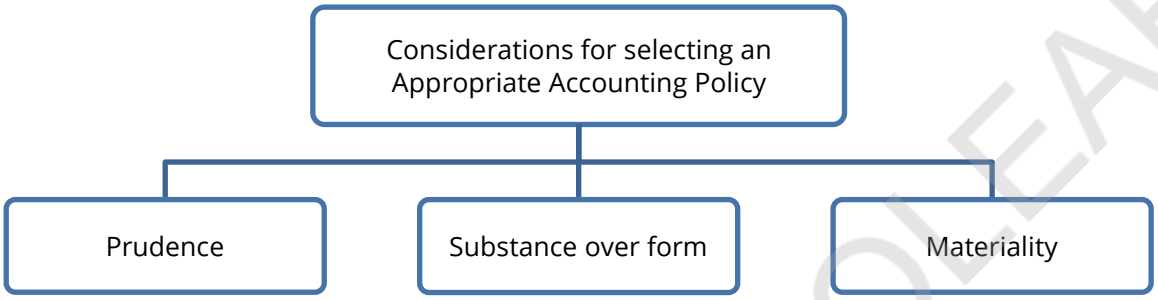
The primary consideration is that the Financial Statements prepared and presented should represent a "True and Fair" view as under: -

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4.2 Other Major Considerations:

AS – 1 identifies the following "three major considerations" for selecting accounting policies:



4.2.1 Prudence:

Prudence is inclusion of a degree of caution while making estimates made under uncertainty.

- Probable profits are not anticipated. Profits are recognized only when they are realised in cash or a third party has legally become liable to pay the amount, but
- Probable losses are provided for as a matter of conservatism. Provision should be created for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Example:
Provision for doubtful debts, Provision for discount on debtors, policy of valuing inventory at lower of cost and net realisable value etc.

Caution while applying the concept of Prudence:

It does not allow creation of hidden reserves by:

- understating profits and assets or
- overstating liabilities and losses.

Example: Suppose a company is facing a damage suit. No provision for damages should be recognised by a charge against profit, unless the probability of losing the suit is more than the probability of not losing it (i.e > 50% chance of losing)

4.2.2 Substance Over Legal form:

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely by their legal form.

Example: (You will understand this in AS-19 leases)
Suppose a company has building under a finance lease of 50 years which is also the useful life. In such a finance lease, though the lessor continues to be legal owner of the asset, he is essentially transferring the risk and reward incidental (attached) to the ownership of the asset to the lessee.

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Lessee is using the asset for generating revenue, and hence the asset is recognized in his books. Thus, the Balance sheet of lessee reflects assets taken on lease and corresponding liability towards the lessor on account of lease payments. Depreciation on such assets is debited to the lessee's Profit and Loss Account.

Similarly, in case of an asset acquired on Hire Purchase, ownership is not transferred till the last instalment is paid. However, the asset is shown in the books of the Hire Purchaser.

4.2.3 Materiality:

Financial statements should disclose all 'material items', i.e., the items the knowledge of which might influence the economic decisions of the users of the financial statement.
Materiality is not always a matter of relative size.

Example:
A small amount lost by fraudulent practices of certain directors can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future.

In certain cases, quantitative limits of materiality are specified. A few of such cases (From general Instructions for preparation of Statement of Profit and Loss in Schedule III to the Companies Act, 2013) are given below. A company should disclose in Notes to Accounts:

- Additional information regarding any item of income or expenditure which exceeds:
  - 1% of the revenue from operations or
  - Rs. 1,00,000,
    whichever is higher.
- Shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held.

5 Disclosure Requirements

Accounting Policies should be disclosed in the Financial Statement for the following reasons:

1. Better Understanding of Financial Statements.
2. Inter-Firm Comparison.
3. Compliance with the Companies Act, 2013.
4. ICAI also provided guidelines for disclosure of significant accounting policies.

5.1 Manner of disclosure:

All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

5.2 Place of disclosure:

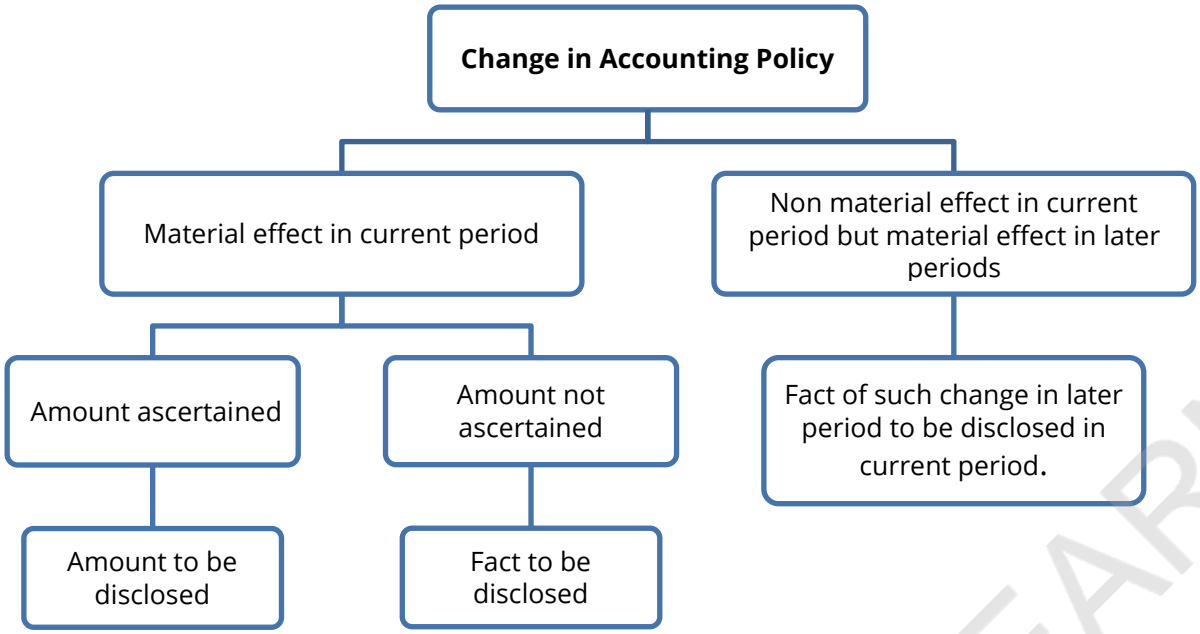
The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place, instead of being scattered over several Statements, Schedules, and Notes.
Note: Being a part of the financial statement, the opinion of auditors should cover the disclosures of accounting policies.

5.3 Disclosure of Changes in Accounting Policies:

Any change in the accounting policies which:

- has a material effect in the current period, or
- is reasonably expected to have a material effect in a later period should be disclosed.

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Example: (Change having material effect in current year)

In the books of M/s Prashant Ltd, closing inventory as on 31.03.20X2 amounts to Rs. 1,63,000 (on the basis of FIFO method). The company decides to change from FIFO method to weighted average method for ascertaining the cost of inventory from the year 20X1-X2.

Based on weighted average method, closing inventory as on 31.03.20X2 amounts to Rs. 1,47,000. Realisable value of the inventory as on 31.03.20X2 amounts to Rs. 1,95,000.

Prashant Ltd. should disclose the change in valuation method of inventory and its effect on financial statements. The company may disclose the change in accounting policy in the following manner:

"The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year i.e., 201X1-X2, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced current profit and value of inventory by Rs. 16,000. "

Example: (Change having material effect in future years)

Suppose a company makes provision for warranty claims based on estimated costs of materials and labour. The company changed the policy in 20X1-X2 to

include overheads in estimating costs for servicing warranty claims. If the value of warranty sales in 20X1-X2 is not significant, the change in policy will not have any material effect on financial statements of 20X1-X2. Yet, the company must disclose the change in accounting policy in 20X1-X2 because the change can affect future accounting periods when value of warranty sales may rise to a significant level.

If the disclosure is not made in 20X1-X2, then no disclosure in future years will be required. This is because an enterprise must disclose changes in accounting policies in the year of change only.

5.4 Disclosure of deviations from fundamental accounting assumptions:

If the fundamental accounting assumptions, viz.

1. Going concern,

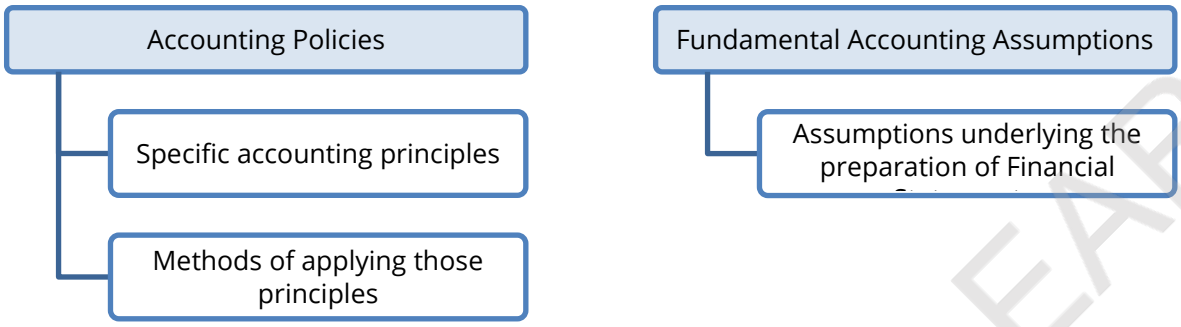
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2. Consistency and
3. Accrual

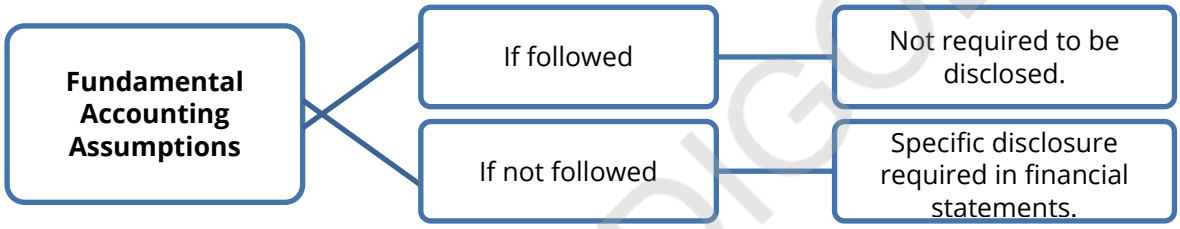
are followed in financial statements, specific disclosure is not required.
If a fundamental accounting assumption is not followed, the fact should be disclosed.

6. Summary

Coverage of AS – 1



Fundamental Accounting Assumptions



Going Concern	An enterprise will continue its operations in the foreseeable future and neither there is any need nor intention to materially curtail its operations. Exception: Joint Venture
Consistency	Practice of using same accounting policies for similar transactions in all accounting periods Change can be made if required by a Statute, an Accounting Standard or for better presentation
Accrual	Revenues and costs are accrued, that is, recognised as they are earned or incurred. Recorded in the financial statements of the periods to which they relate.

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Illustrations

Illustration 1

In the books of M/s Prashant Ltd., closing inventory as on 31.03.2015 amounts to Rs. 1,63,000 (on the basis of FIFO method).

The company decides to change from FIFO method to weighted average method for ascertaining the cost of inventory from the year 2014 -15. On the basis of weighted average method, closing inventory as on 31.03.2015 amounts to Rs. 1,47,000. Realisable value of the inventory as on 31.03.2015 amounts to Rs. 1,95,000.

Discuss disclosure requirement of change in accounting policy as per AS -1.

Solution

Prashant Ltd. should disclose the change in valuation method of inventory and its effect on financial statements. The company may disclose the change in accounting policy in the following manner:

"The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year i.e., 201X1-X2, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced current profit and value of inventory by Rs. 16,000. "

Illustration 2

ABC Ltd. was making provision for non-moving inventories based on issues for the last 12 months up to 31.3.2016. The company wants to provide during the year ending 31.3.2017 based on technical evaluation:

- Total value of inventory Rs. 100 lakhs
- Provision required based on 12 months issue Rs. 3.5 lakhs
- Provision required based on technical evaluation Rs. 2.5 lakhs

Does this amount to change in Accounting Policy? Can the company change the method of provision?

Solution

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting the financial statements. The decision making provision for non-moving inventories on the basis of technical valuation does not amount to change in accounting policy. Accounting policy of a company may require that provision for non-moving inventories should be made but the basis for making provision will not constitute accounting policy.

The method of estimating the amount of provision may be changed in case a more prudent estimate can be made.

In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventories from Rs.3.5 lakhs to Rs.2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to accounts in the annual accounts of ABC Ltd.for the year 2016-17 in the following manner:

" The company has provided for non-moving inventories on the basis of the technical evaluation unlike the preceding year. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year end net assets would have been lower by Rs.1 lakh."

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Illustration 3

Jagannath Ltd. had made a right issue of shares in 2017. In the offer document to its members, it had projected a surplus of Rs. 40 crores during the accounting year to end on 31st March 2018. The draft results for the year prepared on the hitherto followed accounting policies and presented for perusal of the Board of Directors showed a deficit of Rs. 10 crores.

The Board, in consultation with the Managing Director, decided on the following:

1. Value year-end inventory at works cost (Rs. 50 crores) instead of the hitherto method of valuation of inventory at Prime Cost (Rs. 30 crores).

2. Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being Rs. 10 crores.

As chief accountant of the company, you are asked by the Managing Director to draft the Notes on Accounts for inclusion in the annual report for 2016-17.

Solution

As per AS-1, 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 period should be disclosed.

In the case of a change in the 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 an amount is not ascertainable, wholly or in part, the fact should be indicated. Accordingly, the notes on accounts should properly disclose the change and its effect.

NOTES ON ACCOUNTS :

1. During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy expenditure during the year. As a result of this change, the year- end inventory has been valued at Rs. 50 crores and the profit for the year is increased by Rs. 20 crores.
2. The company has decided to provide Rs. 10 crores for the fall in the value of investments which has taken place over the period of past 5 years. The provision so made reduced the profit disclosed in the accounts by Rs. 10 crores.

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AS 10
PROPERTY, PLANT AND EQUIPMENT

1.Introduction

1.1 Objective

- To prescribe accounting treatment of property, plant and equipment.
- Recognition of assets.
- Determination of carrying amount and depreciation charges
- Depreciation, retirement and disposal accounting.

1.2 Scope

PPE are generally grouped into various classes like land and buildings, machinery, ships, aircrafts, furniture, bearer plants etc.

This standard does NOT deal with the following.

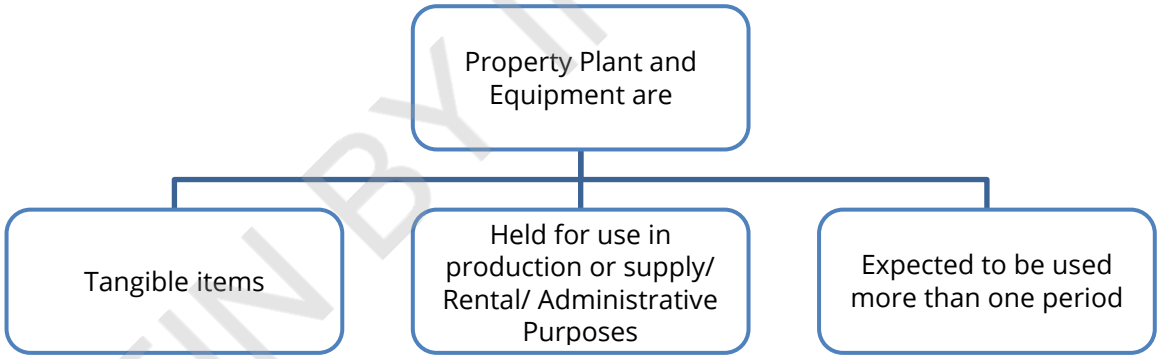
(a) Biological assets related to agricultural activity other than bearer plants

(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 PPE used to develop and maintain above assets.

(c) Investment Property, as defined in AS 13, should be accounted for only in accordance with the cost model prescribed under this standard.

2.Definitions

2.1. Property,Plant and Equipment



2.2. Bearer Plant

Bearer plant is a living plant that

(a) Is used in the production/supply of agricultural produce

(b) Is expected to bear produce for more than a period of twelve months

(c) Has a remote likelihood of being sold as an agricultural produce, except for incidental scrap sales.



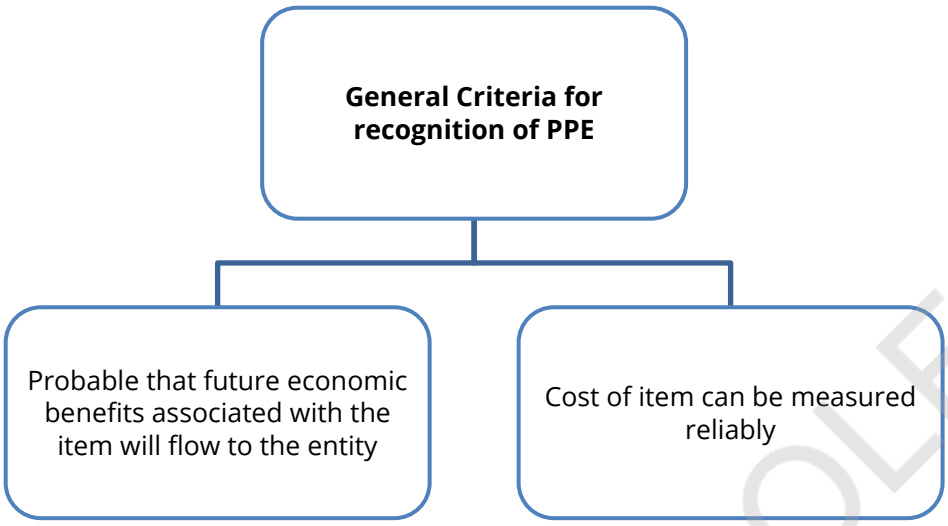
2.3. Carrying Amount

Gross Book Value	xxx

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(-) Accumulated Depreciation	xxx
(-) Accumulated Impairment Loss	xxx
Carrying Amount	**xxx**

3. Recognition



Spare parts, stand-by equipment, and servicing equipment: Recognised in accordance with this standard when they meet the definition of PPE. Otherwise, such items are classified as inventory (AS 2) and charged to the statement of profit or loss when it is issued for usage.

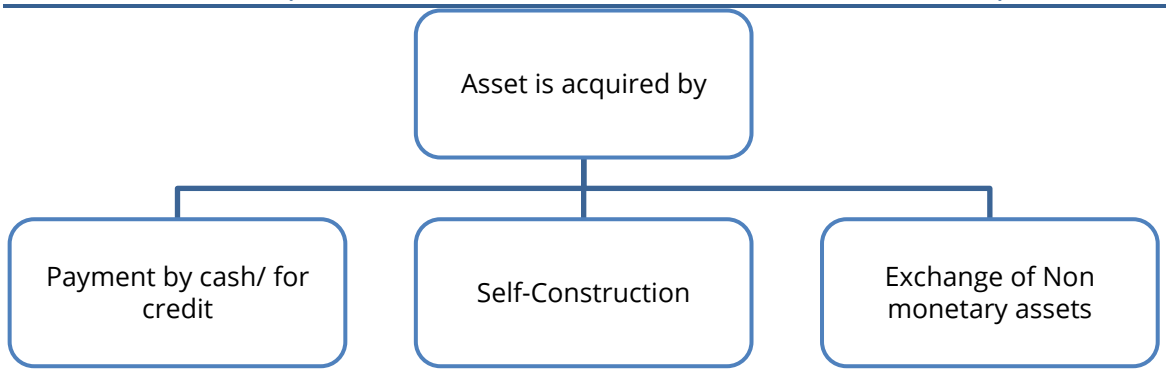
Aggregation of individually insignificant items:
It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the recognition criteria to the aggregate value.

Other important points:
Items of PPE may be acquired for safety or environmental reasons. These may be necessary for an entity to obtain the future economic benefits from its other assets. (Indirect benefits)
Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets more than what could be derived had those items not been acquired.

Measurement at Recognition
An item of property, plant and equipment that qualifies for recognition as an asset should be initially measured at its cost.

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4. Amount to be capitalised is based on the nature of consideration paid for the asset.



If an asset is purchased by payment of cash or credit.

The cost of an item of PPE comprises

Purchase Price	xxx
Add:	
Non-refundable taxes and duties	xxx
Initial delivery and handling charges	xxx
Cost of site preparation	xxx
Installation & Assembly costs	xxx
Professional Fees	xxx
Borrowing costs (If permitted by AS 16)	xxx
Costs of testing (After deducting proceeds from sale of any product produced during testing)	xxx
Present Value of Decommissioning, restoration costs	xxx
Any directly attributable cost to bring the asset to the location and condition, necessary to operate for its purpose intended by the management	xxx
Less:	
Government grant received specific to the asset	xxx
Trade discounts and rebates (If included in above costs)	xxx
Cost of PPE to be capitalised	**xxxx**

Exclusions from Cost of PPE

(a) Costs of conducting business in a new location or with a new class of customer (including costs of staff training)
(b) Costs incurred in introducing a new product or service.
(c) Cost of opening a new facility
(d) Administrative and other general overhead costs

> The income and related expenses of incidental operations are recognised in profit or loss account

Self – Constructed PPE

The cost of a self-constructed asset is determined using the same principles as for an acquired asset.

Inclusions:

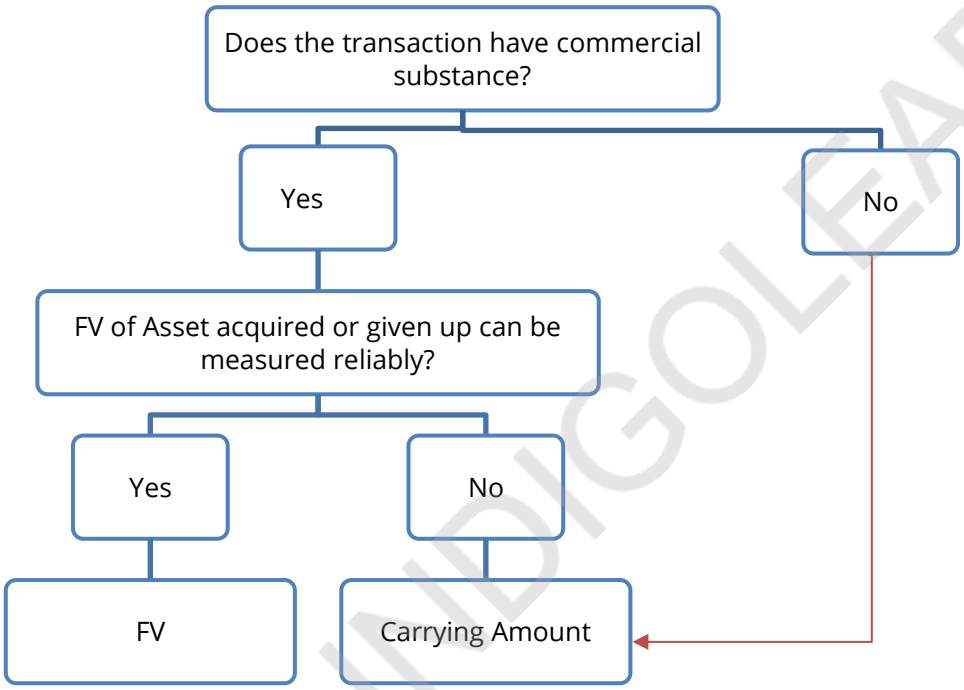
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- Costs of construction that directly relate to the specific assets
- Costs that can be attributable or allocated to the construction activity.
- Borrowing costs if PPE is a qualifying asset as per AS 16

Exclusions:

- Internal profits (Always take cost of construction and not sale price)
- The cost of abnormal amounts of wasted material, labour , or other resources incurred in self-constructing an asset.

PPE is acquired by exchange of non-monetary assets



If both the above conditions are satisfied, PPE is measured at
(a) FV of asset given up (1st Priority)
(b) FV of asset acquired (If this is more evident, use this)

If above conditions are not satisfied, PPE is measured carrying amount of the asset given up.

Commercial Substance:

An exchange transaction has commercial substance if:

(a) The risk, timing, and amount of the cash flows of the asset received are significantly different from the cash flows of the asset transferred.

(b) There is a significant effect on the present value of the after tax cash flows that an entity expects to arise from the continuing use and disposal of the asset due to exchange transactions.

Fair Value of the Asset:

The fair value of an asset is reliably measurable if:

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a) The variability in the range of reasonable fair value measurements is not significant for that asset The probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

The cost of an item of PPE held by a lessee under a finance lease is determined in accordance with AS 19, Leases.

Costs incurred in using or redeploying an item are not included in the carrying amount of that item

Cost of Bearer Plants

All the cost of activities 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.

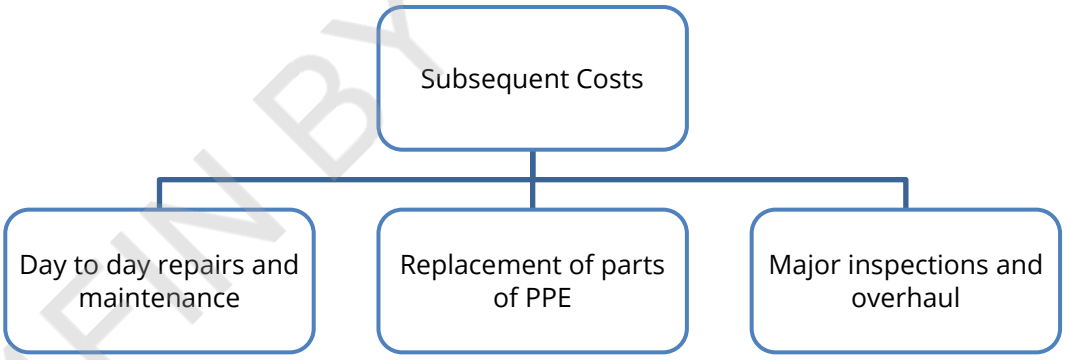
5. Cessation of Capitalisation

Recognition of costs to carrying amount of PPE ceases when the item is in the

- location and
- condition
- necessary for it to be capable of operating in the manner
- intended by management.

For Example, Initial operating losses, cost of relocating or reorganising entity's operations are not included in the cost of PPE.

6. Subsequent Costs



Repair and maintenance

Recognised in profit or loss as incurred.

Replacement of parts of PPE

Parts of some items of PPE may require replacement at regular intervals.

The carrying amount of those parts that are replaced should be derecognised.

If the efficiency of the asset increases by replacing parts then it should be capitalized.

Entity should capitalise the cost of replacement as a component of PPE and depreciate such cost over its useful life.

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Major Inspections or overhauls

A condition of continuing to operate an item of property, plant, and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced.

> When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant, and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection is derecognised.

The inspection costs are recognised irrespective of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed.

