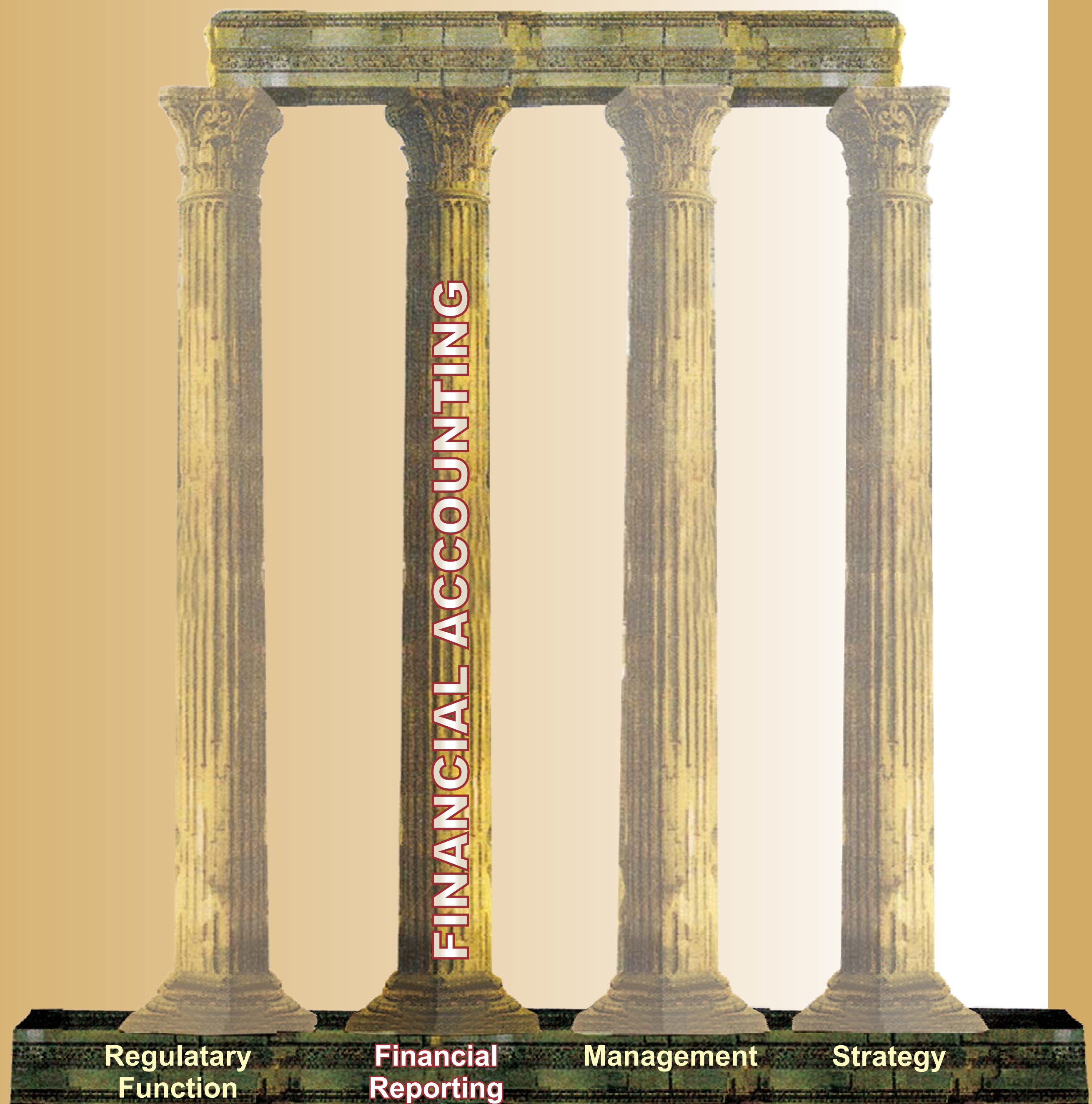

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INTERMEDIATE

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Financial Accounting

INTERMEDIATE : PAPER - 5

STUDY NOTES

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Syllabus

Paper 5: Financial Accounting

(One Paper: 3 hours:100 marks)

OBJECTIVES

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

Learning Aims

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

Preparation of accounts in the format prescribed under various statutes.
Preparation of consolidated statements.
Preparation of accounts for services sector.

Skill set required

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

CONTENTS

1.	Accounting Conventions and Practices	10%
2.	Royalty and Hire Purchase	10%
3.	Receipts & Payments/ Income & Expenditure Accounts	10%
4.	Partnership Accounting	10%
5.	Branch and Departmental Accounts	10%
6.	Accounting Standards	10%
7.	Joint Stock Companies	10%
8.	Preparation of Company Accounts	10%
9.	Accounting services in organizations	10%
10.	Accounting and Interpretation of Financial Statements.	10%

1.Accounting Conventions and Practices

Concept

Depreciation and various methods thereof

Stock valuation

Distinction between Capital and Revenue

2. Royalty and Hire Purchase

Royalty accounting

Need for hire purchase and installment systems and parties involved.

Accounting from the point of view various parties.

Possession and repossession in case of default in payments.

3. Receipts & Payments/ Income & Expenditure Accounts

Receipts & Payments

Income & Expenditure Account

4. Partnership Accounting

Past adjustments and guarantee

Admission & Retirement

Assignment of life policy

Amalgamation and Sale of Business

Dissolution, Insolvency

Piecemeal Distribution

5. Branch and Departmental Accounts

Branch accounts- Debtors system, Stock & Debtors system, Foreign Branch.

Treatment of shortages.

Calculation of net profit of various departments and allocation of expenses on the basis of suitable base.

Preparation of common balance sheet.

Treatment of Unrealized profit.

6. Accounting Standards

Applicability of a particular accounting standard.

Interpretation of various accounting standards.

Scope of accounting standards.

Compliance with the Accounting Standards.

7. Joint Stock Companies

Issues of shares at par, discount & premium, forfeiture, reissue of shares

Bonus issue and right issue

Buy back of shares

Redemption of Preference shares

Profit prior to incorporation

Issue and redemption of debentures

8. Preparation of Company Accounts

Preparation of Final Accounts under Company Law

9. Accounting services in organizations

Construction companies, Project Accounting

Service sector such as Software, ITES, Telecommunication, Entertainment, Hospital, educational institutions

Banking , Electricity and Insurance companies

10. Accounting and Interpretation of Financial Statements.

Paper 5 : FINANCIAL ACCOUNTING

Contents

Study Note - 1 : Accounting Convention and Practices

Study Note - 2 : Royalty and Hire Purchase

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Study Note - 5 : Branch Accounting including Foreign Branch

Study Note - 6 : Accounting Standards

Study Note - 7 : Joint Stock Companies

Study Note - 8 : Preparation of Final Accounts Under Companies Act, 1956

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Study Note -10 : Accounting And Interpretation of Financial Statements

STUDY NOTE - 1

ACCOUNTING CONVENTION, AND PRACTICES

This Study Note includes

- Accounting Concepts and Conventions
- Depreciation
- Accounting for Inventory
- Distinction between Capital and Revenue
- Basics of Accounting

1.1 ACCOUNTING CONCEPTS AND CONVENTIONS

Introduction :

Financial statements are to be prepared in accordance with generally accepted accounting principles. This is because if each organisation was to adopt its own principles in the maintenance of accounting records and the publishing of accounting information it will lead to a welter of confusion. Such financial statements will have low acceptability as it will be difficult to understand them without first knowing the principles underlying the preparation of such statements. Also financial statements prepared without the generally accepted accounting principles as their base will be unsuitable for inter-period and inter-firm comparison. It is for this reason that when accounts are audited by the auditors, they see to it that the financial statements are prepared in accordance with generally accepted accounting principles and they also certify that the statements have been prepared in accordance with generally accepted accounting principles.

Nature and Meaning of Accounting Principle

There is ample confusion and controversy as to the meaning and nature of accounting principle. There is a school of thought which believes that the term "*principle*" connotes "fundamental belief" or a "general truth" and as such it is incorrect to use this term with reference to accounting because accounting, merely as an art, is only an adoption for the attainment of some useful and beneficial results. Adaptation, inherently, implies the changing nature and, hence, a sharp contradiction to the meaning of the term "principle" which stands for the "fundamental truth"

There is another school of thought which feels that the term "principle" means only "rule of action or conduct" and as such can be very correctly used with reference to rules used in accounting. The American Institute of Certified Public Accountants (AICPA) has also supported the use of the word "principle" in the sense in which it means "rule of action". It has defined the principle as "a general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice." **Pato and Littleton**, in order to avoid the confusion as to the meaning of the term "principle", have purposely used a new term "*standards*" in place of "principle". 'Principles' would generally suggest a universality and a degree of permanence whch cannot exist in a human service institution such as accounting."

Essential Features of Accounting Principles

Accounting principles are acceptable when they, in general, satisfy the following three basic norms :

(a) usefulness,

(b) objectivity, and

(c) feasibility.

Accounting principles satisfy the first basic feature of usefulness as much as because of these, the accounting records become more meaningful and useful to the reader. In other words, an accounting rule, which does not increase the utility of the records to its readers, is not accepted as an accounting principle.

Accounting principles is that which is objective in nature. It is said to be objective when it is solidly supported by facts. It is objective when it cannot be influenced by the personal bias and whims.

Accounting principles should be such as are practicable. It will be seen that assets in the accounts are recorded at cost less depreciation as against at market price. This accounting principle is practicable and feasible because it does not entail the difficult work of ascertaining the market price of that asset. It does not make it obligatory for the accountant to record all fluctuation in the price of that asset.

Kinds of Accounting Principles

To distinguish accounting principles, from the sense in which the term principles is used in physical science, various other terms like postulates, concepts, conventions, doctrines, tenets, axioms, assumptions, etc., have been used by writers of accounting theory. Instead of wasting our time to discuss the precise meaning of these generic terms, we should concern ourselves with the significance and importance of these ideas in the practical work of the accountants. However, a slight distinction is made between the two terms ‘concepts’ and ‘conventions’. The term “Concept” is used to connote the accounting postulates, i.e., necessary assumptions and ideas which are fundamental to accounting practice. The term “Convention” is used to signify customs or traditions as a guide to the preparation of accounting statements.

The following are the important generally acceptable concepts :

1. Entity Concept
2. Going Concern Concept
3. Money Measurement Concept
4. Cost Concept
5. Accounting Period Concept
6. Dual Aspect Concept
7. Matching Concept
8. Realisation Concept
9. Balance Sheet Equation Concept
10. Verification and Objective Evidence Concept
11. Accrual Concept.

ACCOUNTING CONCEPTS

Entity Concept

It is very important to note that for accounting purposes the *business* is treated as a unit or entity apart from its owners, creditors and others. In other words, the *proprietor* of an enterprise is always considered to be separate and distinct from the business which he controls. All the transactions of the business are recorded in the *books of the business* (though they belong to the proprietor) from the point of view of the business as an entity and even the proprietor is treated as a creditor to the extent of his capital. Capital is thus a liability like any other liability although the amount is owing only to the proprietor. In the case of sole trading and partnership concerns the proprietors may even draw the amounts out, thus reducing the liability of the business. But in the case of corporate bodies, shareholders stand on a different footing. They cannot reclaim the amount they have invested. The can sell the shares to others if they desire to unload their investment. Therefore, in the case of corporate bodies capital is paid out only at the time of winding up, provided surplus assets are available after paying off the creditors. In the case of companies the entity concept is more apparent, as in the eyes of law it has separate legal entity independent of the persons who contribute its capital.

The concept of accounting entity for every business determines the scope of what is to be recorded or what is to be excluded from the business books. Therefore, whenever business receives cash from the proprietors cash account is debited as business receives cash and capital account is credited, capital account representing the personal account of the proprietor. In the case of corporate bodies since there are too many contributors the amount is shown under a single account called share capital account.

In the case of non-corporate bodies there is no separate legal entity. Still the principle of business entity is observed for accounting purposes. For example, although for legal and most practical purposes, we regard the sole trader and his business as one and the same thing, we nevertheless, for accounting purposes, regard them as different entities. Therefore in business, only the business assets and liabilities are recorded although legally there is no distinction between his business assets and liabilities and his private assets and liabilities. Thus, the concepts of legal and business entities are not compatible with each other. This is also clear from the fact that in the case of big companies each department may be the base for accounting although legal entity is much larger and covers all the departments. Likewise, in the case of consolidated statements accounting entity is much larger than the legal entity.

Going Concern Concept

This concept assumes the enterprise will continue to exist in the foreseeable future. This is in contrast with another view that the enterprise will be liquidated. According to A.S. –1 relating to disclosure of accounting policies, going concern concept is a fundamental accounting assumption underlying the preparation of financial statements. Under this assumption, "the enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations".

This assumption implies the following :

(i) Assets will be valued on the basis of going concern assumption. In other words, accountants do not record the values of goods and assets which will be fetched if a sale is forced. Certain assets which are specific to the particular enterprise may have a very low market value. However, the value of such machines to the business is very great because of its productive potential and contribution to profits.

In spite of this accountants prefer to record assets at historical cost rather than adopt 'value-in-use' approach which is favoured by economists. This is because historical cost approach satisfies the test of objectivity and verifiability.

(ii) Assets are depreciated on the basis of expected life rather than on the basis of market value. This facilitates the allocation of the cost of the asset over the expected period of the life of the asset and dispenses with the periodic consideration of market values. This concept strengthen and support the view that 'depreciaiton' is a process of allocation, not of valuation.

Thus, the 'going concern' concept is the basic to the valuation of assets and the provision of depreciation thereon.

Money Measurement Concept

The money measurement concept underlines the fact that in accounting every worth recording event happening or transaction is recorded in terms of money. In other words, a fact or a happening which cannot be expressed in terms of money is not recorded in the accounting books. General health condition of the chairman of the company, working condition in which a worker has to work, sales policy pursued by the enterprise, quality of products introduced by the enerprise, etc., cannot be expressed in money terms and therefore are not recorded in the books. In view of the above condition this concept puts a serious handicap on the usefulness of accounting records for management decisions.

This concept has another serious limitation and is currently attracting the attention of the accountants all over the world.

As per this concept, a transaction is recorded at its money value on the date of occurance and the subsequent changes in the money value are conveniently ignored.

Cost Concept (Historic)

The underlying idea of cost concept is that :

(i) asset is *recorded* at the price paid to acquire it, that is, at cost; and

(ii) this cost is the *basis for all subsequent accounting* for the asset.

When asset is recorded at cost price as said under point (i) above, the change in the real worth of an asset (for variety of reasons) with the passage of time is not ordinarily recorded in the account books. For example, if a piece of land has been purchased for Rs.80,000, then its market price (whether Rs. 1,70,000 or Rs. 50,000) at the time of preparation of final statements will not be considered. Thus the balance sheet on a particular date, prepared on the basis of cost concept, does not ordinarily indicate what the assets could sold for.

As an explanation of the point (ii) of the cost concept, it can be said that the cost concept does not mean that assets are always shown year after year for an indefinite period at the cost price. The assets recorded at cost price at the time of purchase are systemtically reduced by the process called depreciation. These assets ultimately disappear from the balance sheet when their economic life is over and they have been fully depreciated and sold as scrap. Therefore, in the books assets figure at cost less depreciation written off and are called book values to distinguish from their market values which represent their true worth. However, in the case of liquid assets like cash and book debts there is no difference between the book values and current market values. But in the case of other current assets like stocks and investments there may be some difference between the two values but the margin will not be as wide as it will be in the case of fixed assets.

In spite of the limitations of cost concept referred to above, accountants prefer this approach to other for the following reasons :

1. There is too much of subjectivity in 'current worth' or 'market value' or 'realisable value' approach.
2. Fixed assets are purchased for use in production and are not held for sale.
3. It is very difficult and time consuming for an enterprise to ascertain the market values.
4. There is objectivity and verifiability in cost approach which is lacking in the other approaches.

Accounting Period Concept

Strictly speaking, the net income can be measured by comparing the assets of the business existing at the time of its commencement with those existing at the time of its liquidation. Since life of business is assumed to be indefinite (going concern concept), the measurement of income, according to the above concept, is not possible for a very, very long period. The proprietor of the busienss cannot wait for such a long period as the determination of income at the end of the life of business would render such a measurement of income useless in as much as it will be too late to take corrective steps at the time, if it is disclosed that the business had all the time being running at a loss on account of certain reasons or business had not been using its fully capacity to make more profits. Thus, he needs to know at frequent intervals "how things are going".Therefore, accountants choose some shorter and convenient time for the measurement of income. Twelve-month period is normally adopted for this purpose. Under the Companies Act and Banking Regulation Act accounts are to be prepared for a 12-month period. This time interval is called *accounting period.*

Dual Aspect Concept

Financial accounting is transaction based. Of course, we are only concerned with transactions and events involving financial element. In every type of business there are numerous transactions. If one takes a typical trading concern the main activity is purchase of goods and their subsequent sale at a profit. This involves several transactions like purchase of goods from several suppliers, sales to several customers on cash and credit, payment to suppliers, collection from customers, payment of salaries to salesmen, purchase assistants, payment of rent and taxes, electricity bills, etc. In each of the transactions listed above there are two aspects to be recorded from the point of view of entity. For example, if there is purchase of goods – it involves two aspects : one aspect is the receipt of goods and the other aspect is the immediate payment of cash (in the case of cash purchase) or the acknowledgement of debt to the supplier (in the case of credit purchase). The recognition of two aspects to every transaction is known as dual aspect analysis. Modern financial accounting is based on such recognition of the record of the two aspects of every transaction. The term 'double entry book-keeping has come into vogue because of every transaction two entires are made. One entry consists of debit to one or more accounts and another entry consists of credit to one or more accounts. However, the total amount debited always equals the total amount credited. This balancing of debits and credits is the cornerstone of modern book-keeping.

How this accounting principle operates is illustrated with a few examples.

For example, when Manish, the proprietor of the business, starts his business with Cash Rs.40,000 and Building Rs.50,000 then this fact is recorded at two places : Assets account and Capital account. The capital of the business is equal to the assets of the business. This expression can be shown in the form of equation as under :

Capital	=	Assets
Manish	=	Building + Cash
Rs.90,000	=	Rs.50,000+Rs.40,000

If the business increases the assets by borrowing Rs.20,000, then the dual aspect of the transaction affects the equation as under :

Capital + Liabilities	=	Assets
Manish + Loan	=	Building + Cash
Rs.90,000+Rs.20.000	=	Rs.50,000+Rs.60,000

Matching Concept

This concept recognises that the determination of profit or loss on a particular accounting period is a problem of matching the expired cost allocated to an activity period. In other words, the expenses which are actually incurred during a specific activity period, in order to earn the revenue for the said period must be matched against the revenue which are realised for that period. For this pruposes, expenses which are specially incurred for earning the revenue of the related period are to be considered. In short, all expenses incurred during the activity period must not be taken. Only relevant cost should be deducted from the revenue of a period for periodic income statement, i.e., the expenses that are related to the accounting period shall be considered for the purpose of matching. This process of relating costs to revenue is called matching process. It should be remembered that cost of fixed asset is not taken but only the depreciation on such fixed asset related to the accounting period is taken (For the purpose of matching, prepaid expenses are excluded from the total cost but outstanding expenses are added to the total cost for ascertaining the cost related to the period). Like costs all revenues earned during the period are not taken, but revenue which are related to the accounting period are considered.

Application of matching concept creates some problems which are noted below:

(a) Some special items of expenses e.g. preliminary expenses, expenses in connection with the issue of shares and debentures, advertisement expenses etc., cannot be easily identified and match against revenues of a particular period.

(b) Another problem is that how much of the capital expenditure should be written off by way of depreciation for a particulr period for matching against revenue creates the problems of finding out the expected life of the asset. As such, accurate matching is not possible.

(c) In case of long term contracts usually, amount is not received in proportion to the work done. As a result, expenditures which are carried forward and not related to the income received, may create some problems.

Realisation Concept

According to this concept, revenue is considered as earned on the date when it is realised. In other word, revenue realised (either by sale of goods or by rendering services) during an accounting period should only be taken in the income statement (Profit and Loss Accunt). Unearned / Unrealised revenue is treated as earned on some specific matters or transactions. For example, when goods are sold to customers, they are legally liable to pay, i.e. as soon as the property of goods passes from the seller to the buyer. In short, when an order is simply received from a customer, it does not mean that the revenue is earned or realised. On the other hand, when an advance payment is made by a customer, the same cannot be treated as revenue realised or earned. In case of hire-purchase transactions, however, the title or ownership of the goods is not transferred from the seller to the buyer till the last instalment is paid. As such, the down payments and the instalment received or due should be treated as actual sale, i.e., revenue earned.

Balance Sheet Equation Concept

The Historical Cost Concept needs support of two other concepts for practical purposes viz. (i) the Money Measurement Concept (ii) the Balance Sheet Equation Concepts. Accounting processes, however, conforms to an algebric equation which, in other words is involved in two laws of nature, i.e., the law of constancy of matter and the law that every effect originates from a case.

In relation to the former, it may be deduced that all that has been received by us must be equal to (=) all that has been given to us (In accounts, receipts are classified as debits and giving or sacrifices are classified as credits). Here, the equation comes

Debit = Credit

(That is, in other words, every debit must have a corresponding equal credit or vice-versa). All receipts (referred to above) may again be classified into (i) benefits / services received and totally consumed (which are known as expenses), (ii) benefits or services received but not used properly or misused (which are known as losses) and (iii) benefits or services received but kept to be used in future (which are known as assets). Similarly, in the opposite case, all that have been given by others may also be classified into (i) What has been given to us but are not to be repaid (which are known as incomes or gains) and (ii) What has been given by others but has to be repaid at a later date (which are known as liabilities).

Therefore, the above equation may again be re-written as under :

Expenses + Loss + Assets = Income + Gains + Liabilities

Or, *Asset = Net Profit (-) Net Loss + Liabilities*

Liabilities become due either to outsider or to the owner, viz. The proprietors, in the case :

Assets = Net Profit or (-) Net Loss + External liabilities + Dues to Proprietors.

We know that proprietors due increases with the amount of net profit whereas decreases with the amount of net loss. The same is known as equity in the business. So, the above equation comes down to :

Assets = Equity + External Liabilities

Again, from the proprietor's point of view, the equation can also be re-written as under :

Proprietor's Fund or Equity = Asset – Liabilities

$E = A - L$

From the above, it may be said that the entire accounting process depends on the above accounting equation.

Verifiable and Objective Evidence Concept

It expresses that accounting data are subject to verification by independent experts i.e. there must be documentary evidences of transactions which are capable of verification. Otherwise, the same will neither be verifiable nor be realisable or dependable. In other words, accounting data must free from any basic. Because, verifiability and objectivity imply reliability, trustworthiness, dependability which are very useful for conveying the accounting data and information furnished in periodical accounting reports and statements. There should always be some documentary evidences in establishing the truth reflected in the said reports or statements. Entries which are recorded in accounting from the transactions and data which are reported in financial statements must be based on objectively determined evidence. The confidence of users of the financial statement cannot be maintained until there is a close adherence to this principle, invoices and vouchers for purchases, sales and expenses, physical checking of stock in hand.

Accrual Concept

An associated concept to be discussed in the context of 'matching principle' is the accrual system of accounting which is favoured by the modern accountants as against cash system of accounting. Under this method revenue recognition depends on its realisation and not actual receipt. Likewise costs are recognised when they are incurred and not when paid. This necessitates certain adjustments in the preparation of income statement. In relation to revenue, the accounts should exclude amounts relating to subsequent period and provide for revenue recognised but not received in cash. Likewise, in relation to cost provide for costs incurred but not paid and exclude costs paid for subsequent period. Under the cash system of accounting revenue recognition does not take place until cash is received and costs are recorded only after they are paid. From the discussion it is clear that the matching principle is not followed in the case of cash system of accounting and the operating result prepared on this basis are not in conformity with generally accepted accounting principles. There are hybrid systems of accounting which combine the features of cash and accrual systems and are also recognised by taxation authorities. Under hybrid system certain revenues may be shown on cash basis while others are shown on accrual basis.

ACCOUNTING CONVENTIONS

Convention of Disclosure

The convention of disclosure implies that accounts must be honestly prepared and all material information must be disclosed therein. The notion is so important (because of divorce between ownership and management) that the Companies Act makes ample provisions for the disclosure of essential information in company accounts. The contents of balance sheet and profit and loss account are prescribed by law. These are designed to make disclosure of all material facts compulsory.

The term *disclosure* does not imply that all information that anyone could conceivably desire is to be included in accounting statements. The term only implies that there is to be a sufficient diclosure of information which is of material interest to proprietors, present and potential creditors and investors. The practice of appending notes relative to various facts or items which do not find place in accounting statements is in pursuance to the convention of full disclosure of material facts. Examples are :

(a) Contingent liabilties appearing as a note,

(b) Market value of investments appearing as a note.

Business is now increasingly managed by stewards (managers) and they owe a duty to make a full disclosure to the persons who have cotributed the capital. Financial accounting, while reporting on stewardship, has to make full disclosure. 'Openness in company affairs is the best way to secure responsible behaviour. Because of the wide recognition of this principle now there is an "Accounting Standard" which requires the disclosure of all significant accounting policies adopted in the preparation of financial statements, due to the effect of such policies on the financial statements. The accounting principle of 'Going Concern', 'Consistency and 'Accrual' are considered fundamental in the preparation of financial statements and need not be disclosed. Only when the assumption is not followed the fact should be disclosed. Apart from disclosure of accounting policies, A.S. – 1 deals with information to be disclosed in financial statements.

The concept of disclosure also applies to events occurring after the balance sheet date and the date on which the financial statements are authorised for issue. Such events include bad debts, destruction of plant and equipment due to natural calamities, major acquisition of another enterprise and the like. Such events are likely to have a substantial influence on the earnings and financial position of the enterprise. Their non-disclosure would affect the ability of the users of such statements to make proper evaluations and decisions.

Convention of Materiality

The role of this convention cannot be over-emphasised in as much as accounting will be unnecessarily overburdened with more details in case an accountant is not able to make an objective distinction between material and immaterial matters. American Accounting Association (AAA) defines the term materiality as under :

"An item should be regarded as material if there is reason to believe that knowledge of its would influence the decision of informed investor".

Kohler has defined materiality as under :

"The characteristic attaching to a statement, fact, or item whereby its disclosure or the method of giving it expression would be likely to influence the judgement of a reasonable person".

Some of the examples of material financial information to be disclosed are likely fall in the value of stocks, loss of markets due to competition or Government regulation, increase in wage bill under recently concluded agreement, etc. It is now agreed that information known after the date of balance sheet must also be disclosed.

Another example of materiality is the question of allocation of costs. An item of small value may last for three years and technically its cost must be allocated to every one of the three years. Since its value is small, it can be treated as the expense in the year of purchase. Such a decision is in accordance with the principle of materiality. Likewise, unimportant items can be either left out or merged with other items. Sometimes items are shown as footnotes or in parentheses according to their relative importance.

It should be noted that an item material for one concern may be immaterial for another. And similarly, an item material in one year may not be material in the next year.

As per A.S. – 1, materiality should govern the selection and application of accounting policies. According to the consideration of materiality financial statement should disclose all items which are material enough to affect evaluations or decisions.

Convention of Consistency

In order to enable the management to draw important conclusions regarding the working of a company over a number of years, it is but essential that accounting practices and methods remain unchanged from one accounting period to another. The comparison for one accounting period with that in the past is possible only when the convention of consistency is adhered to. But the idea of consistency does not imply non-flexibility as not to permit the introduction of improved techniques of accounting. According to A.S. – 1 consistency is a fundamental assumption and it is assumed that accounting policies are consistent from one period to another. Where this assumption is not followed, the fact should be disclosed together with reasons.

The principle of consistency plays its role particularly when alternative accounting method is equally acceptable. For example, in applying the principle that fixed asset is depreicaied over its useful life a company may adopt any of the several methods of depreciaiton, viz., written-down-value method, straight-line method, sinking fund method, annuity method, sum-of-years-digit method, unit-of-production method or any other method. But in keeping with the convention of consistency it is expected that the company would consistently follow the same method of depreciation which is chosen. Any change from one method to another would result in inconsistency.

In the following cases, however, there is no inconsistency although apparently they make look inconsistent :

(a) The application of principle for stock valuation 'at cost or market price whichever is lower' will result in the valuation of stock sometimes at cost price and sometimes at market price. But there is no inconsistency here because the shift from the cost to market is only the application of the principle.

(b) Similarly, if investments are valued at cost or market price whichever is lower, it is only an application of the principle

Kohler has talked about three types of consistencies :

(a) *Vertical consistency*. This consistency is maintained within the interrelated financial statement of the same date. Vertical inconsistency will occur when an asset has been depreciated on one basis for income statement and on another basis for balance sheet.

(b) *Horizontal consistency*. This enables the comparison of performance of an organisation in one year with its performance in the next year.

(c) *Third dimensional consistency*. This enables the comparison of the performance of one organisation with the performance of other organisation in the same industry.

Convention of Conservatism

This is the policy of 'playing safe'. It takes into consideration all prospective losses but leaves all prospective profits. This accounting principle is given recognition in A.S. – 1 which recommends the observance of prudence in the framing of accounting policies. "Uncertainties inevitably surround many transactions. This should be recognised by exercising prudence in financial statements. Prudence does not, however, justify the creation of secret or hidden reserves". Following are the examples of the application of the convention of conservatism :

(a) Making the provision for doubtful debts and discount on debtors in anticipation of actual bad debts and discount,

(b) Valuing the stock in trade at market price or cost price whichever is less,

(c) Creating provision against fluctuation in the price of investments,

(d) Charging of small capital items, like crockery, to revenue,

(e) Adopting written-down-value method of depreciation as against straight-line method. The written-down-value method of depreciaiton is more conservative in a approach.

(f) Amortization of intangible assets like goodwill which has indefinite life,

(g) Showing joint life policy at surrender value as against the amount paid,

(h) Not providing for discount on creditors,

(i) Taking into consideration claims intimated but not accepted as a loss for calculating profit for a general insurance company,

(j) Considering the loss relating to premium on the redemption of debentures when they are issued at par or at discount but redeemable at premium, at the time of their issue.

The principle of conservatism is applied :

(a) When there is an uncertainty inherent in the activity, e.g., uncertainty as to the useful life of an asset, occurrence of loss, realization of income, remaining utility of an asset, estimated liability.

(b) When there are two equally acceptable methods then the one which is more conservative will be accepted.

(c) When there is judgement based on estimates and doubt exists as to which of the several estimates is correct, the most conservative would be selected.

(d) When there is possibility of the occurrence of a loss or profit, losses will be considered and profits will be overlooked.

This principle has effect on :

(a) Income statement. Here the principle results in lower net income than would otherwise be the case.

(b) Balance sheet. When applied to the balance sheet, the conservative approach results in understatement of assets and capital and overstatement of liabilities and provisions.

The principle of conservatism, however should be applied cautiously. If the principle is stretched without reservations it results in the creation of secret reserves which is in direct conflict with the doctrine of full disclosure. Since the main aim of published accounts is to convey and not to conceal the information, the policy of secrecy is being abandoned in favour of the modern and more logical policy of disclosure.

BASICS OF ACCOUNTING

DOUBLE ENTRY SYSTEM

It was in 1494 that Luca Pacioli the Italian mathematician, first published his comprehensive treatise on the principles of Double Entry System. The use of principles of double entry system made it possible to record not only cash but also all sorts of Mercantile transactions. It had created a profound impact on auditing too, because it enhanced the duties of an auditor to a considerable extent.

Features of Double Entry System

(i) Every transaction has two fold aspects, i.e., one party giving the benefit and the other receiving the benefit.

(ii) Every transaction is divided into two aspects, Debit and Credit.

One account is to be debited and the other account is to be credited.

(iii) Every debit must have its corresponding and equal credit.

Advantages of Double Entry System

(i) Since personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.

(ii) It ensures arithmetical accuracy of the books of accounts, for every debit, there is a corresponding and equal credit. This is ascertained by preparing a trial balance periodically or at the end of the financial year.

(iii) It prevents and minimizes frauds. Moreover frauds can be detected early.

(iv) Errors can be checked and rectified easily.

(v) The balances of receivables and payables are determined easily, since the personal accounts are maintained.

(vi) The businessman can compare the financial position of the current year with that of the past year/s.

(vii) The businessman can justify the standing of his business in comparison with the previous years purchase, sales, stocks, in comes and expenses with that of the current year figures.

(viii) Helps in decision making.

(ix) The net operating results can be calculated by preparing the Trading and Profit and Loss A/C for the year ended and the financial position can be ascertained by the preparation of the Balance Sheet.

(x) It becomes easy for the Government to decide the tax.

(xi) It helps the Government to decide sickness of business units and extend help accordingly.

(xii) The other stakeholders like suppliers, banks, etc take a proper decision regarding grant of credit or loans.

Limitations of Double Entry System

(i) The system does not disclose all the errors committed in the books accounts.

(ii) The trial balance prepared under this system does not disclose certain types of errors.

(ii) It is costly as it involves maintenance of numbers of books of accounts.

Account

An account denotes a summarized records of transactions pertaining to one person, one kind of asset, or one class of income, expense or loss.

It can also be explained as :

"TO COUNT"

→ the financial value of each events,

which are termed as Transactions.

Classification of Accounts

Accounts are usually subdivided into the following classes :

ACCOUNT

- PERSONAL
  - NATURAL PERSON
  - ARTIFICIAL PERSON
  - REPRESENTATIVE PERSON
- IMPERSONAL
  - REAL
  - NOMINAL

1. **Personal Accounts :** These accounts deal with transactions relating to persons or an organization. It can be classified as :
   - (a) Natural Persons : Mr. S. Sharma, Triveni & Sons, etc.
   - (b) Artificial Persons : State Bank of India, ITC Ltd, CC & FC, Royal Calcutta Golf Club, etc.
   - (c) Representative Persons : Outstanding Expenses (represent ting liability for expenses to supplies) ; Prepaid Salary (representating employess) etc.

2. **Impersonal Accounts :** There accounts do not relate to any persons are known as impersonal accounts.
   - (a) Real Accounts : It is an accounts relating to assets and properties.

     Eg: Land, Building, Plant, Machinery, Cash, Bank, Stock, etc.
   - (b) Nominal Accounts : It is an account relating to expenses, losses, incomes and gains. They do not have any physical existence except names.

     Eg: Sales, Purchases, Salary, Wages, Rent, Interest, Repairs, Travelling, etc.

Debit and Credit

Debit is derived from the latin word “debitum”, which means `what we will receive’. It is the destination, who enjoys the benefit.

Credit is derived from the latin word “credre” which means `what we will have to pay’. It is the source, who sacrifices for the benefit.

Diagrammatic Representation of Accounting Rules or the Golden Rules of Accounting

DOUBLE ENTRY

- Traditional Version
  - Personal Accounts
  - Real Accounts
  - Nominal Accounts
- Modern
  - Assets + Expenses = Liabilities + Incomes

GOLDEN RULES

Traditional		Debit	Credit
Version	Personal A/c :	Receiver	Giver
	Real A/c :	What comes in	What goes out
	Nominal A/c :	Expenses and losses	Income and Gains

Modern Version : Any change in any variable of the equation must have another change in another variable either in the opposite direction in the same side, or in the same direction in the opposite side.

Events : Any or all activities which we are doing in our day-to-day life.

Example : Reading, Sleeping, Eating, Thinking, Singing, Gossiping, Buying, Selling, Playing and etc.

Transactions : An event which has the following characteristics :

(i) Which changes the financial position of a person.

(ii) Which can be measured in terms of money.

(iii) Which can be recorded in the Books of Accounts.

Example : Purchase, Sales, Travelling Expenses, Rent, Wages, Salaries, and etc. It is therefore concluded that ***“All transactions are events but all events are not transactions”***.

Classification of Transaction

TRANSACTION

- CASH
- NON-CASH
  - CREDIT
  - OTHERS

Cash Transactions : Those transactions which involves inflow / outflow of cash.

Example : (i) Purchased goods for cash Rs. 100.

(ii) Paid Expenses Rs. 20.

(iii) Sold goods for cash Rs. 300 and etc.

Non-cash Transaction : Those transaction which is not involved with immediate inflow / outflow of cash. They are again sub-divided cost.

Credit Transactions : Those transactions which involve increase in assets / liabilities.

Example : (i) Goods sold to Mr. Sen on credit
— increase in asset.

(ii) Purchased goods from Sunny on credit
— increase in liability.

Other Non - Cash Transactions : Those which involves loses and does not result in immediate outflow of cash.

Example : (i) Depreciation of Fixed assets

(ii) Bad Debts and etc.

Illustrations 1

(i) Miss Chandrima Das started business with cash Rs. 20,000.

(ii) Purchased a Machinery for cash Rs. 5,000.

(iii) Sold goods for cash Rs. 7,000.

(iv) Paid Expenses Rs. 500.

Solution :

Under Traditional Approach

(i) The Cash Account and the Capital Accounts is involved, the former being Real Account and the latter being Personal account.

Cash Account	Dr.	To which comes the benefit (Debit what comes in)
Miss Chandrima Das's Account	Cr.	Account giving the benefit (Credit the giver)

(ii) The Machinery Account and Cash Account are involved both being Real accounts.

Machinery Account	Dr.	To Which Comes the benefit
Cash Account	Cr.	From which goes the benefit.

(iii) The Cash Account and Sales Account are involved. The former being Real Account and the latter being Nominal account.

Cash Account	Dr.	To Which Comes the benefit
Sales Account	Cr.	Incomes and Gains

(iv) The Expenses Account and Cash accounts are involved the former being Nominal account and the latter being Real Account.

Expense Account	Dr.	Expenses and Losses
Cash Account	Cr.	From which goes the benefit.

Under Modern Version.

Assets + Expenses = Liabilities + Income

Transaction :	Assets	+	Expenses	=	Capital	+	External Liabilities	+	Incomes
i. Capital Introduced in Cash Rs. 20,000	20,000	+	0	=	20,000	+	0	+	0
ii. Machinery Purchased for Cash Rs. 5,000	5,000 (5,000)	+	0	=	0	+	0	+	0
	20,000	+	0	=	20,000	+	0	+	0
iii. Sold goods for cash Rs. 7000	7,000	+	0	=	0	+	0	+	7,000
	27,000	+	0	=	20,000	+	0	+	7,000
iv. Paid Expenses Rs. 200 :	(200)	+	200	=	0	+	0	+	0
	26,800	+	200	=	20,000	+	0	+	7000

Rules for Recording under Double Entry System

	Nature	Increase	Decrease
1.	Asset	Debit	Credit
2.	Expenses	Debit	Credit
3.	Liabilities	Credit	Debit
4.	Capital	Credit	Debit
5.	Revenue	Credit	Debit

Diagrammatic Representation of the Rules in T-form of Accounts

Dr.	**Assets Account**	**Cr.**	**Dr.**	**Expenses Account**	**Cr.**
Increase		Decrease	Increase		Decrease
+		?	+		?
Dr.	Revenue Accounts	Cr.	Dr.	Liabilities Account	Cr.
Decrease		Increase	Decrease		Increase
—		+	—		+
Dr.	Capital Accounts	Cr.			
Decrease		Increase			
—		+ ss			

Illustration 2

(i) Mr. Jojo started business with cash Rs. 40,0000.

Cash A/c	—	Real A/c	—	Comes In	—	Debited	—	Dr. ?
Capital A/c	—	Personal A/c	—	Given	—	Credited	—	Cr. ?

It means cash has come into the business and Mr. Jojo was the provider (or giver) of such.

Dr.	**Cash Account**	Cr.
To Capital A/c	Rs.	
	40,000	

Dr.	**Capital Account**	Cr.
To Capital A/c	By Cash A/c	40,000

(ii) Bought furniture for cash Rs. 5000.

Furniture A/c	—	Real A/c	—	Comes In	—	Debited	—	Dr. ?
Cash A/c	—	Real A/c	—	Goes out	—	Credited	—	Cr. ?

Furniture is coming into the business, by sacrificing cash.

Dr.	**Furniture Account**	Cr.
To Cash A/c	5,000	

Dr.	**Cash Account**	Cr.
	By Furniture A/c	5,000

(iii) Purchased goods for Cash Rs. 1,000

Purchase A/c	—	Nominal A/c	—	Expense	—	Debited	—	Dr. ?
Cash A/c	—	Real A/c	—	Goes out	—	Credited	—	Cr. ?

Dr.	**Purchase Account**	Cr.
To Cash A/c	1,000	

Dr.	**Cash Account**	Cr.
	By Purchase A/c	1,000

(iv) Sold goods for Cash Rs. 2500

Cash A/c	—	Real A/c	—	Comes in	—	Debited	—	Dr. ?
Sales A/c	—	Nominal A/c	—	Income	—	Credited	—	Cr. ?

Dr.	**Cash Account**	Cr.
To Sales A/c	2,500	

Dr.	**Sales Account**	Cr.
	By Cash A/c	2,500

(v) Purchased goods from Dip for Rs. 7,000

Dip's A/c	— Real A/c	— Giver	— Credited	— Cr. ?
Purchase A/c	— Nominal A/c	— Expense	— Debited	— Dr. ?

This is a credit transaction, since nothing is mentioned regarding the payment, but the supplier's name is given. There is an increase in liability.

Dr.	**Dip's Account**	Cr.
	By Purchase A/c	7,000

Dr.	**Purchase Acount**	Cr.
To Dip's A/c	7,000	

(vi) Purchased goods from Tarak for Rs. 3000 and paid cash for the same

This is a cash transaction. Although the supplies name is mentioned, but the payment was made in cash.

Purchase A/c	— Nominal A/c	— Expense	— Debited	— Dr. ?
Cash A/c	— Real A/c	— Goes out	— Credited	— Cr. ?

Dr.	**Purchase Account**	Cr.
To Cash A/c	3,000	

Dr.	**Cash Account**	Cr.
	By Purchase A/c	3,000

(vii) Sold goods to Anirban for Rs. 3,000.

This is a non-cash, i.e. credit transaction. The customer's name is mentioned, without any cash inflows. There is an increase in Receivable (Assets).

Anirban's A/c	— Personal A/c	— Receiver	— Debited	— Dr. ?
Sales A/c	— Nominal A/c	— Income	— Credited	— Cr. ?

Dr.	**Anirban Account**	Cr.
To Sales A/c	3,000	

Dr.	**Sales Account**	Cr.
	By Anirban's A/c	3,000

(viii) Loan taken from Zoheb Rs. 20,000

Cash A/c	— Real A/c	— Comes In	— Debited	— Dr. ?
Zoheb's Loan A/c	— Personal A/c (Liability)	— Giver	— Credited	— Cr. ?

There is an increase in liability

Dr.	Cash Account	Cr.
To Zoheb's Loan A/c	20,000	

Dr.	Zoheb's Loan Account	Cr.
	By Cash A/c	20,000

(ix) Paid the supplier of goods Dip, in full Rs. 7000.

Dip's A/c	—	Personal A/c (Liability)	—	Receiver	—	Debited	—	Dr. ?
Cash A/c	—	Real A/c	—	Goes out	—	Credited	—	Cr. ?

There is an decrease in liability

Dr.	Dip's Account	Cr.
To Cash A/c	7,000	

Dr.	Cash Account	Cr.
	By Dip's A/c	7,000

(xi) Received from Anirban Rs. 2,000 on account.

On account means in part payment or receiving against the dues.

Cash A/c	—	Real A/c	—	Comes In	—	Debited	—	Dr. ?
Anirban's A/c	—	Personal A/c (Receivable)	—	Giver	—	Credited	—	Cr. ?

Dr.	Cash Account	Cr.
To Anirban's A/c	2,000	

Dr.	Anirban's Account	Cr.
	By Cash A/c	3,000

(xi) Paid Wages for Rs. 1,200.

Wages A/c	—	Nominal A/c	—	Expenses	—	Debited	—	Dr. ?
Cash A/c	—	Real A/c	—	Goes out	—	Credited	—	Cr. ?

Dr.	Wages Account	Cr.
To Cash A/c	1,200	

Dr.	Cash Account	Cr.
	By Wages A/c	1,200

(xii) Received Commission Rs. 500.

Cash A/c	—	Real A/c	—	Comes In	—	Debited	—	Dr. ?
Commission A/c	—	Nominal A/c	—	Income	—	Credited	—	Cr. ?

Dr.	Cash Account	Cr.
To Commission A/c	500	

Dr.	Commission Account	Cr.
	By Cash A/c	500

(xiii) Further capital introduced by Mr. Jojo Rs. 50,000.

Cash A/c	—	Real A/c	—	Comes In	—	Debited	—	Dr. ?
Capital A/c	—	Personal A/c	—	Giver	—	Credited	—	Cr. ?

Dr.	Cash Account	Cr.
To Capital A/c	50,000	

Dr.	Capital Account	Cr.
	By Cash A/c	50,000

(xiv) Withdraw Cash for household expenses Rs. 2000.

This is referred to as Drawings and is debited to Drawings Account. This results in decrease in Capital, since Drawings is subtracted from Capital to find the Net Capital.

Drawings A/c	—	Personal A/c	—	Receiver	—	Debited	—	Dr. ?
Cash A/c	—	Real A/c	—	Goes Out	—	Credited	—	Cr. ?

Dr.	Drawing Account	Cr.
To Cash A/c	2,000	

Dr.	Cash Account	Cr.
	By Drawings A/c	2,000

(xv) Purchased a machinery from own source and installed for the business Rs. 20,000.

It is clearly mentioned that the payment for machinery was made from own source. This means further capital is introduced, not in Cash, but by purchase of machinery. The Capital has also increased along with increase in assets.

Machinery A/c	—	Real A/c	—	Comes In	—	Debited	—	Dr. ?
Capital A/c	—	Personal A/c	—	Giver	—	Credited	—	Cr. ?

Dr.	Machinery Account	Cr.
To Capital A/c	20,000	

Dr.	Capital Account	Cr.
	By Machinery A/c	20,000

Illustration 3

Classify the following under personal, real and nominal accounts. Also state whether it records assets liability, expense, loss or revenue.

(a) Land (m) Bank Overdraft
(b) Building (n) Loan to Nikhil

(c)	Patent Rights	(o)	Discount received
(d)	Trade Marks	(p)	carriage or Purchase
(e)	Bad debt	(q)	Royalty on Sales
(f)	Depreciation	(r)	Goodwill
(g)	Interest Received	(s)	drawings
(i)	Creditors		
(j)	Debtors		
(k)	discount allowed		
(l)	Sales		

Solutions

	Items	**Account**	**Nature**
(a)	Land	Real	Asset (Tangible)
(b)	Building	Real	Asset (Tangible)
(c)	Patent Rights	Real	Asset (Tangible)
(d)	Trade Marks	Real	Asset (Tangible)
(e)	Bad debt	Nominal	Loss
(f)	Depreciation	Nominal	Loss
(g)	Interest Received	Nominal	Income
(h)	Advertising	Nominal	Expense
(i)	Creditors	Personal	Liability (Payable)
(J)	Debtors	Personal	Asset (Receivable)
(k)	Discount Allowed	Nominal	Loss
(l)	Sales	Nominal	Income
(m)	Bank Overdraft	Personal	Liability
(n)	Loan to Nikhil	Personal	Asset
(o)	Discount Received	Nominal	Gains
(p)	Carriage on Purchase	Nominal	Expense
(q)	Royalty on Sales	Nominal	Expense
(r)	Goodwill	Real	Asset (Intangible)
(s)	Drawings	Personal	Asset (For the Business)
(t)	Purchase	Nominal	Expense

List of Different Types of Ledger accounts

Classification of accounts has already been considered in detail. Among the different types of classification, the grouping between capital items (i.e. assets & liability) and revenue items (i.e. income & expenditure) are extremely important in the preparation of the Final Accounts.

It has been seen earlier that identification of accounts and their proper classification are important for the correct recording of transactions. Lists of Assets Accounts, Expenses are given below in alphabetical order by way of illustration :

Assets	**Liabilities**
Advance Income Tax	Advance (Received
Advance to Staff	
Advance to Others (Recoverable)	
Bank	Bank overdraft
Building	
Books Debts	Capital
Bills Receivable	Creditors
Brand Equity / Value	
Car	Debentures (Issued)
Cash	
Copyright	General Reserve
Computer	
Calculator	Liabilities for Expenses
	Liabilities for goods
Debtors	Loan
Debentures (Investment)	
Fittings	Outstanding Liabilities
Fixtures	Reserves & Surplus
Furniture	
Furniture & Fittings	Share Capital
Furniture & Fixtures	Provisions
Freehold Premises	
Goodwill	
Investment	
Land	
Leasehold Premises	
Land & Buildings	
Livestock	
Trade Mark	
Machinery	
Office Equipment	
Patent	
Plant	

LEDGER

The book which contains accounts is known as the ledger. Since finding information pertaining to the financial position of a business emerges only from the accounts, the ledger is also called the Principal Book. As a result, all the necessary information relating to any account is available from the ledger. This is the most important book of the business and hence is rightly called the "King of All Books".

The specimen form of a leger account is presented below :

Date	***Particulars***	***J.F.***	***V.N.***	***Amount Rs.***	***Date***	***Particulars***	***J.F.***	***V.N.***	***Amount Rs.***
2002	To				2002	By			

It can also be prepared in "T" form :

Date	***Paticulars***	***Amount Rs.***	***Date***	***Paticulars***	***Amount Rs.***
To			By		

J. F. = Journal Folio

Process of Ledger Posting

The two aspects i.e. the debit aspect and the credit aspect if each transaction should be carefully recorded in the Ledger Account.

Each ledger account has two identical parts

— debit side – on the left hand side and

— credit side – on the right hand side.

The basic rules about recording transactions are :

1. Debit the receiver and credit the giver.
2. Debit what comes in and credit what goes out.
3. Debit all expenses and losses and credit all incomes and gains.

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

Assets : Increases on the left handside or the debit side and decreases on the credit side or the right hand side.

Liabilities : Increases on the credit side and decreases on the debit side.

Capitals : The same as liabilities.

Expenses : Increases on the debit side and decreases on the credit side.

Incomes or gain : Increases on the credit side and decrease on the debit side.

To summarise

Dr.	*Assets*	*Cr.*	*Dr.*	*Liabilities & Capital*	*Cr.*
Increase		Decrease	Decrease		Increase

Dr.	*Expenses of losses*	*Cr.*	*Dr.*	*Income or Gains*	*Cr.*
Increase		Decrease	Decrease		Increase

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

A debit denotes :

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

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

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

A credit denotes :

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

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

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

At a glance :

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

Ledger Posting

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

Illustration 1

On 1.4.2001, R started a business with a capital of Rs. 40000.

Journal

Date	*Particulars*	*L.F.*	*Dr. Amount*	*Cr. Amount*
2001			*Rs.*	*Rs.*
April 1	Cash A/c ....Dr	1	40,000	
	To Capital A/c			
	(Being business started with cash as capital)	2		40,000

Ledger Posting :

Dr. *Cash Account* *Cr.*

Date	*Particulars*	*J.F.*	*Amount*	*Date*	*Particulars*	*J.F.*	*Amount*
			Rs.				*Rs.*
2001							
April							
1	To Capital A/c	1	40000				
	↑						
	Dabit what comes in / increase in asset						

Dr. *Cash Account* *Cr.*

Date	*Particulars*	*J.F.*	*Amount*	*Date*	*Particulars*	*J.F.*	*Amount*
			Rs.	2001			*Rs.*
				April			
				1	By Capital A/c	1	40000
					↑		
					Credit the giver / increase in liability		

Balancing of an account

The difference between the debit side total and the credit side total is called balance.

If debit side total is greater than the credit side total of the same ledger account, the "balance" is known as the debit balance.

If credit side total is greater than the debit side total of the same ledger account, the "balance" is known as the credit balance.

A debit balance shows that :

(a) Money is owing to the firm (Personal Account)
(b) The firm owns property or goods. (Real Account)
(c) The firm has lost money or increased certain expense. (Nominal Account)

A debit balance is shown on the credit side as "By Balance carried down" or "By Balance c/d".

A credit balance shows that :

(a) Money is owing to some person (Personal Account)
(b) The firm has given up so much property. (Real Account)
(c) The firm has earned an income or gains. (Nominal Account)

A credit balance is shown on the debit side as "To Balance carried down" or "To Balance c/d".

With reference to the previous illustration, let us show the ledger balancing at the end of the month :

Dr. ***Capital Account*** ***Cr.***

Date	***Particulars***	***J.F.***	***Amount Rs.***	***Date***	***Particulars***	***J.F.***	***Amount Rs.***
2001				2001			
April 1	To Capital A/c	1	40,000	April 30	By Balance c/d (Dr. balance)		40,000
			40,000				40,000
May 1	To balance b/d		40,000				

In the above cash account, the debit side total is Rs. 40,000 while the credit side total is NIL. So, the debit side total is Rs. 40,000 more than the credit side total. This balance is placed on the credit side as "By Balance c/d". again the balance is brought down at the beginning of the next accounting period as "To Balance b/d".

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

Date	***Particulars***	***J.F.***	***Amount Rs.***	***Date***	***Particulars***	***J.F.***	***Amount Rs.***
April 30	To Balance c/d (Cr. balance)		40,000	April 1	By Cash a/c	1	40,000
			40,000				40,000
				May 1	By Balance b/d		40,000

In the above Capital Account, the credit side total is Rs. 40,000 and the debit side total is NIL. So the credit side total is Rs. 40,000 more than the debit side total. This balance is placed on the debit-side as "To Balance c/d". again the balance is brought down at the beginning is brought down at the beginning of the next accounting period as "By Balance b/d".

Closing balance and Opening balance

The debit or credit balance of an account what we get at the end of the accounting period is known as closing balance of that account.

The "balance of the nominal accounts" is closed by transferring to trading account and the profit and loss account which shows the net operating results – net profit or net loss.

The "balance of the personal accounts and real accounts" representing assets, liabilities, owners equity are reflected in the Balance sheet, which shows the financial position of a business on a particular date. These balances are transported as opening balance in the succeeding accounting period.

Some terms used :

Casting — totalling

Balancing — to find the difference between debit side total and credit side total of an account.

C/d -	Carried down	B/d -	Brought down
C/o -	Carried over	B/o -	Brought over
C/f -	Carried forward	B/f -	Brought forward

Illustration 2

Prepare Journal and ledger

2001

May

1. Mr. N. started business with cash Rs. 5,000, stock Rs. 3,000, Furniture Rs. 2,000.
2. Purchased goods from Mr. Y for Rs. 3,000.
3. Paid expenses Rs. 200.
4. Paid Mr. Y on account Rs. 1,000.
5. Sold goods to Mr. T. for Rs. 4,000.
6. Paid wages Rs. 800.
7. Received from Mr. T in full settlement of his account Rs. 3,950.

Solution :

In the Books of N

JOURNAL

Date	*Particulars*	*L.F.*	*Dr. Amount*	*Cr. Amount*
2001				
May			Rs.	Rs.
1.	Cash A/c ….Dr	1	5,000	
	Stock A/c….Dr.	2	3,000	
	Furniture A/c……Dr.	3	2,000	
	To Capital A/c	4		10,000
	(Being business started with cash, stock and furniture as capital)			
2.	Purchase A/c ……….Dr	5	3,000	
	To Mr. Y's A/c	6		3,000
	(Being goods purchased from Mr. Y on credit)			
3.	Expenses A.c ……..Dr	7	200	
	To Cash A/c	1		200
	(Being expenses paid)			
4.	Mr. Y's A/c…..Dr.		1,000	
	To Cash A/c			1,000
	(Being cash paid to mr. Y on account)			
5.	Mr. T's A/c…..Dr.	8	4,000	
	To Sales A/c	9		4,000
	(Being goods sold to Mr. T on credit)			
6.	Wages A/c………..Dr	10	800	
	To Cash A/c	1		800
	(Being wages paid)			
7.	Cash A/c……Dr.	1	3,950	
	Discount Allowed A/c…..Dr	11	50	
	To Mr. T's A/c	8		4,000
	(Being cash received from Mr. T in final settlement and discount allowed thereon)			
			23,000	23,000

LEDGERS

Dr. **Cash Account** L. F. No. 1 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001 May				2001 May			
1	To Capital A/c		5,000	3	By Expense A/c		200
7	To Mr. T's A/c		3,950	4	By Mr. Y's A/c		1,000
				6	By Wages A/c		800
				7	By Balance c/d (Dr. Balance)		6,950
			8,950				8,950

Dr. **Stock Account** L. F. No. 2 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001				2001			
1	To Capital A/c		3,000	7	By Balance c/d		3,000
			3,000				3,000

Dr. **Furniture Account** L. F. No. 3 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001 May				2001 May			
1	To Capital A/c		2,000	7	By Balance c/d (Dr. Balance)		2,000
			2,000				2,000

Dr. **Capital Account** L. F. No. 4 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001 May				2001 May			
7	To Balance c/d (Cr. Balance)		10,000	1	By Cash A/c		5,000
					By Stock A/c		3,000
					By Furniture A/c		2,000
			10,000				10,000

Dr. **Purchase Account** L. F. No. 5 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001				2001			
May				May			
4	To Mr. Y's A/c		3,000	7	By Balance c/d		3,000
					(Dr. Balance)		
			3,000				3,000

Dr. **Mr. Y's Account** L. F. No. 6 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001				2001			
May				May			
4	To Cash A/c		1,000	2	By Purchase A/c		3,000
7	To Balance c/d		2,000				
	(Cr. Balance)						
			3,000				3,000

Dr. **Expenses Account** L. F. No. 7 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001				2001			
May				May			
3	To Cash A/c		200	7	By Balance c/d		200
					(Dr. Balance)		
			200				200

Dr. **Mr T's Account** L. F. No. 8 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001				2001			
May				May			
4	To Sales A/c		4,000	7	By Cash A/c		3,950
					By Dis. Allowed A/c		50
			4,000				4,000

Dr. **Sales Account** L. F. No. 9 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001 May 7	To Balance c/d (Cr. Balance)		4,000	2001 May 5	By Mr. T's A/c		4,000
			4,000				4,000

Dr. **Wages Account** L. F. No. 10 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001 May 4	To Cash A/c		800	2001 May 7	By Balance c/d (Dr. Balance)		800
			800				800

Dr. **Discount Account** L. F. No. 11 Cr.

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001 May 7	To Mr. T's A/c		50	2001 May 7	By Balance c/d (Dr. Balance)		50
			50				50

Ledger Accounts	**Dr. Balance**	**Cr. Balance**
Cash Account	6,950	—
Stock Account	3,000	—
Furniture Account	2,000	—
Capital Account	—	10,000
Purchase Account	3,000	—
Mr Y's Account	—	2,000
Expenses Account	200	—
Sales Account	—	4,000
Wages Account	800	—
Discount allowed Account	50	—
	16,000	16,000

TRIAL BALANCE

Trial Balance is a statement where all the balances of accounts including the Cash Book balances (both Cash and Bank) are written in the debit and credit coloumns together with reference to their folios. The debit and the credit coloumns are totalled and tallied to prove the arithmetical accuracy of the books of accounts. In case of disagreement, existence of errors is indicated, which are to be located.

Definition

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

According to Rolland, Trial Balance is defined as "The final list of balances, totalled and combined, is called Trial Balance".

According to Carter, Trial Balance is "a schedule or list of those debit and credit balances which are extracted from various accounts in the ledger and balances of Cash in hand and at Bank as shown by the Cash Book and are also included in it"

Feature's of a Trial Balance

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

Purpose of a Trial Balance

It serves the following purposes :

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

Preparation of a Trial Balance

1. It may be prepared on a loose sheet of paper.
2. The ledger accounts are balanced at first. They will have either "debit-balance" or "credit balance" or "nil-balance".
3. The accounts having debit-balance is written on the debit column and those having credit-balance are written on the credit coloumn.

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

Is Trial Balance indispensable ?

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

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

Forms of a Trial Balance

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

1. Journal Form
2. Ledger Form

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

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

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

Specimen of Journal Form of Trial Balance :

Trial Balance as on …………

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

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

Specimen of ledger form of Trial Balance

Trial Balance as on …………

Dr. Cr.

Date	Name of the Account	L.F.	Amount	Date	Name of the Account	L.F.	Amount
			Rs.				*Rs.*

Method of Preparation

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

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

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

Advantages : 1. It facilitates arithmetical accuracy of the accounts.

2. Extraction of ledger balances is not required at the time of preparation of Trial Balance.

Disadvantages : Preparation of final accounts is not possible.

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

Advantages : 1. It helps in the easy preparation of final accounts.

2. It saves time and labour in constructing a Trial Balance.

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

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

Advantages: It offers the advantage of both the methods.

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

Summary of Rules

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

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

Errors which are disclosed by a Trial Balance/Advantages of a Trial Balance

It has already been stated earlier that Trial Balance is a way to test the arithmetical accuracy of the records in the books of accounts. If any error, whether clerical or otherwise, exists in the books of accounts *the same will cause for disagreement of a Trial Balance*. The following errors may be noted :

(i) Wrong Posting : Posting on the wrong side of an account and posting of a wrong amount in a ledger account, will cause disagreement of Trial Balance.

(ii) Omission of Posting : Omission of posting of an entry from the subsidiary Book will cause disagreement.

(iii) Errors in casting or Totalling : Errors in casting or totalling or totalling of subsidiary books of accounts will cause disagreement.

(iv) Errors in Balancing : If any errors arises as a result of balancing of an amount, the same will cause disagreements.

(v) Double Posting : If any item is posted twice in a ledger account from a subsidiary book, the same will create disagreement.

Errors which are not disclosed by a Trial Balance/Limitations of a Trial Balance

The following errors cannot be detected by a Trial Balance :

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

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

(c) **Errors of Principal :** Where wrong posting is made in the books of accounts, i.e. accounts are prepared not according to double entry principle e.g. Purchased a Plant wrongly debited to Purchase Account – Trial balance will agree.

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

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

Procedure to locate Errors, Or, Steps to be taken if the Trial Balance does not agree :

If the Trial balance does not agree, the following procedure should carefully by followed :

(i) At first, check the extraction and listing of the ledger account balance one by one.

(ii) Check the addition of both the columns (Debit and Credit) of the Trial Balance and ascertain the amount of difference.

(iii) Divide the difference by 2 and see whether the said figure appear on the correct side or not.

(iv) Check the additions of the subsidiary books.

(v) Check the additions of the ledger accounts and also the balances of each account.

(vi) Check the posting from subsidiary books to the ledger.

(vii) Check that balance of the account which is exactly equal the differences of Trial balance, if any.

(viii) Check the opening balance of all account whether brought forward correctly or not.

(ix) Upto this level, if the errors are not even debited, checking and re-checking must be done both by other stuffs following the same principles

(x) If the trial balance is still not agreed, checking should be started again from the journal and book of original entry using tick mark (<) against each and every transaction,

In order to locate the cause of disagreement of a Trial balance, a thorough checking is necessary in the books of account. After several checking and re-checking if the Trial balance does not agree, put the difference to Suspense Account. This account will be automatically closed, when the error or errors in Trial Balance are subsequently discovered or rectified.

Suspense Account / Differnce in Books of Account

If there arises a difference in the trial balance, it is transferred to 'Suspense Account' or 'Difference in Books Account' to make the Trial Balance agree. After detection of error or errors, they are rectified and the suspense account is closed.

At a glance

Trial Balance

As at / as on .....

Heads of Accounts	Side of Trial Balance	Reasons
Cash in hand	Debit	Assets
Cash at Bank	Debit	Assets
Cash at Bank (overdrawn)	Credit	Liability
Bank Overdraft	Credit	Liability
Capital	Credit	Liability
Opening stock	Debit	Assets
Wages	Debit	Expenses
Purchase	Debit	Expense / Increase in stock
Carriage Inwards	Debit	Expenses
Freight	Debit	Expenses
Royality on production	Debit	Expenses
Gas, Water, Fuel	Debit	Expenses
Motive Power	Debit	Expenses
Import Duty	Debit	Expenses
Sales	Credit	Income / Decrease in stock
Discount Allowed	Debit	Losses
Discount Received	Credit	Gains
Bad Debts	Debit	Losses
Reserve / Provision for Bad & Doubtful Debt (Opening)	Credit	Gains

Heads of Accounts	Side of Trial Balance	Reasons
Commission Received	Credit	Incomes
Salaries	Debit	Expenses
Commission paid	Debit	Expenses
Rent, rates, and taxes	Debit	Expenses
Repairs and maintenance	Debit	Expenses
Insurance	Debit	Expenses
Carriage outward	Debit	Expenses
Trade charges	Debit	Expenses
Royality on sales	Debit	Expenses
Interest paid	Debit	Expenses
Interest received	Credit	Income
Advertisment	Debit	Expenses
Sundry expenses	Debit	Expenses
Miscellaneous expenses	Debit	Expenses
Miscellaneous receipts	Credit	Incomes
Income tax	Debit	Drawings / Assets
L.I.C. Premium	Debit	Drawings / Assets
Office expenses	Debit	Expenses
Export duty	Debit	Expenses
Allowances	Debit	Losses
Rebates	Debit	Losses
Sales tax	Debit	Expenses
Horses and Carts	Debit	Assets
Watch Dag Squad	Debit	Assets
Loan Secured	Credit	Liability
Loans Advanced	Debit	Assets
Reserve Funds	Credit	Liability
Sinking Fund	Credit	Liability
Sinking Fund Investments	Debit	Assets
Ecology Fund	Credit	Liability
Ecology Fund Investments	Debit	Assets
Building Fund	Credit	Liability
Building	Debit	Assets
Land	Debit	Assets
Plant	Debit	Assets

Heads of Accounts	Side of Trial Balance	Reasons
Machinery	Debit	Assets
Furniture & fittings	Debit	Assets
Motor vehicles	Debit	Assets
Computer	Debit	Assets
Office equipments	Debit	Assets
Goodwill	Debit	Assets
Patent rights	Debit	Assets
Copyrights	Debit	Assets
Trade marks	Debit	Assets
Investments	Debit	Assets
Shares & Securities	Debit	Assets
G. P. Notes	Debit	Assets
Sundry debtors	Debit	Assets
Sundry creditors	Credit	Liability
General Reserve	Credit	Liability
Bill Receivable	Debit	Assets
Bills Payable	Credit	Liability
Provision for Discount on Debtors	Credit	Liability
Provision for Discount on Creditors	Debit	Assets
Lighting and Heating	Debit	Expense
Drawings	Debit	Assets
Contribution to Provident Fund	Debit	Assets
Prize Fund	Credit	Liability
Depreciation	Debit	Losses
Provition for Depreciation	Credit	Liability
Returns Inwards	Debit	Losses
Returns Outwards	Credit	Gains
Freehold Property	Debit	Assets
Premises	Debit	Assets
Leasehold Property	Debit	Assets
Loose Tools	Debit	Assets
Petty Cash	Debit	Assets
Provident Fund	Credit	Liability
Debentures Purchased	Debit	Assets
Debentures (from Public)	Credit	Liability

Heads of Accounts	Side of Trial Balance	Reasons
Loan on Mortgage	Credit	Liability
Prepaed Expenses	Debit	Assets
Outstanding Expenses	Credit	Liability
Bad Debts Recovered	Credit	Gains
Accrued Incomes	Debit	Assets
Apprenticeship Premium received	Credit	Income
Books	Debit	Assets
Newspaper and Magazine	Debit	Expenses
Profit to loss a/c (Dr.)	Debit	Losses
Profit and loss a/c (Cr.)	Credit	Gains
Acumulated Depreciation	Credit	Liability
Postage and Telegram	Debit	Expense
Travelling & Conveyance	Debit	Expenses

Illustration 1

Taking Illustration 2 of chapter 10 , we will prepare a Trial Balance under each of the methods :

Method 1 : Total Method or Gross Trial Balance.

Trial Balance

as at/as on………..

Heads of Account	L.F.	Dr. Amount	Cr. Amount
Cash Account		8,950	2,000
Stock Account		3,000	
Furniture Account		2,000	
Capital Account			10,000
Purchase Account		3,000	
Mr. Y's Account		1000	3,000
Expenses Account		200	
Mr. T's Account		4,000	4,000
Sales Account			4,000
Wages Account		800	
Discount Allowed Account		50	
		23,000	23000

Method 2 : Balance Method or Net Trial Balance

Trial Balance

as at/as on..........

Heads of Account	L.F.	Dr. Amount	Cr. Amount
Cash Account		6,950	
Stock Account		3,000	
Furniture Account		2,000	
Capital Account			10,000
Purchase Account		3,000	
Mr. Y's Account			2,000
Expenses Account		200	
Sales Account			4,000
Wages Account		800	
Discount Allowed Account		50	
		16,000	16,000

Method 3 : Compound Method

Cash Account	L.F.	Dr. Totals	Cr. Totals	Dr. Balance	Cr. Balance
Cash Account		8,950	2,000	6,950	
Stock Account		3,000	—	3,000	—
Furniture Account		2,000	—	2,000	
Capital Account			10,000	—	10,000
Purchase Account		3,000	—	3,000	
Mr. Y's Account		1,000	3,000	—	2,000
Expenses Account		200	—	200	—
Mr. T's Account		4,000	4,000	—	—
Sales Account		—	4,000	—	4,000
Wages Account		800	—	800	
Discount Allowed Account		50	—	50	—
		23,000	23,000	16,000	16,000

TRIAL BALANCE OF A TRADING CONCERN

Illustration 2

The under mentioned balances were extracted from the books of Mr. Dey as on 31.03.09 you are asked to prepare a Trial Balance as on that date.

	Rs.
Capital	78,000
Opening stock	5,000
Premises	46,000
Furniture	18,500
Machinery	30,000
Purchases	74,900
Sales	126,620
Discount received	470
Discount allowed	540
Carriage outwards	180
Carriage inwards	170
Returns inwards	1,400
Returns outwards	280
Wages and salaries	17,680
Rent, rates and taxes	1,370
Rent received	530
Sundry expense	1,660
Bills receivable	1,920
Trade creditors	22,760
Book debts	34,000
Drawings	3,000
Bills payable	2,800
Cash in hand	940
Bank loan	5,800
Closing stock	3,900

Solution :

In the Books of Mr. Dey

Trial Balance

as at 31.03.2009

Heads of Account	L.F.	Dr. Amount	Cr. Amount
Capital		—	78,000
Opening stock		5,000	—
Premises		46,000	—
Furniture		18,500	—
Machinery		30,000	—
Purchases		74,900	—
Sales		—	1,26,620
Discount received		—	470
Discount allowed		540	—
Carriage outwards		180	—
Carriage inwards		170	—
Returns inwards		1,400	—
Returns outwards		—	280
Wages and salaries		17,680	—
Rent, rates and taxes		1,370	—
Rent received		—	530
Sundry expense		1,660	—
Trade creditors		—	22,760
Book debts		34,000	—
Drawings		3,000	—
Bills payable		—	2,800
Cash in hand		940	—
Bank loan		—	5,800
Bills receivable		1,920	—
		2,37,260	2,37,260

N.B. : Closing stock does not appear in Trial Balance. It will appear in Trial Balance, only if there is Adjusted Purchase.