If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.
Capitalized as follows

WDV of asset	xxx
+ Cost of new part	xxx
- WDV of old part	xxx
Revised WDV	xxx

7. Deferred credit period

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date.
The difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with AS 16 (Borrowing cost)

8. Depreciation

The depreciable amount of an asset should be allocated on a systematic basis over its useful life.

Historical cost/ Revalued Amount	xxx
Less: Estimated residual value	xxx
Depreciable Amount	xxx

The depreciation charge for each period should be recognised in the statement of profit and loss unless it is included in the carrying amount of another asset.

Commencement of Depreciation	**When the asset is available to use.** i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management.
Cessation of Depreciation	**Ceases at the earliest of** (a) Asset is retired from active use and is held for disposal

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	(b) Date that the asset is derecognised.

Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated.

Component Accounting for depreciation

- An asset may consist of different and significant physical components. If an item of PPE comprises two or more significant components, with substantially different useful lives, usage, or flow of economic benefits, then each component should be recognised and depreciated separately over its individual useful life.
- When a significant component is replaced or restored, the old component is derecognised, and the cost of the new component is capitalised.

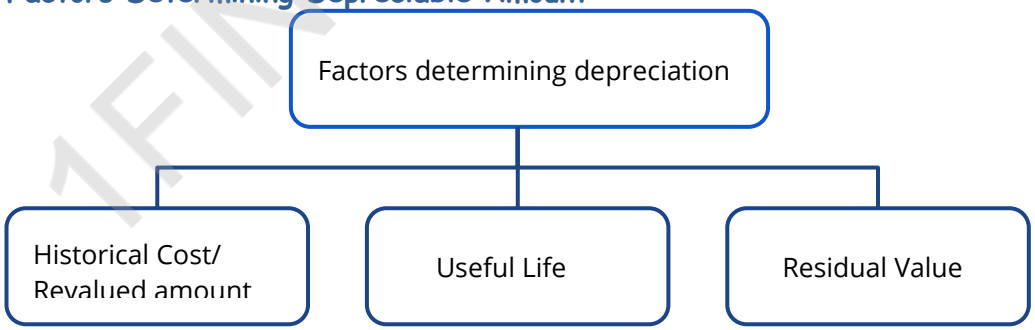
Land and buildings are separable assets and are accounted for separately, even when they are acquired together.

- If the cost of land includes the costs of site dismantlement, removal, and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs.
- A combination of more than one depreciation method is sometimes used depending upon type, nature of circumstances for significant parts one PPE.

For Example: Entity can follow WDV method for aircraft engine whereas SLM for aircraft body.

In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

Factors Determining Depreciable Amount



Depreciable amount is determined based on the following three factors

(a) Historical cost/ Revalued Amount

(b) Expected useful life of the depreciable asset.

(c) Estimated residual value of the depreciable asset.

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Useful life of an asset -

Useful life is

(a) the period over which an asset is expected to be available for use by an entity

(b) the number of production or similar units expected to be obtained from the asset by an entity.

The following factors are considered in determining the useful life of an as

- Expected usage of the asset.
- Expected physical wear and tear (Depends on operational factors)
- Technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.
- Legal or similar limits on the use of the asset.

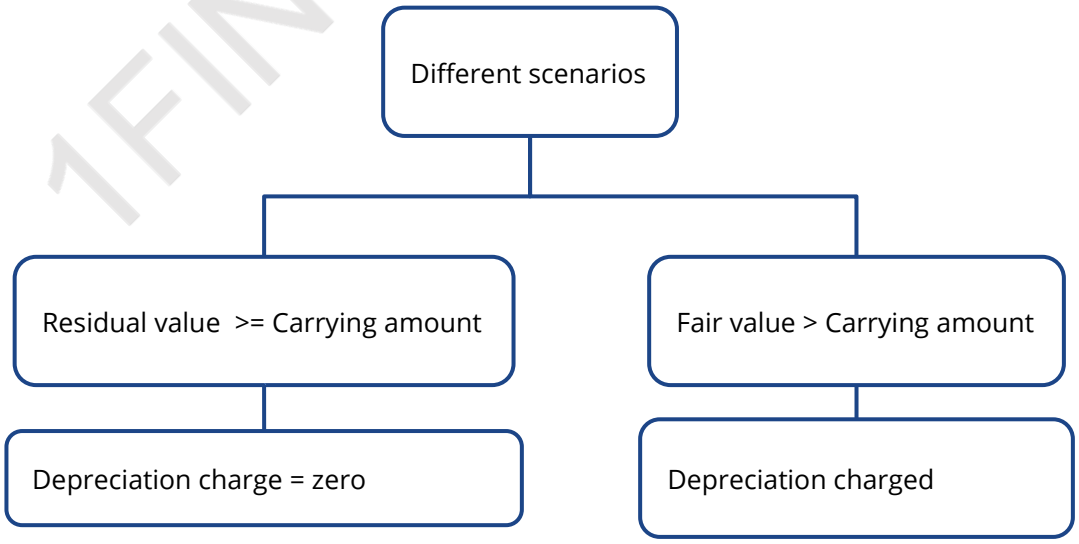
> The useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets

Residual Value

It is an estimated amount, which can be recovered from the asset at the end of its useful life. Residual value is a current estimate based on similar assets which would have reached the end of their useful life.

The estimation is made by the management at the time of acquisition. If the estimated residual value is insignificant, the value is considered as NIL.

> The residual value and the useful life should be reviewed at least at the end of financial year. Any change from expectations should be accounted for as a change in an accounting estimate in accordance with AS 5.
>
> The remaining depreciable amount should be depreciated over the remaining revised useful life.



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Depreciation

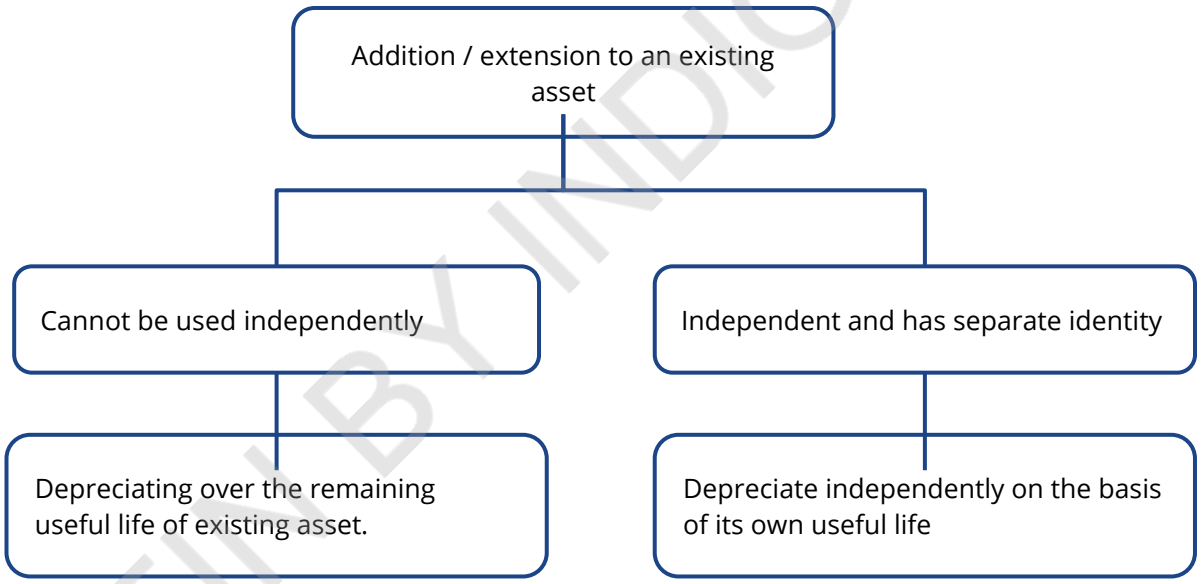
The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

For Example:

Straight line depreciation	Constant charge over the useful life
Diminishing Balance Method	Decreasing charge over the useful life
Units of Production method	Charged based on expected use or output

- The management should consider true & fair view, prudence, substance over form and materiality while selecting depreciation method.
- Depreciation charge can be zero if the entity follows number of units production basis for depreciation and if no production happens in a particular year. (But needs to test for impairment as per AS 28)
- Depreciation method should not be based on ratio of revenue as revenue generated depends upon demand, supply, inflation, sales volume, and prices

Depreciation of an addition/ extension to an existing PPE



Changes in Existing Decommissioning Restoration & Similar Liabilities

The following events change the measurement of an existing decommissioning, restoration or similar liability should be accounted for:

a. A change in the estimated outflow of resources embodying economic benefits required to settle the obligation
b. A change in the current market-based discount rate
c. An increase that reflects the passage of time (unwinding of the discount)

If related asset is measured using cost model:

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i. Changes in liability shall be added to or deducted from the cost of the asset in the current period and related provision is adjusted accordingly.
ii. Decrease in liability cannot exceed the carrying amount of the asset.

> If Decrease in Liability > Carrying Amount, excess is recognised as income

iii. If changes in liability results in addition to the cost of PPE, 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, test for impairment as per AS 28 and account for impairment loss.

If related asset is measured using Revaluation model:

i. Any increase in liability is adjusted against revaluation surplus (to the extent of balance available). Any excess is recognised in the statement of profit and loss
ii. Any decrease in liability is recognised in the revaluation reserve. If any revaluation deficit is charged to profit and loss in the prior periods, to that extent, it is recognised as income in the statement of profit and loss.

> If Decrease in Liability > Carrying Amount, excess is recognised as income in the statement of profit and loss

iii. Any change in liability would require the asset to be tested for impairment to ascertain if there is any change in fair value.

Common points for both cost and revaluation model:

The adjusted depreciable amount of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability shall be recognised in profit or loss as they occur.

The periodic unwinding of the discount shall be recognised in profit or loss as a finance cost, as it occurs. Capitalisation under AS 16 is not permitted.

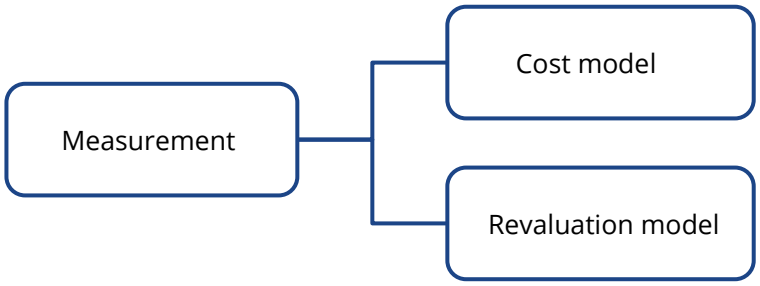
9. Impairment

Entity must calculate the recoverable amount in accordance with AS 28. Impairment means a type of loss which is recognised. Don't worry you will learn about it in detail in AS 28!

Compensation from third parties for items of PPE that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.

10. Measurement After recognition

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Cost Model

Initial Cost	xxx
(-) Accumulated Depreciation	xxx
(-) Accumulated Impairment Loss	xxx
Carrying Amount	**xxx**

Revaluation Model

Fair Value at the date of revaluation	xxx
(-) Subsequent Accumulated Depreciation	xxx
(-) Subsequent Accumulated Impairment Loss	xxx
Carrying Amount	**xxx**

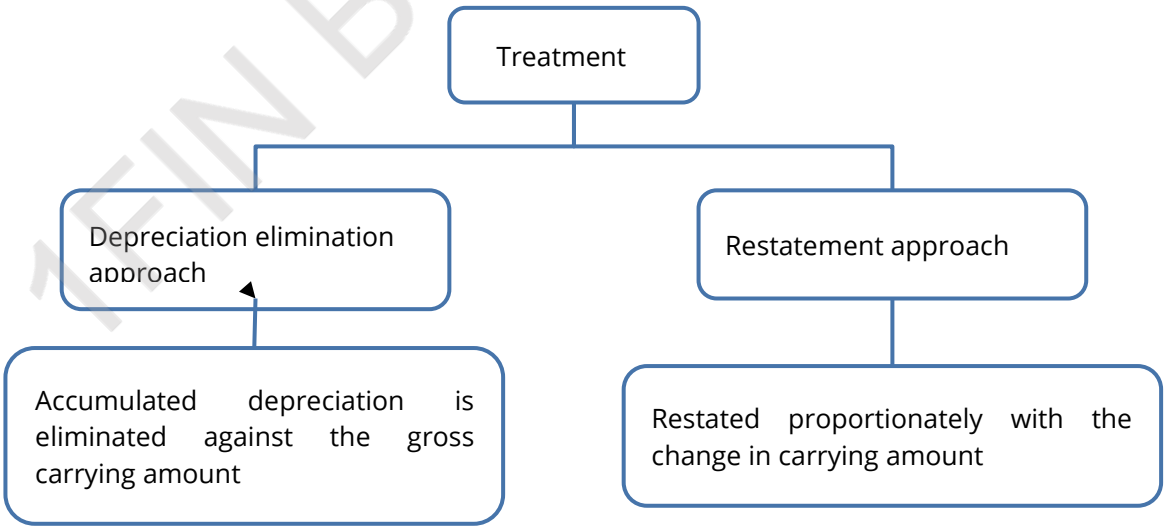
Revaluations are required to be carried out with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

Frequency of revaluations

The frequency of revaluations depends upon the changes in fair values of the items of property Plant and equipment being revalued.

If PPE experiences significant and volatile changes in fair value, there must be annual revaluation. Otherwise, it may be necessary to revalue the item only every three or five years.

Accumulated Depreciation at the date of revaluation



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Restatement approach is used when an asset is revalued by means of applying an index to determine depreciated replacement cost

Limit on Revalued Amount -

The revalued amount should not be more than the recoverable amount (AS 28)

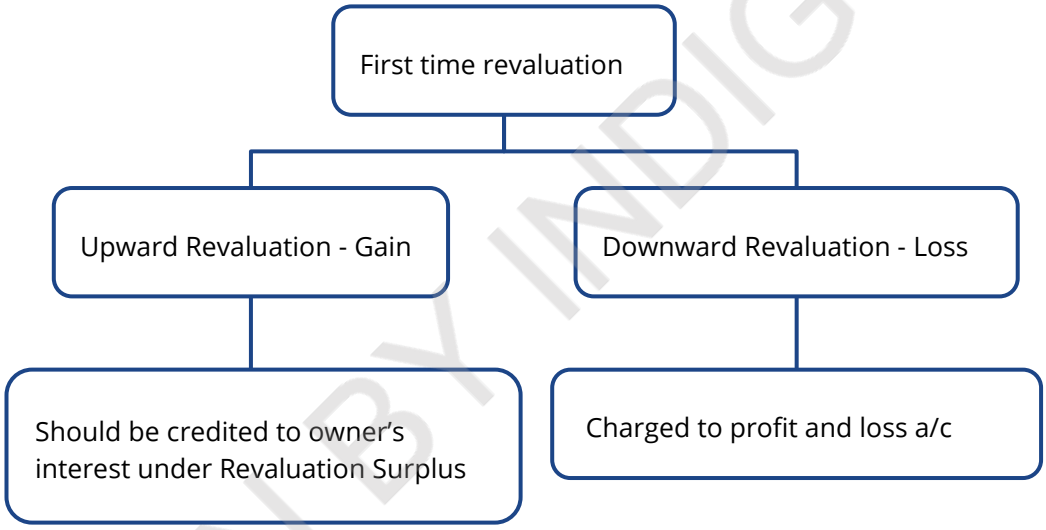
Revaluation to be made for the entire class of assets - Revaluation should be performed for an entire class of PPE.

For Example: If the entity takes a decision to revalue its buildings, it should revalue all the buildings of the entity. i.e., revaluation of selective assets within a class is not permitted.

The entity can divide the PPE into classes based on the nature of items such as land, land and buildings, machinery, ships, aircraft, motor vehicles, furniture and fixtures, office equipment, bearer plants.

Class of assets (Building)	**Valuation model**
2 Office buildings	Cost model
5 Factory buildings	Revaluation model

First Time Revaluation:

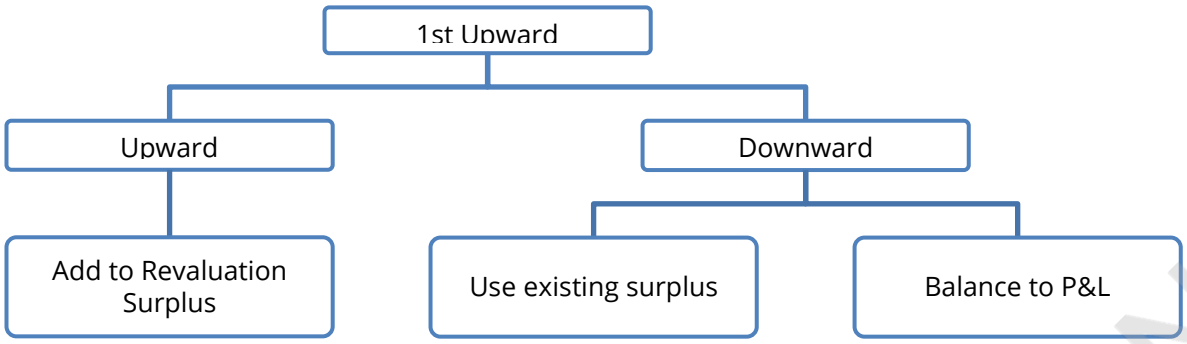


Upward Revaluation	PPE A/c To Revaluation Surplus A/c	**Dr**
Downward Revaluation	Profit & Loss A/c To PPE A/c	**Dr**

Subsequent Revaluation:

(a) If first time is upward revaluation

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Subsequent upward revaluation

Further increase should be credited directly to owner's interests under the heading revaluation surplus

PPE A/c **Dr**

To Revaluation Surplus A/c

Subsequent downward revaluation

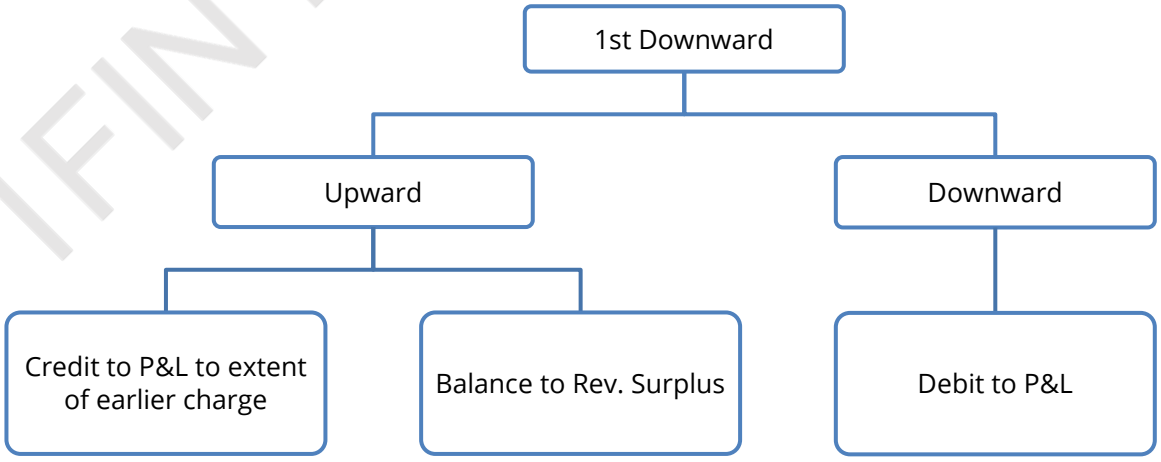
Utilise the available revaluation surplus and remaining balance should be charged to the statement of profit and loss.

Revaluation Surplus A/c **Dr**

Statement of Profit & Loss A/c **Dr** (Balancing Figure)

To PPE A/c

(a) If first time is downward revaluation



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Subsequent downward revaluation

Further decrease should be transferred to the statement of profit and loss.

Profit and Loss A/c **Dr**

To PPE A/c

Subsequent upward revaluation

Credit the statement of profit and loss to the extent it was charged in earlier revaluation and the remaining balance should be accumulated in equity under revaluation surplus.

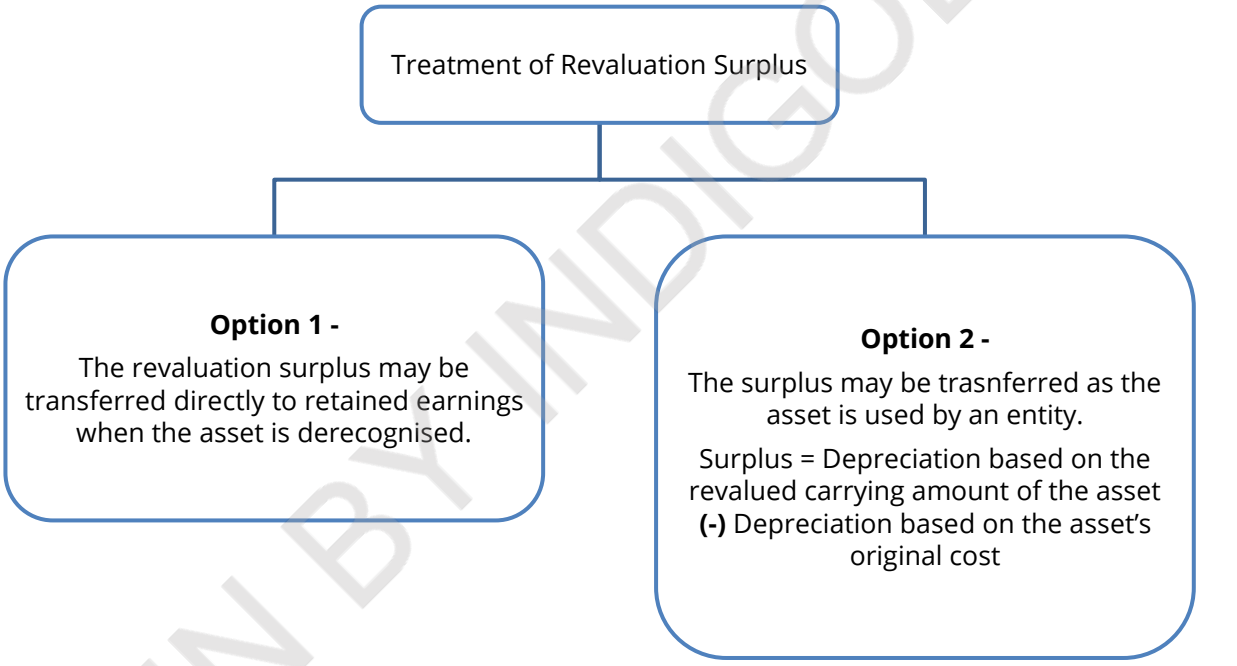
PPE A/c **Dr**

To Profit & Loss A/c (To the extent charged earlier)

To Revaluation surplus (balancing Figure)

The effects of taxes on revaluation are recognised and disclosed as per AS 22

Treatment of Revaluation Surplus:



Transfers from revaluation surplus to retained earnings are not made through profit or loss.

11. Derecognition

The carrying amount of an item of property, plant and equipment should be derecognised

(a) on disposal

(b) When no future economic benefits are expected from its use or disposal.

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The gain or loss arising from the derecognition of an item of property, plant and equipment is included in profit or loss when the item is derecognised.

Transfers from revaluation surplus to general reserve should not be made through statement of profit and loss.

> Gain/Loss from derecognition of PPE = Net disposal proceeds – Carrying Amount.Gains shall not be classified as revenue.

In determining the date of disposal of an item of PPE, an entity applies the criteria in AS 9 for recognising revenue from the sale of goods.

12. Disclosure

The financial statements should disclose, for each class of property, plant and equipment:

(a) the measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount
(b) the depreciation methods used
(c) the useful lives or the depreciation rates used. In case the useful lives or the depreciation rates used are different from those specified in the statute governing the enterprise, it should make a specific mention of that fact
(d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period
(e) a reconciliation of the carrying amount at the beginning and end of the period showing additions:
    - assets retired from active use and held for disposal
    - acquisitions through business combinations
    - increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in revaluation surplus in accordance with AS 28
    - impairment losses recognised in the statement of P&L in accordance with AS 28
    - impairment losses reversed in the statement of P&L in accordance with AS 28
    - depreciation
    - the net exchange differences arising on the translation of the financial statements of a non-integral foreign operation in accordance with AS 11, The Effects of Changes in Foreign Exchange Rates
    - other changes.

The financial statements should also disclose:

(a) the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities
(b) the amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction
(c) the amount of contractual commitments for the acquisition of property, plant and equipment
(d) if it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss
(e) the amount of assets retired from active use and held for disposal.

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If items of property, plant and equipment are stated at revalued amounts, the following should be disclosed

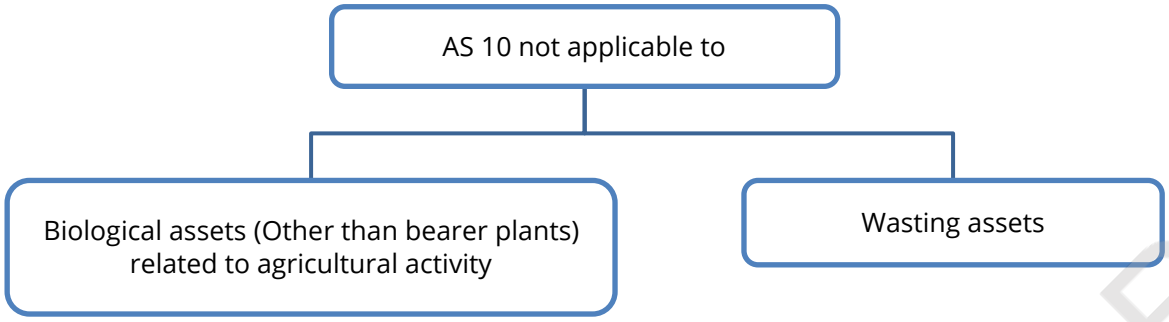
(a) the effective date of the revaluation
(b) whether an independent valuer was involved
(c) the methods and significant assumptions applied in estimating fair values of the items
(d) the extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques
(e) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.
(f) Disclosure of the methods adopted and the estimated useful lives or depreciation rates.
(g) Disclosure as per AS 5, if applicable.
(h) Information on impaired PPE

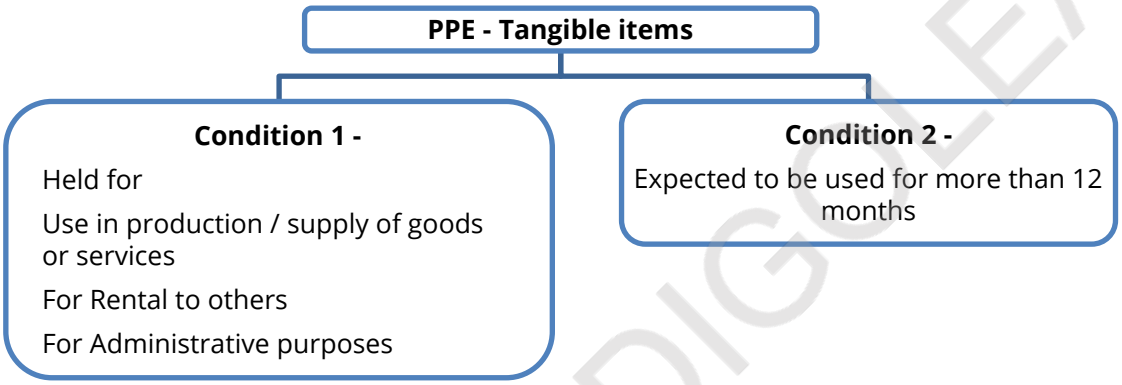
Voluntary disclosures :

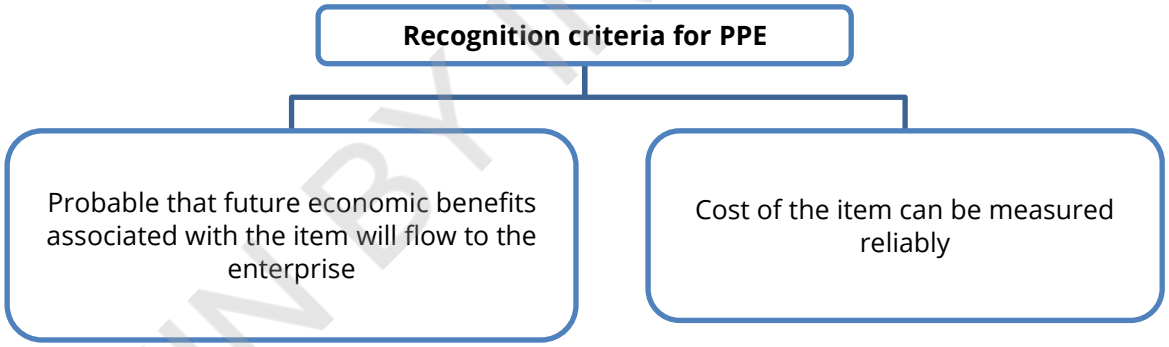
- Carrying amount of temporarily idle property, plant and equipment.
- Gross carrying amount of any fully depreciated PPE that is still in use.
- For each revalued class of PPE, the carrying amount that would have been recognised had the assets been carried under the cost model.
- The carrying amount of PPE retired from active use and not held for disposal.

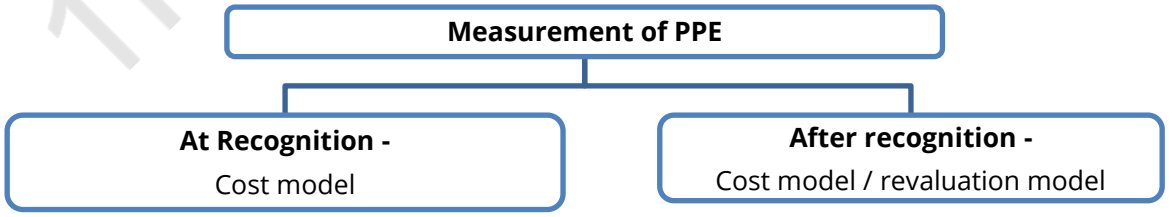
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16. Summary

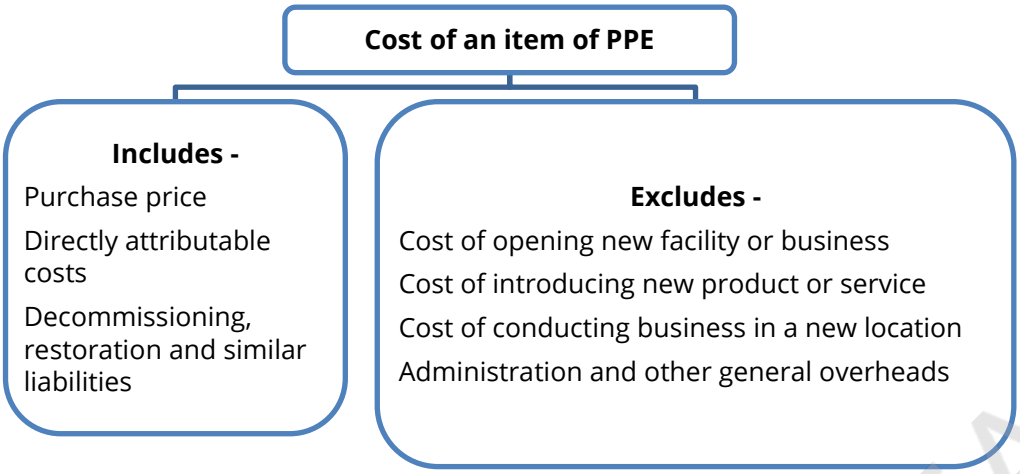








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Revaluation	Upward	Downward
First	Revaluation Surplus	P&L
Subsequent Reversal Balance	Amt Dr to P&L earlier -> Cr P&L Revaluation Surplus	Amt Cr.to Rev Surplus -> Dr. Rev surplus P&L

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 remodelling cost will be capitalised or not.

Solution

The cost of an item of PPE should be recognised 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 capitalised.

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 recognised in the carrying amount of the item of PPE 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.

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Derecognition 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 capitalised 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 reorganising operations of the company and are not necessary for bringing 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 reorganising operations of the company and do not meet the requirement of AS 10 (Revised) and therefore, cannot be capitalised.

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 remodelling 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?

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

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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 capitalised. 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 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 for another asset and the transaction has a commercial substance, the PPE acquired is measured at fair value.

The plant and machinery acquired in this case will be measured at Rs. 25,00,000.

**The value of land realised 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 for 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 industrial zones, whereas the office buildings are in central business districts of the cities. Entity A's management wants to apply the revaluation model as per AS 10 (Revised) to the subsequent

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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 a 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.
- 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 capitalised 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 reviewed the estimated life and decided that the asset will probably be useful for a further 4 years. Calculate the amount of depreciation for each year, if the company charges depreciation on a Straight Line basis.

Solution

Particulars	Amount in ₹
Depreciation for years 1-4	10,000*4 = 40,000
WDV at beginning of year 5	1,00,000 - 40,000 = 60,000
Balance useful life	4 years
Depreciation for balance useful life	60,000/4 = 15,000 per year

Illustration 11

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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 the entity should 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 was 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	Amount
Cost of Property	Rs. 10,00,000
Less : Estimated Salvage Value	Rs. 10,00,000
Depreciable Amount	Nil
Depreciation	Nil

Case b	Amount
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 = Rs. 5000

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 derecognition 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.

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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:

s.n	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 capitalised 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 capitalised at their present values. Initial operating losses do not form part of the cost of property, plant and equipment.

s.no	Particulars	capitalization	Amount in ₹
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
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 capitalised		**43,00,000**

Interest charges paid to suppliers will not be capitalised unless the asset is a qualifying asset as defined by AS-16.

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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.

Solution

Particulars	Debit(₹)	Credit (₹)
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 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	Amount in ₹
Depreciable amount	2,00,000 - 20,000 = 1,80,000
Annual depreciation	1,80,000/ 10 = 18,000
Total depreciation	1,44,000
Carrying amount of an asset at the end of 8 years	2,00,000 - 1,44,000 = 56,000
Asset can be used for 4 more years - revised depreciation	(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

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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 Rs.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.

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

As per AS 10 , certain items of PPE qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets and such assets are depreciated over the period.

The total volume of gas must be virtually split into

(i) Gas held for sale, (related assets)

(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 as PPE under AS 10 and depreciated over the period the cave is expected to be used.

Illustration 19

An entity operates an oil refining plant. For the refining process to take place, the plant must contain a certain minimum quantity of oil. This can only be taken out once the plant is abandoned and would then be polluted to such an extent that the plant's value is significantly reduced. Evaluate whether AS 10 would apply or AS 2?

Solution

As per AS 10 , certain items of PPE qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets and such assets are depreciated over the period.

The portion of oil which remains in the plant should be treated as per AS 10. It should be accounted as PPE under AS - 10 and depreciated over a period .

Illustration 20

In the year 2016-17, an entity acquired a new freehold building with a useful life of 50 years for Rs. 90,00,000. The entity desires to calculate the depreciation charge per annum using a straight-line method. It has identified the following components (with no residual value of lifts & fixtures at the end of their useful life) as follows

Component	Useful life (Years)	Cost (₹)
Land	Infinite	20,00,000
Roof	25	10,00,000
Lifts	20	5,00,000

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Fixtures	10	5,00,000
Remainder of building	50	50,00,000
		90,00,000

Calculate depreciation for the year 2016-17 as per componentization method.

Solution

Component	**Useful life (Years)**	**Cost (₹)**	**Depreciation (₹) = cost / useful life**
Land (non - depreciable)	Infinite	20,00,000	-
Roof	25	10,00,000	40,000
Lifts	20	5,00,000	25,000
Fixtures	10	5,00,000	50,000
Remainder of building	50	50,00,000	1,00,000
			2,15,000

Amount of depreciation for the year 2016-17 is Rs.2,15,000

Illustration 21

Shrishti Ltd. contracted with a supplier to purchase machinery which is to be installed in its Department A in three months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were Rs. 1,41,870. These activities were supervised by a technician during the entire period, who is employed for this purpose of Rs.45,000 per month. The technician's services were given by Department B to Department A, which billed the services at Rs. 49,500 per month after adding 10% profit margin.

The machine was purchased at (Rs.1,58,34,000 inclusive of IGST @12% for which input credit is available to Shrishti Ltd. Rs. 55,770 transportation charges were incurred to bring the machine to the factory site. An Architect was appointed at a fee of Rs.30,000 to supervise machinery installation at the factory site.

Also, payment under the invoice was due in 5 months. However, the Company made the payment in the 3rd month. The company operates on Bank Overdraft @ 14% p.a.

Ascertain the amount at which the Machinery should be capitalised under AS 10.

Solution

As per AS-10 , All Costs incidental to bring the asset to its present form, location and condition should be capitalised including the cost to dismantle the asset at a future date .

S.n	**Particulars**	**Calculations**	**Cost (₹)**
1.	Site preparation	Given	1,41,870
2.	Supervisor's salary	Rs. 45,000 * 3 months	1,35,000
3.	Purchase price (excluding adjustable taxes)	1,58,34,000 * 100/112	1,41,37,500
4.	Transportation	Given	55,770
5.	Architect's fees	Given	30,000
			1,45,00,140

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Machinery is to be capitalised at Rs. 1,45,00,140 as per AS 10

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AS 19 - Leases

1 Introduction

1.1 Objective

The objective of AS 19 is to prescribe

- appropriate accounting policies, and
- disclosures

in relation to finance leases and operating leases for lessees and lessors.

1.2 Scope

Exclusions from the AS:

a) Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals, and other metal rights; and
b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents, and copyrights; and
c) lease agreements to use lands

Condition for Exclusions contracts for services that do not transfer the rights to use assets from one contracting party to the other.

1.3 Definitions:

1.3.1 *Lease*

A lease is **an agreement** whereby lessor (who gives asset on lease) conveys to the lessee (who takes asset on lease) in return for a payment or series of periodic payments (lease rents), the **right to use an asset** for an agreed period of time.

1.3.2 *Inception of lease*

The inception of the lease is **the earlier** of the **date of the lease agreement** and **the date of commitment by the parties** to the principal provisions of the lease.

1.3.3 *Lease term*

The lease term is the **non-cancellable period** for which the lessee has agreed to take **on lease the asset** together with any further periods for which the lessee has option to continue the lease of the asset, with or without any further payment.

1.3.4 *Minimum lease payments (MLP)*

Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding

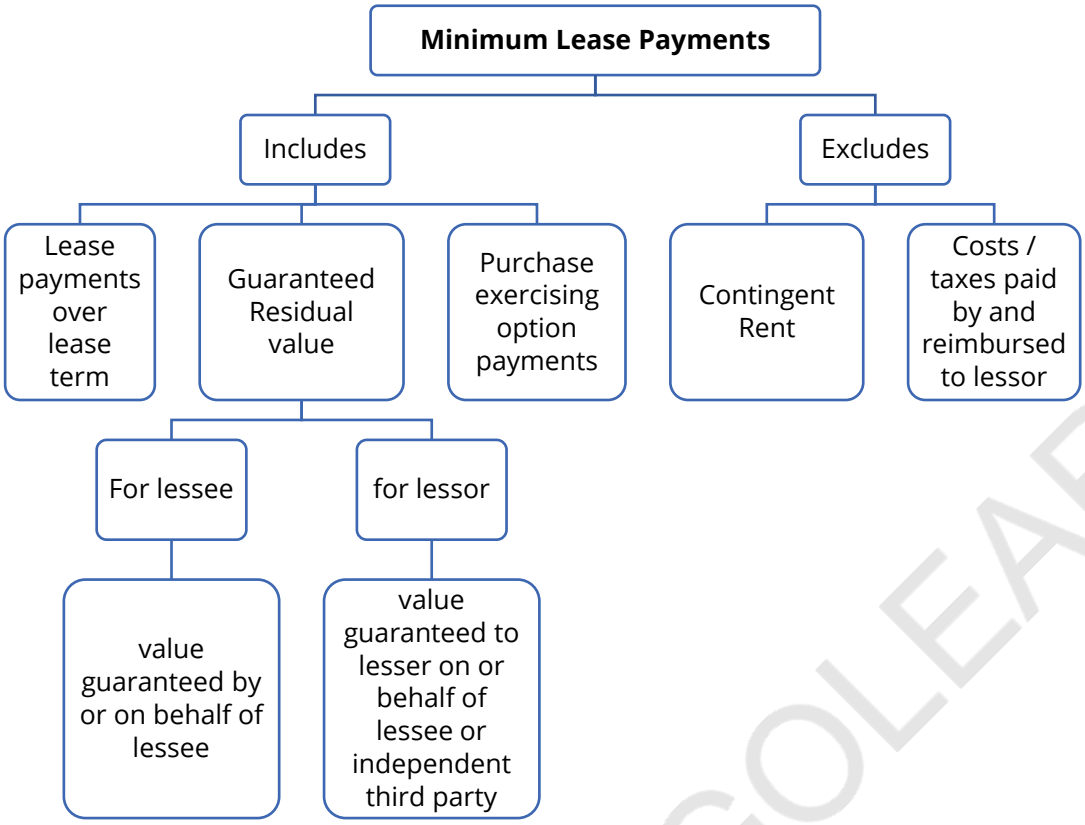
- contingent rent,
- costs for services and taxes to be paid by and reimbursed to the lessor,

together with:

a) in the case of **the lessee**, any residual value guaranteed by or on behalf of the lessee; or
b) in the case of **the lessor**, any residual value guaranteed to the lessor:
   i. by or on behalf of the lessee; or
   ii. by an **independent third party** financially capable of meeting this guarantee.

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Minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise the purchase option, in case the option to exercise is certain at inception.



1.3.5 *Economic Life / Useful Life*

a) the period over which an asset is expected to be **economically usable** by one or more users.
or
b) the **number of production** or similar **units expected** to be **obtained** from the asset by one or more users.

1.3.6 *Residual Value*

Residual value = **estimated fair value** of the asset at the end of the lease term.

1.3.7 *Guaranteed residual value*:

i. For **lessee**, that part of the residual value which is guaranteed (maximum amount that could become payable) by

- the lessee or
- a party on behalf of the lessee; and

ii. For **lessor**, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

1.3.8 *Unguaranteed residual value* of a leased asset is the amount by which the residual value of the asset **exceeds** its guaranteed residual value.

1.3.9 *Gross investment in the lease* is the aggregate of the **minimum lease payments** under a finance lease from the standpoint of the lessor and any **unguaranteed residual value** accruing to the lessor.

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1.3.10 *Unearned finance income* is the **difference** between:

a. the **gross investment** in the lease; and
b. the present value of:
   i. the **minimum lease payments** under a finance lease from the standpoint of the **lessor**; and
   ii. any **unguaranteed residual value** accruing to the **lessor**, at the interest rate implicit in the lease.

1.3.11 *Net investment in the lease* is the gross investment in the lease less unearned finance income.

Net Investment = PV of gross investment.

1.3.12 *The Interest rate implicit in the lease* the **discount rate** that, at the **inception of the lease**, causes the aggregate present value of:

a) the minimum lease payments under a finance lease from the standpoint of the lessor; and
b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

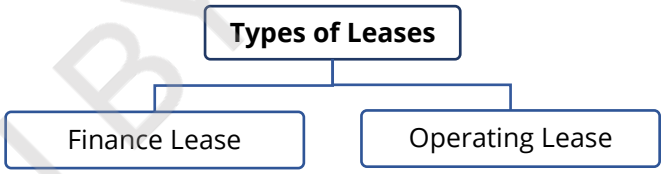
Implicit rate is always calculated from the point of view of lessor.

1.3.13 *The lessee's incremental borrowing rate of interest* is the **rate of interest the lessee** would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a **similar security**, the funds necessary to purchase the asset.

2 Types of Leases

The classification of leases adopted in AS 19 is based on the extent to which risks and rewards incident to ownership of a leased asset lie with

- the lessor or
- the lessee.



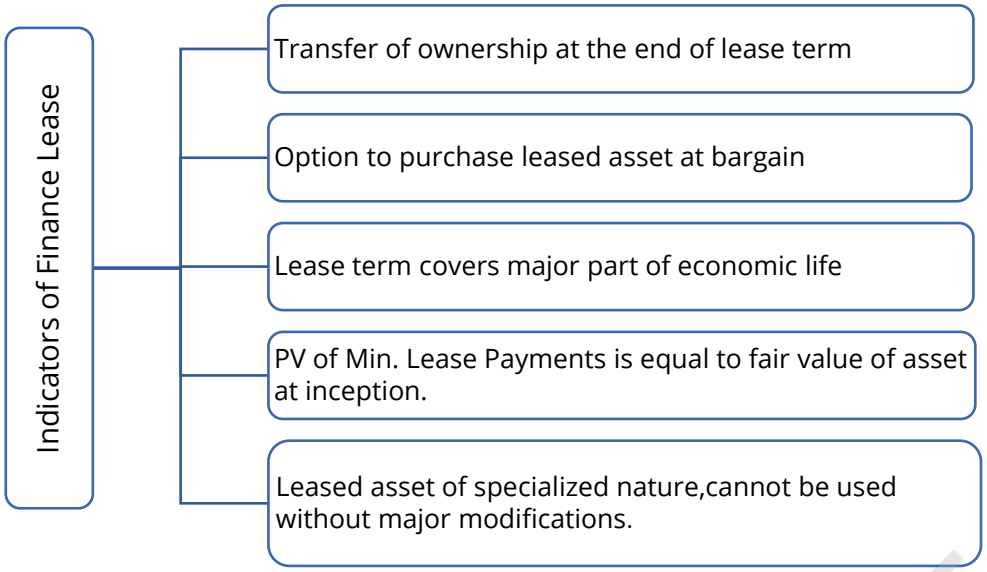
Finance lease: When a lease transfers substantially all the **risks and rewards** incidental to ownership of an asset. Transfer of title of an asset is not the relevant criterion.

Operating Lease: A lease is classified as an operating lease if it **does not** transfer substantially all the risk and reward incident to ownership i.e., Lease other than finance lease is operating lease.

Whether a lease is a finance lease or an operating lease **depends on the substance of the transaction rather than its Legal form.**

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Indicators of finance lease:



If any of the above condition gets satisfied, then the lease would be classified as finance lease.

Additional indicators which would lead to lease being classified as finance lease are:

- Lessee cancels the lease and the lessor's losses associated with the cancellation are **borne by the lessee**.
- Gains or losses from the fluctuation in the fair value of the residual fall to the **lessee**; and
- Lessee can continue the lease for a secondary period at a rent which is substantially **lower than market rent**.

If the parties agree to change the provision of the lease in such a way which results in different classification of the lease, if the changed terms been in effect at the inception of the lease, then the revised agreement is considered as new agreement with revised terms.

Lease classification is made at the **inception of the lease.**

Changes in estimates (estimate of residual value or economic life) or changes in circumstances do not give rise to a new classification of a lease for accounting purpose.

3 Accounting for Finance Lease

3.1 In the books of lessor

- Recognise **asset under a finance lease in its balance sheet** as a receivable at an amount **equal to the net investment** in the lease.
- Gross Investment in lease (GIL) = Minimum Lease Payments (MLP) + Unguaranteed Residual value (URV)

MLP = Lease Rentals + Guaranteed Residual Value

Net Investment in Lease (NIL) = GIL- Unearned Finance Income.
Or Net Investment is simply the Present Value of Gross Investment.

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Unearned Finance Income (UFI) = GIL- (PV Of MLP + PV Of UGR
Or UFI = GIL-NIL

Recognition of **finance income** should be based on a pattern reflecting a **constant periodic rate of return on the net investment** of the lessor **outstanding** in respect of the finance lease.

- The Unearned finance income is recognised **over the lease term** on a systematic basis.
- **Recognise the transaction of sale in the statement of profit and loss** for the period as per sales policy. If low interest rates are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged
- The initial direct costs such as commission or legal fees are recognised immediately in **the statement of P&L** or allocated **against the finance income** over the lease term.

The standard requires lessor **to review URV** used in computing the gross investment in lease **regularly**.

Disclosures to be made by lessor:

a) A **reconciliation** between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date.
b) The **total gross investment** in the lease and the **PV of MLP** receivable at the balance sheet date, for each of the following periods:
    - Not later than one year **(≤ 1 yr)** .
    - Later than one year and not later than five years **(1yr to 5yrs)**.
    - Later than five years. **(>5 yrs)**
c) **Unearned Finance Income**,
d) The **unguaranteed residual value** (URV) accruing to the benefit of the lessor.
e) The **accumulated provision for uncollectible MLPs**,
f) **Contingent rents** recognised in the statement of P&L for the period,
g) **General description** of the significant leasing arrangements of the lessor and
h) **Accounting policy** adopted in respect of **initial direct costs**.

3.2 In the books of lessee

- At the inception of the lease, lessee should record the asset at a value which is **lower of**:
    - **Fair value** of the leased asset at the inception of the lease.
    - **PV of MLP**

Discount rate is the interest rate implicit in the lease (from lessor point of view) or incremental borrowing rate if implicit rate is not known.

- Lease payments to be apportioned between **finance charge**(interest) and the reduction of **outstanding liability**(principal).
- Finance charges to be allocated to periods during the lease term to produce a constant rate of interest on the remaining balance of liability.
- A finance lease gives rise to depreciable expense for the asset as well as finance expense for each accounting period. The **depreciation policy** should be **consistent** for depreciable assets and depreciation should be **calculated based on AS 10**, Property, Plant & Equipment.

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- If there is no reasonable certainty that lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.
  - **Initial direct costs** which are directly attributable to activities performed by the lessee for finance lease are to be **included as part of amount** recognised as an asset.
  - The liability for a leased asset should be **presented separately in the balance sheet as a current liability or a long-term liability** as the case may be.
  - Enterprise should apply AS 28 Impairment of Assets on the leased asset to check impairment and determine recoverable amount.

Journal Entries in the books of Lessee will be:

1. Asset A/c ……Dr
   To Lessor A/c ……
(Being recognition of asset at lower of FV and PV of MLP from the standpoint of lessee)

2. Finance Charge A/c ……Dr
   To Lessor A/c ……
(Being Finance Charge due for the 1st year)

3. Lessor A/c …… Dr
   To Bank A/c ……
(Being payment of lease rent for the year)

4. P & L A/c ……Dr
   To Finance Charge ……
(Being recognition of Finance Charge as expense for the year)

Interest schedule

Year	Opening Bal	Interest @ implicit rate	Lease payments	Closing Balance
	A	B = A x Rate	C	D = A + B - C
Inception	Lower of FV or PV of MLP	Charged to P&L	Reduction from Lease liability	Liability shown in Balance sheet

Disclosures to be made by lessee:

a) Assets acquired under finance lease to be **segregated from the assets owned**.
b) **Net carrying amount** at balance sheet date for each class of assets.
c) a **reconciliation between the total MLPs** at the balance sheet date and their **present value**.
d) **Total MLP** at the balance sheet date, and their present value, for each of the following periods:
   - Not later than one year **(≤ 1 yr)** .
   - Later than one year and not later than five years **(1yr to 5yrs)**.
   - Later than five years. **(>5 yrs)**
e) **Contingent rents** recognised as expense in the statement of P&L,
f) The **total of future minimum subsequent payments** expected to be received under the non-cancellable sub leases at the balance sheet date.

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g) General description of the lessee's significant leasing arrangements including but not limited to the following:
- The basis on which contingent rent payments are determined,
- The existence and terms of renewal or purchase options and escalation clauses and
- Restrictions imposed by the lease arrangements, such as those concerning dividends, additional debts, and further leasing.

4 Accounting for Operating Lease

4.1 In the books of lessor:

- Asset given under operating lease should be shown as fixed asset In its balance sheet.
- Lease Income should be recognised in the statement of P&L on a **straight line basis over the lease term**, unless another systematic basis is more representative of the period in which benefit is derived.
- Depreciation should be recognised as per the depreciation policy of the lessor for similar assets, and it should be calculated based on AS 10.

Journal Entries in the books of lessor will be :

1) Asset A/c .....Dr
To Lessee A/c.....
(Being asset given in operating lease brought into books)

2) Lessee A/c .....Dr
To Lease Equalization A/c
To Lease Rent
(Being lease rent due for the year)

> The difference between lease rent due and lease rent recognised can be credited to Lease equalization Account.
>
> Since lease rent due and lease rent recognised must be same, the lease equalization account will be closed in terminal year.

3) Bank A/c .....Dr
To Lessee A/c
(Being receipt of lease rent for the year)

4) Lease Rent .....Dr
To P&L A/c
(Being recognition of lease rent as income for the year)

5) Depreciation A/c .....Dr
To Asset A/c
(Being depreciation for the year)

6) P&L A/c .....Dr
To Depreciation A/c

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(Being depreciation for the year transferred to P&L A/c)

Disclosures to be made by Lessor:

a) For **each class of assets**,
- the **gross carrying amount**,
- **the accumulated depreciation** and accumulated **impairment losses** at the balance sheet date; and
- **depreciation recognised** in the statement of P&L for the period,
- **Impairment losses recognised and reversed** in the statement of P&L for the period.

b) the **future MLP** under non-cancellable operating lease in the aggregate and for each of the following periods:
- Not later than one year **(≤ 1 yr)** .
- Later than one year and not later than five years **(1yr to 5yrs)**.
- Later than five years. **(>5 yrs)**

c) **Total contingent rents** recognised as income in the statement of P&L for the period.
d) **General description** of the lessor's significant leasing arrangements,
e) **Accounting policy** adopted in respect of initial indirect costs.

4.2 In the books of lessee:

- Lease payments should be recognized in **the statement of P&L** on a **systematic basis** over the lease term.
- Lease payments may be made as to suit the payment capacity of the lessee.