TRIAL BALANCE OF A NON-TRADING CONCERN

Illustration 3

From the following ledger balances prepare a Trial Balance of "The World Needs U Club (India) for the year ended 31.3.09.

	Rs.
Cash in hand	1,000
Cash at Bank	4,000
Club Pavilion and ground	150,000
Building	60,000
Library Books	52,000
Investments in 7% G. P. Notes	40,000
Donations	95,000
Subscriptions Received	63,000
Honorarium to secretary	11,000
Purchase of sports materials	25,000
Billiards table	40,000
Refreshments	15,000
Travelling & conveyance	6,300
Outstanding Subscriptions	3,700
Govt. Grants	10,000
Gardening & Upkeep Costs	28,000
Admission Fees	15,000
Accumulated Fund	2,53,000

Solution :

In the Books of "The World Needs U Club (India)"

Trial Balance

as at 31.03.2009

Heads of Account	L.F.	Dr. Amount	Cr. Amount
Cashi in hand		1,000	
Cash at Bank		4,000	
Club Pavilion and ground		1,50,000	
Building		60,000	
Library Books		52,000	
Investments in 7% G. P. Notes		40,000	

Heads of Account	L.F.	Dr. Amount	Cr. Amount
Donations			95,000
Subscriptions Received			63,000
Honorarium to secretary		11,000	
Purchase of sports materials		25,000	
Billiards table		40,000	
Refreshments		15,000	
Travelling & conveyance		6,300	
Outstanding Subscriptions		3,700	
Govt. Grants			10,000
Gardening & Upkeep Costs		28,000	
Admission Fees			15,000
Accumulated Fund			2,53,000
		4,36,000	4,36,000

TRIAL BALANCE OF AN INDIVIDUAL

Illustration 4

From the following ledger balances of Mr. J's family available on 30th September, 2009, prepare a Trial Balance as on that date :

	Rs.
Expenses for vegetables	2,300
Expenses for fish, meat, eggs, etc	3,700
Expense for food grains	4,100
Expenses for spices and other groceries	1,900
Expense for stationery and provision	2,700
Children education expenses	5,100
Income from salary	19,000
Income for investments	2,000
Cash in hand	1,200

Solution :

In the Books of Mr. J.

Trial Balance

As at 30.09.2009

Heads of Account	L.F.	Dr. Amount	Cr. Amount
Expenses for vegetables		2,300	
Expenses for fish, meat, eggs, etc		3,700	
Expense for food grains		4,100	
Expenses for spices and other groceries		1,900	
Expense for stationery and provision		2,700	
Children education expenses		5,100	
Income from salary			19,000
Income for investments			2,000
Cash in hands		1,200	
		21,000	21,000

TRIAL BALANCE OF A JOINT STOCK COMPANY

Illustration 5

In the books of Hariom Ltd.

Trial Balance

as at 31.03.2009

Heads of Account	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
Equity Share Capital A/c		—	1,00,000
Plant and Machinery A/c		70,000	—
Purchase A/c		52,000	—
Sales A/c		—	98,000
Sundry Debtors A/c		36,000	—
Sundry Creditors A/c		—	16,000
Salaries A/c		12,000	—
Wages A/c		8,000	—
Rent A/c		11,000	—
Miscellaneous Expense A/c		5,000	—

Heads of Account	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
Furniture A/c		6,000	—
Investment A/c		7,000	—
Cash A/c		3,000	—
Bank A/c		4,000	—
Returns Outwards A/c		—	2,000
Returns Inward A/c		2,000	—
Discount Allowed A/c		1,000	—
Discount Received A/c.		—	2,000
General Revenue		—	10,000
Profit & Loss A/c. (Cr.)		—	5,000
Capital Reserve		—	25,000
Secured Loans		—	11,000
5% Debentures		—	50,000
Bank Overdraft		—	10,000
Outstanding Salary		—	3,000
Provision for Taxation		—	25,000
Land & Building		1,00,000	—
Goodwill		40,000	—
		3,57,000	3,57,000

Treatment of closing stock : Usually, closing stock does not appear in the Trial Balance, as no separate account is opened for it. It reflects the balance of unsold goods out of purchase or opening stock.

For Goods purchased :

Purchase A/c Dr.

To Cash A/c (Cash Purchasers)

To Creditors A/c (Credit Purchase)

But the closing stock will appear in the Trial Balance, only when the same is adjusted against purchase, i.e. when there is Adjusted Purchases.

When closing stock is adjusted, then the entry is

Closing stock A/c Dr.

To Purchase A/c

Adjusted Purchase : This reflects the net goods consumed during the accounting period.

Example : Cash Purchases Rs. 10,000, Closing Stock Rs. 500.

∴ Adjusted Purchase = Rs. (10,000 - 500) = Rs. 9,500.

Now, if we reflect Rs. 9,500 in the Trial Balance, then there will be a disagreement in the debit side for Rs. 500.

When Goods were purchased,

Purchase A/c.	Dr	10,000	Stock Increase
To Cash A/c.		10,000	Cash Decrease

So we are to show the adjusted purchase figure in the Trial Balance as Rs. 9,500, alongwith the closing Stock of Rs. 500 to equalise the decrease in Cash Rs. 10,000. Moreover, it will show the correct financial position.

RECTIFICAITON OF A WRONG TRIAL BALANCE

Illustration 6

The total of the debit-side of the Trial Balance of a large boot and shoe repairing firm as at 31.3.09 is Rs. 1,66,590 and that of the Credit side is Rs. 42,470.

After several checking and re-checking the following mistakes are discovered :

Items of Account	Correct figures (as it should be)	Figures at it appears to the Trial Balance
Opening Stock	14,900	14,800
Repairs	61,780	61,780 (appears on the debit side)
Rent and Rates	2,160	2,400
Sundry Creditors	6,070	5,900
Sundry Debtors	8,060	8,310

Ascertain the correct total of the Trial Balance.

		Debit Rs.	Credit Rs.
	Total as per Trial balance	1,66,590	42,470
Add:	Opening Stock understand (14900-14800)	100	—
	1,66,690	42,470	
Less/Add:	Adjustment for repairs, it is an income for the firm, to be credited	(61,780)	61,780
	1,04,910	1,04,250	
Less:	Rent and Rates overstated (2,160-2,400)	(240)	—
Add :	Sundry Creditors under stated (6,070-5,900)	1,04,670	1,04,250
		—	170
	1,04,670	1,04,420	
Less:	Sundry Debtors Overstated (8,060-8,310)	(250)	—
	1,04,420	1,04,420	

MISCELLANEOUS

Illustration 7

(A) **In the Books of Mr. Raju**

Gross Trial Balance

As on 31.3.09

Sl. No.	Name of the Account	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1.	Capital A/c.		—	72,000
2.	Drawings A/c		5,000	—
3.	Purchases A/c		85,000	—
4.	Sales A/c		—	1,80,000
5.	Sales Returns A/c		1,500	—
6.	Purchase Returns A/c		—	2,000
7.	Commission A/c		700	200
8.	Interest A/c		300	100
9.	Office Expenses A/c		9,500	—
10.	Sundry Debtors A/c		1,35,000	1,12,700
11.	Sundry Creditors A/c		50,000	1,25,000
12.	Cash A/c.		2,00,000	25,000
13.	Bank A/c.		85,000	1,00,000
14.	Machinery A/c		50,000	5,000
			6,22,000	6,22,000

(B)

In the Books of Mr. Raju

Net Trial Balance

As on 31.3.09

Sl. No.	Name of the Account	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1.	Capital A/c.		—	72,000
2.	Drawings A/c		5,000	—
3.	Purchases A/c		85,000	—
4.	Sales A/c		—	1,80,000
5.	Sales Returns A/c		1,500	—
6.	Purchase Returns A/c		—	2,000
7.	Commission A/c		500	—
8.	Interest A/c		200	—
9.	Office Expenses A/c		9,500	—
10.	Sundry Debtors A/c		22,300	—
11.	Sundry Creditors A/c		—	75,000
12.	Cash A/c.		1,75,000	—
13.	Bank A/c.		—	15,000
14.	Machinery A/c		45,000	—
			3,44,000	3,44,000

(C)

In the Books of Mr. Raju

Compound Trial Balance

As on 31.3.09

Sl.No.	Name of the Account	L.F.Dr. Total Rs.	Cr. Total Rs.	Dr. Balance Rs.	Cr. Balance Rs.
1.	Capital A/c	—	72,000	—	72,000
2.	Drawings A/c	5,000	—	5,000	—
3.	Purchase A/c	85,000	—	85,000	—
4.	Sales A/c.	—	1,80,000	—	1,80,000
5.	Sales Returns A/c	1,500	—	1,500	—
6.	Purchase Returns	—	2,000	—	2,000
7.	Commission A/c	700	200	500	—
8.	Interest A/c.	300	100	200	—
9.	Office Expenses A/c.	9,500	—	9,500	—
10.	Sundry Debtors A/c.	1,35,000	1,12,700	22,300	—
11.	Sundry Creditors A/c.	50,000	1,25,000	—	75,000
12.	Cash A/c.	2,00,000	25,000	1,75,000	—
13.	Bank A/c.	85,000	1,00,000	—	15,000
14.	Machinery A/c.	50,000	5,000	45,000	-
		6,22,000	6,22,000	3,44,000	3,44,000

1.2. DEPRECIATION

Introduction :

A business or concern holds fixed assets for regular use and not for re-sale. The capability of a fixed asset to render service cannot be unlimited. Except land, all other fixed assets have a limited useful life. The benefit of a fixed asset is received throughout its useful life. So its cost is the price paid for the 'Series of Services' to be received or enjoyed from it over a number of years and it should be spread over such years,

Depreciation is the allocation of the cost of a fixed asset over the years of its working life. **Indian Accounting Standard** (AS 6) states that "Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset."

Long-term fixed assets are used in the process of earning revenue. Due to regular use such assets gradually lose their service potentials. Such losses are considered as expired costs which have to be matched against the periodic revenues. The latin word 'depretium' literally means 'reduction of value'. So depreciation means the reduction in value of assets which has to be considered for determining revenue. **R. S. Anthony and J. S. Reece** observed that "the cost of an asset that has a long but nevertheless limited life is systematically reduced over that life by the process called depreciation."

The cost of a fixed asset is a capital expenditure. Depreciation is allocated for every accounting period as a cost or an expense which is matched against the revenue of such period. Although it is a measure of the decrease in the value of assets put to use, it is actually a process of allocation. For this reason, **International Accounting Standard** (IAS)-4 provides that "Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life." In Accounting Research Bulletin No. 22, **AICPA** observed that "Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurences during the year, it is not intended to be the measurement of the effect of all such occurrences."

Causes of Depreciation

Its causes are :

A. Internal

(i) ***Wear and tear*** : Plant & Machinery. Furniture, Motor Vehicles etc. suffer from loss of utility due to vibration, chemical reaction, negligent handling, rusting etc.

(ii) ***Depletion*** (or exhaustion) : The utility or resources of wasting assets (like mines etc.) decreases with regular extractions.

B. **External or Economic causes**

(i) ***Obsolescence*** : Innovation of better substitutes, change in market demand, imposition of legal restrictions may result into discarding an asset.

(ii) ***Inadequacy*** : Changes in the scale of production or volume of activities may lead to discarding an asset.

C. **Time element :** With the passage of time some intangible fixed assets like lease, patents. copy-rights etc., lose their value or effectiveness, whether used or not. The word "amortization" is a better term to speak for the gradual fall in their values.

D. **Abnormal occurrences** : An Accident, fire or natural calamity can damage the service potential of an asset partly or fully. As a result the effectiveness of the asset is affected and reduced.

<u>Factors on which Depreciation Depends</u>

1. ***Historical (original) cost*** : Which includes money spent for acquisition, installation. addition and improvement of a fixed asset. Cost of the asset, wages paid for installation. transportation costs, legal expenses for registration of lease agreements. etc. are included. There fore, historical cost refers to all expenses incurred before an asset is brought into use.

2 ***Useful life of the asset*** : It is the estimated period over which the utility of an asset will be enjoyed. It depends upon (a) legal or contractual provisions regarding lease, etc., b) level of use of the asset, (c) degree of maintenance and (d) technological developments. Useful life is shorter than the physical life of an asset.

3. ***Estimated residual value*** **:** It is the value expected to be realised after complete commercial utilization of a fixed asset.

4. ***Other Relevant Factors*** **:** Some other relevant factors may be considered for deciding the amount to be charged as depreciation. These are—

   (a) Replacement cost that is the Cost that would be incurred if the old asset has to be replaced by a new asset.

   (b) Provisions of the Companies Act, Income Tax Act regarding depreciation.

   (c) Costs of probable additions, alterations or improvements of the existing asset.

<u>Objects of Charging Depreciation</u>

Eric Kohler defined depreciation as "the lost usefulness, expired utility, the diminution in service yield." Its measurement and charging are necessary for cost recovery. It is treated as a part of the expired cost for an asset. For determination of revenue, that part or cost should be matched against revenue. The objects or necessities of charging depreciation are :

I. ***Correct calculation of cost of production:*** Depreciation is an allocated cost of a fixed asset. It is to be calculated and charged correctly against the revenue of an accounting period. It must he correctly included within the cost of production.

2. ***Correct calculation of profits*** : Costs incurred for earning revenues must be charged properly for correct calculation of profits. The consumed cost of assets (depreciation) has to be provided for correct matching of revenues with expenses.

3. ***Correct disclosure of fixed assets at reasonable value*** : Unless depreciation is charged.the depreciable asset cannot be correctly valued and presented in the Balance Sheet. Depreciation is charged so that the Balance Sheet exhibits a true and fair view of the affairs of the business.

4. ***Provision of replacement cost*** : Depreciation is a non-cash expense. But net profit is calculated after charging it. Through annual depreciation cash resources are saved and accumulated to provide replacement cost at the end of the useful life of an asset.

5. ***Maintenance of capital*** : A significant portion of capital has to be invested for purchasing fixed assets. The values of such assets are gradually reduced due to their regular use and passage of time. Depreciation on the assets is treated as an expired cost and it is matched against revenue. It is charged against profits. If it is not charged the profits will remain inflated. This will cause capital erosion.

6. ***Compliance with technical and legal requirements*** : Depreciation has to be charged to comply with the relevant provisions of the Companies Act and Income Tax Act.

<u>Problems of Measurement of Depreciation</u>

I. ***Difficulty of ascertaining working life :*** It is really difficult to summarise the exact working life of an asset. Where the duration of the benefits of the asset is time-bound, like those of a leasehold asset, no problem arises. But in other cases it becomes a guess work which takes into consideration— (a) the nature of the asset; (b) the quality of the asset; (c) expert's opinions and (d) previous experience. These are all conjectures found to vary. Thus an asset may become incapable of rendering service before its anticipated expiry date. On the other hand, its effectiveness may remain alive much after such date.

2. ***Estimation of residual value :*** Under conservative approach, the residual value is taken below the expected value at the end of the useful life of an asset. This, at best, helps to avoid unforeseen losses. But residual value also depends upon market conditions, technological advancements, etc. So, its correct estimation often proves itself misleading.

3. ***Unwarranted happenings*** : Change of law, technological development, innovations. etc., may cause a drastic reduction or writing off of an asset. These external factors suddenly affect the pre-determined quantum of depreciation. On the other hand, over-use or underuse of an asset may also tell upon the amount of depreciation.

<u>Accounting Implications of Depreciation</u>

I. Depreciation is a charge against profits. It is not a cash cost. It is a notional loss. The estimated depreciation of an accounting period is matched against revenues of that period. The profit or loss of that period is calculated after charging depreciation.

2 It is a compulsory charge. It is not an appropriation of profits. Unless it is considered, the process of matching costs with revenues become defective.

3. Depreciation. as already pointed out, helps to arrive at correct profit or loss. Final accounts can be correctly prepared only when depreciation has been correctly charged.

4. Depreciation is necessary to value fixed assets at the end of each accounting period. Unless it is charged. the assets become overstated.

5. Due to inflation, effective capital of a business is eroded continuously. It means, more amount of capital becomes needed to replenish the same amount of assets consumed or utilized every year in the process of production. By charging adequate depreciation, a proper balance of real capital is maintained.

6. ‘Old order change yielding place to new’. This age-old belief obviates the charging of depreciation. Old may be gold but that cannot be expected to last for ever. Decay and senility have to be accepted for which the concept of depreciation has to be applied as a yardstick of measurement, of such decay.

7. Depreciation Accounting paves the way for replacement of assets. When the effective and working life of an asset comes to an end, it is replaced by a new asset. Depreciation, being a notional cost, helps to set aside a fund every year. Such fund is utilized to acquire the net asset. Thus the requirement of additional capital or loan can be avoided.

8. As per section 205 of the Companies Act of India, a company has to provide for adequate depreciation before declaring dividends. There arc provisions of the Income Tax Act of India regarding the adequacy of depreciation. So charging of depreciation is a legal compliance which a business has to observe.

Characteristics of Depreciation

The Characteristics of Depreciation are :

1. It is a **charge against profit**.

2. It indicates **diminution in service potential**.

3. It is an **estimated loss** of the value of an asset. It is not an **actual loss**.

4. It depends upon different **assumptions**, like effective life and residual value of an asset.

5. It is a process of allocation and not of valuation.

6. It arises mainly from an **internal cause** like wear and tear or depletion of an asset. But it is treated as any expense charged against profit like rent, salary, etc., which arise due to an **external transaction**.

7. Depreciation on any particular asset is **restricted** to the working life of the asset.

8. It is charged on **tangible fixed assets**. It is not charged on any current asset. For allocating the costs of intangible fixed assets like goodwill. etc, a certain amount of their total costs may be charged against periodic revenues. This is known as **amortization**. Depreciation includes amortization of intangible assets whose effective lives are pre-estimated. Intangible assets render benefits but they do not have any physical existence, their ‘economic- values’ are perceived to exist. ‘Amortization’ or ‘Writing Off such assets is made to account for the deterioration of their economic values.

Under depreciation, 'Depletion' and 'obsolescence' are also covered. 'Depletion' means gradual exhaustion of physical resources due to extraction etc, as found in mines, quarries etc. 'Obsolescence' means a major deterioration in the utility of an asset due to (i) innovation of improved substitutes or techniques;' (ii) drastic fall in the demand of a product arising through change in market conditions, tastes or fashions; and (iii) usefulness lost and inability arising to cope with increased scale of operation.

Depreciation Parameters of Different Views

The exact nature of depreciation is viewed by different accountants from different standpoints. These are

1. ***A Process of Allocation*** : The cost of an asset is allocated over the years of its useful life. E. S. Hendriksen observed depreciation as "a systematic and rational method of allocating costs to periods in which benefits are received." Allocated portion of a capital expenditure attributed to any accounting period falling within the working life of a fixed asset is considered as the periodic charge for depreciation. The periodic flow of the service potential of such asset is represented by the periodic charge. According to this concept, the useful working life and the residual value of fixed assets arc considered as constant for determining periodic depreciation.

2. ***A Decline in Service Potential*** **:** With gradual use and effluxion of time, the capability of a fixed asset to render service is reduced. So, depreciation is the measure of the total reduction of service potential over the years of use of a fixed asset. As this concept believes that the consumption of service potentials of a fixed asset follow a decreasing trend, depreciations for different years do not become equal.

3. ***A Source of Fund*** **:** Depreciation is a non-cash expense but it is charged against profits, like rent, salaries etc. As it does not cause any outflow of cash in the period in which it is charged, some accountants prefer to believe that its equivalent amount is retained in cash. This helps to build up a fund which, in turn, helps to replace the old and useless asset by a new and useful asset.

But this view is full of defects. Depreciation is a portion of the total out flow of cash already made for acquiring an asset. It is an internal arrangement that affects the periodic revenue and the value of a fixed asset of a business. It does not involve any other party. A fund presumes appropriation of an amount and its external application. Depreciation neither helps to create, nor to maintain any fund. It definitely affects periodic revenue and quantum of tax but it does not involve the creation or extinction of any fund.

4. ***A Provision for Maintenance of Capital :*** Some accountants think that depreciation helps to maintain Capital. They feel that depreciation is charged as a part of expired cost. So, by the time the fixed asset ceases to render any service, the initial capital that was invested to acquire it, is recovered fully. **The American Accounting Association (AAA)** felt that "depreciation must be based on current cost of restoring the service potential consumed during the period."

For restoring 'service potential consumed' depreciation is needed. But cost of restoration is more related to the replacement cost, that is, the cost that will be required at the time of replacement than the historical cost that was originally incurred at the time of acquiring the asset. If depreciation is based on historical cost, the initial capital invested can be restored. But due to change of price level, replacement cost is bound to be more. So, real capital cannot be maintained. For this reason, **Sprouse and Moontiz opined in the Accounting** Research **Study publised by AICPA that the** current **cost of** restoring service potential should be based **on current replacement cost.**

Application of Accounting Standards Regarding Depreciation

Regarding Depreciation, the applicable accounting standard is 'Depreciation Accounting' (AS 6). While solving problems on depreciation accounting, we should try to follow and apply the texts of these standards. We should also consider 'Accounting for Fixed Assets' (AS 10). Some important aspects of these standards are being mentioned here**.**

Accounting Standard for Fixed Assets (AS 10)

(a) The gross book value of a fixed asset should be either historical cost or a revaluation computed in accordance with the Accounting Standard. [Set out in paragraphs 20 to 26 and 27 to 32 of the Standards]

(b) The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition. Financing costs relating to deferred credits or to borrowed funds attributable to construction or acquisition of fixed assets should also be included in the gross book value of the asset to which they relate. However, the financing costs (including interest) on fixed assets purchased on a deferred credit basis or moneys borrowed for construction or acquisition of fixed assets should not be capitalised. Thus, the installation cost for a machine should be added to its value. But any interest paid on a loan taken to buy the machine should not enhance the value of machine.

(c) In case of any self-constructed assets, costs attributable to its construction and allocable to it, should be included in its value.

(d) Materials items retired from active use and held for disposal should be shown separately in the financial statements and stated at net book value or realizable value, whichever is lower.

(e) If any subsequent expenditure causes an addition to the already expected future benefits of an asset, such expenditure should be added with the value of the asset.

(f) In case a new asset is acquired in part exchange of an old asset the exchange price should be recorded at fair market value or net book value of the old asset.

(g) Fixed asset acquired in exchange of shares, etc. should be recorded at its fair market value or the fair market value of the shares, etc. whichever is lower.

(h) Any loss or gain on the retirement or disposal of any fixed asset carried at cost should be recognised in the profit and loss account.

(i) If the value of any asset increases on revaluation, its accumulated depreciation should not be debited to Profit & Loss Account. The depreciation on such revalued amount should be adjusted against revaluation reserves.

(j) Any fixed asset purchased under hire purchase should be recorded at its Cash Price showing appropriate narration that its full ownership has not been received.

(k) All direct costs incurred in developing the patents should be capitalised and written off over their legal term of validity or over their working life, whichever is shorter.

(l) Amount paid for know-how of the plants, layout or designs of buildings, machinery, etc. should be added with the respective value of the asset. Depreciation should be provided on the total value. However, if such amounts have been paid compositely both for manufacturing process and for assets, the management should reasonably allocate the composite cost.

(o) The following information should be disclosed in the financial statements :

   (i) Gross and net book values of fixed assets at the beginning and end of an accounting period disclosing additions, disposals, acquisitions and other movements;

   (ii) Expenditure incurred on account of used assets in the course of acquisition or construction; and

   (iii) Revalued amounts substituted for historical costs of fixed assets and necessary particulars regarding the process adopted for revaluation.

“Depreciation Accounting” (AS 6) (Revised)

The Accounting Standard regarding depreciation was issued at first in 1982. But it was revised in 1994.

The revised standard (AS 6) is now mandatorily applicable to all concerns in India for accounting periods commencing on or after 1.4.1995. The important matters to be noted from (AS 6) are

1. “Depreciable Assets” are the assets which : -

   (a) are expected to be used for more than one accounting period; and

   (b) have limited useful life; and

   (c) are held by an enterprise for use in production or supply of goods and services, for rental to others or for administrative purposes but not for sale in the ordinary course of business.

2. “Useful Life” of a depreciable asset may be either :

   (a) the period of its expected working life, or

   (b) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

3. (a) The total amount to be depreciated from the value of a depreciable asset should be spread over its useful life on a systematic basis.

(b) The method selected for charging depreciation should be consistently followed. However, if situations demand (like change of statute, compliance with Accounting Standard, etc.) a change of method may be made. In that case, the depreciation should be recalculated under the new method with effect from the date of the asset coming into use, that is, with retrospective effect.

If Depreciation is overcharged earlier, then the following adjustment entry should be made:

Asset A/c.......Dr.

To Profit & Loss Adjustment A/c

If Depreciation is undercharged earlier, then the following adjustment entry should be made:

Profit & Loss Adjustment A/c.....Dr

To Asset A/c

(c) For ascertaining the useful life of a depreciable asset, these factors should be considered :

(i) expected physical wear and tear;

(ii) obsolescence; and

(iii) legal or other limits on the use of the asset.

Useful lives of major depreciable assets may be reviewed periodically.

(d) Any addition or extension essential for an existing asset, should be depreciated over the remaining life of the asset.

(e) If the historical cost of an asset changes due to exchange fluctuations, price adjustments, etc. the depreciation on the revised unamortised depreciable amount should be provided prospectively for the rest of the life of the asset.

(f) For any asset revalued, the provision for depreciation should be made on the revalued amount for the remaining useful life of the asset.

(g) In the financial statements, the matters to be disclosed are

(i) The historical cost or any amount substituting it;

(ii) Total depreciation for the period for each class of depreciable assets; and

(iii) The related accumulated depreciation.

The method of charging depreciation should also be disclosed.

Methods of Charging Depreciation

There are different concepts about the nature of depreciation. Moreover, the nature of all fixed assets cannot be the same. As a result, different methods are found to exist for charging depreciation. A broad classification of the methods may be summarised as follows

Capital /Source of Fund :

1. Sinking Fund Method
2. Annuity Method
3. Insurance Policy Method

Time Base

1. Fixed Instalment method
2. Reducing Balance Method
3. Sum of Years' Digit Method
4. Double Declining Method

Use Base

1. Working Hours method
2. Mileage Method
3. Depletion Unit method
4. Service Hours Method

Price Base

1. Revaluation Method
2. Repairs Provision Method

Methods of Charging Depreciation

I. *Fixed / Equal Instalment OR Straight Line Method*

Features :

(i) A fixed portion of the cost of a fixed asset is allocated and charged as periodic depreciation.

(ii) Such depreciation becomes an equal amount in each period.

Depreciation = (V-S)/n

Where,

V= Cost of the Asset

S= Residual value or the expected scrap value

n= estimated life of the asset.

2. ***Reducing / Diminishing Balance Method OR Written Down Value Method***

Features :

(i) Depreciation is calculated at a fixed percentage on the original cost in the first year. But in subsequent years it is calculated at the same percentage on the written down values gradually reducing during the expected working life of the asset.

(ii) The rate of allocation is constant (usually a fixed percentage) but the amount allocated for every year gradually decreases.

3. *Sum of Years Digit Method*

Features :

(i) It is a revised form of Reducing Balance Method.

(ii) Here also the working life of an asset has to be pre-estimated and Total Depreciation is considered as Cost of the Asset *( )* Residual or Scrap Value.

(iii) The amount of annual depreciation goes on decreasing with the use. For calculating depreciation, the denominator becomes the sum of the digits repre senting the life of the asset. Thus if an asset has a life of *5* years, the denomina tor should be I + 2 + 3 + 4 + *5* or 15.

$$\text{Depreciation} = \frac{\text{(Remaining Life of the Asset x Depreciable Amount)}}{\text{Sum of the Year's Digit}}$$

Where,

Depreciable Amount = Cost of the Asset – Estimated Scrap Value

Sum of the Years' Digit = n(n+1)/2

n = estimated life of the asset

Example:

If an asset costs Rs. *50,000*, it has a residual value of Rs. 5,000 and working life of 5 years the depreciation will be—

1st year	5/15 of *(50,000* —5,000)	or	Rs.	15,000;
2nd year	4/15 of (50,000 —5,000)	or	Rs.	12,000;
3rd year	3/15 of (50,000 —5,000)	or	Rs.	9,000;
4th year	2/15 of *(50,000* 5,000)	or	Rs.	6,000;
5th year	1/15 of (50,000 *—5,000)*	or	Rs.	3,000.

4. *Double Declining Balance Method :*

Features :

(i) Depreciation is charged at a fixed rate and it is calculated on the written down value of an asset brought forward on the opening date of an accounting year.

(ii) The Rate of Depreciation becomes the double of the rate under fixed instalment method. It may be illustrated as follows:

	Rs.
Original Cost of an Asset	2,20,000
Scrap Value (Estimated)	20,000
Working Life (Estimated)	5 years

Total Depreciation Rs. 2,20,000 —Rs. 20,000 =Rs. 2,00,000

Annual Depreciation = Rs. 2,00,000 / 5 =Rs. 40,000

Rate of Depreciation under Straight Line Method $= \dfrac{\text{Rs. } 40{,}000 \quad 100}{\text{Rs } 2{,}00{,}000,} = 20\%$

Depreciation under DDB Method = 2 x 20% or 40%

The depreciation will be calculated as

					Rs.
1st year	*Less :*	Opening Cost Depreciation @	 40%		2,20,000 88,000
2nd year	*Less :*	Opening Value Depreciation @	 40%		1,32,000 52,800
3rd year	*Less:*	Opening Value Depreciation @	 40%		79,200 31,680
4th year	*Less:*	Opening Value Depreciation @	 40%		47,520 19,008
5th year	*Less:*	Opening Value Depreciation		[Opening Value - Scrap Value 28,512 — 20,000] ***Scrap Value***	28,512 8,512 20,000

5. ***Working Hours Method***

Features :

The Hourly Rate of Depreciation of an asset is calculated as—

$$\frac{\text{Acquisition Cost — Scrap Value}}{\text{Estimated Total Working Hours}}$$

Annual Depreciation is found out as— Hourly Rate of Depreciation x actual working hours rendered by the asset during the year.

It may also be called a Machine Hour Rate where total machine hours of a machine are estimated.

6. ***Mileage Method***

(i) It considers the total distance in miles or kilometeres to be run by a vehicle, like bus, car, lorry etc.

(ii) Depreciation per mile/km = $\dfrac{\text{Cost Price —Scrap Value}}{\text{Total miles or kms. expected to be run by the vehicle}}$

(iii) Annual Depreciation = Depn. per mile or km x distance covered during the year

7. ***Depletion Unit Method***

Depreciation or Depletion per unit =

$$\frac{\text{Cost of acquisition and development cost —Residual value}}{\text{Estimated units to be raised or extracted}}$$

Annual Depreciation = Depreciation per unit units produced or raised or extracted during the week.

8. ***Service Hours Method*** : Under this method the expected “service hours or running time~ is considered as the basis of charging depreciation. For example, a locomotive engine renders effective service for some definite running hours. In case of aircrafts “flying hours” are pre-calculated.

Depreciation per Service Hour = $\dfrac{\text{Total Cost —Residual Value}}{\text{Total Running time or Service hours}}$

And Annual Depreciation = Rate of depreciation per hour x service hours rendered during the period.

9. ***Sinking Fund Method***

Annual depreciation is isconsidered as a source of providing the replacement cost of an asset. It becomes a means of maintaining capital.

$$D = \frac{Ci}{(1+i)^n -1}$$

D= Depreciation

C= Cost of the asset

i= Rate of Deprecition

n= Life of the asset

Journal Entries under the Sinking Fund method :

At the end of first year

1. (a) Profit & Loss A / c *Dr*
   To Depreciation A / c (annual contribution)
   or P / L A / c *Dr*
   To Sinking Fund A / c
   (b) Depreciation A / c *Dr.*
   To Sinking Fund A / c
2. Sinking Fund Investment A / c Dr.
   To Bank A / *c* (invested amount)

At the end of second/subsequent years

1. Profit & Loss A / c ... *Dr.*
   To Sinking Fund A / c (annual contribution)
2. Bank A / c *Dr.*
   To Interest on Investment A / c (annual interest)
3. Interest on Investment A / c *Dr.*
   To Sinking Fund A / c (interest transferred)
4. Sinking Fund Investment A / c *Dr.*
   To Bank A / c
   [amt. invested usually = annual contribution + annual interest]

When the working life of the asset ends (1), (2) & (3) same as above; (4) not made in the last year

5. Bank A / c Dr.
   To Sinking Fund Investment A / c
   (Investments sold out)
6. Sinking Fund Investment A / c *Dr.*
   To Sinking Fund A / c (Profit on Sale)
   OR
   Sinking Fund A / c *Dr.*
   To Sinking Fund Investment A / c (Loss on Sale)
7. Sinking Fund A / c............*Dr.*
   To Asset A / c [Asset A / c closed]

Notes:

(i) No investment is made in the last year as the investments are to be sold out.

(ii) Sinking Fund Account may be called Depreciation Fund Account also. It is to be shown on the liability side of Balance Sheet.

(iii) Sinking Fund Investments Account may be called Depreciation Fund Investments Account also. It is to be shown on the Asset side of the Balance Sheet.

(iv) Annual Contribution (charged in lieu of annual depreciation) = Original Cost x Present Value of Re. 1 at given interest rate.

Illustration: Cost of an Asset Rs.40,000 Life:4 years. Depreciation 10% p.a.

Under Sinking Fund Method:

$$\text{Annual Depreciation} = \frac{Ci}{(1+i)^{n}-1}$$

This amount shall be invested at the end of years 1,2 and 3. The amount of investment shall fetch 10% interest p.a. which will lead to accumulation of Rs.40,000 at the end of the 4th year.

The amount of Rs.8,619 shall not be invested at the end of the 4th year.

10. ***Annuity Method***

Cost of an asset is considered to be an investment. such investment would earn interest if invested outside the business.

$$D = Ci(1+i)^n / (1+i)^n - 1$$

D= Depreciation

C= Cost of the asset

i= Rate of Deprecition

n= Life of the asset

Journa.l entries

1. Depreciation A/c *Dr.*
   To Asset A/c
   (Calculated from annuity table)
2. Asset A/c *Dr.*
   To Interest A/c
   (Calculated on diminishing values)
3. Profit & Loss A/c *Dr.* .
   To Depreciation A/c
4. Interest A/c *Dr.*
   To Profit & Loss A/c

Under Annuity Method:

$$\text{Annual Depreciation} = \frac{Ci\,(1+i)^n}{(1+i)^n - 1} = \frac{40{,}000 \times 10\% \times 1.4641}{1.4641 - 1} = 12{,}619$$

In case of Annuity Method, the amount of Rs.12,619 shall not be invested outside the business.

It shall have to be taken as an yearly appropriation. The total amount to be appropriated over a period of 4 years = Rs.12,619 x 4 = Rs.50,476.

Cost of Capital = Total Appropriation - Actual Cost of the Asset = Rs.50,476 -40,000 = Rs.10,476.

11. ***Insurance Policy Method***

(i) It has a close similarity with the Sinking Fund Method. But, here money is not used for investment in securities It is used to pay premium on an Insurance Policy which assures funds necessary for replacement. It may also be called Depreciation Fund Policy Method.

(ii) An insurance policy for an assets is taken on the basis of (a) the specific number of years over which the asset will he used, and (b) the amount that will he required as the replacement cost of the asset.

(iii) At the end of the specific working life of the asset, the policy matures and the Insurance Company pays the amount including bonus, if any.

(iv) Depreciation is substituted by the annual premium on the policy.

Journal Entries : 1st year and subsequent years

1. Profit & Loss A/c *Dr.*
   To Depreciation Fund A/c
   [amt. of depreciation]
2. Insurance Policy A/c *Dr.*
   To Bank A/c
   [Premium paid at the beginning of the yr.]

At the end of working life of the asset (1) and (2) same as above

3. Bank A/c *Dr.*
   To Insurance Policy A/c
   [amt. received on maturity of policy]
4. Insurance Policy A/c *Dr.*
   To Depreciation Fund A/c
   [Profit or Bonus received]
5. Depreciation Fund A/c *Dr.*
   To Asset A/c [for closing these accounts]
6. If the asset is sold out—
   Bank A/c *Dr.*
   To Asset A/c

If Depreciation is based on the Market Price of asset

1. ***Revaluation Method***

   Annual Depreciation is considered to be the reduction in the value of an asset during a year, or Annual Depreciation is the shortfall in the closing value of an asset from its opening value.

2. ***Repairs Provision Method***

(i) This method computes depreciation on an asset on the basis of (a) the cost of the asset and (b) the estimated total cost of repairs to be needed throughout the working life of the asset.

(ii) The expenses for repairs and renewals do not become the same every year. Rather the amounts spent in different years should be different.

The total cost of repairs for an asset throughout its working life is estimated first.

(iii) With total estimated depreciation this total estimated cost of repairs is added.

(iv) The result is divided by the working life of the asset to find out annual depreciation.

Thus, Annual Depreciation = (Depreciation + Repairs Cost) / Working Life of the Asset

[*Estimated Total Depreciation = Cost of Acquisition — Scrap Value]

(v) Whatever may be the actual cost of repairs paid in a year, the Annual Depreciation amount as calculated above is debited to Profit & Loss Account and credited to Provision for Depreciation and Repairs Account.

The **actual amount** paid for repairs is debited to Provision for Depreciation and Repairs account.

(vi) After the expiry of the working life of the asset, the balance of the above mentioned Provision Account is transferred to the Asset Account.

(vii) Some concerns create Provision for Repairs & Renewals Account separately with out including depreciation.

Illustration 1 :

M/s Rajesh and Rakesh commenced business on 1st January 2005, when they purchased plant and equipment for Rs. 7,00,000. They adopted a policy of (i) charging depreciation at 15% p.a. on diminishing balance method and (ii) charging full year's depreciation on additions.

Over the years, their purchases of plant have been :

Date	Amount Rs.
August 1, 2006	1,50,000
September 30, 2009	2,00,000

On January 1,2009 it was decided to change the method and rate of depreciation to 10% p.a. on straight line method with restrospective effect from January 1, 2005, the adjustment being made in the accounts for the year ending 31st December, 2009.

Kolkata the difference in depreciation to be adjusted in the Plant and Equipment Account on January 1, 2009 and show the ledger account for the year 2009.

Solution :

M/s Rajesh & Rakesh

STATEMENT SHOWING DEPRECIATION ON
WRITTEN DOWN VALUE BASIS AND ON STRAIGHT LINE BASIS

(i) On written Down Value basis :

		Purchased on Jan. 1, 2005 Rs.	Purchased on Jan. 1, 2005 Rs.
2005	Cost	7,00,000	
	Less : Depreciation	1,05,000	
	Written down value	5,95,000	
	Cost		1,50,000
2006	*Less* : Depreciation	89,250	22,500
	Written down value	5,05,750	1,27,500
2007	*Less* : Depreciation	75,863	19,125
	Written down value	4,29,887	1,08,375
2008	*Less* : Depreciation	64,483	16,256
	Written down value	3,65,404	92,119
	Depreciation charged	3,34,596	57,881
	Total Depreciation charged (3,34,596+57,881)	3,92,477	

(ii) On Straight Line basis :

Annual Depreciation — 10% on original cost	70,000		15,000
Number of years for which depreciation is to be charged	4		3
Total depreciation	70,000 4 = 2,80,000		15,000 3 = 45,000
(2,80,000+45,000)		3,25,000	
Difference :			
Excess depreciation charged to be adjusted in 2009 (3,92,477 – 3,25,000)		67,477	

Dr. PLANT AND EQUIPMENT ACCOUNT *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2009		Rs.	2009		Rs.
Jan 1.	To Balance b / d (8,50,000 – 3,92,477)	4,57,523	Dec. 31	Depreciation — 10% on original cost Rs. 10,50,000 (8,50,000+2,00,000)	1,05,000
	To Profit and Loss — (excess depreciation adjusted)	67,477			
Sep.30	To Bank	2,00,000		By Balance c / d	6,20,000
		7,25,000			7,25,000
Jan. 1	To Balance b / d	6,20,000			

Illustration 2 :

M Ltd. which depreciates its machinery @ 10% per annum according to diminishing balance method, had on 1st April, 2008 Rs. 4,86,000 balance in its machinery account. During the year ended 31st March, 2009, the machinery purhased on 1st April, 2006 for Rs. 60,000 was sold for Rs. 40,000 on 1st October, 2008 and a new machinery costing Rs. 70,000 was purchased and installed on the same date; installation charges being Rs. 5,000.

The company wants to change its method of depreciation from diminishing balance method to straight line method w.e.f. 1st April, 2006 and adjust the difference before 31st March, 2009, the rate of depreciation remaining the same as before.

Show the Machinery account for the year ended 31st March, 2009.

Solution :

Books of M Ltd.

Dr. MACHINERY ACCOUNT *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2008			2008		
Apr. 1	To Balance b / d	4,86,000	Oct. 1	By Bank	40,000
Oct. 1	To Bank (cost and installation charges)	75,000		By Profit and Loss A / c (loss on sale of Machinery	6,170
			2009		
			Mar. 31	By Depreciation	60,180
				By Profit and Loss A / c (Addl. Depreciation)	5,400
				By Balcne c / d	4,49,250
		5,61,000			5,61,000

Working Notes :

(i) Calculation of loss on sale of Machinery : Rs.

	Cost of Machinery on April 1, 2006	60,000
Less :	Depreciation for 2006-07	6,000
		54,000
Less :	Depreciation for 2007-08	5,400
		48,600
Less :	Depreciation for half year	2,430
	Book value as on 1st October 2008	46,170
Less :	Sale proceeds	40,000
	Loss on sale	6,170

(ii) Additional depreciation :

Cost of Machinery on April 1, 2006 :

$$4{,}86{,}000 \times \frac{100}{90} \times \frac{100}{90} = \text{Rs. } 6{,}00{,}000$$

	Book value on April 1, 2006	6,00,000
Less :	Book value of Machinery sold on 1s October 2008	60,000
	Book value on April 1, 2006	5,40,000
	Depreciation for 2 years (*i.e.*, 2006-07 and 2007-08) @ 10% on Rs. 5,40,000	1,08,000
Less :	Depreciation provided for 2 years under Diminishing balance method (54,000+48,600)	1,02,600
	Additional depreciation due to change in the method charged to profit and loss account	5,400

(iii) Depreciation for 2008-09 will be as under :

on Machinery sold	2,430
on Machinery purchased and installed	3,750
on Original cost of Machinery *viz.*	
Rs. 5,40,000 @ 10%	54,000
	60,180

Illustration 3 :

Ram Ltd. which depreciates its machinery at 10% p.a. on Diminishing Balance Method, had on 1st January, 2009 Rs. 9,72,000 on the debit side of Machinery Account.

During the year 2009 machinery purchased on 1st January, 2007 for Rs. 80,000 was sold for Rs. 45,000 on 1st July, 2009 and a new machinery at a cost of Rs. 1,50,000 was purchased and installed on the same date, installation charges being Rs. 8,000.

The company wanted to change the method of depreciation from Diminishing Balance Method to Straight Line Method with effect from 1st January, 2007. Difference of depreciation up to 31st December, 2009 to be adjusted. The rate of depreciation remains the same as before.

Show Machinery Account.

Solution :

Books of M Ltd.

Dr. MACHINERY ACCOUNT *Cr.*

Date	Particulars		Amount	Date	Particulars	Amount
2009				2009		
Jan. 1	To Balance b / d	Rs.		July 1	By Depreciation (ii)	3,240
	(i)	9,07,200			By Bank — Sale	45,000
	(ii)	64,800	9,72,000		By Loss on sale of Machine (ii)	16,560
July 1.	To Bank (1,50,000+8,000)		1,58,000	Dec. 31	By Depreciation :	
					(i) For the year 1997	1,12,000
					(ii) for year	7,900
					By Profit & Loss A / c Adjustment	11,200
				Dec. 31	By Balance c / d	7,84,000
					(i) 9,07,200–1,12,000 – 11,200)	
					(ii)	Nil
					(iii) (1,58,000– 7,900)	1,50,100
			11,30,000			11,30,000

Working Notes :

(1) At 10% depreciation on Diminishing balance method :

	Rs.
If balance of machinery in the beginning of the year is	10
Depreciation for the year is	1
Balance of Machinery at the end of the year	9

By using the formula, balance of asset on 1st January 2007 will be calculated as follows :

	Rs.
Balance as on 1st January 2009	9,72,000

$\therefore$ Balance as on 1st January 2008 is 9,72,000 $\frac{10}{9}$ =Rs. 10,80,000

Balance as on 1st January 2007 is 10,80,000 $\frac{10}{9}$ =Rs. 12,00,000.

This balance, Rs. 12,00,000 is composed of 2 machines, one of Rs. 11,20,000 and another of Rs. 80,000.

	Rs.
Depreciation at 10% p.a. on straight line method on Rs. 11,20,000	1,12,000
Total Depreciation for 2007 and 2008	2,24,000
Total Depreciation charged for 2007 and 2008 on Diminishing balance method (1,12,000 + 1,00,800)	2,12,800
Balance to be charged in 2009 to change from Diminishing balance method to straight line method	11,200

(2) Machine purchased on 1st January, 2007 for Rs. 80,000 shows the blance of Rs. 64,800 on 1st January 2009 as follows :

	Rs.
Purchase price	80,000
Less : Depreciation for 2007	8,000
	72,000
Less : Depreciation for 2008	7,200
Balance as on Jan. 1, 2009	64,800

(3) On second (ii) machine (original purchase price Rs. 80,000), depreciation at 10% p.a. on Rs. 64,800 for 6 months, *viz.*, Rs. 3,240 has been charged to the machine on July 1 2009 *i.e.*, on date of sale.

(4) Loss on sale of (ii) machine has been computed as under :

	Rs.
Balance of the machine as on 1.1.2009	64,800
Less : Depreciation for 6 months up to date of sale	3,240
Balance on date of sale	61,560
Less : Sale proceeds	45,000
Loss on sale	16,560

DISPOSAL OF AN ASSET

Sometimes, a firm may sell an asset because of obsolescence or inadequacy or any other reason. In such cases, the cost of the asset is transferred to a separate account called 'Asset Disposal Account'. The entry is passed as under :

Asset Disposal A/c	... Dr.
To Asset A/c	

The amount of depreciation provided on this asset from the date of purchase to the date of sale is also transferred from the 'Provision for Depreciatio Account' to the 'Asset Disposal Account' the entry being :

Provision for Depreciation A/c	... Dr.
To Asset Disposal A/c	

When cash is realised on sale of asset, it is credited to Asset Disposal A/c entry being :

Bank A/c	... Dr.
To Asset Disposal A/c	

Loss on disposal is transferred to Profit and Loss Account by passing the following entry :

Profit & Loss A/c	... Dr.
To Asset Disposal A/c	

Profit on disposal is transferred by reversing the above entry, *i.e.,*

Asset Disposal A/c	... Dr.
To Profit & Loss A/c	

Profit on disposal represents excess depreciation provided in the past years now credited back to profit and loss account, whereas loss on disposal represents depreciation not provided for in the ealier years.

Illustration 4 :

From the following particulars prepare Machinery Disposal Account :

	Rs.
Original cost on Jan. 1, 2009	3,00,000
Accumulated depreciation on Jan. 1, 2009	2,25,000
Machinery was sold on Jan. 1, 2009 for	1,20,000

Solution :

Dr. MACHINERY DISPOSAL ACCOUNT *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2009			2009		
Jan. 1	To Machinery A/c	3,00,000	Jan. 1	By Provision for depreciation A/c — Accumulated depreciation	2,25,000
Dec. 31	To Profit & Loss A/c	45,000		By Bank — Sale	1,20,000
		3,45,000			3,45,000

Illustration 5 :

On 1st April 2006, M/s Rishab & Co. purchased four machines for Rs. 50,000 each. His accounting year ends on 31st March. Depreciation @ 20% on orginal cost has been charged to Profit and Loss Account and credited to a separae provision for depreciation account.

On 1st April 2007, one machine was sold for Rs. 35,000 and on 1st April 2008, a second machine was sold for Rs. 33,000. A new machine which cost Rs. 80,000 was purchased on 1st October 2007. The same rate of depreciation was decided for the new machine as well.

Prepare : (i) Machinery A/c,

(ii) Machinery Disposal A/c,

(iii) Provision for Depreciation A/c till March 2009.

Solution :

M/s Rishab & Co.

Dr. MACHINERY ACCOUNT *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2006		Rs.	2007		Rs.
Apr. 1	To Bank	2,00,000	Mar. 31	By Balance c/d	2,00,000
2007					
Apr. 1	To Balance b/d	2,00,000	Apr. 1	By Machinery Disposal A/c	50,000
			2008		
			Mar. 31	By Balance c/d	2,30,000
		2,80,000			2,80,000
2008					
Apr. 1	To Balance b/d	2,30,000	Apr. 1	By Machinery Disposal A/c	50,000
			2009		
			Mar. 31	By Balance c/d	1,80,000
		2,30,000			2,30,000
2009					
Apr. 1	Balance b/d	1,80,000			

Dr. PROVISION FOR DEPRECIATION ACCOUNT *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2007		Rs.	2007		Rs.
Mar. 31	To Balance c / d		Mar. 31	By Depreciation A / c	
		40,000		— 20% on Rs. 2,00,000	40,000
2007			2007		
Apr. 1	To Machinery Disposal A / c transfer	10,000	Apr. 1	By Balance b / d	40,000
2008			2008		
Mar. 31	To Balance c / d	68,000	Mar. 31	By Depreciation :	
				On Rs. 1,50,000 for 1 year	30,000
				On Rs. 80,000 for 6 months	8,000
		78,000			78,000
2008			2008		
Apr. 1	To Machinery Disposal A / c — transfer	20,000	Apr. 1	By Balance b / d	68,000
			Mar. 31	By Depreciation :	
2009				On Rs. 1,00,000 for 1 year	20,000
Mar. 31	To Balance c / d	84,000		On Rs. 80,000 for 1 year	16,000
		1,04,000			1,04,000
			2009		
			Apr. 1	By Balance b / d	84,000

Dr. MACHINERY DISPOSAL ACCOUNT *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2007		Rs.	2007		Rs.
Apr. 1	To Machinery A / c	50,000	Apr. 1	By Provision for Depreciation A / c	10,000
				By Bank — Sale	35,000
			2008		
			Mar. 31	By Profit & Loss A / c — transfer	5,000
		50,000			50,000
2008			2008		
Apr. 1	To Machinery A / c	50,000	Apr. 1	By Provision for Depreciation A / c	20,000
2009				By Bank — Sale	33,000
	To Profit & Loss A / c — transfer	3,000			
		53,000			53,000

Illustration 6 :

M/s Suba Chemicals has imported a machine on 1st July 2007 for $ 6,000, paid customs duty and freight Rs. 52,000 and incurred rection charges Rs. 20,000. Another local machinery costing Rs. 1,00,000 was purchased on January 1, 2008. On 1st July 2009, a portion of the imported machinery (value one-third) got out of order and was sold for Rs. 34,800. Another machinery was purchased to replace the same for Rs. 50,000. Depreciation is to be calculated at 20% p.a. on straight-line method. Prepare the Machinery Account and Machinery Disposal Account for 2007, 2008 and 2009. Exchange rate is Rs. 38 per $.

Solution :

Books of M/s. Suba Chemicals

Dr. MACHINERY ACCOUNT *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2007		Rs.	2007		Rs.
July 1	To Bank — purchase	2,28,000	Dec. 31	By Depreciation	
	(6000 Rs. 38)			—for 6 months	30,000
	To Bank —Duty etc.	52,000		(Rs. 3,00,000	
	To Bank — Erection charges	20,000		20/100 1/2	
				By Balance c/d	2,70,000
		3,00,000			3,00,000
2008			2008		
Jan. 1	To Balance b/d	2,70,000	Dec. 31	By Drpreciation	
	To Bank—purchase	1,00,000		(i) 3,00,000 20/100	60,000
				(ii) 1,00,000 20/100	20,000
				By Balance c/d	2,90,000
		3,70,000			3,70,000
2009			2009		
Jan. 1	To Balance b/d	2,90,000	July 1	By Machinery Disposal A/c	70,000
	To Bank—purchase	1,00,000	Dec. 31	By Decpreciation :	
				(i) 2,00,000 20/100	40,000
				(ii) 1,00,000 20/100	20,000
				(iii) 50,000 20/100	5,000
				By Balance c/d	2,05,000
		3,40,000			3,40,000
2010					
Jan. 1	To Balance b/d	2,05,000			

Dr. MACHINERY DISPOSAL ACCOUNT *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2009		Rs.	2009		Rs.
July 1	To Machinery A/c	70,000	July 1	By Depreciation	10,000
				(1,00,000 20/100)	
				By Bank — sale proceeds	34,800
				By Profit & Loss A/c	25,200
				—Loss	
		70,000			70,000

Note : 1. Written down value of Machinery as on July 1, 2009 will be as follows :

	Rs.
Original cost on July 1, 2007 (3,00,000 1/3)	1,00,000
Less : Depreciation for 2007 (for 6 months)	
(1,00,000 20/100)	10,000
	90,000
Less : Depreciation for 2008	
(1,00,000 20/100)	20,000
	70,000

2. If 'Machinery Disposal Account' is not kept, then, Machinery account for the year 2009 will be prepared as under :

Dr. MACHINERY ACCOUNT (for 2009) *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2009		Rs.	2009		Rs.
Jan. 1	To Balance b/d	2,90,000	July 1	By Depreciation	10,000
July 1	To Bank	50,000		(For 6 months)	
				By Bank — sale proceeds	34,800
				By Profit & Loss A/c	25,200
				Loss on sale (70,000–44,800)	
			Dec. 31	By Depreciation	65,000
				By Balance c/d	2,05,000
		3,40,000			3,40,000
2010					
Jan. 1	To Balance b/d	2,05,000			

EXERCISE

1. *Why depreciation is charged ?*
2. *Why Depreciation is called Notional Cost ?*

Problem 1.

Special Points : (a) Depreciation under Fixed Instalment Method; (b) Assets purchased on different dates, (C) *Sale of Asset, (d) Loss on Sale*

B. Co. Purchased machinery as follows :

Date of Purchase	Cost of Machine (Rs.)
1.4.86	60,000
1.10.86	40,000
1.7.87	20,000

On 1.1.88 one-third of the machinery which was purchased on 1.4.86 became obsolete and was sold for Rs. 6,000. The machinery was to be depreciated by Fixed Instalment Method at 10% p a.

Show how the Machinery Account would appear in the ledger of the Company for the years 1986. 1987 and 1988. Assume that the accounting year of the Company ends on 31st December every year.

(Ans: Loss on *sale Rs. 10,500; Annual Depreciations 1986 Rs. 5,500: 1987 Rs.* 11,000; *1968 Rs. 10,000.* Balance at *Machinery Account on 31. 2.1988 Rs. 77,000)*

(Hints : Depreciations 1986 = Rs. 5,000, 1987 = Rs. 11,000, 1988 = Rs. 10,000)

Problem 2.

Special Points : (a) Use of Provision for Depreciation Account, (b) Journal Entries, (c) Sale and Profit on sale.

After Rs. 5,000 was provided for depreciation in the current year. the accumulated provision for depreciation went up to Re. 50,000. The Machine concerned whose original cost had been Rs. 55,000 was then sold as scrap for Rs. 20,000 (cash) and replaced thereafter by a new machine costing Rs. 75,000. Give Journal entries to record the above transactions.

(Ans.: Profit on sale of scrap Rs.15000]

Problem 3.

Special Points (a) Depreciation under diminishing balance method, (b) Purchase of Assets on different dates, (c) Sale and profit or loss on sale.

Q Ltd, purchased on 1st January, 1988 a machine for Rs. 10,000. On 1.7.88 it again purchased another machine for Rs. 5,000. On 1.7.89 the machine purchased on 1.1.1988 was sold for Rs. 4,000. On 1.7.1990 a new machine was purchased for Rs. 12,000. On the same date the machine purchased on 1.7.88 was sold for Rs. 4,200.

Depreciation was provided at 10% p.a. on the written down value every year. Show the Machinery Account .

(Ans.: Loss on sale in 1989= Rs.. 4,550 Profit on sale in 1990 = Rs. 139)

(Hints : Depreciation in

$1988 = 10000 \quad \frac{10}{100} + 5{,}000 \text{ x} \frac{10}{100} \quad 12 =$ Rs. 1250; $1989 = 9{,}000 \quad \frac{10}{100} \quad \frac{6}{12} + 4{,}750 \quad \frac{10}{100}$ Rs. 925;

$1990 = 12{,}000 \quad \frac{10}{100} \quad \frac{6}{12} + 4{,}275 \quad \frac{10}{100} \quad \frac{6}{12} = Rs.$ 814)

Problem 4.

Special Points : (a) Change in method of depreciation with prospective effect; (b) Sale of Asset.

ABC Ltd. purchased on 1.1.90 a second hand plant for Rs. 30,000 and spent Rs. 20,000 for overhauling it. On 1.7.90 additional machinery costing Rs. *25,000* was purchased. On 1.7.92 the plant purchased on 1.1.90 became obsolete and was sold for Rs. 10,000. On that date a new machine was purchased at a cost of Rs. 60,000.

Depreciation was provided annually on 31st December @ 10% per annum on the original cost. In1993. however the company changed this method of providing depreciation and adopted the method of providing off 15% on the diminishing value.

Show the Machinery Account for the years 1990 to 1994.

(Hints *and Ans:*

1990 Cost of Machines purchased = 50,000(1.1.90) + 25,000 (1.7.90) = Rs. 75,000

Depreciation: 10% *0f* 50,000 + 10% of 25,000 lot yr Rs. 6,250.

Balance of Machinery Rs. 68,750 on 31. 12.1990

1991 Depreciation: 10% of (50,000 + 25,000) : Rs. 7,500;

Balance of Machinery on 31.12.91 = Rs. 61,250.

1992 Depreciation of machine sold: 10% *of* 50,000 lot 6 months = Rs. 2,500:

1993 Loss on sale = Rs. 27,500.

Depreciation on other machines 10% of 25,000 + 10% of 60,000 lot yr- Rs. 5,500.

Balance of Machinery on 31.12.92 = Rs. 75,750.

1993 Depreciation = 15% of W.D.V = 15% of 75,750 = Rs. 11,362.50 or Rs. 11,363;

Balance on 31.12.93 Rs. 64,367.

1994 Depreciation 15% of Rs. 64,387 = Rs. 9,658; Balance of machinery on 31.12.94 = Rs. 54.729}

Problem 5.

Change of Method — Prospective Effect

A firm purchased on 1st January. 1996. certain machinery for Rs. 19,40,000 and spent Rs. 60,000 on its erection. On 1st July in the same year additional machinery costing Rs. 10,00,000 was acquired. On 1st July. 1998. the machinery purchased on 1st January 1996 having become obsolete was auctioned for Rs. 8,00,000 and on the same date fresh machine was purchased at a cost of Rs. 15,00,000.

Depreciation was provided for annually on 31st December at the rate of 10% per annum on the original cost of the asset. In 1999, however, the firm changed this method of providing depreciation and adopted the method of writing off 20% on the written down value.

Give the Machinery Account as it would stand at the end of each year from 1996 to 2000.

Problem 6.

Special Point: Change from diminishing balance to straight line method with retrospective effect..

Messrs M & W commenced business on 1.1.1990 when they purchased plant and equipment for Rs. 70,000. They adopted a policy of (i) charging depreciation at 15% per annum on diminishing ba1ance basis and (ii) charging full year's depreciation on additions. Over the years, their purchases of plant have been 1.4.91—Rs. 1,50,000; 30.9.94—Rs. 2,00,000

On 1.1.94 it was decided to change the method and rate of depreciation to 10% on straight line basis with retrospective effect from 1.1.90, the adjustment being made in the accounts for the year ending 31st December 1994. Calculate the difference in depreciation to be adjusted in the plant and Equipment Account on 1.1.94 and show the Ledger A/c for the year 1994.

Problem 7.

Change of Method with retrospective effect

Chartered Planes Ltd which depreciates its machinery at 10% on Diminishing Balance Method had on 1st

January 1995, Rs. 9,72,000 to the debit of Machinery Account. During the year 1995 a part of the machinery purchased on 1st July, 1993 for Rs. 80,000 was sold for Rs. 45,000 on 1st July, 1995 and a new machinery at a cost of Rs. 1,50,000 was purchased and installed on the same date. installation charges being Rs. 8,000. The company wanted to change its method of depreciation from Diminishing Balance Method to Straight Line Method with effect from 1st January, 1993 and adjust the difference in the accounts for 1991. The rate of depreciation remained the same as before.

Show the Machinery Account and entries in the Profit & Loss Account as regards depreciation and obsolescence loss in 1995.

[Ans : Balance of *Machinery Account on 31.12.95 Rs, 2,34,100 Additional Depreciation to be provided for changing the method Rs. 12,000; Depreciation in 1995 (a) on machinery sold Rs. 4,000 (b) Rs. 1,19,900 on remaining assets; loss on sale Rs. 15,000]*

[Hints Balance on 1.1.95 = 9,72,000 $\therefore$ Balance on 1.1.94 = $\dfrac{9{,}72{,}000}{10}$ 9=10,80,000

Balance on 1.1.93 = $\dfrac{10{,}80{,}000}{10}$ 9 = 12,00,000.

W. D. Value on 1.1.95 under S.LM= 12,00,000 -.10% x 2 of 12,00,000 = Rs. 9,60,000)

Problem 8.

(a) Change of method, with retrospective effect (b) use of provision for Depreciation Account and Asset Disposal Account

On 1.1.91 a new plant was purchased by Mrs. Kalyani Basu for Rs. 1,00,000 and a further sum of Rs. 5,000 was spent on its installation. On 1.6.92 another plant was acquired for Rs. 65,000.

On 2.10.93 the first plant was totally destroyed and an amount of Rs. 2,500 only was realised by selling the scraps. It was not insured.

On 20.10.93, a second hand plant was purchased for Rs. 75,000 and a further sum of Rs. 7,500 was spent on its repairs and Rs. 2,500 on its erection. It came into use on 15.11.93. Depreciation has been provided at 10% on the original cost annually on 31st December. It was the practice to provide depreciation for full year on all acquisitions made at any time during any year and to ignore depreciation on any item sold during the year. The accounts are closed annually on 31st December.

In December, 1993, it was decided to change the method of depreciation and to follow the rate of 15% on diminishing balance method of depreciation with retrospective effect in respect of the existing items of plant and to make necessary adjustments on 31:12.93.

Show the Plant Account, Plant Disposal Account and Provision for Depreciation Account for 3 years.

[Ans: Balance *of Plant* Account *on* 31.12.93 Rs. *1,50,000* Loss on sale as per Plant *Disposal* Account Rs. 81,500 Balance *Of Prov.* for Depreciation A/c on 31.12.93 *Rs. 30,788.)*

Problem 9.

Special Point: (a) Change of method with retrospective effect. (b) Part sale of the asset.

Machinery Account of R. C. Ltd. showed a debit balance of Rs. 32,400 on 1st January 1995. depreciation being provided at 10%. On 1st July 1995 a part of the machinery purchased for Rs. 10,000 on 1st January 1993 was sold for Rs. 7,000 and on the same date a new machinery which cost Rs. 20,000 was purchased.

On 31st December. 1995, the company decided to change the method of depreciation from written down value method to straight line method with effect from 1st January. 1993, depreciation remaining at 10% pa.

Show the Machinery Account.

[Ans : *Balance of Machinery A/c on 31. 12.95 Rs. 40,000; Loss* on *Sale of Machinery Rs. 695; Further depreciation to be charged due to change of method Rs.* 300 *under Straight Line Method Depreciation on Machinery Sold Rs. 405 on other machinery Rs. 4,000)*

[Hints : For converting to straight line method original cost on 1.1.93 to be found out.

W.D. Value on l.1.95=Rs.32,400 :. Value on l.1.94 =32,400 $\frac{10}{9}$ = Rs. 36,000;

Value on 1.1.93 =36,000 $\frac{10}{9}$ = Rs. 40,000

(a)	Cost of Machinery on 1,1.93	Rs.	40,000
	Less : Cost of Machine sold on 1.7.95	Rs.	10,000
		Rs	30,000
	Add: Purchase on 1.7.95	Rs.	20,000
	Cost Price on Machinery *in* hand	Rs.	50,000

(b)	Depreciation on 30,000 @ 10%	3.000
	Under S.L.M. on 20,000 10% for 6 months	1,000
	[1.7. to 31.12.95]	4,000

(c) Difference of Depreciation

	Under S. L M.	Under W. D. V. M.	Difference
1993	3,000	3,000	—
1994	3,000	2,700	300
		To be charged	300

1.3 ACCOUNTING FOR INVENTORY

Introduction

Inventory means any stock held by a manufacturing business to meet its production requirements. A trading concern holds stock of goods for sale.

As per Indian Accounting Standard 2 [AS.-2] Inventories mean tangible property held

(i) for sale in the ordinary course of business, or

(ii) in the process of production for such sale, or

(iii) for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.

Valuation of Inventory

AS 2 and its implications

Before going into any discussion regarding any method of inventory valuation the epitome of Indian Accounting Standard 2 (AS 2) should be understood. It says that—

(i) Inventory should normally be valued at historical cost or net realisable value whichever is lower.

(ii) **Historical Cost** is the combination of (a) cost of purchase; (b) cost of conversion; and (c) any other cost incurred in the normal course of a business to bring the inventories up to their present location and condition.

(iii) **Net realisable value** represents the actual or the estimated selling price less cost of completion and sale.

(iv) **By Products** should be valued as the lower of cost and net realisable value. Consumable stores and maintenance supplies should generally be valued at cost.

Re-usable wastes should be valued at net realisable value, if reprocessing is possible.

Goods which are not interchangeable and which are manufactured for a specific purpose should be valued at specific costs.

Where there is a scope of analysing the difference between the Standard Cost and Actual Cost (that is, Variance An**alysis) direct costing or absorption Costing** may be applied.

(v) **Cost of Purchase** = Purchase Price + Duties and Taxes (unless recoverable from taxing authorities like CENVAT credit) + Other expenses directly related to the acquisition of goods (-) Trade Discounts, Rebates, etc.

(vi) Cost of Conversion includes any cost related to, production including any overhead cost.

(vii) For retail businesses, adjusted selling price (that is, selling price less gross margin of profit) may be applied.

(viii) Production Overheads should be included only to the extent which has brought the inventory to the present condition or location. It may be illustrated as—

(a) Production Overheads may be Fixed or Variable by nature.

(b) Fixed Overheads should normally be spread over units produced on the basis of normal capacity.

For example, if the normal capacity is 10,000 units, actual production is 6,000 units, units sold is 5,000 units and Fixed Overhead is Rs. 30,000—

Normal Recovery Rate should be Rs.30,000 / 10,000 or Rs. 3 per unit. In the case of actual production overhead recovered becomes 6,000   Rs. 3 or Rs. 18,000 (at normal rate). The under recovery of Rs. 30,000 — Rs. 18,000 or Rs. 12,000 is treated as an expense of the year. For valuation of Stock (in this case 6,000 — 5,000 = 1,000 units), Fixed Production Cost is 1,000   Rs. 3 = Rs. 3,000.

BUT if actual production is abnormally high say 20,000 units, the overhead rate applicable for stock valuation should be based on the actual production. It should be Rs. 30,000 / 20,000 or Rs. 1.50 per unit.

(c) Variable Overheads should be based on the actual units produced.

(iii) Inventory carried at net realisable value should be separately disclosed.

Methods of Inventory Valuation

As per AS-2, the following two methods of inventory valuation are recommended :

1. FIFO.

2. Weighted average cost.

Cost Formulae

Inventory should be valued at cost price or net realisable price whichever is lower.

If inventory valuation is **made at cost** any one of the following methods may be adopted

1. ***First in First out (abbreviated as FIFO) method*** **:** Under this method, the goods which are produced first or acquired first are sold first or used first for production. The sequence of issue of goods for sale or production follows the sequence or order in which they have been received. The goods which remain as unsold stock are valued at current cost price. According to **Littleton and Paton** "the cost factors move through the business in procession fashion" under FIFO method.

Advantages

(i) Stock represents goods purchased recently. So the valuation is made at current purchase price,

(ii) Accounting involves recording of transactions in a chronological manner. FIFO conforms to that order.

(iii) It is a simple method approved by Tax and other authorities.

(iv) As issues are priced in the same order in which materials have been acquired, the issues are made at actual cost.

(v) Where the nature of materials is slow moving or bulk items are not issued, this method is very useful.

Disadvantages

(i) Where the price level goes up steadily or it fluctuates, this method is not useful.

(ii) The prices of issues do not reflect the current market prices.

(iii) Matching of current costs with current revenues does not become possible.

2. Last in First out (abbreviated as LIFO) method **:** Here the materials received last are assumed to be issued first from the stores. So, the issue price becomes the price of that lot of materials which has entered last into the stores. The current cost of materials is charged against revenue. The unsold stock is valued at an old price which, generally becomes lower than the current cost price.

It is a method used for 'pricing of issues'. The physical issue of materials may not follow the principle that goods received last are to be issued first. Its emphasis is on the use of latest or current cost for computing cost of production. If it is followed, the replacement of used stock does not involve additional cost. So, it is also known as Replacement Cost Method.

Advantages:

(i) Cost of production is charged at current price. If the price level shows an increasing trend, higher amount is charged against revenue for cost of materials used.

(ii) Closing Stock is valued at an earlier or old price. So, the valuation will conform to minimum realisable price and shall not include any profit element.

(iii) During inflation, application of this method gives more pragmatic result.

(iv) Current cost is matched against revenue. So, the matching cost principle can be used more effectively.

Disadvantages:

(i) If the price level is decreasing or fluctuating, this method gives inaccurate result.

(ii) The closing stock can never reflect current market price.

(iii) In India AS 2 does not approve it. The Income Tax Authorities do not allow it. In USA the Generally Accepted Accounting Principles allow it for use in Tax Returns only.