Journal Entries:

1) Lease rent A/c ……Dr
Lease Equalization A/c……Dr
To lessor A/c
(Being lease rent due)

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2) Lessor A/c…….Dr
To Bank A/c
(Being payment of lease rent for the year)

---

3) P&L A/c …….Dr
To Lease rent A/c
(Being recognition of lease rent as expense for the year)

Disclosures to be made by lessee:

a) The **total of future MLP** under non-cancellable operating lease for each of the following periods:
- Not later than one year **(≤ 1 yr)** .
- Later than one year and not later than five years **(1yr to 5yrs)**.
- Later than five years. **(>5 yrs)**

b) The **total of future minimum sublease payments** expected to be received under non-cancellable subleases at balance sheet date.
c) **Lease payments recognised in the statement of P&L** for the period with separate amounts for MLP and contingent rents.
d) **Sub lease payments received and recognized** in the statement of P&L,

e) **General description** of the lessee's significant leasing arrangements including but not limited to, the following:

- The basis on which contingent rent payments are determined.
- The existence and terms of renewal or purchase options and escalation clauses; and
- Restrictions imposed by lease arrangements such as those concerning dividends, additional debt, and further leasing.

The **depreciation of leased assets** should be as per **AS 10**, Property, Plant and Equipment.

5 Sale and leaseback

- Sale and leaseback is a **financial transaction** that allows a person to lease an asset to himself after selling it to another party.
- Under such transaction, an asset previously owned by seller(lessee) is sold to someone else(lessor) at an agreed valuation and is leased back to the seller. The lessee gets cash immediately and is required to make periodic payments in the form of lease rents for right to use property.
- For example: Mr A sells its plant & Machinery to Mr B and then enters into an agreement with Mr B to lease back the plant- & machinery for a term of 3 years.
- The accounting treatment of sale & leaseback depends upon the type of lease involved.

- When sale & leaseback results in **finance lease**, the excess or deficiency of sale proceeds over the carrying amount should be **deferred over the lease term** in proportion to the depreciation of the leased asset.

- When sale & leaseback results in **operating lease**, there can be three possible scenarios.

Scenario 1: Sale Price =Fair Value

Treatment : Profit or loss should be recognised immediately.

Scenario 2: Sale price< Fair Value

Treatment : Profit or loss should be recognised immediately. However, if the loss is compensated by the future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which asset is expected to be used.

Scenario 3: Sale price> fair value

Treatment : The excess over the fair value should be deferred and amortised over the period for which asset is expected to be used.

Note: *Students are requested to refer Illustration 3 of the Module for the better understanding of the concept.*

6 Summary

- A lease is an **agreement** between lessor (owner) and lessee (user) where right to **use an asset** is given for **periodic payments** (lease rents) for an agreed period.
- **Two types of leases:** Finance lease and operating lease.
  A **finance lease** - substantial risk and rewards incidental to ownership gets transferred.

An **operating lease** is a lease other than finance lease

Finance Lease Treatment

In the books of Lessor

- Recognise lease receivable at Net Investment in Lease(PV of GIL).
- Recognise Finance Income over lease term on systemnatic basis.
- Initial Indirect cost can be tfd to P&L or adjusted against Finance Income over lease term.
- In case of manufacture or dealer lessor,transaction of sale should be recognised in the statement of P&L.

In the books of Lessee

- Recognise leased asset and leased liability
- Recognised at PV of MLP or Fair Value,whichever is lower.
- Apportion lease rent as Finance Charge (P&L) and as principal (reduction in O/S liability.
- Charge depreciation on leased asset as per AS 10.
- Initial Indirect cost to be added in cost of asset.

Disclosures in case of Finance Lease

In the books of Lessee

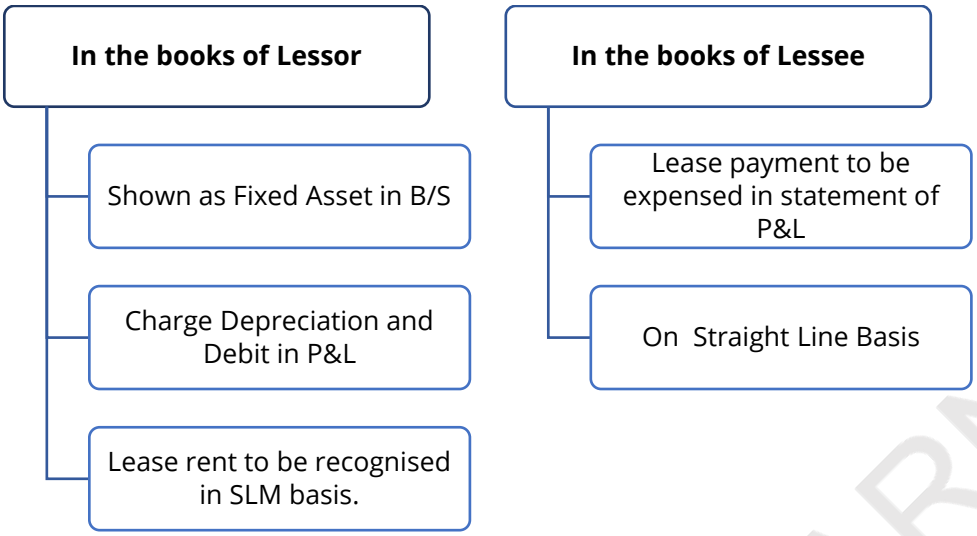
- Asset acquired to be segregated
- Net carrying amount for each class of assets.
- Reconciliation between total of MLP and thier PV at B/S date.
- Contingent rent recognised as expense
- Total of future MLP expected to be received.
- General description of lessee's significant leasing arrangements.

In the books of lessors

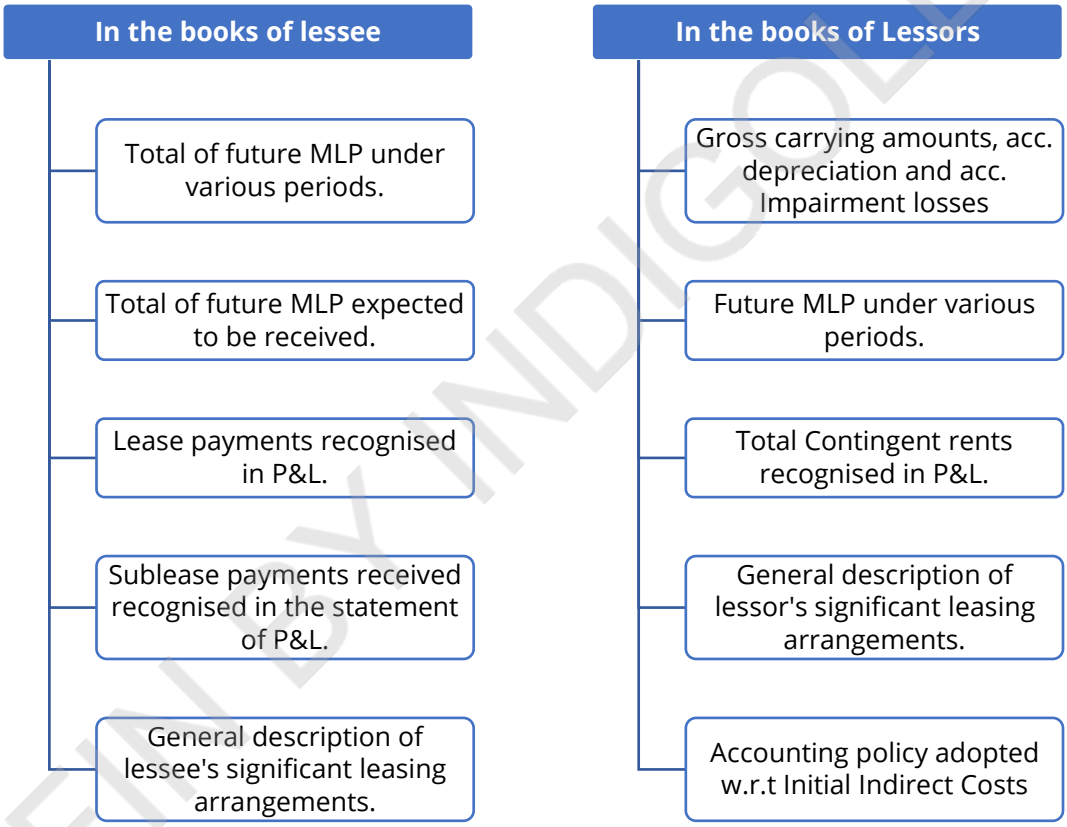
- Reconciliation b/w total gross investment and PV of MLP at B/S date.
- Unearned finance income.
- Ungurranteed residual value accruing to lessor.
- Accumulated provision for uncollectible MLP.
- Contingent rent recognised as expense.
- General description of lessor's significant leasing arrangements.
- Accounting policy adopted w.r.t initial indirect costs.

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Operating Lease Treatment



Operating Lease - Disclosures



Sale and leaseback: Financial transaction involving the sale of an asset by the vendor and the leasing of the same asset back to the vendor.

The seller or lessee receives cash immediately and makes periodic payments in the form of lease rents for right to use the asset.

The accounting treatment of a sale and leaseback depends upon the type of lease involved.

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7 Illustrations

1. Illustration

X Ltd. sold JCB Machine having WDV of Rs.20 Lakhs to Y Ltd. for Rs.24 Lakhs and the same JCB was leased back of Y Ltd to X Ltd. The lease is operating lease.

Comment according to relevant Accounting Standard if

(i) Sale price of Rs.24 Lakhs is equal to fair value
(ii) Fair Value is Rs. 20 Lakhs and sale price is Rs. 24 Lakhs.
(iii) Fair value is Rs. 22 Lakhs and sale price is Rs. 25 Lakhs.
(iv) Fair value is Rs. 25 Lakhs and sale price is Rs. 18 Lakhs
(v) Fair value is Rs. 18 Lakhs and sale price is Rs. 19 Lakhs

Answer:

Following will be the treatment in the given cases:

(i) When sale price of Rs.24 lakhs is equal to fair value, A Ltd. should immediately recognize the profit of Rs.4 lakhs (i.e. 24 – 20) in its books.

(ii) When fair value is Rs.20 lakhs & sale price is Rs. 24 lakhs then profit of Rs.4 lakhs is to be deferred and amortized over the lease period.

(iii) When fair value is Rs.22 lakhs & sale price is Rs.25 lakhs, profit of Rs.2 lakhs (22 - 20) to be immediately recognized in its books and balance profit of Rs.3 lakhs (25-22) is to be amortized/deferred over lease period.

(iv) When fair value of leased machinery is Rs.25 lakhs & sale price is Rs. 18 lakhs, then loss of Rs.2 lakhs (20 – 18) to be immediately recognized by A Ltd. in its books provided loss is not compensated by future lease payment.

(v) When fair value is Rs.18 lakhs & sale price is Rs. 19 lakhs, then the loss of Rs.2 lakhs (20-18) to be immediately recognized by A Ltd. in its books and profit of Rs.1 lakhs (19-18) should be amortized/ deferred over lease period.

2. Illustration

Jaya Ltd. took a machine on lease from Deluxe Ltd., the fair value being Rs. 11,50,000. Economic life of the machine as well as lease term is 4 years. At the end of each year, lessee pays Rs. 3,50,000 to lessor. Jaya Ltd. has guaranteed a residual value of Rs. 70,000 on expiry of the lease to Deluxe Ltd., however Deluxe Ltd. estimates that residual value will be only Rs. 25,000. The implicit rate of return is 10% p.a. and present value factors at 10% are : 0.909, 0.826, 0.751 and 0.683 at the end of 1st, 2nd, 3rd and 4th year respectively.

Calculate the value of machinery to be considered by Jaya Ltd. and the value of the lease liability as per AS-19.

Answer:

Provision

According to AS 19 "Leases", the lessee should recognize the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee.

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In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Minimum lease payments	Internal rate of return (Discount rate @10%)	Present value
1	3,50,000	.909	3,18,150
2	3,50,000	.826	2,89,100
3	3,50,000	.751	2,62,850
4	4,20,000	.683	4,20,000
Total	14,70,000		11,56,960

Present value of minimum lease payments Rs. 11,56,960 is more than fair value at the inception of lease i.e. Rs.11,50,000, therefore, the lease liability and machinery should be recognized in the books at Rs. 11,50,000 as per AS 19.

3. Illustration

Sun Limited wishes to obtain a machine costing Rs. 30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 3 years. It enters into an agreement with Star Ltd., for a lease rental for Rs. 3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Suraj Limited is not sure about the treatment of these lease rentals and seeks your advice.

You are required to explain the necessary accounting treatment in line with AS 19 (use annuity factor at @ 15% for 3 years as 3.36)

Answer:

As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment• amounts to at least substantially all of the fair value of leased asset.

In the given case, the implicit rate of interest is given at 15% and annuity factor @ 15% for 3 years is 3.36)

The present value of minimum lease payments at 15% = (Rs.3 lakhs each year x 3.36) = Rs.10.08 lakhs (approx.)

Thus, present value of minimum lease payments is Rs.10.08 lakhs and the fair value of the machine is Rs.30lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred.

However, in the given case, the effective useful life of the machine is 14 years while the lease is only for five years. Therefore, lease agreement is an operating lease. Lease payments under an operating lease should be recognized as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

4. Illustration

B & P Ltd. availed a lease from N&L Ltd. The conditions of the lease terms are as under :

(i) Lease period is 3 years, in the beginning of the year 2009, for equipment costing Rs. 10,00,000 and has an expected useful life of 5 years.

(ii) The Fair market value is also Rs. 10,00,000.

(iii) The property reverts back to the lessor on termination of the lease.

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(iv) The unguaranteed value is estimated at Rs. 1,00,000 at the end of the year 2011.
(v) 3 equal annual payments are made at the end of each year.
Consider IRR = 10%

The present value of Re. 1 due at the end of 3rd year at 10% rate of interest is Re. 0.7513. The present value of annuity of Re. 1 due at the end of 3rd year at 10% IRR is Rs. 2.4868. State whether the lease constitute finance lease and also calculate unearned Finance income.

Answer:

In following situations, the lease transactions are called finance lease:

1. The lessee will get the ownership of leased asset at the end of the lease term.

2. The lessee has an option to buy the leased asset at the end of term at price, which is lower than its expected fair value on the date on which option will be exercised.

3. The lease term covers the major part of the life of asset.

4. At the beginning of lease term, present value of minimum lease rental covers substantially the initial fair value of the leased asset.

5. The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.

Calculation of Annual lease Payment

Cost of equipment 10,00,000

Unguaranteed residual value 1,00,000

P.v of residual value for 3 years (@ 1,00,000 x .7513) 75,130

Value to be recovered from lease payments : 10,00,000 – 75,130 = 9,24,870

Annual lease payment = 3,71,911.7 (9,24,870/2.4868)

Unearned Finance income

Total Lease Payment (3,71,911.7 x 3)	11,15,735
Add : Residual value	1,00,000

Gross Investment	12,15,735
Less : PV of Investment	(10,00,000)
Unearned finance income	**2,15,735**

The present value of lease payment i.e., Rs. 9,24,870 equals 92.48% of the fair market value i.e., ` 10,00,000. As the present value of minimum lease payments substantially covers the initial fair value of the leased asset it constitutes a finance lease.

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AS 11
The Effects of Changes in Foreign Exchange Rates

1. Scope of AS 11

AS 11 deals with the issues of deciding which exchange rate to use and how to recognise the financial effects of changes in exchange rates in the financial statements

1.1. Applicability

a) Accounting for transactions in foreign currency.
b) Translating financial statements of foreign operation
c) Accounting for foreign currency transactions in the nature of forward exchange contracts.

1.2. Non –Applicability

AS 11 doesn't specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If an entity currency different from its domestic currency, it has to disclose the reason. The Standard also requires disclosure of the reason for any change in the reporting currency.

a. Presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (addressed in AS 3)
b. Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (AS-16).
c. Restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

2. Definitions

1. Monetary Items

Money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. For example, cash, receivables and payables.

2. Non- Monetary Items

Assets and liabilities other than monetary items.
For example, fixed assets, inventories and investments in equity shares.

3. Exchange Difference

Difference resulting from reporting the same number of units of a foreign currency in the reporting currency at a different exchange rate.

4. Foreign Operation

Foreign operation is a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

5. Integral Foreign Operation

Foreign operation, which is an integral part of those of the reporting enterprise. It carries on its business as if it were an extension of the reporting enterprise's operations.
For example, such an operation might only sell goods imported from the reporting enterprise and remits the proceeds to the reporting enterprise.

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6. Non-Integral Foreign Operation (NFO)

Foreign operation that is not an integral foreign operation. 'Net investment in a non-integral foreign operation' is the reporting enterprise's share in the net assets of that operation.

7. Forward Exchange Contract

It is an agreement to exchange different currencies at a specified rate in future.

8. Foreign Currency

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

Example – A company in India will have rupees (₹) as reporting currency and US Dollars ($) as foreign currency.

3.Foreign Currency Transactions

3.1. Meaning

A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency.

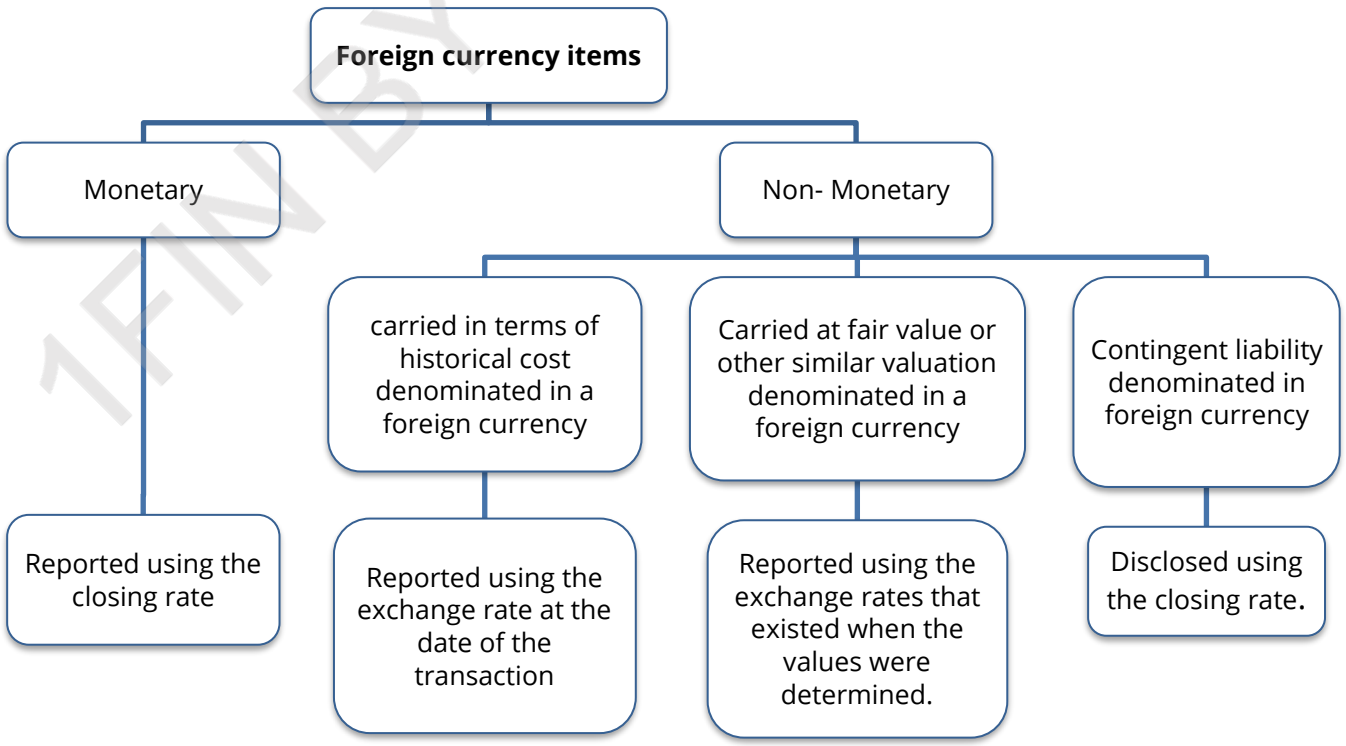
It includes transactions arising when an enterprise either:

a) Buys or sells goods or services whose price is denominated in a foreign currency.
b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.
c) Becomes a party to an unperformed forward exchange contract or
d) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

3.2. Initial Recognition

A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction

4. Reporting At Each Balance Sheet Date



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5.Recognition of Exchange Difference

An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction.

Exchange differences arising on

- the settlement of monetary items or
- monetary items of an enterprise (as monetary items are reported at rates different from those at which they were initially recorded during the period), or
- monetary items reported in previous financial statements,

should be recognized as income or as expenses in the period in which they arise.

6. Recognition of transactions

Settlement	Recognition
Transaction is settled within the same accounting period as that in which it occurred	All the exchange difference is recognised in that period
Transaction is settled in a subsequent accounting period	Exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period

7.Long-term foreign currency monetary items

7.1.Depreciable Asset

Exchange differences arising on reporting of long-term foreign currency monetary items at rates different from

- those at which they were initially recorded during the period, or
- reported in previous financial statements,

In so far, they relate to the acquisition of a depreciable capital asset, can be

- added to or
- deducted from

the cost of the asset and should be depreciated over the balance life of the asset;

7.2.Others

In other cases, exchange difference can be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITDA) Account and (amortised over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods)

8.Para 46 and 46A – Applicable to Long Term Foreign Currency Monetary Item

Initially, all the exchange differences were to be taken to the profit or loss statement.

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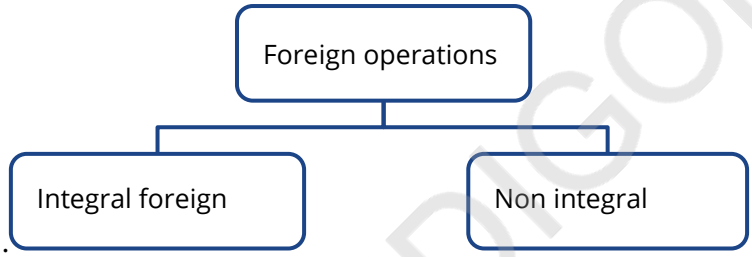
However, the Union Government of India, vide its notification issued on March 31st, 2009, inserted the para 46 (with retrospective effect from 2006) in the "AS 11 The Effects of Changes in Foreign Exchange Rates".

Foreign exchange gains or losses on Long Term Foreign Currency Monetary Items are treated as below

In case of Depreciable Asset	In Other cases
Can be added to / reduced from cost of asset	Accumulate in Foreign Currency Monetary Items Translation Difference Accounts (FCMITDA)
Depreciation is calculated based on revised amount	The balance in FCMITDA account is amortised over the balance life of asset/liability

9.Classification of Foreign Operations as Integral or Non-integral

The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise.
Foreign operations are classified as either 'integral foreign operations' or 'non-integral foreign operations

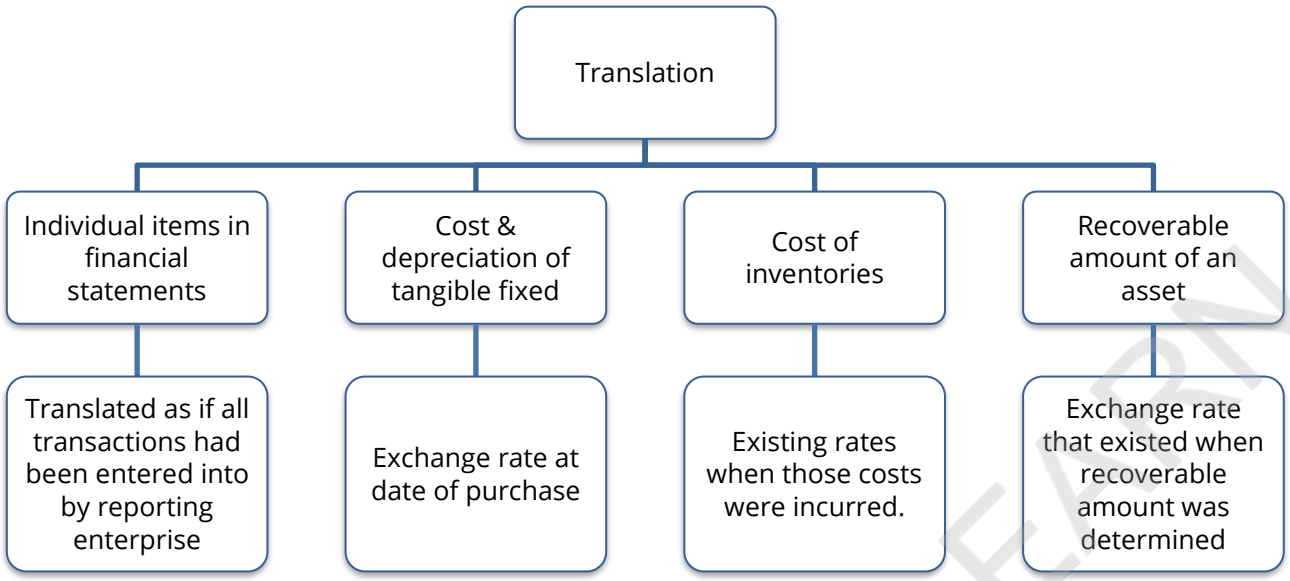


10.Indications that a FO is a NFO

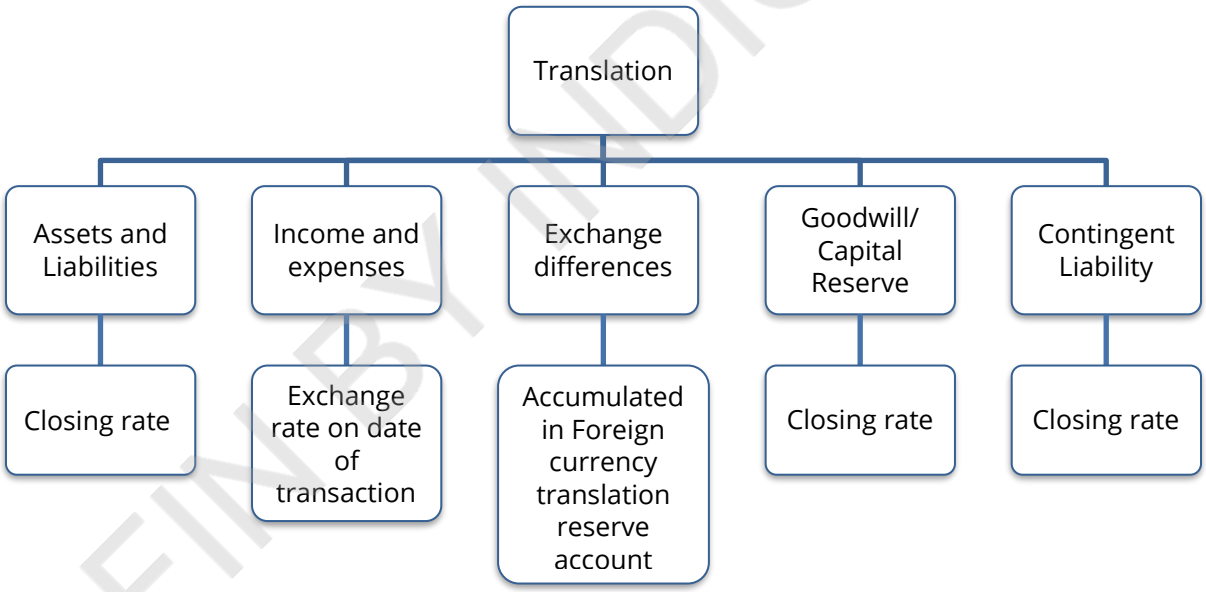
- A foreign operation should have a significant degree of independence in its activities.
- Transactions with reporting entity are not large in number
- Cost of material, labour and other expenses are paid or settled in its local currency.
- Sales are mainly not in reporting currency.
- Sale prices are determined based on its local competition and local regulations.
- Activities are funded either from profit from its own operations or from local borrowings.

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11. Translation of Integral Foreign Operations (IFO)



12. Translation of Non-Integral Foreign Operations (NFO)



Consolidation of Reporting Enterprise

Exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances.

In the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognised as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.

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Different reporting dates

When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the assets and liabilities of the non-integral foreign operation are translated at the exchange rate at the balance sheet date of the non-integral foreign operation and adjustments are made when appropriate for significant movements in exchange rates up to the balance sheet date of the reporting enterprise.

13. Reclassification of a Foreign Operation

- When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

- When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve.

- When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

14. Disposal of Non-Integral Foreign Operation

On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.

A write- down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

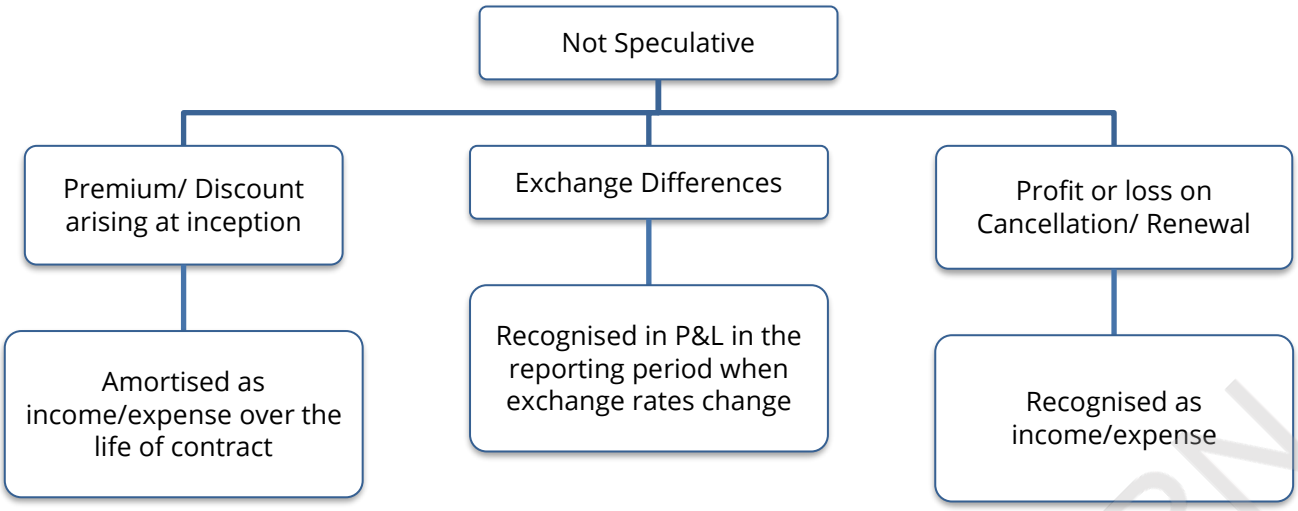
15. Tax Effects of Exchange Differences

Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22.

Forward Exchange Contract

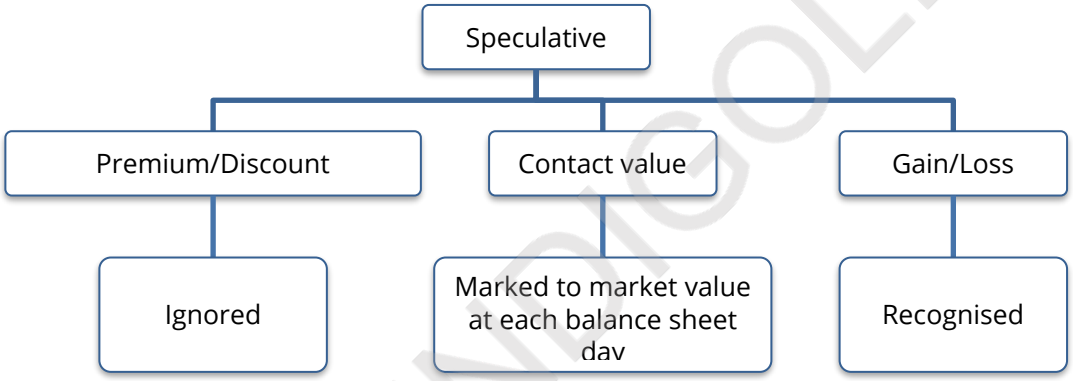
Non-Speculative Forex Contract

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Speculative Forex Contract

Gain / Loss = Foreign currency amount in contract X (forward rate at the reporting date - the contracted forward rate/ forward rate last used).



16. Disclosure

An enterprise should disclose:

(a) The amount of exchange differences included in the net profit or loss for the period

(b) Net exchange differences accumulated in foreign currency translation reserves as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

(a) The nature of the change in classification;

(b) The reason for the change;

(c) The impact of the change in classification on shareholders' funds; and

(d) The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

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Presentation of Foreign Currency Monetary Item Translation Difference Account (FCMITDA)

FCMITDA is open for exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a non-depreciable capital asset.

Debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

Illustrations

Illustration1 (Q&A Part1)

Explain Monetary Items as per AS 11. How are Foreign Currency Monetary items to be recognized at each balance sheet date?

Classify the following as monetary or non-monetary items.

Share Capital, Trade Receivables, Investments, Fixed Assets

Solution:

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Example : debtors, creditors, loans etc.

Foreign Currency monetary items are recognized at closing rate at each balance sheet date.

- Share Capital - Non Monetary Item
- Trade Receivables - Monetary Item
- Investments - Non Monetary Item
- Fixed Assets - Non Monetary Item

Illustration 2 (Q&A Part1)

BK Limited purchased a fixed asset costing Rs. 5,000 lacs on 1.4.2012 payable in foreign currency (USD) on 5.4.2013. Exchange rate of 1 USD is Rs.50 and Rs.54.98 as on 1.4.2012 and 31.3.2013 respectively. The Company also obtained a soft loan of USD 100,000 on 1.4.12 payable in 3 equal annual instalments. First instalment was due on 1.5.13. You are required to state how these transactions are to be accounted for in the books of accounts for the year ended 31.3.13

Solution:

Part 1

Date of acquisition of Fixed Asset 1.4.2012

Cost of acquisition: Rs.5000 lacs = USD 100 lacs X Rs. 50/USD

Creditor Reinstatement Date: 31.03.2013; Exchange rate 1 USD = Rs.54.98

Rupee Depreciation over the year 2012-13: Rs.4.98 per USD

Increase in creditor payables consequent to reinstatement following rupee depreciation:

Rs.4.98 /USD x USD 100 lacs = Rs.498 Lacs

Option 1: Rs.498 lacs of forex fluctuation can be debited to P&L in FY13

Option 2:The Company may also choose to capitalise this loss to the cost of the fixed asset so acquired.

Part 2:

Assume USD 100,000 of loan was used to acquire a Fixed asset / a non-monetary item

Loss on the reinstatement of the loan for FY2013 is

USD 100,000 x Rs.4.98 / USD = Rs. 4.98 lacs

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Option 1: If the asset is depreciable, the loss of Rs.4.98 lacs has to be transferred to the fixed asset account or charged off in P&L

Option 2:

If the asset so acquired is not a depreciable fixed asset or is for Long term working capital, the loss can be transferred to Foreign Currency Monetary Item Translation Difference Account (FCMITDA) and written off in 3 years starting FY13. That will be transferred before 31.03.2020, the date before which all FCMITDA balances are to be written off as mandated by AS11.

Illustration 3 (Q&A Part2)

Sterling Ltd. purchased a plant for US $ 20,000 on 31st December, 2011 payable after 4 months. The company entered into a forward contract for 4 months @ Rs. 48.85 per dollar. On 31st December, 2011, the exchange rate was Rs. 47.50 per dollar.How will you recognize the profit or loss on forward contract in the books of Sterling Limited for the year ended 31st March, 2012?

Solution:

Forward premium Paid by the Company per USD = Rs.48.85 - 47.50 = Rs1.35

The forward premium of Rs.1.35 is for a period of 4 months

Total forward premium = Rs. 1.35 X 20,000 = Rs. 27,000

Amount to be amortised per month = Rs 27,000/4 = Rs. 6750

Amount to be amortised for year ending 31.03.2012 = Rs. 6,750 X 3 months = Rs. 20,250

Rs.20,250 will be recognized in the books of sterling limited as forward premium expense for the year ended 31st March 2012.

Illustration 4 (Q&A Part2)

Goods purchased on 1.1.11 of USD 10,000 when USD 1 = Rs.45. Exchange rate on 31.3.11 is Rs.44 and the exchange rate on the date of actual payment (07.07.11) was Rs.43 . Ascertain the gain or loss for FY10-11 and FY11-12. Also give treatment as per AS 11.

Solution :

Technical context:

As per AS 11, Monetary items have to be restated at the end of an accounting period at the closing rate prevailing on such date

Analysis & Conclusion

Liability towards Creditors for Cost of goods purchased on 1.1.11 = Rs.45 X 10,000 = Rs.4,50,000

On 31.3.11 such creditor balance (monetary item) needs to be reinstated at closing rate.

Closing rate on 31.3.11 is Rs.44 / USD

Rupee appreciated from Rs.45/ USD to Rs.44 USD – there is gain of Re 1.

For FY11 gain of Rs.10,000 (USD 10,000 x Re.1/ USD of gain) will be recognized in P&L

Rupee appreciated by additional Re.1 between 31.3.11 and 7.7.11 and the payment was made at Rs.43/ USD on 7.7.11

Additional gain of Rs.10,000 (USD 10,000 x Re.1/ USD of gain) will be recognized in P&L in FY12

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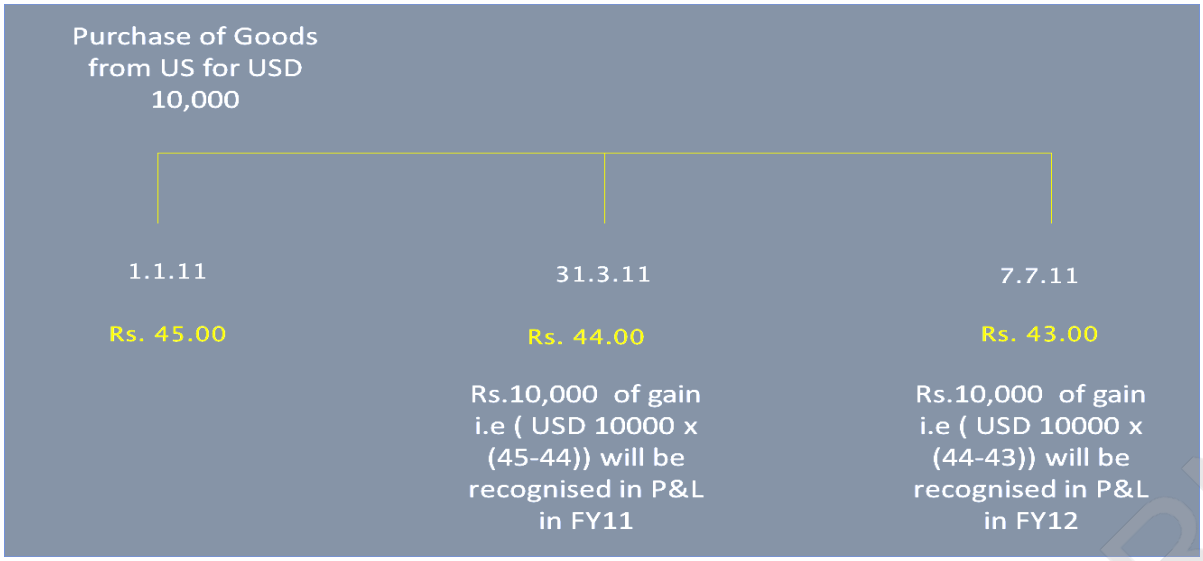


Illustration 5 (Q&A Part2)

Sunshine Company Limited imported raw materials worth US Dollars 9,000 on 25th February, 2011, when the exchange rate was Rs. 44 per US Dollar. The transaction was recorded in the books at the above mentioned rate. The payment for the transaction was made on 10th April, 2011, when the exchange rate was Rs. 48 per US Dollar. At the year end 31st March, 2011, the rate of exchange was Rs. 49 per US Dollar.

The Chief Accountant of the company passed an entry on 31st March, 2011 adjusting the cost of raw material consumed for the difference between Rs. 48 and Rs. 44 per US Dollar. Discuss whether this treatment is justified as per the provisions of AS-11.

Solution:

Technical context:

As per AS 11, Monetary items have to be restated at the end of an accounting period at the closing rate prevailing on such date

Analysis:

In the current case, creditor in respect of raw materials is a monetary item and has to be restated at the closing rate on 31.3.11 in the books of Sunshine Limited.

The creditor has to be reinstated on 31.3.11 at the exchange rate prevailing on 31.3.11 i.e. at Rs. 49 per USD

Exchange loss of Rs.45,000 i.e USD 9000 x (Rs.49 –Rs.44 = Rs.5) is recognized in FY11.

There is an exchange gain from the balance sheet date (31.03.2011) to the date of actual payment.

Exchange gain of Rs.9000 i.e USD 9000 x (Rs.49/ USD –Rs.48/ USD = Rs.1/USD) is recognized in FY12.

Conclusion

The amount payable to the creditor (which is a monetary item) must be reinstated. Any loss or gain arising due to such reinstatement must be transferred to a profit and loss account as "Foreign Exchange Fluctuation Gain/(Loss). Treatment of recognizing exchange gain of Rs.36000 by reducing the cost of raw material in FY11 as proposed by the chief accountant is is not justified

Illustration 6 (Q&A Part3)

Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.3.15:

1) Sundry debtors include amount receivable from Umesh Rs.5 lacs recorded at the prevailing Exchange rate on the date of sale. Transaction recorded at USD 1 = Rs. 58.50
2) Long term loan taken from a US company amounting to Rs.60 lacs recorded at USD 1 = 55.6; exchange rate taken at rate prevailing on date of transaction.

On 31st March 2015 USD 1 = Rs.61.20

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Solution :

Sundry Debtors: Amount receivable from Umesh in USD = Rs. 5,00,000 / (Rs.58.5 per USD) = USD 8547

Accounting as on 31.3.15:

Rupee depreciation from date of transaction to 31.3.15 :

Rs. 61.20 / USD– Rs. 58.5/ USD = Rs. 2.70/ USD of gain

Total gain on monetary items i.e receivable from Umesh = USD 8547 x Rs.2.70 / USD = Rs.23,077This gain will be recognized in P&L with corresponding increase in the receivable account.

Treatment of long term loan:

Loan in USD = Rs.60 lacs / Rs.55.60 per USD = USD 107913.67

For a monetary payable, rupee depreciation will result in a loss.

Loss is Rs.61.20/ USD – Rs.55.60 / USD = Rs.5.60/ USD

Total loss = Rs.5.60 / USD x USD 107913.67 = Rs.604317

This loss on long term loan can be

1) transferred to P&L or
2) If it is for a depreciable asset capitalised it along with the cost of the fixed asset, If not it can be accumulated in FCMITDAt and written off

Illustration 7

AXE Limited purchased fixed assets costing $ 5,00,000 on 1st Jan. 2018 from an American company M/s M&M Limited. The amount was payable after 6 months. The company entered into a forward contract on 1st January 2018 for five months @ Rs. 62.50 per dollar.

The exchange rate per dollar was as follows :

On 1st January, 2018 Rs. 60.75 per dollar

On 31st March, 2018 Rs. 63.00 per dollar

You are required to state how the profit or loss on forward contract would be recognized in the books of AXE Limited for the year ending 2017-18, as per the provisions of AS 11

Solution

As per AS 11 "The Effects of Changes in Foreign Exchange Rates", an enterprise may enter into a forward exchange contract to establish the amount of the reporting currency required, the premium or discount arising at the inception of such a forward exchange contract should be amortised as expenses or income over the life of the contract.

Forward Rate	₹ 62.50
Less: Spot Rate	(₹ 60.75)
Premium on Contract	₹ 1.75

Contract Amount US$ 5,00,000

Total Loss (5,00,000 x 1.75) ₹ 8,75,000

Contract period 5 months

3 months falling in the year 2017-18; therefore loss to be recognized in 2017-18

(8,75,000/5) x 3 months = ₹ 5,25,000.

Rest ₹ 3,50,000 will be recognized in the following year 2018-19.

Illustration 8 (RTP Nov 2019)

(i) Trade receivables as on 31.3.2019 in the books of XYZ Ltd. include an amount receivable from Umesh Rs. 5,00,000 recorded at the prevailing exchange rate on the date of sales, i.e. at US $ 1= Rs. 58.50. US $ 1 = Rs. 61.20 on 31.3.2019.

Explain briefly the accounting treatment needed in this case as per AS 11 as on 31.3.2019.

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(ii) Power Track Ltd. purchased a plant for US$ 50,000 on 31st October, 2018 payable after 6 months. The company entered into a forward contract for 6 months @Rs. 64.25 per Dollar. On 31st October, 2018, the exchange rate was Rs.61.50 per Dollar.

You are required to recognise the profit or loss on forward contract in the books of the company for the year ended 31st March, 2019.

Solution

(i) As per AS 11 "The Effects of Changes in Foreign Exchange Rates", exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or as expenses in the period in which they arise.

Particulars	**Calculations**	**Amount (₹)**
Trade receivables as on 31/3/2019	₹5,00,000 × ₹ 61.20 ⁄ ₹ 58.50	5,23,076
Less : Trade receivables as on 31/3/2018	Given	5,00,000
Difference on trade receivables		**23,076**

Accordingly, exchange difference on trade receivables amounting ₹23,076 should be charged to Profit and loss account.

(ii) Calculation of profit or loss to be recognized in the books of Power Track Limited

Particulars	
Forward contract rate	₹ 64.25
Less : Spot rate	₹ (61.50)
Loss on forward contract	₹ 2.75
Forward Contract Amount	$ 50,000
Total loss on entering into forward contract = ($ 50,000 × ₹ 2.75)	₹ 1,37,500
Contract period	6 months
Loss for the period 1st Nov, 2018 to 31st March, 2019 (5 months falling in the year 2018-19)	5 months
Hence the loss for 5 months will be ₹ 1,37,500 × 5 / 6	**₹ 1,14,583**

Thus, the loss amounting to ₹ 1,14,583 for the period is to be recognized in the year ended 31st March, 2019.

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AS - 12
Accounting for Government Grants

1 Introduction

1.1 Importance

The receipt of government grants by an enterprise is significant for preparation of the financial statements for 2 reasons:

- It is not a regular revenue, so an appropriate method of accounting is necessary.
- It is desirable to give an indication of the extent to which the enterprise has benefited from such grants during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

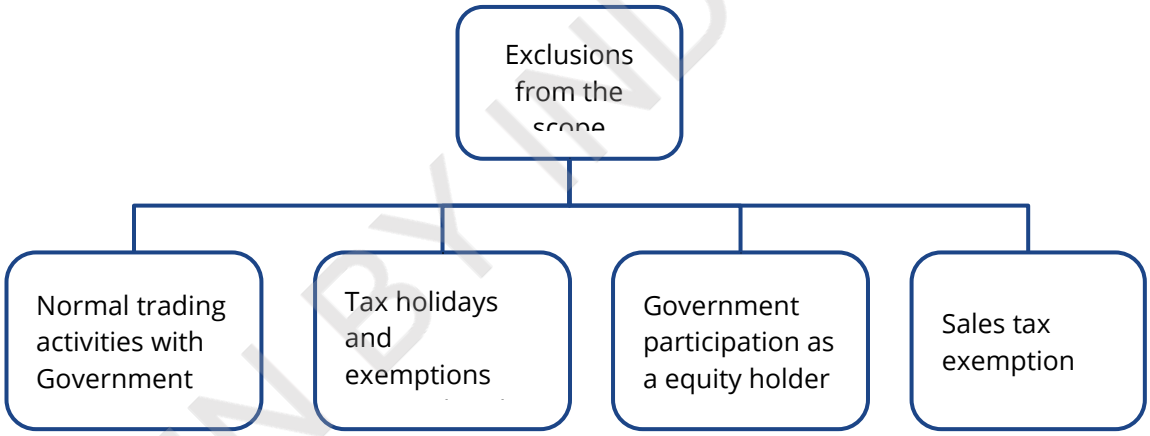
1.2 Scope

AS – 12 deals with grants or assistance from various government agencies, of both nature:

- Capital Nature
- Revenue Nature

Also referred to as subsidies, bounties, cash incentives, duty drawbacks etc.

1.2.1 Exclusions from the Scope



1.3 Definitions :

1.3.1 Government refers to:

- State and Central Government,
- Government agencies and similar bodies (like cantonments and development agencies), whether local, national, or international.

1.3.2 Government Grants are assistance by the government in cash or kind to an enterprise for past or future compliance with certain conditions.

They exclude:

- Those forms of government assistance which cannot reasonably have a value placed upon them and

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- Transactions with the government which cannot be distinguished from the normal trading transactions of the enterprise.

Example:
Company A deals in a product which attracts 5% Goods and Services Tax. However, under some package scheme of incentive, the Company is exempt from Goods and Services Tax up to a certain limit. This is not a Government Grant. Tax benefits (if any) are not considered as grant under AS-12.

2 Accounting Treatment

2.1 Recognition of Government Grants:

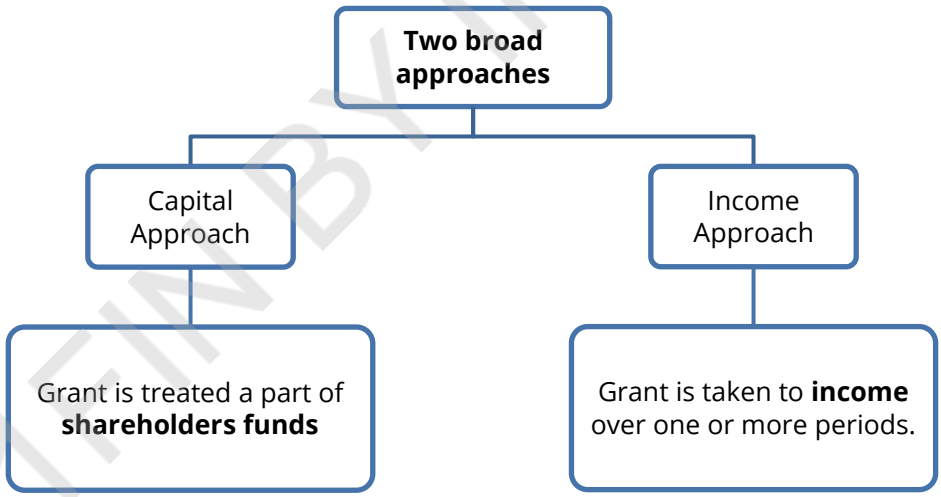
Based on the concept of prudence, a government grant is not recognised until there is reasonable assurance that:

- The enterprise must
  - have met the conditions or
  - must have the ability and willingness to meet the conditions related to the grant; and
- The grant should be sanctioned and certain to be received.

Receipt of a grant is not itself conclusive evidence that the conditions attaching to the grant have been or will be fulfilled. The enterprise must have the ability and willingness to fulfil the conditions to be able to recognise the grant.

Note: Grant received as a compensation towards loss due to Natural Calamities should be shown as an extraordinary item.

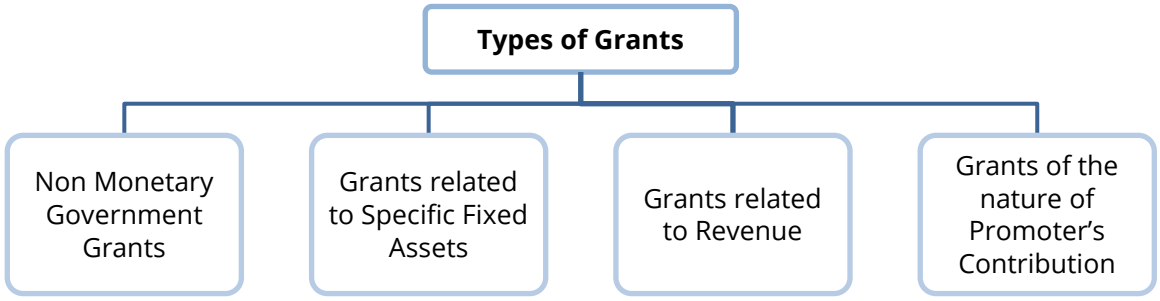
2.2 Accounting Treatment of Government Grants:



2.3 Method adopted: It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant.

- Grants which have the characteristics like those of promoters' contribution should be treated as part of shareholders' funds.
- Income approach may be more appropriate in the case of other grants

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3.1 Non-Monetary Government Grants

Government grants may take the form of non-monetary assets, such as land or other resources.

3.1.1 At concessional rates:

These assets are accounted for at their actual acquisition cost.

E.g., Land allotted in industrial park at concessional rate of Rs. 10 Lakhs instead of its market value of Rs. 50 Lakhs, in such a case it shall be recorded at its acquisition cost.

3.1.2 Free of cost: These assets are recorded at a nominal value.E.g., Grant may be in the form of machinery, received free of cost. In such cases it is recorded at a Nominal value (say Rs.1) for the purpose of identification and control.

Entry required:

Machinery A/c …… Dr.

To Provision for Depreciation A/c

(Being an asset recorded at a nominal value.)

Example:

Santosh Ltd. received land free of cost from the State Government, but it has not recorded it at all in the books. The company argues that:

(a) No money has been spent by the Company on its acquisition

(b) Land is not a depreciable asset

As per AS – 12, this treatment is not correct. Even if the company has not spent money for the acquisition of land, land should be recorded in the books of accounts at a nominal value for the purpose of identification and control. Whether it is depreciable or non-depreciable is not relevant in this regard.