3. Weighted Average Method For finding out the weighted average rate for stock valuation both quantity and price of different lots of materials existing in the stock are considered. The weighted average rate is found by adding the costs of all lots held at the time of issue and then dividing that total cost by the total quantity of the materials held. Once a rate is calculated it is applied until a new purchase is made. It does not consider whether the quantities purchased earlier have already been consumed.

Advantages:

(i) If prices fluctuate considerably and issue of materials has to be made in several lots, this method becomes very much useful.

(ii) Weighted average rate is mathematically sound as it considers both quantity and price.

(iii) During inflation, the value of stock becomes much more realistic.

(iv) One rate can be consistently applied till a new purchase is made.

Disadvantages :

(i) The prices at which goods are issued do not reflect their actual costs.

(ii) Closing stock cannot show the current market price.

(iii) Where purchases and receipts of materials are frequent, this method results into mathematical complications.

(iv) If arithmetical accuracy is ignored at the time of calculating the weighted average rate, unrealised profit or loss may creep into the value of materials.

4. **Base Stock Method :** Under this method,, according to Para 10 of AS 2, it is assumed that a minimum quantity of inventory (or base stock) must be held at all times to carry on business. Up to this quantity the inventory is valued at the cost at which it was acquired. Any excess over this base stock may be valued under FIFO or LIFO method.

As this method assumes that a minimum level of stock must be maintained at all times, it has a limited application. Where some basic raw materials are required and these are of the same type. This method is suitable. It is applied in processing industries where processing takes a considerable time.

Advantages:

(i) As already said this method is ideal for processing industries like refineries, taneries, etc.

(ii) Base stock is always valued at its cost of acquisition.

(iii) The additional stock over the basic requirement can be valued under any suitable method.

Disadvantages:

(i) Base stock is valued at historical cost. It is treated as a fixed asset, but there is no scope of depreciating it.

(ii) The disadvantages of FIFO or LIFO exist regarding the valuation of additional stock.

(iii) This method is somewhat rigid. It requires necessary changes to cope with changes of production capacity and policy matters regarding stock.

5. **Specific Identification Method** : As per Para 11 of AS 2 "The specific identification formula attributes specific costs to identified goods that have been bought or manufactured and are segregated for a specific purpose." Thus, under this method valuation is made at the original or actual cost price for the specific quantity of identified goods.This method has limited applications. The scale of operation should not be large and identification of goods must be possible. There should not be frequent receipts and issues of materials. The inventories should not be interchangeable and these have to be earmarked for specific purposes.

Its greatest advantage is that it renders a correct valuation of stock and at the same time ensures correct matching of costs with revenues.

It involves difficulties and clerical errors if The movement of goods is frequent and if there are considerable price fluctuations.

6. ***Standard Cost Method*** **:** Under this method a rate is predetermined and considered as the standard rate for valuing cost of sales and inventories. It uses some anticipated rates. According to AS—2, such rates should be realistic and should be reviewed regularly. There should be sufficient scope of analysing and reconciling the variances between actual costs and standard costs. It is usually found in job and process type of industries.

7. ***Adjusted Selling Price (also Called Retail Inventory) Method***: It is used in retail business or in business where the stock consists of items whose individual costs cannot be readily asertained. At first, the retail price of the goods is ascertained and from that the anticipated gross margin of profit on such goods is deducted. The calculation of the said gross margin may be made for individual items or groups of items or by the individual departments where departmental accounting is possible.

This method may also be used in manufacturing organisations which like to value inventory of finished products held against forward sale contracts.

8. ***Latest Purchase Price Method & Next In First Out (or NIFO) Method*** **:** Under this method stock is not valued at any historical cost already incurred. Rather valuation of inventory is made at a price which is the probable price of the goods to be received next to the issue of the inventory.

This method is found to exist very rarely. Its only advantage is that stock valuation is made at the up-to date replacement cost.

There are some more methods where stock valuation is made at cost. These are

(a) ***Highest in First Out or HIFO Method :*** Under this method it is assumed that the lot of materials whose price is the maximum is to be issued first. The date of actual price of such materials need not be considered. Thus cost of production is charged at the highest rate but inventory is valued at the lowest price.

During a period when the price level changes rapidly, this method becomes useful.

(b) ***Moving Average Method :*** This may also be Simple Moving Average or Weighted Moving Average. A moving period is ascertained from a study of past move ments of materials. Then the average is calculated on the basis of such period.

<u>If Inventory is Valued at Market Price (not recommended by AS 2)</u>

Issues of materials may be priced at the **current market price**. This may again be :

(a) ***Replacement Price or Purchase Price:*** It is the price existing at the time of issue. If materials are consumed in the process of production or sale, replacement has to be made by new purchase from the market. So the replacement cost is given importance for inventory valuation.

(b) ***Realisable Price or Sale Price Method*** **:** It is the price which can be realised if the materials issued to different jobs or work orders are sold out.

<u>If Inventory is Valued at a Notional Price</u>

Notional Price is not the cost or market price. It is a price ascertained on some notional basis. It may be—

(a) ***Standard Price Method***: The standard price is fixed on the basis of the specific nature of the product or service and the factors related to that. All issues during an accounting period are charged at the Standard Price. The stock is valued as the balancing amount of

   (i) costs of materials purchased or received at different rates and

   (ii) the value of quantities issued at standard price.

(b) ***Inflated Price Method*** : Issues are priced at an inflated rate. Such rate is calculated after considering—

   (i) addition of proportionate stock holding or carrying costs like costs of inspecting, issuing. etc.

   (ii) deduction of natural or normal losses of materials, like leakage, evaporation, etc.

   The cost of material issues is computed first by applying any method discussed earlier.

   The adjustments [(i) and (ii) as stated above] are made to find out the inflated price. The inventory is valued by deducting the issues priced at inflated rate from the total cost of materials purchased during a period.

It is to be noted that :

1. Inventories mean any tangible property held for sale, in the process of production for such safe or for consumption in the production of goods or services for sale. Maintenance supplies and consumables shall be included. But machinery spares should be excluded.

2. Valuation of Inventories is required at the end of each accounting period for (i) determining profit / loss during that period; and (ii) for representing these as assets in the Balance Sheet.

3. The contents of AS 2 mandatory w.e.f. 1.4.1999, should be complied with by all enterprises for Valuation of Inventories.

4. The method of valuation should be consistent but should not be rigid.

5. In India, inventories should normally be valued at historical cost or net realisable value whichever is lower.

6. Historical cost is the combination of : (a) Cost of Purchase; (b) Cost of Conversion and (c) any other cost incurred in the normal course of business for bringing the inventories up to their present location and condition.

7. Net Realisable value is the Actual or Estimated Selling Price less cost of completion of works and cost to be incurred to complete the sale.

8. Inventories are to be classified normally in the financial statements as :

   (i) Raw materials and components;

   (ii) Work-in-Process;

   (iii) Finished goods; and

   (iv) Stores and spares

9. Where an Inventory is carried at net realisable value, it should be disclosed in the financial statements separately.

10. By-products should be valued at cost or Net Realisable Value, whichever is lower. But if the cost of byproducts cannot be ascertained separately, their stock should be valued at Net Realisable Value.

11. If there is any scope of reprocessing, the inventory of re-usable scrap should be valued at cost (of material) less reprocessing cost. But if there is no such scope, the inventory of re-usable scrap should be valued at Net Realisable Value.

12. Inventory of non-reusable scrap should be valued at Net Realisable Value.

13. Perishable goods may be valued even below cost if conditions demand.

Methods of Ascertaining Net Realisable Value (NRV)

For ascertaining the net realisable value of different items of stock any one of the following methods may usually be followed :

1. ***Total Inventory Method*** : The aggregate of the total cost of all items is found out. It is compared with the total net realisable value of such items. The lower of the two is applied for inventory valuation.

2. ***Group Method*** : Items of same nature are grouped. The cost and NRV of each group are separately compared and the lower amount for each group is applied for stock valuation.

3. ***Individual Identification Method*** : For each item of stock, corresponding cost and net realisable value are compared and the lower of the two is considered for valuation of the individual stock.

Valuation of Stock as on the Balance Sheet Date

1. Stocktaking should be made on the date of the close of a financial period. It should include every item of goods of which the business is the owner. If there are any goods-in-transit or goods with the selling agent or goods sent on approval for which the sale is yet to be confirmed such goods should be included in stock. On the other hand, goods sold but not yet delivered should be excluded.

   Goods purchased within the accounting period and recorded in the accounts should be included in stock. Thus physical stock in the godown of the business may not be the actual value of stock to be included in the final accounts.

2. If stock taking is made on a date a few days before or after the date of the close of the financial period, Purchases, Purchase Returns, Sales and Sales Return between these two dates should be adjusted (to arrive at the value of the stock on the closing date of the accounting period).

The sales and Sales Return should be taken at cost price or market price whichever is lower.

Notes

1. Where any sale has been made at a loss or at a profit not conforming to the normal rate of profit, the cost price of the goods thus sold should be separately ascertained.

2. For valuation of inventory the principle of Cost Price or Net Realisable Price whichever is lower should be applied.

3. Adjustments for undercasting / overcasting of stock, goods held for consignment basis, etc., should also be made.

Illustration 1 :

Mr. X is a retailer. During the accounting year ending on 31.03.2008 he purchased 500 units @ Rs. 350 each and sold 450 units @ Rs.250 each, through his agent who charged a commission of 10% on sales. X also paid Rs. 8,000 as expenses. But towards the end of this year the market price fell down to Rs. 250 per unit. How the unsold stock should be valued?

Solution

Here Cost Price = Rs. 350 per unit; Unsold Stock = 500 — 450 = 50 units; Market Price = Rs. 250 Per unit

Particulars	**Rs.**
Value of unsold stock [50 Rs. 250]	12,500
(at Market Price, which is lower than the Cost Price)	
Less : Probable marketing expenses (Commission @ 10% of Rs. 12,500]	1,250
Net Realisable Value	11,250

Illustration 2 :

From the following particulars, ascertain the value of inventory on 31.03.2008, the closing date of the financial year of a trader

Normal Capacity of Production (Annual)	20,000 units
Fixed Production Overhead charges on normal capacity	Rs. 40,000
Direct Material Cost	Rs. 80 per unit
Direct Labour Cost	Rs. 40 per unit
Variable Production Overhead	Rs. 8 per unit
Actual Production	18,000 units
Units sold	15,000 units
Selling Price	Rs. 220 per unit

Solution

Particulars	**Rs.**
Direct Material	80
Direct Labour	40
Fixed Overhead [According to AS — 2 fixed production overhead should be absorbed to production over normal capacity. So it is Rs. 40, 000 for 20,000 unts	2
Variable Production Overhead	8
	130

Market Price per unit is Rs. 220. Units of unsold stock = 18,000 — 15,000 = 3,000 units. Value of Inventory = 3,000 Rs. 130 = **Rs. 39,000**

Illustration 3 :

Kay Pee Ltd., a manufacturer and seller of car parts, received an order for manufacturing and delivering some car head lights for passenger cars to be launched by Bharatiya Ltd. during the year ended 3 1.3.2008. It received a non-refundable advance of Rs. 40,000 against such order. But before the year end, Bharatiya Ltd. refused to take the delivery of the head lights as it discovered some technical defects in its own manufacturing plan.

So, on 31.3.2008, Kay Pee Ltd. which had partly finished the products, had these in its stock. It asked for your help regarding their valuation and submitted the following particulars :

		Option 1	Option 2
1.	Realisable Value	[Sale at its present condition]	[Sale as finished products after making slight change of design]
	(a) Reilisable Price expected	Rs. 30,000	Rs. 90,000
	(b) Selling Commission payable	10%	10%
	(c) Further processing cost for finishing the products	—	RS. 24,000
	(d) Additional cost for making a change of design	—	Rs. 6,000
	(e) Additional Labour hours required to complete production		80
2.	**Costs incurred so far**		
	Cost of Design [original]		Rs. 14,000
	Cost of Materials		Rs.38,000
	Labour Hour Rate		Rs. 40
	Labour Hours used for the above products		120
	Fixed Overhead—.		
	Actual		Rs. 6,80,000
	Budgeted		Rs. 6,00,000
3.	Other information related to the factory :		
	No. of Workers in the factory		20
	No. of Working Hours per day		8
	Normal Working Days during a year		300
	Days lost for repairing breakdown of Machinery		50
	Duty drawback on raw materials used		Rs. 500

Please give your suggestion.

Solution

The inventory is to be valued at cost or at Net Realisable Value whichever becomes lower.

Now, the realisable values will be different if the products are sold (a) at **as is where is** condition, that is, in their partly finished stage and (b) as finished products.

So, the costs and the net realisable values for both these forms should be ascertained as follows

1. **Ascertainment of Costs**	**Option 1 (Rs.)**	**Option 2 (Rs.)**
	[Partly finished goods]	[FinishedProducts]
Cost of Materials	38,000	38,000
Cost of Design	14,000	20,000
Conversion Costs [120 Rs. 57]	6,840	11,400
200 Rs. 57	58,840	69,400

2. **Ascertainment of Net Realisable Value**	**Option 1 (Rs.)**	**Option2 (Rs.)**
Expected Selling Price	30000	90,000
Less : Selling Commission @ 10%	3,000	9,000
	27,000	81,000
Less : Additional Cost for Completion		
[6,000 + 24,000]	—	30,000
	27,000	51,000

The realisable values being lower than costs in each case, stock should be valued at Rs. 27,000 or at Rs. 51,000. But the second option will cause an inflow of cash to the extent of Rs. 51,000. So this amount should better be taken as the value of stock. The company should go for the second option.

Note

Calculation of Conversion Costs

Actual Working Hours (annual) = No. of Workers *x* Daily Working Hours [Normal Working Days — Day Lost for repairs] = 20 8 [300 – 50] = **40,000**

Fixed Overhead per Hour (Actual) = Rs. 6,80,000 / 40000 hrs. = Rs. 17

Conversion Cost per hour = Labour Cost + Fixed Overhead = Rs. 40 + Rs. 17 = Rs. 57

Illustration 4 :

X who was closing his books on 31.3.2008 failed to take the actual stock which he did only on 9th April, 2008 when it was ascertained by him to be worth Rs. 25,000.

It was found that sales are entered in the sales book on the same day of despatch and return inwards in the returns book as and when the goods are received back. Purchases are entered in the Purchase Day Book once the invoices are received.

It was found that sales between 31.3.2008 and 9.4.2008 as per the sales day book are Rs. 1,720. Purchases between 31.3.2008 and 9.4.2008 as per Purchase Day Book are Rs. 120, out of these goods amounting to Rs. 50 were not received until after the stock was taken.

Goods invoiced during the month of March, 2008 but goods received only on 4th April, 2008 amounted to Rs. 100. Rate of Gross Profit is 33 1/3% on cost.

Ascertain the value of stock as on 31.03.2008.

Solution

Mr. X
Statement showing Value of Stock on 31.03.2008

Particulars	**Amount**	**Amount**
	Rs	**Rs.**
Stock as on 9.4.2008		25,000
Add: Cost of Goods Sold between 31.03.2008 and 09.04.2008 :		
Sales	1720	
Less : Gross profit @1/4 th on selling price (i.e. 33 1/3% on cost)	430	1,290
		26,290
Less : (a) Purchases made and goods actually received between 31.03.2008 and 09.04.2008		
Purchases between these dates 120		
Less : Goods not received till 09.04.2008 50	70	
(b) Purchases related to March, 2008 but received on 04.04.2008	100	170
***Stock on 31.03.*2008**		26,120

Illustration 5 :

The financial year of Mr. Chalaman ends on 31st March, 2008 but the stock in hand was physically verified only on 8th April, 2008. You are required to determine the value of Closing Stock (at cost) as at 31st March, 2008 from the following information.

(i) The stock (valued at cost) as verified on 8th April, 2008 was Rs. 15,000.

(ii) Sales have been entered in the Sales Day Book only after the despatch of goods and sales returns only on receipt of goods.

(iii) Purchases have been entered in the Purchase Day Book on receipt of the purchase invoice irrespective of the date of receipt of the goods.

(iv) Sales as per the sales day book for the period 1st April, 2008 to 8th April, 2008 (before the actual verification) amounted to Rs. 6,000 of which goods of a sale value of Rs. 1,000 had not been delivered at the time of verification.

(v) Purchases as per the purchase day book for the period 1st April, 2008 to 8th April, 2008 (before the actual verification) amounted to Rs. 6,000 of which goods for purchases of Rs. 1,500 had not been received at the date of verification and goods for purchases of Rs. 2,000 had been received prior to 31st March, 2008.

(vi) In respect of goods costing Rs. 5.000 received prior to 31st March, 2008, invoices had not been received up to the date of verification of stocks.

(vii) The gross profit is 20% on sales.

Solution

Mr. Chalaman
Statement showing Value of Stock on 31.3.2008

	Particulars	Amount Rs.	Amount Rs.
	Stock as on 8.4.08		15,000
Add :			
(a)	Cost of Goods Sold and sent Out between 1.4.08 and 8.4.08		
	Sales in this period .	6,000	
	Less: Goods sold but not delivered (at Selling Price)	1,000	
		5,000	
	Less : Gross Profit included [20% of 5,000]	1,000	4,000
			19,000
Less :			
(a)	Goods purchased and received between 1.4.08 and 8.4.08 :		
	Purchases in this period	6,000	
	Less : Goods not received till 8.4.08	1,500	4,500
(b)	Goods received before 31 .3.08 for which the invoice is yet to be received		5,000
Stock on 31.3.2008			9,500

EXERCISE

Problem 1.

A firm closed its books annually on 31st March, 2008 but could carry out its physical stock taking on 10th April following. The storekeeper disclosed the value of stock on 10.04.08 as Rs. 45,000. You are to value its stock on 31.03.08 from the following

a. Purchases between 01.04.08 and 10.04.08 as per the Invoice Book amounted to Rs. 9,500. You find that an office furniture purchased for Rs. 700 was recorded through the invoice book.Purchase book was carried forward Rs. 30 less on a certain page and a purchase of Rs. 1,400 duly recorded in the books was still in transit.

b. Goods of Rs. 2,000 received on consignment were lying in stores and counted within the physical stock taking.

c. Sales between 01.04.08 and 10.04.08 which amounted to Rs. 10,400 included (a) goods sent on consignment at an invoice price of Rs. 1,000 which included a profit of 25% on cost price,

d. Goods invoiced to branch at Rs. 420 which included a profit of 16% of sale, (c) Goods sold for Rs. 800 at a loss of 20% of cost.

The firm normally sells goods at a profit of 25% on sales. Prepare a statement showing the actual value of stock on 31.03.2008.

Problem 2**.**

Jyoti Prakash Ltd. makes up its accounts up to 31st December every year. It was able to take stock by physical inventory only on 10th January, 2008, on which date the stock at cost was valued at Rs. 2,05,000.

You asscertain the following regarding the period intervening between January 1 to January 10, 2008.

(a) Purchases totalled Rs. 58,000 and included (i) Rs. 13,000 in respect of goods received in December, 2007, (ii) Rs. 6,000 in respect of goods received on 15th January, 2008 and (iii) Rs. 2,000 in respect of goods received but returned to suppliers on January 9, 2008 for which no credit note has been received or passed through the books.

(b) Sales totalled Rs. 70,000 and included (i) Rs. 3,550 in respect of goods which left the warehouse on 29th December, 2007, (ii) Rs. 3,000 in respect of goods which were not despatched until 13th January 2008 and (iii) Rs. 2,000 in respect of goods invoiced and 05.01.2008 but returned by customers on January 8, 2008 for which no credit note had been passed but which were, in fact, included in stock taken on 10th January, 2008.

(c) Other returns to suppliers totalled Rs. 2,700 and other returns by customers were Rs. 450.

(d) The rate of gross profit was 20% on selling price with the exception of an isolated purchase on 5th December, 2007 of 10 identical articles which had cost Rs. 11,000. 5 Articles out of these were sold on January 5, 2008 at a profit of Rs. 1,000. The remainder had been included at Cost in Stock taken on 10.01.2008. Show the estimated value of stock on 31st December, 2007.

1.4. DISTINCTION BETWEEN CAPITAL AND REVENUE

Introduction

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

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

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

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

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

1. When the owner brings in more capital to the business; and / or

2. When the owner does not consume the entire periodic income.

When the owner brings in further capital to his business, the amount is credited to the Capital Account.

Likewise, the net income for a period is credited to the Capital Account, and if his drawings are less than that income, the capital is increased by the difference.

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

Capital and Revenue Expenditures

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

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

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

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

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

The following are the points of distinction between capital expenditure and revenue expenditure:

Sl. No.	Capital Expenditure	S1. No.	Revenue Expenditure
1.	Capital expenditures are incurred for more than one accounting period.	1.	Revenue expenditures are incurred for a particular accounting period.
2.	Capital expenditure are of non-recurring nature.	2.	Revenue expenditures are of recurring nature.
3.	All capital expenditures eventually become revenue expenditures.	3.	Revenue expenditures are not generally capital expenditures.
4.	Capital expenditures are not matched with capital receipts.	4.	All revenue expenditures are matched with revenue receipts.
5.	Capital expenditures are incurred before or after the commencement of the business.	5.	Revenue expenditures are incurred always after the commencement of the business.

Rules *for* Determining Capital Expenditure

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

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

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

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

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

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

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

Some examples of capital expenditure:

(1) Purchase of land, building, machinery or furniture; (2) Cost of leasehold land and building; (3) Cost of purchased goodwill; (4) Preliminary expenditures; (5) Cost of additions or extensions to existing assets; (6) Cost of overhauling second-hand machines; (7) Expenditure on putting an asset into working condition; and (8) Cost incurred for increasing the earning capacity of a business.

Rules for Determining Revenue Expenditure

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

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

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

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

Some examples of revenue expenditure

(1) Salaries and wages paid to the employees; (2) Rent and rates for the factory or office premises; (3) Depreciation on plant and machinery; (4) Consumable stores; (5) Inventory of raw materials, work-in-progress and finished goods; (6) Insurance premium; (7) Taxes and legal expenses; and (8) Miscellaneous expenses.

Replacement of Fixed Assets

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

Deferred Revenue Expenditures

Deferred revenue expenditures represent certain types of assets whose usefulness does not expire in the year of their occurrence but generally expires in the near future. These types of expenditures are carried forward and are written off in future accounting periods. Sometimes, we make some revenue expenditure but it eventually becomes a capital asset (generally of an intangible nature). If *one* undertake substantial repairs to the existing building, the deterioration of the premises may be avoided. We may employ our own employees to do that work and pay them at prevailing wage-rate, which is of a revenue nature. If this expenditure is treated as a revenue expenditure and the current year's-profit is charged with these expenses, we should be making the current year absorb the entire expenses, the benefit of which will be enjoyed for a number of accounting years. To overcome this difficulty, the entire expenditure is capitalised and is added to the asset account. Another example is an insurance policy. A business can pay insurance premium in advance, say, for a 3 year period. The right does not expire in the accounting period in which it is paid but will expire within a fairly short period of time (3 years). Only a portion of the total premium paid should be treated as a revenue expenditure (portion pertaining to the current period) and the balance should be carried forward as an asset to be written off in subsequent years.

Capital and Revenue Receipts

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

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

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

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

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

Sl. No.	Capital Receipts	S1. No.	Revenue Receipts
1.	Capital receipts are not available for distribution as profits.	1.	Revenue receipts are available for distri bution as profits only after deducting revenue expenses.
2.	Capital receipts cannot be utilised for creating a reserve fund.	2.	Revenue receipts can be utilised for creating a reserve fund after deducting revenue expenses.
3.	A business can survive without any capital receipts during an accounting period.	3.	The survival of a business mainly de pends on the revenue receipts during an accounting period.
4.	Capital receipts are the sources for creating capital reserves.	4.	Revenue receipts are the sources for creating revenue reserves.

Capital and Revenue Profits

While ascertaining the trading profit of a business for a particular period, a proper distinction is to be made between capital and revenue profits. If profit arises out of an ordinary nature, being the outcome of the ordinary function and object of the business, it is termed as 'revenue profit'. But, when a profit arises out of a casual and non-recurring transaction, it is termed as capital profit. Revenue profit arises out of the sale of the merchandise that the business deals in.

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

Capital and Revenue Losses

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

***Illustration* 1**

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

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

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

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

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

Solution

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

(ii) Advertising expenses for launching a new product of the company should be treated as a *Deferred Revenue Expenditure.*

(iii) Rs 250 paid for servicing and oil change should be treated as a *Revenue Expenditure.*

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

***Illustration* 2**

State whether the following are capital or revenue expenditure.

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

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

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

Solution

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

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

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

***Illustration* 3**

Classify the following items as capital or revenue expenditure:

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

(ii) Wages paid to machine operators;

(iii) Installation costs of new production machine;

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

(v) Rent paid for the factory;

(vi) Payment for computer time to operate a new stores control system, (vii) Wages paid to own employees for building the foremen's offices. Give reasons for your classification.

Solution

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

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

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

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

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

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

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

***Illustration* 4**

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

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

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

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

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

Solution

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

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

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

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

***Illustration* 5**

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

(1) Freight and cartage on the new machine Rs 150, and erection charges Rs 500.

(2) Fixtures of the book value of Rs 2,500 sold off at Rs 1,600 and new fixtures of the value of Rs 4,000 were acquired cartage on purchase Rs 5.

(3) A sum of Rs 400 was spent on painting the factory.

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

Solution

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

(2) Loss on sale of fixtures Rs (2,500 -1,600) = Rs 900 should be treated as a *Capital Loss.* The cost of new fixtures and carriage thereon should be treated as a *Capital Expenditure* because the fixture will be used for a long period.

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

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

***Illustration* 6**

State the nature (capital or revenue) of the following expenditure which were incurred by Vedanta & Co. during the year ending 30th June, 2009:

(i) Rs 350 was spent on repairing a second hand machine which was purchased on 8th July, 2008 and Rs 200 was paid on carriage and freight in connection with its acquisition.

(ii) A sum of Rs 500 was paid as compensation to two employees who were retrenched.

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

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

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

Solution

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

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

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

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

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

Illustration 7 State with reasons whether the following items relating to Parvati Sugar Mill Ltd. are capital or revenue:

1. Rs 50,000 received from issue of shares including Rs 10,000 by way of premium.
2. Purchased agricultural land for the mill for Rs 60,000. Rs 500 also paid for land revenue.
3. Rs 5,000 paid as contribution to PWD for improving roads of sugar producing area.
4. Rs 40,000 paid for excise duty on sugar manufactured.
5. Rs 70,000 spent for constructing railway siding.

Solution

(1) Rs 40,000 (Rs 50,000 - Rs 10,000) received from issue of shares will be treated as a *Capital Receipt*. The premium of Rs 10,000 should be treated as a *Capital Profit*.

(2) Cost of land Rs 60,000 to be treated as *Capital Expenditure* and land revenue of Rs 500 to be treated as *Revenue Expenditure.*

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

(4) Excise duty of Rs 40,000 should be treated as a *Revenue Expenditure.*

(5) Rs 70,000 spent for constructing railway siding to be treated as a *Capital Expenditure.*

***Illustration* 8**

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

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

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

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

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

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

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

Solution

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

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

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

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

(v) Rs 10,000 incurred on advertising is to be treated as a *Deferred Revenue Expenditure* because the benefit of advertisement is available for 4 years, Rs 2,500 is to be written off every year.

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

***Illustration* 9**

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

(i) The redecoration expenses Rs 6,000.

(ii) The installation of a new wine bar for Rs 10,000.

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

(iv) The purchase of wines and spirits Rs 2,000.

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

Solution

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

(ii) The installation of a new wine bar is a *Capital Expenditure* because it is the acquisition of an asset.

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

(iv) The purchase of wines and spirits of Rs 2,000 is a *Revenue Expenditure.*

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

EXERCISE

1. Explain the basic principles which would guide you in allocating expenditure as between capital & revenue.
2. Define capital expenditure, revenue expenditure and deferred revenue expenditure.

PROBLEMS

1. State which of the following expenditures are capital expenditure and which are revenue expenditure. Give reasons in each case.

(a) Payment of carriage on goods purchased paid by cheque.

(b) Purchase of packing materials for distribution of goods from Andhra Pradesh Paper Mills Ltd.

(c) Purchase of xerox machine for use in own office from Business Equipment Suppliers Ltd.

2. Explain whether the following items of expenditure and income are of a capital or revenue nature.

(a) Amount realised from sale of a discarded Machine.

(b) Repairs done to second hand furniture purchased.

(c) Cost of concrete water drains constructed on the land.

(d) Amount received as rent during the year for a part of the building sublet.

(e) Canal irrigation charges paid to the government.

(t) Directors' fees.

3. Classify the following between Capital and Revenue giving reasons for the same:

(a) Rs 10,000 spent towards additions to the machinery.

(b) Repairs for Rs 2,000 necessitated by negligence.

(c) Rs 1,500 spent to remove a worn-out part and replace it with a new one.

(d) Rs 400 wages paid in connection with the erection of a new machinery.

(e) Old machinery of book value of Rs 10,000 wornout, dismantled at a cost of Rs 2,000 and scraps realised for Rs 500.

(f) Second hand motor-car purchased for Rs 20,000 and spent Rs 2,000 for repairs immediately.

(g) Employees' State Insurance premium Rs 800 paid.

(h) Insurance claim of Rs 5,000 received from the Insurance Company for loss of goods by fire of Rs 6,000.

4. State which of the following items whould be charged to capital and which to revenue:

(i) A second-hand truck was purchased for Rs 50,000 and Rs 12,000 was spent on overhauling and painting it.

(ii) Rs 10,000 was spent for whitewashing the factory building.

(iii) An old machine which stood in the books at Rs 50,000 was sold for Rs 30,000.

(iv) Wages paid to workmen for installation of a new machinery Rs 10,000.

(v) Legal expenses Rs 5,000 incurred for purchasing a land.

5. The Pritam Industries removed their works to more suitable premises:

(a) A sum of Rs 4,750 was expended on dismantling, removing and reinstalling plant, machinery and fixtures.

(b) The removal of stock from the old works to the new one costs Rs 500.

(c) Plant and machinery which stood in the books at Rs 75,000 included a machine at a book value of Rs 1,700. This being obsolete was sold off at Rs 450 and was replaced by a new machine which cost Rs 2,400.

(d) The freight and cartage on the new machine amounted to Rs 15000 and the erection charge cost Rs 275.

(e) The fixtures and furniture appeared in the books at Rs 7,500. Of these, some portion of the book value of Rs 1,500 was discarded and sold off at Rs 600 and new furniture of the value of Rs 1,200 was acquired.

(f) A sum of Rs 1,100 was spent on painting the new factory.

State which items of expenditure would be charged to Capital and which to Revenue.

STUDY NOTE - 2

ROYALTY AND HIRE PURCHASE

This study note includes

- Royalty Accounting
- Hire Purchase and Installment Purchase Systems

2.1. ROYALTY ACCOUNTING

Introduction

The owner of an asset (e.g. mines, quarries, patent, copyright, etc), as a business arrangement, may allow other party (lessee, licencee, publisher, etc) the right to use that asset against some consideration. Such consideration is calculated with reference to the quantity produced or sold. This payment to the owner by the user of the asset is termed as **Royalty**.

We can therefore say that the royalty is the amount of consideration paid by a party to the owner of the asset in return for the right to use that asset.

For example, when a publisher publishes a book, he makes a payment to the author which is based on the number of copies sold known as royalty.

The following are some of cases where one party paid to another in the form of Royalty:

1. where the owner of a mine allows another the right to extract minerals from land;
2. where right such as patents or copyrights are licensed in favour of another;
3. where an author, artist or designer gives exclusive rights to another to copy the work.

Common terms Used in Connection with Accounting for Royalty:

1. Minimum Rent / Dead Rent

A contract is entered into between the landlord and the lessee for payment of royalty, usually calculated upon the quantum of production or sale at a certain stipulated rate.

So, if there is little or no production or sale, the landlord would receive little or no royalty at all, thus affects the monetary interest of the landlord as well as the lessee. It is normally not acceptable to the owner, since sale or production mostly depends on the capacity of the person to whom the rights have been given. To avoid such a situation, the landlord and the lessee agreed upon a minimum periodical amount that the landlord will receive from the lessee, even if the actual royalty as calculated on the basis of actual production or sale is less than such minimum amount.

This assured and mutually agreed periodical minimum amount is known as "**Minimum Rent".**

Example: Suppose royalty per ton of production is Rs 10 and the minimum (annual) rent is Rs 4,00,000. Now, the actual production is 35,000 tons, then actual royalty would become Rs 3,50,000. In this case the minimum rent of Rs 4,00,000 will have to be paid by the lessee. On the other hand, if the actual production is 46,000 tons, then the actual royalty would become Rs 4,60,000. In this case Rs 4,60,000 will have to be paid by the lessee.

Thus, as there is a stipulation for minimum rent, then either the minimum rent or the actual royalty whichever is more shall have to be paid by the lessee.

The minimum rent is also called dead rent, certain rent, fixed rent, etc.

2. Short workings / Redeemable Dead Rent

Short workings is the amount by which the minimum rent exceeds the actual royalty. It is the difference between Actual Rent and Minimum Rent.

In the above example, the short workings is Rs 50,000 (Rs 4,00,000 - Rs 3,50,000). Where there is short workings in any period the lessee is liable to pay the minimum rent and, in effect, short workings becomes the part of the minimum rent and not represented by the use of rights.

The question of short workings will arise only when there is a stipulation for minimum rent in the agreement.

3. Excess working

It refers to the amount by which the actual royalty exceeds the minimum rent. In the above example, the excess workings is Rs 60,000 (Rs 4,60,000 -Rs 4,00,000) if the production is 46,000 tons.

4.Ground Rent / Surface Rent

It refers to the fixed yearly or half-yearly rent payable by the lessee to the landlord in addition to the minimum rent.

5.Recoupment of Short workings

Generally the royalty agreement contains a provision for carrying forward of short workings with a view to adjust it in the future. In the subsequent years, such shortworking is adjusted against the surplus royalty. This process of adjustment is called recoupment of short workings. The right of recoupment of short workings enables the lessee to recover the excess payment, made in the earlier years to meet the condition of payment of minimum rent. A time is usually agreed upon the number of years for which such short workings can be recouped. This time limit for recoupment of short workings may be fixed or fluctuating. If the short workings cannot be recouped within the specified time, they lapse and are charged to Profit and Loss Account in the year when that specified time limit for recoupment ends.

i) Fixed right:

When the lessee can recoup shortworkings within a certain period from the date of the lease it is known as fixed right. For example, short workings can be recouped within three years from the date of the lease. So, after three years from the date of the lease the short workings cannot be recouped.

ii) Fluctuating right :

In this type of agreement, lessee can recoup short workings of any year during the next following year(s). For example, shor tworkings can be recouped in the year subsequent to the year of short workings.

6. Strike and Lockout, etc :

If agreement so provides, the minimum rent may be proportionately reduced in the event of strike and / or lockout. So special entry is required for the same except the adjustment of minimum rent for that particular year.

Accounting Entries in the Books of the Lessee/Licencee/Publisher etc.

1. Where a minimum rent exists with right to recoup short workings

(a) *Where the actual royalty is less than the minimum rent*

(i)	Royalties (payable) Account	Dr.	[Actual royalties for the period]
	Short workings Account	Dr.	[Minimum rent - Actual royalties]
	To Landlord Account		[Minimum rent]
(ii)	Landlord Account	Dr.	[Minimum rent]
	To Bank Account		[Net amount paid]
	To Income Tax Payable Account		[Tax deducted at source]
(iii)	Manufacturing / Profit & Loss Account	Dr.	[Transfer]
	To Royalties (payable) Account		[Actual royalties for the period]

If the user is a manufacturer and royalties are calculated on the basis of production, the actual royalties are debited to Manufacturing Account. Where royalties are calculated on the basis of sales, they are debited to Profit and Loss Account.

In case of a limited company, which does not prepare Manufacturing Account separately, the actual royalties are debited to Profit and Loss Account and they are shown in production or manufacturing section of the Profit and Loss Account.

Treatment of Short workings

As per agreed terms, short workings can be recouped in the year when the actual royalty is more than the Minimum rent. Any short workings, which cannot be recouped within the specified period becomes irrecoverable and it should be charged to Profit and Loss Account in the year in which the period ends.

However, the recoupable short workings should be carried forward and they are shown in the Balance Sheet as a Current Asset.

The relationship between Minimum rent, Actual Royalty and Royalty payable are in below:

Minimum rent = Actual Royalty + Short workings.

(b) Where the actual royalty is more than the minimum rent:

(i) Royalties (payable) Account Dr.
To Landlord Account
[Actual royalties for the period]

(ii) Landlord Account Dr
To Short workings Account
(Short workings, if any, recouped)

(iii) Landlord Account Dr
To Bank Account
To Income Tax Payable Account

(iv) Profit & Loss Account Dr
To Short workings Account
(Short workings, which can not be recouped)

(v) Manufacturing / Profit & Loss Account Dr
To Royalties (payable) Account

Important Points to note:

1. When the royalty agreement does not contain a clause for minimum rent, the question of short workings and its recoupment does not arise.
2. The landlord is always entitled to get either the minimum rent or the actual royalty whichever is higher subject to any adjustment for short workings recouped.

Illustration 1

The Bihar Coal Co. Ltd. holds a lease of coal mines for a period of twelve years, commencing from 1st April 2002. According to the lease, the company is to pay Rs 7.50 as royalty per ton with a minimum rent of Rs 150,000 per year. Short workings can, however, be recovered out of the royalty in excess of the minimum rent of the next two years only. For the year of a strike the minimum rent is to be reduced to 60%. The output in tons for the 6 years ending 31st March,2008 is as under:

2002-03 : 10,000; 2003-04 : 12,000; 2004-05:25,000; 2005-06: 20,000; 2006-07: 50,000; and 2007-08: 15,000 (strike). Write up the necessary Ledger Accounts in the books of Bihar Coal Co. Ltd.

Solution :

Statement showing Royalty Payable

Fig in (Rs)

Year	Output (Tons)	Actual Royalties	Min. Rent	Excess Short Workings	Shortworkings Occurred	Shortworkings Recouped	Shortworkings Written off	Shortworkings C/F	Amount Payable
2002-03	10,000	75,000	150,000	0	75,000	0	0	75,000	150,000
2003-04	12,000	90,000	150,000	0	60,000	0	0	135,000	150,000
2004-05	25,000	187,500	150,000	37,500	0	37,500	37,500	60,000	150,000
2005-06	20,000	150,000	150,000	0	0	0	60,000	0	150,000
2006-07	50,000	375,000	150,000	225,000	0	0	0	0	375,000
2007-08	15,000	112,500	90,000	22,500	0	0	0	0	112,500

Dr Royalties Account Cr

Date	Particulars	Amt (Rs)	Date	Particulars	Amt(Rs)
31.03.03	To Landlord A/c	75,000	31.03.03	By Profit & Loss A/c	75,000
31.03.04	To Landlord A/c	90,000	31.03.04	By Profit & Loss A/c	90,000
31.03.05	To Landlord A/c	187,500	31.03.05	By Profit & Loss A/c	187,500
31.03.06	To Landlord A/c	150,000	31.03.06	By Profit & Loss A/c	150,000
31.03.07	To Landlord A/c	375,000	31.03.07	By Profit & Loss A/c	375,000
31.03.08	To Landlord A/c	112,500	31.03.08	By Profit & Loss A/c	112,500

Dr Landlord Account Cr

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.03	To Bank A/c	150,000	31.03.03	By Royalties A/c	75,000
				By Short workings A/c	75,000
		150,000			150,000
31.03.04	To Bank A/c	150,000	31.03.04	By Royalties A/c	90,000
				By Short workings A/c	60,000
		150,000			150,000
31.03.05	To Bank A/c	150,000	31.03.05	By Royalties A/c	187,500
	To Short workings A/c	37,500			
		187,500			187,500
31.03.06	To Bank A/c	150,000	31.03.06	By Royalties A/c	150,000
		150,000			150,000
31.03.07	To Bank A/c	375,000	31.03.07	By Royalties A/c	375,000
		375,000			375,000
31.03.08	To Bank A/c	112,500	31.03.08	By Royalties A/c	112,500
		112,500			112,500

Dr. Short workings Account Cr.

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.03	To Landlord A/c	75,000	31.03.03	By Balance c/d	75,000
		75,000			75,000
1.4.03	To Balance b/d	75,000	31.03.04	By Balance c/d	135,000
31.03.04	To Landlord A/c	60,000			
		135,000			135,000
1.4.04	To Balance b/d	135,000	31.03.05	By Landlord A/c	37,500
				By Profit & Loss A/c	37,500
				By Balance c/d	60,000
		135,000			135,000
1.4.05	To Balance b/d	60,000	31.03.06	By Profit & Loss A/c	60,000
		60,000			60,000

Illustration 2 :

SKG Oil. Ltd. holds a lease of Oil field for a period of twenty years, commencing from 1st April 2002. According to the lease, the company is to pay Rs 20.00 as royalty per ton with a minimum rent of Rs 250,000 per year. Short workings can, however, be recovered out of the royalty in excess of the minimum rent of the 1st four years from the date of operation. The output in tons for the 6 years ending 31st March,2008 is as under:

2002-03: Nil; 2003-04: 12,000; 2004-05: 15,000; 2005-06: 20,000; 2006-07: 22,000; and 2007-08 : 11,000.

Write up the necessary Ledger Accounts in the books of SKG Oil Ltd.

Solution

Statement showing Royalty Payable

Fig in Rs

Year ended 31.03	Output (Tons)	Actual Royalty	Min. Rent	Excess Short Workings	Shortworkings Occurred	Recouped	Written off	C/F
2003	0	0	250,000	0	250,000	0	0	250,000
2004	12,000	240,000	250,000	0	10,000		0	260,000
2005	15,000	300,000	250,000	50,000	0	50,000		210,000
2006	20,000	400,000	250,000	150,000	0	150,000	60,000	0
2007	22,000	440,000	250,000	190,000	0	0	0	0
2008	11,000	220,000	250,000	0	30,000	0	30,000	0

Dr. Short workings Account Cr.

Date	Particulars	Ant (Rs)	Date	Particulars	Amt (Rs)
31.03.03	To Landlord A/c	2,50,000	31.03.03	By Balance c/d	2,50,000
		2,50,000			2,50,000
1.4.03	To Balance b/d	250,000	1.4.03	By Balance c/d	260,000
31.03.04	To Landlord A/c	10,000	31.03.04		
		260,000			260,000
1.4.04	To Balance b/d	260,000	1.4.04	By Landlord A/c	50,000
				By Balance c/d	210,000
		260,000			260,000
1.4.05	To Balance b/d	210,000	1.4.05	By Landlord A/c	150,000
				By Profit & Loss A/c	60,000
		210,000			210,000
31.03.08	To Landlord A/c	30,000	31.03.08	By Profit & Loss A/c	30,000
		30,000			30,000

Dr. RoyaltyPayable Account Cr.

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.03	To Landlord A/c	0	31.03.03	By Profit & Loss A/c	0
31.03.04	To Landlord A/c	240,000	31.03.04	By Profit & Loss A/c	240,000
31.03.05	To Landlord A/c	300,000	31.03.05	By Profit & Loss A/c	300,000
31.03.06	To Landlord A/c	400,000	31.03.06	By Profit & Loss A/c	400,000
31.03.07	To Landlord A/c	440,000	31.03.07	By Profit & Loss A/c	440,000
31.03.08	To Landlord A/c	220,000	31.03.08	By Profit & Loss A/c	220,000

Landlord Account

Dr Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs) Cr
31.03.03	To Bank A/c	250,000	31.03.03	By Royalties A/c	0
				By Short workings A/c	250,000
		250,000			250,000
31.03.04	To Bank A/c	250,000	31.03.04	By Royalties A/c	240,000
				By Short workings A/c	10,000
		250,000			250,000
31.03.05	To Bank A/c	250,000	31.03.05	By Royalties A/c	300,000
	To Short workings A/c	50,000			
		300,000			300,000
31.03.06	To Bank A/c	400,000	31.03.06	By Royalties A/c	400,000
		400,000			400,000
31.03.07	To Bank A/c	440,000	31.03.07	By Royalties A/c	440,000
		440,000			440,000
31.03.08	To Bank A/c	250,000	31.03.08	By Royalties A/c	220,000
				By Short workings A/c	30,000
		250,000			250,000

Note: Short workings beyond fourth year can not be recouped since the right of recoupment expired after fourth year. So, the short workings in fifth year to be written off and need not be carried forward.

Accounting Entries in the Books of the Landlord / Lessor

1. Where a minimum rent exists with right to recoup short workings

(a) Where the actual royalty is less than the minimum rent

(i)	Lessee Account	Dr.	[Minimum rent]
	To Royalty Receivable Account		[Actual Royalties for the period]
	To Royalty Suspense Account/ **Or** Shortworkings Allowable A/c		[Short fall in Royalties]
(ii)	Bank Account	Dr.	[Net amount paid]
	Tax Deducted at source	Dr.	[Tax deducted at source]
	To Lessee Account		[Minimum rent]
(iii)	Royalties Receivable Account	Dr.	
	To Profit & Loss Account		(Transfer)

(b) Where the actual royalty is more than the minimum rent:

(i)	Lessee Account	Dr.	[Minimum rent]
	To Royalty Receivable Account		[Actual Royalties for the period]
(ii)	Royalty Suspense Account/ **Or** Short workings Allowable A/c	Dr.	
	To Lessee Account		(Recoupment of Short workings, if any)
(iii)	Bank Account	Dr	[Net amount paid]
	Tax Deducted at source	Dr.	[Tax deducted at source]
	To Lessee Account		
(iv)	Royalties (Receivable) Account	Dr.	
	To Profit & Loss Account		(Transfer)
(v)	Royalty Suspense Account/ **Or** Short workings Allowable A/c	Dr.	
	To Profit and Loss Account (Short workings, which can not be recouped)		

Illustration 3 :

For the same figures as given in illustration 1, prepare necessary accounts in the books of Landlord.

Solution :

Dr. ROYALTY RECEIVABLE ACCOUNT Cr.

Date	Particulars	Amt. Rs	Date	Particulars	Amt. Rs
31.03.03	To Profit & Loss A/c	75,000	31.03.03	By Bihar Coal Co.Ltd	75,000
31.03.04	To Profit & Loss A/c	90,000	31.03.04	By Bihar Coal Co.Ltd	90,000
31.03.05	To Profit & Loss A/c	187,500	31.03.05	By Bihar Coal Co.Ltd	187,500
31.03.06	To Profit & Loss A/c	150,000	31.03.06	By Bihar Coal Co.Ltd	150,000
31.03.07	To Profit & Loss A/c	375,000	31.03.07	By Bihar Coal Co.Ltd	375,000
31.03.08	To Profit & Loss A/c	112,500	31.03.08	By Bihar Coal Co.Ltd	112,500

Bihar Coal Co. Ltd. Account

Dr *Cr*

Date	Particulars	Amt (Rs)	Date	Particulars	Amt(Rs)
31.03.03	To Royalties Receivable A/c	75,000	31.03.03	By Bank A/c	150,000
	To Shortworkings Susp.A/c	75,000			
		150,000			150,000
31.03.04	To Royalties Receivable A/c	90,000	31.03.04	By Bank A/c	150,000
	To Shortworkings Susp.A/c	60,000			0
		150,000			150,000
31.03.05	To Royalties Receivable A/c	187,500	31.03.05	By Bank A/c	150,000
				By Shortworkings Susp.A/c	37,500
		1,87,500			1,87,500
31.03.06	To Royalties Receivable A/c	150,000	31.03.06	By Bank A/c	150,000
		150,000			150,000
31.03.07	To Royalties Receivable A/c	375,000	31.03.07	By Bank A/c	375,000
		375,000			375,000
31.03.08	To Royalties Receivable A/c	112,500	31.03.08	By Bank A/c	112,500
		112,500			112,500

Dr. **Shortworkings Suspense Account** Cr.

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.03	To Balance c/d	75,000	31.03.03	By Bihar Coal Co. Ltd	75,000
			1.4.03	By Balance b/d	75,000
31.03.04	To Balance c/d	135,000	31.03.04	By Bihar Coal Co. Ltd	60,000
		135,000			135,000
31.03.05	To Bihar Coal Co.Ltd	75,000	1.4.04	By Balance b/d	135,000
	To Profit & Loss A/c	37,500	31.03.05	By Bihar Coal Co. Ltd	37,500
	To Balance c/d	60,000			
		172,500			1,72,500
31.03.06	To Profit & Loss A/c	60,000	1.04.05	By Balance b/d	60,000
		60,000			60,000

SUB-LEASE

In some cases the lessee transfers a part to its right of lease to an another party to complete the work under lease with terms and condition as agreed between himself and that party.

In these cases, there are three parties, viz. Landlord, lessee and sub-lessee. So far accounting entries are concern, the status of lessee with the sub-lessee is like a landlord.

Accounting Entries

a> In the books of Landlord:

Same as before. Payment to landlord will depend on the total production /sell made by lessee as well as sub-lessee.

b> In the books of the Lessee.
In this book both royalty payable and receivable account to be opened since he has two status. He has to maintain,if any, both short workings and Royalty suspense account.

c> In the books of sub-lessee.

In this case the entry will be from the view point of lessee in normal cases as explained earlier.

Illustration 4 :

On 1.4.2003 Mayami got a mining lease and from that date a part of the mine was sub-leased to Pathan. The terms of payment and the production of 5 years are as below.

Particulars	Lessee	Sub-Lessee
Royalty (Rs/Tonne)	2.00	3.00
Dead Rent per anum(Rs)	15,000	10,000
Short working recoverable(Years)	3	2
Production (Year ended....31.3.)		
2004	1,000	1,000
2005	3,000	2,000
2006	12,000	5,000
2007	9,000	2,000(strike)
2008	5,000	12,000

In case of strike, royalty earned will discharge all liabilities for the year only.
Show ledger accounts in the books of Mayami.

Solution :

In the Books of Mayami

Statement showing Royalties Payable

Fig in Rs

Year Ended 31.3	Output (Tons)	Actual Royalties	Min. Rent	Excess Workings	Shortworkings Occurred	Shortworkings Recouped	Shortworkings Written off	Shortworkings C/F	Amount Payable
2004	2,000	4,000	15,000	0	11,000	0	0	11,000	15,000
2005	5,000	10,000	15,000	0	5,000	0	0	16,000	15,000
2006	17,000	34,000	15,000	19,000	0	16,000	0	0	18,000
2007	11,000	22,000	15,000	7,000	0	0	0	0	22,000
2008	17,000	34,000	15,000	19,000	0	0	0	0	34,000

Statement showing Royalties Receivable

Fig in Rs

Year Ended 31.3	Output (Tons)	Actual Royalties	Min. Rent	Excess Workings	Shortworkings Occurred	Shortworkings Recouped	Shortworkings Written off	Shortworkings C/F	Amount Payable
2004	1,000	3,000	10,000	0	7,000	0	0	7,000	10,000
2005	2,000	6,000	10,000	0	4,000	0	0	11,000	10,000
2006	5,000	15,000	10,000	5,000	0	5,000	2,000	0	10,000
2007	2,000	6,000	6,000	0	0	0	4,000	0	-
2008	12,000	36,000	10,000	26,000	0	0	0	0	36,000

Dr. **Shortworkings Account** Cr.

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.04	To Landlord A/c	11,000	31.03.04	By Balance c/d	11,000
		11,000			11,000
1.4.04	To Balance b/d	11,000	31.03.05	By Balance c/d	16,000
31.03.05	To Landlord A/c	5,000			
		16,000			16,000
1.4.05	To Balance b/d	16,000	31.03.06	By Landlord A/c (recouped)	16,000
		16,000			16,000

Dr. **Shortworkings Suspense Account** Cr.

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.04	To Balance c/d	7,000	31.03.04	By Pathan A/c	7,000
		7,000			7,000
31.03.05	To Balance c/d	11,000	1.04.04	By Balance b/d	7,000
			31.03.05	By Pathan A/c	4,000
31.3.06	To Pathan A/c	5,000			11,000
	To P& L A/c	2,000	1.04.05	By Balance b/d	11,000
	To Balance c/d	4,000			
		11,000			11,000
31.03.07	To P &L A/c	4,000	1.4.06	By Balance b/d	4,000
		4,000			4,000

ROYALTY RECEIVABLE ACCOUNT

Dr Cr

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.04	To Royalties Payable A/c (1000*2)	2000	31.03.04	By Pathan A/c (1000*3)	3,000
	To Profit & Loss A/c	1,000			
		3,000			3,000
31.03.05	To Royalties Payable A/c (2000*2)	4000	31.03.05	By Pathan A/c (2000*3)	6,000
	To Profit & Loss A/c	2,000			
		6,000			6,000
31.03.06	To Royalties Payable A/c (5000*2)	10000	31.03.06	By Pathan A/c (5000*3)	15,000
	To Profit & Loss A/c	5,000			
		15,000			15,000
31.03.07	To Royalties Payable A/c (2000*2)	4000	31.03.07	By Pathan A/c (2000*3)	6,000
	To Profit & Loss A/c	2,000			
		6,000			6,000
31.03.08	To Royalties Payable A/c (12000*2)	24000	31.03.08	By Pathan A/c (12000*3)	36,000
	To Profit & Loss A/c	12,000			
		36,000			36,000

ROYALTY PAYABLE ACCOUNT

Dr | Cr

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.04	To Landlord A/c	4000	31.03.04	By Royalties Receivable A/c	2,000
	(2000*2)			(1000*2)	
				By Profit & Loss A/c	2,000
		4,000			4,000
31.03.05	To Royalties Payable A/c	10000	31.03.05	By Pathan A/c	4,000
	(5000*2)			(2000*2)	
				By Profit & Loss A/c	6,000
		10,000			10,000
31.03.06	To Royalties Payable A/c	34000	31.03.06	By Pathan A/c	10,000
	(17000*2)			(5000*2)	
				By Profit & Loss A/c	24,000
		34,000			34,000
31.03.07	To Royalties Payable A/c	22000	31.03.07	By Pathan A/c	4,000
	(11000*2)			(2000*2)	
				By Profit & Loss A/c	18,000
		22,000			22,000
31.03.08	To Royalties Payable A/c	34000	31.03.08	By Pathan A/c	24,000
	(17000*2)			(12000*2)	
				By Profit & Loss A/c	10,000

Note:

1> Royalty to be paid to Landlord on total production including the production from sub-lessee.

2> Royalties receivable from sub lease to be adjusted against the payable amount to the extent of royalty payable to Landlord.

Pathan's Account

Dr. Cr.

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.04	To Royalties Receivable A/c	3,000	31.03.04	By Bank A/c	10,000
	To Shortworkings Susp.A/c	7,000			
		10,000			10,000
31.03.05	To Royalties Receivable A/c	6,000	31.03.05	By Bank A/c	10,000
	To Shortworkings Susp.A/c	4,000			
		10,000			10,000
31.03.06	To Royalties Receivable A/c	15,000	31.03.06	By Bank A/c	15,000
		15,000			15,000
31.03.07	To Royalties Receivable A/c	6,000	31.03.07	By Bank A/c	6,000
		6,000			6,000
31.03.08	To Royalties Receivable A/c	36,000	31.03.08	By Bank A/c	36,000
		36,000			36,000

Landlord's Account

Dr. Cr.

Date	Particulars	Amt (Rs)	Date	Particulars	Amt (Rs)
31.03.04	To Bank A/c	15,000	31.03.04	By Royalties A/c	4,000
				By Shortworkings A/c	11,000
		15,000			15,000
31.03.05	To Bank A/c	15,000	31.03.05	By Royalties A/c	10,000
				By Shortworkings A/c	5,000
		15,000			15,000
31.03.06	To Bank A/c	18,000	31.03.06	By Royalties A/c	34,000
	To Shortworkings A/c	16,000			
		34,000			34,000
31.03.07	To Bank A/c	22,000	31.03.07	By Royalties A/c	22,000
		22,000			22,000
31.03.08	To Bank A/c	34,000	31.03.08	By Royalties A/c	34,000
		34,000			34,000

Illustration 5.

The following information has been obtained from the books of a lesee relating to the years 2005-06 to 2008-09 :

Payments to Landlord (after tax deducted @ 20% at Source) :

	2005-06	Rs. 12,000
	2006-07	Rs. 12,000
	2007-08	Rs. 2,000
	2008-09	Rs. 19,200
Short-working recovered :	2006-07	Rs. 2,500
	2007-08	Rs. 1,000
Short-working recovered :	2007-08	Rs. 500

Balance of Short-working Account forward on April 1, 2005 Rs. 800 (which are in 2005–06). According to the terms of agreement short-working is recoverable within the next two years following the year in which short-working arises.

You are required to show the necessary accounts in the books of the lessee for the four years ended 31st March 2009.

Solution :

Before preparing the ledger accounts we are to find out some missing information :

1. The recoupment which was made is 2006-07 for Rs. 2,500 is inclusive of Rs. 800 of 2004-05 and the balance Rs. 1,700 for 2005-06.

   Again, the short-working which was recovered and written-off Rs. 1,000 and rs. 500 (i.e., Rs, 1,500), respectively, in 2006-07 are also for the year 2005-06. So, the total-working for 2005-06 amounted to Rs. 3,200 (i.e., Rs. 1,700 + Rs. 1,500).
2. Rate of taxes @ 20% on gross i.e., 25% (i.e., $\frac{20}{80} = \frac{1}{4}$) on net amount paid.
3. Actual Payment = Annual Royalty + Short-working – Recoupment.

Thus, actual royalty is calculated as under :

		2005-06 Rs.	2006-07 Rs.	2007-08 Rs.	2008-09 Rs.
	Payment to landlord (after tax)	12,00	12,000	12,000	19,200
Add :	Back Tax Deducted at Source @ $\frac{1}{4}$ th	3,000	3,000	3,000	4,800
	Payment to landlord (before Tax)	15,000	15,000	15,000	24,000
Less :	Short-working	—	—	—	—
Add :	Recoupment	—	2,500	1,000	—
		11,800	17,500	16,000	24,000

In the books of ....
Royalty Account

Dr. *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2006			2006		
Mar. 31	To Landlord A/c	11,800	Mar. 31	By Profit and Loss A/c	11,800
		11,800			11,800
2007			2007	By Profit and Loss A/c	17,500
Mar. 31	To Short-working A/c	2,500	Mar. 31		
	” Landlord A/c	15,000			
		17,500			17,500
2008			2008	By Profit and Loss A/c	16,000
Mar. 31	To Short-working A/c	1,000	Mar. 31		
	” Landlord A/c	15,000			
		16,000			16,000
2009			2009		
Mar. 31	To Landlord A/c	24,000	Mar. 31	By Profit and Loss A/c	24,000
	”	24,000			24,000

Short-working Account

Dr. *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2006			2006		
Apr. 1	To Balance b/d	800	Mar. 31	By Balance c/d	4,000
	” Landlord A/c	3,200			
		4,000			4,000
2007			2007		
Apr. 1	To Balance b/d	4,000	Mar. 31	By Royalty A/c	2,500
			”	Balance c/d	1,500
		4,000			4,000
2008			2008		
Apr. 1	To Balance b/d	1,500	Mar. 31	By Royalty A/c	1,000
			”	Balance c/d	500
		1,500			1,500

Landlord Account

Dr. *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
2006			2006		
Mar. 31	To Income-Tax Payable A/c	3,000	Mar. 31	By Royalty A/c	11,800
	” By Bank A/c	12,000		” Short-working A/c	3,200
		15,000			15,000
2007			2007		
Mar. 31	To Income-Tax Payable A/c	3,000	Mar. 31	By Royalty A/c	17,500
	” Bank A/c	12,000			
		15,000			15,000
2008			2008		
Mar. 31	To Income-Tax Payable A/c	3,000	Mar. 31	By Royalty A/c	15,000
	” Bank A/c	12,000			
		15,000			15,000
2008			2009		
Mar. 31	To Income-Tax Payable A/c	4,800	Mar. 31	By Royalty A/c	24,000
	” Bank A/c	19,200			
		24,000			24,000

Illustration 6.

A fire occurred in the office premises of lessee in the evening of 31.3.2009 destroying most of the books and records. From the documents saved, the following information is gathered :

Short-working recovered :

2006-07 Rs. 2,000 (towards short-workings which arose in 2003-04)

2008-08 Rs. 4,000 (including Rs. 1,000 for short-working 2004-05)

2008-09 Rs. 1,000

Short-working lapsed :

2005-06 Rs. 1,500

2006-07 Rs. 1,800

2008-09 Rs. 1,000

A sum of Rs. 25,000 was paid to the landlord in 2005-06. The agreement of Royalty contains a clause of Minimum Rent payable for fixed amount and recoupment of short-workings within 3 years following the year in which Short-workings arise.

Information as regards payments to landlord subsequent to the year 2005-06 is not four years ended 31.3.2009.

Solution :

Before preparing the respective ledger accounts we are to compute the following information :

Year	Royalty	Short-working	Short-working recovered	Short-working Lapsed	Payment to Landlord
	Rs.	Rs.	Rs.	Rs.	Rs.
2005-06	—	—	—	1,500	25,000
2006-07	—	—	Rs. 2,000 (for 2003-04)	8,800	—
2007-08	—	—	Rs. 4,000 (including Rs. 1,000 for 2004-05)	—	—
2008-09	—	—	1,000	1,000	—

From the above statement it is quite clear that :

(i) Short-working lapsed in 2008-09 Rs. 1,000 which relates to 2005-06 as per terms, short-working should be recouped within three years i.e., 2008-09 is the last year for recoupment.

(ii) Short-working recovered in 2007-08 Rs. 4,000, out of which Rs. 1,000 for 2004-05 and the balance Rs. 3,000 for the year 2005-06.

(iii) Short-working recovered in 2008-09 Rs. 1,000 which is also related to 2005-06 in which year actually is arose.

Thus, the total short-working balance in 2005-06 amounted to Rs. 5,000 (i.e., Rs. 1,000 + Rs. 3,000 + Rs. 1,000).

Now, we can prepare our usual statement as under :

Hence, Actual Royalty = Payment to Landlord + Recoupment – Short-working

For, 2005-06 = Rs. 25,000 + Nil – Rs. 5,000

= Rs. 20,000.

For, 2006-07 = Rs. 25,000 + Rs. 2,000 – Nil

= Rs. 27,000

For, 2007-08 = Rs. 25,000 + Rs. 4,000 – Nil

= Rs. 29,000

For, 2008-09 = Rs. 25,000 + Rs. 1,000 – Nil

= Rs. 26,000

Year	Royalty	Short-working	Recoupment	Tr. to P&L A/c	Payment to Landlord
	Rs.	Rs.	Rs.	Rs.	Rs.
2005-06	20,000	5,000	—	1,500	25,000
2006-07	27,000	—	2,000	1,800	25,000
2007-08	29,000	—	4,000	—	25,000
2008-09	26,000	—	1,000	1,000	25,000

In the books of ....
Royalty Account

Dr. *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
31.3.06	To Landlord A/c	20,000	31.3.06	By Profit and Loss A/c	20,000
		20,000			20,000
31.3.07	To Short-working A/c	2,000	31.3.07	By Profit and Loss A/c	27,000
	” Landlord A/c	25,000			
		27,000			27,000
31.3.08	To Short-working A/c	4,000	31.3.08	By Profit and Loss A/c	29,000
	” Landlord A/c	25,000			
		29,000			29,000
31.3.09	To Short-working A/c	1,000	31.3.09	By Profit and Loss A/c	26,000
	” Landlord A/c	25,000			
		26,000			26,000

Short-working Account

Dr. *Cr.*

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
31.3.06	To Balance b/d	6,300	31.3.06	By Profit and Loss A/c	1,500
	” Landlord A/c	5,000		” Balance c/d	9,800
		11,300			11,300
31.3.07	To Balance b/d	9,800	31.3.07	By Royalty A/c	2,000
				” Profit and Loss A/c	1,800
				” Balance c/d	6,000
		9,800			9,800
31.3.08	To Balance b/d	6,000	31.3.08	By Royalty A/c	4,000
	” Landlord A/c	25,000		” Balance c/d	2,000
		6,000			6,000
31.3.09	To Balance b/d	2,000	31.3.09	By Royalty A/c	1,000
				” Profit and Loss A/c	1,000
		2,000			2,000

This is includes the following :

		Rs.
Lapsed :	in 2005-06	1,500
	in 2006-07	1,800
Recoupment :	in 2006-07	2,000
	in 2007-08	1,000
		6,300

EXERCISE

Problems :

1. A colliery is leased to National Coal Syndicate on a royalty of Re. 1 per tonne on the output. A minimum rent of Rs. 16,000 a year and allowances for shortworking are provided in the lease. The coal actually raised in a series of years is as follows:

	Tonnes
1st year	8,000
2nd year	10,000
3rd year	18,000
4th year	28,000
5th year	14,000

Draw up Royalty account. Landlord's account. Shortworking account and Minimum rent account in the books of the Syndicate.

(Shortworking recouped 3rd *year Rs. 2,000;* 4th *year Rs. 12,000;*
Balance of shortworking at the end *of fifth year Rs. 2,000)*

2. A Colliery company took a lease of a coal mine for a period of 20 years from January 1. 2002 upon the terms of royalty of 50 paise per tonne of the output with a minimum rent of Rs. 8.000 per annum with power to recoup short workings over the first four years of the lease.

You are required to prepare the royalty account. minimum rent account and shortworking account in the books of the colliery company assuming the output for the first six year to be as follows:

2003	6,000 tonnes	2006	20,000 tonnes
2004	8,000 tonnes	2007	18,000 tonnes
2005	16,000 tonnes	2008	15,000 tonnes

(Shortworking recouped in 2006 *Rs. 2,000; Shortworking transferred* to *profit* and
loss account in 2006 *Rs. 7,000* and *in* 2008 *Rs. 500)*

3. On 1st January 2005. the Andal Mines leased some land for a minimum rent of Rs. 3,000 for the first year. Rs. 5,000 for the second year and thereafter Rs. 10.000 per annum merging into a royalty of 50 paise per tonne with power to recoup shortworkings over two years after occurring of short workings. The outputs were as follows:

2005	3,000 tonnes	2007	22,000 tonnes
2006	8,600 tonnes	2008	50,000 tonnes

Show how the accounts would appear in the books of the Andal Mines.

(*Unrecouped short workings transferred* to P & L *account* in 2007 Rs. *500;*
Short workings recouped in 2007 Rs. *1,000;* in *2008* Rs. *700)*

4. Mr. Butcher developed a software package *for* a Turnkey project *for* offshore drilling.

He granted Mr. Joshi a license *for* 7 years to use the software and sell the same in India on following terms.

(1) Mr. Joshi should pay to Mr. Butcher a royalty of Rs. 50 *for* each software package sold with a minimum annual payment of Rs. 5,00,000. Account should be settled on 31st December.

(2) In any year the royalties amounted to less then Rs. 500.000, Mr. Joshi should have the right to deduct deficiencies *from* the royalties payable in excess of that sum in the two following years.

The number of packages sold were as follows:

Year ended 31st March 2005	8,000
Year ended 31st March 2006	9,000
Year ended 31st March 2007	11,000
Year ended 31st March 2008	18,000

You are required to prepare

(1) Royalties Account,

(2) Short workings Account, and

(3) Mr. Butcher's Account in the books of Mr. Joshi which are closed annually on 31st March

(Ans: Short workings 2005: Rs, *100,000;* 2006 Rs. *50,000; Recovery of Short workings* : 2007; Rs.50,000; 2008 Rs. *50,000; Shortworking lapsed:* 2007 Rs.50,000)

5. The Ranee Colliery Co. Ltd. leased a property from Atma Ram on a royalty of one rupee per tonne with a minimum rent of Rs. 30,000 per annum. Each year's excess of minimum rent over royalties is recoverable out of the royalties of the next five years.

In the event of strike and the minimum rent not being reached the lease provided that the actual royalties earned for the year should be paid. The result of the working were as follows:

Year ending 31stMarch	*Actual Royalties*
	Rs.
2001	NIL
2002	9,750
2003	27,750
2004	33,750
2005	42,000
2006	52,500
2007	28,500
2008	45,000

The year 2007 was a strike year. You are required to write up the necessary ledger accounts.

(Answer:

Shortworkings : 2001 to Rs.30,000; 2002-Rs.20,250; 2003-Rs.2,250
Shortworkings Recovered : 2004-Rs.3,750; 2005-Rs.12,000; 2006-Rs.22,500; 2008-Rs.2,250
Shortworking transfered to P&L A/c: 2007-Rs.12,000)

6. The lease of a plot of land is granted to Bikash upon the basis of a royalty of 10 paise per tonne on the day extracted, subject to a minimum rent of Rs. 2,000 per annum.A has the right to recoup short workings during the first seven years of the lease but not afterwards.

Bikash granted a sub-lease for the same period, from 31st December. 2004, to PT Ltd. of one-half of the area, for the royalty of 15 paise per tonne merging into a minimum rent of Rs. 1,250 per annum. Under the terms of the sub-lease, PT Ltd. can recoup shortworking in any two years immediately following that in which short workings accrued. The output in terms for Bikash and PK Ltd. was as follows

	Tonnes	
	Bikash	PK Ltd.
First year	10,000	6,500
Second year	16,000	8,000
Third year	20,000	8,200
Fourth year	25,000	9,000
Fifth year	26,000	9,900

Write the Journal entries in the books of Bikash for all the years.

Answer :

Shortworkings :	1st year Rs.350
Shortworking Recouped :	2nd year Rs.350
Shortworking Suspense :	1st year Rs.275 2nd year Rs.50 3rd year Rs.20
Shortworking Suspense transfered to P&L A/c :	3rd year Rs. 275
Shortworkings Suspense Recovered :	4th year Rs.70

2.2 HIRE-PURCHASE AND INSTALLMENT PURCHASE SYSTEMS

HIRE-PURCHASE SYSTEM

INTRODUCTION

It is not always possible by a purchaser to meet up the higher demand for goods due to immediate cash payment. To meet this demand the concept of Hire purchase is very popular in the market.

Under this system the purchaser **(Hirer)** pays the entire amount in staggered way viz. monthly, quarterly or yearly with some interest. Under this system the goods are sold with the following conditions.

Possession of goods is delivered to a hirer but the title to the goods (Ownership) are transferred only when the agreed sum(Hire Purchase price) is paid by the hirer.