3.2 Grants related to Specific Fixed Assets:

Grants related to specific fixed assets are government grants with:

- **Primary condition:** An enterprise qualifying for them should purchase, construct, or otherwise acquire such assets.
- **Other conditions**: Restrict the type or location of the assets or the periods during which they are to be acquired or held.

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Example:
Sagar Ltd. has received a grant of Rs. 8 crores from the Government for setting up a plant and machinery in a backward area. Out of this grant, the company distributed Rs. 2 crores as dividend. As per AS - 12, when a government grant is received for a specific purpose, it should be utilised for the same. So, the grant received for constructing a plant and machinery is not available for distribution of dividend.

Methods of Presentation of Grants related to Fixed Assets:

The accounting treatment depends on whether the fixed asset is a depreciable asset or a non-depreciable asset.

3.2.1 Depreciable Fixed Assets

Method 1: Reduced Cost Approach

- The grant is shown as a deduction from the gross value of the asset concerned and the net book value is shown in the balance sheet.
- The grant is recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.
- Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

Entries required:

1. Fixed Asset a/c ……Dr.
   To Cash/Bank a/c
   (Being fixed asset acquired)

---

2. (a) If Government Grant is received :
   Bank a/c ……Dr.
   To Government Grant a/c
   (Being the grant received)

(b) If Government Grant is receivable :
Government Grant Receivable a/c ……Dr.
To Government Grant a/c
(Being the grant receivable)

When the grant is subsequently received
Cash / Bank a/c ……Dr.
To Grant Receivable a/c
(Being the grant received)

---

3. Government Grant a/c ……Dr.
   To Fixed asset a/c

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(Being grant deducted from gross value of an asset)

NOTE : Depreciation is charged on the adjusted balance of fixed assets.

Example: (Reduced Cost Approach)

Gross value of asset Rs.100 Lakhs
Useful life of the asset 10 years
Method of Depreciation Straight Line Method
Government grant (i) Rs. 20 lakhs
(ii) Rs. 100 Lakhs

In situation (i), the asset will be recorded at a net book value of Rs 80 lakhs (100 Lakhs – 20 Lakhs) in the balance sheet and depreciation of Rs. 8 Lakhs will be charged every year for a period of 10 years.

In situation (ii), the net book value will be reduced to 0 (100 Lakhs – 100 Lakhs). So, the asset should be recorded at a nominal value, say, Rs 100, in the balance sheet, so that the existence of the asset is reflected. No depreciation is to be charged in this case.

Method 2: Deferred Income Approach

Grants related to depreciable assets are treated as deferred income. It is recognised in the profit and loss statement on a systematic and rational basis (in the ratio of depreciation) over the useful life of the asset.

Entries required:

1. Fixed Asset Account…… Dr.
To Cash/Bank A/c
(Being Fixed Asset acquired)

2. Cash/Bank Account…… Dr.
To Deferred Government Grant A/c
(Being grant received and treated as deferred income)

3. Depreciation A/c…… Dr.
To Fixed Asset / Provision for Depreciation A/c
(Being Fixed Asset depreciated.)

4. Deferred Government Grant A/c…… Dr
To Profit & Loss Account
(Being Deferred Grant recognised.)

(Entries No 3 & 4 are passed each year during the useful life of the asset.)

Example: (Deferred Income Approach)

In the example discussed in Method 1, if Method 2 is followed, then in both the situations, the asset will be recorded at the full value of Rs 100 Lakhs in the balance sheet.

In situation (i), an amount of Rs 2 lakhs will be credited to the Profit and Loss Account.

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In situation (ii), an amount of Rs 10 lakhs will be credited to the profit and loss account every year for a period of 10 years.

Note: The net impact on the Profit and Loss A/c under both the approaches will be the same.

3.2.2.Non-Depreciable Fixed Assets

Case 1: When the conditions are already met

Grants related to non-depreciable assets are credited to capital reserve, as there is usually no charge of depreciation in respect of such assets.

Entries required:

1. Asset Account..... Dr.
   To Cash/Bank A/c.
(Being land acquired.)

2. Bank Account ..... Dr.
   To Government Grant A/c
(Being the Grant received.)

3. Government Grant A/c ..... Dr.
   To Capital reserve A/c
(Being a Government Grant credited to the Capital Reserve.)

Example:
Sunny Ltd. received a grant of Rs. 20 Lakhs for acquiring an industrial land. Since land is a non-depreciable asset, the amount of grant will be credited to Capital Reserve A/c.

Case 2: When the conditions are to be met in the future

If a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant will be transferred to Profit & Loss A/c in the ratio of costs to be incurred to meet the grant conditions.

Entries required:

1. Asset Account..... Dr.
   To Cash/Bank A/c.
(Being land acquired.)

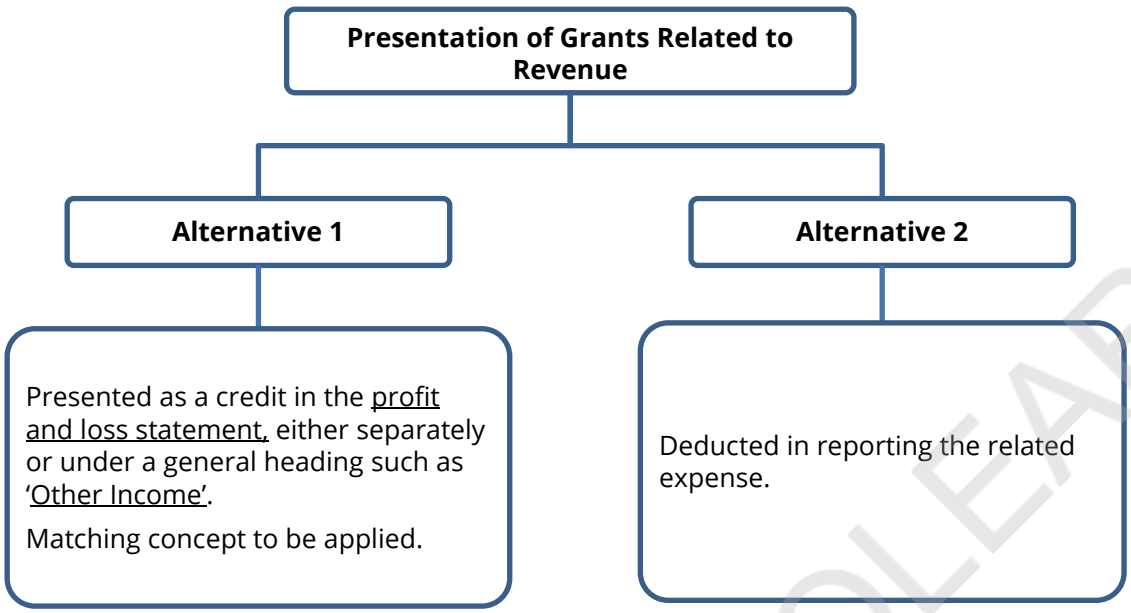
2. Bank Account ..... Dr.
   To Deferred Government Grant A/c
(Being the Grant received.)

3. Deferred Government Grant A/c ..... Dr.
   To Profit & Loss A/c
(Being a Government Grant transferred to Profit and Loss A/c.)

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3.3 Grants related to Revenue:

Grants may be provided by the Government for incurring a specific expenditure, like expenditure on public welfare, special expenditure on welfare of employees, expenditure on training of employees etc.



Example:

Kiran Ltd. received a grant of Rs. 25 Lakhs from the Local Authority for providing medical facilities to its employees.Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'.

Alternatively, Rs. 25 lakhs may be deducted in reporting the related expense i.e., employee benefit expenses.

3.2 Grants of the Nature of Promoter's Contribution:

Government grants are of the nature of promoters' contribution when they are:

- given with reference to the total investment in an undertaking, or
- by way of contribution towards its total capital outlay (for example, central investment subsidy scheme).

No repayment is ordinarily expected in respect of such grants. It may be given before or after the investment.

Accounting Treatment:

The grants are treated as capital reserve which can be:

- neither distributed as dividend
- nor considered as deferred income.

Journal Entries required:

1. Cash/Bank Account..... Dr.
   To Government Grant A/c

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(Being a grant received.)

2. Government Grant A/c …… Dr.
To Capital Reserve A/c
(Being Govt. Grant transferred to the Capital Reserve.)

Example:
Suraj Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment, for which no repayment was ordinarily expected. Moreover, there was no condition that the company should purchase any specified assets for this subsidy.
Having fulfilled all the conditions under the scheme, the company on its investment of Rs. 50 crores in capital assets, received Rs. 10 crores from the Government in January, 20X2 (accounting period being 20X1-20X2). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 20X2.
In the given case, the subsidy received is neither in relation to specific fixed assets nor in relation to revenue. Thus, it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by the government without related costs. The correct treatment is to credit the subsidy to capital reserve.

4 Refund of Government Grants

Government grants sometimes become refundable because certain conditions are not fulfilled.
Treatment: Treated as an extraordinary item (AS 5). The accounting entry will depend on the entry passed at the time of receipt.

4.1 Grant related to specific fixed asset:

4.1.1 Depreciable Fixed Asset

Method 1: Reduced Cost Approach
The amount refundable is recorded by increasing the book value of the asset.
Further, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

Example: (Reduced Cost Approach)
Thick Ltd. purchased a fixed asset for Rs. 50 lakhs, which has the estimated useful life of 5 years with a salvage value of Rs. 5 Lakhs. On purchase of the assets, the government granted it a grant for Rs. 10 lakhs which was reduced from the gross value of the asset. Grant was considered as refundable at the end of 2nd year to the extent of Rs. 7,00,000.
Journal entry for refund of the grant:

Fixed Assets Account ……. Dr.	7,00,000	
To Bank Account		7,00,000

(Being Grant refunded.)

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Method 2: Deferred Income Approach

The amount refundable is recorded by reducing the deferred income balance.

Further, the amount of income to be recognised in the profit and loss account gets reduced.

Example: (Deferred Income Approach)

Srikanth Ltd. received a specific grant of Rs. 30 Lakhs for acquiring the plant of Rs.150 Lakhs during 2010-11 having a useful life of 10 years. The Grant received was credited to Deferred Income in the Balance Sheet. During 2013-14, due to non-compliance of conditions laid down for the grant, the Company had to refund the whole grant to the Government. Balance in the Deferred Income on that date was Rs. 21 Lakhs and Written Down Value of Plant was Rs. 105 Lakhs.

Journal entry for refund of the grant:

Deferred Grant A/c ……	Dr.	21 Lakhs	
Profit and Loss A/c (Balancing figure) ….	Dr.	9 Lakhs	
To Bank A/c			30 Lakhs

(Being Grant refunded, and excess provided from Profit & Loss A/c.)

Note: There will not be any change in the carrying Amount of the Asset. Depreciation will be charged on the same basis as charged in the earlier years.

4.1.2 Non-Depreciable Fixed Asset

As the amount of grant was earlier credited to Capital Reserve A/c, its refund will reduce the balance of Capital Reserve.

Journal entry for refund of the grant:

Capital Reserve A/c ……	Dr.	
To Cash / Bank A/c		

(Being grant refunded and reduced from the Capital Reserve.)

4.2 Grant related to Revenue:

The amount refundable in respect of a government grant related to revenue is applied:

- First, against any unamortised deferred credit remaining in respect of the grant.
- If the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to the profit and loss statement.

Example:

ABC Ltd. received a Grant of Rs. 100 Lakhs from the Government during the previous accounting year for providing medical facilities to its employees. Out of this, Rs. 70 Lakhs has been recognised in the Profit and Loss A/c and Rs. 30 Lakhs is kept as unamortised deferred credit in the books of the company. Due to violation of certain conditions, the grant was considered refundable to the amount of Rs. 50 Lakhs.

Journal entry for the refund of Grant:

Deferred Grant A/c ……	Dr.	30 Lakhs	
Profit and Loss A/c ……	Dr.	20 Lakhs	
To Bank A/c			50 Lakhs

(Being the grant refunded and excess charged to Profit and Loss A/c)

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4.3 Grants of the Nature of Promoter's Contribution:

The relevant amount recoverable (in part or in full) by the government is reduced from the capital reserve.

Example:

Three years ago, Nikhil Ltd. had received a Grant of Rs. 25 Lakhs from the Government by way of contribution towards its Total Capital Outlay. However, due to non-fulfilment of some specified conditions. Rs. 16 Lakhs was recovered by the Government during the current accounting year.

Journal entry for the refund of Grant:

Capital Reserve A/c …… Dr. 16 Lakhs

To Bank A/c 16 Lakhs

(Being Grant refunded and reduced from the Capital Reserve.)

5. Disclosure Requirements

- The accounting policy adopted for government grants, including the methods of presentation in the financial statements.
- The nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

6 Summary

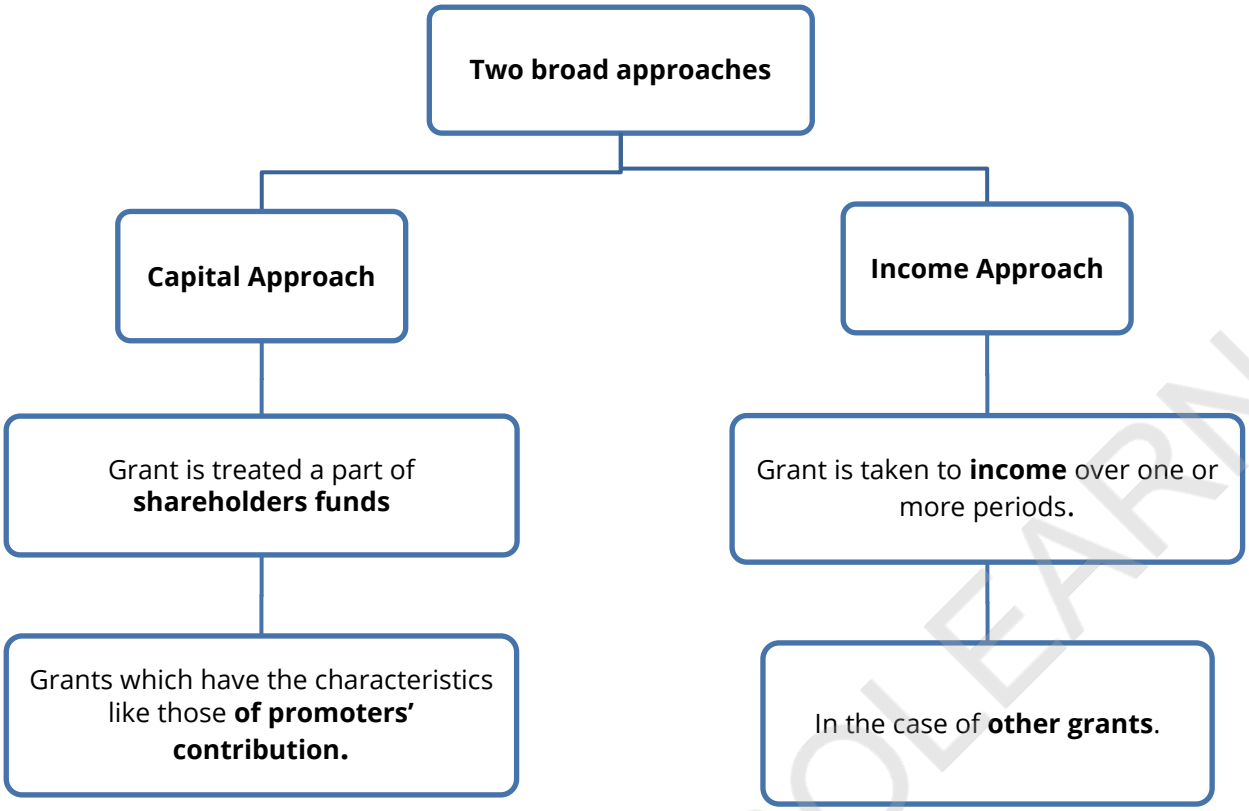
Government Grant:

Includes -assistance by the government, in cash or kind, to an enterprise, for compliance with certain conditions.

Excludes - assistance which cannot reasonably have a value placed upon them Normal Trading transactions of the business.

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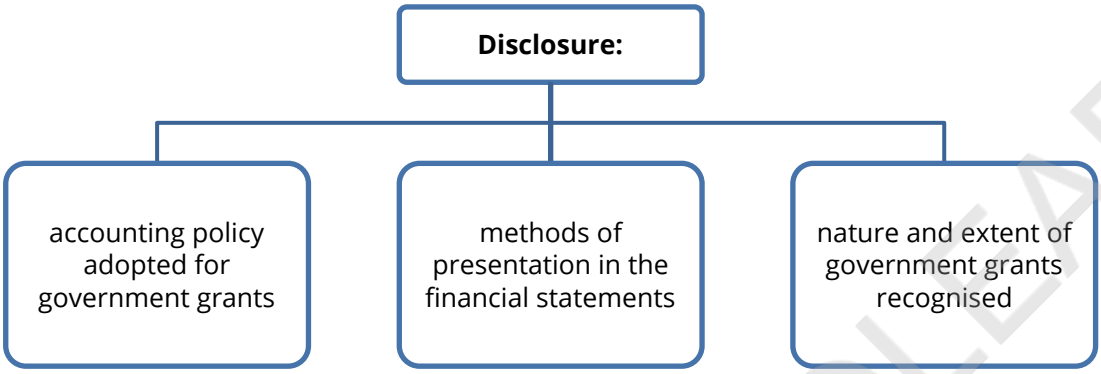
Accounting Approaches:



	Non - monetary grants	Grants related to revenue	Grants for specific asset		Grants as promoter's contribution
			Method 1	Method 2	
Accounting on Receipt of Grant	At concessional rates: At acquisition cost. Free: At nominal value	Shown as deferred credit balance	Deducted from cost of fixed assets	Shown as deferred income and charged in the ratio of depreciation	Amount credited to Capital Reserve A/c
Accounting on Refund of Grant	Amount of acquisition is increased in the books of accounts.	Deducted from deferred credit balance. Any balance after deduction is charged to	Amount deducted initially is increased in the books of accounts.	Deferred income balance is decreased in the books of accounts.	Amount deducted from Capital Reserve A/c

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		P&L A/c as expense			



Illustrations

Illustration 1 (Q&A Part1)

Supriya Ltd. received a grant of Rs. 2,500 lakhs during the accounting year 2010-11 from Government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilisation. However, during the year 2011-12, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full.

Elucidate the correct accounting treatment, with reference to the provisions of AS-12.

Solution :

- The Government grant was received for carrying out welfare activities for its employees. The Grant received was of revenue in nature and hence would have been credited to profit and loss account at the time of receipt (or in proportion of expenses over the years in which expenses for employee welfare was incurred). The amount refundable in respect of a government grant related to revenue is applied first, against any unamortised deferred credit remaining in respect of the grant.
- To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to the profit and loss statement.

In the present case, the amount of refund of government grant should be shown in the profit & loss

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account of the company as an extraordinary item during the year 2011-12

A government grant that becomes refundable is treated as an extraordinary item as per AS 5.

Illustration 2 (Q&A Part1)

A Ltd. purchased machinery for Rs. 40 lakhs. (Useful life 4 years and residual valueRs. 8 lakhs). Government grant received is Rs. 16 lakhs.

Show the Journal Entry to be passed at the time of refund of grant and the value of the fixed assets, if:

i. The grant is credited to Fixed Assets A/c.

ii. The grant is credited to Deferred Grant A/c.

Solution :

i. If the grant is credited to Fixed Asset Account,

Fixed Asset A/c .... Dr. ... Rs. 16 lacs

To Cash/Bank Rs. 16 lacs

Particulars	**Amount in ₹**
Original Cost	40 lacs
Less: Grant Received	16 lacs
Carrying Amount	24 lacs
Less: Residual Value	8 lacs
Depreciable Value	16 lacs
Useful Life	4 years
Depreciation Per Year	16 lacs/4 = Rs. 4 lacs
WDV at the end of Second Year	24 lacs – Rs. 4 lacs X 2 = Rs. 16 lacs
Add: Amount of Refund	16 lacs
Value of Asset after Refund	**32 lacs**

ii. If the grant was credited to the Deferred Grant Account.

Depreciation per year = Rs. (40 lacs – Rs. 8 lacs) /4 = Rs. 8 lacs per annum.

The grant will be credited to the Profit and Loss Account equally (because depreciation is charged on SLM basis and hence ratio of depreciation is 1:1:1:1).

Amount credited to Profit & Loss Account for 2 years = Rs. 16 lacs/4 X 2 = Rs. 8 lacs.

Balance left in Deferred Grant Account after 2 years = Rs. 16 lacs – Rs. 8 lacs = Rs. 8 lacs.

The refund of grant in this case should be debited to Deferred Grant Account to the extent of balance available.

Since the amount of refund is more than the balance in the Deferred Grant Account, the shortfall will be debited to a profit and loss account.

The journal entry will be:

Deferred Government Grant Dr …… Rs. 8 lacs

Profit & Loss Account Dr……. Rs. 8 lacs

To Cash/Bank Rs. 16 lacs

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The refund of the grant will not impact the fixed asset account.
Balance in fixed asset account at the time of refund = Rs. 40 lacs – Rs. 8 lacs X 2 = Rs. 24 lacs.

Illustration 3 (Q&A Part 1)
Santosh Ltd. has received a grant of Rs. 8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed Rs. 2 crores as dividend. Also, Santosh Ltd received land free of cost from the State Government but it as not recorded it at all in its books as no money has been spent. In the light of AS 12 examine, whether the treatment of both the grants is correct.

Solution :
Grant received for setting up a factory is in the nature of the promoter's contribution and should be credited to the Capital Reserve.
Such an amount is not available for distribution as a dividend. Hence, the company is not permitted to distribute dividends out of such grant.

The accounting treatment given by the company is not in accordance with AS-12. According to AS-12, if assets are received free of cost from the Government as a grant, such assets should be recorded at nominal value. Hence, in the given case, the company must record the land received free of cost at a nominal value (say Rs. 1 or Rs. 10). The accounting treatment given by the company is not correct.

Illustration 4 (Q&A Part 1)
Viva Limited received a specific grant of Rs. 30 lacs for acquiring a plant of Rs. 150 lacs during 2007-08 having a useful life of 10 years. The grant received was credited to deferred income in the balance sheet.
During 2010-11, due to non-compliance of conditions laid down for the grant, the company had to refund the whole grant to the government. Balance in the deferred income account on that date was Rs. 21 lacs and the written down value of the plant was Rs. 105 lacs.

i. What should be the treatment of refund of grant and the effect on cost of the fixed asset and amount of depreciation charged during the year 2010-11 in profit and loss account?
ii. What should be the treatment of refund, if grant was deducted from the cost of plant during 2007-08 assuming plant account showed a balance of Rs. 84 lacs as on 1.4.2010?

Solution :
i. If the amount was initially recorded to deferred income initially, the amount of refund must be debited to the deferred account to the extent of balance available.
Any shortfall in a deferred income account should be debited to a profit and loss account.
The total amount of refund is Rs. 30 lacs and the balance available in deferred income account is only Rs. 21 lacs. The shortfall of Rs. 9 lacs must be debited to the profit and loss account.

Deferred Income A/c .....Dr. Rs. 21 lacs

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Profit & Loss A/c ……Dr. Rs. 9 lacs
To Cash/Bank a/c Rs. 30 lacs

ii. If the grant was deducted from the cost of the fixed asset account, the amount of refund must be debited to the fixed asset account.
The value of the fixed asset account in this case would be increased by Rs. 21 lacs and the revised value of fixed asset would be depreciated over the balance useful life.

Fixed Asset A/c Dr. ... Rs. 30 lacs
To Cash/Bank Rs. 30 lacs

Balance in Fixed Asset account = Rs. 84 lacs + Rs. 30 lacs = Rs. 114 lacs.
Revised depreciation = Rs. 114/7 = Rs. 16.286 lacs per year.

Illustration 5
Samrat Limited has set up its business in a designated backward area which entitles the company for a subsidy of 25% of the total investment from the Government of India.
The company has invested Rs. 80 crores in the eligible investments. The company is eligible for the subsidy and has received Rs. 20 crores from the government in February 2019.
The company wants to recognize the said subsidy as its income to improve the bottom line of the company. Do you approve the action of the company in accordance with the Accounting Standard?

Solution
Technical context :
As per AS 12 "Accounting for Government Grants", if government grants are given with reference to the total investment in an undertaking or by way of contribution towards its capital outlay and no repayment is ordinarily expected in respect there of, the grants are treated as Capital Reserves/Capital Subsidy which can be neither distributed as dividend nor considered as deferred income.
which can be neither distributed as dividend nor considered as deferred income.

Conclusion - Company cannot recognize the said subsidy as its income for increasing bottom line.

- It has to be credited to the Capital Reserve.
- It can neither be distributed as dividend nor considered as deferred income.

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AS 16
Borrowing Costs

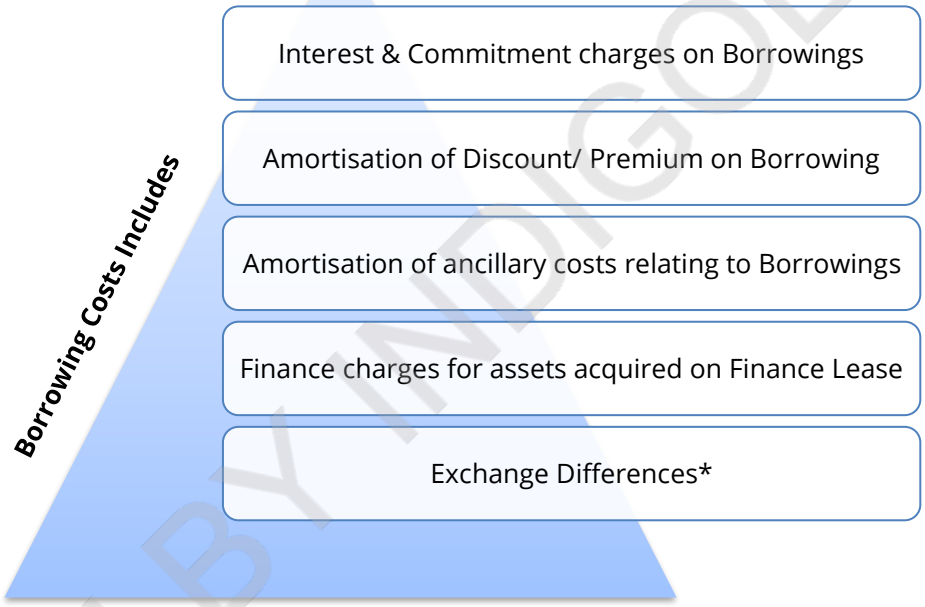
1. Scope of AS 16

The objective of AS 16 is accounting for borrowing costs. It does not deal with the cost of raising equity and preference share capital. It applies only to external borrowings.

2. Important Terms

Borrowing Costs

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.



*To the extent they are regarded as an adjustment to interest

Qualifying Assets

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Examples are

- Manufacturing plants
- Power generation facilities
- Inventories that require a substantial period of time to bring them to a saleable condition
- Investment properties

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Exclusions of Qualifying Asset

- All other investments and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets.
- Assets that are ready for their intended use or sale when acquired also are not qualifying assets

Substantial period of time

Substantial period of time primarily depends on the facts and circumstances of each case. Ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case

Exchange differences on foreign currency borrowings- Para 46(e)

- Interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised borrowings locally if the enterprise had not decided to raise the foreign currency borrowings.
- Exchange difference to the extent of following is treated as borrowing cost
  Interest on Local Currency Borrowings – Interest on Foreign Currency Borrowing
- Exchange gain is credited to P&L as per AS-11
- Exchange loss not considered as borrowing cost is treated as per AS-11

Example

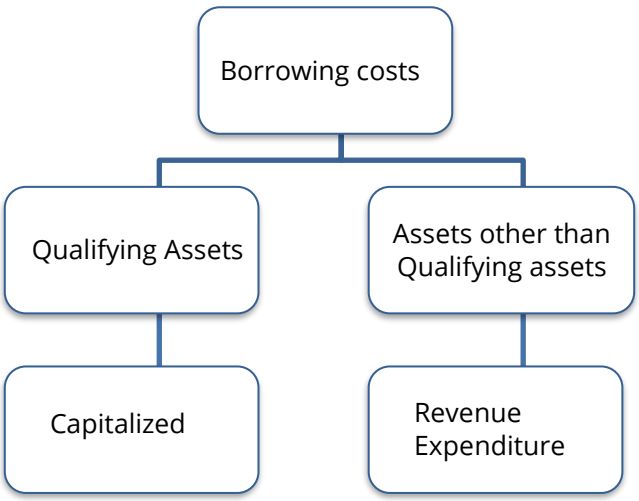
Suraj Ltd. has taken a loan of USD 10,000 on April 1, 20X1, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X1, the exchange rate between the currencies was Rs.45 per USD. The exchange rate, as at March 31, 20X2, is Rs.48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 20X1.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:
(i) Interest for the period = USD 10,000 x 5% x Rs.48/USD = Rs.24,000
(ii) Increase in the liability towards the principal amount = USD 10,000 x (48-45) = Rs.30,000
(iii) Interest that would have resulted if the loan was taken in Indian currency = USD 10,000 x 45 x 11% = Rs.49,500
(iv) Difference between interest on local currency borrowing and foreign currency borrowing = Rs.49,500 – Rs.24,000 = Rs.25,500

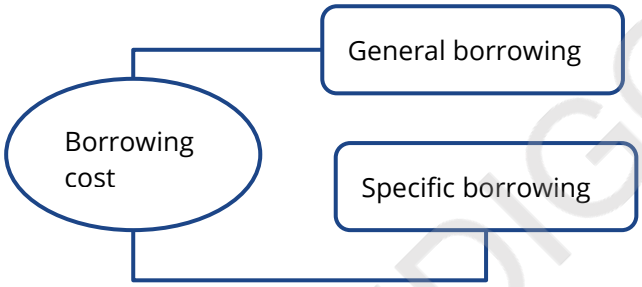
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3. Borrowing costs eligible for capitalisation

Treatment of Borrowing costs



Types of Borrowing



Specific Borrowings –

- Borrowed funds specifically for the purpose of obtaining a particular qualifying asset
- Borrowing costs that directly relate to that qualifying asset can be readily identified.
- If funds temporarily invested –
  Capitalised borrowing costs = Borrowing costs less any income earned on the temporary investment of those borrowings

General Borrowings –

- No Direct relationship between particular borrowings and a qualifying asset
- Amount of borrowing costs eligible for capitalisation determined by applying a capitalisation rate to the expenditure on that asset.
  The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.
- The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

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Step 1 Compute the capitalisation rate

Capitalization rate = Borrowing cost on general borrowings/Weighted average of general borrowings X 100

Step 2 Amount eligible for capitalisation

Expenditure incurred on Qualifying asset X Capitalisation rate

Step 3 Cross check

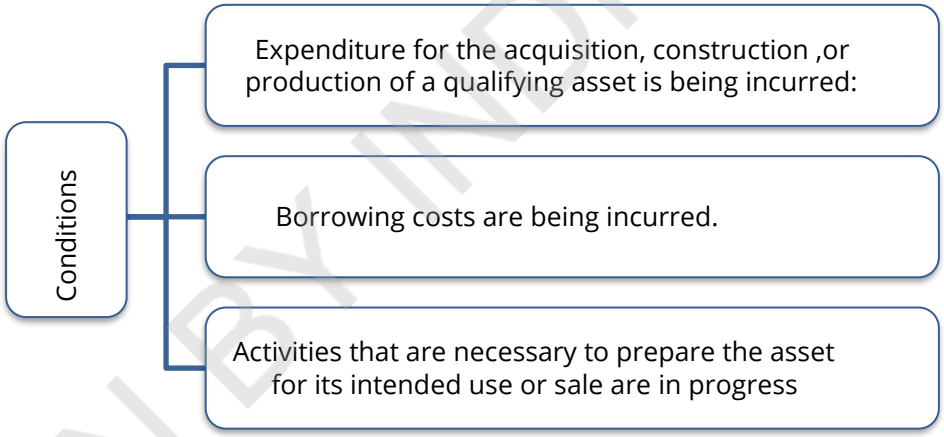
Amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

- When the carrying amount or the expected ultimate cost of the qualifying asset
- Exceeds its recoverable amount or net realisable value,
- Carrying amount is written down or written off in accordance with the requirements of other Accounting Standards.
- In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

Commencement of Capitalisation -

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied :

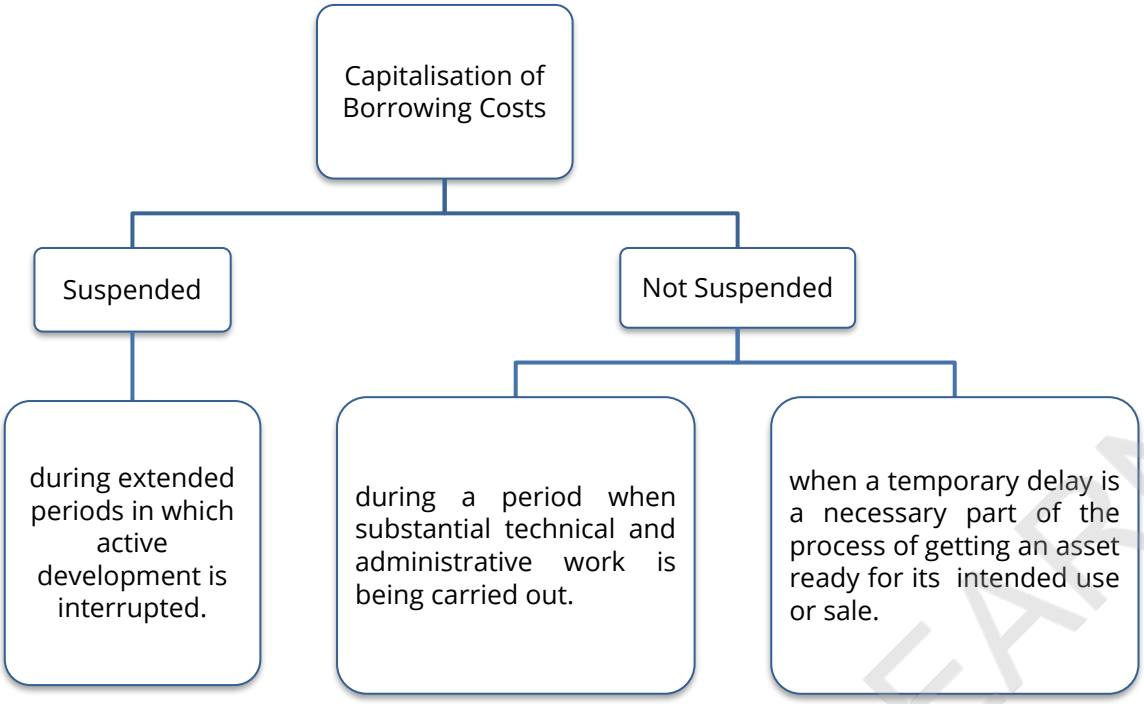


Suspension of Capitalisation

Capitalization of borrowing cost is commenced when the above mentioned 3 points are satisfied. However, if there is a temporary delay in which the active necessary developments are interrupted then there will be a suspension of capitalization. Suspension means stopping temporarily.

However, if the temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale, then there will be no suspension of capitalization.

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Cessation of Capitalisation:

- Capitalisation of borrowing costs should cease/ stop when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
- An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.
- When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

Disclosure

The financial statements should disclose:

- The accounting policy adopted for borrowing costs ; and
- The amount of borrowing costs capitalised during the period.

Summary

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised. Other borrowing costs shall be expensed
- A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale
- Substantial period of time primarily depends on the facts and circumstances of each case
- Specific Borrowing – Actual borrowing cost less income on temporary investment
- General Borrowing – based on capitalisation rate

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- **Commencement of Capitalisation** –
    - Expenditure is incurred
    - Borrowing costs are being incurred
- Activities are under progress **Suspension** - During extended periods when active development is interrupted.
- **Capitalisation of borrowing costs** - should cease/ stop when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
- **Disclosure**-Accounting policy adopted for borrowing costs ;and
  Amount of borrowing costs capitalised should be disclosed

Illustrations

Illustration 1(Q&A Part 1)

GHI Limited obtained a loan for Rs.70 lacs on 15.4.2010 from JKL Bank to be utilised as under:
On March 31st construction of the factory shed was completed and machinery which was ready for its intended use was installed. Delivery of Truck was received in the next financial year.

Particulars	Amount (₹)
Factory shed	25 lakhs
Purchase of machinery	20 lakhs
Working capital	15 lakhs
Advance for purchase of truck	10 lakhs
	70 lakhs

Total interest of Rs.9.1 lacs was charged by the bank for FY11. Show the treatment of interest under AS 16 and explain the nature of the asset.

Solution1:

Treatment of Interest (Borrowing cost) as per AS 16 'Borrowing Costs'

Construction of Factory Shed:

If the period April 2010 to March 2011 is substantial period as per the Company's policy, then interest incurred on borrowings taken for such construction can be capitalised, if not such interest cost should be charged off to the P&L Interest attributable to Factory shed:

Rs. 9.1lacs x Rs.25 lacs /Rs. 70 lacs = Rs.3.25 lakhs

Purchase of Machinery:

It is not a qualifying asset as it is ready for intended use on its purchase itself. The interest cost on same should be charged off to P&L: Rs. 9.1 lacs X 20/70 = Rs. 2.6 lakhs

Working Capital:

Interest cost on inventory can be capitalised if it takes a substantial period of time. Working capital is generally a non-qualifying asset and interest cost on such working capital should be charged off: Rs. 9.1 lacs X 15/70 = Rs. 1.95 lakhs

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Advance for purchase of truck:

Even after delivery is made, if an asset takes a substantial period of time to be ready for intended use only then will it be considered as a qualifying asset.

Hence, a truck is a non-qualifying asset and the interest pertaining to the loan will be debited to a profit and loss account: Rs. 9.1 X 10/70 = Rs. 1.3 lacs.

Illustration 2 (Q&A Part 1)

Axe Ltd began construction of a new plant on 1.4.2011 and obtained a special loan of Rs.4 lacs to finance construction of the plant. Interest rate is 10%. Expenditure that was made on the project of plant was as follows:

Date	Amount (₹)
1.1.2011	5 lakhs
1.1.2011	12 lakhs
1.1.2012	2 lakhs

The Company's other outstanding non-specific loan was Rs.23 lacs at interest rate of 12%. Construction of the plant was completed on 31.3.2012. You are required to:

(a) Calculate the amount of interest to be capitalised as per the provisions of AS 16 "Borrowing Cost".

(b) Pass a journal entry for capitalising the cost and the borrowing cost in respect of the plant.

Solution2:

Total expenses to be capitalised for borrowings as per AS 16 "Borrowing Costs":

Particulars	Amount in ₹
Cost of plant (5 lakhs + 12 lakhs + 2 lakhs)	19,00,000
Add: Interest to be capitalised (w.n. 1)	1,54,000
	20,54,000

Journal Entry

Date	Particulars	Amount (₹)	Amount (₹)
31.3.2012	Plant a/c. Dr	20,54,000	
	To bank a/c		20,54,000
	(Being cost of plant and borrowing cost thereon capitalised)		

Working Notes:

1. Computation of Interest

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Date	Amount (₹)	Months	Rate	Interest (₹)
1.4.2011	4,00,000	12	10%	4,00,000*10%*12/12 = 40,000
1.4.2011	1,00,000	12	12%	1,00,000*12%*12/12 = 12,000
1.8.2011	12,00,000	8	12 %	12,00,000*12%*8/12 = 96,000
1.1.2012	2,00,000	3	12%	2,00,000*12%*3/12 = 6,000
				Total =**1,54,000**

Illustration 3 (Q&A Part 2)

On 18th April, 2011, Amazing Construction Ltd. obtained a loan of Rs. 32 crores to be utilised as under:

Sl. n	Particulars	Amount(Rs.)
1	Construction of sea link across two cities (work has held up totally for a month during the year due to high water levels)	25 crores
2	Purchase of equipments and machines	3 crores
3	Working capital	2 crores
4	Purchase of vehicles	50 lakhs
5	Advances for tools/Cranes etc	50 lakhs
6	Purchase of technical know-how	1 crores
7	Total interest charged by the bank for the year ending 31st March 2012	80 lakhs

Show the treatment of interest by Amazing Construction Ltd.

Solution:

According AS 16 'Borrowing costs', a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

- In the given case, construction of a sea-link is a qualifying asset. The capitalisation is continued for periods in which active development is stopped due to high water levels (which is common in construction of bridges).
- Purchase of equipment and vehicles are not qualifying assets as they are generally ready for use at the time of purchase.
- Similarly, technical know-how are not qualifying assets.
- Working capital for day to day operations of business is not a qualifying asset.

The treatment of interest by Amazing Construction Ltd. can be shown as:

Particulars	Qualifying asset	Calculation of an interest	Interest to be capitalised (₹)	Interest charged to P&L a/c (₹)

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Construction of sea link	yes	[80,00,000*(25/32)	62,50,000	Nil
Purchase of equipment and machinery	No	[80,00,000*(3/32)]	Nil	7,50,000
Working capital	No	[80,00,000*(2/32)]	Nil	5,00,000
Purchase of vehicles	No	[80,00,000*(0.5/32)]	Nil	1,25,000
Advance for tools,cranes etc.	No	[80,00,000*(0.5/32)]	Nil	1,25,000
Purchase of technical know how	No	[80,00,000*(1/32)]	Nil	2,50,000
Total			**62,50,000**	**17,50,000**

Illustration 4 (Q&A Part 2)

Suhana limited issued 12% secured debentures of Rs.100 lakhs on 1.5.2013 to be utilised as under:

- Construction of factory building – Rs.40 lacs
- Purchase of Machinery – Rs.35 lacs
- Working Capital Rs.25 lacs

In March 2014 construction of the factory building was completed and Machinery was installed and is ready for its intended use.

Total interest on debentures for FY14 was 11 lacs. During the year 13-14, the company had invested idle funds out of the money raised from debentures in Bank FDs and earned interest of Rs.2 lacs. Show the treatment of interest under AS 16 and explain the nature of the asset.

Solution :

According to AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset.Other borrowing costs should be recognised as an expense in the period in which they are incurred.

Also para 10 of AS 16 "Borrowing Costs" states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost = Rs. 11,00,000 - Rs. 2,00,000 = Rs. 9,00,000

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Particulars	Qualifying asset	Calculation of interest	Interest to be capitalised (₹)	Interest charged to P&L a/c (₹)
Construction of factory building	Yes	9,00,000*40/100	3,60,000	Nil
Purchase of machinery	No	9,00,000*35/100	Nil	3,15,000
Working capital	No	9,00,000*25/100	Nil	2,25,000
Total			**3,60,000**	**5,40,000**

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Illustration 5 (Q&A Part 3)

Shan Builders Limited has borrowed a sum of US $ 10,00,000 at the beginning of Financial Year 2014-15 for its residential project at LIBOR + 3 %. The interest is payable at the end of the Financial Year. At the time of availing the loan, exchange rate was Rs. 56 per US $ and the rate as on 31st March,2015 was Rs. 62 per US $. If Shan Builders Limited had borrowed the loan in India in Indian Rupee equivalent, the pricing of loan would have been 10.50%. Compute Borrowing Cost and exchange difference for the year ending 31st March, 2015 as per applicable Accounting Standards. (Applicable LIBOR is 1%).

Solution :

(i) Applicable interest rate : 1% +3% = 4%
Interest for the period 2014-15 = US $10,00,000 x 4% × Rs. 62 per US $ = Rs. 24.80 lakhs

(ii) Increase in the liability towards the principal amount = US $ 10,00,000 × Rs. (62 - 56) = Rs. 60,00,000

(iii) Interest that would have resulted if the loan was taken in Indian currency = US $ 10,00,000 × Rs. 56 x 10.5% = Rs. 58,80,000

(iv) Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 58,80,000– Rs. 24,80,000 = Rs.34,00,000.

Borrowing Costs include exchange differences arising from foreign currency borrowings
To the extent that they are regarded as an adjustment to interest costs. Therefore, out of exchange fluctuation loss of Rs.60 lakhs towards principal amount, only Rs. 34 lakhs will be considered as the borrowing cost.

Total Borrowing Cost = Rs. 24,80,000 + Rs. 34,00,000 = Rs. 58,80,000

Hence, Rs. 58.80 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 "Borrowing Costs" and the remaining Rs.26 lakhs (60 - 34) would be considered as the exchange difference to be accounted for as per AS 11 "The Effects of Changes in Foreign Exchange Rates".

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Illustration 6 (RTP May 2019)

M/s First Limited began a construction of a new building on 1.4.2017. It obtained Rs. 2 lakh as a special loan to finance the construction of a factory building on 1.1.2017 at an interest rate of 8% per annum.

Further, expenditure on construction of the factory building was financed through other non-specific loans.

Details of the company's other outstanding non-specific loans were:

Loan	Rate of Interest
Rs.4,00,000	9%
Rs.5,00,000	12%
Rs.3,00,000	14%

The expenditure that was made on the buildings project were as follows:

Date	Expenditure on buildings
1st April 2017	Rs.3,00,000
31st May 2017	Rs. 2,40,000
1st Aug 2017	Rs. 4,00,000
31st Dec 2017	Rs.3,60,000

Construction of Building was completed by 31.03.2018. As per the provisions of AS-16, you are required to:

1. Calculate the amount of interest to be capitalised and
2. Pass Journal entry for capitalising the cost and borrowing cost in respect of the factory building

Solution

If it is assumed that the specific loan is used for the first expense of the project

A. Interest capitalised out of average accumulated expenses

Loan Date	Computation	Avg. Expenses (₹)	Interest@ 11.5% (₹)
1st Apr	1,00,000 x 12/12	1,00,000	11,500
31st May	2,40,000 x 10/12	2,00,000	23,000
1st Aug	4,00,000 x 8/12	2,66,667	30,667
31st Dec	3,60,000 x 3/12	90,000	10,350
		6,56,667	**75,517**

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B. Interest on specific loan of Rs.2,00,000 @ 8% on total period = 16,000

Interest to be capitalised(A+B) = Rs.91,517

Illustration 7 (RTP May 2018)

In May, 2016, Capacity Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2017 and the building was put to its use immediately thereafter.

Interest on the actual amount used for construction of the building till its completion was Rs. 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2017 amounted to Rs. 25 lakhs.

Can Rs. 25 lakhs be treated as part of the cost of factory building and thus be capitalised on the plea that the loan was specifically taken for the construction of factory building?

Explain the treatment in line with the provisions of AS 16.

Solution

Given

- Qualifying Asset – Factory Building
- Loan Taken – May 2016
- Asset ready for intended use & put to use – January 2017
- Interest till January 2017 – Rs.18,00,000
- Interest till 31st March 2017 – Rs.25,00,000

Technical context

AS 16 clearly states that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed.

Conclusion

Therefore, interest on the amount that has been used for the construction of the building up to the date of completion (January, 2017)

- Rs. 18 lakhs alone can be capitalised.
- Rs. 25 lakhs will be charged to P&L a/c as interest expense

Illustration 8 (RTP Nov 2018)

A company incorporated in June 2017, has set up a factory within a period of 8 months with borrowed funds. The construction period of the assets had reduced drastically due to usage of technical innovations by the company. Whether interest on borrowings for the period prior to the date of setting up the factory should be capitalised although it has taken less than 12 months for the assets to get ready for use. You are required to comment on the necessary treatment with reference to AS 16.

Solution:

As per para 3.2 to AS 16 'Borrowing Costs', a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

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It is a rebuttable presumption that 12 months period constitutes a substantial period of time. Ordinarily, a period of 12 months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case considering the time which an asset takes, technologically and commercially, to get it ready for its intended use or sale, which the management might decide as an accounting policy.

Therefore, if the factory is constructed in 8 months then it shall be considered as a qualifying asset. The interest on borrowings for the same shall be capitalised although it has taken less than 12 months for the asset to get ready to use. An enterprise that completes the asset in 8 months should not be penalised for its efficiency by denying it interest capitalization and vice versa.

Illustration 9 (Weighted Average Interest)

X Ltd. Began construction of a new building on 1st January, 20X1. It obtained Rs.1 lakh special loan to finance the construction of the building on 1st January, 20X1 at an interest of 10%

The Company's other outstanding two non-specific loans were:

Amount	Rate of Interest
Rs.5,00,000	11%
Rs. 9,00,000	13%

The expenditures that were made on the building project were as follows:

Month	Amount withdrawn
January 20X1	Rs.2,00,000
April 20X1	Rs.2,50,000
July 20X1	Rs.4,50,000
December 20X1	Rs.1,20,000

Building was completed by 31st December 20X1. Following the principles prescribed in AS 16 'Borrowing Costs', calculate the amount of interest to be capitalised and pass one Journal Entry for capitalising the cost and borrowing cost in respect of the building.

Solution Assumption : Assume that 1.1.20X1 to 31.12.20X1 is considered as a substantial period to make this asset a qualifying asset and thereby capitalise the borrowing cost.

The total expenditure on the project over the year is Rs.10,20,000. It is not incurred on one single day , so we should calculate interest only for such a period on such amounts.

Assumed that borrowings are drawn on the 1st of that respective month.

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Working notes :

1. Computation of weighted average interest rate

Amount (₹)	**Rate of Interest**	**Interest per annum (₹)**
5,00,000	11%	55,000
9,00,000	13%	1,17,000
14,00,000		**1,72,000**

Weighted average rate of interest = 1,72,000 / 14,00,000 * 100 = **12.285 %**

2. Interest on expenses

Month	**Amount withdrawn (₹)**	**Interest calculation**	**Interest (₹)**
January 20X1	Rs.2,00,000	1,00,000*12/12*10% + 1,00,000* 12/12*12.285%	10,000 12,285
April 20X1	Rs.2,50,000	2,50,000*9/12*12.285 %	23,034.375
July 20X1	Rs.4,50,000	4,50,000*6/12*12.285 %	27,641.25
December 20X1	Rs.1,20,000	1,20,000*1/12*12.285 %	1,228.5
			74,189.125

Borrowing cost is **₹ 74,189.**

3. Amount for capitalization

Cost of asset	**Amount (₹)**
Cost of building	10,20,000
Borrowing cost	74,189
	10,94,189

Journal entries

Date	**Particulars**	**Debit (₹)**	**Credit(₹)**
31/3/20X1	Building a/c Dr.	10,94,189	
	To bank a/c		10,94,189

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	(Being cost of building and borrowing cost thereon capitalised)		

Illustration 10 (RTP May 2018)

In May, 2018, Capacity Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2019 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was Rs. 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2019 amounted to Rs. 25 lakhs. Can Rs. 25 lakhs be treated as part of the cost of factory building and thus be capitalised on the plea that the loan was specifically taken for the construction of factory building? Explain the treatment in line with the provisions of AS 16.

Solution

AS 16 clearly states that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed.

Therefore, interest on the amount that has been used for the construction of the building up to date of completion (January, 2017) i.e, Rs.18 lakhs alone can be capitalised. It cannot be extended to Rs.25 lakhs.

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AS – 22
Accounting for Taxes on Income

1 Scope

This standard prescribes the accounting treatment of taxes on income and follows the **Matching concept** (matching expenses against revenue for the period).

Often, the taxable income may be significantly different from the income reported in the financial statements due to the **difference in treatment of certain items:**

- under taxation laws, and
- in the books of accounts.

1.2 Definitions:

Accounting income / (loss) is the net profit or loss (before Income Tax) for a period, as reported in the statement of profit and loss.

Taxable income / (loss) is the amount of the income / (loss) for a period, as per the tax laws. Income-tax payable / (recoverable) is determined based upon this income / (loss).

Current tax is the amount of income tax (domestic as well as foreign taxes) determined to be payable / (recoverable) in respect of the taxable income / (tax loss) for a period.

Current Tax = Taxable Income x Tax Rate

Note: The payment of tax under section 115JB of the Income Tax Act, 1961 is a current tax for the period.

Deferred tax is the tax effect of timing differences.

Deferred Tax =Timing Differences x Tax Rate

Note: Deferred Tax Assets / Liabilities should be measured using the regular tax rates and not the tax rate under section 115JB of the Income Tax Act, 1961.

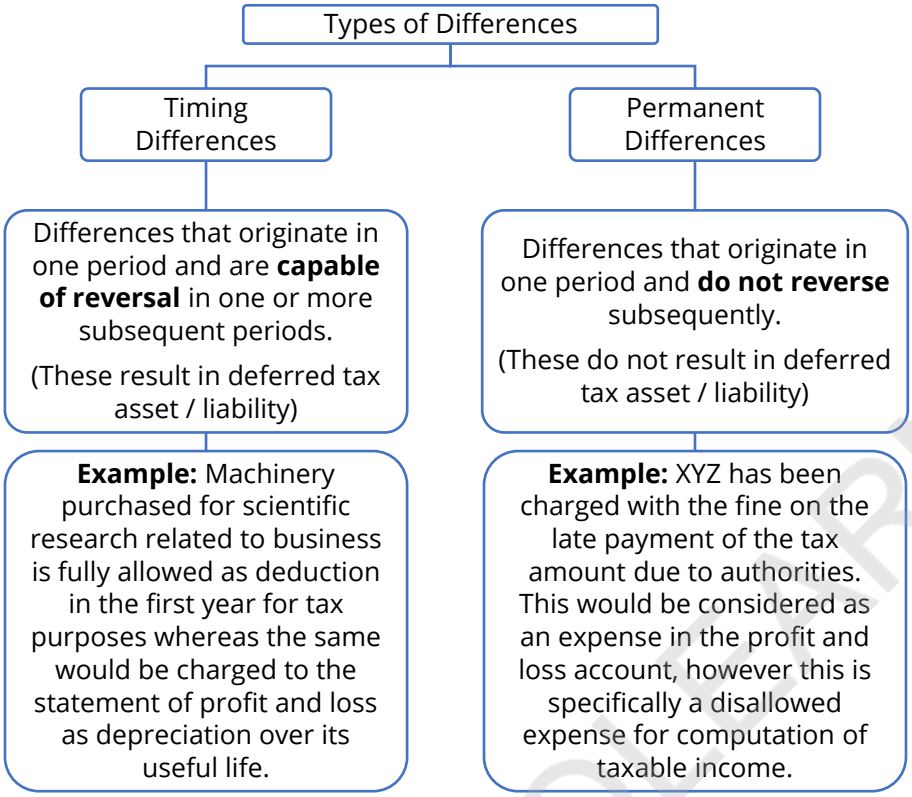
Tax expense / (tax saving) is the overall cost related to income tax.