Such hirer has a right to terminate the agreement at any time before the property so passes. That means he has the option to return the goods in which case he need not pay installments falling due thereafter. However, the hirer cannot recover the sums already paid as such sums legally represent hire charges of the goods in question.

The hire-purchaser, during that period of possession of goods, cannot damage, destroy, pledge or sell such goods. He is supposed to take all such care of goods as a prudent person does in his own goods.

In case of Installment sale, it is not only the possession of goods but also the *ownership* in goods is transferred to the buyer immediately at the time of agreement.

Further. in installment system if the buyer stops the payment of dues, then He does not have the right of seizing his goods. The differences between installment sale and hire-purchase are as below:

Particulars	Hire Purchase	Installment sale
Ownership	Stipulates the time at which the ownership passes to the buyer. It is usually on the payment of last installment	Ownership passes at the time of Sale
Default in making payment	Seller can repossess the goods. In that case the installment so far paid is treated to be Hiring charges.	Seller does not have any other right except the right of suing the buyer for the non-payment of price.
Right of sale or other wise	No right to sale or otherwise transfer the goods since the legal position of the hirer is bailee.	Right to sale or otherwise transfer the goods
Loss or damages to the goods.	Any loss occurring to goods has to be borne by the seller if the buyer takes reasonable care.	Any loss occurring to goods has to be borne by the buyer.

SITUATION I : WHEN RATE OF INTEREST, TOTAL CASH PRICE AND INSTALLMENTS ARE GIVEN

Illustration 1 : X purchases a car on hire-purchase system on 1.1.07. The total cash price of the car is Rs. 4,50,000 payable Rs. 90000 down and three installments of Rs. 1,70,000, Rs. 1,50,000 and Rs. 1,08,460 payable at the end of first, second and third year respectively. Interest is charged at 10% p.a.

You are required to calculate interest paid by the buyer to the seller each year.

Solution: Following table is useful for calculating interest paid with each installment:

Analysis of Instalments

Year	Opening Balance of Cash Price Rs.	Instalements Rs.	Payment to wards Principal / Cash Price Rs.	Payment towards Interest Rs.	Closing Balance 0f Cash Price Rs.
01.01.08	4,50,000	90,000	90,000	-	3,60,000
31.12.08	3,60,000	1,70,000	1,34,000	36,000	2,26,000
31.12.09	2,26,000	1,50,000	1,27,400	22,600	98,600
31.12.10	98,600	1,08,460	98,600	9,860	-

SITUATION II : WHEN RATE OF INTEREST AND INSTALLMENTS ARE GIVEN BUT TOTAL CASH PRICE IS NOT GIVEN.

Illustration 2 :

X purchased a T.V on hire-purchase system. As per terms he is required to pay Rs. 3000 down, Rs. 4000 at the end of first year, Rs. 3000 at the end of second year, and Rs. 5000 at end of third year. Interest is charged at 12% p.a.

You are required to calculate total cash price of T.V and interest paid with each install ment.
Solution:

Calculation of Cash Price		Analysis of Instalments	
	Instament Rs.	Interst Rs.	Cash Price Rs.
3rd Instalment			
(-) Interest (12 / 112 x 5,000)	5,000		
	536	536	4,464
Balance of Cash Price	4,464		
(+) 2nd Instalment	3,000		
	7,464		
(-) Interest (12 / 112 x 7,464)	800	800	2,200
Balance of Cash Price	6,664		
(+) 1st Instalment	4,000		
	10,664		
(-) Interest (12 / 112 x 10,664)	1,143	1,143	2,857
Balance of Cash Price	9,521		
(+) Down Payment	3,000	-	3,000
Total Cash Price	12,521	2479	12,521

SITUATION III: -WHEN ONLY INSTALLMENTS ARE GIVEN, BUT CASH PRICE AND RATE OF INTEREST ARE NOT GIVEN.

Illustration 3 :

X & Co. purchased a Motor car on April 1, 2007 on hire-purchase paying Rs. 60,000 cash down and balance in four annual installments of Rs. 55,000, Rs. 50,000.,Rs. 45000 and Rs. 40,000 each Installment comprising equal amount of cash price at the end of each accounting period. You are required to calculate total cash price and amount of interest in each Installment.

Solution: Hire-purchase Price

Down Payment	60,000
1st installment	55,000
2nd installment	50,000
3rd installment	45,000
4th installment	40,000
Total	2,50,000

As each installment comprises equal amount of cash price the differences in installment amounts are due to interest amount only. Assuming X is the amount of Cash Price in each installment and I is the amount of interest.

Thus for the installments, starting from last installment, we have the following equations:

(i)	X+ I	=	40,000
(ii)	X+ 2I	=	45,000
(iii)	X+3I	=	50,000
(iv)	X +4I	=	55,000

Subtracting any preceding equation from the following equation we get I=Rs. 5,000 and by substituting the value of I in any equation we get X= Rs. 35,000.

The hire-purchase price is divided into cash price and interest parts as under:

Particulars	Cash Price Rs.	Interest Rs.	Installment Rs.
Down Payment	60,000	-	60,000
First installment	35,000	20,000	55,000
Second installment	35,000	15,000	50,000
Third installment	35,000	10,000	45,000
Fourth installment	35,000	5,000	40,000
Total	200,000	50,000	250,000
Total Cash Price	Rs.200,000		
Hire Purchase Price	Rs.250.000		
Total Interest	Rs.50.000		

SITUATION IV: WHEN REFERENCE TO ANNUITY TABLE RATE OF INTEREST AND INSTALLMENTS ARE GIVEN BUT TOTAL CASH PRICE IS NOT GIVEN.

In such questions the reference to annuity table gives the present value of the annuity for a number of years at a certain rate of interest. This present worth is equal to total cash price. Therefore, with the help of annuity tables the total cash price of the total installments given can be calculated and then question can be solved by the first method.

Accounting treatment.

Accounting treatment in the books of buyer and seller are in below:

In the Books of theHire-Purchaser

The following methods are followed:

(1) Cash Price Method

(2) Interest Suspense Method

Cash Price Method:

Under this method, we will have to prepare the following ledger accounts:

(i) H.P.Asset Account.

(ii) Hire Vendor Account.

Accounting Entries:

First year(At the begining);

(1) on acquisition of H.P.Asset

H.P.Asset A/c Dr.
To Hire Vendor A/c

(2) for Down payment:

Hire Vendor A/c Dr.
To Bank A/c

At the end of the first year:

(3) For instalment due:

Interest A/c Dr.
To Hire Vendor A/c (with the amount of interest)

(4) For Payment of Instalment
Hire Vendor A/c Dr.
To Bank A/c

(5) For Depreciation on H.P.Asset
Depreciation A/c Dr.
To H.P.Asset A/c

(6) For transfering interest and depreciation
Profit & Loss A/c Dr.
To Interest A/c
To Depreciation A/c

For 2nd and subsequent years: Entries (3) to (6) will be recorded.

Interest Suspense Method:

First Year (at the begining)

(1) On acquisition of the H.P.Asset

H.P.Asset A/c Dr. (cash price)
Interest Suspense A/cDr. (total interest)
To Hire Vendor A/c

(2) For down payment:
Hire Vendor A/cDr.
To Bank A/c

At the end of the first year:

(3) For instalment due
Interest A/c Dr.
To Interest Suspense A/c (with the amount of yearly interest)

(4) For payment of instalment:

Hire Vendor A/c Dr.

To Bank A/c

(5) For Depreciation

Depreciation A/c Dr.

To H.P.Asset A/c

(6) For transferring interest and depreciation

Profit and Loss A/c Dr

To Interest A/c

To Depreciation A/c

For 2nd and every subsequent years: entries (3) to (6) will be recorded.

In the Books of Vendor

Goods which are sold under HP system may be classified into two categories. They are

(A) Items of large value and long life which buyers treat as fixed assets and

(B) Small consumer items which are purchased by general public such as radios, TV sets, tape recorders, fans, washing machines, etc. The buyers of such items being general public do not make any accounting entries. The accounting methods depend on the nature of goods sold. Let us discuss the accounting treatment for large items.

(A) ***Large items***: In the case of hire-purchase sales there are three components in the selling price as shown below:

(1) Cost Price

+ (2) Gross Profit = Cash Price

+ (3) Interest = Hire-Purchase sales price.

The accounting methods generally recognize gross profit at the point of sale. Regarding interest there are two methods.

(1) Sales Method.

(2) Interest Suspense Method.

Sales Method :

Under this method, interest is recognized only when the instalment is due.

Accounting Entries:

At the beginning 1st year :

(1)At the time of signing the contract :

H.P.Debtors A/c Dr.

To H.P.Sales A/c [With Cash Price]

(2)At the time of Down Payment

Cash / Bank A/c Dr.

To H.P.Debtors A/c (with down payment)

At the end of the first year and all subsequent years :

(3) For Instalment due

H.P.Debtors A/c Dr.

To Interest account [With Interest due for the year]

(4) On receipt of instalment

Cash / Bank A/c Dr

To H.P.Debtors A/c [With Installment amount]

(5) For transferring interest:

Interest A/c Dr

To Profit and loss A/c

Interest Suspense Method :

In this method the total interest is credited to interest suspense account and is transferred to interest account proper at the end of each accounting period.

Accounting Entries:

At the begining of the first year:

(1) At the time of signing of the contract:

H.P.Debtors A/c Dr.

To H.P.Sales A/c(cash price)

To Interest Suspense A/c (with the total amount of interest)

(2) On receipt of down payment :

Bank A/c Dr.

To H.P.Debtors A/c

At the end of the first year:

(3) For instalment due:

Interest Suspense A/c Dr.

To Interest A/c

(4) On receipt of instalment:

Cash/Bank A/c Dr.

To H.P.Debtors A/c

At the end of 2nd and subsequent years, entriers (3) & (4) will be recorded.

DEFAULT AND REPOSSESSION

When hirer is in default in making payments in time, the owner takes back the possession of goods. There are two possibilities:

(a) Complete repossession When seller takes back the possession of complete goods.

Accounting treatment in this case is as follows:

Books of Purchaser

1. All entries, except the entry for payment, are passed as usual up to the date of default.
2. Buyer closes the account of seller by debiting his account. The same amount will be credited to asset account.
3. Any balance left in asset account is closed by transferring to profit and loss account.

Books of Seller

1. All entries, except the entry for payment, are passed as usual up to the date of default.
2. Seller closes purchaser's account by crediting his account (by the amount credit given) and debiting goods returned account (a new account).
3. Goods returned account, as opened, is further debited with expenses incurred on repair of the goods and credited with actual resale price. Any balance in this account, being profit or loss on resale, is transferred to profit and loss account.

Illustration 4 :

X purchased a truck for Rs. *2,80,000,* payment to be made Rs. *91,000* down and 3 installments of Rs. 76*,000* each at the end of each year. Rate of interest is charged at 10% p.a. Buyer depreciates assets at 15% p.a. on written down value method.

Because of financial difficulties, X*,* after having paid down payment and first installment to the end of 1st year could not pay second installment and seller took possession of the truck. Seller, after spending Rs. 9,200 on repairs of the asset sold for Rs. *150,000.* Show the relevant accounts in the books of the purchaser & the vendor.

Solution :

Calculation of Interest

Particulars	Total Cash Price Rs	Installment Paid @ 10% Int Rs	Interest Paid Rs	Paid towards Cash Price (Installment-Interest) Rs
	280,000			
Down Payment	91,000	91,000	0	91,000
	189,000			
End of 1st year	57,100	76,000	18,900	57,100
	131,900			
End of 2nd Year	62,810	76,000	13,190	62,810
	69,090			
End of 3rd Year	69,090	76,000	6,910	69,090
Total	0	319,000	39,000	280,000

In the Books of X

Car Account

Dr **Cr**

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
1st Year	To Vendor	280,000		By Depreciation	42,000
				By Bal c/d	238,000
		280,000			280,000
2nd Year	To Bal b/d	238,000		By Depreciation	35,700
				By Vendors A/C	145,090
				By P/L A/c (Bal. figure)	57,210
		238,000			238,000

Vendors Account

Dr **Cr**

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
1st Year	To Bank (Down Payment)	91,000		By Car (Cash Price)	280,000
	To Bank(Installment)	76,000		By Interest	18,900
	To Bal c/d	131,900			
		298,900			298,900
2nd Year	To Asset A/C (Default- Assets Taken Over	145,090		By Bal b/d	131,900
				Interest	13,190
		145,090			145,090

In the Books of Vendor

X Account

Dr | | | | | Cr

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
1st Year					
	To Sales	280,000		By Bank (Down)	91,000
	To Interest	18,900		By Bank(Installment)	76,000
				By Bal c/d	131,900
		298,900			298,900
2nd Year					
	To Bal b/d	131,900		By Goods Repossessed A/C	145,090
	To Interest	13,190			
		145,090			145,090

Goods Repossessed Account

Dr | | | | | Cr

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
	To X A/c (Purchaser)	145,090		By Bank (Sales)	150,000
	To Bank (Repairing Charge)	9,200		By P/L A/c (Bal Figure)	4,290
		154,290			154,290

(b) **Partial Repossession - When seller takes possession of only part of the total asset sold to buyer.** In this case accounting entries in the books of both the parties are similar to those done in the first case. The additional precautions to be taken are as follows:

(i) Both buyer and seller do not close seller's and buyer's account in their respective books. The entry is passed with the agreed value of the asset which is taken away by the seller. The basis for finding out the value of asset taken away is given in the question.

(ii) The buyer finds out the value of asset still left with him using the *normal rate of depreciation.* He *keeps the asset account* open. This account shows the balance of that asset which is left to him by the seller *(iii)* After crediting the asset account (in buyer's books) with the value of asset taken away by the seller (with such value as agreed upon) and after keeping the balance of the asset left [normal value as calculated in *(ii)* above], the difference shown by the asset account represents either profit or loss on default. This difference is transferred to profit and loss account.

Illustration 5 :

Z Ltd. purchased seven trucks on hire purchase on 1st July, 2005. The cash purchase price of each truck was Rs 1,00,000. The company has to pay 20% of the cash purchase price at the time of delivery and the balance in five half yearly instalment starting from 31st December, 2005 with interest at 5% per annum at half yearly rest. On the Company's failure to pay the instalment due on 30th June 2006, it was agreed that the Company would return 3 trucks to the vender and the remaining four would be retained. The vendor agreed to allow him a credit for the amount paid against these 3 trucks less 25%. Show the relevant Accounts in the books of the purchase and vendor assuming the books are closed in June every year and depreciation @ 20% p.a. is charged on Trucks. Vendor after spending Rs. 2,000 on repairs sold away all the three trucks for Rs. 80,000.

Solution :

In Books of Hire-Purchaser

Dr. **Trucks Account** *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
01.07.05	To Hire Vendor's A/c (Cost of Trucks @ Rs. 1,00,000 each)	7,00,000	30.06.06	By Depreciation A/c	1,40,000
				By Hire Vendor's A/c (Value of 3 Trucks returned to Vendor)	81,000
				By P & L A/c (Loss on surrender)	1,59,000
				By Balance c/d	3,20,000
		7,00,000			7,00,000

Dr. **Hire Vendor's Account** Cr.

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
01.07.05	To Bank A/c (7,00,000 x 20/100)	1,40,000	01.07.05	By Trucks A/c	7,00,000
31.12.05	To Bank A/c [(20% of 5,60,000 + 14,000]	1,26,000	31.12.05	By Interest A/c [5,60,000 x 5% x 6/12]	14,000
30.06.06	To Trucks A/c (Value of Trucks surrendered)	81,000	30.06.06	By Interest A/c [4,48,000x5%x 6/12]	11,200
30.06.06	To Balance c/d	3,78,200			
		7,25,200			7,25,200

Working Notes :

(i) Credit allowed by Vendor against 3 trucks

	Rs
Total amount of principal paid against 7 trucks (Rs 1,40,000 + Rs 1,12,000)	2,52,000
Total amount of principal paid against 3 trucks (Rs 2,52,000 x 3/7)	1,08,000
Credit allowed by Vendor (Rs 1,08,000 - 25% of Rs 1,08,000)	**81,000**

(ii) Loss on surrender of 3 trucks

Book value of 3 turcks surrendered[(Rs 1,00,000 x 3) less 20% of Rs 3,00,000]	2,40,000
Less : Credit allowed by Vendor against these 3 Trucks	81,000
Loss on surrender of 3 Trucks	1,59,000

In Books of Hire Vendor

Dr. **Z Ltd's Account** *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
01.07.05	To H.P. Sales A/c	7,00,000	01.07.05	By Bank A/c	1,40,000
31.12.05	To Interest A/c	14,000	31.12.05	By Bank A/c	1,26,000
30.06.06	To Interest A/c	11,200	30.06.06	By Goods Repossessed A/c	81,000
			30.06.06	By Balance c/d	3,78,,000
		7,25,200			7,25,200

Dr. **Goods Repossessed Account** *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
30.6.06	To Banerjee & Co.	81,000	30.6.06	By Bank A/c (Sales)	80,000
30.6.06	To Cash A/c (expenses)	2,000	30.6.06	By Profit & Loss A/c (Loss on Sale)	3,000
		83,000			83,000

Illustration 6 :

HT Ltd. purchased three electric motors costing Rs. 10,000 each from KM Ltd on 1st January, 2004 on the hire purchase system. The terms were : Payment on delivery Rs 2,500 for each motor and balance of the principal amount by 3 equal instalments plus interest at 15% per annum to be paid at the end of each year. HT. Ltd writes off 25% depreciation each year on the diminishing balance method. HT. Ltd failed to pay the last instalment. KM. Ltd repossessed two motors adjusting values against the amount due. The repossession was done on 1st January, 2007 on the basis of 40% depreciation on the diminshing balance method. You are required to: (a) Write up the ledger accounts in the books of H.T. Ltd showing the above transactions upto 1.1.2007, and (b) Show the disclosure of the balance arising from the above in the Balance Sheet of H.T. Ltd an on 31st December 2006.

Solution : **In the Books of HT Ltd.**

Dr. **Motor Account** *Cr.*

Date	*Particulars*	*Rs*	*Date*	*Particulars*	*Rs*
01.01.04	To KM Ltd. A/c		31.12.04	By Depreciation A/c	7,500
		30,000		By Balance c/d	22,500
		30,000			30,000
01.01.05	To Balance b/d	22,500	31.12.05	By Depreciation A/c	5,625
				By Balance c/d	16,875
		22,500			22,500
01.01.06	To Balance b/d	16,875	31.12.06	By Depreciation A/c	4,218
				By Balance c/d	12,657
		16,875			16,875
01.01.07	To Balance b/d	12,657	01.01.07	By KM Ltd	4,320
				By Profit & Loss A/c	4,118
				By Balance c/d (1/3 of Rs 12,657)	4,219
		12,657			12,657

Dr. **Hindustan Auto Ltd Account** *Cr.*

Date	*Particulars*	*Rs*	*Date*	*Particulars*	*Rs*
31.12.04	To Bank A/c	7,500	01.01.04	By Motor A/c	30,000
	To Bank (Rs 7,500 + Rs 3,375)	10,875	31.12.04	By Interest (15% on Rs 22,500)	3,375
	To Balance c/d	15,000			
		33,375			33,375
31.12.05	To Bank A/c	9,750	01.01.05	By Balance b/d	15,000
	To Bank c/d	7,500	31.12.05	By Interest (15% on Rs 15,000)	2,250
		17,250			17,250
31.12.06	To Balance c/d	8,625	01.01.06	By Balance b/d	7,500
			31.12.06	By Interest (15% on Rs 7,500)	1,125
		8,625			8,625
01.01.07	To Motor A/c	4,320	01.01.07	By Balance b/d	8,625
	To Balance c/d	4,325			
		8,625			8,625

Working Notes :

(i) Agreed Value of two motors repossessed on 01.01.2007 at 40% depreciation

	2004	2005	2006
	Rs	Rs	Rs
Cost / WDV in the beginning	20000	12,000	7,200
Less: Depreciation for the year@ 40%	8,000	4,800	2,880
Book Value	12,000	7,200	4,320

(ii) Loss on surrender of two motors

	Rs
Written down value of 3 motors as on 01.01.2007	12,657
Less: Value of one truck retained (Rs 12,657 x 1 / 3)	4,219
Written down value of repossessed motors	8,438
Less: Agreed value of repossesed motors	4,320
Loss on surrender of two motors	**4,118**

Illustration 7 :

On 1.1.2004, B & Co. bought 5 computers from Chirag Computers on hire-purchase. The cash price of each computer was Rs 20,000. It was agreed Rs 30,000 each at the end of each year. The Vendor charges interest @ 10% p.a. The buyer depreciates computers at 20% p.a. on the diminishing balance method.

B & Co. paid cash down of Rs. 5,000 each and two instalments but failed to pay the last instalment. Consequently, the Computers Co. repossessed three sets, leaving two sets with the buyer and adjusting the value of 3 sets against the amount due. The sets repossessed were valued on the basis of 30% depreciation p.a. on the written down value. The sets repossessed were sold by the Chirag Computers for Rs 30,000 after necessary rapairs amounting to Rs 5,000 on 30th June 2007.

Required : Open the necessary ledger account in the books of both the parties.

Solution :

In the Books of B & Co.

Dr. **Computers Account** *Cr.*

Date	*Particulars*	*Rs*	*Date*	*Particulars*	*Rs*
01.01.04	To Chirag Computers A / c	1,00,000	31.12.04	By Depreciation A / c	20,000
				By Balance c / d	80,000
		1,00,000			1,00,000
01.01.05	To Balance b / d	80,000	31.12.05	By Depreciation A / c	16,000
				By Balance c / d	64,000
		80,000			80,000
31.12.06	To Balance b / d	64,000	31.12.06	By Depreciation A / c	12,800
				By Chirag Computers (computers surrendered)	20,580
				By P & L A / c - Loss on surrender	10,140
				By Balance c / d	20,480
		64,000			64,000

Dr. **Chirag Computers Account** *Cr.*

Date	*Particulars*	*Rs*	*Date*	*Particulars*	*Rs*
01.01.04	To Cash A / c	25,000	01.01.04	By Computers A / c	1,00,000
31.12.04	To Cash A / c	30,000	31.12.04	By Interest A / c [(Rs 1,00,000 – Rs 25,000) x 10%]	7,500
	To Balance c / d	52,500			
		1,07,500			1,07,500
31.12.05	To Cash	30,000	01.01.05	By Balance b / d	52,500
	To Balance c / d	27,750	31.12.05	By Interest A / c [52,500 x10%]	5,250
		57,750			57,750
31.12.06	To Computers A / c (surrendered)	20,580	01.01.06	By Balance b / d	27,750
	To Balance c / d	9,420	31.12.06	By Interest A / c	2,250
		30,000			30,000

Working Notes :

(i) Total Interest = Hire Purchase Price – Cash Price

= [Rs 25,000 + (Rs 30,000 x 3)] – (Rs 20,000 x 5)

= Rs 1,15,000 – Rs 1,00,000 = Rs 15,000

(ii) Interest for 3rd year = Rs 15,000 – Rs 7,500 – Rs 5,250 = Rs 2,250

(iii) Agreed Value of 3 Computers Repossessed on the basis of depreciation @ 30% p.a.

	Rs
Cost (Cash Price) of 3 Computers	60,000
Less : Depreciation @ 30% p.a. for 3 years [Rs 18,000 + Rs 12,600 + Rs 8,820]	39,420
	20,580

(iv) Book Value of 3 Computers Repossesed on the basis of depreciation @ 20% p.a

Cost (Cash Price) of 3 Computers	60,000
Less : Depreciation @ 20% WDV for 3 years [Rs 12,000 + Rs 9,600 + Rs 7,680]	29,280
	30,720

(v) Loss on Surrender = Book value – Agreed Value = Rs 30,720 – Rs 20,580 = Rs.10,140

In the Books of Chirag Computers

Dr. **B & Co. Account** *Cr.*

Date	*Particulars*	*Rs*	*Date*	*Particulars*	*Rs*
01.01.04	To H.P.Sales A/c	1,00,000	01.01.04	By Cash A/c	25,000
31.12.04	To Interest A/c	7,500	31.12.04	By Cash A/c	30,000
				By Balance c/d	52,500
		1,07,500			1,07,500
01.01.05	To Balance b/d	52,500	31.12.05	By Cash A/c	30,000
31.12.05	To Interest A/c	5,250	31.12.05	By Balance c/d	27,750
		57,750			57,750
01.01.06	To Balance b/d	27,750	31.12.06	By Goods Repossessed A/c	20,580
31.12.06	To Interest A/c	2,250		By Balance c/d	9,420
		30,000			30,000

Dr. **Goods Repossessed Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To B & Co. A/c	20,580	By Cash A/c (sales)	30,000
To Cash A/c (Repairs)	5,000		
To Profit & Loss A/c (Profit)	4,420		
	30,000		30,000

(B) Items of Small Value-Hire-Purchase Trading Account

For items of 'B' category, *i.e..* of small value such as cycles, radios, fans etc. sold on hire-purchase system it would be impractical for the seller to calculate the interest involved in each installment (as discussed earlier). It involves huge amount of clerical work. It is impossible to distinguish the gross profit and interest for each and every contract. Therefore on grounds of expediency no distinction is made between one contract and another on the one hand and the gross profit element and interest on the other. It is the combined figure of gross profit and interest for all contracts that is apportioned for each accounting period on an appropriate basis.

(a) **Book-keeping procedures.** Maintain a subsidiary book and record therein the name of article, selling price of article, number of installments to be paid etc. provide many small columns for recording the receipt of installments as and when received.

(b) At the end of the financial year, collect the following statistics from the subsidiary records;

(i) Cost price of total goods paid to various customers during the year;

(ii) Total cash received from customers;

(iii) Total installments due but not paid by customers. This happens only when there is delay an the part of customers to make payments; and

(iv) Cost price of unpaid and *not* due installments; because at the end of the year, there are always some customers from whom installments do not become due. The cost price calculated from the amount of installments unpaid and not due, gives us the cost price of the goods in the hands of the customers. This item is known as 'Stock out on hire purchase system at cost price'. The value of this item can be ascertained in three ways provided the gross profit margin is uniform.

Accounting procedure for preparing Hire-Purchase Trading Account

There are two ways in which the Hire-Purchase Trading Account may be prepared and both methods produce the same profit figures and same value of "stock out on hire at cost" for Balance Sheet purposes. The methods are (A) Stock on Hire Method and (B) Provision for stock or Provision for Unrealized Profit method.(H.P.Adjustment)

(A) Stock on Hire Method

Under this method the following accounting entries are made resulting in the preparation of Hire- Purchase Trading Account and the ascertainment of the Profit.

Transaction	DR	CR
(1) Goods sold on hire-purchase at Hire-purchase selling price	Hire-Purchase Debtors	Hire-Purchase Sales
(2) (i) Deposits and installments received from customers. (ii) -do- (Total)	Bank Hire-Purchase Sales	Hire-Purchase Debtors (Individual A/c) Hire-Purchase Trading A/ c
(3) Cost price of goods sold on hire-purchase	Hire-Purchase Trading	Purchases/ Trading
(4) (i) Installment due and unpaid (ii) -do- (Total)	Installment Due Hire-Purchase sales	Hire- Purchase Debtors Hire-Purchase Trading A/c
(5) Hire-purchase Trading profit	Hire-Purchase Trading	General Profit and Loss

Notes:

(1) The balance in the Hire-purchase Debtors Account represents amount not due and not paid on hire-purchase contracts.

(2) The balance in the Hire-purchase Sales amount will be equal to Hire-purchase Debtors. The nature of the balances is however, opposite. Therefore, these balances need not be shown in the balance sheet.

(B) Provision for Unrealized Profit Method

Under this method provision is made for the unrealized profit included in hire-purchase debtors not yet due to reduce them to the cost basis. Because of this the method is named as "Provision for unrealized profit method"

The accounting entries are:

Transaction	DR	CR
(1) Goods sold on hire-purchase at Hire-purchase selling price	Hire-purchase debtors	Hire-Purchase sales
(2) Deposits and installments received from customers.	Bank	Hire-Purchase debtors
(3) Installment due and unpaid.	Installment Due	Hire- Purchase Debtors
(4) Balance in hire-purchase sales	Hire-Purchase Sales	Hire-Purchase Trading
(5) Cost price of goods sold on hire-purchase.	Hire-Purchase Trading	Purchases/ Trading
(6) Provision for unrealized profit.	Hire-Purchase Trading	H.P. Adjustment A/c
(7) Hire-purchase Trading profit	Hire-Purchase Trading	General Profit and Loss

Notes:

(1) Formula for Provision for unrealized profit is:-

Installments not yet due / (Total Hire - purchase sales) x Total profit

(2) In the Balance Sheet balance of Hire-purchase debtors (not yet due) *minus* the provision for unrealized profit is shown under 'Current assets'

(C) Debtors System

Hire- Purchase Trading Account prepared under this system is similar to branch account prepared under the debtors system. Just as branch account gives the profit made by the branch, Hire-Purchase Trading Account also discloses the profit made through hire sales of items of small value. The logic of preparing the H.P. Trading account and the Journal entries made are similar to the preparation of branch account under the debtors system.

Meaning of some of the terms used in this system.

(a) *Hire Purchase Debtors: (Installments due and unpaid):* These are installments due in the accounting period, but not paid by the buyers of goods.

(b) *Hire-Purchase Stock.* This represents instalments from buyers are not due. These installments are payable in subsequent accounting period. This can be valued at selling or cost price . Other names to this item are 'Stock out on Hire', 'Stock with Customers' and 'Installments not due'.

(c) *Shop Stock account.* This represents the cost of goods with the Hire Vendor which have not yet been sold to Hire Purchasers.

(d) *Purchases.* This item represents the cost of goods purchased during the accounting period.

(e) *Installments paid.* This represents installments received during the accounting period and may relate to current or earlier periods.

The Accounting entries under this method are:

Transaction	DR	CR
(1) Cost price of goods sold on hire-purchase	Hire-Purchase Trading	Goods sold on H.P
(2) Installments received from customers	Bank	Hire-Purchase Trading
(3) Installment due and unpaid (at cost)	H.P. Debtors A/c	Hire-Purchase Trading
(4) Goods with customers on hire at close	Hire-Purchase Stock	Hire-Purchase Trading
(5) Hire-purchase Trading profit	Hire-Purchase Trading	General Profit and Loss

Repossessed Goods

The seller can repossess the goods *from* the buyer defaulting to make payments due under the contract. The seller is not bound to return any deposits and installments received in respect of such goods. Such goods are usually repaired or reconditioned and then sold. There are two ways of dealing with such repossessed goods. First, they can be dealt with in the framework of HP Trading account. Secondly the figures relating to such repossessed goods can be segregated and shown separately so that HP Trading account shows the normal gross profit.

First *Method*:

Under this method the installments due in respect of such repossessed goods are transferred to general profit and loss account, the entry being

General Profit and loss account Dr

To Installments due account

This entry is made at Hire-purchase price and represents abnormal loss written off to profit and loss account. Goods repossessed are valued at cost or market price whichever is less and are included in the stock and shown on the credit side of HP Trading account, the entry being:

Goods Repossessed account Dr

To Hire-Purchase Trading account

(D) Stock and debtors system

Under this system the following accounts are to be opened.

1) Hire-purchase stock account.
2) Shop stock account
3) Goods on hire purchase account
4) Hire purchase adjustment account.

And the treatments are like below.

Transaction	DR	CR
1. Cost price of goods available for hire-purchase sale.	Shop Stock	Purchase
2. Goods sold on hire Purchase during the year	a) Hire-purchase Stock b) Goods sold on hire Purchase	1) Goods sold on hire Pur b) (i) Shop Stock b(ii) H.P.Adjustment
3. Installment Due During the year	Hire-Purchase debtors	Hire-Purchase Stock
4. Installments Received in Cash	Bank	Hire Purchase Debtors
5. Loading on un-matured Installments	Hire Purchase Adjustment	Stock Reserve
6. Unpaid Installments of Repossessed Goods	Repossessed Goods	Hire Purchase Debtors
7. Balance of Hire Purchase Adjustment	Hire Purchase Adjustment	Profit and Loss

Illustration 8 : S Ltd has a hire purchase department. Goods are sold on hire purchase at cost plus 50%. The following information is provided for the year ending on 31st March 2008

	01.04.2007	31.03.2008
Stock out with Hire Purchase Customers (Rs.)	9,000	?
Stock at shop (Rs.)	18,000	20,000
Instalment Due (Customers still Paying)(Rs.)	5,000	9,000

Required : Prepare Hire Purchase Trading Account in each of the following alternative cases:

Case (a) If Cash received from hire purchasers amounted to Rs 60,000 and Goods purchased during the year amounted to Rs 60,000.

Case (b) If Cash received from hire purchasers amounted to Rs 60,000 and Goods purchased during the year amounted to Rs 60,000. Goods repossessed (Instalments due Rs 2000) valued at Rs 500 which have not been included in the Stock at shop at the end.

Case (c) If Cash received from hire purchasers amounted to Rs 60,000 and Goods purchased during the year amounted to Rs 60,000. Goods repossessed (Instalments unpaid Rs 2,000 of which Rs 1,400 were overdue) valued at Rs 500 which have not been included in the Stock at shop at the end.

Solution : ***Case (a)***

Dr. **Hire Purchase Trading Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Opening Balances:		By Hire Purchase Stock Reserve	
Hire Purchase Stock	9,000	[Rs 9,000 x 50/150]	3,000
Hire Purchase Debtors	5,000	By Bank A/c	60,000
To Goods Sold on Hire Purchase	87,000	By Goods Sold on Hire Purchase A/c	29,000
To Hire Purchase Stock Reserve A/c	10,667	[Rs 87,000 x 50/150]	
[Rs 32,000 x 50/150]		By Closing Balances :	
To Profit t/f to General		Hire Purchase Stock	32,000
P & L A/c	21,333	Hire Purchase Debtors	9,000
	1,33,000		1,33,000

Working Notes

Dr. **(i) Stop Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	18,000	By Goods Sold on Hire Purchase A/c	58,000
To Purchases	60,000	By Balance c/d	20,000
	78,000		78,000

Dr. **(ii) Goods Sold on Hire Purchase Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Stop Stock A/c	58,000	By Hire Purchase Trading A/c	87,000
To Hire Purchase Trading A/c	29,000		
	87,000		87,000

Case (b)

Dr. **Hire Purchase Trading Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Opening Balances:		By Hire Purchase Stock Reserve	
Hire Purchase Stock	9,000	[Rs 9,000 x 50/150]	3,000
Hire Purchase Debtors	5,000	By Bank A/c	60,000
To Goods Sold on Hire Purchase	87,000	By Goods Sold on Hire Purchase A/c	29,000
To Hire Purchase Stock Reserve A/c	10,000	[Rs 87,000 x 50/150]	
[Rs 30,000 x 50/150]		By Goods Repossessed A/c	500
To Profit t/f to General	20,500	[At Revalued Figure]	
P & L A/c		By Closing Balances :	
		Hire Purchase Stock	30,000
		Hire Purchase Debtors	9,000
	1,31,500		1,31,500

Working Notes

Dr. **(i) Shop Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	18,000	By Goods Sold on Hire Purchase A/c	58,,000
To Purchases	60,000	By Balance c/d	20,000
		[Excluding Goods Repossessed]	
	78,000		78,000

Dr. **(ii) Goods Sold on Hire Purchase Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Stop Stock A/c	58,000	By Hire Purchase Trading A/c	87,000
To Hire Purchase Trading A/c	29,000		
	87,000		87,000

Dr. **(iii) Memorandum Hire Purchase Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	9,000	By Hire Purchase Debtors A/c	66,000
To Goods Sold on Hire Purchase	87,000	By Balance c/d	30,000
	96,000		96,000

Dr. **(iv) Memorandum Hire Purchase Debtors Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	5,000	By Bank A/c	60,000
To Hire Purchase Stock A/c	66,000	By Goods Repossessed A/c	2,000
		By Balance c/d	9,000
	71,000		71,000

Case (c)

Dr. **Hire Purchase Trading Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Opening Balances:		By Hire Purchase Stock Reserve	
Hire Purchase Stock	9,000	[Rs 9,000 x 50 / 150]	3,000
Hire Purchase Debtors	5,000	By Bank A / c	60,000
To Goods Sold on Hire Purchase	87,000	By Goods Sold on Hire Purchase A / c	29,000
To Hire Purchase Stock Reserve A / c	10,000	[Rs 87,000 x 50 / 150]	
[Rs 30,000 x 50 / 150]		By Goods Repossessed A / c	500
To Profit t / f to General	20,500	[At Revalued Figure]	
P & L A / c		By Closing Balances :	
		Hire Purchase Stock	30,000
		Hire Purchase Debtors	9,000
	1,31,500		1,31,500

Working Notes

Dr. **(i) Shop Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b / d	18,000	By Goods Sold on Hire Purchase A / c	58,000
To Purchases	60,000	By Balance c / d	20,000
		[Excluding Goods Repossessed]	
	78,000		78,000

Dr. **(ii) Goods Sold on Hire Purchase Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Stop Stock A / c	58,000	By Hire Purchase Trading A / c	87,000
To Hire Purchase Trading A / c	29,000		
	87,000		87,000

Dr. **(iii) Memorandum Hire Purchase Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b / d	9,000	By Hire Purchase Debtors A / c	65,400
To Goods Sold on Hire Purchase	87,000	By Goods Repossessed A / c	600
		By Balance c / d	30,000
	96,000		96,000

Dr. **(iv) Memorandum Hire Purchase Debtors Account** Cr.

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	5,000	By Bank A/c	60,000
To Hire Purchase Stock A/c	65,400	By Goods Repossessed A/c	1,400
		By Balance c/d	9,000
	70,400		70,400

Illustration 9 : Mr. Gulab sells goods on hire purchase basis. He fixes hire purchase price at $33^{1/3}$%profit on invoice price of the goods. The following are the fugures relating to his hire purchase business for the year ending on 31st March 2008 :

	01.04.2007	31.03.2008
	Rs	Rs
Hire Purchase Stock	60,000	?
Hire Purchase Debtors	1,500	?
Shop Stock	50,000	75,000

Goods purchased during the year Rs 3,27,000, Cash received from customers during the year Rs 4,62,000. Total amount of instalments that fell due during the year Rs 4,63,500.

One customer to whom goods had been sold for Rs 6,000 paid only 5 instalments of Rs 500 each. On his failure to pay the monthly instalment of Rs 500 each on 4th March 2008, the goods were repossessed on 27th March 2008 after due legal notice.

Required : Prepare the Hire Purchase Trading Account.

Solution :

Dr. **Hire Purchase Trading Account** Cr.

Particulars	*Rs*	*Particulars*	*Rs*
To Opening Balances:		By Hire Purchase Stock Reserve	
Hire Purchase Stock	60,000	[60,000 x 50/150]	20,000
Hire Purchase Debtors	1,500	By Bank A/c	4,62,000
To Goods Sold on Hire Purchase	4,53,000	By Goods Sold on Hire Purchase A/c	1,51,000
To Hire Purchase Stock Reserve A/c	15,500	[4,53,000 x 50/150]	
[46,500 x50/150]		By Goods Repossessed A/c	2,333
To Profit t/f to General		[At Revalued Figure]	
P & L A/c	1,54,333	By Closing Balances :	
		Hire Purchase Stock	46,500
		Hire Purchase Debtors	2,500
	6,84,333		6,84,333

Working Notes

Dr. **(i) Shop Stock Account** Cr.

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	50,000	By Goods Sold on Hire Purchase A/c	3,02,000
To Purchases	3,27,000	By Balance c/d	75,000
		[Excluding Goods Repossessed]	
	3,77,000		3,77,000

Dr. **(ii) Goods Sold on Hire Purchase Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Stop Stock A/c	3,02,000	By Hire Purchase Trading A/c	4,53,000
To Hire Purchase Trading A/c	1,51,000		
	4,53,000		4,53,000

Dr. **(iii) Memorandum Hire Purchase Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	60,000	By Hire Purchase Debtors A/c	4,63,500
To Goods Sold on Hire Purchase	4,53,000	By Goods Repossessed A/c	3,000
		By Balance c/d	46,500
	4,65,000		4,65,000

Dr. **(iv) Memorandum Hire Purchase Debtors Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	1,500	By Bank A/c	4,62,000
To Hire Purchase Stock A/c	4,63,500	By Goods Repossessed A/c	500
		By Balance c/d	2,500
	4,65,000		4,65,000

Working Note :

Calculation of the value of Goods Repossossed Value of Goods Repossessed

$$= \frac{\text{Cost Price}}{\text{H.P. Price}} \quad \text{Unpaid Amount (whether due or not)}$$

$$= \frac{4,000}{6,000} \quad 3,500 = 2,333/-$$

Illustration 10 : Goods amounting to Rs 6,23,988 at hire purchase price were sold on hire purchase system. The hire-vendor normally sells goods at retail price showing a gross profit of 30% on that price. But when goods are sold on hire-purchase, he adds 5 per cent to retail price to cover additional risk. During the year goods costing Rs 42,000 were repossessed for non-receipt of any payment on them. These goods were valued at cost on 31 March. Cash received from customers amounted to Rs 2,52,000.

Required : Prepare Hire Purchse Trading Account for the year ending on 31st March, 2008, so that profits to be taken into account is such proportion of the profits as instalments due bear to the total goods sold on hire-purchase.

Solution :

Dr. **Hire Purchase Trading Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Opening Balances:		By Bank A/c	2,52,000
Hire Purchase Stock	–	By Goods Sold on Hire Purchase A/c	2,07,996
Hire Purchase Debtors	–	[Rs 6,23,988 x35/105]	
To Goods Sold on Hire Purchase	6,23,988	By Goods Repossessed A/c	42,000
To Hire Purchase Stock Reserve A/c	1,02,996	By Closing Balances :	
[Rs 3,08,988 x 35/105]		Hire Purchase Stock	3,08,988
To Profit t/f to General	84,000	Hire Purchase Debtors	–
P & L A/c			
	8,10,984		8,10,984

Working Notes

Dr. **(i) Memorandum Hire Purchase Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	–	By Hire Purchase Debtors A/c	3,15,000
To Goods Sold on Hire Purchase	6,23,988	By Balance c/d	3,08,988
	6,23,988		6,23,988

Dr. **(ii) Memorandum Hire Purchase Debtors Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	–	By Bank A/c	2,52,000
To Hire Purchase Stock A/c	3,15,000	By Goods Repossessed A/c	63,000
		[Rs 42,000 x 105/70]	
		By Balance c/d	–
	3,15,000		3,15,000

Note: Retail Price of the goods = 100 + 5 = 105. So, Loading is calculated as 35/105.

Illustration 11 : Considering the same information as given in Illustrtion 8, prepare Shop Stock Account,Goods Sold on Hire Purchase Account, Hire Purchase Stock Account, Hire Purchase Debtors Account, Hire Purchase Adjustment Account.

Case(a)

Dr. **(i) Shop Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	18,000	By Goods Sold on Hire Purchase A/c	58,000
To Purchases	60,000	By Balance c/d	20,000
	78,000		78,000

Dr. **(ii) Good Sold on Hire Purchase Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Shop Stock A/c	58,000	By Hire Purchase Stock A/c	87,000
To Hire Purchase Adjustment A/c	29,000		
	87,000		87,000

Dr. **(iii) Hire Purchase Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	9,000	By Hire Purchase Debtors A/c	64,000
To Goods Sold on Hire Purchase A/c	87,000	By Balance c/d (b.f.)	32,000
	96,000		96,000

Dr. **(iv) Hire Purchase Debtors Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	5,000	By Bank A/c	60,000
To Hire Purchase Stock A/c	64,000	By Balance c/d	9,000
	69,000		69,000

Dr. **(v) Hire Purchase Adjustment Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Hire Purchase Stock Reserve A/c	10,667	By Hire Purchase Stock Reserve A/c	
[32,000 x 50/150]		[9,000 x 50/150]	3,000
To Profit t/f to Profit & Loss A/c	21,333	By Goods Sold Hire Purchase A/c	
		[87,000 x 50/150]	29,000
	32,000		32,000

Case (b)

Dr. **(i) Shop Stock Account** Cr.

Particulars	Rs	Particulars	Rs
To Balance b/d	18,000	By Goods Sold on Hire Purchase A/c	58,000
To Purchases (b.f.)	60,000	By Balance c/d	
		[Excluding Goods Repossessed]	20,000
	78,000		78,000

Dr. **(ii) Good Sold on Hire Purchase Account** Cr.

Particulars	Rs	Particulars	Rs
To Shop Stock A/c	58,000	By Hire Purchase Stock A/c	87,000
To Hire Purchase Adjustment A/c	29,000		
	87,000		87,000

Dr. **(iii) Hire Purchase Stock Account** Cr.

Particulars	Rs	Particulars	Rs
To Balance b/d	9,000	By Hire Purchase Debtors A/c	66,000
To Goods Sold on Hire Purchase A/c	87,000	By Balance c/d (b.f.)	30,000
	96,000		96,000

Dr. **(iv) Hire Purchase Debtors Account** Cr.

Particulars	Rs	Particulars	Rs
To Balance b/d	5,000	By Bank A/c	6,0,000
To Hire Purchase Stock A/c	6,6,000	By Goods Repossessed A/c	2,000
		By Balance c/d	9,000
	71,000		71,000

Dr. **(v) Hire Purchase Adjustment Account** Cr.

Particulars	Rs	Particulars	Rs
To Hire Purchase Stock Reserve A/c	10,000	By Hire Purchase Stock Reserve A/c	
[30,000x50/150]		[9,000 x 50/150]	3,000
To Goods on Repossessed A/c	1,500	By Goods Sold on Hire Purchase A/c	
[Loss on Repossession]		[87,000 x 50/150]	29,000
[2,000 – Rs 500]			
To Profit t/f to Profit & Loss A/c	20,500		
	32,000		32,000

Case (c)

Dr. **(i) Shop Stock Account** Cr.

Particulars	Rs	Particulars	Rs
To Balance b/d	18,000	By Goods Sold on	
To Purchases (b.f.)	60,000	Hire Purchase A/c (b.f.)	58,000
		By Balance c/d	20,000
		[Excluding Goods Repossessed]	
	78,000		78,000

Dr. **(ii) Good Sold on Hire Purchase Account** Cr.

Particulars	Rs	Particulars	Rs
To Shop Stock A/c	58,000	By Hire Purchase Stock A/c (b.f.)	87,000
To Hire Purchase Adjustment A/c	29,000		
	87,000		87,000

Dr. **(iii) Hire Purchase Stock Account** Cr.

Particulars	Rs	Particulars	Rs
To Balance b/d	9,000	By Hire Purchase Debtors A/c	65,400
To Goods Sold on Hire Purchase A/c	87,000	By Goods Repossessed A/c	600
		By Balance c/d (b.f.)	30,000
	96,000		96,000

Dr. **(iv) Hire Purchase Debtors Account** Cr.

Particulars	Rs	Particulars	Rs
To Balance b/d	5,000	By Bank A/c	60,000
To Hire Purchase Stock A/c	65,400	By Goods Repossessed A/c	1,400
		By Balance c/d	9,000
	70,400		70,400

Dr. **(v) Hire Purchase Adjustment Account** Cr.

Particulars	Rs	Particulars	Rs
To Hire Purchase Stock Reserve A/c	10,000	By Hire Purchase Stock Reserve A/c	
[30,000 x 50/150]		[9,000 x 50/150]	3,000
To Goods on Repossessed A/c	1,500	By Goods Sold on Hire Purchase A/c	
[Loss on Repossession]		[87,000 x 50/150]	29,000
To Profit t/f to Profit & Loss A/c	20,500		
	32,000		32,000

Illustration 12 : Capital Electronics sold a colour TV set to X on hire purchase system on 1.1.2008 for Rs 18,400 *X* paid Rs 4,000 on the same date to receive the delivery of the TV set and agreed to pay the balance in 12 equal monthly instalments, each instalment becoming due on the last date of each month. *X* paid six instalments in time but failed to pay other instalments. In September 2008 (before the monthly instalment has become due) the seller repossessed the TV set. The repossessed set was valued at Rs 7,000.
Required : Show the necessary ledger accounts (on the basis of Stock and Debtors system) in the books of Capital Electronics.

Solution :

Dr. **(i) Hire Purchase Stock Account** Cr.

Particulars	Rs	Particulars	Rs
To Balance b/d	–	By Hire Purchase Debtors A/c	13,600
To Goods Sold on H. P. A/c	18,400	By Goods Repossessed A/c (1200x4)	4,800
		(Instalment not yet due)	
		By Balance c/d	–
	18,400		18,400

Dr. **(ii) Hire Purchase Debtors Account** Cr.

Particulars	Rs	Particulars	Rs
To Balance b/d	–	By Cash A/c/Bank A/c	
To Hire Purchase Stock A/c	13,600	[4000 + (1,200 x 6)]	11,200
		By Goods Repossessed A/c(1,200x2)	2,400
		(Instalment due but not paid)	
		By Balance c/d	–
	13,600		13,600

Dr. **(iii) Goods Repossessed Account** Cr.

Particulars	Rs	Particulars	Rs
To Hire Purchase Stock a/c	4,800	By Hire Purchase Adjustment A/c	200
To Hire Purchase Debtors A/c	2,400	By Balance c/d	7,000
	7,200		7,200

Dr. **(iv) Hire Purchase Adjustment Account(extracts)** Cr.

Particulars	Rs	Particulars	Rs
To Goods Repossessed A/c	200		

Illustration 13 : Trans Co. records transactions relating to its hire purchase business on Stock & Debtors System, It sold to Rasheed a Handicam (Cost Rs 27,000) for which Rasheed was required to pay in all Rs 36,000 in the form of 12 monthly instalments of Rs 3,000 each. Rasheed paid four instalments in time but thereafter stopped paying instalments. Trans Co. after the seventh instalment, had also become due (but before the eight instalment had fallden due) repossessed the tape recorder. Trans Co. spent Rs. 2000 on reconditioning of the tape recorder and sold the same for Rs 30,000

Required : Give the necessary journal entries relating to Goods repossessed and prepare the Goods Repossessed Account.

Case (a) If the repossessed tape recorder was valued at Rs 19,500.

Case (b) If no other information is given.

Solution :

Case (a)

Journal

Particulars		Dr. (Rs)	Cr. (Rs)
Goods Repossessed A/c	Dr.	24,000	
To Hire Purchase Stock A/c			15,000
To HIre Purchase Debtors A/c			9,000
(Being 5 instalments not yet due credited to H.P. Stock A/c, 3 instalments due but not paid, credited toHire Purchase Debtors A/c)			
Hire Purchase Adjustment A/c	Dr.	4,500	
To Goods Repossessed A/c			4,500

Being the repossessed goods valued at Rs 19,500 and thus, the difference (i.e. Rs 19,500 – Rs 24,000) being debited to Hire Purchase Adjustment Account)			
Goods Repossessed A/c	Dr.	6,000	
To Bank A/c			6,000
(Being the reconditioning charges paid)			
Bank A/c	Dr.	30,000	
To Goods Repossessed A/c			30,000
(Being the repossessed goods sold)			
Goods Repossessed A/c	Dr.	4,500	
To Hire Purchase Adjustment A/c			4,500
(Being the profit on sale of repossessed goods transferred)			

Dr. **Goods Repossessed Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Hire Purchase Stock A/c	15,000	By Hire Purchse Adjustment A/c	4,500
To Hire Purchased Debtors A/c	9,000	By Balance c/d	19,500
	24,000		24,000
To Balance b/d	19,500	By Bank A/c (Sale proceeds)	30,000
To Bank A/c (Expenses)	6,000		
To Hire Purchase Adjustment A/c	4,500		
	30,000		30,000

Case (b) **Journal**

Particulars		*Dr, (Rs)*	*Cr. (Rs)*
Goods Repossessed A/c	Dr.	24,000	
To Hire Purchase Stock A/c			15,000
To Hire Purchase Debtors A/c			9,000
(Being 5 instalments not yet due credited to H.P. Stock A/c, 3 instalments due but not paid, credited to Hire Purchase Debtors A/c)			
Hire Purchase Adjustment A/c	Dr.	6,000	
To Godds Repossessed A/c			6,000
(Being the repossessed goods valued at theoretical cost of Rs 6,000 and thus, the difference (i.e. Rs 18,000 – Rs 24,000) being debited to Hire Purchase Adjustment Account) [*Refer Note*]			
Goods Repossessed A/c	Dr.	6,000	
To Bank A/c			6,000
(Being the reconditioning charges paid)			
Bank A/c	Dr.	30,000	
To Goods Repossessed A/c			30,000
(Being the repossessed goods sold)			
Goods Repossessed A/c	Dr.	6,000	
To Hire Purchased Adjustment A/c			6,000
(Being the profit on sale of repossessed goods t/f)			

Working Note : Calculation of the Value of goods repossessed

$$\text{Value of goods repossessed} = \frac{\text{Cost Price}}{\text{H.P. Price}} \text{ X Unpaid amount (whether due or not)}$$

$$= \frac{\text{Rs. } 27{,}000}{\text{Rs. } 36{,}000} \text{ X Rs. } 24{,}000 = \text{Rs. } 18{,}000$$

Dr. **Goods Repossessed Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Hire Purchase Stock A/c	15,000	By Hire Purchse Adjustment A/c	6,000
To Hire Purchased Debtors A/c	9,000	By Balance c/d	18,000
	24,000		24,000
To Balance b/d	18,000	By Bank A/c (Sale proceeds)	30,000
To Bank A/c (Expenses)	6,000		
To Hire Purchase Adjustment A/c	6,000		
	30,000		30,000

Illustration 14 : The hire purchases department of Zapak Ltd provides you the following information for the year ending on 30th September 2008 :

Purchase cost per unit	Rs	3,000
Cash sales price per unit	Rs	4,000
Cash down payment per unit	Rs	400
Monthly payment per unit	Rs	350
Number of instalments per unit		12
Number of units sold on hire purchase basis		120
Number of instalments collected		420
Nuber of instalments due but not yet collected		58

Required : Calculate the following :

(a) Number of instalments fallen due during the year, (b) Number of instalments not yet due on 30. 9. 2008, (c) Amount of instalment not yet due, (d) Amount of istalment due but not yet collected, (e) Amount fallen due during the year, (f) Cash collected during the year, (g) Hire Purchase price per unit, (h) Total hire purchase price of units sold, (i) Total cost price of units sold on hire purchase, (j) % of profit margin on H.P. Sales, (k) Profit included in total hire purchases price, (l) Profit included in the amount of instalments not yet due, (m) Gross Profit.

Also Prepare Hire Purchase Stock Account, Hire Purchases Debtors Account and Hire Purchase Adjustment Acount.

Solution :

Step 1 **Prepare the Analysis of No. of Instalments**

Total No. of Instalments = No. of Units sold   Total No. of Instalments Payable

= 120   12 = 1440

Again, Total No. of instalments = Instalment Due + Instalments not Due

Where, **Instalments Due** = Instalments Received + Instalments not received = 420 + 58 = 478

Instalments Not Due = Total No of Instalments – Instalments Due
= 1440 – 478 = 962 (Balancing Figure)

Step 2 Prepare the Analysis of Total Hire Purchase Price
Total Hire Purchase Price = No. of Units sold   H.P. Selling price per unit
= 120   4,600 = Rs. 5,52,000
Again, **Total Hire Purchase Price=Down Payment received+ Instalments Receivable**

Down Payment Received = No. of units sold   Down Payment per unit
= 120   Rs. 400 = Rs. 48,000
Instalments Receivable = 1,440   Rs. 350 = Rs. 5,04,000

Again, **Instalments Receivable=Instalments Due +Instalments not Due**

Where, **Instalments Due** = 478   Rs. 350 = Rs. 1,67,300
Instalments Not Due = 962   Rs. 350 = Rs. 3,36,700

Again, **Instalments Due= Instalments due & received + Instalments due but not received**

Where, Instalments due & received = 420 x 350 = 1,47,000
Instalments due but not received = 58   Rs. 350 = Rs. 20,300

Let us answer the given questions on the basis of above :

(a) Number of Instalments fallen due = 478

(b) Number of Instalments not yet due = 962

(c) Amount of Instalments not yet due = Rs. 3,36,700

(d) Amount of Instalments due but not yet collected = Rs. 20,300

(e) Total Amount fallen due = Down Payment + Instalments due
= Rs. 48,000 + Rs. 1,67,300 = Rs. 2,15,300

(f) Total Cash Collected = Down Payment + Instalments due and received
= Rs. 48,000 + Rs. 1,47,000 = Rs. 1,95,000

(g) Hire Purchase Price per unit = Down Payment / Unit + Amount of Instalment / Unit
= Rs. 400 + (Rs. 350   12) = Rs. 4,600

(h) Total Hire Purchase Price = Rs. 5,52,000

(i) Total Cost Price of Units sold on H.P. = No. of Units sold Cost per unit
= 120   Rs. 3,000 = Rs. 3,60,000

(j) % of Profit Margin on H.P. Sales =[{(H. P. Price - Cost Price) / H. P. Price} (100)]

= [{(4,600 - 3,000) / 4,600} (100)]

= 34.78%

(k) Profit included in Total Hire Purchase P = [{(4,600 - 3,000) / 4,600} (5,52,000)]

(l) Profit included in the Total Amount of Instalments not yet due

= [{(4,600 - 3,000) / 4,600} (3,36,700)]

= 1,17,113

(m) Gross Profit on Hire Purchase Sales = % of Profit Margin Total Amount fallen due

= [{(4,600 – 3,000) / 4,600} (2,15,300)]

= 74,887

Dr. **(i) Hire Purchase Stock Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	–	By Hire Purchase Debtors A/c	2,15,300
To Goods Sold on Hire Purchase A/c	5,52,000	By Balance c/d	3,36,700
	5,52,000		5,52,000

Dr. **(ii) Hire Purchase Debtors Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Balance b/d	–	By Bank A/c	1,95,000
To Hire Purchase Stock A/c	2,15,300	By Balance c/d	20,300
	2,15,300		2,15,300

Dr. **(iii) Hire Purchase Adjustment Account** *Cr.*

Particulars	*Rs*	*Particulars*	*Rs*
To Hire Purchase Stock Reserve A/c [3,36,700 x 1,600/4,600]	1,17,113	By Goods Sold on Hire Purchase A/c [5,52,,000 x 1,600/4,600]	1,92,000
To Profit t/f to Profit & Loss A/c	74,887		
	1,92,000		1,92,000

STUDY NOTE 3

ACCOUNTING FOR NON-PROFIT SEEKING ORGANISATIONS

This study note includes -

- Final Accounts and Balance Sheet of Non-Profit Seeking Concerns

3.1. FINAL ACCOUNTS AND BALANCE SHEET OF NON-PROFIT SEEKING CONCERNS

Certain concerns like Clubs, Charitable Institutions, Medical Association, Societies, etc. do not intend to earn profit. They render service to the society or to their members. Their members do not get any share of profit or dividend. These concerns are known as non-profit concerns as their transactions are service-based but not profit-based.

Their annual accounts are regularly prepared to convey their financial affairs to their members or others like (govt. etc.) for seeking financial grants. If the size of the concern is small, the accounting records are usually kept under single entry system. Complete double entry system is followed only in big concerns. In any case they all prepare — (A) Receipts & Payments Account for a financial period; (B) Income & Expenditure Account for a financial period and *(C)* Balance Sheet at the end of the financial period.

A. Receipts & Payments Account

1. It is an Account which contains all Cash and Bank transactions made by a non-profit organization during a particular financial period.

2. It starts with the opening balances of Cash and Bank. All Cash Receipts both capital & revenue during the period are debited to it.

3. All Cash Payments both capital & revenue during the period are credited to this Account. It ends with the closing Cash and Bank Balances.

4. While recording the Cash and Bank transactions all entries are made on Cash Basis.

5. It is a summary of Cash Book.

6. It follows Real Account

PROFORMA RECEIPTS & PAYMENTS ACCOUNT

In the Books of ....
Receipts & Payments Account for the year ended........

Dr. **Cr.**

Receipts	Amount Rs.	Amount Rs.	Payments	Amount Rs.	Amount Rs.
To Balanceb/d			**By Sundry**		
Cash in hand		**xxx**	**Payments**		**xxx**
Cash at Bank		**xxx**	**(Both Capital &**		
			Revenue)		
To Sundry Receipts		**xxx**	**By Balancec/d**		
(Both Capital &Revenue)			**Cash in hand**		**xxx**
			Cash at Bank		**xxx**
		xxx			**xxx**

B. Income & Expenditure Account

1. It follows Nominal Account.

2. All expenses of revenue nature for the particular period are debited to this Account on accrual basis.

3. Similarly all revenue incomes related to the particular period are credited to this account on accrual basis.

4. All Capital incomes and Expenditures are excluded.

5. Only current year's incomes and expenses are recorded. Amounts related to other periods are deducted. Amounts outstanding for the current year are added.

6. Profit on Sale of Asset is credited. Loss on Sale of Asset is debited. Annual Depre ciation on Assets is also debited.

7. If income is more than expenditure, it is called a Surplus, and is added with Capital or General Fund etc. in the Balance Sheet.

8. If expenditure is more than in come, it is a deficit, and is deducted from Capital or General Fund etc. in the Balance Sheet.

PROFORMA INCOME & EXPENDITURE ACCOUNT

In the Books of ....
Income & Expenditure Account for the year ended........

Dr. **Cr.**

Expenditure	Amount Rs.	Amount Rs.	Income	Amount Rs.	Amount Rs.
To Revenue Expenses		**xxx**	**By Revenue Incomes**		**xxx**
To Surplus (Excess of Income over Expenditure			**By Deficit (Excess of Expenditure over Income**		**xxx**
		xxx			**xxx**

C. Balance Sheet

The Balance Sheet is prepared in the similar way as followed in a Trading concern. The marshalling of the assets and liabilities may be made in order of liquidity or in order of permanence.

Calculation of opening capital Fund : (If not mentioned)

Opening Capital Fund = Openeng Assets - Opening Liabilites.

Distinction between Receipts & Payment Account and Income & Expenditure Account

	Receipts & Payments Account		**Income & Expenditure Account**
1	It is a summarised Cash Book.		It closely resembles the Profit & Loss Account of a Trading concern.
2.	Receipts are debited and Payments are credited.		Incomes are credited and Expenditures are debited.
3.	Transactions are recorded on Cash basis.		Transactions are recorded on Accrual basis
4.	Amounts related to previous period or future period may remain included. Outstanding amount for current year is excluded.		Transactions are recorded on accrual basis. All amounts not related to the current period are excluded. Outstanding amounts of current period are added.
5.	It records both Capital and Revenue transactions.		It records of Revenue transactions only.
6.	It serves the purpose of a Real Account.		It serves the purpose of a Nominal Account.
7.	It starts with opening Cash and Bank Balances and ends with closing Cash and Bank Balances.		It does not record such balances,rather its final balance shows a surplus or a deficit for the period.
8.	It does not record notional loss or non-cash expenses like bad debts, depreciations etc.		It considers all such expenses for matching against revenues
9.	Its closing balance is carried forward to the same account of the next accounting period.		Its closing balance is transferred to Capital Fund or General Fund or Accumulated Fund in the same period's Balance Sheet.
10.	It helps to prepare an Income & Expenditure A/c.		It helps to prepare a Balance Sheet.

Some Important Considerations

1 ***Capital Fund*** **:** It is also called "General Fund" or "Accumulated Fund." It is actually the Capital of a non-profit concern. It may be found out as the excess of assets over liabilities. Usually "Surplus" or "Deficit" during a period is added with or deducted from it. A portion of Capitalised incomes like donations may be added with it.

2. ***Special Fund:*** It may be created out of special donation or subscription or out of a portion of the "Surplus". For example a club may have a "Building Fund". It may be used for meeting some specific expenses or for acquiring an asset. If any income is derived out of investments made against this fund or if any profit or loss occurs due to sale of such investments, such income or profit or loss is transferred to this fund.

Other Treatments

(a) If the Special Fund is used to meet an expense

Special Fund A / c **Dr.**

To Bank A / c (amt. of expense)

The balance of the Fund is shown as a liability.

If the balance is transferred to Capital Fund, the entry will be—

Special Fund A / c **Dr.**

To Capital Fund A / c (Balance of Special Fund)

(b) *If the Special Fund is used to purchase an asset*

Asset A / c **Dr.**

To Bank A / c (Cost of the asset)

Special Fund A / c **Dr.**

To Capital Fund A / c (Special Fund closed)

3. ***Donations***

(a) Donation received for a particular purpose should be credited to Special Fund. For example, Donation received for Building should be credited to Building Fund A / c.

(b) For other donations received the by-laws or rules of the concern should be followed.

(c) If there is no such rule, donations received of non-recurring nature should be credited to Capital Fund. Recurring donations received should be credited to Income & Expenditure Account.

(d) Donation paid by the concern should be debited to Income & Expenditure Account.

4. ***Legacy received*** : It is to be directly added with Capital Fund after deduction of tax,(if any). It is a kind of donation received according to the will made by a deceased person.

5. ***Entrance Fees or Admission Fees***

(a) The rules or by-laws of the concern should be followed.

(b) If there is no such rule, Admission or Entrance Fees paid once by members for acquiring membership should be added with Capital Fund.

(c) If such fees are of small amounts covering the expenses of admission only, the fees may be credited to Income & Expenditure Account.

6. ***Subscriptions***

(a) Annual subscriptions are credited to Income & Expenditure Account on accrual basis.

(b) Life membership subscription is usually credited to a separate account shown as a liability. Annual Subscription apportioned out of that is credited to Income & Expenditure Account and deducted from the liability. Thus the balance is carried forward till the contribution by a member is fully exhausted. If any mem ber dies before hand, the balance of his life Membership contribution is trans ferred to Capital Fund or General Fund.

Illustration 1 :

Special Points : (a) Preparation of Income & Expenditure Account and calculation of Closing Capital Fund; (b) Loss on Sale of Asset; (c) Donation to a Specific Fund.

The following is the Receipts and Payments Account of a Club for the year ended 31st December, 2007 ***Receipts*** Cash in hand (1.1.07) Rs. 1,000; Cash at Bank **(1.1.07)** Rs. 4,000; Donation for Building

Rs. 10,000; Sale of Furniture (Balance on **1.1.07** Rs. 100) Rs. 80; Sale of Newspapers Rs. 200; Subscriptions Rs. 20,000.

Payments : Sports Materials Rs. 2,500; Salaries Rs. 3,250; Furniture Rs. 1,600;Newspapers Rs. 500

Building Fund Investment Rs. 10,000; Tournament Expenses **Rs.** 11,000; Postage Rs. 200; Cash in hand (closing balance) Rs. 1,030;Cash at Bank (Closing Balance) Rs. 5,200.

The following adjustments are to be made

Of the Subscriptions collected Rs. 2,000 was outstanding for 2006; (ii) on 1.1.07 Stock of Raw Materials was Rs. 500 and 31.12.07 it was Rs. 700.

Prepare the Income and Expenditure Account for the year ended 31st December,2007 and show the Capital Fund of the Club as on that date.

Solution:

Dr . **Income & Expenditure Account for the year ended 31.12.2007** Cr.

Expenditure	Amount Rs.	Amount Rs.	Income	Amount Rs.	Amount Rs.
To Salaries		3,250	By Subscription	20,000	
,, Purchase of Newspapers		500	*Less* :Received		
			for last year	2,000	18,000
,, Tournament Expenses		11,000	By Sale of old		
			Newspapers		200
,, Postage		200			
,, Use of Sports Materials					
Opening Stock	500				
Add: Purchase	2500				
	3,000				
Less : Closing Stock	700	2,300			
,,Loss on Sale of Furniture					
[100 — 80]		20			
,,Surplus (Excess of Income					
over Expenditure)		930			
		18200			18,200

Statement Showing Capital Fund as on 31.12.07

	Amount Rs.	Amount Rs.
Assets as on 1.1.07		
Cash in hand	1,000	
Cash at Bank	4,000	
Furniture	100	
Sports Material Subscriptions	500	
Outstanding for 2006	2000	7,600
Less : Liabilities on 1.1.07		Nil
Capital Fund on 1.1.07		7600
Add : Surplus for the year ended on 31.12.07		930
Capital Fund on 31.12.07		8,530

Notes

(a) Donation Received for Building should be credited to Building Fund Account

(b) Both opening and closing stocks of Sports Materials is given. So the use or consumption of sports materials during the year has been debited to I & E ***Account.***

Illustration 2 : The Dreamers' Club makes up its accounts to 31st December in each year. On 31st December, 2007 the cashier of the club absconded leaving behind no information or cash. An examination of the records showed that the books had not been written up for a considerable time and it was decided to reconstruct the figures from 1.1.2007.

A summary of the Bank Account for the year showed that :

Receipts	Amt. Rs.	Payments	Amt. Rs.
Balance on 1.1.2007	420	Rent & Rates	460
Bank Deposits	42,610	Insurance	40
		Light & Heat	156
		Bar Purchases	35,067
		Telephone	59
		Cash Withdrawn	5,848
		Balance as on31.12.07	1,400
	43,030		43,030

The following information is also obtained :

I. The Barman places takings in the bank night safe on his way home for crediting to the club account. The bartakings totalled Rs. 44,610 for the year. The treasurer had no access to bar takings.

2. The receipt counterfoils for members subscriptions totaled Rs. 3,050 for the year.

3. A summary of expenditure for petty cash and wages revealed Glasses, crockery main tenance— Rs. 1,310; Wages—Rs. 2,650; Sundry Expenses—Rs. 475

4. Outstanding or Prepaid Amounts were :

	31.12.06	31.12.07
Prepaid Rates	Rs. 26	Rs. 28
Outstanding Expenses	Rs. 64	Rs. 100

The Bar Stock on 1.1.2007 was Rs. 3,607 and 31.12.07 Rs. 2,916. Opening Cash with the Cashier at the beginning of the year 2007 was Rs. 35 only.

Prepare an Income & Expenditure Account of the club for the year ended 31.12.2007.

Working Notes:

1. Cash Defalcation by Cashier :

Dr. **Cash Account**

Particulars	Amount Rs.	Particulars	Amount Rs.
To Balance b/f	35	By Bank [Difference in deposited amount 44,610 — 42,610)	2,000
Subscriptions	3,050	Glasses, Crockery etc.	1,310
Bank (Withdrawals from Bank)	5,848	Wages	2,650
		Sundry Expenses	475
		Defalcation of Cash (Balance Figure)	2,498
	8,933		8,933

2.Rent & Rates

	Rs.
Paid from Bank	460
+ Prepaid as on 31.12.06 (relating to current year)	26
	486
— Prepaid Rates as on 31.12.07(relating to next year)	28
	458

Dr. **Bar Trading Account for the year ended 31.12.07** Cr.