Tax Expense / (tax saving) = Current Tax + Deferred Tax

2 Differences between Accounting Income and Taxable Income

2.1 Reasons:

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2.2 Types:

Example:

The Profit before tax as per Books of A Limited for the year ended 31st March 2022 is Rs. 25,00,000. The tax rate applicable is 35%.

(i) The Company has charged Depreciation of Rs. 742,900 in its Books of Accounts while as per Income Tax computation, the Depreciation available to the Company is Rs. 8,65,400.
(ii) The Company has made provision for doubtful Debts for Rs. 54,300 during the year.
(iii) The Company has unamortised preliminary expenses as per tax record of Rs. 6,23,500 which will be available for deduction under the Income Tax Act from the next year.
(iv) The Company has made Donation of Rs. 2,00,000 which has been debited to Profit and Loss account and only 50% thereof will be allowed as deduction as per Income Tax Law.

Description	Net Amount	Nature of Difference	Treatment	Deferred Tax @ 35%
Profit before Tax as per books	25,00,000			
Less: Depreciation (7,42,900-8,05,400)	(1,22,500)	Timing	Deferred Tax Liability	(42,875)
Add: Provision disallowed in Income tax	54,300	Permanent	Ignored	
Add: Unamortised Preliminary expenses	6,23,500	Timing	Deferred Tax Asset	2,18,225
Add: Donation (50% of 2 Lakh)	1,00,000	Permanent	Ignored	

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Total Income as per Tax Laws	**31,55,300**		**Deferred Tax Asset (Net)**	**1,75,350**

Examination Tip

Due to differences	**Present**	**Future**	**Creation of**
Tax payable	Higher	Lower	Deferred Tax Asset
Tax Payable	Lower	Higher	Deferred Tax Liability

If depreciation for tax purposes is lower as compared to accounting depreciation, the taxable income will be higher resulting in higher tax now. In future when depreciation for tax is higher, tax payable would be lower. Hence, the entity will recognise as Deferred Tax Asset now.

3 Accounting Treatment

3.1 Recognition of Tax Expense:

Taxes on income are considered to be an **expense** incurred by the enterprise in earning income. Based on the matching concept, these are **accrued in the same period** as the revenue and expenses to which they relate.

The tax effects of timing differences are included:

- in the statement of profit and loss – as tax expense, and
- in the balance sheet - as deferred tax assets / deferred tax liabilities.

Prudence:

Deferred tax assets should be recognised only to the extent that there is a **reasonable certainty of their realisation**, which can be known by examining the past record of the enterprise and by making realistic estimates of profits for the future.

Virtual certainty regarding future taxable income:

Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is **virtual certainty supported by convincing evidence, and not merely on forecasts of performance** that sufficient future taxable income will be available against which such deferred tax assets can be realised.

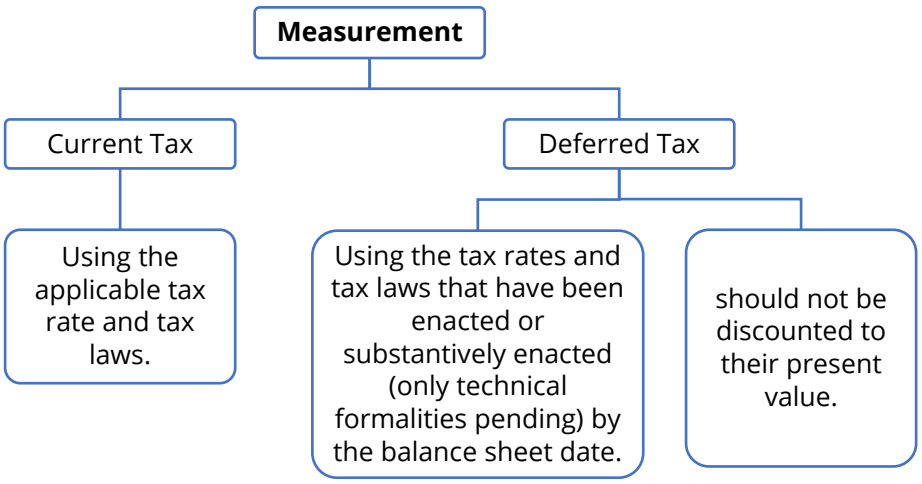
The evidence should be definite and available at the reporting date.

Example: A profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party.

On the other hand, a projection of the future profits made by an enterprise cannot, in isolation, be considered as convincing evidence.

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3.2 Measurement:



Note: If there are different tax rates for different levels of income, average rates should be used.

3.3 Accounting Entries:

(a) For Deferred Tax Liability: Profit & Loss Account ..... Dr.
To Deferred Tax Liability Account

(b) For Deferred Tax Asset: Deferred Tax Asset Account .... Dr.
To Profit & Loss Account

Example: For B Limited, following information is given:

Particulars	Rs.
Accounting Profit	6,00,000
Profit as per Income Tax	60,000
Tax Rate	20%
Book Profit as per MAT	3,50,000
MAT Rate	7.50%

Tax as per accounting profit = 6,00,000 × 20% = Rs. 1,20,000
Tax as per Income-tax Profit = 60,000 × 20% = Rs. 12,000
Tax as per MAT = 3,50,000 × 7.50% = Rs. 26,250

Timing difference = 6,00,000 – 60,000 = 5,40,000
Deferred Tax Liability = 5,40,000 x 20% = 1,08,000

Tax expense= Current Tax + Deferred Tax
Rs. 1,20,000 = Rs. 12,000 + Deferred tax
So, Deferred Tax liability as on 31-03-20X1= Rs. 1,20,000 – Rs. 12,000 = Rs. 1,08,000

Amount of tax to be debited in Profit and Loss account for the year
= Current Tax + Deferred Tax liability + Excess of MAT over current tax
= Rs. 12,000 + Rs. 1,08,000 + Rs. 14,250 (26,250 – 12,000) = Rs. 1,34,250

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The excess tax paid over MAT is allowed as a credit in future. Hence, an asset of Rs. 14,250 is recognised with a corresponding credit to Profit and Loss.

3.4 Transitional Provisions:

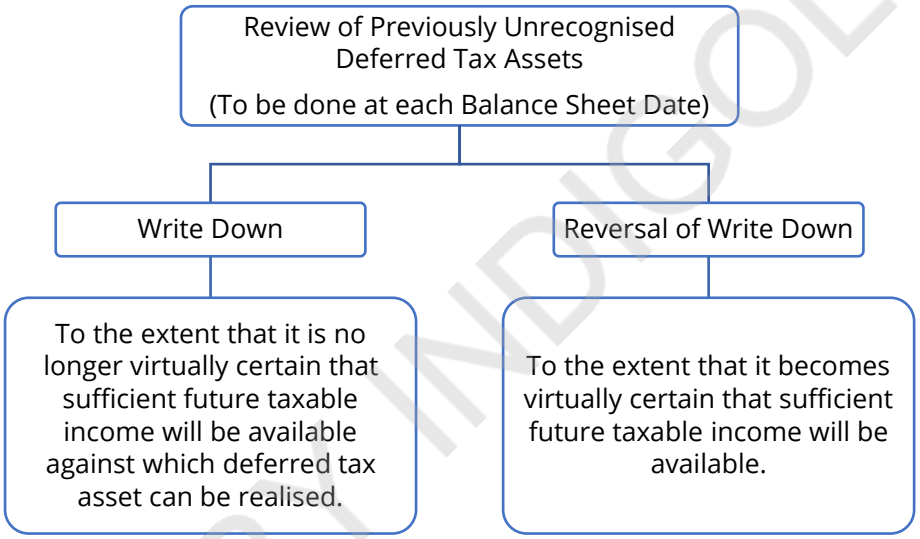
For the first time, the enterprise should recognise the deferred tax **balance that has accumulated** prior to the adoption of this Standard as deferred tax asset / liability with a corresponding credit / charge to the revenue reserves in the financial statements.

The amount so credited / charged to the revenue reserves should be the same as that which would have resulted if this Standard had been in effect from the beginning.

3.5 Re-assessment of Unrecognised Deferred Tax Assets:

- To be done **at each balance sheet date**.
- The previously unrecognised deferred tax assets are to be realized only to the extent that it has become **virtually certain that sufficient future taxable income will be available** against which such deferred tax assets can be realised.

3.6 Review of previously recognised Deferred Tax Assets:



4 Disclosures

4.1 In the Statement of Profit & Loss:

- **No specific requirement to disclose** current tax and deferred tax.
- **No reconciliation** between accounting profit and the taxable income is required.

Note: Under the Companies Act, 2013, the amount of income tax and other taxes on profits should be disclosed.

4.2 In the Balance Sheet:

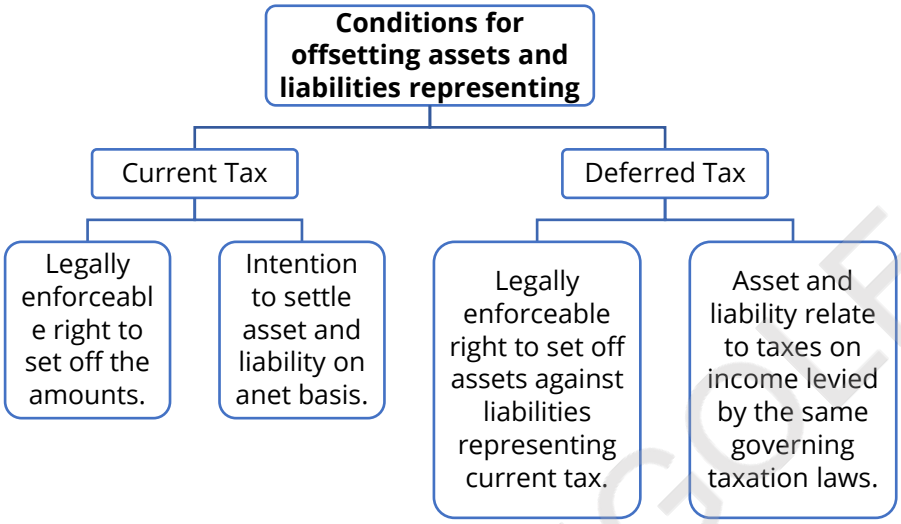
- Deferred tax assets and liabilities should be **distinguished from current tax** and **disclosed under a separate heading** in the balance sheet separately from current assets and current liabilities.

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(As per Schedule III of the Companies Act, 2013, Deferred Tax Assets or Liabilities are disclosed in Non – Current Assets or Liabilities as a separate line item)

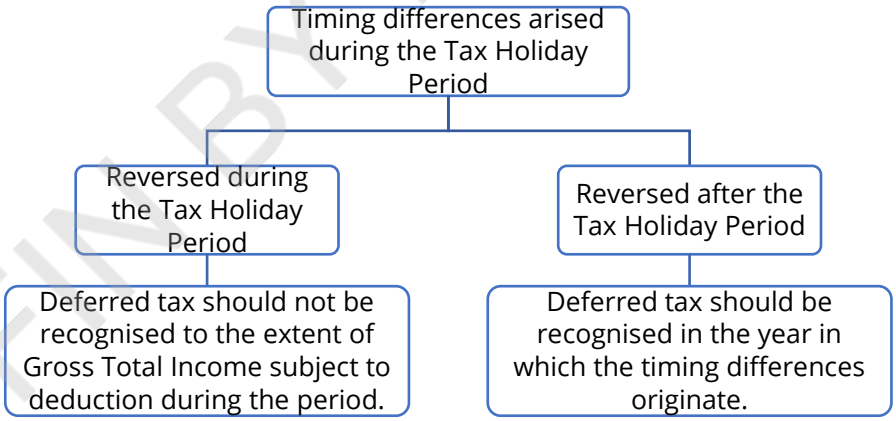
- The **break-up** of deferred tax assets and deferred tax liabilities into major components of the respective balance should be disclosed in the notes to accounts.

- If an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, the **nature of the evidence supporting the recognition of deferred tax assets** should be disclosed.



5 Explanations

5.1 Tax Holiday under sections 80-IA, 80-IB, 10A and 10B of the Income Tax Act, 1961:



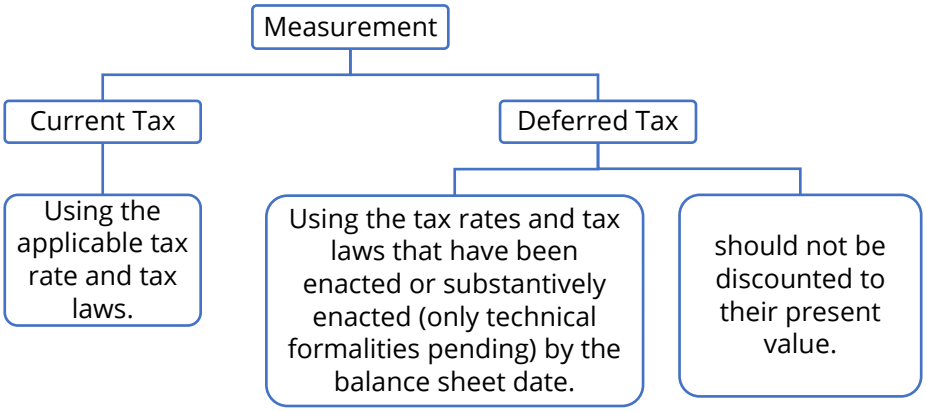
For the above purposes, the timing differences which originate first should be considered to reverse first (FIFO Basis).

6 Summary

- Save now & Pay Later – DTL
- Pay Now & Save later – DTA

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- Losses carried forward - DTA



Disclosures:

Profit & Loss Account	• No specific requirement to disclose current tax and deferred tax. • No requirement of reconciliation between accounting profit and the taxable income.
Balance Sheet	• Disclose under Non - Current liabilities • Break-up of deferred tax assets and deferred tax liabilities into major components. • Nature of evidence supporting the recognition of deferred tax assets (in case of unabsorbed depreciation or loss).

Assets and Liabilities representing

(i) Current Tax can be set off if legally enforceable right to sef off exists

(ii) Deferred Tax can be set off if legally enforceable right to set off assets against liabilities representing current tax exists ad the asset and liability relate to taxes on income under same law

7 Illustrations

1. Illustration

Particulars	
FY ending every year	31st March
1.04.2001: Purchase of machinery	Rs 150,000
Useful life	3 years
Expected scrap value	Zero
IT depreciation	100% - year 1
Accounting depreciation	SLM
Profit before depreciation and taxes (each year)	Rs 200,000
Corporate tax rate	40%

Answer:

The purchase of machine at a cost of Rs. 1,50,000 in 20x1 gives rise to a tax saving of Rs. 60,000. If the cost of the machine is spread over three years of its life for accounting purposes, the amount of the tax saving should also be spread over the same period as shown below:

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(Rs in '000)

	2011	2012	2013
Profit before depreciation and tax	200	200	200
Less: Depreciation for accounting purposes	50	50	50
Profit before tax	150	150	150
Tax expense			
Current tax (WN 1)	20	80	80
Deferred tax (WN 2)	40	(20)	(20)
Tax expense	60	60	60
Profit after tax	150-60 = 90	150-60 = 90	150-60 = 90

(Rs in '000)

WN 1: Current Tax	**2011**	**2012**	**2013**
Profit before depreciation and tax	200	200	200
Depreciation as per Taxation	150	0	0
Profit before tax (as per P&L)	50	200	200
Tax @ 40% [A]	20	80	80
WN 2: Deferred tax			
Depreciation as per Taxation	150	0	0
Depreciation as per accounts	50	50	50
Difference - current period	100	(50)	(50)
Cumulative difference	**100**	**100 -50=50**	**50-50=0**
As the difference originated in 2011 reversed in 2012 and 2013, it is timing difference, Hence, deferred tax can be applied.			
Enacted or substantively enacted tax rate	40%	40%	40%
Deferred tax liability (closing bal.) Cumulative difference x Tax rate	100 x 40% = 40	50 x 40% = 20	0 x 40% = 0
Closing position	DTL	DTL	DTL
P&L impact	40 is expense debited to P&L	40-20= 20. This isreversal of DTL of 2011, reduced **(credited)** from Tax expense of 2012	20-0=20 This is reversal of DTL of 2011, reduced **(credited)** from Tax expense of 2013

2. Illustration

If in Illustration 1, the substantively enacted tax rates for 2011, 2012 and 2013 are 40%, 35% and 38% respectively, how will be the amount of deferred tax liability computed.

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Answer:

If the rate of tax changes, it would be necessary for the enterprise to adjust the amount of deferred tax liability carried forward by applying the tax rate that has been enacted or substantively enacted by the balance sheet date on accumulated timing differences at the end of the accounting year.

(in Rs '000)

WN 1: Current Tax	**2011**	**2012**	**2013**
Profit before depreciation and tax	200	200	200
Depreciation as per Taxation	150	0	0
Profit before tax (as per P&L)	50	200	200
Tax @ 40% [A]	20	80	80
WN 2: Deferred tax			
Depreciation as per Taxation	150	0	0
Depreciation as per accounts	50	50	50
Difference - current period	100	(50)	(50)
Cumulative difference	**100**	**100-50=50**	**50-50=0**
As the difference originated in 2011 reversed in 2012 and 2013, it is timing difference, Hence, deferred tax can be applied.			
Enacted or substantively enacted tax rate	40%	35%	38%
Deferred tax liability (closing bal.) Cumulative difference x Tax rate	100 x 40% = 40	50 x 35% = 17.5	0 x 40% = 0
Closing position	DTL	DTL	DTL
P&L impact	40 is expense debited to P&L	40-17.5= 22.50. This is reversal of DTL of 2011, **reduced (credited)** from Tax expense of 2012	17.5-0=17.5 This isreversal of DTL of 2011, **reduced (credited)** from Tax expense of 2013

3. Illustration

Profit/ (loss) data	
FY ending every year	31st March
20x1	(100000)
20x2	50,000
20x3	60000
Tax rate:	40%

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Tax loss permitted carried forward upto	8 years

Assumptions:

• At the end of 20x1, it was virtually certain, supported by convincing evidence, that the company would have sufficient taxable income in the future years against which unabsorbed depreciation and carry forward of losses can be set- off.

• It is also assumed that there is no difference between taxable income and accounting income except that set-off of loss is allowed in years 20x2 and 20x3 for tax purposes.

Answer:

(Rs in '000)

	2011	**2012**	**2013**
Profit/ (loss) before tax	(100)	50	60
Tax expense			
Current tax	0	0	(4)
Deferred tax	100*40% = 40	(20)	(20)
Tax expense	40 Tax savings	(20) Tax expense	(24) Tax expense
Profit after tax	(100) + 40= (60)	50-20 =30	60-24 = 36

(Rs in '000)

WN1: Current Tax	2011	2012	2013
Profit before tax (as per P&L)	(100)	50	60
Tax @ 40%	0 since it is loss	0 since loss brought forward is more than current profit	(4) since profit after adjusting loss brought forward is 10
WN2: Deferred Tax			
Enacted or substantively enactedtax rate	40%	40%	40%
Deferred tax asset (closing bal.) Cumulative difference x Tax rate	100 x 40% = 40	50 x 40% = 20	0 x 40% = 0
Closing position	DTA	DTA	DTA
P&L impact	40 is DTA credited to P&L i.e., reduced from currenttax	40-20=20. This is reversal of DTA of 2011, **added (Debited)** to Tax expenseof 2012	17.5-0=17.5 This is reversal of DTL of 2011, **added (Debited)** to Tax Expense of 2013

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4. Illustration

Goodwill Limited is a full tax-free enterprise for the first 12 years of its existence and is in third year of operations. Depreciation timing difference resulting in a deferred tax liability in 1st, 2nd and 3rd year is Rs.200 lakhs, Rs.300 lakhs and Rs.400 lakhs respectively. From the 4th year onwards, it is expected that the timing difference would reverse each year by Rs.10 lakhs. Assuming tax rate @35%, find out the deferred tax liability at the end of 3rd year and any charge to the Profit and Loss Account.

Answer:

As per AS 22, 'Accounting for Taxes on Income', deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Income-tax Act.

Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence. For this purpose, the timing differences which originate first should be considered to reverse first. Therefore the treatment of Deferred tax as hereunder:

Deferred Tax Liability Account

Particulars	Amount (₹in lacs)	Particulars	Amount (₹in lacs)
Year 1 To Balance c/d	 38.5	By Balance b/d By Deferred Tax	0 38.5
	38.5		38.5
Year 2 To Balance c/d	 143.5	By Balance b/d By Deferred Tax	38.5 105
	143.5		143.5
Year 3 To Balance c/d	 283.5	By Balance b/d By Deferred Tax	143.5 140
	283.5		283.5

Workings:

Year 2

Cumulative timing Difference = 200 + 300 = 500

Difference reversing beyond tax holiday = 500 – 90 = 40

Deferred Tax Liability = 410 × 35% = 143.5

Year 3

Cumulative timing Difference = 200 + 300 + 400 = 900

Difference reversing beyond tax holiday = 900 – 90 = 810

Deferred Tax Liability = 810 × 35% = 283.5

5. Illustration

Rama Ltd. has provided the following information:

	Rs.
Depreciation as per Accounting Records	2,00,000
Depreciation as per Income tax records	5,00,000

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Unamortised preliminary expenses as per tax record	30,000

There is adequate evidence of future profit sufficiency. How much deferred tax asset / liability should be recognised as transition adjustment. Tax rate 50%.

Answer:

Particulars	Amount ₹	Timing Differences	Deferred Tax	Amount @ 50% ₹
Excess Depreciation as per tax records (₹5,00,000 – ₹2,00,000)	3,00,000	Timing	Deferred Tax Liability	1,50,000
Unamortized Preliminary expenses as per tax records	30,000	Timing	Deferred Tax Asset	(15,000)
Net deferred tax liability				1,35,000

6. Illustration

Acute Ltd is the owner of a CGU (Cash Generating Unit)block of assets whose current carrying cost is Rs. 999 lakhs. The company, after a detailed study by its technical team, has assessed the present recoverable amount of this CGU block of assets at Rs. 555 lakhs. The value of the block of assets as per the Income tax Records is Rs. 777 lakhs. The Board of Directors of the company have issued a signed statement confirming that the impairment in the value of the CGU is only a temporary phenomenon which is reversible in subsequent periods and also assuring virtual certainty of taxable incomes in the foreseeable future.

You are required to show Deferred Tax workings as per Accounting Standards in force, given the tax rate of 30% plus 10% surcharge thereon. The depreciation rate for tax purposes is 15% and that per books is 13.91%.

Answer:

	₹In Lakhs
Depreciation as per Accounting Records	161.41
Less: Depreciation as per IT records	(137.12)
Timing Difference resulting in Deferred Tax Assets	24.39
Deferred Tax asset = (30% + 10% Surcharge) on 24.29	8.02
Add: Deferred Tax asset on account of Impairment (₹444 Lakhs × 33%)	146.52
Total Deferred Tax asset	**154.54**

Depreciation as per Accounting Records

		₹In Lakhs	₹In Lakhs
Opening Balance	100.00		1,160,41
Less: Depreciation @ 13.91%	13.91	13.91 × 999/86.09	161.41
Closing Balance of assets	86.09	999.00	999.00

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Depreciation as per Income Tax Records

		₹In Lakhs	₹In Lakhs
Opening Balance	100		914.12
Less: Depreciation @ 15%	15	15 × 777/85	137.12
Closing Balance of assets	85	777	777.00

7. Illustration

Beta Ltd. is a full tax free enterprise for the first ten years of its existence and is in the second year of its operation. Depreciation timing difference resulting in a tax liability in year 1 and 2 is Rs. 1,000 lakhs and Rs. 2,000 lakhs respectively. From the third year it is expected that the timing difference would reverse each year by Rs. 50 lakhs.

Assuming tax rate of 40%, you are required to compute to the deferred tax liability at the end of the second year and any charge to the Profit and Loss account.

Answer:

Timing Difference reversing beyond tax holiday period will be considered for deferred tax calculation, as per AS 22

	Year 1	Year 2
	₹ In Lakhs	₹ In Lakhs
Timing Difference	1000	3,000 (2,000 + 1,000)
Less: Reversed on Tax holiday period	(400)	(400)
Eligible Timing Difference	600	2,600
Deferred Tax Liability/Charged to P&L (600 × 40%)	240	1,040 (2,600 × 40%) -P&L=800 (1,040 – 240) - Liability 1,040

8. Illustration

Is it permissible not to recognise deferred tax liability on the ground that an enterprise intends to carry out a major capital expansion programme in near future?

You are required to give advice to the Company.

Answer:

The Company Should provide for deferred tax liability on the timing differences irrespective for the fact that there will be losses both for accounting and tax purposes in near future. It may, however, be added that the deferred tax liability recognized at the balance sheet date will give rise to future taxable income at the time of reversal thereof.

If the same in the case of a Deferred Tax Asset (DTA) can be recognised only when the company reliably estimates sufficient future taxable income based either on reasonable or virtual certainty.

9. Illustration

The Accountant of Sohna Ltd. provides the following information for the year ended 31-03-2019:

Particulars	Rs.

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Accounting Profit	7,50,000
Book Profit as per MAT	4,37,500
Profit as per Income Tax Act	90,000
Tax rate	20%
MAT rate	7.50%

You are required to calculate the deferred tax asset/ liability as per AS 22 and amount of tax to be debited to the Profit and Loss Account for the year.

Answer:

Tax as per accounting profit (Tax Expense) 7,50,000 × 20% = ₹1,50,000
Tax as per MAT: 4,37,500 × 7.50% = ₹32,812.50

Tax Expense = Current Tax + Deferred Tax
1,50,000 = 90,000 × 20% + Deferred Tax
⇒Deferred Tax = 1,50,000 – 18,000
= ₹40,000

Profit & Loss Account

Tax (MAT) Since it is more than current tax	32,812.50	MAT Credit (₹32,812.50 – ₹18,000)	14,812.50
Deferred Tax	1,32,000		

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