Particulars	Amt. Rs.	Particulars	Amt. Rs.
To Opening Stock	3,607	By Bar takings	44,610
To Purchases	35,067		
To Income &		By Closing Stock	2,916
Expenditure A/c	8,852		
Profit of the bar transferred			
	47,526		47,526

Dreamers' Club

Dr. Income and Expenditure Account for the year ended 31.12.2007 Cr.

Particulars	Amount Rs.	Amount Rs.	Particulars	Amount Rs.	Amount Rs.
To Rent & Rates [Note 2]		458	By Subscriptions		3,050
" Insurance		40	By Bar Trading A/c		
			(Profit from Bar)		8,852
Light & Heat		156			
Telephone Charges		59			
" Glass and Crockery		1,310			
Maintenance					
" Wages		2,650			
" Sundry Expenses	475				
Add Outstanding for '07	100				
	575				
Less : Outstanding for '06	64	511			
'' Defalcation of Cash		2,498			
" Surplus (Excess of Income over expenditure)		4,220			
		11,902			11,902

Illustration 3 :

(a) Preparation of Receipts & Payments Account and Balance Sheet from Income & Expenditure Account and other information; (b) Opening Cash balance not given

Joggers Club

Income & Expenditure Account for the year ended 31.12.2007

Dr. Cr.

Expenditure	Amt. Rs.	Income	Amt. Rs.
To Salaries	47,500	By Subscriptions	75,000
" General Expenses	5,000	" Entrance Fees	2,500
" Audit Fees	2,500	" Contribution for Annual Dinner	10,000
" Secretary's Honorarium	10,000	" Profit on Annual Sports	7,500
" Printing & Stationery	4,500		
" Annual Dinner Expenses	15000		
" Interest and Bank Charges	1,500		
Depreciation on Sports " Equipments	3,000		
" Surplus (excess of income over expenditure)	6,000		
	95,000		95,000

The account had been prepared after the following adjustments : Subscriptions outstanding at the end of 2006—Rs. 6,000; Subscriptions received in advance on 31.12.2006—Rs. 4.500; Subscriptions received in advance on 31.12.2007—Rs. 2,700; Subscriptions outstanding on 31.12.2007—Rs. 7,500

Salaries outstanding at the beginning of '07 and at the end of '07 were respectively Rs. 4,000 and Rs. 4,500. General expenses include insurance prepaid to the tune of Rs. 600. Audit Fee for 2007 is as yet unpaid. During 2007 Audit Fees for 2006 amounting to Rs. 2,000 was paid.

The club owned a football ground valued at Rs. 1,00,000. It had Sports Equipments of Rs. 26,000 on 1.1.2007. On 31.12.2007 such Sports Equipments after depreciation amounted to Rs. 27,000. In 1994 the club raised a bank loan of Rs. 20,000 which remained outstanding throughout 2007. On 31st December, 2007Cash in hand amounted to Rs. 16,000.

Prepare the Receipts & Payments Account for the year ended 2007 and a Balance Sheet as on 31.12.2007.

Solution :

Working Note :

1. Subscription Received in Cash

Dr. Subscription Account Cr

Particulars	Amount Rs	Particulars	Amount Rs.
To Subscription receivable A/c (Opening Balance as on 1.1.07	6,000	By Subscription received in Advance A/c (Opening Balance as on 1.1.07	4,500
To Income & Expending A/c (Income for the year given)	75,000	By Bank A/c (received during the year-balancing figure	71,700
To Subscription received in advance Closing balance as on 31.12.07	2,700	By Subscription receivable closing balance as on 31.12.07	7,500
	83,700		83,700

2. Purchase of Sports Equipment

Dr. Sports Equipments Account Cr.

Particulars	Amount Rs.	Particulars	Amount Rs
To Balance b/d	26,000	By Depreciation	3,000
To Cash (Purchases Balance Figure)	4000	" Balance c/d	27,000
	30,000		30,000

3. Salaries Paid by Cash

Dr. Salary Account Cr.

Particulars	Amount Rs.	Particulars Rs.	Amount
To Cash A/c (Balancing figure- paid during the year)	47,000	By Outstanding salary A/c (as on 1.1.07)	4,000
To Outstanding salary A/c (as on 31.12.07	4,500	By Income & expenditure A/c (given)	47,500
	51,500		51,500

4. Capital Fund on 1.1.2007

Balance Sheet as at 1.1.2007

Liabilities	Amount Rs.	Assets	Amount Rs.
Outstanding Audit Fees	2,000	Cash in hand	13,900
Outstanding Salaries	4,000		
Subscription Received in Adv.	4,500	Outstanding Subscription	6,000
Bank Loan	20,000	Sports Equipments	26,000
Capital Fund (Excess of		Football Ground	1,00,000
Assets over Liabilities)	1,15,400		
(B-fig)	1,45,900		1,45,900

Joggers Club

Receipts & Payments Account for the year ended 31.12.2007

Dr. Cr.

Receipts	Amount Rs.	Payments	Amount Rs.
To Cash in hand	13,900	By Salaries [Note 3]	47,000
(B-fig)		" General Expenses (5,000 + 600)	5,600
" Subscription [Note 1]	71,700	" Audit Fees (2006)	2,000
" Entrance Fees	2,500	" Sports Equipments	4,000
" Contribution to Annual	10,000	" Secretary's Honorarium	10,000
" Dinner	7,500	" Printing & Stationery	4,500
" Profit on Annual Sports		" Annual Dinner Expenses	15,000
		" Interest and Bank Charges	1,500
		" Cash in hand	16,000
	1,05,600		1,05,600

Balance Sheet as on 31.12.2007

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Outstanding Salaries		4,500	Cash in hand		16,000
Outstanding Audit Fees		2,500	Insurance Paid in Adv.		600
Prereceived Subscription		2,700	Accrued Subscription		7,500
Bank Loan		20,000	Sports Equipment	26000	
Accumulated Fund :			Add : Purchase	4000	
Opening Balance	1,15,400			30,000	
Add: Surplus	6,000	1,21,400	Less : Depreciation	3,000	27,000
			Football Ground		1,00,000
		1,51,100			1,51,100

Ilustration 4 :

The Accountant of City Club furnished the following information about the Receipts and Payments of the club for the year ended 31st March, 2008 :

Receipts	Rs.	Payments	Rs.
To Subscriptions	62,130	By Premises	30,000
“ Fair Receipts	7,200	“ Rent	2,400
“ Variety show Receipts (net)	12,810	“ Rates and Stationery	3,780
“ Interest	690	“ Printing & Stationery	1,410
“ Bar Collections	22,350	“ Sundry Expenses	5,350
		“ Wages	2,520
		“ Fair Expenses	7,170
		“ Honorarium to Secretary	11,000
		“ Bar Purchases (Payment)	17,310
		“ Repairs	960
		“ New Car (less proceeds of old car Rs.9,000)	37,800

The following additional information could be obtained :

	1.4.07(Rs.)	31.3.08 (Rs.)
Cash in hand	450	NIL
Bank Balance as per Cash Book	24,420	10,350
Cheque issued for Sundry Expenses not presented to the bank (entry has been duly made in the Cash book)	270	90
Subscriptions Due	3,600	2,940
Premises at cost	87,000	117,000
Provision for Depreciation on Premises	56,400	
Car at cost	36,570	46,800
Accumulated Depreciation on Car	30,870	
Bar Stock	2,130	2,610
Creditors for Bar Purchases	1,770	1,290

Annual Honorarium to Secretary is Rs. 12,000 Depreciation on Premises is to be provided at 5% on written down value. Depreciation on new car is to be provided at 20%.

You are required to prepare Receipts and Payments Account and Income and Expenditure Account for the year ended 31.3.08.

Solution :

Working Notes :

		Rs.
(1) Depreciation on New Car :		
	Net Amount	37,800
Add :	Sale proceeds of Old Car	9,000
	Actual Cost	46,800
Less :	Depreciation @ 20%	9,360
		37,440
(2) Profit on sale of Old Car :		
	Sale proceeds	9000
Less:	Written Down Value : Cost - 36,570	
	Provision for Depreciation - 30,870	
		5700
	Profit on Sale	3300

(3) Cheques issued for Sundry Expenses not presented to the Bank need not be considered as Bank Balance as per Cash Book is given and the entry for the expenses have been duly made in the Cash Book.

(4) Calculation of Bar Parchases

Dr. **Creditors for Bar Purchases Account** **Cr**

Particulars	Rs	Particulars	Rs
31.3.08 To cash Payment for Bar Purchases	17,310	1.4.07 By Balance b/d	1,770
31.3.08 To Balance c/d	1,290	31.3.08 By Purchases (Balance Figure)	16,830
	18,600		18,600

(5)

Dr. Bar Trading Account for the year ended 31.03.08 **Cr**

Particulars	Rs	Particulars	Rs
To Opening stock	2,130	By Bar collections	22,350
To Bar Purchases	16,830	By Close stock	2,610
To Income & Expenditure A/c profit from Bar transfered	6,000		
	24,960		24,960

City Club

Dr Receipts and Payments Account for the year ended 31 March, 2008 Cr.

Receipts	Amount Rs.	Payments	Amount Rs.
ToBalance b/d :		By Premises	30,000
" Cash in hand	450	" Rent	2,400
" Cash at Bank	24,420	" Rates & Taxes	3,780
" Subscriptions	62,130	" Printing & Stationery	1,410
		" Sundry Expenses	5,350
" Fair Receipts	7,200	" Wages	2,520
" Variety Show Receipts (Net)	12,810	" Fair Expenses	7,170
" Interest	690	" Honorarium to Secretary	11,000
" Bar Collections	22,350	" Payments for Bar Purchases	17,310
" Sale Proceeds of Old Car	9,000	" Repairs	960
		" Cost of New Car	46,800
		" Balance c/d : Cash at Bank	10,350
	1,39,050		13,9050

City Club

Income and Expenditure Account for the year ended 31st March, 2008

Dr. Cr

Expenditure	Amount Rs.	Amount Rs.	Income	Amount Rs.	Amount Rs.
To Rent		2,400	By Subscription	62,130	
Rates & Taxes		3,780	Add: Amount Due		
			On 31.3.08	2,940	
" Printing & Stationery		1,410		65,070	
" Wages		2,520	Less: Amount Due		
" Honorarium to Secy.	11000		On 31.3.07	3,600	61470
" Add: O/S on 31.3.08	1000	12,000	" Profit on Sale of		
" Sundry Expenses		5,350	Old Car [Note 1]		3300
" Repairs		960	" Profit from Bar		
" Depreciation :			[Note 5]		6000
On Car [Note 1]	9360		" Variety Show		
On Premises					
[5% of 60600]	3030	12,390	Receipts (net)		12810
			" Income from Fair :		
" Surplus (Excess of Incomes over			Receipts Less : Expenses	7200 7170	30
Expenditure, transfer		43,490	" Interest		690
to Capital Fund)					
		84,300			84,300

Ilustration 5 :

Progressive Education Society submits to you the following Receipts & Payments Account and Income & Expenditure Account for the year ended 31st March, 2008.

Dr. Receipts and Payments Account for the year ended 31.3.08 Cr.

Receipts			Amt. Rs	Payments	Amt. Rs.
To Balance b/d			450	By Printing Charges	75
" Interest :	2006-07	100		" Advertisement	141
	2007-08	150	250	" Salary to staff (including payment for 2006-07)	1,300
" Tuition Fees :					
	2007-08	1000			
	2008-09	100	1,100	" Rent	520
" Entrance Fees :				" Miscellaneous Expenses	110
	2007-08		420	" Furniture Purchased	670
" Membership Fees :				" Balance c/d	1,374
	2006-07	300			
	2007-08	1150			
	2008-09	390	1,840		
" Miscellaneous Income			130		
			4,190		4,190

Dr. Income and Expenditure Account for the year ended 31.3.08 Cr.

Expenditure	Rs.	Income	Rs.
To Printing Charges	80	By Tuition Fees	1100
" Advertisement	150	" Membership Fees	1150
" Rent	600	" Miscellaneous Income	130
" Salary to Staff	1200	" Interest	160
" Miscellaneous Expenses	110		
" Excess of Income over Expenditure	400		
	2540		2540

You are asked to prepare the Balance Sheet of the Society as on 31st March , 2007 and 31st March , 2008 :

Additional information :

As on 31st March , 2007, the society had :

Investment Rs. 4000; Furniture Rs. 2000; Library Books : Rs.1,500

Working Note :

A. For the Balance Sheet as on 31.3.2007

i) Salary to staff

		Rs.
	Payment as per R & P A/c (including payment for 2007-08)	1300
Less:	Payment for 2007-08 as per Income & Expenditure A/c	1200
	Outstanding on 31.3.2008	100

ii) Membership Fees of 2006-07 received in 2007-08 Rs. 300

Membership Fees Receivable (or due to be received) on 2007 = Rs. 300

iii) Interest Rs. 100 for 2006-07 received in 2007-08

Outstanding Interest Receivable Rs. 100

B. For the Balance Sheet as on 31.3.2008

i) Outstanding / prepaid Expenses

	Amount payable as per I & E A/c Rs.	Amount paid as per R & P A/c Rs.	Prepaid Rs.	Outstanding to be paid Rs.
Printing Charges	80	75	—	5
Advertisement	150	141	—	9
Rent	600	520	—	80

ii) Acerued income / Income Received in advance :

	Amount payable as per I & E A/c Rs.	Amount paid as per R & P A/c Rs.	Received in advance Rs.	Accrued income Rs.
Tuition Fees	1,100	1000	—	100
	—	100 (2008-09)	100	—
Membership Fees	1,150	1150	—	—
	—	390 (2008-09)	390	—
Interest	160	150	—	10

iii) Entrance Fees Rs. 420 recorded in R & P A/c but not in I & E A/c Entrance Fees Capitalised Rs. 420

Solution :

Progressive Education Society

Balance Sheet as at 31.3.2007

Liabilities	Amount Rs.	Assets	Amount Rs.
Capital Fund	8,250	Furniture	2,000
(Excess of Assets over Liabi.)		Investments	4,000
Outstanding Salary	100	Library Books	1,500
		Interest Receivable	100
		Membership Fees Receivable	300
		Cash	450
	8,350		8,350

Balance Sheet as at 31.3.2008

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Capital Fund	8250		Furniture	2000	
Add : Surplus	400		Add : Purchase	670	2670
Entrance Fees					
Capitalised	420	9070	Investments		4000
Incomes Received in Advance :			Library Books		1500
Tuition	100		Interest Receivable		10
Membership Fees	390	490	Tuition Fees		
			Receivable		100
Outstanding Liabilities for :			Cash		1374
Printing Charges	5				
Advertisement	9				
Rent	80	94			
		9654			9654

Ilustration 6 :

Preparation of R & P A/c, I & E A/c and Balance Sheet for the initial/starting year of a club from information given.

The following information were obtained from the books of Delhi Club as on 31.3.2008 at the end of the first year of the club. You are required to prepare Receipts and Payments Account, Income and Expenditure Account for the year ended 31.3.2008 and a Balance Sheet as at 31.3.2008 on mercantile basis :

i) Donations received for Building and Library Room Rs. 2,00,000.

ii) Other revenue income and actual receipts :

	Revenue Income Rs.	Actual Receipts Rs.
Entrance Fees	17,000	17,000
Subscription	20,000	19,000
Locker Rents	600	600
Sundry Income	1,600	1,060
Refreshment Account	—	16,000

iii) Other expenditure and actual payments :

	Revenue Expenditure Rs.	Actual Payments Rs.
Land (Cost Rs. 10,000)	—	10,000
Furniture (Cost Rs. 1,46,000)	—	1,30,000
Salaries	5,000	4,800
Maintenance of Playgrounds	2,000	1,000
Rent	8,000	8,000
Refreshment Account	—	8,000

Donation to the extent of Rs. 25,000 were utilised for the purchase of Liabrary Books, balance was still un utilised. In order to keep it safe, 9% Govt. Bonds of Rs. 1,60,000 were purchased on 31.3.2008. Remaining amount was put in the Bank on 31.3.2008 under the term deposit. Depreciation at 10% p.a. was to be provided for the whole year on Furniture and Library Books.

Please note that :

1. This is the first year. The Club has no Capital Fund at the beginning.
2. Donation must be capitalized as it has been made towards Building and Library Room.
3. The Investments in 9% Govt. Bonds have been made on the closing day of the year. So no interest has accrued.

Solution :

Delhi Club

Dr. Receipts and Payments Account for the year ended 31 March, 2008 Cr.

Receipts	Amount Rs.	Payments	Amount Rs.
To Donations for Building		By Land	10,000
and Library Room	2,00,000	" Furniture	1,30,000
" Entrance Fees	17,000	" Salaries	4,800
" Subscription	19,000	" Maintenance of	
		Playgrounds	1,000
" Locker Rents	600	" Rent	8,000
" Sundry Incomes	1,060	" Payments for Refreshments	8,000
" Receipts from			
Refreshment		" Library Books	25,000
Account	16,000	" 9% Govt. Bonds	1,60,000
" Balance c/f :			
Overdraft	1,08,140	" Term Deposit with Bank	15,000
	3,61,800		3,61,800

Dr. Income and Expenditure Account for the year ended 31 March, 2008 Cr

Expenditure	Amount Rs.	Amount Rs.	Income	Amount Rs.	Amount Rs.
To Salaries	4,800		By Entrance Fees	17,000	
Add:- Outstanding	200	5000	Less:- Capitalised	——	17,000
" Maintenance of					
Playground	1,000		" Locker Rent		600
Add:- Outstanding	1,000	2,000			
" Rent		8,000	" Sundry Incomes	1,060	
			Add: Accrued	540	1,600
" Depreciation on:-			" Net Income from		
			Refreshment:		
Furniture @ 10%p.a.	14,600		Receipts	16,000	
Library Books@10%p.a	2,500	17,100	Less:- Payment	8,000	8,000
' Surplus (Excess of			Subscriptions	19,000	
Income over			Add: Receivable		
Expenditure)		15,100	On 31.3.08.	1,000	20,000
		47,200			47,200

Balance Sheet as on 31.3.2008

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Capital Fund			Land		10,000
Opening Balance	Nil		Furniture	1,46,000	
Add : Surplus	15,100	15,100	Less:Depreciation	14,600	1,31,400
Building &					
Library Fund		2,00,000	Library Books	25,000	
Creditors for Furniture		16,000	Less:- Depreciation	2,500	22,500
Creditors for			Term Deposit		
Liabilities for:			with Bank		15,000
Salaries		200	9% Govt. Bonds		1,60,000
Maintenance of					
Playground		1,000			
Bank Overdraft		1,08,140	Subscription	1,000	
			ReceivableAccrued		
			Sundry Income	540	1,540
		3,40,440			3,40,440

EXERCISE

Problem 1 :

A summary of Receipts and Payments of Bakers Club for the year ended 31st March, 2008

Receipts	Rs.	Payments	Rs.
To Opening Balance	3,000	By Salaries & Rent	1,500
" Subscription	20,000	" Electric Charges	300
" Donations	5,000	" Sports Expenses	1,000
" Entrance Fees	1,000	" Sports goods purchase	9,000
" Interest	100	" Books purchase	5,000
" Charity show Receipts	2,400	" Miscellaneous Expenses	700
		" Charity show Expenses	2,000
		" Investment	8,000
		" Closing balance	4,000
	31,500		31,500

Following information are available at the end of the year :

(i) Of the total subscriptions received Rs. 500 for 2006-07 and Rs. 600 for 2008-09 but Rs. 100 is due for 2007-08.

(ii) The total sum received on Entrance fees is to be transferred to Capital Fund.

(iii) Salary is remaining due to be paid Rs. 300.

(iv) Interest is receivable Rs. 500.

The club had the following assets on the opening day of the year Sports goods Rs. 3,000; Books Rs. 2,000; Investment Rs. 6,000.

As on 31.3.08 : spors goods valued at Rs. 10,000.

From the above information prepare an Income and Expenditure Account for the year ended 31.3.08 and Balance sheet as on that date.

(***Ans & Hints :*** Surplus Rs. 14,200. Balance sheet come Rs. 35,600)

Opening capital Fund Rs.14,500

Problem 2.

Receipts and Payments Account Monster Club for the year ended 31st March, 2008.

Dr. Receipts	Rs.	Payments	Cr. Rs.
To Cash in hand	50	By Salaries	2,400
" Cash at Bank	565	" Rent	720
" Subscription		" Postage	30
" (including Rs. 150 for 06-07		" Printing & Stationery	255
" and Rs. 100 for 08-09)	4,550	" Electricity charges	300
" Interest on Investments	2,000	" Meeting Expenses	150
" Bank Interest	25	" Purchase of library books	1,000
" Sale of Furniture	200	" Investment in bonds	1,000
		" Cash in hand	155
		" Cash at Bank	1,380
	7,390		7,390

The following additional information is supplied to you—

1. On 1st April. 2007 the club had the following assets and liabilities : (a) Investments Rs.40,000; (b) Furniture Rs. 3,000; (c) Library Books Rs. 5,000; (d) Liability for Rent Rs.60 and Salary Rs. 200.
2. On 31st March, 2008 Rent Rs. 80 and Salary Rs. 300 were in arrear.
3. The book value of furniture sold was Rs. 250.
4. The club has has 45 members with an annual subscription of Rs. 100 each.

Prepare the Income & Expenditure Account of the Club for the year ended 31st March, 2008 and the Balance Sheet as on that date.

*(*Ans: SurplusRs.2,500; Total of Balance Sheet on 31.3.08. Rs. 51,485]

Capital Fund (as on 1.4.07) Rs. 48,505.

Problem 3.

The following particulars relate to International Club for the year ended 30.608. You are required to prepare therefrom an Income and Expenditure Account for the year and a Balance Sheet as on 30.6.08.

Dr. **Cash Book** Cr.

	Rs..		Rs.
To Balance b/d	2,350	By Salaries	1200
" Entrance Fees	300	" Electricity	120
" Subscription		" Newspapers and Journals	525
2006-07 50		" Fixed deposits	2,500
2007-08 3,500		" Utensils	200
2008-09 75	3,625	" Payment to creditors	1,000
" Profit from Refreshment	100	" Balance carried c/d	1,150
" Locker Rent	200		
" Sundry Income	120		
	6,695		6,695

Entrance fees to be Capitalised.

The assets and liabilities on 1st July 2007 were Utensils. Rs. 800 Furniture Rs. 2.500:Consumable stores Rs. 350 and Creditors Rs. 1,200.

On 30.6.08 value of consumable stores was Rs. 700; creditors amounted to Rs. 550: the subscriptions outstanding were Rs. 75 for 2007-08 toRs. 100 for 2006-07 and the interest accrued on fixed deposit was Rs, 25.

(Ans: Surplus 2,050 ; Capital Fund on 1.7.07 Rs. 4,950; Total of Balance Sheet on 30.06.08 Rs.7,925)

Consumable stors Purchased during the year Rs. 350; Consumable stores used during year Rs. 100

Problem 4.

From the following particulars related to Anand Charitable Hospital, prepare an Income and Expenditure Account for the year ended 30th June, 08 and a Balance Sheet on that date.

Receipts & Payments Account for the year ended 30.6.08

Dr. Cr.

Receipts	Rs.	Payments	Rs.
Balance in hand on 1.7.07	7,130	Payments for Medicines	30,590
Subscriptions	48,000	Honorarium to Medical staff	9,000
Donations	14,500	Salaries to House Staff	27,500
Interest on Investment @ 7%	7,000	Petty Expenses	460
Proceeds from Annual Day	10,450	Equipment Purchase	15,000
		Expenses for Annual Day	751
		Closing Balance (30.6.08)	3,779
	87,080		87,080

Additional information :

	On 30.6.07(Rs.)	On 30.6.08 (Rs.)
Subscription Receivable	240	280
Subscription Received in Advance	64	100
Stock of Medicines	8,810	9,740
Value of equipment	21,200	31,600
Buildings	40,000	38,000
Outstanding liability to Medicine suppliers	10,000	8,000

(Ans: Deficit Rs. 6,517; Capital Fund on 1.7.07 Rs. 1,67,316; *Total of Balance Sheet on 30.6.08* Rs, *1,83,399; Medicine consumed during the year Rs.27,660)*

Problem 5.

D Literary Society showed the following position on 31st December. 2007 Balance Sheet as at 31st December, 2007

Liabilities	Rs.	Assets	Rs.
Capital Fund	79,300	Electrical Fittings	15,000
Outstanding Expenses	700	Furniture	5,000
		Books	40,000
		Investment in	
		Securities	15,000
		Cash at Bank	2,500
		Cash in hand	2, 500
	80,000		80,000

Receipts and Payments Account for the year ending on 31st December, 2007

Receipts	Rs.	Payments	Rs.
To Balance b/d		By Electric Charges	720
Cash at Bank	2,500	‘’ Postage & Stationery	500
Cash in hand	2,500	Telephone charges	500
Entrance Fees	3,000	Books Purchased (1.1.07)	6,000
Membership Subscriptions	20,000	Outstanding Expenses	700
Sale proceeds of Old		Rent Account	8,800
Newspapers	150	Investment in Securities	
Hire of lecture Hall	2,000	(1.7.07)	4,000
Interest on Securities	800	Salaries A/c	6,600
		Balance c/d : Cash at Bank	2,000
		Cash in hand	1,130
	30,950		30,950

You are required to prepare an Income & Expenditure Account for the year ending on 31.12.2007 and a Balance Sheet on that date after incorporating the following adjustments

(i) Membership subscriptions included Rs. 1.000 received in advance.

(ii) Provide for outstanding Rent Rs. 400 and Salaries Rs. 300.

(iii) Books to be depreciated @ 10% including additions. Electrical Fittings and Furniture are also to be depreciated at the same rate.

(iv) 75% of the Entrance Fees are to be capitalised.

(v) Interest on Securities to be calculated at 5% p.a.

[Ans: Deficit Rs. 1670; Total ol Balance Sheet an 31.12.07 As. 81,580]

STUDY NOTE - 4

PARTNERSHIP ACCOUNTING

This study note includes

- Admission of a Partner
- Appropriation of Profits
- Retirement, Death and Dissolution
- Amalgamation of Firms and Conversions to a Company

4.1. ADMISSION OF A PARTNER

Introduction

Partners of a continuing business may, by common consent, decide to admit a new partner for additional capital, technical skill or managerial efficiency. At the time of such admission, the usual adjustments required are : (1) Adjustment regarding Profit Sharing Ratio; (2) Adjustment regarding Valuation of Assets and Liabilities; (3) Adjustment regarding Goodwill; (4) Adjustments regarding accumulated Profits or Losses and (5) Adjustment regarding Capital Contribution of New partner and Capitals of existing partners.

1. ***Adjustment regarding Profit Sharing Ratio :*** The new partner becomes entitled to a share of future profits which is sacrificed by the existing (old) partners in his favour. The sacrifice may be made by one or all of the existing partners. **The new profit sharing ratio has to be found out.**

It should be noted that :

(a) The new profit sharing ratio may be agreed upon by the partners. [It may be given and we need not calculate it]

(b) The mutual profit sharing ratio among the existing partners may remain unaltered after giving away the new partner's share.

Example : X and Y were partners sharing profit/losses as 3 : 2. They admit as a new partner giving him 1/5th share of future profits. What should be the new profit sharing ratio?

Solution : Z's share = 1/5 Balance = 1 – 1/5 = 4/5
X's share = 4/5 x 3/5 = 12/25; Y's share = 4/5x2/5 = 8/25; Z's share = 1/5 = 5/25.
The new profit sharing ratio = 12 : 8 : 5.

(c) The mutual profit sharing ratio among existing partners may be changed by agreement.

Example : P and Q were partners sharing profits/losses as 4 : 3. R is admitted as a new partner for 1/5 th share. P and Q decide to share the balance of profits equally.

Solution : R's share = 1/5 Balance = 1- 1/5 = 4/5.
P's share = 4/5 x 1/2 = 4/10; Q's share = 4/5 x 1/2 = 4/10; R's share = 1/5 = 2/10.
New Ratio = 4 : 4 : 2 or 2 : 2 : 1.

(d) If the sacrifice made individually by the existing partners is given then New Ratio should be calculated by deducting the sacrifice from the old ratio.

Example : A, B & C were partners sharing profits/loses as 3 : 2: 1. They admitted D as a new partner giving him 1/6th share of future profits. D acquired 3/24 th share from A and 1/24 share from B. Calculate the new Profit Sharing Ratio.

Solution : New Ratio = Old Ratio – Sacrifice Ratio

A=3/6 – 3/24 = 12/24 – 3/24 = 9/24; B=2/6-1/24 = 8/24 – 1/24 = 7/24; C=1/6 – Nil = 4/24 – Nil = 4/24; D=3/24 + 1/24=4/24 The new ratio = 9 : 7 : 4 : 4.

Thus regarding Profit Sharing Ratio we can sum up as follows :-

1. **Old Ratio** = Profit Sharing Ratio of existing Partners (before admission of new partner)
   = Given or Equal (If not mentioned)
2. **New Ratio** = Future Profit Sharing Ratio among all partners (including new partner, after his admission)
   = Given ***or*** = Old Ratio – Sacrificing Ratio made by each of existing partners.
3. **Sacrificing ratio** = Share of an existing partner under Old Ratio – his Share under new ratio.

But unless otherwise mentioned the mutual profit sharing Ratio between the existing partners will remain unaltered. In that case Sacrifice Ratio = Old Ratio.

It will be evident from subsequent discussions that proper use of the above ratios will be required for solving problems regarding Admission of a new partner.

2. ***Adjustment Regarding Valuation of Assets and Liabilities*** : The Book values of assets as shown in the Balance Sheet may not reflect their current realizable values. Similarly the liabilities included in the Balance Sheet may not exhibit their actual position. Whenever a change takes place in a partnership business in the form of admission or retirement or death of a partner or due to change in profit sharing ratio, revaluation of assets or liabilities become necessary.

The effect of Revaluation are given in two ways : (a) **by incorporation the changes of the Balance Sheet Values** and (b) **without changing the Balance Sheet values.**

By Incorporating Changes in the Balance sheet values prepare : Revaluation Account

(i) For decrease in the value of assets, increase in the value of liabilities, provision for unrecorded liabilities Revaluation A/c Dr

To Assets A/c (with the decrease in value)

To Liabilities A/c (with the increase in value)

(ii) For increase in the value of assets, decrease in the value of liabilities, unrecorded assets

Assets A/c Dr (with the increase in value)

Liabilities A/c Dr (with the decrease in value)

To Revaluation A/c

(iii) For profit on revaluation :

Revaluation A/c Dr

To old partners capital A/c (in their old profit sharing ratio)

[For loss on revaluation, the reverse entry should be made]

Proforma : Revaluation Account

	Rs.		Rs.
To Assets (Decrease)	xx	By Assets (Increase)	xx
To Liabilities (Increase)	xx	By Liabilities (Decrease)	xx
To Partners Capital A/c	xx	By Partners Capital A/c	xx
(Share of Revaluation Profit)		(Share of Revaluation loss)	
	xx		xx

Without changing the Balance sheet Values.

Prepare : Memorandum Revaluation Account

(i) Record increase/decrease in the value of assets and liabilities as discussed.

(ii) Share the profit or loss on Revaluation amongst the old partners in thire old profit sharing Ratio.

(iii) Reverse the increase/decrease in the value of assets and liabilities.

(iv) After reversal, calculate profit or loss.

(v) Share the profit/loss, after reversal amongst all the partners (including the new partner) in their new profit sharing ratio.

Memorandum Revaluation Account

Dr. Cr.

	Rs.		Rs.
To Assets (Decrease)	xx	By Assets(Increase)	xx
ToLiabilities (Increase)	xx	By Libilities (Decrease)	xx
To Partners Capital A/c	xx	By Partners Capital A/c	xx
(Share of Revaluation Profit)		(Share of Revaluation loss)	
Old Partners in old	xx	Old Partners in their	
Profit sharing Ratio		Old profit sharing ratio	
	xxx		xxx
To Reversal of Items b/d	xx	By Revarsal of Items b/d	xx
To Partners Capital A/c	xx	By Partners capital A/c	xx
(Revaluation Profit amount all partners in new profit sharing Ratio)		(Revaluation loss amought all partners in their new Profit sharing (Ratio)	
	xxx		xxx

3. ***Adjustment regarding Goodwill*** : **It is being separately discussed later.**

4. ***Adjustment Regarding Accumulated Profits or Losses*** : Usually accumulated Profits like Profit & Loss *(Cr.)* or General Reserve and accumulated losses like Profit & Loss *(Dr.)* should be apportioned among the Old Partners in Old Ratio.

However, the partners may decide to maintain the Accumulated Profits at original figure even after the new partner's admission.

In that case the usual entries made are

(a) Accumulated Profits (P/L Reserve).....................*Dr.*

To Old Partners' Capitals (Old Ratio)

(b) 'All Partners' Capitals......................................*Dr.*

To Accumulated Profit (New Ratio)

In most cases, the question remains silent regarding the treatment of accumulated profits or losses. In that case, these should be shared among old partners in old ratio.

5. *Adjustment Regarding Capitals* The new partner may have to introduce proportionate capital on the basis of the combined adjusted capitals of the existing (or old) partners.

On the other hand, the old partners may agree to make their capitals proportionate to the new profit sharing ratio on the basis of the capital contribution of the new partner or on any other basis.

In that case additional capital may be withdrawn by them or transferred to Current Accounts. Similarly shortfall may be made good by introduction of further capital.

But Capital contributions may not be in Profit Sharing Ratio, unless said otherwise.

Adjustment Regarding Goodwill

Goodwill is an invisible force that helps a business to earn more than the normal return on investment enjoyed by similar businesses. It is the sum total of the reputation and other favourable attributes built up by a business. Goodwill results into larger number of customers, higher turnover and more profits for a business. The additional profits earned by the business or its "super profits" indicate that it has goodwill. Thus goodwill is a real but intangible asset.

When the amount paid for the purchase of a business is in excess of its net assets, such excess payment is treated as "Goodwill at Cost" or "Purchased Goodwill".

Where there is no purchase or sale but a change of constitution takes place like admission of a new partner etc., the value of goodwill may be recognised as "Inherent/Potential" Goodwill.Accounting Treatment of Goodwill as Read with the Relevant Accounting Standard issued by the ICAI.

(A) Accounting Standard 10 (AS—10) to related is 'Accounting for Fixed Assets'.

(B) Paragraph 16 of this standard stipulates that "Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is excess of the value of the net assets of the business taken over the excess is to be termed as 'goodwill'."

Illustration :

X and Y were partners sharing profits as 4 : 3. Z joined as a new partner. The new profit sharing ratio between X, Y and Z was agreed to be 7 : 5 : 3. The Goodwill of the firm was valued at Rs. 84,000. But Z could not pay any premium for goodwill.

Solution

Step 1 : Calculate Z's premium : 3/15 of Rs. 84,000 = Rs. 16,800

Step 2 : Calculate sacrifices made by X and Y : X =4/7-7/15=11/105

Y =3/7-5/15=10/105 Sacrifice Ratio : 11:10.

Z's Capital A/c Dr 16,800

To X's Capital A/c 8,800

To Y's Capital A/c 8,000

Treatment of Goodwill (At the time of Admission of a New Partner)

Sl.No	Case	Journal Entry	Ratio used	Remarks
1.	New Partner pays Premium for Goodwill.	Cash / Bank………….. *Dr.* To Old Partners Capital (Premium money)	Sacrifice Ratio	(1) If mutual ratio between old partners do not change sacrifice ratio = Old Ratio (2) If Goodwill stands at or is raised to full value, no premium should be paid.
2.	If the premium or its part is immediately withdrawn by old partners	Old Partners Capital...... *Dr.* To Bank (Amount withdrawn)	As withdrawn	
3.	New Partner pays Premium although Goodwill appears in the Books at full value	Either Old Partners Capital *Dr.* To Goodwill (written off) Cash / Bank……. *Dr.* To New Partner's Capital [Premium Money treated as part of new partner's capital]	Old Ratio	Write off Goodwill if it is already existing in the Books.
4.	New Partner pays privately for premium for Goodwill to old partners	No Entry		Not a transaction of the business.
5.	New Partner cannot pay the Premium temporarily	Loan to New Partner *Dr.* To Old Partners Capitals	Sacrifice Ratio	OR old ratio if the mutual ratio between old partners do not change.
6.	New Partner is unable to pay the Premium (a) A Goodwill Account is raised at its full value	Goodwill A / c ……. *Dr.* To Old Partners Capital A / c [Full Value]	Old Ratio	'Full value may be given or may have to be calculated. For example, the new partner for his 2 / 5th the share failed to pay premium Rs. 5,000. Full value = (5000 x 5) / 2 = Rs. 12,500 As a result No GOODWILL ACCOUNT will appear in the Balance Sheet
	(b) A Goodwill Account is raised and written off	(i) Goodwill A / c.... *Dr.* To Old Partners Capitals (Raised) (ii) All Partners Capital A / c *Dr* (including new partner) To Goodwill (Written off)	Old Ratio New Ratio	Goodwill Account will not appear in the Balance Sheet

Illustration :

X and Y are partners having Capitals of Rs. 80,000 and Rs. 20,000 respectively and a profit sharing ratio of 4 : 1. Z is admitted for 1/5 th share in the profits of the firm and he pays Rs. 30,000 as Capital. Find out the value of the Goodwill.

Total Capital of the firm 30,000 x 5/1 = Rs.1,50,000

[Taking Z's Capital as base]

Less: Combined Adjusted Capital

80,000 + 20,000 + 30,000 = Rs. 1,30,000

Hidden Goodwill = Rs. 20,000

7.	New Partner is unable to pay the Premium and an adjustment is to be made through the Capital A/c.	New Partner's Capital *Dr.* To Old Partners Capitals [Premium Money]	Sacrifice Ratio	Or, old ratio if the mutual ratio between old Partners remain unchanged.
8.	New partner pays only a portion of the Premium but cannot pay the remaining portion: (a)For Portion Paid (b)For unpaid Portion	(a) Cash/Bank *Dr.* To Old Partners Capitals [Portion Paid] (b) Goodwill *Dr.* To Old Partners Capital [Goodwill for unpaid portion]	Sacrifice Ratio Old Ratio	Or, old ratio 'Goodwill is valued on the basis of unpaid Premium. For example, the new partner for his 2/5th share paid Rs. 12,000 out of Rs. 20,000 Premium. Unpaid Premium for 2/5th share = Rs. 8,000. Value of Goodwill= (8, 000 x5)/2 = Rs. 20,000
9.	If Goodwill Account already appears in the Books and Goodwill is to be raised at its full value (a) If Book value is lower than full value (b) If Book value is more than full value	(a) Goodwill *Dr.* To Old Partners Capital A/c [Full value—Book Value] (b) Old Partners Capital Dr. To Goodwill [Book value — Full Value]	Old Ratio Old Ratio	

Valuation of Inherent or Non-Purchased Goodwill

Serial No.	Name of the Method	Description of the method		Other Consideration
1.	Average Profits Methods	Under this method : Value of Goodwill = Agreed Number of Years Purchase x Average Maintainable Profits Average Maintainable Profit / Average Annual Profits xx (Simple average or may be weighted average considering the trend of profits. *Less:* Exceptional / Casual Income <u>xx</u> xx *Add:* Abnormal Loss xx *Add:* Capital Expenditure wrongly charged against profits xx *Less:* Provision for Taxation (As may be required) xx Adjusted Maintainable Profits xxx (Adjustments for undercharged or overcharged Depreciation or under / over valuation of stocks to be made, if required)	(i) (ii) (iii)	If profits are fluctuating, simple average is taken. If profits show an increasing trend, weights may be used. If profits constantly decrease, the lowest of the profits after adjustments may be considered. Exceptional Income or Expense of any particular year, should better be adjusted against the profit of that year. More weightage is usually given to later years.
2.	Annuity Method	It is a derivative of super profit concept If super profit is expected to be earned uniformly over a number of years, Goodwill is computed with the help of Annuity Table. Calculate Super Profit as discussed before Goodwill = Annual Super Profit x Present Value of Annuity of Re. 1. (Annuity Table in this case, to be provided)		Here also similar principles as said before should be followed for calculating— Capital Employed or Average Capital Employed, Annual Average Profits and Annual Super Profits. Super Profit = Average Maintenable Profit (-) Normal Profit

Illustration Regarding Valuation of Goodwill

Valuation of Goodwill for a non corporate assessee

From the following information, calculate the value of goodwill by super profit method and CapitaIisation method

(i) Average Capital employed in the business Rs. 7,00,000.

(ii) Net trading profit of the firm for the past three years Rs. 1,47,600; Rs. 1,48,100 and Rs. 1,52,500.

(iii) Rate of Interest expected from capital having regard to the risk involved —18%.

(iv) Fair remuneration to the partners for their services 12,000 per annum.

(v) Sundry Assets (excluding goodwill) of the firm Rs. 7,54,762.

(vi) Sundry Liabilities Rs. 31,329.

(vii) Goodwill valued at 2 years' purchase

YearsRs.	Profits Given Rs.	Adjusted Profits after Considering Remunerations Rs.
1st	1,47,600	1,35,600
2nd	1,48,100	1,36,100
3rd	1,52,500	1,40,500
Total Profits	4,48,200	4,12,200

	Rs.
Average Adjusted Annual Profits	4,12,200 / 3
Less : Normal Return on Capital @ 18% of Rs. 7,00,000	126000
Super Profits	137400
	11,400

Therefore Goodwill = Super profit x year of Purchase = 11,400 x 2 = 22,800

Illustration.

The new partner cannot pay premium and a Goodwill Account is raised.

A and B are partners sharing profits and losses as 3 : 2. They admit C as a partner who is unable to bring Goodwill premium in cash but pays Rs. 10,000 as capital. A Goodwill Account is raised in the hooks of the firm which is valued at two years' purchase of the last three years average profits. The profits for the last 3 years were Rs. 5.000; Rs. 4,000 and Rs. 4,500. The Profit sharing ratio among the partners has been agreed to be 5: 2 : 2. The partners decide to write-off Goodwill after C's admission.
Journal Entries, Points to be noted

1.	Valuation of Goodwill Average Annual Profits of last 3 years = (Rs. 5,000 +4000+4500) / 3 = Rs. 4500
2.	Goodwill = Rs. 4,500 x 2 = Rs. 9,000
3.	Goodwill to be raised = New Value — Book Value = Rs. 9,000 — Nil = Rs. 9,000 It is to be raised in Old Ratio and written off in new ratio. So sacrifice ratio is not required.

Date Particulars	L.F.	Amount Rs.	Amount Rs.
Goodwill A/c..*Dr.*		9,000	
To A's Capital Nc			5,400
To B's Capital A/c			3,600
(Goodwill Account raised and credited to old partners in old ratio 3 : 2]			
Bank A/c..*Dr.*		10,000	
To C's Capital A/c			10,000
[Capital introduced by new partner on admission]			
A's Capital A/c......................................*Dr.*		5,000	
B's Capital A/c.......................................Dr.		2,000	
C's Capital A/c.......................................*Dr.*		2.000	
To Goodwill A/c			9,000

Illustration.

New partner pays premium for Goodwill but Goodwill Account is appearing at the Balance Sheet at full value.

Gargi and Khana were partners sharing profits and losses as 5 : 3. They agreed to admit Lilabati as a new partner on payment of Rs. 9,000 as premium for Goodwill. The new profit sharing ratio was agreed as 3 : 2 : 1. The Goodwill Account appearing in the books amounted to Rs. 54,000. Pass the necessary Journal Entries.

Points to be noted

Lilabati brought in Rs.9,000 as his share of premium for Googwill for 1/6 in there.
Therefore Full value of Goodwill = 9,000 x 6/1 = 54,000
There is neither overvaluation nor undervaluation.

Khana had a gain of 2/48 in Profit Sharing Ratio.
She shall have to pay propotionately for her share of Goodwill = 2/48 x 54,000 = 2,250/-

Calculation of Sacrifice	Gargi	Khana	Lilabati
Old Ratio	$\frac{5}{8}$	$\frac{3}{8}$	—
New Ratio	$\frac{3}{8}$ $\frac{5}{8}-\frac{3}{6}=\frac{30-24}{48}=\frac{6}{48}$ (Sacrifice)	$\frac{2}{6}$ $\frac{3}{8}-\frac{2}{6}=\frac{18-16}{48}=\frac{2}{48}$ (Gain)	$\frac{1}{6}$ $Nil-\frac{1}{6}=\frac{0-8}{48}=\frac{8}{46}$ (Gain)

Journal Entries

Date	Particulars		L.F.	Amount Rs.	Amount Rs.
	Gargi's Capital A/c	Dr.			33,750
	Khana's Capital A/c	*Dr.*			20,250
	To Goodwill A/c				54,000
	[Goodwill Account written back between the old partners in old ratio)				
	Bank A/c	*Dr.*			9,000
	To Gargi's Capital A/c				6,750
	Khana's Capital A/c				2,250
	[Premium for Goodwill brought in by new partner and shared by old partners in their sacrifice ratio 3 :1				
	Alternatively				
	Bank A/c	*Dr.*			9,000
	To Lilabati's Capital A/c				9,000

Illustration

Premium for Goodwill paid privately

P and Q are partners sharing profits as 3:2. They admit R as a new partner for 1/4th share. The Goodwill Account appears in the books at its full value Rs. 20,000. R is to pay proportionate amount as premium and he pays it privately to P and Q.

Show the Journal Entries.

Points to be noted

1. For private payment of premium, no entry is required in the books of the partnership.
2. The new partner is paying premium although a Goodwill Account is appearing in the books at full value. So the Goodwill Account should be written back between the old partners in old ratio.

Solution

Date	Particulars	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
	P's Capital A/c	Dr.		12,000
	Q's Capital A/c	Dr.		8,000
	To Goodwill A/c			20,000
	(Goodwill Account written back between the old partners in old ratio 3 : 2]			

Illustration :

Premium for Goodwill in "true sense"

Jatin and Lalit are partners sharing profit as 3 : 2, Anu Malik is admitted as a new partner for 1/5th share on payment of Rs. 20,000 as capital and Rs. 5,000 as premium for Goodwill. A Goodwill Account appearing in the books at Rs. 20,000 is decided to be left undisturbed.

Show the Journal Entries.

Points to be noted

1. Premium for 1/5th share = Rs. 5,000 (It may be called premium in popular sense)

   Goodwill should be taken as Rs. 25,000

   But Goodwill appearing in Books and to be maintained = Rs. 20,000.

   Undervaluation of Goodwill = Rs. 5,000

   Premium in 'true sense" should be 1/5th of Rs. 5,000 = As. 1,000 (to be shared by old partners) The excess premium paid Rs. 4,000 should be credited to Anu Malik himself.
2. Premium should be shared in old ratio which is the same as sacrifice ratio as mutual ratio between Jatin and Lalit has not changed.

Solution

Journal Entries

Date	Particulars	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
	Bank A/c..Dr.		25000	
	To Jatin's Capital [3/5 of 1000]			600
	"Lalit's Capital [2/5 of 1000]			400
	"Anu Malik's Capital [20,000 + 4,000]			24000
	[True Premium shared by Jatin and Lalit in sacrifice ratio 3:2 and the balance of contribution made by Anu Malik transferred to his capital)			

Illustration

Where the new partner pays premium for goodwill and also brings his own goodwill to the business.

Amal and Bimal are partners sharing profits in the ratio of 2 : 3. Charu is admitted as a partner on 1st January, 2008 and he pays into the firm cash Rs. 9,000 out of which Rs. 3,000 is to be premium on his admission to a quarter share, the raitio between Amal and Bimal to be 1 : 2.

Charu also brings into the business his own Goodwill to be run as a separate unit and the Goodwill is agreed at Rs. 4,800.

Show the entries required to give effect to the above arrangements (for both the units separately).

Points to be noted

1. For the First unit, Rs. 3,000 paid as premium should be shared by Amal and Bimal in their sacrifice ratio. We should calculate the new ratio and the sacrifice ratio.
2. For the 2nd unit, an adjustment should be made for Charu's own goodwill to be credited to his capital and debited to Amal and Bimal in remaining ratio 2 : 3, excluding Charu's share.

Working Notes:

1. Calculation of New Profit Sharing Ratio

   Charu's share =1/4 ; Balance left =1-1/4=3/4. Amal's new share = x 1/3 =1/4;

Bimal's new share =3/4 x 2/3 = 2/4 and Charu's new share =1/4 .

New Ratio = 1:2:1 Sacrifice Ratio = 3 : 2

solution

Journal Entries

Date	Particulars	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1.1.08	Bank A/C Dr		6,000	
	To Charu's Capital A/c			6,000
	[Amount invested as capital contribution by Charu]			
1.1.08	Bank A/C Dr		3000	
	To Amal's Capital A/c [3/5]			1800
	To Bimal's Capital A/c [2/5]			1200
	[Premium paid by Chanu and credited to Amal and Bimal in their sacrifice ratio 3: 2]			
1.1.08	Amal's Capital A/c [2/10 of Rs. 4800] *Dr.*		960	
	Bimal's Capital A/c [3/10 of Rs. 4.800] *Dr.*		1440	
	To Charu's Capital A/c			2400
	[Adjustment made for Charu's own Goodwill brought into the business]			

Illustration

Special Points : (a) Journal Entries; (b) Portion of Premium for Goodwill and Reserve withdrawn; (c) Discount received on payment of creditor.

Brick, Sand and Cement were partners in a firm sharing profits and losses in the ratio of 3:2:1 respectively.

Following is their Balance Sheet as on 31st December, 2007.

Liabilities	Rs.	Rs.	Assets	Rs.
Capital Accounts:				
Brick	30,000		Land & Buildings	50,000
Sand	20,000		Furniture	15,000
Cement	10,000	60,000	Stock	20,000
Reserve		29,800	Bill Receivable	5,000
Creditors		6,200	Debtors	7,500
Bills Payable		4,000	Cash in hand and at Bank	2,500
		1,00,000		1,00,000

Lime is to be admitted as a partner with effect from 1st January,2008 on the following terms

(a) Lime will bring in Rs. 15,000 as Capital and Rs. 12,000 as premium for goodwill. Half of the premium will will be withdrawn by the partners.

(b) Lime will be entitled to :1/6th share in the profits of the firm.

(c) The assets will be revalued as follows Land and Building—Rs. 56,000; Furniture—Rs. 12.000; Stock—Rs. 16,000; Debtors—Rs. 7,000

(d) The claim of a creditor for Rs. 2,300 is paid at Rs. 2,000.

(e) Half of the Reserve is to be withdrawn by the partners.

Record the Journal entries (including cash transactions) in the books of the firm and show the opening Balance Sheet of the new firm.

Solution :

Books of Brick, Sand, Cement and Lime
Journal Entries

Date	Particulars	L.F.	Amount Rs.	Amount Rs.
	Bank A/c..........*Dr.*		15,000	
	To Lime's Capital A/c			15,000
	[Being amount contributed by lime on admission as a new partner]			
	Bank A/c..........*Dr.*		12,000	
	To Brick's Capital A/c [3/6]			6,000
	" Sand's Capital A/c [2/6]			4,000
	" Cement's Capital A/c [1/6]			2,000
	[Being premium for goodwill brought in by new partner and credited to old partners Capitals in their sacrifice ratio 3 :2:1]			
	Land and Buildings A/c..........*Dr.*		6,000	
	To Revaluation A/c			6,000
	[Being value of Land & Buildings appreciated on revaluation]			
	Revaluation A/c..........*Dr.*		7,500	
	To Furniture A/c			3,000
	" Stock A/c			4,000
	" Provision for Bad Debts A/c			500
	[Being values of assets decreased on revaluation]			

	Creditors A/c...Dr. To Bank A/c " Revaluation A/c [Being creditors claim discharged at a discount]		2,300	 2,000 300
	Brick's Capital A/c...Dr. Sand's Capital A/c...Dr. Cement's Capital A/c..Dr. To Revaluation A/c [Loss on revaluation debited to' old partners in old ratio 3 2 :1]		600 400 200	 1,200
	Reserve A/c...Dr. To Brick's Capital A/c " Sand's Capital A/c " Cement's Capital A/c [Reserve A/c closed and credited to old partners in old ratio 3 : 2 :1]		29,800	 14,900 9,933 4,967
	Brick's Capital A/c...Dr. Sand's Capital A/c...Dr. Cement's Capital A/c..Dr. To Bank A/c [Half of the Reserve withdrawn by old partners]		7,450 4,967 2,483	 14,900
	Brick's Capital A/c...Dr. Sand's Capital A/c...Dr. Cement's Capital A/c..Dr. To Bank A/c [Half of the premium money withdrawn by old partners]		3,000 2,000 1,000	 6,000

Balance Sheet as on 1.1.2009

Liabilities	Amount Rs.	Amount Rs.	Assets Rs.	Amount Rs.	Amount Rs.
Capital Accounts : [Note 3]			Land & Buildings		56,000
Brick	39,850		Furniture		12,000
Sand	26,566		Stock		16,000
Cement	13,284		Debtors	7,500	
Lime	15,000	94,700	*Less* : Provision for Bad Debts	500	7,000
Creditors [6,200 -2,300]		3,900	Bill Receivable		5,000
Bills Payable		4,000	Cash in hand and at Bank [Note 2]		6,600
		1,02,600			1,02,600

Working Notes :

1. It is assumed that after giving 1/6th share of profits to Lime, the balance will be shared by old partners in old ratio 3 : 2 :1. So, Sacrifice Ratio = Old Ratio = 3 : 2 :1.

2. Cash and Bank			Rs.	Rs.
As per last Balance Sheet				2,500
+Lime's Capital Contribution and Premium (net)				27,000
				29,500
— Paid to creditors				2,000
—Portion of Reserve withdrawn				14,900
—Share of premium withdrawn				6,000
				6,600

3. Capital	Brick	Sand	Cement	Lime
Balances	30,000	20,000	10,000	—
+ Capital brought in	—	—	—	15,000
+ Share of Premium for Goodwill	6,000	4,000	2,000	—
+ Share of Reserves	14,900	9,933	4,967	—
- Share of Reserves withdrawn	7,450	4,967	2,483	—
- Share of Premium for goodwill withdrawn	3,000	2,000	1,000	—
- Loss on Revaluation	600	400	200	—
	39,850	26,566	13,284	15,000

Illustration

(a) Portion of Premium unpaid — Goodwill Account raised. (b) General Reserve maintained.

Arun and Anand were partners sharing profits in the ratio of 3:2. Their position as on 31st March, 2008 was as under :

Liabilities	Rs.	Assets	*Rs.*
Arun's Capital	12,000	Land and Buildings	8,000
Anand's Capital	10,000	Plant and Machinery	10,000
General Reserve	12,000	Sundry Debtors	11,000
Workmen's Compensation Fund	4,000	Stock	12,000
Sundry Creditors	12,000	Cash at Bank	9,000
	50,000		50,000

They decided to admit Ashok for a 20% profit on the following terms : (a) The liability on Workmen's Compensation Fund is to be determined at Rs. 2,000; (b) Ashok to bring in Rs. 3,000 as premium out of his share of Rs. 3,600. He is also to bring in Rs. 20,000 as his capital; (c) General Reserve is to be maintained at its original value; (d) Rs. 2,000 out of creditors to be paid at 5% discount.

Pass the necessary journal entries to give effect to the above arrangement; to show the capital accounts and prepare the Balance Sheet of the new firm.

Points to be noted

1. Ashok pays premium Rs. 3,000. This should be shared by Arun and Anand in their sacrifice ratio, which is eventually the old ratio 3 : 2. For the unpaid Premium [Rs. 3,600 — Rs. 3,000 = Rs. 600]. Goodwill Account to be raised at Rs. 3,000 5 / 1 = 600. This is to be credited to old partners in old ratio 3:2.

2. For General Reserve to be maintained, the following adjustment will be required

Arun	Arun Rs.	Anand Rs.	Ashok Rs.
Credited in Old Ratio between old partners (12,000 as 3 : 2)	7,200(Cr)	4,800 *(Cr.)*	
Debited in New Ratio(12:8:5)	5,760 *(Dr.)*	3,840 *(Dr.)*	*2,400(Dr.)*
Net Effect	1,440 (Cr)	960 *(Cr.)*	2,400 *(Dr.)*

Arun, Anand and Ashok
Journal Entries

Date	Particulars	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
31.3.08	Workmen's Compensation Fund A/c ….. Dr. [Rs. 4,000 — Rs. 2,000] To Revaluation A/c [Value of liability reduced]		2,000	 2000
31.3.08	Bank A/c……………………………………….........Dr. To Ashok's Capital A/c [Amount contributed as capital by incoming partner]		20,000	 20,000
	Bank A/c………………………………………………Dr. To Arun's Capital A/c " Anand's Capital A/c (Premium for Goodwill paid by incoming partner and shared by existing partners in their sacrificing ratio 3 : 2)		3,000	 1,800 1,200
	Goodwill A/c………………………………………Dr. To Arun's Capital A/c " Anand's Capital *A/c* [Goodwill A/c raised and credited to existing partners in old ratio 3 : 2]		3,000	 1,800 1,200
	Creditors A/c…………………………………....Dr To Bank A/c (actual payment at 95%) " Revaluation A/c (A creditor paid off and the discount received credited to revaluation A/c)		2,000	 1,900 100
	Revaluation A/c Dr. To Arun's Capital A/c To Anand's Capital A/c (Being Revaluation profit credited to old partners in the ratio 3 : 2)		2,100	 1,260 840

Illustration

No alteration of book values of assets and liabilities

Baisakhi and Srabarni are partners sharing profits and losses in proportion to their capitals. Their Balance Sheet as on 31st March, 2008 is given below:

Liabilities	Rs.	Assets	Rs.
Creditors	15,000	Freehold Premises	10,000
General Reserve	2,100	Machinery	3,500
Capitals :		Furniture	1.750
Baisakhi	20,000	Office Equipments	550
Srabani	15,000	Stock	14,100
		Bill Receivable	3,060
		Debtors	17,500
		Bank	1,590
		Cash	50
	52,100		52,100

On 1st April, 2008 they admit Poushali on the following conditions:

(i) Poushali should bring in Rs. 10,000 as capital and to pay Rs. 3,500 for goodwill as she will get 1/4th share in profits.

(ii) A provision of 2% to be raised against debtors, stock to be reduced by 5%, Freehold Premises to be revalued at Rs. 12,650, Machinery at Rs. 2,800, Furniture at Rs. 1,540 and Office equipments at Rs. 495.

(iii) Partners agreed that the values of assets and liabilities should remain unaltered.

Show the necessary accounts and prepare the opening Balance Sheet of the new firm.

Points to be noted

1. The Partners have decided not to alter the book values of the assets and liabilities. The effects of revaluation may be ascertained by preparing a Memorandum Revaluation Account as follows.

(a) Calculation of Profit / Loss on Revaluation

Memorandum Revaluation Account

Dr. **Cr.**

	Rs.		Rs.
To Provision for bad debts (@ 2% of 17,500)	350	By Freehold Premises	2,650
To Stock	705		
To Machinery	700		
To Funiture	210		
To Office Equipments	55		
To Partners Capital A/c's			
Baisakhi : (4/7)	360		
Sarbani : (3/7)	270		
	2,650		2,650
To Reversal of Items b/d	2650	By Reversal of Items b/d	2,020
		By Partners Capital A/c (In New Ratio) [Loss on Revaluation]	
		Baisakhi 270	
		Sarbani 203	
		Poushali 157	630
	2,650		2,650

(b) As General Reserve is to remain unaltered, similar adjustment will be required to be shared among old partners in old ratio and then written back among all partner's in new ratio

2. Calculation of net effects on Capital Accounts

New Profit Sharing Ratio : 12 : 9 : 7

Solution

Capital Accounts

Dr. *Cr*

Date	Particulars	Baisakhi Amt Rs.	Srabani Amt Rs.	Poushli Amt Rs.	Date	Particulars	Baisakhi Amt Rs.	Srabani Amt Rs.	Poushali Amt Rs.
31.3.08	To Gen. Res.	900	675	525	1.4.07	By Balance b / d	20000	15000	-
	To M. Rev.					By General Reserve	1,200	900	-
	A / c	270	203	157	31.3.08	By Bank A / c	-	-	10000
						By M.Rev. A / c	360	270	-
						By Bank A / c (Premium) at 4:3.	2000	1500	-
	"Balance c / d	22,390	16,792	9,318					
		23,560	17,670	10,000			23,560	17,670	10,000

Balance Sheet as on 1.4.2008

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Capitals:			Freehold Premises		10,000
Baisakhi	22,390		Machinery		3,500
Srabani	16,792		Furniture		1,750
Poushali	9,318	48,500	Office Equipments		550
General			Stock		14,100
Reserve		2,100	Bill Receivable		3,060
Sundry			Debtors		17,500
Creditors		15,000	Bank [1,590 + 10,000 + 3,500]		15,090
			Cash		50
		65,600			65,600

EXERCISE

Problem 1 : Maruti and Ford are partners in a firm sharing profits and losses in the ratio of 3 :2. On 31st March, 2008 their Balance Sheet stood as under:

Liabilities		Amt (Rs.)	Assets	Amt (Rs.)
Capital Accounts :			Freehold Premises	24,000
Maruti	40,000		Plant	4,000
Ford	20,000	60,000	Stock	33,000
General reserve		15,000	Debtors	12,000
Creditors		10,000	Bank	7,000
			Profit & Loss A/c	5,000
		85,000		85,000

On the same day, they admitted Suzuki as a partner and new profit sharing ratio became 7 : 3 : 3. Goodwill of the firm was valued at Rs. 20,800. Suzuki was to bring required premium and proportionate Capital. Capitals of Maruti and Ford as between themselves were also to be adjusted in their profit sharing ratios.

Pass Journal entries in the books of the new firm and prepare the Balance Sheet of the reconstituted firm.

[Ans : Total Capital Rs. 97,240; Suzuki's Capital contribution Rs. 22,440; Premium paid by him Rs. 4,800]

Problem 2 : Ranu & Mill are partners in a firm sharing profits and losses in the ratio of 2/3 and 1/3. The Balance Sheet of the firm on 31st December, 2007 was as follows :

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Creditors		7,000	Goodwill		4,980
Investment provision		2,000	Investments		25,000
General Reserve		10,500	Stock		15,000
Workmen's Compensation Fund		6,000	Debtors	20,000	
Capital Accounts :			Less : Prov.	2,500	17,500
Ranu	30,000		Bill Receivable		12,500
Mili	24,500		Bank		5,020
		54,500			
		80,000			80,000

On the above date, Manisha is admitted for 2/5th share in the profit or losses of the firm. Following revaluations were made at the time of admission:

(a) Manisha is required to bring in Rs. 50,000 as capital.

(b) Her goodwill was calculated at Rs. 12,000.

(c) Ranu & Mili had purchased a machinery on hire purchase system for Rs. 15,000 of which only Rs. 500 are to be paid. Both machinery and unpaid liability did not appear in the balance sheet.

(d) There was a Joint Life policy on the lives of Ranu & Mili for Rs. 75,000. Surrender value of the policy on the date of admission amounted to Rs. 12,000.

(e) Accrued incomes not appearing in the books were Rs. 500.
(f) Market value of investments is Rs. 23,900.
(g) Sikha, an old customer whose account was written off as bad, has promised to pay Rs. 1,750 in full settlement of her claim.
(h) Claim on account of compensation is estimated at Rs. 750.
(i) Provision for doubtful debts is required at Rs. 3,000.

Prepare Revaluation Account, Partners Capital Accounts and opening Balance Sheet after admission of Manisha.

[Ans : Profit on Revaluation Rs. 32,650 balance Sheet Total Rs. 1,82,020 raising Goodwill at full value]

Problem 3.

Quick and Slow are partners in a firm sharing profits and losses in the ratio of 3 :2. The Balance Sheet of the firm as on 31st March, 2008 was as under:

Liabilities	Rs.	Rs.	Assets	Rs.
Capital Accounts:			Furniture & Fixture	60,000
Quick	1,20,000		Office Equipments	30,000
Slow	77,000	1,97,000	Motor Car	75,000
General Reserve		30,000	Stock	50,000
Sundry Creditors		96,000	Sundry Debtors	90,000
			Cash at Bank	18,000
		3,23,000		3,23,000

Smooth was admitted as a new partner with effect from 1st April, 2008 and it was agreed that he would bring some private furniture worth Rs. 10,000 and private stock costing Rs. 8,000 and in addition contribute Rs. 50,000 cash towards capital.

He would also bring proportionate share of goodwill which is to be valued at two years purchase of the average profits of the last three years.

The Profits of the last three years were : 2006-07 Rs. 52,000; 2005-06Rs. 32,000; 2004-05 Rs. 28,000.

However, on a checking of the past records, it was noticed that on 1.4.05 a new furniture costing Rs. 8,000 was purchases but wrongly debited to revenue, and in 2006-07 a purchase invoice for Rs. 4,000 dated 25.3.07 has been omitted from the books. The firm charges depreciation @ 10% p.a. under the diminishing balance method.

You calculation of goodwill is to be made on the basis of correct profits.

On revaluation, value of stock is to be reduced by 5% and Motor Car is worth Rs. 85,000.

Smooth duly paid the required amount of goodwill and cash towards capital.

It was decided that the future profits of the firm would be shared as Quick 50%, Slow 30% and Smooth 20%.

Assuming the above mentioned arrangements were duly carried out, show the Capital Accounts of the partners and the Balance Sheet of the firm after Smooth's admission.

[Ans : Profit on Revaluation Rs. 2,480; Adjusted average profits Rs. 38,160; Goodwill Rs. 76,320; Profit on Revaluation Rs. 7,500; Balance sheet total Rs. 4,20,244]

Problem 4

Admission cum-Guarantee

Gnat, Jet and Mig were in partnership sharing profits & losses as 6 : 3 : 1.

The partnership deed provided :

(i) Interest @ 6% p.a. shall be allowed on fixed capitals. No interest shall be allowed on current accounts but 8% per annum is to be charged on any debit balance at the commencement of the year.

(ii) Goodwill shall be valued at 80% of the average annual profits of the previous 3 or 4 years which ever is lower.

The following are particulars of partner's accounts :

	Fixed Capitals as on 31.12.07	Balance on Current A/cs on 31.12.07
Gnat	Rs. 18,000	Rs. 5,000 (Cr.)
Jet	Rs. 9,000	Rs. 1,000 (Cr.)
Mig	Rs. 3,000	Rs. 1,200 (Cr.)

The partners agreed to take Mirage into partnership as on 1st January, 2008 and on that date he introduced Rs. 3,500 in cash which included his fixed capital of Rs. 3,000. He is to receive a salary of Rs. 1,500 p.a. in addition to his share of profits. Gnat personally guaranteed that the aggregate of Mirage's salary and share of profit shall not be less than Rs. 3,000 p.a.

Agreed profits for goodwill purposes for the past four years are as follows :

2007 — Rs. 16,337; 2006— Rs. 10,758; 2005 — Rs. 10,255; 2004 — Rs. 14,164

No account for goodwill is to be maintained in the books, adjusting entries for transactions between the partners being made in their current accounts.

The draft accounts for the year ended 31st December, 2008 before taking account Mirage's Salary or interest on partner's accounts, show a profit of Rs. 17,640. Partner's drawings during the year are: Gnat Rs. 6,320, Jet Rs. 4,900, Mig Rs. 4,900 and Mirage including salary Rs. 2,193.

You are required to prepare : (a) a statement showing the division of profit for the year ended 31st December, 2008 and (b) The partner's current accounts for the year ended 31st December, 2008 recording therein the entries necessary upon Mirage's admission as a partner.

[Ans : Value of goodwill 9,960; Current Accounts after adjustments on 1.1.95 Mog 792, Mirage 496. Interest on Current A/cs (Cr.)]

Problem 5.

Marigold and Rose were in partnership sharing profits and losses as two-thirds and one-third. As from April 1, 2007 they agreed to take Jasmine as a new partner. The new partner will have $1/6^{th}$ share, the old partners agreeing to share equally as between them in the new firm. Jasmine brings in Rs. 50,000 as capital and Rs. 4,000 as his share of goodwill to be retained in the business.

The following is the Balance Sheet of the old firm as on 31^{st} March, 2007 –

Liabilities	Rs.	Assets	Rs.
Capital Accounts :		Cash	7,000
Marigold	62,500	Stock	50,000
Rose	37,500	Debtors	30,000
Creditors	50,000	Plant	25,000
		Investments	38,000
	1,50,000		1,50,000

The following revaluation is agreed upon : Stock – Rs. 55,000; Plant – Rs. 20,000; Investment – Rs. 35,000; Reserve for Bad Debts – 5%.

It was further agreed that Marigold alone is to be charged with any loss arising from the above.

The profits after depreciating plant @ 5% p.a. for the year ended 31^{st} March, 2008 was Rs. 1,20,000 and the drawings of the partners were : Marigold – Rs. 40,000; Rose – Rs. 40,000; Jasmine – Rs. 10,000.

You are required to Journalise the opening adjustments and draw up the Balance Sheet as on 31.3.2008.

[Ans : Balance Sheet Rs. 1,79,500; M's Capital Rs. 74,000; R's Capital Rs. 45,500; J's Capital Rs. 60,000]

4.2. APPROPRIATION OF PROFITS

INTRODUCTION

According to section 4 of the Partnership Act, 1932 a Partnership is "the relation between persons who have agreed to share the profits of a business carried on by all or any one of them acting for all."

If we analyse the definition we find three basic element of a Partnership :

(1) It arises out of an agreement made by two or more persons;

(2) The agreement is made regarding sharing profits of a business;

(3) Such business is carried on by all or any one of them acting for all.

   (a) Partnership is the result of an agreement. It does not arise from status.

   (b) The agreement may be either verbal or in writing. There should be some terms and conditions binding the Partnership.

   (c) The existing law does not enforce that the terms of the Partnership must be in writing. If written, the agreement is known as Deed or Articles of Partnership.

   (d) For the formation of a Partnership more then one person is requires. For a banking business the maximum number of Partners is 10, in other businesses it is 20.

<u>Partnership Deed</u>

Mode of Appropriation : Among other details the deed contains the mode of appropriation of profits (or losses) specially regarding interest on partners capitals, salary or commission, etc. payable to partners and the profit-sharing ratio.

In the absence of deed the following guidelines should be followed :

1. Every Partner should share profits equally [Section 13 (b)].
2. No interest is to be allowed on Partners' capitals [Section 13 (c)].
3. No interest should be charged on the drawings of the Partners.
4. No salary is to be allowed to any partner.
5. Interest on advances made by partners should be provided @ 6% per annum. [Section 13(d)].
6. Every partner should be to have equal share in the property of the Partnership as per Section 14.

Some Important Considerations

<u>Partners' Capitals</u>

(a) Where the Partners decide and the agreement provides, the Capitals Accounts of the Partners remain unchanged over years. In that case the Capital Accounts show the original amounts invested by the Partners as capitals unless some change (like change in capital Ratio etc.) takes place. The Capitals are called Fixed Capitals.

Partners' Current Accounts are opened and used for recording subsequent trans actions between the Partner and the firm for salary / commission to Partners, Interest on Partners Capitals, their drawings and interests on drawings, share of profit / loss and interest on loans / advances given by Partners to the firm. Where Capitals are Fixed, Current Accounts serve as the appendix.

(b) Where there is no agreement to keep Capitals fixed over years, entries1 regarding Partners' drawings, Salary / Commission / Interest on Capital and share profit / loss are recorded through the Partners' Capital Accounts. As a result, the Capitals undergo changes from period to period and are called Fluctuating Capitals.

(c) If any Partner gives any amount as Loan or Advance to the firm separately, Partners Loan Accounts are opened and maintained. Interest on Loan may be transferred to Loan Account or to Current Account (if any).

(d) A separate Drawings Account may be maintained to record withdrawals made by the partners from the firm. On the closing date of a financial period, the balance of the Drawings Account is transferred to Capital Account or to Current Account (if capitals are fixed).

One must remember also that,

(i) A Capital represents a liability. The balances of fixed capitals should always be credit balances. The balances of Current Accounts may be credit balances or debit balances (Where a partners' drawings exceed his share of profits / interests etc).

(ii) The balances of Fluctuating capital may be credit or debit balances.

(iii) Capitals of partners may not be as per their profit sharing ratio.

(iv) A partner may contribute his capitals in cash and also in the form of any other asset including goodwill. If he brings in any liability his Capital = Assets brought in – Liabilities brought in = Net Assets brought in.

Guaranteed Partnership

In a Partnership, there may be special agreement by virtue of which a Partner may get the guarantee of earning a minimum amount of profit.

This guarantee may be given by one partner in particular or by the firm. It is given generally to encourage a junior partner or any sincere clerk of the business inducted to the benefits of Partnership.

(a) Guarantee given by one Partner :

  (i) The appropriation of profit should be made in the general course by applying the existing profit sharing ratio.

  (ii) The minimum amount guaranteed is to be decided.

(iii) In case the guaranteed amount (ii) is more, the excess should be deducted from the share of profit of the Partner given guarantee and calculated under (i) above.

The same amount should be added with the original share of profit of the Partner to whom the guarantee has been given.

Illustration 1 :

X and Y are Partners sharing profit as 5:3. Z is the clerk of their business getting a salary of Rs. 500 p.m. and a commission of 5% of the net profit after deducting his salary and commission. Now, X guarantee that Z be made a Partners with 1/10th share of profit and nothong clse. If the annual profits is Rs. 1,32,000. Show the appropriation.

Steps :

(i) General Application of Profit Z's Share as clerk :

	Rs.
Salary 500 * 12	6,000
Commission 5/105 of [1,32,000 – 6,000]	6,000
	12,000

Balance of profit 1,20,000 Shared as : X =5/8 x 1,20,000 = Rs. 75,000 ;
Y = 3/8 x 1,20,000 = Rs. 45,000

(ii) Minimum guaranteed share of Z = 1/10th of Rs. 1,32,000 = Rs. 13,200

(ii) Shortfall = Rs. 13,200 – Rs. 12,000 = Rs. 1200 to be deducted from share and added with Z's share.

Final appropriation should be –

	Rs.
X : Rs. 75,000 – Rs. 1200	73,800
Y :	45,000
Z : Rs. 12,000 + Rs. 1200	13,200
	1,32,000

X's Capital / Current A/c Dr. 1,200

To Z's Capital / Current A/c 1,200

(Being Guaranteed share of profits provided

Guarantee given by firm :

(i) The share of profit of the guaranteed Partner is to be calculated according to the profit – sharing ratio.

(ii) His minimum guaranteed amount is ascertained.

(iii) The higher of (i) and (ii) is given or credited to him.

(iv) The remaining profits are shared among the remaining Partners in their remaining ratio.

If the minimum guaranteed amount is more, the shortfall may be agreed to be in a ratio specially agreed upon.

Illustration 2 :

The profit sharing ratio among X, Y and Z is 3: 2: 1. Z is guaranteed a minimum profit of Rs. 84,000 p.a. Annual profit are Rs. 4,20,000. Show the distribution.

Steps :

(i)	Normal Distribution :	
	X : 3/6 of Rs. 4,20,000	2,10,000
	Y : 2/6 of Rs. 4,20,000	1,40,000
	Z : 1/6 of Rs. 4,20,000	70,000
(ii)	Z's guaranteed share is Rs. 84,000	
(iii)	Z's share should be Rs. 84,000 (higher than Rs. 70,000)	
(iv)	X's share [4,20,000 – 84,000] * 3/5	2,01,600
	Y's share [4,20,000 – 84,000] * 2/5	1,34,400
	Z's share	84,000
		4,20,000

X's Capitable / Current A/c Dr. 8,400
Y's Capitable / A/c Dr. 5600
To Z's Capitable / Current A/c 14,000

Prior Period Adjustments

Errors committed in making appropriations of profit or in measuring revenues or profits in any earlier year may be located by a partnership firm in a subsequent year. Such errors may result from wrong valuation of inventory, incorrect distribution of profit, errors of misposting or principles, etc. Their adjustments should be made with retrospective effect from the date of initiation of errors. The adjustment is usually made with the help of adjustment entries made through the partner's Capital Accounts. A 'Prior Period Adjustment Account' or 'Profit & Loss Adjustment Account' may be used to accommodate the adjustments and the balance of this account may be transferred either to this Profit & Loss Account of the current year or to the partners capital accounts.

Also there may be situations involving personal payment of salary by one partner to another, omission to charge Interests, etc.

Illustrations 3 :

A,B and C are partners sharing profits and loss as 2 : 2 : 1. They get interest on their Capitals at 5% p.a and are charged @ 6% p.a on their Drawings.

A and B are paid salary @ Rs 250 per month respectively. A would be paid 6% interest on his loan. A paid Rs. 25,000 as loan on 1st July, 2007. A, B and C withdrew Rs. 10,000, Rs. 8,000 and Rs. 6,000 respectively during 2007. C is entitled to a commission at 2% on total sales which amounted to Rs. 3,46,000 during the year. On 1st January, 2007 the capital balances of A, B and C were Rs 1,00,000, Rs. 80,000 and Rs. 60,000 respectively. The net profit for the year is Rs. 1,00,000. Prepare the Profit & Loss Appropriation Account and the Capital Accounts of partners.

Solution :

Profit & Loss Appropriation Account for the year ended 31.12.2007

Dr. Cr.

Particulars	Amt Rs.	Amt Rs.	Particulars	Amt Rs.	Amt Rs.
To Salary			By Profit & Loss (Net Profit)		100,000
A [250 X 12]	3,000		" Interest on Drawings :		
B [150 X12]	1,800	4,800	@ 6% p.a. on an average		
’’ Commission –C		6,920	of 6 months)		
[2% of Rs. 3,46,000]			A	300	
’’ Interest on Capital :			B	240	
A	5,000		C	180	720
B	4,000				
C	3,000	12,000			
’’ Interest on Loan – A		750			
’’ Share of profits :					
A [2/5]	30,500				
B [2/5]	30,500				
C [1/5]	15,250	76,250			
		1,00,720			1,00,720

Capital Accounts

Dr. Cr.

Date 2007	Particulars	A Rs.	B Rs.	C Rs.	Date 2007	Particulars	A Rs.	B Rs.	C Rs.
31.12	To Drawings	10,000	8,000	6,000	1.1	By balance b/d	1,00,000	80,000	60,000
"	" Interest on Drawings	300	240	180	31.12	" Salary	3,000	1,800	-
"	"Balance c/d	1,28,200	1,08,060	78,990	"	" Commission	-	-	6,920
					"	" Interest on Capital	5,000	4,000	3,000
					"	"Share of Profit	30,500	30,500	15,250
		1,38,500	1,16,300	85,170			1,38,500	1,16,300	85,170

Illustration 4 :

A and B are partners in a firm sharing profits and losses equally. On 1st April, 2007 the balance of their Capital Accounts were : A-Rs. 50,000 and B-Rs. 40,000. On that date the balances of their Current Accounts were : A-Rs. 10,000 (credit) and B-Rs. 3,000 (debit). Interest @ 5% p.a. is to be allowed on the balance of Capital Accounts as on 1.4.2007. B is to get annual salary of Rs. 3,000 which had not been withdrawn. Drawings of A and B during the year were Rs. 1,000 and Rs. 2,000 respectively. The profit for the year ended 31st March, 2008 before charging interest on capital but after charging B's salary was Rs. 70,000. It is decided to transfer 10% of divisible profit to a Reserve Account.

Prepare Profit & Loss Appropriation Account for the year ended 31st March, 2008 and show Capital and Current Accounts of the Partners for the year.

Points to be noted :

(i) Profit before charging interest on Capital and Salary to B = Rs. 70,000 + Rs. 3,000 = Rs. 73,000

(ii) Transfer to Reserve = 10 % of Divisible Profits.

Solution :

Dr. Profit & Loss Appropriation Account for the year ended 31.03.2008 Cr.

Particulars	Amount	Amount	Particulars	Amount	Amount
To Salary - B		3,000	By Profit & Loss (Net		73,000
" Interest on Capitals :			Profit before Charging		
A	2,500		Salary and Interest)		
B	2,000	4,500			
" Reserve					
[10% of 65,500]		6,550			
" Share of Profit					
A [1/2]	29,475				
B [1/2]	29,475	58,950			
		73,000			73,000

Capital Accounts

Dr. Cr.

Date	Particulars	A Rs.	B Rs.	Date	Particulars	A Rs.	B Rs.
31.3.08	To balance c/d	50,000	40,000	1.4.07	By Balance b/d	50,000	40,000

CurrentAccounts

Dr. Cr.

Date	Particulars	A Rs.	B Rs.	Date	Particulars	A Rs.	B Rs.
1.4.07	To balance b/d	-	3,000	1.4.07	By Balance c/f	10,000	-
31.3.08	" Drawings	1,000	2,000	31.3.08	" Interest on Capital	2,500	2,000
31.3.08	" Balance c/d	40,975	29,475	"	" Salary	-	3,000
				"	" Share of Profit	29,475	29,475
		41,975	34,475			41,975	34,475

Calculation of Interest on Drawings

1. If the date of drawings is mentioned, then calculate interest according to the time.
2. If the date of drawings is not mentioned, then calculate interest on the average of the time period.
   i.e. if the accounting period is for one-year, then interest for 6 months, and so on.
3. If unequal amounts are drawn at irregular intervals :

Illustration 5 : Accounting Period : January – December. Interest @ 12% p.a

Month	Amount Drawn (Rs.)	Period (In Months)	Product (Amount × Period)
February	10,000	11	1,10,000
May	5,000	8	40,000
September	15,000	4	60,000
November	10,000	2	20,000
December	20,000	1	20,000
			2,50,000

$$\text{Interest} = \text{Product} \times \text{Rate of Interest} \times \frac{1}{12}$$

$$= 2,50,000 \times \frac{12}{100} \times \frac{1}{12} = 2500$$

4. If equal amounts are drawn at a fixed date every month, throughout the accounting period :
   (a) Drawn at the begining of every month
   (b) Drawn at the middle of every month
   (c) Drawn at the end of every month

Interest = Amount Drawn p.m × Rate of Interest × Time

Again, the Accouning Preiod may be for 12 months; 6 months; 3 months or etc. "How to calculate the time?"

If the Accounting Period is for 12 months : (January – December)

	Begining of the month			Middle of the month			End of the month		
	One-Year	6-months	3-months	One-year	6-months	3-months	One-Year	6-months	3-months
January	12	6	3	11.5	5.5	2.5	11	5	2
February	11	5	2	10.5	4.5	1.5	10	4	1
March	10	4	1	9.5	3.5	0.5	9	3	0
April	9	3	6	8.5	2.5	4.5	8	2	3
May	8	2		7.5	1.5		7	1	
June	7	1		6.5	0.5		6	0	
July	6	21		5.5	18		5	15	
August	5			4.5			4		
September	4			3.5			3		
October	3			2.5			2		
November	2			1.5			1		
December	1			0.5			0		
	78			72			66		

Time Period :

Accounting Period	At the Begining	At the Middle	At the End
12 months	78 / 12	72 / 12	66 / 12
6 months	21 / 12	18 / 12	15 / 12
3 months	6 / 12	4.5 / 12	3 / 12

Note : It is a general tendency to learn the time period of 6.5, 6 & 5.5, irrespective of understanding the rationale behind on such.

Refer to the 1st Row (where the amount is drawn at the begining of every month and throughout the year), we find 78 / 12 = 6.5, 72 / 12 = 6 & 66 / 12 = 5.5.

The rationale is Rate of interest being mentioned as per annum. But, if the rate of interest is mentioned per month basis, then interest shall be calculated by considering the time period for 78 months, 72 months & so on.

Illustration 6 :

Amount Drawn p.m. Rs. 1000. Rate of Interest @ 12% p.a.

If drawn at the begining of every month.

A/c Period	Interest
12 months	$= 1000\times\frac{12}{100}\times\frac{78}{12}=780$
6 months	$= 1000\times\frac{12}{100}\times\frac{72}{12}=720$
3 months	$= 1000\times\frac{12}{100}\times\frac{66}{12}=660$

If drawn at the middle of every month.

A/c Period		Interest
12 months	=	$1000 \times \frac{12}{100} \times \frac{21}{12} = 210$
6 months	=	$1000 \times \frac{12}{100} \times \frac{18}{12} = 180$
3 months	=	$1000 \times \frac{12}{100} \times \frac{15}{12} = 150$

If drawn at the end of every month.

A/c Period		Interest
12 months	=	$1000 \times \frac{12}{100} \times \frac{6}{12} = 60$
6 months	=	$1000 \times \frac{12}{100} \times \frac{4.5}{12} = 45$
3 months	=	$1000 \times \frac{12}{100} \times \frac{3}{12} = 30$

Illustration 7 :

Rani, Rini and Rina are three partners in a firm. According to partnership deed, the partners are entitled to draw Rs. 800 per month. On 1st day of every month Rani, Rini and Rina drew Rs. 700 Rs. 600 and Rs. 500 respectively. Profit during the year 2008 was Rs. 85,500 out of which Rs 30,000 was transferred to General Reserve. Rini and Rina are entitled to received salary of Rs. 3,000 and Rs. 4,500 p.a. respectively and Rani is entilled to received commission at 10 % of net distributable profit after charging such commission. On 1st January, 2008 the balance of their Capital Accounts were Rs. 50,000 Rs. 40,000 and Rs. 35,000 respectively. Interest on Capital provided at 8 % p.a.

You are required to show Profit & Loss Appropriation Account for the year ended 31st December, 2008 and Capital Accounts of Partners in the book of the firm.

Points to be noted :

1. A partner was allowed to draw Rs. 800 per deed in this case, none of the Partners draw more than that.

2. Interest on Drawings should be calculated as 1st month's drawings for 12 months, for second month's drawings for 11 months and so on.

Alternatively, 6.5 month interest is to be calculated on total drawings of each partners. (See theoretical discussion regarding interest on drawings.)

Ripa's total drawings = 700 x 12 = Rs. 8,400; Int. on Drawings = 8,400 x 10 / 100 x 13 / 24 = Rs. 455

Rini's total drawings = 600 x 12 = Rs. 7,200; Int. on Drawings = 7,200 x 10 / 100 x 13 / 24 = Rs. 390

Rima's total drawings = 500 x 12 = Rs. 6,000; Int. on Drawings = 6,000 x 10 / 100 x 13 / 24 = Rs. 325

Solution :

Dr. Profit & Loss Appropriation Account for the year ended 31.12.2008 Cr.

Particulars	Amount Rs.	Amount Rs.	Particulars	Amount Rs.	Amount Rs.
To General Reserve		30,000	By Profit & Loss (Net Profit)		85,500
" Salary - Rini	3,000		Interest on Drawings :		
Rina	4,500	7,500	Rani	455	
" Interest on Capital (at 8%)			Rini	390	
Rani	4,000		Rina	325	1,170
Rini	3,200				
Rina	2,800	10,000			
" Commission-Rani-(Note)		3561			
" Share of Profit					
Rani [1 / 3]	11,870				
Rini [1 / 3]	11,870				
Rina [1 / 3]	11,869	35,609			
		86,670			86,670

Capital Accounts

Dr. Cr.

Date 2008	Particulars	Rani Rs.	Rini Rs.	Rina Rs.	Date 2008	Particulars	Rani Rs.	Rini Rs.	Rina Rs.
	To Drawings	8,400	7,200	6,000		By Balance b / d	50,000	40,000	35,000
31.12	" Interest on Drawings	455	390	325	31.12	" Interest on Capital	4,000	3,200	2800
	" Balance c / d	60,576	50,480	47,844		" Salary	-	3,000	4,500
						" Commission	3,561	-	-
						" Share of Profit	11,870	11,870	11,869
		69,431	58,070	54,169			69,431	58,070	54,169

Working Notes :

	Rs.
Net Profit before Commission [86,670 – 30,000 -7,500 – 10,000]	39,170
Less : Rina's Commission = 10/100 of 39,170 (approx)	3,561
Share of Profit	35,609

Illustration 8 :

Calculation of Interest on Drawings made uniformly at the end of each quarter.

On January 1, 2008, Amethyst and Emerald commenced business as partners introducing capitals of Rs. 20,000 and Rs. 30,000 to their respective accounts. The partnership deed, provided inter alia that:

(i) Profit/Losses shall be shared in the ratio of 2 : 3 as between Amethyst and Enerald.

(ii) Partners shall be entitled to interest on Capital at the commencement of each year at 6 % p.a.; and

(iii) Interest on Drawings shall be charged at 8 % p.a.

During the year ended 31.12.2008 the firm made a profit of Rs. 19,280 before adjustment of interest on Capital and drawings. The Partners withdrew during the year Rs. 3,000 each at the end of every quarter commencing from 31.3.2008.

You are required to prepare a Profit Loss Appropriation A/c and show the entries therein for distribution of Profit.

Show also the Capital A/cs of the partners for the year.

Points to be noted :

Each Partner drew Rs. 3,000 at the end of each quarter or Rs. 12,000 during the year. But interest on drawings for each of them should be :

(a) On 3,000 draw at the end of 1st Quarter – Interest for 9 months = 3,000 x 8/100 x 9/12 = Rs. 180

(b) On 3,000 draw at the end of 2nd Quarter – Interest for 6 months = 3,000 x 8/100 x 6/12 = Rs. 120

(c) On 3,000 draw at the end of 3rd Quarter – Interest for 3 months = 3,000 x 8/100 x 3/12 = Rs. 60

(d) On 3,000 draw at the end of 4th Quarter – No interest

* Total Interest on Drawings for each partner = Rs. 180 + Rs. 120 + Rs. 60 = Rs. 360

Solution :

Dr. Profit & Loss Appropriation Account for the year ended 31.12.1995 Cr.

Particulars	Amount Rs.	Amount Rs.	Particulars	Amount Rs.	Amount Rs.
To Interest on Capital :			By Profit & Loss (Net Profit)		19,280
(at 6% p.a)			" Interest on Drawings :		
Amethyst	1,200				
Enerald	1,800		Amethyst	360	
" Share of Profit		3,000	Emerald	360	720
" Amethyst [2/5]	6,800				
Emerald [3/5]	10,200	17,000			
		20,000			20,000

Capital Accounts

Dr. Cr.

Date	Particulars	Amrthyst Rs.	Emerald Rs.	Date	Particulars	Amrthyst Rs.	Emerald Rs.
31.12.08	To Drawings	12,000	12,000	1.1.08	By Bank	20,000	30,000
31.12.08	" Drawings	360	360		" (Capital Introduced)		
"	" Balance c/d	15,640	29,640	31.12.08	" Interest on Capital	1,200	1,800
					" Share of Profit	6,800	10,200
		28,000	42,000			28,000	42,000

llustration 9 :

Azu and Biju are partners firm contributing Rs. 25,000 and Rs. 20,000 respectively as capitals and sharing profit as Azu 3/5 th and Biju 2/5 th. Interest on Capitals is to be allowed at 10 % per annum. The net profit for year ended 31st March, 2008 amounts to Rs. 3,600 before making any allowance for interest. Show the appropriation of profit.

Solution :

	Azu (Rs.)	Biju (Rs.)	Total (Rs.)
Interest on Capital @ 10 % p.a.	2,500	2,000	4,500

The profit are Rs. 3,600.

Unless specifically agreed upon, interest on capitals should be allowed only up to Rs. 3,600 and should be shared in Capital Ratio [25,000 : 20,000 or 5 : 4]

Azu's share = 5/9 x Rs. 3,600 = Rs. 2,000 ; Biju's share = 4/9 × Rs. 3,600 = Rs. 1,600

If the partners have agreed upon provision for interest on capital irrespective of profits, the distribution should be :

Dr. Profit & Loss Appropriation Account for the year ended 31.12.2008 Cr.

Particulars	Amt Rs.	Amt Rs.	Particulars	Amt Rs.	Amt Rs.
To Interest on Capital :			By profit & Loss (Net Profit)		3,600
Azu	2,500		" Share of Loss :		
Biju	2,000	4,500	Azu [3/5]	540	
			Biju [2/5]	360	900
		4,500			4,500

Illustration 10 :

Sharing of profit on Effective Capital Ratio.

Sachin, Sanat and Sohali Started a partnership firm on 1.1.2008. Sachin introduced Rs. 10,000 on 1.1.2008 and further introduced Rs. 5,000 on 1.7.08 Sanat introduced Rs. 20,000 at first on 1.1.08 but withdrew Rs. 8,000 from the business on 31.7.08. Sohali introduced Rs. 12,000 at the beginning on 1.1.08, increased it by Rs. 4,000 on 1.6.08 and reduced it to Rs. 10,000 on 1.11.08.

During the year 2008 they made a net profit of Rs. 56,100. The partners decided to provide interest on their capitals at 12 % p.a. and to divide the balance of profit in their effective capital contribution ratio.

Prepare the Profit & Loss Appropriation Account for the year ended 31.12.08.

Solution

(a) Calculation of effective capital contribution :

		Product (Rs.)
Sachin :	Rs. 10,000 for 6 months (1.1.to 1.7)	60,000
	Rs. 15,000 for 6 months (1.7.to 31.12)	90,000
		1,50,000
Sanat :	Rs. 20,000 for 7 months (1.1.to 31.7)	1,40,000
	Rs. (20,000 – 8,000) for 5 months (1.8.to 31.12)	60,000
		2,00,000
Sohali :	Rs. 12,000 for 5 months (1.1.to 1.6)	60,000
	Rs. (12,000 + 4,000) for 5 months (1.6.to 1.11)	80,000
	Rs. 10,000 for 2 months (1.11.to 31.12)	20,000
		1,60,000

- Profit Sharing Ratio = Effective Capital Ratio = 15 : 20 : 16

(b) Interest on Capitals = Product x Interest on Capital x 1/12

Sachin = 1,50,000 x 12/100 x 1/12 = 1,500; Sanat = 2,00,000 x 12/100 x 1/12 = 2,000; Sohali = 1,60,000 x 12/100 x 1/12 = 1,600

Dr. Profit & Loss Appropriation Account for the year ended 31.12.1996 Cr.

	Particulars	Amount Rs.	Amount Rs.	Particulars	Amount Rs.	Amount Rs.
To	To Interest on Capital :			By Profit & Loss (Net Profit)		56,100
	" Sachin	1,500				
	" Sanat	2,000				
	" Sohali	1,600	5,100			
	" Share of Profit :					
	" Sachin [15/51]	15,000				
	" Sanat [20/51]	20,000				
	" Sohali [16/51]	16,000				
			51,000			
			56,100			56,100

Interest on Capitals omitted to be charged.

Illustration 11 :

A, B, C and D are partners sharing profit and losses in the rato of 4 : 3 : 3 : 2 Their respective capitals on 31st March, 2008 were Rs.3,000 Rs. 4,500 Rs. 6,000 and Rs. 4,500. After closing and finalizing the accounts it was found that interest on capital @ 6 % per annum was omitted. Interest to altering the signed accounts it was decided to pass a single adjusting entry on 1st April, 2008 crediting or debiting the respective partners' accounts. Show the Journal Entry.

Solution : Statement showing Rectification of Profits

Partner	Interest on Capital @ 6%p.a. not provided Rs.	Amount Wrongly distributed in PSR Rs.	(Excess)/Deficit Rs.	Adjust Rs.
A	180	360	(180)	Debit
B	270	270	-	-
C	360	270	90	Credit
D	270	180	90	Credit
	1,080	1,080	-	

Date	Particulars	L.F	Dr. Amount Rs.	Cr. Amount Rs.
1.4.08	A's Current A/c ……………………..…Dr.		180	
	To C's Current Account			90
	To D's Current Account			90
	[Interest on Capital not provided			
	@ 6% p.a. now rectified]			

Illustration 12 :

The Capital Accounts of Adhar and Bhudhar stood at Rs. 40,000 and Rs. 30,000 respectively after the necessary adjustment in respect of the drawings and the net profit for the year ended 31st December, 2008. It was subsequently ascertained that 5% p.a. interest on Capitals and drawings was not taken into account in arriving at the net profit. The drawings of the partners had been : Adhar Rs. 1,200 at the end of each quarter and Bhudhar Rs. 1,800 at the end of each half year.

The profit for the year as adjusted amounted to Rs. 20,000. The partners share profit in the proportion of Adhar 3/5 and Bhudhar 2/5

You are required to pass journal entries and show the adjusted capital accounts of the partners.

Solution :

Working Notes :

(i) Interest Drawings

	Adhar Rs.	Bhudhar Rs.
On 1,200 drawn at the end of 1st quarter [1,200 x 5/100 x 9/12]	45	
On 1,200 drawn at the end of 2nd quarter [1,200 x 5/100 x 6/12]	30	
On 1,200 drawn at the end of 3rd quarter [1,200 x 5/100 x 3/12]	15	
On 1,200 drawn at the end of last quarter	Nil	
	90	
On 1,800 drawn at the end of 1st half year [1,200 x 5/100 x 6/12]		45
On 1,800 drawn at the end of 2nd half year		Nil
		45

(ii) Statement showing Rectification of Profits

		Adhar Rs.	Bhudhar Rs.
(A)	Capital as on 31.12.08	40,000	30,000
	Add : Drawings	4,800	3,600
	Less : Share of Profits already Credited	12,000	8,000
	Capital as on 1.1.08	32,800	25,600
	Add : Interest on Capital @ 5%	1,640	1,280
	Less : Interest on Drawings	90	45
	Add : Share of Profits = 17,215		
	[20,000 - 1,640 - 1,280 + 90 + 45]	10,329	6,886
	Less : Drawings	4,800	3,600
(B)	Adjusted Capital as on 31.12.08	39,879	30,121
	Difference of Capital [A-B}	121 (Excess)	121 (Deficit)

Solution :

Adjustment Entry :

Journal Dr. Cr.

Date	Particulars	L.F.	Amount Rs.	Amount Rs.
1.1.2009	Adhar's Capital Account ………………….…Dr. To Bhudhar's Capitals Account [Adjustment made for Interests on Capital and on Drawings not provided and the net amount wrongly shared as Profits]		121	121

Capital Accounts

Dr. Cr.

Date	Particulars	Adhar Rs.	Bhudhar Rs.	Date	Particulars	Adhar Rs.	Bhudhar Rs.
1.1.09	To Bhudhar's Capitals	121		1.1.09	By balance b/f	40,000	30,000
	,, Balance c/f	39,879	30,121		,, Ashar's Capital		121
		40,000	30,121			40,000	30,121

Adjustment for wrong distribution of Profits.

Illustration 13 :

Dr. Profit & Loss Appropriation Account for the year ended 31st March 2008 Cr.

Particulars	Amt Rs.	Particulars	Amt Rs.
To Interest on Capital :		By Net Profit	40,000
Dhruva 8% of Rs. 40,000	3,200	,, Interest on Drawings (calculated	
Rohini 8% of Rs. 30,000	2,400	on average of 6 months)	
,, Salary – Dhruva	4,800	Dhruva 6% of Rs. 8,000	240
,, Share of Profit : Dhruva [1/2]	15,010	Rohini 6% of Rs. 6,000	180
Rohini [1/2]	15,010		
	40,420		40,420

The entries were duly passed in the books but the following discrepancies were subsequently discovered :

(i) Interest on capital should have been allowed at 6% p.a. and that on drawings should have been charged at 8% p.a.

(ii) Dhruva was not entitled to get any salary but Rohini was to get a monthly salary of Rs. 250.

(iii) Profits should have been shared in opening capital ratio.

You are required to redistribute the profits correctly.

Solution :

Calculation of Net Amounts already Credited to each Partner's Capital

	Dhruva Rs.	Rohini Rs.
Amounts Credited : Interest on Capital	3,200	2,400
Salary	4,800	—
Share of Profit	15,010	15,010
	23,010	17,410
Less : Amount debited – Interest on drawings	240	180
	22,770	17,230

Dr. Profit & Loss Appropriation Account for the year ended 31.12.2008 Cr.

Particulars	Amount Rs.	Amoun Rs.	Particulars	Amount Rs.	Amount Rs.
To Interest on Capital :			By Dhruva'a Capital		22,770
Dhruva [6% of 40,000]	2,400		(Amount written back)		
Rohini [6% 0f 30,000]	1,800	4,200	''Rohini's Capitals		
''Salary – Rohini		3,000	(Amount written back)		17,230
[250 × 12]			''Interest on Drawings :		
			[@ 8% p.a. on average		
			6 months]		
			Dhruva	320	
''Share of Profit :			Rohini	240	560
Dhruva [4/7]	19,063				
Rohini [3/7]	14,297	33,360			
		40,560			40,560

Illustration 14 :

Cross Guarantee

Susmita and Aishwarya were partners of a Beauty Parlour sharing profit and Losses as 3 : 2 Manpereet who had been running a similar business as a beauty consultant requested Susmita and Aishwarya to form a new partnership to which all of them agreed on the conditions that :

1. They would share the profits and losses 3 : 2 : 1.
2. Susmita and Aisharwya guranteed to the effect that Manpreet's share of profit would not be lower than Rs. 22,500 per annum.
3. Manpreet guaranteed that gross fees earned by her for partnership business shall be at least equal to her average gross fees of the preceeding three years when she was doing business on her own. Her average gross fees were Rs. 37,500.

The profit of the new partnership for the first accounting year ended on 31st March, 2008 was Rs. 1,12,500 and the gross fees earned by Manpreet for the firm were Rs. 24,000.

Show the distribution of the above profit in a Profit & Loss Appropriation Account for the year ended 31st March, 2008.

Solution : Susmita , Aisharwya & Manpreet

Dr. Profit & Loss Appropriation Account for the year ended 31.3.08 Cr.

Particulars	Amount Rs.	Amount Rs.	Particulars	Amount Rs.	Amount Rs.
To Partnerships'			By Profit + Less A/c		1,12,500
Capital A/cs :			(Net Profit)		
(Share of Profit) [Note 2]			''Manpreet's Capital A/c		13,500
Susmita	62,100		[Note 2]		
Aisharwya	41,400				
Manpreet	22,500	1,26,000			
		1,26,000			1,26,000

Note :

1. Manpreet's shortfall in gross fees earned by her for the partnership = Rs. 37500 – Rs. 24,000 = Rs. 13,500. This amount is to be paid by her out of her Capital Account.

   Manpreet's Capital A/c Dr. 13,500

   To Profit Loss Appropriation A/c 13,500

2. Manpreet's share of actual profit =1/6 of Rs. 1,26,000 = Rs. 21,000. As amount guaranteed to her is Rs. 22,500.

- Deficit = Rs. 1,500 to be shared by Susmita and Aishwarya as 3 : 2.
- Final Distribution of Profit should be :

Susmita = 3/6 of 1,26,000 – 3/5 of 1,500 = 63,000 – 900 = Rs. 62, 100;

Aishwarya = 2/6 of 1,26,000 – 2/5 of 1,500 = 42,000 – 600 = Rs. 41,400;

Manpreet = 1/6 of 1,26,000 + 1,500 = 21,000 + 1,500 = Rs. 22,500.

Susmita's Capiital A/c Dr. 900

Aishwarya's Capital A/c Dr.600

To Manpreet's Capital A/c 1,500

Illustration 15 :

Guarantee with Retrospective effect

Kalyani and Ranu commenced business on 1st July, 2005 as partners with capitals of Rs. 1,80,000 and Rs. 1,20,000 respectively. The capitals would remain fixed and carry interest at 10% p.a. profit and losses were to be shared in proportion to their capitals.

They appointed Anita as their Manager on 1st July, 2005 at a salary of Rs. 9,600 per annum plus a bonus of 5% of the net profits after charging such bonus and interest as a partner from the commencement of the business. She had to deposit Rs. 80,000 as security, carrying an interest @ 12%p.a. It was agreed that she would be entitled to one-fifth share of the profits and her security deposit would be treated as her capital carrying interest @ 10% p.a. It was further agreed that this new arrangement should not result in Anita's share for any of these years being less than what she had already received under the original agreement and terms of her appointment.

The profits before charging Anita's bonus and interest on Capital of the partners or giving effect to the new arrangement were – (a) for the year 2005-06 - Rs. 60,000; (b) for the year 2006 – 07 – Rs. 1,20,000; (c) for the year 2007-08 – Rs. 1,60,000

Show by a single journal entry to give effect to the new arrangement with explanatory computation.

Points to be noted :

1. As a Manager, Anita received (a) bonus @ 5% on Net Profits after charging such bonus and interest on capital at 10% p.a. to Kalyani and Ranu (b) Salary Rs. 9,600 p.a. (c) Interest on security deposit at 12% p.a.

2. As a Partner Anita is entitled to (a) Interest on Capital at 10% p.a. (b) 1/5th of profit after providing interest on capital at 10% p.a. to all partners including herself.

3. If total dues of Anita under (2) above is more than that under (1) above, she should get the difference. But if such dues under (1) above is more, she would not refund the excess already received.

Solution :

Workings (1) – Calculation of Anita's Dues as Manager

	2005-06 Rs.	2006-07 Rs.	2007-08 Rs.
Salary	9,600	9,600	9,600
Interest on Security Deposit : 12% of 80,000	9,600	9,600	9,600
Bonus 5/105 of profit after charging interest on capitals of Kalyani and Ranu			
2005-06 = 5/105 of (60,000 - 10% of 3,00,000)	1,429		
2006-07 = 5/105 of (1,20,000 – 10% of 3,00,000)		4,286	
2007-08 = 5/105 of (1,60,000 – 10% of 3,00,000)			6,190
	20,629	23,486	25,390

(2) Calculation of Distributable profit under the new arrangement

	2005-06 Rs.	2006-07 Rs.	2007-08 Rs.
Net profits given (after charging interest on security deposit and Anita's salary but before charging interest on capitals)	60,000	1,20,000	1,60,000
Add : Anita's Salary and Interest on Deposit no more payable [9,600 +9,600]	19,200	19,200	19,200
	79,200	1,39,200	1,79,200
Less : Interest on Capitals to all partners @ 10% of [1,80,000 + 1,20,000 + 80,000]	38,000	38,000	38,000
Distributable Profits	41,200	1,01,200	1,41,200
Anita's Share of Profit = 1/5th of Distributable Profit	8,240	20,240	28,240

(3) – Difference in Payments to Anita

	2005-06 Rs.	2006-07 Rs.	2007-08 Rs.
A. Anita's Dues as Partner :			
Interest on Capital @ 10% of 80,000	8,000	8,000	8,000
Share of Profit [as per workings 2]	8,240	20,240	28,240
	16,240	28,240	36,240
B. Anita's Dues as manager [as per workings 1]	20,629	23,486	25,390
Difference Payable to Anita	-	4,754	10,850
Total			15,604

Journal

Date	Particulars	L.F	Dr. Amount Rs.	Cr. Amount Rs.
	Kalyani's Current A/c [3/5 of 15,604]..................Dr.		9,362	
	Ranu's Current A/c [2/5 of 15,604]......................Dr.		6,242	
	To Anita's Current A/c			
	[Adjustments made through Partners' Current			15,604
	A/cs to the to new arrangement regarding profits]			

As capitals remained fixed and interest was calculated every year on these fixed capitals,the necessary adjustment has been made through current accounts.

Illustration 16 :

Adjusments without alteration of book values

R,S and T are partners of a firm, sharing profits and losses as 5 : 3 : 2. Their Balance Sheet as on 31st March, 2007 stood as follows :

Liabilities	Rs.	Assets		Rs.
Sundry Creditors	25,000	Cash at bank		10,000
General Reserve	20,000	Sundry Debtors	22,000	
S Loan Account	15,000	Less: Reserve for Bad Debts	2,000	20,000
Capital Account :		Furniture		10,000
R	25,000	Machinery		35,000
S	10,000	Stock		25,000
T	5,000			
	1,00,000			100,000

From 1st April, 2007 the partners decided to change their profit sharing ratio as 2 : 1 : 2 in place of their previous ratio 5 : 3 : 2 and the following adjustments were agreed upon :

(1) The Reserve for Bad Debts was to be raised to 10%; (2) Furniture was to be appreciated by Rs. 5,200.

They did not want to alter the book values of the assets and reserve but recorded the change by passing one single journal entry.

The profit for the year ended 31st March, 2008 showed a net profit of Rs. 22,900.

You are required :-

1. To show the single journal entry adjusting the partners' capital on 1st April, 2007, and
2. To prepare the Profits and Loss Account for the year ended 31st March, 2008 after taking into account the following : (i) Interest on Capital at 5% p.a.; (ii) Interest on S's loan and (iii) Transfer 25% of the divisible profit to Reserve Fund after charging interest on Capital & Loan.

Solution :

Working Notes :

1. Calculation of Net Effect of the adjustments

	Rs.
Profit due to increase of Value of Furniture	5,200
General Reserve	20,000
Less : Additional Reserve for Bad Debts (Provision)	25,200
[10% of (Rs.22,000-Rs.2000)]	200
Profit	25,000

2. Adjustment of Capital as on 01.04.07

	R Rs.	S Rs.	T Rs.
Profit Rs. 25,000 shared in old ratio 5 : 3 : 2	12,500	7,500	5,000
Loss Rs. 25,000 shared in new ratio 2 : 1 : 2	(10,000)	(5,000)	(10,000)
Net Effect	2,500	2,500	(5,000)
Capitals as on 31.03.07	25,000	10,000	5,000
Adjusted Capital on 1.4.07	27,500	12,500	—

Books of R, S & T

Journal Entry

Date	Particulars	L.F.	Amount	Amount
1.4.07	T's Capital A/c ....*Dr.*		5,000	
	To, R's Capital			2,500
	S's Capital			2,500
	(*Adjustment made due to change in profit sharing ratio*)			

Dr. ***Profit & Loss Account for the year ended 31st March, 2008*** *Cr.*

Particulars	Amount Rs.	Amount Rs.	Particulars	Amount Rs.	Amount Rs.
To Interest on Capital :			By, Profit & Loss A/c (Net Profit)		22,900
R - [5% of 27,500]	1,375				
S - [5% of 12,500]	625	2,000			
'' Interest on S's loan [6% of 15,000]		900			
'' Reserve Fund [25/125×(22,900–2,900)]		4,000			
'' Shares of Profit :					
R [2/5]	6,400				
S [1/5]	3,200				
T [2/5]	6,400	16,000			
		22,900			22,900

Illustration 17 :

Adjustment of Profits A typical problem

Agni and Bani started a partnership on April 1, 2005 with respective capital contributions of Rs. 60,000 and Rs. 20,000. On 31.03.2007 they prepared the following Trial Balance for their business :

	Dr. (Rs.)	*Cr. (Rs.)*
Stock	46,000	-
Machinery	46,500	-
Debtors and Creditors	58,000	12,000
Provision for Depreciation		9,500
Cash and Bank	21,000	-
Capitals : Agni	-	1,04,750
Bani	-	45,250
	1,71,500	1,71,500

The transactions recorded in the Capital Accounts during these two years were interest on capital at 10% p.a. on initial investments and allocation of incomes. On 31.03.07 it was further discovered that total drawings of Rs. 21,000 by Agni and Rs. 15,000 by Bani had been wrongly treated as business expenses. The Partnership Accounts were to be correctly adjusted.

On 1.4.2007 Agni and Bani offered partnership to Clara and Dela on the following terms :

1. The new partners should introduce capitals as Clara Rs. 50,000 and Dela Rs. 40,000.
2. All partners would be entitled to interest on opening balance of the new partnership @ 10% p.a.
3. Agni and Bani are to receive salaries for their special services @ Rs. 10,000 p.a. and Rs. 6,000 p.a.
4. The minimum dues of Clara and Dela would be Rs. 10,000 p.a. and 12,000 p.a. respectively (inclusive of their interest on capital)
5. Profits after charging Partners' salaries and interests on capitals would be shared as 3 : 3 : 2 : 2 among Agni, Bani, Clara and Dela.

You are required to show : (1) Correct Capital balance of Agni and Bani on31.03.07 (2) the net income that must be earned by the new firm during the year ended 31st March 2008 so that Agni and Bani receive equal shares of Profit and Agni receives an aggregate of Rs. 30,000 inclusive of interest on Capital, Salary and Share of Profit.

Solution :

Notes :

1. Profits already credited

	Agni Rs.	Bani Rs.
Opening Capitals	60,000	20,000
+ Interest on Capital for 2 years @ 10% p.a. on original capitals	12,000	4,000
+ Profits Credited (Balance)	32,750	21,250
Closing Balance	1,04,750	45,250
Therefore Total Profit Credited = 32,750 + 21,250 = Rs.54,000		

Therfore rectified Profit = Profits Credited + drawings treated as an expense
= 54,000 + 21,000 + 15,000 = 90,000/-

2. Sharing Profits

	Agni Rs.	Bani Rs.
Correct Profit equally divided [90,000 as 1 : 1]	45,000	45,000
Profits wrongly credited	32,750	21,250
Adjustment Required	12,250	23,750

Statement showing correction of Capitals of Agni and Bani on 31.03.07
And correction of Profits upto that date

Correction of Capital Balance	Agni Rs.	Bani Rs.
Balance as per Trial Balance on 31.3.07	1,04,750	45,250
Less : Drawing	21,000	15,000
	83,750	30,250
Add : Adjustment for Profit [Note 1 & Note 2]	12,250	23,750
Adjusted Capitals on 31.3.07	96,000	54,000

Statement Showing Calculation of Minimum Income to be earned during the year ended 31.3.08

		Amt Rs.	Amt Rs.
Minimum Amount Payable to :			
Agni :	Interest on Capital [10% of 96,000]	9,600	
	Salary	10,000	
	Share of Profit [Balancing amount to make total dues Rs. 30,000]	10,400	30,000
Bani :	Interest on Capital [10% of 54,000]	5,400	
	Salary	6,000	
	Share of Profit [Equal share with Agni]	10,400	21,800
Clara :	Interest on Capital [10% of 50,000]	5,000	
	Share of Profit [Balancing Amount to make total Rs. 10,000]	5,000	10,000
Dela :	Interest on Capital [10% of 40,000]	4,000	
	Share of Profit [Balancing Amount to make total Rs. 12,000]	8,000	12,000
	Total Profits Required to be earned		73,800

EXERCISE

1. In which set of business organization Profit and Loss appropriation Account is to be maintained?

2. What do you mean by guranteed Partnership?

3. In absence of partnership deed which item will be reflected in Profit and Loss appropriation Account

Problem 1.

Guarantee with retrospective effect

A and B commenced business on 1st April, 2005 as partners with capitals of Rs. 1,20,000 and Rs. 80,000 respectively. The capitals remained fixed carrying interest @ 7% per annum. Profits were shared in proportion to their capitals.

They appointed C as their manager on 1st April, 2005 at a salary of Rs. 4,800 per annum plus a bonus of 5% of the profits after charging such bonus and interest on capital. C had to deposit on 1.4.05 Rs. 40,000 as security deposit carrying interest at 8% per annum.

In March, 2008 it was settled that C should be treated as partner from 1st April, 2005. It was agreed that he should be entitled to 1/6th of the profits and his security deposit would be treated as his capital carrying interest at 7% instead of the 8% he had received. It was further agreed that this new arrangement should not result in C's share for any of these years being less than what he had received under the original agreement and terms of his appointment.

The profits before charging C's bonus and interest on capital or giving effect to the new arrangement were : (a) for the year ended 31st March, 2006 – Rs. 30,000; (b) for the year ended 31st March, 2007 – Rs. 58,000; (c) for the year ended 31st March, 2008 – Rs. 83,000.

Show the necessary Journal entries to give effect to the new arrangement with explanatory computation.

[Ans :	A's Current A/c .... Dr.	2,872	
	B's Current A/c .... Dr.	1,914	
	To C's Current A/c		4,786]

Problem 2.

Conversion of method of accounting from Cash Basis to Mercantile Basis with retrospective basis.

P, Q and R are partners of a firm of consultants since 1st January, 2005 sharing profits and losses as 3 : 2 : 1. They maintain their accounts under cash basis after allowing salaries as P Rs. 1,500 per month, Q Rs. 1,200 per month and R Rs. 300 per month. Besides R's share is guaranteed to a fixed minimum of Rs. 6,000 (including his salary).

In 2008 they decide to change the method of accounting to mercantile basis with retrospective effect. Relevant pieces of information are :

Year	Profit under cash basis before charging partner's salaries Rs.	Outstanding Expenses on the closing date of the year Rs.	Fees earned but not received on the closing date of the year Rs.
2005	50,000	10,000	14,500
2006	61,000	9,000	16,500
2007	40,000	10,500	8,000

Pass a single Journal Entry adjusting the partners accounts to give effect to the above change.

[Ans : Adjustment Entry :

A's Capital (Dr.)	2,210	Outstanding Expenses (Cr.)	10,500
B's Capital (Dr.)	1,473	C's Capital (Cr.)	1,183

Problem 3.

S, T and O were partners sharing profits as 3 : 2 : 1. Their capitals on 31st December, 2008 stood as S Rs, 45,000, O Rs. 15,000 and T Rs. 15,500 after adjustments of net profit Rs. 18,000 for the year ending that date and their drawings of Rs. 6,000 Rs. 4,000 and Rs. 2,000 respectively. It was discovered however that while ascertaining the profit the accountant did not take into consideration the following matters :

1. Interest @ 6% p.a. on Capital as on 1.1.2008
2. O was entitled to a salary of Rs. 2,000 per annum of which Rs. 490 was unpaid.
3. Till 31.12.2007 partners were sharing profits equally and that goodwill was valued at Rs. 12,000 on the date of re-ascertaining the profit the accountant did not take into consideration the following matters :
4. A loan of Rs. 5,000 from T as brought forward from 2007 carrying interest at 8% p.a. was merged into his capital on July 1, 2008. No interest on loan was, however, charged to profit & loss account.

You are required to work out a Profit & Loss adjustment account and show the journal entries necessary for re-adjustment of capital accounts and the revised capital accounts of partners assuming that all their dues are to be adjusted in Capitals Accounts.

[Hints : See Appropriation of Profits – Wrong Distribution]

[Ans : Revised Profit 12,720; Capital Balances for charging interest S Rs. 46,000, T Rs. 12,000; O Rs. 18,500;

Revised Capitals : S Rs. 49,120, T Rs. 18,160, O Rs. 20,220

T A/c ....Dr	840		Goodwill A/c .... Dr.	12,000	
S A/c (Cr.)		120	S, T & O each (Cr.)		12,000
O A/c (Cr.)		720	(Rs. 4,000 each)		

Problem 4.

Apportionment between Pre-admission and Post-admission Profits

A and B are partners in a firm sharing profit & losses in the ratio of 3 : 2, with capitals of Rs. 1,20,000 and Rs. 40,000 respectively. The interest on capital @ of 5% p.a. They admit C into partnership with effect from 1st October, 2008 on the following conditions :

(i) That C is to bring in Rs 15,000 as premium for goodwill, which will be withdrawn by A & B in their old profit-sharing ratio.

(ii) That C is to contribute Rs. 22,400 to the firm as his share of capital.

(iii) That the partner's capitals will carry interest at 5% p.a.

(iv) That the profit earned during 2008 will be apportioned between the pre-admission and post-admission period on the basis of turnover.

The profits for the year ending 31st December, 2008 before charging interest on partners Capitals amounted to Rs. 66,500. The monthly average turnover during the first 9 months of the calendar year was twice the corresponding figure for the remaining 3 months.

You are required to prepare : (1) Profits & Loss Account of the firm for the pre-admission period and (2) Profit & Loss Account of the firm for the post-acquisition period.

[Hints : (1) Ratio of Turnover : 1.1.2008 to 30.9.08: 1.10.08 to 31.12.08 = 9 × 2 : 3 × 1 = 18 : 3 or 6 : 1 (2) Profit Sharing Ration between A & B = 3 : 2 and Profit Sharing Ratio between B & C = 3 : 2, So, Ratio between A, B and C = 9 : 6 : 4]

[Ans : (a) Pre-Admission Periods distributable profits = 51,000; (b) Post-Admission Periods distributable profits = 7,220; (c) Interest on Capitals of Capitals for (a) = Rs. 6,000 and for (b) Rs. 2,280]

4.3. RETIREMENT, DEATH AND DISSOLUTION

A . Retirement

INTRODUCTION

A Partner may leave the firm by taking retirement. Normally the retirement takes place by consent of all the partners and / or by other mode of communication by the intended partner to all other partners.

In case of retirement, for paying off the retiring partner(s) some adjustment are required to be done in the books of accounts.

Steps for Adjustments / Books of Accounts :

Following steps to be taken and books of accounts to be prepared to calculate the due of retiring partner.

1) Revaluation of Assets and liabilities.

This is required for giving the share of net assets of the firm. Treatments are:

Profit or loss on revaluation to be transferred to all the partners in old Profit Sharing ratio.

If the remaining partners decide not to alter the book value of assets or liabilities then the profit or loss on revaluation as distributed earlier should be reversed through remaining partner's capital account in new profit sharing ratio. We shall have to prepare Memorandum Revaluation Account.

2) Undistributed profit or loss.

Any undistributed profit or loss including reserve is to be transferred in old profit sharing ratio.

Journal entries:

In case of undistributed profit or reserves:

Profit and Loss A/c	Dr
Reserve account A/c	Dr
To Old Partners capital A/c (In old P.S.R)	

In case of undistributed Loss

Old partners capital A/c	Dr
To Profit and loss A/c	

3) Adjustment regarding goodwill:

At the time of retirement the retiring partner is also eligible for share of goodwill of the firm. This can be made in the following ways:

a) Raising of goodwill : (If goodwill is already existing in the Balance sheet the difference shall be raised)

Goodwill account Dr

(Value of goodwill – existing goodwill in the balance sheet)

To all partners capital account (Old P.S.R)

b) Goodwill raised and written off :

i) Raise goodwill as discussed above.

ii) Write off goodwill

Existing partners Capital A/c Dr.

To Goodwill A/c

<u>Settlement of Dues to the Retiring Partner :</u>

The retiring partner becomes entitled to get back his dues from the firm which consists of the following :

i) Balance of his capital and current account at the time of retirement.

ii) Share of goodwill, undistributed profit or loss, reserves and profit or loss on revaluation of assets and liabilities.

iii) Salary, commission, interest on capital, if any and all other dues till the date of retirement.

iv) Any adjustment in drawings and interest thereon.

<u>Payment of dues.</u>

i) Payment at a time. Subject to availability of the fund, the payment may be made at a time. Journal entry:

Retiring Partner's Capital A/c Dr

To Bank A/c

ii) If part payment be made by giving assets:

Retiring Partner's Capital A/c Dr

To Assets A/c

iii) If the dues are transferred to Loan account.

Retiring Partner's Capital A/c Dr

To Retiring partners' Loan A/c

iv) If the existing partners bring in cash for making payment :

Bank / Cash account Dr

To Existing Partners' Capital A/c

v) For interest due on Retiring Partners Loan Account.

Interest on Retiring partner's loan account Dr

To Retiring Partner's Loan account.

Illustration :

The Balance Sheet of Baichung, Tausif and Vijayan who shared profits and losses in the ratio 3:3:2 respectively was as follows on 31st December, 2007 :

Capitals :			Machinery	31,600
Baichung	24,000		Furniture	6,400
Tausif	10,000		Stock	8,500
Vijayan	8,000	42,000	Debtors	4,300
Reserve		4,800	Cash at Bank	4,700
Creditors		8,700		
		55,500		55,500

Baichung retired from the business on 1st January, 2008. Revaluation of assets were made as :

Machinery Rs. 34,000, Furniture Rs. 5,000, Stock Rs. 9,600, Debtors Rs. 4,000 and Goodwill Rs. 10,000.

Baichung was paid Rs. 4,225 immediately and the balance was transferred to a Loan Account for payment in 4 equal half-yearly installments together with interest @ 6% p.a.

Show the necessary accounts, the Balance Sheet of the firm immediately after Baichung's retirement and his Loan Account till finally paid off.

Solution :

Books of baichung, Tausif and Vijayan

Revaluation Account

Dr. Cr.

Date	Particulars	Amt. Rs.	Amt. Rs.	Date	Particulars	Amt. Rs.	Amt. Rs.
1.1.08	To Furniture A/c		1,400	1.1.08	By Machinery A/c		2,400
	To Provision On Debtors A/c		300		By Stock A/c		1,100
	To Capital A/c : (Profit on Revaluation)						
	Baichung [3/8]	675					
	Tausif [3/8]	675					
	Vijayan [2/8]	450	1,800				
			3,500				3,500

Capital Account

Dr. Cr.

Dt	Particulars	Baichung Rs.	Tausif Rs.	Vijayan Rs.	Dt	Particulars	Baichung Rs.	Tausif Rs.	Vijayan Rs.
1.1	To Bank A/c	4,225	-	-	1.1	By Balance b/d	24,000	10,000	8,000
	To 10% Loan A/c (Balance Transferred)	26,000	-	-		By Reserve A/c [3:3:2]	1,800	1,800	1,200
						By Revaluation A/c	675	675	450
	To balance c/d	–	16,225	12,150		“ Goodwill	3,750	3,750	2,500
		30,225	16,225	12,150			30,225	16,225	12,150

Tausif and Vijayan

Balance Sheet as at 1.1.08

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Capitals :			Goodwill		10,000
Tausif	16,225		Machinery		34,000
Vijayan	12,150	28,375	Furniture		5,000
Baichung’s 10% Loan		26,000	Stock		9,600
			Debtors	4,300	
Sundry Creditors		8,700	Less : Provision	300	4,000
			Cash at Bank [4,700-4,225]		475
		63,075			63,075

Baichung's Loan 10% Account

Dr. Cr.

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
30.6.08	To Bank A/c [1/4 of 26,000 + 780]	7,280	1.1.08	By Baichung's Capital A/c	26,000
			30.6.08	By Interest [6% of 26,000 for 6 months]	780
31.12.08	To Bank A/c [1/4 of 26,000 + 585]	7,085	31.12.08	By Interest A/c of [6% of (26,000 – 6,500) for 6 months]	585
	To Balance c/d	13,000			
		27,365			27,365
30.6.09	To Bank A/c [6500+390]	6,890	1.1.09	By Balance b/d	13,000
31.12.09	To Bank A/c [6,500+195]	6,695	31.06.09	By Interest A/c [6% of 13,000 for 6 months]	390
			31.12.09	By Interest A/c [6% of 6,500 for 6 months]	195
		13,585			13,585

Illustration 2 :

On 31st March, 2008 the Balance Sheet of M/s. Ram, Hari and Mohan sharing profits & losses as 2:3:2, stood as follows :

Liabilities		Rs.	Assets	Rs.
Capital Accounts :			Land & Building	10,00,000
Ram	10,00,000		Machinery	17,00,000
Hari	15,00,000		Closing Stock	5,00,000
Mohan	10,00,000	35,00,000	Sundry Debtors	6,00,000
Sundry Creditors		5,00,000	Cash & Bank Balance	2,00,000
		40,00,000		40,00,000

On 31st March, 2008 Hari decided to retire from the firm and the remaining partners decided to carry on. It was agreed to revalue the Assets and Liabilities on that date on the following basis : (1) Land & Buildings be appreciated by 30%; (2) Machinery be depreciated by 20%; (3) Closing Stock to be revalued at Rs. 4,50,000; (4) Provision for bad debts be made at 5%; (5) Old credit balances of Sundry Creditors Rs. 50,000 be written back; (6) Joint Life Policy of the partners surrendered and cash obtained Rs. 3,50,000; (7) Goodwill of the old firm be valued at Rs. 6,30,000 and Hari's Share of the Goodwill adjusted in the accounts of Ram and Mohan who share the profits and losses as 3:2. No goodwill being raised; (8) The total capital of the firm is to be the same as before retirement, Individual capitals be in their profit sharing ratio; (9) Amount due to Hari is to be settled on the following basis : 50% on retirement and the balance 50% within one year.

Prepare Revaluation Account, Capital Accounts of Partners, Cash Account and Balance Sheet as on 1.4.2008 of M/s Ram & Mohan.

Solution :

Books of M/s Ram, Hari & Mohan

Revaluation Account

Dr. Cr.

Particulars	Amt. Rs.	Amt. Rs.	Particulars	Amt. Rs.	Amt. Rs.
To Machinery A/c		3,40,000	By Land & Buildings A/c		3,00,000
To Stock A/c		50,000	By Sundry Creditors		50,000
To Provision for Bad Debts		30,000	By Partners Capital A/cs :		
			Ram [2/7]	20,000	
			Hari [3/7]	30,000	
			Mohan [2/7]	20,000	70,000
		4,20,000			4,20,000

[Treatment of Joint Life Policy - Surrender value

<u>For proceeds from Joint Life Policy</u>

Bank A/c Dr.	3,50,000	
To Joint Life Policy A/c		3,50,000

<u>For sharing the proceeds of Joint Life Policy</u>

Joint Life Policy A/c Dr.	3,50,000
To Ram's Capital A/c	1,00,000
To Hari's Capital A/c	1,50,000
To Mohan's Capital A/c	1,00,000

Hari's share of goodwill = 3/7 × 6,30,000 = 2,70,000

Ram's Capital A/c Dr.	1,62,000	
Mohan's Capital A/c Dr.	1,08,000	
To Hari's Capital A/c		2,70,000
(Being Hari's is share of goodwill adjusted)		

Partner's Capital Account

Dr. Cr.

Date 2008	Particulars	Ram Rs.	Hari Rs.	Mohan Rs.	Date 2008	Particulars	Ram Rs.	Hari Rs.	Mohan Rs.
31.3	To Hari's Capital A/c	1,62,000	--	1,08,000	31.3	By Balance b/d	10,00,000	15,00,000	10,00,000
	To Revaluation A/c	20,000	30,000	20,000		By Bank A/c (Joint Life Policy as 2:3:2)	1,00,000	1,50,000	1,00,000
	To Cash /Bank A/c [50%]	-	9,45,000	-		By Ram's & Mohan's Capital (G/will shared)	-	2,70,000	-
	To Loan A/c	-	9,45,000	-		By Cash/Bank A/c (Bal. figure)	11,82,000	-	4,28,00
	To Balance c/d (Note)	21,00,000		14,00,000					
		22,82,000	19,20,000	15,28,000			22,82,000	19,20,000	15,28,000

Total Capital of the new firm	=	Total capital of the old firm (given)
	=	Rs. 35,00,00
Therefore Ram's Capital = 3/5 x 35,00,000	=	21,00,000
Mohan's Capital = 2/5 x 35,00,000	=	14,00,000

Cash/Bank

Dr. Cr.

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
31.3.08	To Balance b/d	2,00,000	31.3.08	By Hari's Capital A/c	9,45,000
	To (Joint Life Policy A/c	3,50,000			
	To Ram's Capital A/c	11,82,000		By Balance c/d	12,15,000
	To Mohan Capital A/c	4,28,000			
		21,60,000			21,60,000

Balance Sheet as on 1.4.2008

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Capital Accounts:			Land & Building		13,00,000
			Machinery		13,60,000
Ram		21,00,000	Stock		4,50,000
Mohan		14,00,000	Sundry Debtors		
Sundry Creditors		4,50,000	Less : Provision	6,00,000	
			for Bad Debts	30,000	5,70,000
Hari's Loan		9,45,000	Cash and Bank		12,15,000
		48,95,000			48,95,000

Working Notes :

1. Calculation of Gaining Ratio [New Ratio – Old Ratio]

   Ram = 3/5 – 2/7 = 11/35; Mohan = 2/5 – 2/7 = 4/35 So, Gaining Ratio = 11:4

Illustration 3 :

A, B and C were in partnership sharing profits in the proportion of 5:4:3. The Balance Sheet of the firm as on 31st March, 2008 was as under :

Liabilities	Rs.	Assets	Rs.
Capital Accounts		Goodwill	40,000
A	1,35,930	Fixtures	8,200
B	95,120	Stock	1,57,300
C	61,170	Sundry Debtors	93,500
Sundry Creditors	41,690	Cash	34,910
	3,33,910		3,33,910

A had been suffering from ill-health and gave notice that he wished to retire. An agreement was, therefore entered into as on 31st March, 2008, the terms of which were as follows:

(i) The Profit & Loss Account for the year ended 31st March, 2008, which showed a net profit of Rs. 48,000 was to be reopened. 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 ratio was to be revised as from 1st April, 2007 to 3:4:4.

(ii) Goodwill was to be valued at two years' purchase of the average profits of the preceding five years. The Fixtures were to be revalued by an independent valuer. A provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book values.

(iii) The valuations arising out of the above agreement were Goodwill Rs. 56,800 and Fix ture Rs. 10,980.

(iv) B and C agreed, as between themselves, to continue the business, sharing profits in the ratio of 3:2 and decided to eliminate Goodwill from the Balance Sheet, to retain the Fixtures on the books at revised value, and to increase the provision for doubtful debts to 6%.

You are required to submit the Journal Entries necessary to give effect to the above arrangement and to draw up the Capital Accounts of the partners after carrying out all adjustment entries as stated above.

Solution

Books of the Firm A, B & C

Journal Entries

Date	Particulars		Amount	Amount
			Rs.	Rs.
31.3.08	A's Capital A/c [5/12 of Rs. 48,000]	Dr.	20,000	
	B's Capital A/c [4/12 of Rs. 48,000]	Dr.	16,000	
	C's Capital A/c [3/12 of Rs. 48,000]	Dr.	12,000	
	To Profit & Loss Adjustment A/c			48,000
	[Profits of Rs. 48,000 already shared by A,B & C as 5:4:3 written back]			
	Profit & Loss Adjustment A/c	Dr.	4,000	
	To B's Capital A/c			4,000
	[B Credited with bonus of Rs. 4,000 for his extra work]			

	Profit & Loss Adjustment A/c	Dr.	44,000	
	To A's Capital A/c [3/11 of Rs 44,000]			12,000
	To B's Capital A/c [4/11 of Rs 44,000]			16,000
	To C's Capital A/c [4/11 of Rs 44,000]			16,000
	[The remaining profits re-distributed as 3:4:4]			
	Goodwill A/c	Dr.	16,800	
	Fixtures A/c	Dr.	2,780	
	To Profit & Loss Adjustment A/c			19,580
	[Values of assets increased on revaluation]			
	Profit & Loss Adjustment A/c	Dr.	1,870	
	To Provision for doubtful debts A/c			1,870
	[Provision created @ 2% on Debtors]			
	Profit & Loss Adjustment A/c	Dr.	17,710	
	To A's Capital A/c [3/11]			4,830
	To B's Capital A/c [4/11]			6,440
	To C's Capital A/c [4/11]			6,440
	[Profit on Revaluation shared among all partners as 3:4:4]			
	A's Capital A/c	Dr.	1,32,760	
	To A's Loan A/c			1,32,760
	[Transfer of A's dues to his Loan A/c]			
	B's Capital A/c [3/5]	Dr.	36,324	
	C's Capital A/c [2/5]	Dr.	24,216	
	To Goodwill A/c			56,800
	To Provision for doubtful debts A/c			3,740
	[Goodwill Account written off and provision on debtors increased by 4%further on Rs.93,500]			

Dr. Capital Accounts Cr.

Date	Particulars	A	B	C	Date	Particulars	A	B	C
2008		Rs.	Rs.	Rs.	2008		Rs.	Rs.	Rs.
31.3	To Profit & Loss Adjustment A / c	20,000	16,000	12,000	31.3	By Balance b / d	1,35,930	95,120	61,170
	To Loan A / c (Balance Transferred)	1,32,760	-	-		By P&l Adjustment A / c (Bonus)	-	4,000	-
	To Goodwill & Provision for Doubtful Debts	-	36,324	24,216		By Profit & Loss Adjustment A / c	12,000	16,000	16,000
	To Balance c / d	-	69,236	47,394		By Profit & Loss Adjustment A / c	4,830	6,440	6,440
		1,52,760	1,21,560	83,610			1,52,760	1,21,560	83,610

Illustration 4 :

Sona, Mona and Dona were partners sharing profits in the proportions of ½, 1/3 and 1/6 respectively. Their Balance Sheet as on 31st March, 2008 was as under :

Liabilities		Rs.	Assets		Rs.
Sundry Creditors		24,000	Cash		2,500
Reserve		12,000	Debtors	16,000	
			Less : Prov.	500	15,500
Capitals :			Stock		25,000
Sona	35,000		Motor Vans		8,000
Mona	30,000		Plant		35,000
Dona	30,000	95,000	Buildings		45,000
		1,31,000			1,31,000

Mona retired on that date subject to the following adjustments : (a) The Goodwill of the firm be valued at Rs. 18,000; (b) Plant and Motor Vans be depreciated by 10% and 15% respectively; (c) Stock and Buildings be appreciated by 20% and 10% respectively; (d) Provision for Doubtful Debts be fixed at Rs. 2,450; (e) Liability for damages be provided at Rs. 450; (f) The new profit sharing ratio between Sona and Dona be 3/5 and 2/5 respectively.

Pass the necessary Journal entries and prepare the Capital Accounts and the Balance Sheet assuming that no alteration of book values of assets and liabilities is to be made.

Solution :

Note :

1. As book values are not to be altered, there should be Memorandum Revaluation Account
2. The share of Reserve of the retiring partner should be credited to her account and debited to continuing partners in their gaining ratio.
3. Calculation of Gaining Ratio

   Gain by Sona = New Ratio – Old Ratio = 3/5 – ½ = 6-5/10 = 1/10 or 3/30 ;

   Gain by Dona 2/5 – 1/6 = 12- 5/30 = 7/30, So Gaining Ratio = 3 : 7.
4. Effect of Revaluations

Dr. Memoraudum Revaluation Account Cr.

Particulars	Amount Rs.	Particulars	Amount Rs.
To Liab. for Damages	450	By Stock	5,000
" Plant	3,500	" Building	4,500
" Motor Van	1,200		
" Prov. for D/Debts	1,950		
" Partners Capital A/c			
Sona - 1200			
Mona - 800			
Dona - 400	2,400		
	9,500		9,500
To Reversal of Items b/d		By Reversal of Items b/d	
Stock	5,000	Liab. for Damage	450
Building	4,500	Plant	3,500
		Motorvan	1,200
		Prov. for D / Debts	1,950
		By P/Capital A/c	
		Sona - 1,440	
		Dona - 960	2,400
	9,500		9,500

Solution :

Sona, Mona and Dona

Journal Entries

Date	Particulars		L.F.	Amount (Dr.)	Amount (Cr.)
				Rs.	Rs.
31.3.08	Sona's Capital A/c [3/10] …………………..	Dr.		1,200	
	Dona's Capital A/c [7/10] ………………….	Dr.		2,800	
	To Mona's Capital A/c				4,000
	[Mona's share of Reserve credited to her capital on her retirement and debited to continuing partners capitals in gaining ratio 3 : 7]				
31.3.08	Sona's Capital A/c …………………...	Dr.		1,800	
	Dona's Capital A/c ………………………	Dr.		4,200	
	Mona's Capital A/c				6,000
	[Retiring Partner's share of Goodwill borne by continuing partners]				
31.3.08	Mona's Capital A/c ……………………….	Dr.		40,800	
	To Mona's Loan A/c				40,800
	[Balance due to the retiring partner transferred to her loan account]				

Dr. Capital Account Cr.

Date 2008	Particulars	Sona Rs.	Mona Rs.	Dona Rs.	Date 2008	Particulars	Sona Rs.	Mona Rs.	Dona Rs.
31.3	To Mona's Capital A/c	1,200	—	2,800	31.3	By Balance b/d	35,000	30,000	30,000
	To Mem. Rev. A/c	1,440	—	960		By Sona & Dona's Capital A/c	—	4,000	—
	To Mona's Capital A/c	1,800	—	4,200		By Mem. Rev. A/c	1,200	800	400
	To Mona's Loan A/c transfer	—	40,800	—		By Sona & Dona's Capital A/c	—	6,000	—
	To Balance c/d	31,760	—	22,440					
		36,200	40,800	30,400			36,200	40,800	30,400

Sona and Dona

Balance Sheet as on 31st March, 2008

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Sundry Creditors		24,000	Cash		2,500
Reserve		12,000	Debtors	16,000	
Mona's Loan A/c		40,800	Less : Prov.	500	15,500
Capital A/c :			Stock		25,000
Sona	31,760		Motor Vans		8,000
Dona	22,440	54,200	Plant		35,000
			Buildings		45,000
		1,31,000			1,31,000

Illustration 5 :

P, Q & R were equal partners. R retired on 31st March, 2008. The Balance Sheet of the firm as on 31st December, 2007 was as follows :

Liabilities		Rs.	Assets	Rs.
Capitals :			Goodwill	18,900
P	30,000		Buildings	40,000
Q	20,000		Investments (at Cost)	5,000
R	20,000	70,000	Stock	10,000
Investment			Debtors	10,000
Fluctuation Fund		1,200	Cash at Bank	10,000
Bad Debts		800		
General Reserve		4,000		
Trade Creditors		17,900		
		93,900		93,900

On 31.3.08 the following adjustments were considered : (a) Buildings were appreciated by Rs. 18,000; Book Debts were considered good; Investments were considered worth Rs. 4,700 and Stock was valued at Rs. 9,400; (b) Goodwill was considered equivalent to the average annual profits of the last three years; (c) R's share of Profit up to the date of his retirement was calculated on the basis of the average annual profits of the preceding three years which were Rs. 8,000; Rs. 9,000 and Rs. 10,000.

Show the Journal Entries and prepare the Balance Sheet immediately after R's retirement.

Working notes :

1. Valuation of Goodwill : Average Annual Profits = 8,000 + 9,000 + 10,000 / 3 = Rs. 9,000

   Decrease in value of Goodwill = Rs. 18,900 – Rs. 9,000 = Rs. 9,900

   This shall be shared amongst all the Partners' in their old ratio.

2. R retired on 31st March, 2008, that is, after 3 months from the date of the last year ending. Estimated Profits for 3 months = 3 / 12 of 9,000 = Rs. 2,250. The retiring partner should be credited with 1 / 3rd of 2,250 = Rs. 750.

   Either the continuing Partners' Capital accounts should be debited in their Gaining Ratio OR Profit and Loss Suspense Account may be debited.

3. Investment at cost was shown at Rs. 5,000. Now It is valued at Rs. 4,700. Loss on Revaluation is Rs. 300. The fluctuation fund in excess of Rs. 300 (that is Rs. 1,200- Rs. 300= 900) should be transferred to Revaluation Account.

P, Q & R

(Journal Entries) Dr. Cr

Date	Particulars		L.F.	Amount	Amount
31.3.08				Rs.	Rs.
	P's Capital A/c	Dr.		3,300	
	Q's Capital A/c	Dr.		3,300	
	R's Capital A/c	Dr		3,300	
	To Goodwill A/c				9,900
	[Value of Goodwill written down and partners capitals debited in old ratio 1 : 1: 1]				
	Profit & Loss Suspence A/c	Dr.		750	
	To R's Capital A/c				750
	[Adjustment made for retiring partner's estimated share of profit]				
	Buildings A/c	Dr.		18,000	
	Provision for Bad Debts A/c	Dr.		800	
	Investment Fluctuation Fund A/c [1,200 - 300]	Dr.		900	
	To Revaluation A/c				19,700
	[Adjustment made for revaluation of assets and liabilities]				
	Revaluation A/c	Dr.		600	
	To Stock A/c				600
	[Value of stock reduced on revaluation]				
	Revaluation A/c	Dr.		19,100	
	To P's Capital A/c				6,366
	To Q's Capital A/c				6,367
	To R's Capital A/c				6,367
	[Profit on Revaluation shared by all partners equally]				
	General Reserve A/c	Dr.		4,000	
	To P's Capital A/c				1,334
	To Q's Capital A/c				1,333
	To R's Capital A/c				1,333
	[Undistributed Reserve shared equally by all partners]				
	R's Capital A/c	Dr.		25,150	
	To R's Loan A/c				25,150
	[Dues to the retiring partner transferred to Loan A/c]				

Partners Capital Accounts

Dr. Cr.

	P Rs.	Q Rs.	R Rs.		P Rs.	Q Rs.	R Rs.
To Goodwill A/c				By Bal b/d	30,000	20,000	20,000
- Written off	3,300	3,300	3,300	" P & L Susp. A/c	-	-	750
" R's Loan A/c							
(Transfer)	-	-	25,150	" RevA/c -Sh.of			
				Profit	6,366	6,367	6,367
				" Gen. Reserve	1,334	1,333	1,333
To Balance c/d	34,400	24,400	-				
	37,700	27,700	28,450		37,700	27,700	28,450

P and Q

Balance Sheet as on 31st March, 2008

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Capital :			Goodwill		9,000
P	34,400		Buildings	40,000	
Q	24,400	58,800	Add: Appreciation	18,000	58,000
R's Loan A/c		25,150	Investment at Cost		5,000
Investment			Stock		9,400
Fluctuation Fund		300	Debtors		10,000
Trade Creditors		17,900	Cash at Bank		10,000
			P & L Suspense A/c Dr.		750
		1,02,150			1,02,150

Illustration 6 :

X, Y and Z were partners sharing profits & losses as 4:3:1. On 1.4.2007 their capitals were Rs. 15,000, Rs. 15,000 and Rs.10,000 respectively. The Partnership Deed contained :

1. Interest on Capital would be provided @ 10% p.a.
2. In case of retirement, the goodwill would be valued at 2 years purchase of the average distributable profits of the preceeding 5 years.
3. The Profit of the retiring partner to the date of retirement would be estimated on the basis of the average distributable profit of the last 3 years; and
4. The firm would effect a Joint Life Policy for Rs. 30,000 whose premium would be charged as business expense.

X retired from the firm on 1.10.07. The surrender value of the policy as on that date was ascertained as Rs. 8,000. Drawings of the partners upto that date were X Rs. 3,000; Y Rs. 2,000 and Z Rs. 1,000. The annual net profits after charging interest on capital and joint life policy premia were : 2002-03 – Rs. 8,000; 2003-04- Rs. 8,800; 2004-05-Rs. 7,200; 2005-06- Rs. 9,500; 2006-07-Rs. 10,000.

X's final claims regarding revenue accounts were met out of the assets of the business and the rest was paid out of cash brought in by Y and Z in such proportions as to set their capital balances equated to their shares of profits. Show the Partners Capital Accounts.

Solution :

Working Notes:

1. Calculation for Goodwill

Average Annual Profits for last 5 years = $\frac{8,000+8,800+7,200+9,500+10,000}{5}$ = Rs. 8,700

Goodwill = 2 × 8,700 = 17,400

2. Profits upto the date of retirement & share of profits :

Average Annual Profits of last 3 years = $\frac{7,200+9,500+10,000}{3}$ = Rs. 8,900

Therefore, Propotionate share of profits = 8,900 x 6/12 x 4/8 = 2,225 /-

3. Share of Joint Life Policy at surrender value = 4/8 x 8000 = Rs.4,000 /-

4. Total claim of X on Retirement

Amount Payable to Mr. X

	Rs.
Capital (as on 1.4.07)	15,000
(+) Share of Goodwill (4/8 x 17,400) (Note 1)	8,700
(+) Interestion Capital (15,000 x 10/100 x 6/12)	750
(+) Proportionate share of profits (Note 2)	2,225
(+) Share of Surrender Value of Joint Life Policy (Note 3)	4,000
	30,675
Less: Drawings	3,000
	27,675

Note : (1) Interest on Capital, proportionate share of profits are adjusted through profit & Loss Suspense A/c as follows :

P & L Suspense A/c Dr. 2,975

To X 's Capital A/c (2,975)

(Being interest on capital & propotionate share of profits provided)

(2) Adjustment of X's share of Goodwill

Y's Capital A/c Dr. 6,525

Z's Capital A/c Dr. 2,175

To X's Capital A/c 8,700

(Being X's Share of Goodwoll adjusted against existing partners in their Gaining ratio (3 : 1)

(3) Proportionate capital of Y & Z

Balance of Y's Capital		=	6,475
(15,000 - 6,525 - 2,000)			
Balance of Z's Capital		=	6,825
(10,000 - 2,175 - 1,000)			
(+) Cash Paid to X	=	27,675	
		40,975	

Therefore Y's Capital = 3/4 x 40,000 = 30,731

Z's Capital = 1/4 x 40,975 = 10,244

Y & Z Balance sheet as at 1.10.07 (after retirement)

Capital	Rs.	Rs.		Rs
Y :	30,731		Sundry Assets	38,000
Z :	10,244	40,975		
			P & L Susp. A/c	2,975
		40,975		40,975

Balance sheet (Before retirement)

Captial				
X =	15,000		Sundry Assets	34,000
Y =	15,000			
Z =	10,000			
		40,000	Advance to Partners	6,000
		40,000		40,000

Date 2007	Particulars	X Rs.	Y Rs.	Z Rs.	Date 2007	Particulars	X Rs.	Y Rs.	Z Rs.
1.10	To X Capital A/c	-	6,525	2,175	1.4	By Balance b/d	15,000	15,000	10,000
	To Drawings	3,000	2,000	1,000		By Y and Z's Capital A/c	8,700	--	--
	To Cash (Bal. Paid off)	27,675	-	-		By P & L Susp. A/c	750	--	--
	To Balance c/d	-	30,731	10,244		By Cash A/c (brought in)		24,256	3,419
						By JLP A/c	4,000	-	-
		30,675	39,256	13,419			30,675	39,256	13,419

Illustration 7 :

M, J and P were partners sharing profits/losses in the ratio of M 40%, J 35% and P 25%. The draft Balance Sheet of the partnership as on 31st December, 2008 was as follows:

Liabilities		Rs.	Assets		Rs.
Sundry Creditors		30,000	Cash in hand and at Bank		67,000
Bills payable		8,000	Stock		42,000
Loan from J		30,000	Sundry Debtors	34,000	
			Less : Prov.	6,000	28,000
Current Accounts :					
M	12,000		Plant & Machinery	80,000	
J	8,000		Less: Dep.	28,000	52,000
P	6,000	26,000	Premises (at cost)		75,000
Capital Accounts:					
M	90,000				
J	50,000				
P	30,000	1,70,000			
		2,64,000			2,64,000

J retired on 31.12.08. M and P continued in partnership sharing profit/losses in the ratio of M 60% and P 40%.

50% of J's loan was repaid on 1.1.2009 and it was agreed that out of the amount then remaining due to him a sum of Rs. 80,000 should remain as loan to partnership and the balance to be carried forward as ordinary trading liability. The following adjustments were agreed to be made to the above-mentioned Balance Sheet:

1. Rs. 10,000 should be written off from the premises, which was acquired two years back on lease for a term of 15 years.
2. Plant & Machinery was revalued at Rs. 58,000;
3. Provision for Doubtful Debts to be increased by Rs. 1,200;
4. Rs. 4,000 to be written off stock;
5. Rs. 5,000 due to creditors for expenses had been omitted from the books of accounts;
6. Provide Rs. 1,200 for professional charges in connection with the revaluation.

As per the deed of partnership, in the event of retirement of a partner, goodwill was to be valued at an amount equal to one year's purchase of the average profits of the preceeding 3 years on the date of retirement. Before determining the said average profits, a notional amount of Rs. 80,000 should be charged for remuneration of partners. The necessary profits (before charging such remuneration) for the years ending on 31st December, 2006, 2007 and 2008 were Rs. 1,44,000, Rs 1,68,000 and Rs. 1,88,200 (as per draft accounts) respectively.

It was agreed that, for the purpose of valuing goodwill, the amount of profit for the year 2008 be recomputed after charging the loss on revaluation in respect of premises and stock, the unprovided expenses (except professional expenses) and increasein the provision for doubtful debts. The continuing partners decided to eliminate goodwill account from their books.

Prepare the Revaluation Account; Capital Accounts (merging current accounts therein); J's Account showing balance due to him, and Balance Sheet of M and P as at 1st January, 2009.

Solution :

M, J & P

Dr. Revaluation Account Cr.

Particulars	Amount Rs.	Amount Rs.	Particulars	Amt. Rs.	Amt. Rs.
To Premises A/s		10,000	By Machinery A/c [58,000 – 52,000]		6,000
To Provision for Bad Debts A/c		1,200	By Capital A/cs : (Loss on Revaluation)		
To Creditors for Expenses A/c		5,000	M [8/20]	6,160	
To Stock A/c		4,000	J [7/30]	5,390	
To Outstanding Professional Charges A/c		1,200	P [5/20]	3,850	15,400
		21,400			21,400

Gaining Ratio = New Ratio - Old ratio

M = 60/100 - 40/100 = 20/100

P = 40/100 - 25/100 = 15/100 = 4 : 3

Capital Accounts

Dr. Cr.

Particulars	M Rs.	J Rs.	P Rs.	Particulars	M Rs.	J Rs.	P Rs.
To Revaluation A/c	6,160	5,390	3,850	By Balance b/d	90,000	50,000	30,000
To J's Capital A/c	16,000	—	12,000	By Current A/c	12,000	8,000	6,000
To J's loan A/c		80,610		By M and	—	28,000	—
(Bal. Transferred)			—	P's Cap. A/c			
To Balance c/d	79,840	—	20,150	[Note]			
	1,02,000	86,000	36,000		1,02,000	86,000	36,000

Dr. J's Loan Account Cr

Particulars	Amount Rs.	Particulars	Amount Rs.
To bank A/c [50% of 30,000]	15,000	By Balance b/d	30,000
To J's A/c (Bal. Fig treated as ord. Liability)	15,610	By J's Capital A/c	80,610
	80,000		
To Balance c/d	1,10,610		1,10,610

Balance Sheet as on 1.1.2009

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Sundry Creditors [30,000+J's A/c 15,610]		45,610	Cash in hand and at Bank [67,000 – 15,000]		52,000
Bills Payable		8,000	Stock		38,000
Creditors for Expenses		5,000	Sundry Debtors	34,000	
O/S professional Charges		1,200	Less : Provision for Debts	7,200	26,800
Loan from J		80,000	Plant & Machinery		58,000
Capital Accounts :			Premises [75,000 – 10,000]		65,000
M	79,840				
P	20,150	99,990			
		2,39,800			2,39,800

Working Notes :

Adjustment of Profit & Valuation of Goodwill

	Rs.	Rs.
Total Profits for the last 3 years [1,44,000 + 1,68,000 + 1,88,200]		5,00,200
Less : (1) Notional Remuneration for 3 years [80,000 x 3]	2,40,000	
(2) Premises w/off	10,000	
(3) Creditors for Expenses	5,000	
(4) Provision on Debtors	1,200	
(5) Stock written off	4,000	2,60,200
Adjusted Profits for last 3 years		2,40,000

Goodwill = Average of Adjusted Profits = 1/3 of 2,40,000 = Rs. 80,000

Goodwill A/c Dr. 80,000

To M 32,000
To J 28,000
To P 20,000

M-Dr. 48,000
P-Dr. 32,000
(To Goodwill A/c 80,000)

Or,

M - Dr. 16,000
P - Dr. 12,000
To J 28,000 (In Gaining Ratio 4 : 3)

Illustration 8 :

X, Y, & Z were equal partners. Their Balance Sheet as on 31.12.07 was as follows:

Partners' Capital			Land & Freehold Property	1,00,000
X	1,00,000		Plant & Machinery	2,00,000
Y	1,00,000		Furniture & Equipment	50,000
Z	2,00,000	4,00,000	Stock in-trade	1,00,000
Partner's Current A/c :			Sundry Debtors	1,00,000
X	50,000		Balance with Bankers	1,50,000
Y	75,000			
Z	25,000	1,50,000		
Sundry Creditors		1,50,000		
		7,00,000		7,00,000

On 1.1.08 X retired and it was agreed that he should be paid all his dues in full on that date. For this purpose, goodwill was to be calculated on the basis of 3 years purchase of past 3 years profits which amounted to Rs. 1,00,000, 1,40,000 and 1,20,000 respectively.

In order to meet his obligation, a bank loan was arranged on 1.1.08 for Rs. 2,00,000 pledging the fixed assets as security.

Further, to compensate a loyal manager Q, it was agreed between Y and Z that Q should be admitted as a partner, who should bring in, over and above a capital of Rs. 1,00,000, his share of Goodwill in cash to serve as working capital. Y and Z agreed to forego 1/3rd of their individual share of profits to Q.

Prepare the opening Balance Sheet of the firm as on 1.1.08.

Solution :

Working Notes:

(1) Valuation of Goodwill

Average Annual Profits = $\frac{1,00,000 + 1,40,000 + 1,20,000}{3}$ = Rs. 1,20,000

So, Goodwill = 3 x ,20,000 = Rs. 3,60,000

Premium to be paid by Q = 1/3 of 3,60,000 = Rs. 1,20,000 and to be shared by Y and Z equally. Similarity X should be provided Rs. 1,20,000 by Y and Z equally.

(2) (Journal Entries)

a)	Y's Current A/c Dr.	60,000	
	Z's Current A/c Dr.	60,000	
	To X's Current A/c		(1,20,000)

(Being X's share of goodwill adjusted against existing partners Y & Z in their gaining ratio 1 : 1)

b)	Cash A/c Dr.	1,00,000	
	To Q's Capital A/c		(1,00,000)

(Being Capital contributed by C)

c)	Cash A/c Dr.	1.20,000	
	To Y's Current A/c		(60,000)
	To Z's Current A/c		(60,000)

(Being Q's share of premium for goodwill share between Y & Z in their sacrificing ratio)

D) Bank A/c Dr. 2,00,000

To Bank Loan A/c 2,00,000

(Being loan taken from Bank against hypothecation of fixed assets)

(3)

Partner Capital Accounts

Dr. Cr.

	X	Y	Z	Q		X	Y	Z	Q
					By Balance b/d	1,00,000	1,00,000	2,00,000	-
					" X's Current Transfer	1,70,000	-	-	-
To Cash A/c Final settlement	2,70,000	-	-	-	" Cash A/c Capital introduced	-	-	-	1,00,000
To Balance c/d	-	1,00,00	2,00,00	1,00,000					
	2,70,000	1,00,000	2,00,000	1,00,000		2,70,000	1,00,000	2,00,000	1,00,000

(4)

Partner Current Accounts

Dr. Cr.

	X	Y	Z	Q		Z	Y	Z	Q
To X's Cap A/c(Tran)	1,70,000	-	-	-	By Bal. b/d	50,000	75,000	25,000	-
To X's Current A/c	-	60,000	60,000	-	" Y's Current A/c	60,000	-	-	-
					" Z's Current A/c	60,000	-	-	-
To Balance C/d	-	75,000	25,000	-	" Cash A/c	-	60,000	60,000	-
	1,70,000	1,35,000	85,000	-		1,70,000	1,35,000	85,000	-

(5) Bank Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	1,50,000	By X's capital A/c	2,70,000
To Bank Loan A/c	2,00,000		
To Cash A/c (Premium for goodwill)	1,20,000		
To Q's capital A/c	1,00,000	By Balance c/d	3,00,000
	5,70,000		5,70,000

Balance Sheet as at 31.12.08

Liabilities	Amount Rs.	Amount Rs.	(Assets)	Amount Rs.	Amount Rs.
Partners' Capital A/cs:			Land and Freehold Property		1,00,000
			Plant & Machinery		2,00,000
Y	1,00,000		Furniture & Equipment		50,000
Z	2,00,000		Stock		1,00,000
Q	1,00,000	4,00,000	Debtors		1,00,000
Partner's Current A/cs :			Cash at Bank (W5)		3,00,000
Y	75,000				
Z	25,000	1,00,000			
Bank loan (Secured)		2,00,000			
Sundry Creditors		1,50,000			
		8,50,000			8,50,000

Illustration 9 :

Khana and Lilavati started practicing as Chartered Accountants since 1965 sharing profits as equal partners. They admitted Gargi in 1970 from which time they have all been equal partners. The accounts were maintained on cash basis without regard to debtors and work-in-progress. At the time of Gargi's admission. She paid Khana and Lilabati privately in respect of debtors and work-in-progress.

On 31st December, 2008 Khana and Lilavati retired from the partnership and Maitrayee, their paid assistant, became an equal partner with Gargi. Upon the elevation of Maitrayee as partner, Arundhati was engaged on a salary of Rs. 24,500 per annum to take over the place, so long held by Maitrayee who was paid Rs. 15,000, Rs. 17,500 and Rs. 20,000 respectively as salary for the last three financial years. It was agreed that Maitrayee would effectively replace Khana and Lilavate. The Profits of the last three years as shown by partnership accounts were Rs. 85,000 Rs. 87,000 and Rs. 92,000 respectively. The fees received in each of the past three years have been about Rs. 6,00,000 accruing evenly throughout the year.It is agreed that goodwill based on one year's purchase of the average of the past 3 years profits, as adjusted, should be shown in the books in lieu of the present book value of Rs. 60,000. On 31st December, 2008, the Capital Accounts of Khana, Lilavati and Gargi stood at Rs. 40,000 each without any adjustment suggested above. Maitrayee was to pay adequate cash to make her capital equivalent to that of Gargi and this amount was to be withdrawn equally by Khana and Lilavati, any balance due to them should be transferred to their loan accounts.

As the financial adviser to the partnership you are requested to opine on inter-partner payments required regarding debtors and work-in-progress. You come to know that normally a job takes 6 months from start to finish, at the end of which the client concerned is billed and payment is received.

Show :

1. The Capital Accounts of Khana, Lilavati, Gargi and Maitrayee showing the Goodwill adjustments; and

2. Prepare a statement showing your recommendations concerning inter-partner payments in respect of debtors and work-in-progress.

Solution :

Working Notes :

1. Adjustment for Goodwill

	2006 Rs.	2007 Rs.	2008 Rs.
Annual Profits as per accounts	85,000	87,000	92,000
Add: Salary of Maitrayee	15,000	17,500	20,000
	1,00,000	1,04,500	1,12,000
Less : Salary of Arundhati	24,500	24,500	24,500
	75,500	80,000	87,500
Value of Goodwill [75,500 + 80,000 + 87,000] / 3			81,000
Less : The present value of Goodwill			60,000
Increase in the value of goodwill			21,000

2. Debtors & Work-in-Progress

Average time taken to complete a job = 6 months

Fees Receivable in a year = Rs. 6,00,000

Fees Receivable in 6 months = Rs. 3,00,000

Here it has been said that jobs accrue evenly throughout the year. So Debtors & work-in- Progress should be equal to three months work. Its value should be Rs. 1,50,000

Partners Capital Accounts

Dr. Cr.

Particulars	Khana Rs.	Lilavati Rs.	Gargi Rs.	Mait-yrayee Rs.	Particulars Rs.	Khana Rs.	Lilavati Rs.	Gargi Rs.	Mait-rayee Rs.
					By Balance b/d	40,000	40,000	40,000	
To Cash A/c	23,500	23,500	-	-	By Goodwill A/c	7,000	7,000	7,000	-
To Loan A/c	23,500	23,500	-	-	[21,000 as 1:1:1]				
To Balance c/d	-	-	47,000	47,000	By Cash A/c	-	-	-	47,000
	47,000	47,000	47,000	47,000		47,000	47,000	47,000	47,000

2nd Part : Recommendations Re : Inter-Partner Payments for Debtors & Work-in-Progress

	Khana Rs.	Lilavati Rs.	Gargi Rs.	Maitrayee Rs.
Average value Rs. 1,50,000 credited to Khana, Lilavati and Gargi as 1:1:1	50,000 (Cr.)	50,000 (Cr.)	50,000 (Cr.)	--
Average value now debited equally to Gargi & Maitrayee as 1:1	-	-	75,000 (Dr.)	75,000 (Dr.)
	50,000 (Cr.)	50,000 (Cr.)	25,000 (Dr.)	75,000 (Dr.)

Illustration 10 :

P, Q and R were partners sharing Profits & Losses as 2 : 3 : 5. P retired on 31.3.08 and X joined as a new partner on the same date, the new profit sharing ratio between Q, R and X being 2: 3:1. The Balance Sheet of P, Q & R on 31.3.2008 was as follows:

Sundry Creditors		50,000	Cash in hand	2,000
Loan from X		50,000	Cash at Bank	93,000
General Reserve		40,000	Sundry Debtors	30,000
Capitals :			Stock	20,000
P	10,000		Machinery	30,000
Q	15,000		Buildings	10,000
R	20,000	45,000		
		1,85,000		1,85,000

X was admitted on the following terms :

(1) Machinery was to be depreciated by Rs. 3,000 (2) Buildings were revalued at Rs. 30,000 (3) Stock was to be written off by Rs. 5,000 (4) Provision of 5% was made against doubtful debts (5) General Reserve would be apportioned among the partners (6) The firm's Goodwill was to be valued as two years purchase of the average profits of the last three years (7) The amount due to P was retained in the business as a loan but X's Capital contribution should be $1/5^{th}$ of the combined adjusted capitals of Q and R. His capital would be transferred from his Loan Account, (8) the Goodwill would be wiped off from the books after X's admission. (9) Partners decided not to alter the book values of assets & liatilities after admission.

The profits/losses during the last 3 years had been 31.3.06 Rs. 20,000 (Profit) 31.3.07 Rs. 15,000 (loss) and 31.3.08 Rs. 40,000 (Profit).

Show the necessary journal entries to give effect to the above transactions.

Solution :

Working Notes :

1.Valuation of Goodwill

Profits for years ended :	31.3.06	Rs. 20,000
	31.3.07	Rs.(15,000)
	31.3.08	Rs. 40,000
		Rs. 45,000

So, Average Annual Profits = $\frac{45,000}{3}$ = Rs. 15,000. Goodwill = 2 x Rs. 15,000 = Rs. 30,000

For Goodwill raised :

Goodwill A/c	Dr.	30,000
To P		(6,000)
To Q		(9,000)
To R		(15,000)

For Goodwill written off :

Q - Dr.	10,000	
R - Dr.	15,000	
X - Dr.	5,000	
To Goodwill		(30,000)

Memorandum Revaluation Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Machinery	3,000	By Building	20,000
" Stock	5,000		
" Prov. for doubtful Debts	1,500		
" P/Capital A/c			
(Share of Rev. Profit)			
P - 2,100			
Q - 3,150			
R - 5,250	10,500		
	20,000		20,000
To Reversal of Items b/d		By Reversal of Items b/d	
Building	20,000	Machinery	3,000
		Stock	5,000
		Prov. for D/Debts	1,500
		By P/Capital A/c	
		(Share of Rev. loss)	
		Q - 3,500	
		R - 5,250	
		X - 1,750	10,500
	20,000		20,000

(3) Partners Capital Accounts

Dr. Cr.

	P Rs.	Q Rs.	R Rs.	X Rs.		P Rs.	Q Rs.	R Rs.	X Rs.
To Mem.Rev A/c - Sh. of loss	-	3,500	5,250	1,750	By Balance b/d	10,000	15,000	20,000	-
To Goodwill written off	-	10,000	15,000	5,000	By Gen. Reserve	8,000	12,000	20,000	-
To P's loss A/c(transfer)	26,100				By Mem. Rev. A/c Sh. of profit	2,100	3,150	5,250	-
					By Goodwill raised	6,000	9,000	15,000	-
To Balance C/d	-	25,650	40,000	13,130	By loan from X A/c (Transfer)	-	-	-	19,880
	26,100	39,150	60,250	19,880		26,100	39,150	60,250	19,880

Capital Balance of X = 1/5 of (25,650 + 40,000) = 1/5 X 65,650 = 13,130

Therefore from X's loan A/c : Loan from X A/c Dr. 19,880

To X's Capital A/c 19,880

(4)

Q, R & X

Balance sheet as at 31.3.08

Dr. Cr.

	Rs.		Rs.
S/Creditors	50,000	Building	10,000
Loan for X	30,120	Machinery	30,000
Loan from P	26,100	Stock	20,000
Capitals			
Q : 25,650		Debtors	30,000
R : 40,000		Cash in hand	2,000
X : 13,130	78,780	Cash at Bank	93,000
	1,85,000		1,85,000

Illustration 11 :

Shukla, Grewal, Jain and Narang were partners sharing profits and losses as 4:3:2:1. Their Balance Sheet as on 31.03.08 was as follows:

Liabilities		Rs.	Assets	Rs.
Capital :			Goodwill	9,000
Shukla	7,000		Stock	2,000
Grewal	6,500		Debtors	11,000
Jain	5,000		Cash	5,000
Narang	4,000	22,500	Profit and Loss (Dr. Bal) A/c	3,000
Sundry Creditors		7,500		
		30,000		30,000

On that date Grewal retired and the amount due to him was paid privately by the other partners in their profit sharing ratio. Chakraborty was then admitted as a new partner. The latter paid Rs. 5,000 as capital and Rs. 3,200 as his share of goodwill, his share being 1/5th of the future profits. Shukla, Jain and Narang resolved to share the remaining profits as 3 : 3 :2. It was also decided that the capitals of Shukla, Jain, Narang and Chakraborty should be made proportionate to their new profit sharing ratio and for this they should bring in or withdraw cash, as necessary.

1. The undistributed loss should be shared by Shukla, Grewal, Jain and Narang (the old partners) in old ratio 4 : 3: 2 : 1.

2. Grewal retived and the amount due to him was paid privately by the other Partners, Shukla, Jain, Narang in their profits haring ratio.

3.

(a) For 1/5th share Chakraborti's premium is Rs. 3,200.

Full value of Goodwill = 3,200 x 5/1 = 16,000

(b) Write off Goodwill as per B/S

Shukla's Capital A/c Dr.	5,143	
Jain's Capital A/c Dr.	2,571	
Narang's Capital A/c Dr.	1,286	
To Goodwill A/c		9,000

(Goodwill written off in 4 : 2 : 1)

Jain & Narang shall also pay to Shukla the only sacrificing partner, in their gaining ratio.

Jain's share = 1/70 X 16,000 = 229

Narang's = 4/70 X 16,000 = 914

Jain's Capital A/c Dr. 229

Narang's Capital A/c Dr. 914

Cash A/c Dr. 3,200

To Shukla's Capital A/c 4,343

(c) New Profit Sharing Ratio

Chakraborty's Share = 1/5

Balance left = 1- 1/5 = 4/5 to be shared in 3:3:2

Shukla's Share = 4/5 x 3/8 = 3/10;

Narang's Share = 4/5 x 2/8 = 2/10;

Jain's Share = 4/5 x 3/8 = 3/10

New Ratio = 3/10 : 3/10 : 2/10 : 2/10 = 3:3:2:2

(d) Sacrifice/Gains = Old Ratio – New Ratio

	Shukla Rs.	Jain Rs.	Narang Rs.	Ckakraborty Rs.
Old Ratio [S : J : N = 4 : 2: 1]	4/7	2/7	1/7	-
New Ratio [S : J : N : C]	3/10	3/10	2/10	2/10
Differences	19/70 (Sacrifice)	1/70 (Gain)	4/70 (Gain)	14/70 (Gain)

4. Adjustment of Capital Balances

Partculars	Shukla	Jain	Narang	Chakraborthy
	Rs.	Rs.	Rs.	Rs.
Capital as per last B/s or Invested	7,000	5,000	4,000	5,000
(+) Grewal's Capital aquired against				
private Payment (6,500 - 900) in 4:2:1	3,200	1,600	800	-
Adjustment for goodwill				
- Write off Goodwill as per B/s	(5,143)	(2,571)	(1,286)	-
- Adjustment for goodwill	4,343	229	914	-
- Share of loss	(1,200)	(600)	(300)	-
Adjusted Capitals	8,200	3,200	2,300	5,000
Therefore, Capital in Profit				
Sharing Ratio (3:3:2:2)	5,610	5,610	3,740	3,740
	2,590	2,410	1,440	1,260
	Excess	Deficit	Deficit	Excess

Journal Entries

Date	Particulars	L. F.	Amount	Amount
			Rs.	Rs.
	Shukla's Capital A/c ……………………….. Dr.		1,200	
	Grewal's Capital A/c ………………………… Dr.		900	
	Jain's Capital A/c …………………………….. Dr.		600	
	Narang's Capital A/c ………………………… Dr.		300	
	To Profit & Loss A/c			3,000
	[unshared loss written off in old ratio 4 : 3 : 2: 1]			
	Grewal's Capital A/c ………………………. Dr.		5,600	
	To Shukla's Capital A/c			3,200
	To Jain's Capital A/c			1,600
	To Narang's Capital A/c			800
	[Retiring partners credited to continuing partners in their remaining profit sharing ratio 4 : 2 : 1 on their private payments to the retiring partner]			

Date	Particulars	L. F.	Amount Rs.	Amount Rs.
	Cash A/c .... Dr. To Chakraborti's Capital A/s [Cash brought in by the incoming partner as capital]		5,000	5,000
	Shukla's Capital A/c .... Dr. Chakraborty's Capital A/c .... Dr. To Cash A/c [Excess Capitals, after adjustment of balances with new profit sharing ratio, withdrawn in cash]		2,590 1,260	3,850
	Cash A/c .... Dr. To Jain's Capital A/c To Narang's Capital A/c [Additional Cash invested to make capitals proportionate to new profit sharing ratio]		3,850	2,410 1,440

Shukla, Jain, Narang & Chakrabarti

Balance Sheet as at 1.4.2008

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Capital A/cs:			Stock		2,000
Shukla	5,610		Debtors		11,000
Jain	5,610		Cash [5,000 + 5,000 + 3,200 + 3,850 – 3,850]		13,200
Narang	3,740				
Chakrabarti	3,740	18,700			
Creditors		7,500			
		26,200			26,200

B. DEATH OF A PARTNER

If a partner dies, the partnership is usually dissolved. But if the surviving partners desire so, they may purchase the share of the deceased partner and carry on the business. In that case they have to decide (1) the total amount payable to the legal representative or executor of the deceased partner and (2) the mode of such payment.

Total Amount Payable includes:

(i) The deceased partner's Capital and / Current Accounts last Balance.

(ii) His share of undistributed profit/loss.

(iii) His share of revaluation profit/loss (iv) his share of goodwill.

(v) His share of Joint Life Policy, if any and

(vi) His share of profit/loss made by the firm between the last year ending and the date of his death.

The accounting procedure involved is similar to that followed in case of retirement of a partner.

The mode of payment depends on the agreement between the partners. It may be:

(i) Lump Sum Payment : If the firm has sufficient funds, the total amount payable on account of the deceased partner is transferred to his Representative's Account (or Executor). Such Representative's Account is debited and Bank Account is credited on payment of the dues.

(ii) Instalment Payment/Loan Payment : The firm may not have enough funds to make prompt payment. In such a case, the total amount payable is transferred to a loan account in the name of the legal representative or executor. The loan is paid off gradually by instalments after considering interest on unpaid balance. The word "Loan" may or may not be appended with the Account. But its gradual payment will definitely resemble the payment of loan.

Joint Life Policy and its Treatment

The partners of a firm may have a Joint Life Policy covering the lives of all the partners. It helps to realize money from the Insurance company in case of death of a partner. The dues of the deceased partner can be paid off without affecting the working capital of the firm.

The policy matures when a partner dies. The money realized from the Insurance Company is distributed among all the partners, including the deceased partner. The accounting entries made are stated below:

1. If Premium paid is treated as a revenue expense of the firm : The Premium is charged to Profit & loss Account which reduces the divisible profits. The amount paid by the Insurance Company in case of death of a partner or on surrender of the Policy is shared by all the partners (including the deceased partner) in their profit sharing ratio.

1. If premium paid is treated as an expense

Journal Entries :

(a) Premium Paid

Joint Life Insurance Premium A/c .... Dr,

To Bank A/c (amount of the Premium)

(b) For charging premium as expense

P & L A/c Dr.

To J.L.P. Premium A/c

(c) Amount Realised from Insurance Company

Bank A/c .... Dr.

To Joint life Policies A/c (in profit sharing ratio)

(d) For sharing the surplus of Joint Life Policy

Joint Life Policy A/c Dr.

To all partners Capital A/c

2. If premium is treated as a capital expenditure (Joint Life Policy Method) :

Here the premium is debited to Life Policy Account. At the end of the accounting period, the book value of the Life Policy [Opening Balance of Joint Life Policy + Current year's premium] is adjusted to its surrender value [amount receivable in case the Policy is surrendered before maturity]. Under this method the Policy appears on the Asset side at its surrender value.

Journal Entries :

(a) Premium Paid

Joint Life Policy A/c .... Dr.

To Bank A/c (amount of Premium)

(b) At the end of the year :

Profit & Loss A/c .... Dr.

To Joint Life Policy (Difference between Book value and surrender value).

(c) Policy Money Realised

Bank A/c .... Dr

To Joint Life Policy A/c (amount received)

(d) Transfer of Credit Balance of Joint Life Policy A/c

Joint Life Policy A/c .... Dr.

To All Partners Capital A/c's (in their profit sharing ratio)

3. Joint Life Policy Reserve Method

Journal Entries :

(a) Premium Paid

Joint Life Policy A/c …………………… Dr.

To Bank Ac/ (amount of premium)

(b) At the end of the year :

Joint life Policy Reserve A/c Dr.

To Joint Life Policy A/c

(Excess of surrender value over book value)

(c) Transfering from J.L.P. Reserve to P&L A/c

Profit & Loss A/c ……………….. Dr.

To Joint Life Policy Reserve A/c

Adjusting the difference between premium paid and the increase in surrender value

(d) Recording the receipt of Policy money

Bank A/c ………………….. Dr.

To Joint Life Policy A/c

(e) Transferring the balance of the Reserve A/c

Joint Life Policy Reserve A/c …………………. Dr,

To Joint Life Policy A/c

(f) Distributing the Life Policy among partners

Joint Life Policy A/c ………………….. Dr.

To All Partners Capital A/cs (Old ratio)

Illustration 1 :

The following was the Balance Sheet of A, B and C who shared profits in the ratio of 1 : 2 : 2 as on 31st December, 2007.

Sundry Creditors		10,000	Goodwill	15,000
Capital A/c:			Debtors	10,000
A	10,000		Machinery	20,000
B	20,000		Buildings	30,000
C	20,000	50,000	Stock	10,000
General Reserve		5,000	Cash at Bank	5,000
Investment Fluctuation Fund		3,000	Investments	10,000
Bad Debts Reserve		2,000		
Bank Loan		30,000		
		1,00,000		1,00,000

C died on 31st March, 2008. His account is to be settled under the following terms :

Goodwill is to be calculated at the rate of 2 years purchase on the basis of the average of 5 years profit or loss. Profit for January to March' 08 is to be calculated proportionately on the average profit of 3 years. The profits were : 2003 Rs. 3,000, 2004 Rs. 7,000, 2005 Rs. 10,000, 2006 Rs. 14,000, 2007 loss Rs. 12,000. During 2007 a Moped costing Rs. 4,000 was purchased and debited to Travelling Expenses Account on which depreciation is to be calculated @ 25%/. Other values agreed on assets are : Stock Rs. 12,000, Building Rs, 35,000, Machinery Rs,. 25,000 and Investments Rs. 8,000. Debtors are considered good.

Prepare new Balance Sheet of the firm, necessary Journal entries and Ledger Accounts of the Partners.

Solution :

Working Notes :

1. <u>Adjusted profit for 2007</u>

Profit		(12,000)
Add :	Cost of Moped	
	Wroughly treated as Travelling Expense	4,000
Less :	Depreciation not charjed on Moped @25%	
	on Rs. 4,000	<u>(1,000)</u>
	Adjusted Profit	<u>(9,000)</u>

2. Valuation of Goodwill

   Total Profit/Loss for the last 5 years = 3,000 + 7,000 + 10,000 + 14,000 – 9,000 = Rs. 25,000

   Average Profit = Rs. 25,000/5 = Rs. 5,000; Goodwill = 2 x Rs. 5,000 = Rs. 10,000

   But Goodwill is appearing at Balance Sheet at Rs. 15,000. Over valuation of Goodwill Rs. 5,000 should be written off among A, B & C as 1 : 2 : 2.

   The balance of Goodwill between A & B in the ratio 1:2

3. Share of Profit of Deceased Partner till his date of death

   Average Profit of the last 3 years [2005, 2006 & 2007] = (10,000 + 14,000 – 9,000)/3 = Rs. 5,000

   Estimated Profit for 3 months [Jan to March, '08] = Rs. 5,000 x 3/12 = Rs. 1,250

   C's share of profit = Rs. 1,250 x 2/5 = Rs. 500

Solution :

Books of A, B & C

Journal Entries

Date	Particulars		Amount (Rs)	Amount (Rs)
	Stock A/c	Dr.	2,000	
	Buildings A/c	Dr.	5,000	
	Machinery A/c	Dr.	5,000	
	Moped A/c [4,000 –Depr. 1,000]	Dr.	3,000	
	To Revaluation A/c			15,000
	[Values of assets increased on revaluation]			
	General Reserve A/c	Dr.	5,000	
	Investment Fluctuation Fund A/c	Dr.	3,000	
	Bad Debts Reserve A/c	Dr.	2,000	
	To A's Capital A/c			2,000
	To B's Capital A/c			4,000
	To C's Capital A/c			4,000
	[Transfer of Reserves etc. to Partners Capitals in 1 : 2 : 2]			
	Revaluation A/c	Dr.	2,000	
	To Investment A/c			2,000
	[Value of investments reduced]			
	Revaluation A/c	Dr.	13,000	
	To A's Capital A/c			2,600
	To B's Capital A/c			5,200
	To C's Capital A/c			5,200
	(Being profit on revaluation shared in 1 : 2 : 2)			
	A's Capital A/c	Dr.	1,000	
	B's Capital A/c	Dr.	2,000	
	C's Capital A/c	Dr.	2,000	
	To Goodwill A/c			5,000
	[Value of Goodwill reduced]			
	Profit & Loss Suspense A/c	Dr.	500	
	To C's Capital A/c			500
	[Estimated share of Profit till his date of death transferred to the decreased partner's Capital]			
	C's Capital A/c	Dr.	27,700	
	To C's Executors A/c			27,700
	[Total dues to the deceased partner transferred to his Executor's A/c]			

Capital Accounts

Date 2008	Particulars	A Rs.	B Rs.	C Rs.	Date 2008	Particulars	A Rs.	B Rs.	C Rs.
31.3	To Goodwill A/c	1,000	2,000	2,000	1.1. 31.3	By Balance b/d	10,000	20,000	20,000
	To Goodwill A/c	3,333	6,667	-		" Revaluation A/c	2,600	5,200	5,200
	To C's Executors A/c (Balance transferred)			27,700		" Sundry Reserves A/c	2,000	4,000	4,000
	To Balance c/d	10,267	20,533	--		" P & L Suspense A/c	--	--	500
		14,600	29,200	29,700			14,600	29,200	29,700

A and B

Balance Sheet as at 31.3.2008

Liabilities	Amt Rs.	Amt Rs.	Assets	Amt Rs.	Amt Rs.
Capital A/cs:			Buildings		35,000
A	10,267		Machinery		25,000
B	20,533	30,800	Moped (cost less depreciation)		3,000
C's Executor's A/c		27,700	Investments		8,000
Bank Loan		30,000	Stock		12,000
Sundry Creditors		10,000	Debtors		10,000
			Bank		5,000
			Profit &Loss Suspense A/c (Dr.)		500
		98,500			98,500

Illustration 2 :

A and B entered into partnership on 1.1.2005 agreeing to share profits and losses as 2 : 1. On that date they introduced capital : A Rs. 90,000 and B Rs. 30,000. They effected a policy of Insurance for Rs. 30,000 of their joint lives. The net profits before charging interests on capitals as at the beginning of each year at 6% per annum and on drawings averaged at 4% per annum were as follows:

Year	Net Profits (Rs.)	A's Drawings (Rs.)	B's Drawings (Rs.)
2005	34,800	10,000	5,000
2006	37,600	12,000	7,000
2007	38,000	14,000	7,500

The annual insurance premium Rs. 3,000 was being charged to Profit & Loss Account as a business expense

A died on 31st March, 2008. According to the terms of the Partnership Deed, the deceased partner's executors became entitled to receive his share of capital as it stood on 31st December, 2007 plus his share of profits for the three months calculated upon the previous year's rate of profit and share of goodwill which was calculated as 2/3rds of the previous three years profits after adjusting for interest on capital and drawings but without deducting the premium paid on Joint Life Policy.

Show the amounts payable to the Executors of A.

Solution :

Working Notes :

1. Adjustment of Profits

		2005 Rs.	2006 Rs.	2007 Rs.
	Profits before adjusting interests	34,800	37,600	38,000
Add :	Interest on Drawings @ 4% p.a. [4% of total drawings of A & B	600	760	860
	for every year]	35,400	38,360	38,860
Less :	Interest on Capital [see working Note 2 below]	7,200	8,388	9,504
	Profits after adjustments	28,200	29,972	29,356
	A's Share [2/3]	18,800	19,981	19,571
	B's Share [1/3]	9,400	9,991	9,785

2. Adjustment of Capitals

	Total Rs.	A Rs.	B Rs.
Capital on 1.1.2005	1,20,000	90,000	30,000
Add: Interest on Capital @ 6% p.a.	7,200	5,400	1,800
Add: Share of Profits(34,800-7,200+600)	28,200	18,800	9,400
Less : Drawings	15,000	10,000	5,000
Less : Interest on Drawings @4%	600	400	200
Capital on 1.1.06	1,39,800	1,03,800	36,000
Add: Interest on Capital @ 6% p.a.	8,388	6,228	2,160
Add: Share of Profits [Note 1]	29,972	19,981	9,991
Less : Drawings	19,000	12,000	7,000
Less: Interest on Drawings	760	480	280
Capitals on 1.1.07	1,58,400	1,17,529	40,871
Add : Interest on Capital @ 6% p.a.	9,504	7,052	2,452
Add : Share of Profits [Note 1]	29,356	19,571	9,785
Less : Drawings	21,500	14,000	7,500
Less: Interest on Drawings @ 4%	860	560	300
Capital as on 1.1.08	1,74,900	1,29,592	45,308

3. Valuation of Goodwill

Total Profits after adjustments for Interest [Note 1]

	Rs.	Rs.
2005	28,200	
2006	29,972	
2007	29,356	87,528
Added Back : Insurance Premium for 3 years [3 x 3,000]		9,000
		96,528

Average Annual Profits before charging insurance premium = 96,528 / 3 = 32,176

Goodwill = 32,176 x 2 = 64,352; A's share = 2 / 3 x 64,352 = Rs. 42,901

4. Profits between 1.1.08 and 31.3.08

Profits for 2007 after interest = Rs. 29,356

Average Profits for 3 months = 29,356 x 3 / 12 = 7,339, A's share = 2 / 3 x 7,339 = Rs. 4,893

Executor of A's Account

Dr. Cr.

Date	Particulars	Amt Rs.	Date	Particulars	Amt Rs.
31.3.08	To Balance c / d	1,99,330	31.3.08	By A's Capital A / c	1,29,592
				By P & L Suspense A / c	
				Interest on Capital	1,944
				Share of Profits	4,893
				By Goodwill	42,901
				By Joint Life Policy A / c	20,000
		1,99,330			1,99,330

Illustration 3 :

Peter, Paul and Prince were partners sharing profit and losses in the ratio 2 : 1 : 1. It was provided in the partnership deed that in the event of retirement / death of a partner he / his legal representatives would be paid :

(i) The balance in the Capital Account.

(ii) His share of Goodwill of the firm valued at two years purchase of normal average profits (after charging interest on fixed capital) for the last three years to 31st December preceeding the retirement or death.

(iii) His share of profits from the beginning of the accounting year to the date of retirement or death, which shall be taken on proportionate basis of profits of the previous year as increased by 25%.

(iv) Interest on Fixed Capital at 10% p.a. though payable to the partners, but not payable in the year of death or retirement.

(v) All the assets are to be revalued on the date of retirement or death and the profit and loss be debited / credited to the Capital Accounts in the profit sharing ratio.

Peter died on 30th September, 2008. The books of Account are closed on calendar year basis from 1st January to 31st December.

The balance in the Fixed Capital Accounts as on 1st January, 2008 were Peter – Rs. 1,00,000; Paul – Rs. 50,000 and Prince – Rs. 50,000. The balance in the Current Accounts as on 1st January, 2008 were Peter—Rs. 20,000; Paul – Rs 10,000 and Prince – Rs. 7,000, Drawings of Peter till 30th September, 2008 were Rs. 10,000. The Profits of the firm before charging interest on capital for the calendar years 2005, 2006 and 2007 were Rs. 1,00,000; Rs, 1,20,000 and Rs. 1,50,000 respectively. The profits include the following abnormal items of credit :

	2005	2006	2007
Profit on Sale of Assets	Rs. 5,000	Rs. 7,000	Rs. 10,000
Insurance claim received	Rs. 3,000	—-	Rs. 12,000

The firm has taken out a Joint Life Policy for Rs. 1,00,000. Besides the partners had severally insured their lives for Rs. 50,000 each, the premium in respect thereof being charged to the Profit and Loss Account. The surrender value of the Policies were 30% of the face value. On 30th June, 2008 the firm received notice from the insurance company that the insurance premium in respect of a fire policy had been undercharged to the extent of Rs. 6,000 in the year 2007 and the firm has to pay immediately. The revaluation of the assets indicate an upward revision in value of assets to the extent of Rs. 20,000. Prepare an account showing the amount due to Peter's legal representatives as on 30th September, 2008 along with necessary working.

Working Notes:

1. Peter's Share of Profit on Revaluation

   Profit on Revaluation = Upward revision in values of assets = Rs. 20,000

   Peter's share = 2/4 of 20,000 = Rs. 10,000 (to be transferred to Capital A/c as said in the problem)

2. Valuation of Goodwill and Peter's share thereof

	2005 Rs.	2006 Rs.	2007 Rs.
Reported Profits	1,00,000	1,20,000	1,50,000
Less: (a) Interest on Capital 10% of Rs. 20,000	2,000	2,000	2,000
(b) Profit on Sale of assets	5,000	7,000	10,000
(c) Insurance claim received	3,000	-	12,000
(d) Undercharged insurance			6,000
	90,000	1,11,000	1,20,000

Average Profits = 1/3 of (90,000 + 1,11,00 + 1,20,000) = Rs. 1,07,000

Goodwill = 2 x Rs. 1,07,000 = Rs. 2,14,000

Therefore Peter's share of Goodwill = 2/4 × 2,14,000 = 1,07,000

3. Peter's Share of Profits between 1.1.2008 and 30.9.2008 (date of his death)

	Rs	Rs.
Profits (as reported) for 2007	1,50,000	
Less: Interest on Capital @ 10% p.a. to the Surviving partners [not to Peter in the Year of his death] @ 10%	10,000	
Add : Undercharged insurance premium (Peter's share)	3,000	1,43,000
Add: 25% increase on 1,43,000		35,750
Expected Annual Profits for 2008		1,78,750

Profits up to 30.9.08 = 9/12 of 1,78,750 = Rs. 1,34,062 (approx) , Peter's Share = 2/4 of 1,34,062 = 67,031

(Undercharged Insurance Premium = Rs. 6,000; To be borne by Peter = 2/4 of 6,000 = Rs. 3,000)

Amount Payable to the Executor of Peter

	Rs.
Capital (as on 1.1.08)	1,00,000
(+) Share of Revaluation Profit (Note - 1)	10,000
(+) Share of Goodwill (Note - 2)	1,07,000
(+) Proportionate share of Profits (Note - 3)	67,031
(-) Drawings upto 30/09/2008	(10,000)
	2,74,031

EXERCISE

Problem 1

Rabi, Sashi and Tara are in partnership sharing profits and losses in the ration of 6 : 5 : 4.

They take out a Joint Life Policy for Rs. 2,00,000, so that funds required to pay off the dues of a Partner on his death may be available without presenting any financial difficulty to the firm. The annual premium on the policy is Rs. 7,500 and this is treated as a business expense. Accounts are closed annually on 31st December every year.

The partnership deed provides that the representatives of a deceased partner are entitled to :

(i) the deceased partner's Capital appearing in the last Balance Sheet (ii) interest on capital at 6% p.a., to the date of his death; (iii) his share of profits calculated till the date of his death on the average of the last three year's profits after inclusion of the policy premium as business expenses and (iv) share of goodwill calculated at two year's purchase of the average of the last three years' profits before inclusion of the policy premium as a business expense.

Shashi died on 1.4.2008. His drawings in 2008 amounted to Rs. 3,000. His capital as per 31.12.2007 Rs. 80,000.

The profits for the years 2005, 2006 and 2007 after inclusion of the policy premium as business expenses, amounted to Rs. 65,000; Rs. 64,000 and Rs. 69,000 respectively.

Draw up Sashi's Account to show the amount due to him from the firm.

[Ans : Amount due to legal representatives of Sashi Rs. 1,99,367. Adjusted Average Annual Profits Rs. 73,500. Value of Goodwill Rs. 1,47,000. Sashi's share of Profit Rs. 5,500]

Problem 2

Firm ABC consisted 3 partners, A, B and C sharing profits and losses in the ration of 5 : 3 : 2 respectively. A died on February 20, 2008. Profit & Loss Account of the period up to the date of death and Balance Sheet as on that date was as below :

Capital :				
A	12,000		Goodwill	6,000
B	16,000		Machinery	35,000
C	12,000	40,000	Furniture	6,000
Loan from A		5,000	Stock	9,000
General Reserve	7,000	Debtors		15,000
Creditors		22,000	Bank	3,000
		74,000		74,000

In addition to the assets shown above, the firm had three life policies in the name of each partner, for insured value of Rs. 20,000 each, the premium of which were charged to Profit & Loss Account.

According to the Partnership deed, on the death of a partner, the assets and liabilities are to be valued independently by a valuer. The revalued figures were:

(1) Goodwill Rs. 21,000; Machinery Rs. 45,000; Debtors are subject to a provision for doubtful debts at 10% and Furniture at Rs. 7,000.

(2) Provision for Taxation to be created for Rs. 1,500.

(3) Death-claim for Policy in the name of A will be realized in full and the surrender values of other two policies were Rs. 7,500 each.

The business would be continued by B and C, henceforth sharing profits and losses equally. The net balance due to A was transferred to Loan Account, which will be paid off later. Show the Revaluation Account, Partners' Capital Accounts and Balance of the new firm.

{Ans : Profit on Revaluation Rs. 23,000; A's Executor's Loan A / c 49,500; Capital Accounts of B and C Rs. 35,500 and Rs. 25,000 respectively. Total of Balance Sheet Rs. 1,33,500.}

Problem 3.

The following is the Balance Sheet of X, Y and Z, as on 31.12.2007, sharing profit s in the ratio of 4 : 3 : 1.

Liabilities	Rs.	Assets	Rs.
Capitals :		Property and Assets	2,28,000
X	1,00,000	Joint Life Policy	32,000
Y	70,000	Bank	50,000
Z	20,000		
Creditors	1,20,000		
	3,10,000		3,10,000

On 1.1.07. S was admitted as a new partner with 1/5th share of profits. S paid Rs. 30,000 for capital and Rs. 20,000 as his share of goodwill (which was retained in the business).

On 30.6.08 X died. The joint policy realized Rs. 50,000. The share of the deceased partner in the goodwill was determined at Rs. 36,000.

The Profit for the period ending on 30.6.08 was estimated at Rs. 45,000. The surviving partners carried on the business, profit sharing remaining unchanged between them. Net Profit between 1.7.08 and 31.12.08 amounted to Rs. 33,000.

Drawings of the Partners were :

	X (Rs.)	Y (Rs.)	Z (Rs.)	S (Rs.)
Up to 30.6.08	13,000	10,000	4,000	7,500
Between 1.7.08 and 31.12.08	—	8,000	5,000	5,000

A sum of Rs. 50,000 was advanced by Y to pay off the dues of the deceased Partner on 1.12.08. Show the Partner's Capital Accounts and the draft Balance Sheet as on 31.12.08 assuming that on that date creditors were Rs. 1,17,000 and Property and Assets were Rs. 2,37,000 respectively.

[Loan : X's Loan paid off on 31.12.08 Rs. 1,76,387; Balance of Capitals of Y,Z & S on 31.12.08 Y – Rs. 70,812; Z – Rs. 16,977; S – Rs. 19,954; B/S Total on 31.12.08 Rs. 2,74,113]

[Hints: X died on 30.6.08 but final settlement of accounts could not be made on that date. Under section 37 of the Indian Partnership Act, his executors are entitled to a share of profit even after his death or to an interest @6% p.a. on the unsettled share of the deceased partner in the property of the firm.]

Problem 4.

Basu, Chatterjee and Saxena were in partnership sharing profits as 3/6, 2/6 and 1/6 respectively. There was no provision in the agreement for interest on capital / drawings. Basu Died on 31st December, 2006 and on that date the partner balances were as follows:

	Current Account	Capital Account
Basu	29,000 (Cr.)	60,000 (Cr.)
Chatterjee	20,000 (Cr.)	40,000 (Cr.)
Saxena	5,000 (Cr.)	20,000 (Cr.)

By Virtue of the Partnership agreement the sum due to Basu's estate was required to be paid within a period of 3 years, and minimum instalments of Rs. 20,000 were to be paid, the first such instalment falling due immediately after death and the subsequent instalments at half yearly intervals thereafter. Interest @ 5% per annum was to be credited half yearly.

In ascertaining his share, goodwill (not recorded in the books) was to be valued at Rs. 60,000 and the assets, including the Joint endowment Assurance Policy mentioned below, were valued at Rs. 36,000 in excess of the book values.

No goodwill account was raised and no alteration was made to the book values of the assets. The Joint Assurance Policy shown in the books at Rs. 20,000 matured on 1.1.2007 realising Rs. 26,000. Payments of Rs. 20,000 each were made to Basu's estate on 1st January, 2007, 30th June, 2007 and 31st December, 2007. Chatterjee and Saxena contined trading on the same terms as previously existing and the net profits for the year to 31st December, 2007 (before charging the interest due to Basu's Estate) amounted to Rs. 32,000. During the period the Partner's Drawings were : Chatterjee Rs. 15,000 and Saxena Rs. 8,000.

On 1.1.1995 the partnership was dissolved, an offer to purchase the business as a going concern for Rs. 1,40,000 being accepted on that day. A cheque for that sum was received on 15.3.2008.

The balance due to Basu's Estate, including interest, was paid on 30th June, 2008 and that day Chatterjee and Saxena received the sums due to them.

You are to prepare the Partner's Capital and Current Accounts between 1.1.08 and 30.6.08. Also show the account of the Executors of Basu.

[Ans : Current Accounts : (a) 1.1.08 (After Adjustments) Basu 80,000 (Cr.); Chatterjee 10,000 (Dr.) and Saxena 20,000 (Dr.) (b) 30.6.08 (for transfer to Capital A / cs); Chatterjee Rs. 5,190 (Cr.); Saxena Rs. 12,905 (Dr.); (c) 31.12.08 Chatterjee Rs. 7,383 (Dr.); Saxena 19.192 ; Total of Basu's Executors Rs. 1,40,000 Distributable Profit for 2008 Rs. 26,425; Payments to Basu's Executors on 30.6.08 Rs. 87,715]

C. DISSOLUTION OF A FIRM

Whenever a reconstitution takes place within a Partnership in the form of admission, retirement or death of a Partner, the existing partnership is dissolved. The Partnership firm, may however, continue, if the remaining partners desire so.

But if the partnership firm is discontinued for any reason, that is called Dissolution of the firm.

Dissolution of Firm – when does it take place [in accordance with the Indian Partnership Act of 1932]

1. By Mutual consent of all the partners or in accordance with a contract made by them [Section 40]
2. By Notice – given in writing, by any partner to all other partners if the Partnership is at will [Section 43].
3. On the happening of any one of the following events : [Section 42] : (i) expiry of the term, where the Partnership was constituted for a fixed term; (ii) completion of the adventure for which the firm was constituted; (iii) Death of a partner, (iv) Adjudication of a Partner as insolvent.
4. Compulsory Dissolution [Section 41]
   - (i) Where all the partners or all but one are adjudged insolvent.
   - (ii) If any event occurs making it unlawful for the business of the firm to be carried on.
5. Dissolution by Court: According to Section 44 of the Indian Partnership Act the court, at the suit of a partner, may dissolve a firm on any one of the grounds namely –
   - (i) insanity of a partner ;
   - (ii) permanent incapability of a partner to do his duties ;
   - (iii) if a partner is guilty of misconduct that might affect prejudicially the carrying on of the business ;
   - (iv) If a partner willfully or persistently commits breach of agreement ;
   - (v) If a partner transfers all his shares to a third party or has allowed his share to be charged under the Provisions of Rule 49 of order XXI of the First Schedule to the Code of Civil Procedure, 1908 ;

(vi) If the court considers that the business cannot be carried on except at loss ;

(vii) On any other ground on which the court considers the dissolution as just and equitable.

Settlement of Accounts on Dissolution

According to Section 48 of the Indian Partnership Act the following rules should be observed for settlement of Accounts after dissolution, subject to agreement by partners :

(a) Regarding Losses : "Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and lastly if necessary, by the partners individually in the proportions in which they are entitled to share profits". [Section 48(1)]

(b) Regarding Assets : "The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order:

(i) in paying the debts of the firm to third parties ;

(ii) In paying each partner rateably what is due to him from the firm for advances as distinguished from capital ;

(iii) In paying to each partner rateably what is due to him as capital; and

(iv) The residue, if any, shall be divided among the partners in the proportions in which they are entitled to share profits." [Section 48(2)]

Accounting Entries Regarding Dissolution

The two separate aspects of Dissolution for which accounting entries have to be made are:

[A] Realization of Assets and Payment of liabilities and [B] Settlement of the dues of the Partners,

[A] Realization of Assets and Payment of liabilities

(i) Prepare Realisation Account

(ii) Trausfer all assets (except cash, bank & fictitious assets) and liabilities at book values to Realisation Account.

Journal Eutries

Item/Purpose	Entry	Special Points to be noted
1. Transfer of book values of assets as recorded in the Balance Sheet	Realization A/c………. Dr. To Sundry Assets [Book value] (including goodwill if any, shown in the Balance Sheet) Realization A/c. ……Dr. To Debtors A/c Provision for Bad Debts A/c Dr To Realization A/c.	(a) Cash or Bank A/c are not to be credited unless the firm, as a whole, is sold out as a going concern. (b) Debit balance of any Cap. A/c etc. or Debit balance of P/L A/c not to be transferred to Realization A/c. (c) If there is any Provision for bad Debts, debit Realization A/c and credit Debtors A/c with gross figure. Then debit Provision A/c and credit Realization A/c. Same treatment for Provision for Depreciation.
2. Realization/Sale of above assets	Cash/Bank A/c (amt. realized) …. Dr. OR Partners Cap. A/c….. Dr. (agreed value at which a partner takes over an asset/assets) To Realization A/c.	
3. Shares etc. received as purchase consideration in exchange of the firm's assets.	Shares A/c ……….Dr. To Realization A/c. (agreed value)	

4. Closing the External liabilities	External Liabilities A/c .. Dr. (such as creditors, outstanding expenses, Bank Loan etc.) To Realization A/c. (book value)	(a) Alternatively – this entry may be passed (combining 4,5 & 6) Liability A/c ……. Dr. To Bank A/c (actual amt. paid) OR, To Partners Cap. A/c (agreed value) To Realization A/c (Discount, if any received on payment/discharge) (b) Where assets and liabilities are taken over by another business on making some lump sum payment, separate entries for realization of assets and / payment of liabilities need not be made.
5. External liabilities paid off	Realization A/c. …………. Dr. To Cash/Bank A/c (actual amt. paid)	
6. External liabilities taken over by any partner	Realization A/c……….. Dr. To Partner's Cap. A/c (agreed value)	
7. Unrecorded asset sold or taken over by any partner	Cash / Bank A/c Dr. Partners Capital A/c Dr. To Realisation A/c	
8. If any unrecorded liability is paid.	Realization A/c …….. Dr. To Cash/Bank A/c (actual amt. paid)	
9. If shares etc. received and shown in (3) above are sold out or transferred to partners.	Cash/Bank A/c ……… Dr. OR, Partners Cap. A/c. …….. Dr. [excluding insolvent partner] To shares A/c	For sale, there may be profit or loss on sale which is transferred to Realization A/c.
10. Payment of Expenses of Realization .	Realization A/c……. Dr. To Cash/Bank A/c (if paid by the firm) OR To Partners Cap. A/c (if paid by any partner)	If a partner bears such expenses personally in pursuance of a separate agreement – NO ENTRY is required.
11. Balance of Realization A/c. representing Profit or Loss on Realization.	Realization A/c. ……….. Dr. To Partners Cap. A/c (Profit shared in Profit Sharing Ratio) OR, Partner's Cap. A/c …….. Dr. To Realization A/c. (Loss shared in Profit Sharing Ratio)	

[B] Settlement of Partners Dues – through Capital Accounts

Item/Purpose	Entry	Special Points to be noted
1. Prepare Capital Accounts with balance as per Balance Sheet before the dissolution.		
2. Transfer of Current A/c s, if any	Partner's Current A/c … Dr. To Partner's Cap. A/c. (Credit Balance) OR Partner's Capital A/c … Dr. To Partner's Current A/c (Debit balance)	
3. Undistributed Profit, Reserve, Joint Life Policy Reserve, Investment Fluctuation Fund, Contingency Reserve etc. transfer.	Profit & Loss (Cr.) A/c… Dr. OR, Any Reserve A/c …….. Dr. To Partner's Capital A/cs [Profit sharing ratio]	
4. Undistributed Loss, Fictitious/Unrealizable Assets etc. transfer.	Partners Capital A/c… Dr. To Profit & Loss (Dr.) A/c OR, To Fictitious Assets A/c (Profit Sharing Ratio)	Example of unrealizable Asset- Advertisement Suspense A/c
5. Any loan taken from any partner	Partner's Loan A/c …. Dr. To Cash/Bank A/c	U/s 48 Repayment of loan should enjoy priority over repayment of capital.
6. Any loan given to any partner	Cash/Bank A/c….. Dr. To Partner's Loan A/c OR, Partners Capital A/c Dr. To Partners Loan A/c	If such amount is realized. Adjustment of loan against Capital
7. If any Partner's Capital A/c shows a debit balance (after balancing)	Cash/Bank A/c….. Dr. To Particulars Partner's Capital A/c [Cash brought in to make up the shortfall]	If the deficient partner is insolvent, treatment will be different-Vide – Insolvency of Partner.
8. Payment of credit balance (after final balancing)	Particulars Partner's Cap. A/c Dr. To Cash/Bank A/c	

Illustration 1 :

X, Y and Z sharing profits & Losses in the ratio of 2 : 2: 1 agreed upon dissolution of their partnership on 31st December, 2007 on which date their Balance Sheet was as under :

Liabilities		Rs.	Assets		Rs.
Capital :			Fixed Assets		50,000
X		40,000	Joint Life Policy (at surrender		10,000
Y		30,000	Value)		
Reserve Fund		10,000	Debtors	10,000	
Joint Life Policy Fund		10,000	Less : Prov	500	9,500
Creditors	19,000		Stock at Invoice Price	10,000	
Less: Prov	500	18,500	Less: Price loading	2,000	8,000
Salary Outstanding		2,000	Investments	8,000	
			Less: Fluctuation Fund	500	7,500
			Capital Account –Z		2,000
			Bank		23,500
		1,10,500			1,10,500

Investments were taken over by X at Rs. 6,000, creditors of Rs. 10,000 were taken over by Y who has agreed to settle account with them at Rs. 9,900. Remaining creditors were paid Rs. 7,500. Joint Life Policy was surrendered and Fixed Assets realized Rs. 70,000, Stock and Debtors realized Rs. 7,000 and Rs. 9,000 respectively. One customer, whose account was written off as bad, now paid Rs. 800 which is not included in Rs. 9,000 mentioned above. There was an unrecorded asset estimated at Rs. 3,000, half of which as handed over to an unrecorded liability of Rs. 5,000 in settlement of claim of Rs 2,500 and the remaining half was sold in the market which realized Rs. 1,300.

Y took over the responsibility of completing the dissolution and he is granted a salary of Rs. 400 per month. Actual expenses amounted to Rs. 1,100. Dissolution was completed and final payments were made on 30th April, 2008.

You are required to prepare the Realization Account, Capital Account and Bank Account.

Solution:

Dr. Realization Account Cr.

Particulars	Amt. Rs.	Amt. Rs.	Particulars	Amt Rs.	Amt. Rs.
To Fixed Assets A/c		50,000	By Provision on Debtors A/c		500
To Joint Life Policy A/c		10,000	By Provision on Stock A/c		2,000
To Debtors A/c		10,000	By Investment Fluctuation		
To Stock (at I.P.)		10,000	Fund A/c		500
To Investments A/c		8,000	By Joint Life Policy Fund A/c		10,000
To Pro. for Disc. on			By Creditors A/c		19,000
Creditors A/c		500	By Outstanding Salary A/c		2,000
To Y's Capital A/c			By X' Capital A/c		6,000
[Creditors taken over-			(Investments taken over)		
see Note]		10,000	By Bank A/c:		
To Bank A/c :			Joint Life Policy		10,000
Creditors paid off		7,500	Fixed Assets		70,000
Unrecorded liability			Stock		7,000
paid [1/2 X 5,000]		2,500	Debtors [9,000 + 800]		9,800
Outstanding Salary		2,000	Unrecorded Assets (Sold)		1,300
Outstanding Expense		1,100			
To Y's Cap. A/c					
[Salary 400 x 4]		1,600			
To Partner's Capital A/c					
(Profit on					
Realization)					
X [2/5]	9,960				
Y [2/5]	9,960				
Z [2/5]	4,980	24,900			
		1,38,100			1,38,100

Dr. Bank Account Cr.

Particulars	Amount Rs.	Particulars	Amount Rs.
To Balance b/f	23,500	By Realization A/c	
To Realization A/c		Creditors	7,500
Joint Life Policy	10,000	Unrecorded Liability	2,500
Fixed Assets	70,000	Outstanding Salary	2,000
Stock	7,000	Expenses	1,100
Debtors	9,800	By X's Capital A/c	47,960
Unrecorded Asset	1,300	By Y's Capital A/c	55,560
		By Z's Capital A/c	4,980
	1,21,600		1,21,600

Dr. Partners Capital Account Cr.

Date 2008	Particulars	X Rs.	Y Rs.	Z Rs.	Date 2008	Particulars	X Rs.	Y Rs.	Z Rs.
1.1	To Balance b/d	—	—	2,000	1.1.	By Balance b/d	40,000	30,000	—
30.4	To Realization A/c	6,000	—	—	30.4	By Reserve Fund [2:2:1]	4,000	4,000	2,000
	To Bank A/c	47,960	55,560	4,980		By Realization A/c (Profit)	9,960	9,960	4,980
	(Balances withdrawn)					By Realization A/c (Creditors)		10,000	
						By Realization A/c (Salary)		1,600	
		53,960	55,560	6,980			53,960	55,560	6,980

NOTE :

1. Unrecorded Asset and unrecorded liability were not recorded. Any part of such asset utilized to discharge any part of such liability and discount received there on have been ignored.

   But unrecorded asset realized (debts previously written off now recovered) has been recorded. Similarly unrecorded asset sold has been recorded.

2. Y took over creditors of Rs. 10,000. This has been recorded. How he settles such liability is his personal matter. The discount on payment does not benefit the firm.

Special considerations for a retiring partner and the estate of a deceased partner in relation to debts contracted by the partnership firm:

(a) debts due on the date of retirement/death: the retiring partner and the estate of the deceased partner is liabile for the whole of the debts due by the firm at the date of retirement or death, to the extent of their share.

(b) debts incurred after retirement: where the notice of retirement is not published in accordance with law, the retiring partner is liable for debts contracted after retirement.

(c) deceased/ insolvent partner: the estate of a deceased or bankrupt partner will not be liable for debts contracted by the firm after the death or bankruptcy.

Applicability of Section 37 of the Partnership Act:

In case of retirement, the retiring partner or in case of death, the executor of the deceased partner, if the dues are not settled, then such retired partner or the executor is entitled to the following :

Maximum of:

Interest @ 6% p.a. on the amount due to them(i.e. if the amount is unsettled, like, rate of interest on loan to be allowed to the retired partner or the executor is not mentioned)

Or

The share of profit earned for the amount due to the partner

Conditions:

(a) The surviving partners/continuing partners continue to carry on the business of the firm.

(b) The business is carried on without any final settlement of accounts between the continuing partners and the outgoing partners or his estate.

(c) There is no contract to the contrary of the options contained in Section 37 i.e. share in the profits or interest @ 6% p.a. on the unsettled capital.

Example: Unsettled capital of C Rs.52,000 (Date of retirement : 30.9.08, financial year 2008-09). Net Profit earned by the firm after C's retirement Rs.25,000. Capitals of A:Rs.57,000 and B Rs.76,000)

C is entitled to the maximum of the following:

(i) interest on unsettled capital = Rs.52,000 x 6% x 6 months = Rs.1,560

(ii) Profit earned out of unsettled capital = Profit x Retired or Deceased Partner's unsettled Dues /Total Capital of the firm(including the amount due to the retired or deceased partner)

= Rs.(25,000 x 52,000) / (Rs.52,000 + 57,000 + 76,000) = Rs.7,027.

For inclusion in Dissolution:

In the case of insolvency, the deficiency of the insolvent partner shall be taken over by the solvent partners in their capital contribution ratio(fixed or fluctuating capitals).

Solvent Partners Capital A/cs Dr.

To Insolvent Partners Capital A/cs

There are two methods followed to share the deficiency of the insolvent partner:

(a) Garner Vs. Murray Rule

(b) Indian Partnership Act, 1932.

Garner Vs.Murray Rule : (The third partner who became insolvent was Mr. Wilkins)
The deficiency of the insolvent partner shall be taken over by the solvent partners. The following steps are taken:
(a) The loss on realisation shall be shared between all the partners (including the insolvent partner) in their profit-sharing ratio.
(b) The solvent partners shall bring in cash equal to the amount of loss suffered by them.

Cash A/c Dr.
To Solvent Partners Capital A/cs

(c) The deficiency of the insolvent partner shall be taken over by the solvent partners in their capital contribution ratio (fixed or fluctuating capitals)

Solvent Partners Capital A/cs Dr.
To Insolvent Partner's Capital A/c

Indian Partnership Act,1932
As per the Indian Partrnership Act,1932, the deficiency of the insolvent partrner is shared as follows:
(a) The loss on realisation shall be shared between all the partners (including the insolvent partner) in their profit-sharing ratio.

(b) The deficiency of the insolvent partner shall be taken over by the solvent partners in their capital contribution ratio (fixed or fluctuating capitals)

Solvent Partners Capital A/cs Dr.
To Insolvent Partner's Capital A/c

Note: As per Indian Partnership Act, the solvent partners shall not bring in cash, their share of loss on realisation.

Ilustration: Balance Sheet as at 31.10.08

Capitals			
A	25,000	Cash	15,000
B	15,000	C's Capital	10,000
		Realisation A/c(Dr.)	15,000
	40,000		40,000

Profit sharing ratio:5:3:2. C is declared insolvent.
Solution:

Partners Capital Accounts

Dr. Cr.

Particulars	A	B	C	Particulars	A	B	C
To Balance b/d			10,000	By Balance b/d	25,000	15,000	—
To Realisation A/c	7,500	4,500	3,000	By Cash	7,500	4,500	—
To C's Capital A/c	8,125	4,875	—	By A & B's Cap.A/c	—	—	13,000
To Cash A/c	16,875	10,125	—	(final repayment)			
	32,500	19,500	13,000		32,500	19,500	13,000

Note : The deficiency of the insolvent partner C= Rs.13,000 (= 10,000 + 3,000). This will be shared by the solvent partners in their capital contribution ratio 5:3

A's Capital A/c	Dr	8,125
B's Capital A/c	Dr	4,875
To C's Capital A/c		13,000

If all the partners are insolvent:

If all the partners are insolvent, the external liabilities shall have to take the share of deficiency of the insolvent partners, i.e. the firm.

We shall have to prepare the following ledger accounts:
(a) Realisation A/c- the external liabilities shall not be transferred to realisation account, as they will be paid off at the end, after they have taken the share of deficiency of the insolvent partners.

Partners Capital A/cs Dr (in their profit sharing ratio)
To Realisation A/c

(b) Partners Capital A/cs- the total deficiency of the insolvent partners shall have to be transferred to Deficiency A/c.

Deficiency A/c Dr
To Partners Capital A/cs

(c) The total of the deficiency shall be shared between/amongst the external liabilities in the ratio of their amount outstanding as on the date of dissolution:

External Liabilities A/c Dr
To Deficiency A/c

(d) The external liabilities shall be paid off:

External Liabilities A/c Dr.
To Cash A/c

Illustration: Balance Sheet as at 30.10.08

Capitals		Fixed Assets	1,00,000
P	5,000		
Q	3,000	Cash	10,000
R	2,000		
Bank Loan	60,000		
Sundry Creditors	40,000		
	1,10,000		1,10,000

All the partners were declared insolvent. Profit sharing ratio :5:3:2. Assets realized Rs.60,000. Prepare necessary ledger accounts to close the books of the firm.

Solution :

Dr Realisation Account Cr

To Fixed Assets	1,00,000	By Cash A/c(realisation)	60,000
		By Partners Capital A/cs (loss on realisation) P:20,000 Q:12,000 R: 8,000	40,000
	1,00,000		1,00,000

Dr Partners Capital Acounts Cr

Particulars	P	Q	R	Particulars	P	Q	R
				By Balance b/d	5,000	3,000	2,000
To Realization A/c	20,000	12,000	8,000	By Deficiency A/c	15,000	9,000	6,000
	20,000	12,000	8,000		20,000	12,000	8,000

Dr Deficiency Account Cr

To Partners Capital A/cs:			
P	15,000	By Bank Loan A/c	18,000
Q	9,000	By Creditors	12,000
R	6,000		
	30,000		30,000

Dr Bank Loan Account Cr

To Deficiency A/c	18,000	By Balance b/d	60,000
To Cash A/c	42,000		
	60,000		60,000

Dr. Creditors Account Cr

To Deficiency A/c	12,000	By Balance b/d	40,000
To Cash A/c	28,000		
	40,000		40,000

Dr Cash Account Cr

To Balance b/d	10,000	By Bank Loan A/c	42,000
To Realisation A/c	60,000	By Creditors A/c	28,000
	70,000		70,000

Note: The total deficiency of the partners i.e. the firm is Rs.30,000. This is shared between the external liabilities in the ratio of their amount outstanding Rs.60,000 : Rs.40,000 = 3:2

Bank Loan A/c	Dr.		18,000
Creditors A/c	Dr.	12,000	
To Deficiency A/c			30,000

Return of Premium to a partner on dissolution before expiry of term:
Conditions:
(i) A partner was admitted in the partnership firm for a fixed term period,
(ii)Such partner had paid a premium for goodwill at the time of admission.
(iii) The partnership firm has dissolved.

Exceptions: The partner will not be entitled to any claim under any of the following conditions:
(i) the firm is dissolved due to death of a partner
(ii) the dissolution is due to the misconduct of the partner claiming refund
(iii) dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.
Amount of Refund: the amount to be repaid will be determined having regard to the terms upon which the admission was made and to the length of the period agreed upon and the period that has expired.
Liability of other partners: the amount of refund payable shall be borne by the other partners in their profit sharing ratio.

Ilustration: X was admitted into partnership for 5 years, for which he paid a premium of Rs.1,20,000. After 39 months, the partnership firm was dissolved due to misconduct of Mr.Z , another partner of the firm. Y ,being the third partner. Profit Sharing Ratio: Y:Z:X= 5:3:2.

Solution: X is entitled to claim the refund of premium paid at the time of admission, since the admission was for a fixed term period and the firm is getting dissolved due to a misconduct of Mr.Z, another partner of the firm.

The amount of refund is

= (Total Premium Paid x Unexpired term of the partnership) / Total term of the partnership

= 1,20,000 x 21/60 = 42,000

This shall be shared by the other partners Y and Z in their profit sharing ratio 3:2.

Y's Capital A/c	Dr	25,200
Z's Capital A/c	Dr	16,800
To X's Capital A/c		42,000

EXERCISE

1. How the deficit will be treated in case of insolvency of all partners?
2. What do you mean by Realisation Accounts?
3. Explain Garner Vs. Murray in case of Accounting treatment?

Problem 1.

The following is the Balance Sheet as at 31st March, 2008 of Antony, Birdy and Costello carrying on business in partnership sharing profits and losses as 2 : 2 : 1:

Liabilities		Rs	Assets	Rs.
Capital Accounts :			Fixed Assets	70,000
Antony	40,000		Sundry Debtors	30,000
Birdy	25,000	65,000	Stock	10,000
Mortgage Loan		40,000	Cash	5,000
Reserve		6,000	Capital A / c (Dr.)	
Sundry Creditors		10,000	Costello	6,000
		1,21,000		1,21,000

They decided to dissolve the partnership and the following arrangements were agreed upon:

1. Fixed Assets included :
   (i) Motor Car Rs. 5,500 taken over by Birdy at an agreed value of Rs. 9,000 after necessary repairing cost amounting to Rs. 2,000 to be borne by the firm.
   (ii) Land and Building Rs. 50,000 subject to Mortgage loan taken over by Antony at an agreed value of Rs. 60,000 subject to Mortgage loan to be taken over at Rs. 40,000.
2. Other Assets excluding Cash and Creditors are taken over by Eureka Ltd. in consideration of issue of 5,000 equity shares of Rs. 10 each fully paid. These shares are taken over at a total agreed value of Rs. 48,000 equally Antony and Birdy.
3. A Creditor for Rs. 2,500 not provided in the books had to be paid.

   Prepare the Realization Account, Partners Capital Accounts and Cash Account assuming that the final settlement was made by partners bringing in necessary amounts.

   [Ans : Profit on Realization : Rs. 12,500; Shared as Antony Rs. 5,000; Birdy Rs. 5,000 and Costello Rs. 2,500 Final Settlement Cash paid to Antony Rs. 3,400, Brought by Birdy Rs. 600 and Costello Rs. 2,300]

Problem 2.

X, Y and Z were in partnership sharing profits & losses in the ratio of 3 : 2 :1. No interest was to be allowed on Current or Capital Accounts of the partners but their loans were to carry interest @ 10% p.a. Due to persistent losses and the continued illness of X the firm got dissolved on 31st March, 2008. Its accounts were closed for the last time on 31st December, 2007 on which date their Balance Sheet was as under :

Liabilities		Rs.	Assets	Rs.
Capital Accounts:			Plant & Machinery	60,000
X	48,000		Furniture & Fittings	10,000
Y	33,000	81,000	Motor Cars	40,000
Loan Account X		22,000	Stock	55,000
Trade Creditors		80,000	Sundry Debtors	40,000
Bank Overdraft		30,000	Capital Account : Z	8,000
		2,13,000		2,13,000

Between 31.12.07 and 31.3.08 goods to the value of Rs. 30,000 were purchased and sales amounted to Rs. 45,000. In addition to payment to trade creditors, payments made were for salaries and wages Rs. 12,000 and office expenses Rs. 6,000. Drawing of each partner were Rs. 800 p.m. On 31.3.08 debtors, creditors and stock were Rs. 60,000, Rs. 70,000 and Rs. 45,000 respectively.
In dissolution proceedings the partners agreed to transfer the entire business (with all assets and liabilities including partner's loan) as a going concern to D for a consideration of Rs. 90,000, costs of dissolution amounted to Rs. 2,800 which were paid by X.
Show the necessary entires for the dissolution of the fir and also the Capital Accounts of the partners assuming that all of them are solvent.
{Ans : Trading Loss for 3 months Rs. 13,550; Loss on Realization Rs. 34,950; Final payment to X Rs. 59,100 and Y Rs. 37,333; Z brings in Rs. 6,833}
Problem 3 :The following was the Balance Sheet of A, B and C who were in partnership sharing profits & losses as 3 : 2 : 1.

Liabilities		Rs.	Assets		Rs.
Capital Accounts:			Cash		500
A	15,000		Machinery		10,000
B	10,000	25,000	Debtors	16,000	
Reserve		6,000	Less : Prov.	1,000	15,000
A's Loan		5,000	Stock		12,000
Creditors		10,000	C's Capital (Dr.)		8,500
		46,000			46,000

The firm was dissolved. Assets other than Cash realized Rs. 26,000. Expenses of winding up were Rs. 1,000. C was insolvent but Rs. 2,000 was realized from his estate. Show the necessary ledger accounts to close the books of the firm (Apply Garner Vs. Murray principle).

[Ans : Realization loss Rs. 12,000; Capital deficiency of C Rs. 7,500 to be shared by A and B in the ratio of 3 : 2. Final payments to A Rs. 13,500 and to B Rs. 9,000]

Problem 4

A, B, C and D were in partnership. Their position on 30.6.2008 was as follows. They shared profits and losses in the ration of 4 : 3 : 2 : 1.

Liabilities		Rs.	Assets	Rs.
Capitals:			Sundry Assets	32,000
A	7,000		Loss to date	15,000
B	8,000		B's Drawings	4,000
C	4,000		D's Drawings	1,000
D	3,000	22,000		
Creditors		30,000		
		52,000		52,000

They decided to dissolve the firm on that date. The assets realized Rs. 27,000. A and B both are insolvent. B's private estates amount to R.s 10,000 and his private liabilities Rs. 7,000. D's private assets are Rs. 7,000 and his private liabilities are Rs. 1,000. Show the relevant accounts presuming that all the transactions are put through on 30.9.2008 and that B's estate realized only Rs. 4,000 and D's estate realized Rs. 5,000.

[Ans : Loss on Realization Rs. 5,000; Capital deficiency of A and B, Rs. 1,000 and Rs. 2,000 respectively to be shared by C and D as 2 : 1]

Problem 5

A, B and C were equal partners. Their Balance Sheet on 31.12.2008 stood as under, when the firm was dissolved:

Balance Sheet as at 31.12.2008

Liabilities	Rs	Assets	Rs.
Sundry Creditors	32,000	Machinery	12,000
A's Capital	4,000	Furniture	3,000
B's Capital	3,000	Sundry Debtors	5,000
		Stock	4,000
		Cash at Bank	2,800
		C's Capital	12,200
	39,000		39,000

The Assets realized as under : Machinery Rs. 6,000; Furniture Rs. 1,000; Sundry Debotrs Rs.4,000 and Stock Rs. 3,000.

The expenses of realization came of Rs. 1,400.

A’s personal properties are not sufficient to pay his personal liabilities, whereas in B’s and C’s private estate there is a surplus of Rs. 2,400 and Rs. 3,000 respectively.

Show the necessary Accounts closing the books of the firm.

[Ans : Loss on Realisation Rs. 11,400; Rs. 3,800 each. Balance of Capital Accounts transferred to Deficiency Account A Rs. 200 (Cr.); B Rs. 1,600 (Cr.); and C Rs. 13,000 (Dr.); Final Payment to Creditors Rs. 20,800]

Problem 6

X, Y and Z are partners in a firm dealing in fancy goods, and sharing profits and losses as 2 : 2 : 1. They decided to dissolve the firm and to appoint Y to realize the assets and distribute the proceeds. Y is to receive 5% of the amounts coming to X and Z as his remuneration and to bear all expenses of realization.

Their Balance Sheet on the date of dissolution is :

Liabilities		Rs.	Assets		Rs.
Creditors		1,247	Debtor	4,297	
Capitals			Less: Prov.	211	4,018
X	4,106		Stock		1,872
Y	3,080	7,186	Cash		476
			Other Assets		1,710
			Z-Overdraft		357
		8,433			8,433

The proceeds of realization were : (i) Debtors Rs. 3,462; Stock 1,444; Goodwill Rs. 50 and other assets Rs. 909. (ii) Creditors omitted from the balance Sheet Rs. 100 had to be paid. (iii) The expenses of realization amounted to Rs. 100.

Z informs that he has only Rs. 100 and the other partners agree that if as a result of realization, Z is still indebted to more than this amount, they accept it in full settlement. Prepare the Dissolution Accounts.

[Ans : (i) Loss on Realization : X 793, Y 793 and Z 396; Y’s Remuneration Rs. 147; Cash paid to X and Y Rs. 2,940 and Rs. 2,154 respectively, Z’s deficiency Rs. 653 shared by X and Y as 4 : 3]

4.4 PIECEMEAL DISTRIBUTION

On the event of dissolution of a partnership firm, the assets are realised and liabilities paid off.
The process of asset realisation takes place gradually. As a result of such the liabilities are also paid off as and when such realisation takes place.

"Piece-meal Distribution" represents the process of "Pay as and when you realise" strategy.

Methods followed under Piece-meal Distribution :
(1) Highest Relative Capital Method
OR
Proportionate Capital Method
OR
Absolute Surplus Capital Method.
(2) Maximum Loss Method.

Higher Relative Capital Method :
Under this method, the partner who had contributed highest capital in terms of their profit-sharing ratio are paid off prior to the other partners.

We have to prepare :
(i) Statement showing Absolute Surplus
[to determine which partner has contributed maximum proportionate capital]
(ii) Statement Showing Distribution of Cash

Illustration 1 :

Capitals (as on the date of dissolution) :

P = Rs. 35,000 ; Q = Rs. 37,500 ; R = Rs. 31,500 ; Profit-Sharing Ratio = 5 : 3 : 2

Statement showing the Highest Relative Capital ***or*** Absolute Surplus :

	P	Q	R
1. Actual Capital	55,000	37,500	31,500
2. Profit Sharing Ratio (PSR)	5	3	2
3. Actual Capital ÷ PSR = Proportionate Capital	11,000	12,500	15,750
4. Consider the smallest of proportionate capital as per (3) as base capital ×PSR [i.e. 11,000 × PSR]	55,000	33,000	22,000
5. Surplus Capital [(1) —(4)]	—	4,500	9,500
6. PSR	—	3	2
7. Surplus Capital (as per 5) ÷ PSR	—	1,500	4,750
8. Consider the smallest of Proportionate capital as per (7)× PSR	—	4,500	3,000
9. Absolute Surplus [5-8]	—	—	6,500

This means that R will be paid Rs. 6,500 to clear off his Absolute Surplus Capital.

Illustration 2 :

Capitals : X = Rs. 15,000 ; Y = Rs. 18,000 ; Z = Rs. 9,000
Profit Sharing Ratio = 2 : 2 : 1

Statement showing the Highest Relative Capital

	X	Y	Z
1. Actual Capital	15,000	18,000	9,000
2. PSR	2	2	1
3. Actual Capital ÷ PSR = Prop. Capital	7,500	9,000	9,000
4. Consider the smallest of Proportionate Capital as Base × PSR [i.e. 7,500×PSR]	15,000	15,000	7,500
5. Surplus Capital [1—4]	NIL	3,000	1,500

Since the Surplus Capitals for Y & Z are in their profit-sharing ratio, no further steps are required.

Illustration 3 : Partners M, N and P have called upon you to assist them in winding up the affairs of their partnership on 30th June, 2008. Their Balance Sheet as on that date is given below :

Liabilities	*Rs.*	*Assets*	*Rs.*
Sundry Creditors	17,000	Cash at Bank	6,500
Capital Accounts :		Sundry Debtors	22,000
M	67,000	Stock in trade	13,500
N	45,000	Plant and Equipment	99,000
P	31,500	Loan : M	12,000
		Loan : N	7,500
	1,60,500		1,60,500

(a) The partners share profits and losses in the ratio of 5 : 3 : 2.

(b) Cash is distributed to the partners at the end of each month.

(c) A summary of liquidation transaction are as follows :

July :

Rs. 16,500 — collected from Debtors ; balance is irrecoverable.

Rs. 10,000 — received from sale of entire stock.

Rs. 1,000 — liquidation expenses paid.

Rs. 8,000 — cash retained in the busines at the end of the month.

August :

Rs. 1,500 — liquidation expenses paid ; as part of the payment of his capital, P accepted an equipment for Rs. 10,000 (book value Rs. 4,000).

Rs. 2,500 — cash retained in the business at the end of the month.

September :

Rs. 75,000 — received on sale of remaining plant and equipment.

Rs. 1,000 — liquidation expenses paid. No cash is retained in the business.

Required : Prepare a Schedule of cash payments as on 30th September, showing how the cash was distributed.

Solution :

Statement showing the Distribution of Cash
(According to Proportionate Capital Method)

Particulars	*Creditors*		*Capital*	
	Rs.	*M* *Rs.*	*N* *Rs.*	*P* *Rs.*
A. Balance Due	17,000	55,000	37,500	31,500
B. Amount distributed as on 31st July	17,000	—	—	6,500
C. Balance Due (A - B)	-	55,000	37,500	25,000
D. Cash paid to 'N' and Equipment given to P on 31st August.		—	4,000	10,000
E. Balance due (C - D)		55,000	33,500	15,000
F. Amount paid to partners on 30th September		41,500	25,400	9,600
G. Loss on Realisation (Unpaid Balance) [E - F]		13,500	8,100	5,400

Working Notes :

(i) Statement showing the Calculation of Highest Relative Capital

	Particulars	*M*	*N*	*P*
A	Balance of Capital Accounts	67,000	45,000	31,500
B	*Less* : Loan	12,000	7,500	—
C	Actual Capital (A - B)	55,000	37,500	31,500
D	Profit sharing raito	5	3	2
E	Actual Capital ÷ Profit sharing ratio	11,000	12,500	15,750
F	Proportionate Capitals taking *M*'s Capital as Base Capital	55,000	33,000	22,000
G	Excess of Actual Capitals over Proportionate Capitals (C - F)		4,500	9,500
H	Profit Sharing Ratio	—	3	2
I	Surplus Capital ÷ Profit Sharing Ratio	—	1,500	4,750
J	Revised Proportionate Capital taking *N*'s Capital as Base Capital	—	4,500	3,000
K	Excess of Surplus Capital over Revised Proportionate Capitals (G - J)	—	—	6,500

Scheme of distribution of available cash : First instalment up to Rs. 6,500 will be paid to *P*. Next instalment up to Rs. 7,500 will be distribution between *N* and *P* in the ratio of 3 : 2. Balance realisation will be distributed among *M*, *N* and *P* in the ratio of 5 : 3 : 2.

(ii) Statement showing the Calculation of Cash Available for Distribution

	Particulars	*July Rs.*	*August Rs.*	*September Rs.*
A	Opening Balance	6,500	8,000	2,500
B	*Add* : Net amount realised (Gross amount — Expenses)	25,000	(1,500)	74,000
C	*Less* : Closing Balance	8,000	2,500	—
D	Amount available for distribution (A+B–C)	23,500	4,000	76,500

(iii) Statement showing the Manner of Distribution of amount available in August and September

Particulars	*M* *Rs.*	*N* *Rs.*	*P* *Rs.*
First Rs. 7,500	—	4,500	3,000
Balance Rs. 83,000 (Cash and Equipment)	41,500	24,900	16,600
	41,500	29,400	19,600
Less : Actual Distribution in August	—	4,000	10,000
Manner of Distribution in September	41,500	25,400	9,600

Illustration 4 : The firm of Blue Collars presented you with the following Balance Sheet drawn as on 31st March 2008 :

Liabilities		*Rs.*	*Assets*		*Rs.*
Sundry Creditors		37,000	Cash in hand		3,000
Capital Accounts :			Sundry Debtors		34,000
L	40,000		Stock in trade		39,000
K	30,000		Plant and Mechinery		51,000
J	27,000	97,000	Current Accounts :		
			K	4,000	
			J	3,000	7,000
		1,34,000			1,34,000

Partners shared profits and losses in the ratio of 4 : 3 : 3. Due to difference among the partners, it was decided to wind up the firm, realise the assets and distribute cash among the partners at the end of each month.

The following realisations were made :.

(i) May — Rs. 15,000 from debtors and Rs. 20,000 by sale of stock. Expenses on realisation were Rs. 500.

(ii) June — Balance of debtors realised Rs. 10,000. Balance of stock fetched Rs. 24,000.

(iii) August — Part of machinery was sold for Rs. 18,000. Expenses incidental to sale were Rs. 600.

(iv) September — Part of machinery valued in the books at Rs. 5,000 was taken by *B*, in part discharge at an agreed value of Rs. 10,000. Balance of machinery was sold for Rs. 30,000 (net).

Partners decided to keep a minimum cash balance of Rs. 2,000 in the first 3 months and Rs. 1,000 thereafter.

Required : Show how the amounts due to partners will be settled.

Solution :

(i) Statement showing the Distribution of Cash
(According to Proportionate Capital Method)

Particualr	*Creditors* *Rs.*	*Capital* *L*	*K*	*J*
	Rs.	*Rs.*	*Rs.*	*Rs.*
A Amount due	37,000	40,000	26,000	24,000
B Amount distribution as on 31st May	35,500	—	—	—
C Balance Due (A - B)	1,500	40,000	26,000	24,000
D Amount Distributed as on 30th June				
First Rs. 1,500	1,500			
Next Rs. 5,333	—	5,333	—	—
Next Rs. 4,667	—	2,667	2,000	—
Balance Rs. 22,500	—	9,000	6,750	6,750
E Balance due (C - D)		23,000	17,250	17,250
F Amount Distributed as on 31st August		7,360	5,520	5,520
G Balance Due (E - F)		15,640	11,730	11,730
H *Add* : Profit on realisation (Rs. 41,000 – Rs. 39,100)		760	570	570
I Amount Distributed (including Machinery taken by L) as on 30th September. * Includes value of Machinery Rs. 10,000 and Cash Rs. 2,300		16,400	12,300*	12,300

Working Notes :

(i) *Assumption* : As the firm is dissolved due to difference among the partners, all partners are presumed to be solvent and the problem has been worked out on the basis of the highest relative capital.

(ii) Statement showing the Calculation of Highest Relative Capitals

Particulars	*L* *Rs.*	*K* *Rs.*	*J* *Rs.*
A Actual Capitals	40,000	26,000	24,000
B Profit sharing ratio	4	3	3
C Actual Capitals ÷ Profit ratio	10,000	8,667	8,000
D Proportionate Capitals taking *J*'s Capital as Base Capital	32,000	24,000	24,000
E Suplus Capital of *L* and *K* (A - D)	8,000	2,000	—
F Revised Proportionate Capital of *L* and *J*	2,667	2,000	—
G Revised Surplus Capital of *L* (E - F)	5,333	—	—

While distributing surplus among partners, 1st instalment up to Rs. 5,333 will be paid to *L*, next instalment up to Rs. 4,667 will be distributed between *L* and *K* in the ratio of 4 : 3 and the Balance among *L, K* and *J* in the ratio of 4 : 3 : 3.

(iii) Statement showing the Calculation of Cash available each month

Particulars	*May* *Rs.*	*June* *Rs*	*August* *Rs*	*September* *Rs*
A Opening Balance	3,000	2,000	2,000	1,000
B *Add* : Amount realised *Less* Expenses	34,500	34,000	17,400	30,000
C *Less* : Closing blance	2,000	2,000	1,000	—
D Total Cash available for Distribution (A+B–C)	35,500	34,000	18,400	31,000

Dr. (iv) Realisation Account *Cr.*

Particulars	*Rs.*	*Particulars*	*Rs.*
To Sundry Debtors	34,000	By Sundry Creditors	37,000
To Stock in trade	39,000	By Cash / Bank	1,17,000
To Plant and Machinery	51,000	By *L* (Assets taken over)	10,000
To Cash / Bank :			
Creditors	37,000		
Expenses	1,100		
To Profit transferred to Capital A / c	1,900		
	1,64,000		1,64,000

Illustration 5 : A partnership firm was dissolved on 30th June, 2008. Its Balance Sheet on the date of dissolution was as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Capitals :		Cash	5,400
Atrik	38,000	Sundry Assets	94,600
Mohit	24,000		
Rupa	18,000		
Loan A/c — Mohit	5,000		
Sundry Creditors	15,000		
	1,00,000		1,00,000

The assets were realised in instalments and the payments were made on the proportionate capital basis. Creditors were paid Rs. 14,500 in full settlement of their account. Expenses of realisation were estimated to be Rs. 2,700 but actual amount spent on this account was Rs. 2,000. This amount was paid on 15th September. Draw up a Memorandum of distribution of Cash, which was realised as follows :

On 5th July	Rs. 12,600
On 30th August	Rs. 30,000
On 15th September	Rs. 40,000

The partners shared profits and losses in the ratio of 2 : 2 : 1. Give working notes.

Solution :

Statement Showing the Distribution of Cash
(According to Proportionate Capital Method)

Particualr	*Creditors Rs.*	*Mohit's Loan Rs*	*Atrik Rs*	*Mohit Rs*	*Rupa Rs*
A Balance Due	15,000	5,000	38,000	24,000	18,000
B Cash paid (Rs. 5,400 – Rs. 2,700)	2,700	—	—	—	—
C Balance unpaid (A - B)	12,300	5,000	38,000	24,000	18,000
D 1st Instalment of Rs. 12,600	11,800	800	—	—	—
E Balance unpaid (C - D)	500	4,200	38,000	24,000	18,000
F *Less* : Written-off	500				
G 2nd instalment of Rs. 30,000		4,200	16,320	2,320	7,160
H Balance unpaid (E-F-G)			21,680	21,680	10,840
I 3rd Instalment (Rs. 40,000+Rs. 700)			16,280	16,280	8,140
J Unpaid Balance (H-I) = Loss on Realisation			5,400	5,400	2,700

Working Notes :

(i) Statement showing the Calculation of Highest Relative Capitals

	Particulars	*Atrik* *Rs.*	*Mohit* *Rs.*	*Rupa* *Rs.*
A	Actual Capitals	38,000	24,000	18,000
B	Profit-sharing ratio	2	2	1
C	Actual Capitals ÷ Profit Sharing Ratio	19,000	12,000	18,000
D	Proportionate Capitals taking Mohit's Capital as Base Capital	24,000	24,000	12,000
E	Surplus Capital [A-D]	14,000	Nil	6,000
F	Surplus Capital ÷ Profit Sharing Ratio	7,000	—	6,000
G	Revised Proportionate capitals taking Rupa's Capital as the basis	12,000	—	6,000
H	Revised Surplus Capital (E - G)	2,000	—	—

(ii) *Distribution of Second Instalment of Rs. 30,000*

			Mohit's Loan	*Atrik*	*Mohit*	*Rupa*
First	Rs. 4,200		4,200	—	—	—
Next	Rs. 2,000	(Absolute Surplus)		2,000	—	—
Next	Rs. 18,000	(Balance of Surplus)		12,000	—	6,000
Balance	Rs. 5,800	(2 : 2 : 1)		2,320	2,320	1,160
Total	30,000		4,200	16,320	2,320	7,160

Illustration 6 : East, South and North are in partnership sharing profits and losses in the ratio 3 : 2 : 1 respectively. They decide to dissolve the business on 31st July, 2008 on which date their Balance Sheet was as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital accounts :		Land and Buildings	30,810
East	38,700	Motor car	5,160
South	10,680	Investment	1,080
North	11,100	Stock	19,530
Loan account : North	3,000	Debtors	11,280
Creditors	10,320	Cash	5,940
	73,800		73,800

The assets were realised piecemeal as follows and it was agreed that cash should be distributed as and when realised :

		Rs.
14th Agust		10,380
20th September		27,380
16th October		3,600
	North took over investment at a value of	
15th November		1,260
18th November		19,200

Dissolution expenses were originally provided for an estimated amount of Rs. 2,700, but actual amount spent on 25th October was Rs. 1,920. The editors were settled for Rs. 10,080.

Required : Prepare a statement showing distribution of cash amongst the partners, according to Proportionate Capital Method.

Solution :

Statement Showing the Distribution of Cash
(According to Proportionate Capital Method)

	Particualr	*Creditors Rs.*	*Loan Rs*	*East Rs*	*South Rs*	*North Rs*
A	Balance Due	10,320	3,000	38,700	10,680	11,100
B	Paid to Creditors [Rs. 5,940 - Rs. 2,700]	3,240	—	—	—	—
C	Balance Due (A - B)	7,080	3,000	38,700	10,680	11,100
D	Amount paid on 14th August	6,840	3,000	540		
		240	—	38,160	10,680	11,100
E	*Less* : Written off	(240)	—	—	—	—
F	Balances Due (D - E)			38,160	10,680	11,100
G	Amount paid on 20th February					
	(i) First 4,860 (i.e. Rs. 5,400 - Rs. 540)			4,860	—	—
				33,300	10,680	11,100
	(ii) Balance Rs. 23,040			17,280	—	5,760
H	Balance Due (F - G)			16,020	10,680	5,340
I	Amount paid on 16th October			(1,800)	(1,200)	(600)
J	Balance Due (H-I)			14,220	9,480	4,740
K	Amount paid on 25th October (being excess over estimated expenses Rs. 780)			(390)	(260)	(130)
L	Balance due (J - K)			13,830	9,220	4,610
M	Cash brought in by North & paid to East & South			(630)	(420)	1,050
N	Investment taken over by North			—	—	1,260
O	Balance Due (L-M-N)			13,200	8,800	4,400
P	Amount paid on 18th November			9,600	6,400	3,200
Q	Balance unpaid (O-P)			3,600	2,400	1,200

Working Note :

Statement Showing the Calculation of Highest Relative Capitals

	Particulars	*East* Rs.	*South* Rs.	*North* Rs.
A	Actual Capitals	38,700	10,680	11,100
B	Profit Sharing Ratio	3	2	1
C	Actual Capital + Profit Sharing Ratio	12,900	5,340	11,100
D	Proportionate capitals taking South's Capital as Base Capital	16,020	10,680	5,340
E	Surplus capital (i.e. Excess of Actual Capitals over proportionate capital) [A-D]	22,680	—	5,760
F	Profit Sharing Ratio	3		1
G	Surplus Capital + Profit Sharing Ratio	7,560		5,760
H	Revised Proportionate Capitals taking North's Capital as Base Capital	17,280		5,760
I	Revised Surplus Capital [E-H]	5,400		—
J	Distribution Sequence			
	First Rs. 5,400	[To East]		
	Next Rs. 23,040[To East & North in the ratio of 3 : 1]			
	Balance[To East, South & North in the ratio of 3 : 2 : 1]			

Illustration 7 : The firm of M/s LMS was dissolved on 31.3.2008, at which date its Balance Sheet stood as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors	2,00,000	Fixed Assets	45,00,000
Bank Loan	5,00,000	Cash and Bank	2,00,000
L's Loan	10,00,000		
Capitals :			
L	15,00,000		
M	10,00,000		
S	5,00,000		
	47,00,000		47,00,000

Partners share profits equally. A firm of Chartered Accounts is retained to realise the assets and distributed the cash after discharge of liabilities. Their fees which are to include all expenses is fixed at Rs. 1,00,000. No loss is expected on realisation since fixed assets include valuable land and building.

Realisations are : 1st Rs. 5,00,000, 2nd Rs. 15,00,000, 3rd Rs. 15,00,000, 4th Rs. 30,00,000, 5th Rs. 30,00,000.

The Chartered Accountant firm decided to pay off the partners in 'Higher Relative Capital Method'. You are required to prepare a statement showing distribution of cash with necessary workings.

Solution :

Statement showing the Distribution towards Firm's Outside Debts' and Partner's Loan

Particulars	*Ratio*	*Total Rs*	*Creditors Rs*	*Bank Loan Rs*	*L 's Loan Rs*
A Balance Due		17,00,000	2,00,000	5,00,000	10,00,000
B *Less* : Amount paid out of its instalment	2 : 5	6,00,000	1,71,429	4,28,571	—
C Balance Due (A-B)		11,000,000	28,571	71,429	10,00,000
D *Less* : Amount paid out of 2nd installment					
First Rs. 1,00,000	2 : 5	1,00,000	28,571	71,429	—
Next Rs. 10,00,000	0 : 0 : 1	10,00,000	—	—	10,00,000
E Balance Due (C-D)		Nil	Nil	Nil	Nil

Statement showing the Distribution of Cash among Partners (According to Proportionate Capital Method)

Particualr	*Ratio*	*Total Rs*	*L Rs*	*M Rs*	*S Rs*
A Balance Due		30,00,000	15,00,000	10,00,000	5,00,000
B *Less* : Amount paid out of 2nd instalment	1 : 0 : 0	4,00,000	4,00,000	—	—
C Balance Due (A-B)		26,00,000	11,00,000	10,00,000	5,00,000
D *Less* : Amount paid out of 3rd Instalment					
First Rs. 1,00,000		1,00,000	1,00,000	—	—
Next Rs. 10,00,000	1 : 1 : 0	10,00,000	5,00,000	5,00,000	—
Balanc Rs. 4,00,000	1 : 1 : 1	4,00,000	1,33,334	1,33,333	1,33,333
		15,00,000	7,33,334	6,33,333	1,33,333
E Balance Due (C-D)		11,00,000	3,66,666	3,66,666	3,66,667
F *Add* : Realisation Profit credited (Rs. 30,000,000 – Rs. 11,00,000)	1 : 1 : 1	19,00,000	6,33,334	6,33,334	6,33,333

G	Balance Due (after taking into Realisation Profit (E + F)		30,00,000	10,00,000	10,00,000	10,00,000
H	*Less* : Amount paid out of 4th Instalment	1 : 1 : 1	30,00,000	10,00,000	10,00,000	10,00,000
I	Balance Due (G - H)		Nil	Nil	Nil	Nil
J	*Add* : Realisation Profit credited	1 : 1 : 1	30,00,000	10,00,000	10,00,000	10,00,000
K	Balance due (after taking into Realisation profit) (I + J)		30,00,000	10,00,000	10,00,000	10,00,000
L	*Less* : Amount paid out of 5th Instalment	1 : 1 : 1	30,00,000	10,00,000	10,00,000	10,00,000
M	Balance Due (K - L)		Nil	Nil	Nil	Nil

Working Notes :

(i) Statement showing the computation of Highest Relative Capital

	Particulars	*L*	*M*	*S*
A	Actual Capitals	15,00,000	10,00,000	5,00,000
B	Profit Sharing Ratio	1	1	1
C	Actual Capital × Profit Sharing Ratio	15,00,000	10,00,000	5,00,000
D	Proportionate Capital taking S's Capital as Base Capital	5,00,000	5,00,000	5,00,000
E	Surplus Capital (A - D)	10,00,000	5,00,000	—
F	Profit Sharing Ratio	1	1	—
G	Surplus Capital × Profit Sharing Ratio	10,00,000	5,00,000	—
H	Revised Proportional Capital taking M's Capital as Base Capital	5,00,000	5,00,000	—
I	Revised Surplus Capital (E - G)	5,00,000	—	—

(ii) *Scheme of Distribution* : First Rs. 5,00,000 will be paid to *L*, next Rs. 10,00,000 will be distributed between *L* and *M* in their profit sharing (i.e. 1 : 1) and the balance will be distributed among *L, M* and *S* in their profit sharing ratio (i.e. 1 : 1 : 1).

(iii) It has been assumed that the amounts of realisation given in the question pertain to realisation of fixed assets.

(iv) *Calculation of amount available for distribution at the time of first realisation of fixed asset*

= Cash & Bank Balance + 1st Realisation – Liquidator's remuneration

= Rs. 2,00,000 + Rs. 5,00,000 – Rs. 1,00,000 = Rs. 6,00,000.

Maximum Loss Method

Steps (1) Prepare a statement showing distribution of cash

(2) Pay off the external Liabilities

(3) After all the payment is made for the external liabilities, the partners will be paid off.

Total Due of Partners	xxx
Less : Net / Balance of Realisation	(x)
Maximum Loss	xxx

(4) The maximum loss shall be shared amongst the partners in their profit sharing ratio, as if, there will be no further realisation.

(5) If any of the partner capitals, after step (4) is negative, that partner shall be treated like an insolvent partner.

(6) The deficiency of the insolvent partner as per step(5) shall be shared by the other solvent partners (i.e. those partners who has positive capital balances) in their capital contribution ratio as per Garner vs. Murray Rule.

(7) Repeat the steps (3) to (6) till final realisation.

PROBLEMS ON MAXIMUM LOSS METHOD

Illustration 8 : The following is the Balance Sheet of *X*, *Y* and *Z*, who were sharing in the ratio 5 : 3 : 2, on 31st December, 2007 when they decided to dissolve the partnership.

Liabilities	*Rs.*	*Assets*	*Rs.*
X's Capital	55,000	Cash	20,000
Y's Capital	37,500	Other assets	13,04,000
Z's Capital	31,500		
Y's Loan	2,00,000		
Creditors	10,00,000		
	13,24,000		13,24,000

Note : There was a bill for Rs. 4,000 due on 1.4.2008 under discount.

Other assets realised as under :

1st Jan. : Rs. 8,85,000, 1st Feb. : Rs. 3,00,000 ; 1st March : Rs. 8,000 ; 1st April : Rs. 5,000 ; 1st May : Rs. 10,000. The expenses of realisation were expected to be Rs. 5,000, but ultimately amounted to Rs. 4,000 only and were paid on 1st May. The acceptor of the bill under discount met the bill on the due date.

Required : Prepare a statement showing the monthly distribution of cash according to Maximum Loss Method.

Solution :

Statement Showing the Distribution of Cash towards Firm's Outside Debts and Partner's Loan

Particulars	Creditors Rs.	Y's Loan Rs.
A Amount Due	10,00,000	2,00,000
B Amount paid on 1st Jan. (Rs. 20,000 + Rs. 8,85,000 – Rs. 5,000)	9,00,000	—
C Balance Due (A - B)	1,00,000	2,00,000
D Amount paid on 1st February	1,00,000	2,00,000
E Balance Due (C - D)	—	—

Statement showing the Distribution of Cash (According to Maximum Loss Method)

Particulars	Total Rs.	X Rs.	Y Rs.	Z Rs.
(i) Distribution of Rs. 4,000				
A Amount due as on 1st March	1,24,000	55,000	37,500	31,500
Less : Max. Possible Loss if the remaining nothing (Rs. 1,24,000 – Rs. 4,000) in the ratio of 5 : 3 : 2	1,20,000	60,000	36,000	24,000
Note : Cash available=Rs. 8,000–Rs. 4,000 (Reserved for discounted B/R)=Rs. 4,000				
Adjustment of *X*'s Deficiency between B and *Z* in their Capital ratio i.e. 375 : 315		5,000	(2,717)	(2,283)
			(1,217)	5,217
Adjustment of *Y*'s Deficiency (charged to *Z*)		—	1,217	(1,217)
B Cash paid as on 1st March	4,000	—	—	4,000
(ii) Distribution of Rs. 9,000 (including Amount kept reserved for B/R no longer required)				
C Balance due (A-B)	1,20,000	55,000	37,500	27,500
Less : Max. Possible Loss (Rs. 1,20,000 – Rs. 9,000)	1,11,000	55,500	33,300	22,200
Note : Cash available=Rs. 5,000+Rs. 4,000 = Rs. 9,000		(500)	4,200	5,300
Adjustment of *X*'s Deficiency between *Y* and *Z* in their Capital ratio i.e. 375 : 315		500	(272)	(228)
D Cash paid as on 1.4.96	9,000	—	3,928	5,072
(iii) Distribution of Rs. 11,000				
E Balance due (C-D)	1,11,000	55,000	33,572	22,428
Less : Max. Possible Loss (Rs. 1,11,000–Rs. 11,000)	1,00,000	50,000	30,000	20,000
F Cash paid as on 1st May	11,000	5,000	3,572	2,428
G Unpaid Balance (E - F)	1,00,000	50,000	30,000	20,000

Illustration 9 : The following is the Balance Sheet of *P*, *Q* and *R* on 31st August, 2008 when they decided to dissolve the partnership. They share profits in the ratio of 2 : 2 : 1.

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors	2,000	Sundry Assets	48,500
P's Loan	5,000	Cash	500
P's Capital	15,000		
Q's Capital	18,000		
R's Capial	9,000		
	49,000		49,000

The assets realised the following sums in instalments.

I—Rs. 1,000, II—Rs. 3,000, III—Rs. 3,900, IV—Rs. 6,000, V—Rs. 20,000.

The expenses of realisation were expected to be Rs. 500 but ultimately amounted to Rs. 400 only.

Required : Show, how at each stage, the cash received should be distributed among partners according to Maximum Loss Method.

Solution :

Statement showing the Realisation and Distribution of Cash

Instalments	*Realisation* *Rs.*	*Creditors* *Rs.*	*Partners' Loans* *Rs.*	*Partners' Capital* *Rs.*
(I) (Afer taking into account cash and amount set aside for expenses)	1,000	1,000		
(II)	3,000	1,000	2,000	
(III)	3,900		3,000	900
(IV)	6,000	—	—	6,000
(V) (including saving in expenses)	20,100	—	—	20,100
	34,000	2,000	5,000	27,000

Statement showing the Distribution of Cash among partners
(According to Maximum Loss Method)

Particulars	*Total* *Rs.*	*P* *Rs.*	*Q* *Rs.*	*R* *Rs.*
(i) Distribution of Rs. 900				
A Balance Due	42,000	15,000	18,000	9,000
B *Less* : Max. Possible loss, if the remaining assets prove to be worthless (Rs. 42,000 – Rs. 900) in the ratio (2 : 2 : 1)	41,100	16,440	16,440	8,220

C Deficiency of *P*'s Capital charged to *Q* and *R* in the ratio of their Capitals i.e., 18,000 : 9,000 (Garner vs. Murray)	—	1,440	(960)	(480)
D Amount paid	900	—	600	300
(ii) Distribution of Rs. 6,000				
E Balance after payment (A -D)	41,100	15,000	17,400	8,700
F *Less* : Max. Possible loss (Rs. 41,100 – 6,000)	35,100	14,040	14,040	7,020
G Amount paid	6,000	960	3,360	1,680
(iii) Distribution of Rs. 20,100				
H Balance after payment (E - G)	35,100	14,040	14,040	7,020
I *Less* : Max. Possible loss (Rs. 35,100 – Rs. 20,100)	15,000	6,000	6,000	3,000
J Amount paid	20,100	8,040	8,040	4,020
K Unpaid balance (H - J)	15,000	6,000	6,000	3,000

Illustration 10 : Rahul, Roshan and Rohan were in partnership sharing profits and losses in the ratio of 3 : 2 : 1 respectively. The partnership was dissolved on 30th June, 2008 when the position was as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Capitals :		Cash in hand	28,000
Rahul	1,40,000	Sundry Debtors	2,94,000
Roshan	70,000	Stock in trade	1,12,000
Rohan	14,000		
Creditors	2,10,000		
	4,34,000		4,34,000

There was bill for Rs. 10,000, due on 30th November, 2008, under discount. It was agreed that the net realisations should be distributed in their due order (at end of each month) but as safely as possible. The realisations and expenses were as under :

Date	*Stock and Debtors Rs.*	*Expenses Rs.*
31st July	84,000	7,000
31st August	1,26,000	5,400
30th September	70,000	4,900
31st October	77,000	3,500
30th November	35,500	3,500

The Stock was completely disposed off and amounts due from debtors were realised, the balance being irrecoverable. The acceptor of the bill under discount met the billl on the due date. Prepare a Statement showing the piecemeal distribution of cash according to Maximum Loss Method.

Solution :

Statement showing the Distribution of Cash
(According to Maximum Loss Method)

	Particulars	Creditors Rs.	Rahul Rs.	Roshan Rs.	Rohan Rs.
A	Balance Due	2,10,000	1,40,000	70,000	14,000
B	Cash on hand on 30th June paid to creditors	28,000	—	—	—
C	Balance outstanding (A - B)	1,82,000	1,40,000	70,000	14,000
D	Cash paid on 31st July	77,000	—	—	—
E	Balance outstanding (C - D)	1,05,000	1,40,000	70,000	14,000
F	Rs 1,05,000 paid to creditors on 31st August	1,05,000	—	—	—
G	Balance outstanding (E -F)	—	1,40,000	70,000	14,000
	Balance available for distribution (Rs. 1,20,600 - Rs. 1,05,000 - Rs. 10,000) = Rs. 5,600				
	Less : Maximum loss (Rs. 2,24,000 - Rs. 5,600) in ratio of 3 : 2 : 1		(1,09,200)	(72,800)	(36,400)
	Balance		30,800	(2,800)	(22,400)
	Deficiency of Roshan and Rohan's capital charged to Rahul		(25,200)	2,800	22,400
H	Cash paid on 31st August		5,600	—	—
I	Balance outstanding (G - H)		1,34,400	70,000	14,000
	Less : Maximum Loss (Rs. 2,18,400 – Rs. 65,100)		(76,650)	(51,100)	(25,550)
	Balance		57,750	18,900	(11,550)
	Deficiency of Rohan's capital charged to Rahul and Roshan (2 : 1)		(7,700)	(3,850)	11,550
J	Cash paid on 30th September		50,050	15,050	—
K	Balance outstanding (I - J)		84,350	54,950	14,000
	Less : Maximum loss (Rs 1,53,300 – Rs. 73,500)		(39,900)	(26,600)	(13,300)
L	Cash paid on 31st October		44,450	28,350	700
M	Balance outstanding (K - L)		39,900	26,600	13,300
	Less : Maximum loss (Rs 79,800 – Rs. 42,000*)		(18,900)	(12,600)	(6,300)
N	Cash paid on 30th November		21,000	14,000	7,000
O	Unpaid Balance (M - N)		18,900	12,600	6,300

*Note : Cash available on 30th November = (Rs 35,500 – Rs. 3,500) + Rs. 10,000 (Reserved for Discounted B/R, now no longer required) = Rs. 42,000.

Illustration 11 : *E*, *F* and *G* were partners in a firm, sharing profits and losses in the ratio of 3 : 2 : 1, respectively. Due to extreme competition, it was decided to dissolve the partnership on 31st December, 2007. The Balance Sheet on that date was as follows :

Liabilities		*Rs.*	*Assets*	*Rs.*
Capitals Accounts :			Machinery	1,54,000
E	1,13,100		Furniture and Fittings	25,800
F	35,400		Investments	5,400
G	31,500	1,80,000	Stock	97,700
Current Accounts :			Debtors	56,400
E	26,400		Bank	29,700
G	6,000	32,400	Current Account : *F*	18,000
Reserves		1,08,000		
Loan Account : *G*		15,000		
Creditors		51,600		
		3,87,000		3,87,000

The realisation of assets is spread over the next few months as follows :

February, Debtors, Rs. 51,900; March : Machinery, Rs. 1,39,500; April, Furniture, etc. Rs. 18,000; May : *G* agreed to take over Investments at Rs. 6,300; June, Stock, Rs. 96,000.

Dissolution expenses, originally provided, were Rs. 13,500, but actually amounted to Rs. 9,600 and were paid on 30th April. The partners decided that after creditors were settled for Rs. 50,400, all cash received should be distributed at the end of each month in the most equitable manner.

Required : Prepare a statement of actual cash distribution as is received following "Maximum Loss basis".

Solution :

Statement showing the Distribution of Cash
(According to Maximum Loss Method)

	Particular	*Creditors*	*G's Loan*	*Capital Accounts E*	*F*	*G*	*Total*
		Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*
A	Balance due	51,600	15,000	1,93,500	53,400	55,500	3,02,400
B	Paid to Creditors and *G*	50,400	15,000	—	—	—	—
C	Balance due (A - B)	—	—	1,93,500	53,400	55,500	3,02,400
	Max. Possible Loss if remaining assets fetch nothing (Rs. 3,02,400 – Rs. 2,700) in the ratio of 3 : 2 : 1			1,49,850	99,900	49,950	2,99,700
				43,650	(46,500)	5,550	

	Adjustment of *F*'s Deficiency between *E* and *G* in the ratio of their fixed capitals i.e. 1,13,100 : 31,500	(36,370)	46,500	(10,130)	
	Balance	7,280	—	(4,580)	
	Adjustment of *G*'s Deficiency (charged to *E*)	(4,580)		4,580	
D	Cash paid to *E* on 28th Feb.	2,700	—	—	2,700
E	Balance due (C - D)	1,90,800	53,400	55,500	2,99,700
	Possible Max. Loss (Rs. 2,99,700 – Rs. 1,39,500)	80,100	53,400	26,700	1,60,200
F	Cash paid on 31st Mar.	1,10,700	—	28,800	1,39,500
G	Balance Due (E - F)	80,100	53,400	26,700	1,60,200
	Possible Max. Loss (Rs. 1,60,200 – Rs. 21,900)	69,150	46,100	23,050	1,38,300
H	Cash paid on 30th April	10,950	7,300	3,650	21,900
I	Balance Due (G - H)	69,150	46,100	23,050	1,38,300
J	Maximum Loss (Rs. 1,38,300 – Rs. 6,300)	66,000	44,000	22,000	1,32,000
		3,150	2,100	1,050	6,300
K	Cash brought in by *G* (6,300 – 1050)	—	—	5,250	5,250
L	Cash paid to *E* & *F*	(3,150)	(2,100)		(5,250)
M	Investment given to *G*	—	—	(6,300)	6,300
N	Balance Due (I+K–L–M)	66,000	44,000	22,000	1,32,000
	Possible Max. Loss (Rs. 1,32,000 – Rs. 96,000)	18,000	12,000	6,000	36,000
O	Cash paid on 30th June	48,000	32,000	16,000	96,000
P	Unpaid Balance (N - O)	18,000	12,000	6,000	36,000

Working Note :

Statement showing the Calculation of Cash Available for Distribution

	Particular	*February* *Rs.*	*March* *Rs.*	*April* *Rs.*	*May* *Rs.*	*June* *Rs.*
A	Opening Balance	29,700	—	—	—	—
B	*Add* : Net Amount realised	51,900	1,39,500	18,000	—	96,000
C	*Less* : Provision for Expenses	13,500	—	—	—	—
D	*Add* : Provision no longer required	—	—	3,900	—	—
E	Cash available for distribution (A + B – C + D)	68,100	1,39,500	21,900	—	96,000

Illustration 12 : Ajay, Rama, Adesh and Sharad were partners in a firm. The capital of the firm consisted of Rs. 40,000 contributed originally in the proportion of 4 : 3 : 2 : 1. The profits and losses were shared in the same proportion. The firm was dissolved on 31st March, 2008. The Balance Sheet as on that date was as under :

Liabilities	*Rs.*	*Assets*	*Rs.*
Capitals :		Cash	6,000
Ajay	20,000	Debtors	50,000
Rama	14,000	Stock	19,000
Adesh	10,500		
Sharad	2,500		
Loans :			
Ajay	5,000		
Adesh	8,000		
Creditors	15,000		
	75,000		75,000

It was decided on 15th April that the net realisations should be distributed on the first of each month in the appropriate order. The realisation and expenses at the end of each month were as under :

	Debtors *Rs.*	*Stock* *Rs.*	*Expenses* *Rs.*
April	15,000	7,000	500
May	8,500	5,000	1,000
June	11,000	Nil	250
July	5,500	4,000	150
August	7,000	2,500	100

The Stock was completely disposd off. It was further agreed that Rama should take over the remaining debts for Rs. 2,500.

Required : Show how the cash was distributed according to Maximum Loss Method.

Solution :

Statement showing the Distribution of Cash
(According to Maximum loss method)

	Particular	Creditors Rs.	Ajay's Loan Rs.	Adesh's Loan Rs.	Ajay Rs.	Rama Rs.	Adesh Rs.	Sharad Rs.
A	Balance Due	15,000	5,000	8,000	20,000	14,000	10,500	2,500
B	Cash balance Rs. 6,000 paid to creditors	6,000	—	—	—	—	—	—
C	Balances Due (A-B)	9,000	5,000	8,000	20,000	14,000	10,500	2,500
D	Paid to Creditors & Ajay & Adesh	9,000	4,808	7,692	—	—	—	—
E	Balance unpaid (C - D)		192	308	20,000	14,000	10,500	2,500
F	First Rs. 500 out of Net Collection to Ajay & Adesh Loan		192	308	—	—	—	—
G	Balance Unpaid				20,000	14,000	10,500	2,500
	Max. Loss distributd [Rs. 47,000 – Rs. 12,000]				(14,000)	(10,500)	(7,000)	(3,500)
					6,000	3,500	3,500	(1,000)
	Sharad's deficiency charged to other Partners				(450)	(315)	(235)	1,000
H	Amount paid on 1st June				5,550	3,185	3,265	Nil
I	Balance unpaid [G - H]				14,450	10,815	7,235	2,500
	Max Loss distributed [Rs. 35,000 – Rs. 10,750]				(9,700)	(7,275)	(4,850)	(2,425)
J	Amount paid on 1st July				4,750	3,540	2,385	75
K	Balance Unpaid (I - J)				9,700	7,275	4,850	2,425
	Max. Loss distributed [Rs. 24,250 – Rs. 9,350]				(5,960)	(4,470)	(2,980)	(1,490)
L	Amount paid on 1st Aug.				3,740	2,805	1,870	935
M	Balances unpaid [K - L]				5,960	4,470	2,980	1,490
N	Max Loss distributed [Rs. 14,900 – Rs. 9,400 – Rs. 2,500]				(1,200)	(900)	(600)	(300)
O	Balances payable				4,760	3,570	2,380	1,190
P	Cash paid on 1st Sept.				(4,760)	(1,070)	(2,380)	(1,190)
Q	Book debts taken over on 1st Sept.				—	(2,500)	—	—
R	Balances unpaid being los on realisation [N - P - Q]				1,200	900	600	300

llustration 13 : Given below is the Balance Sheet of Alpha, Beta and Cappa as on 31st March, 2008 on which date they dissolved their partnership. They shared profits and losses in the ratio 3 : 4 : 3. They decided to distribute amount as and when feasible and to appoint Cappa for the purpose who was to get as his remuneration 1% of the value of the assets realised other than cash at Bank and 10% of the amount distributed to the partners :

Liabilities	*Rs.*	*Assets*	*Rs.*
Capitals :		Cash at Bank	275
Alpha	7,500	Sundry assets	53,725
Beta	15,000		
Cappa	15,000		
Sundry Creditors	16,500		
	54,000		54,000

Assets realised as under :

First Instlment Rs. 16,250, Second Instalment Rs. 12,750, Third Instalment Rs. 10,000, Last Instalment Rs. 7,500.

Required : Prepare a statement showing distribution of cash according to Maximum Loss Method.

Solution :

Statement showing the Distribution of Cash
(According to Maximum Loss Method)

Instalment Number	*Particulars*		*Sundry Creditors Rs.*	*Alpha's Capital Rs.*	*Beta's Capital Rs.*	*Cappa's Capital Rs.*
(1)	A. Balance Due					
	Bank Balance	275	16,500	7,500	15,000	15,000
	SalesProceeds of assets	16,250				
		16,525				
	Paid to creditors	16,500	16,500	—	—	—
	B. Balance Carried forward	25	Nil	7,500	15,000	15,000
(2)	Sale proceeds of assets	12,750				
		12,775				
	Commission to C (i)	1,425				
	Balance available	11,350				
	Maximum loss allocated Rs. 26,150 (i.e. Rs. 37,500 – Rs. 11,350)			7,845	10,460	7,845
				(345)	4,540	7,155

	Deficiency of Beta's Capital allocated to Alpha and Cappa in Capital Ratio	345	(173)	(173)
	C Amount paid	—	4,367	7,983
(3)	D Balance Unpaid [B - C]	7,500	10,633	8,018
	Sale proceeds of assets 10,000			
	Less : Cappa's commission (ii)1,000			
	Balance available 9,000			
	Maximum loss allocated Rs. 17,150 (i.e. Rs. 26,150 – Rs. 9,000)	5,145	6,860	5,145
	E Amount paid	2,355	3,773	2,873
Last	F Balance unpaid [D - E]	5,145	6,860	5,145
	Sale Proceeds of assets 7,500			
	Less : Cappa's Commission (iii)750			
	Balance available 6,750			
	Maximum loss allocated	3,120	4,160	3,120
	G. Amounts Paid	2,025	2,700	2,025
	H. Unpaid Balance [F - G]	3,120	4,160	3,120

Working Note : *Calculation of Commission payable to Cappa* *Rs.*

(i)	Commission on the sale of assets @ 1% on 1st and 2nd instalments		290
	1/11th of amount available for distribution to partners [1/11×Rs. 12,485]		1,135
		Total	1,425
(ii)	Commission on sale of assets 1% on Rs. 10,000		100
	1/11 of amount available for distribution, [i.e., 1/11×Rs. 9,900]		900
		Total	1,000
(iii)	Commission on sale of assets 1% on Rs. 7,500		75
	1/11 of amount available for distribution [i.e., 1/11 × Rs. 7,425]		675
		Total	750
	Grand Total of Commission payable to Cappa	Rs.	3,175

(iv) Commission is not paid Cappa during the first instalment due to insufficiency of cash. Hence the small balance available is carried forward.

EXERCISE

Problem 1 : The firm of LMS was dissolved on 31.3.08 at which date its Balance Sheet was as follows:

Liabilities		Rs.	Assets	Rs.
Creditors		2,00,000	Fixed Assets	45,00,000
Bank Loan		5,00,000	Cash and Bank	2,00,000
L's Loan		10,00,000		
Capitals:				
L	15,00,000			
M	10,00,000			
S	5,00,000	30,00,000		
		47,00,000		47,00,000

Partners share profits equally. A firm of Chartered Accountants is retained to realize the assets and distribute the cash after the discharge of liabilities. Their fees which are to include all expenses are fixed at Rs. 1,00,000. No loss is expected on realization since fixed assets include valuable land and buildings.

Realization are S. No.	1	2	3	4	5
Amount in Rs.	5,00,000	15,00,000	15,00,000	30,00,000	30,00,000

The C. A. Firm decided to pay off the partners in 'Higher Relative Capital Method'. You are required to prepare a statement showing distribution of cash with necessary workings.

[Ans: 1^{st} Realizaton (5,00,000 – 1,00,000) = Rs. 4,00,000 creditors and Bank Loan as 2 : 5]

Problem 2 :

Ayaram, Gayaram and Chhayaram were partners sharing profit s as 5 : 3 : 2. The firm was dissolved on 30^{th} June, '08 when the position was as follows:

Capitals:		Cash	250
Ayaram	20,000	Debtors	24,000
Gayaram	Nil	Stock	22,750
Ayaram – Loan	7,000	Chhyaram's Capital	5,000
Mrs. Ayaram – Loan	8,000		
Bank overdraft	2,000		
Creditors for goods	15,000		
	52,000		52,000

It was agreed that the realizations should be distributed at the end of each month. Gayaram was adjudged insolvent on 12.8.08 and nothing could be recovered from Chhyaram till the end of the calendar year 2008.

The realization were : 12.7.08. – Rs. 4,750; 28.7.08 – Rs. 5,000; 22.8.08 – Rs. 5,000; 19.9.08 – Rs. 15,000; 20.10.08 –Rs. 3,000; 23.10.08 – Rs. 10,000; 23.10.08 – Rs. 1,000

Show the distributions of Cash.

[Ans : Chhyaram's loss to be borne by Ayaram; Payments to Ayaram : 23.10.08 – Rs. 8,000; 20.11.08 – Rs. 3,000; 23.12.08 – Rs. 1,900 assuming Gayaram can bring in Rs. 900]

Problem 3 :

A, B and C sharing profits in the ratio 3 : 2 :1. dissolved their partnership on 31st December, 2007 when their Balance Sheet was as under :

Liabilities		Rs.	Assets	Rs.
Capitals :			Fixed Assets	60,000
A	4,950		Stock	15,000
B	26,850		Debtors	30,000
C	53,700	85,500		
Bank Overdraft		15,000		
Sundry Creditors		4,500		
		1,05,000		1,05,000

The assets were sold piecemeal and distribution was made immediately. The details of realization are 15.2.08 – Rs. 21,750; 31.3.08 – Rs. 24,750; 30.6.08 – Rs. 40,500

A is insolvent is unable to contribute. Prepare a statement showing the distribution applying the rule of Garner Vs. Murray.

[Ans : Final Payments Rs. 19,500 and Rs. 21,000]

4.5. AMALGAMATION OF FIRMS AND CONVERSION TO A COMPANY

INTRODUCTION

As defined earlier, a Partnership firm is formed with two or more persons. But it can also be formed in any of the following ways.

(A) When two or more sole proprietors forms new partnership firm;

(B) When one existing partnership firm absorbs a sole proprietorship;

(C) When one existing partnership firm absorbs another partnership firm;

(D) When two or more partnership firms form new partnership firm.

The amalgamation is used to be done to avoid competition amongst them and to maximize the profit of the firm / firms.

Accounting entries under different situation are in below:

(A) When two or more sole proprietors form a new partnership firm

When two or more sole proprietorship businesses amalgamate to form a new partnership firm, the existing sets *of* books will be closed and a new set of books of accounts to be opened, recording all assets, liabilities and transactions *of* the partnership.

Steps to be taken for the existing books.

Step 1: Prepare the Balance Sheet *of* the business on the date *of* dissolution.

Step 2 : Open a Realisation Account and transfer all assets and liabilities, except cash in hand and cash at bank, at their book values.

However, cash in hand and cash at bank are transferred to Realisation Account only when they are taken over by the new firm.

Step 3 : Calculate Purchase Consideration on the basis of terms and conditions agreed upon by the parties. Generally, purchase consideration is calculated on the basis of agreed value of assets and liabilities taken over by the new firm. The purchase consider ation is calculated as under:

Agreed values of assets taken over	xxxx
Less: Agreed values of liabilities assumed	(xxx)
Purchase consideration	xxxx

Step 4 : Credit Realisation Account by the amount of Purchase Consideration.

Step 5 : If there are any unrecorded assets or liabilities, they are to be recorded.

Step 6 : The Profit or loss on relisation (balancing figure of Realisation Account) to be transferred to the Capital Account of the proprietor.

Step 7: To ensure that all the accounts of the Sole Proprietor's business are closed.

Accounting Entries in the Books of Amalgamating Sole Proprietors:

1. For transferring sundry assets to Realisation Account

Realisation *A/c*	*Dr.*	
To Sundry Assets *A/c*		[Individually]
(Assets transferred to Realisation Account at their book values)		

2. For transferring sundry liabilities to Realisation Account

Liabilities *A/c*	*Dr.*	[Individually]
To Realisation *A/c*		
(Liabilities transferred to Realisation Account at their book values)		

3. For Purchase Consideration due

New Firm *A/c*	*Dr*
To Realisation *A/c*	
(Purchase consideration due from the new firm)	

4. For assets taken over by the proprietor

Capital *A/c*	*Dr*
To Realisation *A/c*	
(Assets taken over by the proprietor)	

5. For realisation of assets not taken over by the new firm

Bank *A/c*	*Dr.*
To Realisation *A/c*	
(Realisation of assets not taken over by the new firm)	

6. For recording unrecorded assets

Assets *A/c*	*Dr*
To Capital *A/c*	
(Unrecorded assets recorded)	

7. For realisation of unrecorded assets

Bank *A/c* *Dr*

To Assets *A/c*

(Realisation of unrecorded assets)

(Note: If unrecorded assets are taken over by the new firm,
it is also transferred to Realisation Account along with other assets.)

8. For payment of liabilities not taken over

Realisation *A/c* *Dr*

To Bank *A/c*

(Payment of liabilities not taken overby the new firm)

9. For recording unrecorded liabilities

Capital *A/c* *Dr*

To Liabilities *A/c*

(Being the unrecorded liabilities recorded)

10. For payment of unrecorded liabilities

Liabilities *A/c* *Dr*

To Bank *A/c*

(Payment of unrecorded liabilities)

(Note: If unrecorded liabilities are taken over by the new firm, it is also transferredto Realisation Account along with other liabilities.)

11. For liabilities taken over by the proprietor

Realisation *A/c* *Dr*

To Capital *A/c*

(Being liabilities assumed by the proprietor)

12. For realisation expenses

Realisation *A/c* *Dr.*

To Bank *A/c*

(Realisation expenses paid)

13. For profit on realisation

Realisation *A/c* *Dr*

To Capital *A/c*

(Profit on realisation transferred to Capital Account)

14. For loss on realisation

Capital *A/c* *Dr*

To Realisation *A/c*

(Loss on realisation transferred to Capital Account)

15. For accumulated profits / reserves

Reserves *A/c* *Dr*

Profit and Loss *A/c* *Dr*

To Capital *A/c*

(Undrawn profits transferred to Capital Account)

16. For accumulated losses

Capital *A/c* *Dr*

To Profit and Loss *A/c* (if any)

(Accumulated losses transferred to Capital *A/c)*)

17. For settlement of purchase consideration by the New firm

Capital in New Firm *A/c* *Dr*.

To New Firm *A/c*

(Settlement of purchase consideration)

18. For final adjustment

Capital *A/c* *Dr*

To Capital in New Firm *A/c*

To Bank *A/c* (if any)

(Final adjustment to close the books of account)

Accounting Entries in the Books of the New Firm

The new firm records all the assets and liabilities at the values it has decided to take over. If the purchase consideration payable is, more than the net assets (assets *minus* liabilities) acquired, it represents goodwill. Conversely, if the purchase consideration payable is less than the net assets acquired, it represents capital reserve.

1. If the net acquired assets is equal to purchase consideration.

Assets A/c	Dr.	[Acquired value]
To Liabilities A/c		[Assumed value]
To Partners' Capital A/c		[Purchase consideration]

2. If the net acquired asset is more than the purchase consideration:

Assets A/c	Dr	[Acquired value]
To Liabilities A/c		[Assumed value]
To Partners' Capital A/c		[Purchase consideration
To Capital Reserve A/c		[Purchase consideration - net assets)

3. If the net acquired asset is less than the amount of purchase consideration, it represents goodwill.

Assets A/c	Dr.	[Acquired value]
Goodwill A/c	Dr.	[Purchase consideration - net assets]
To Liabilities A/c		[Assumed value]
To Partners' Capital A/c		[Purchase consideration]

Illustration 1 :

A and B carry on independent business and their position on 31.03.2008 are reflected in the Balance Sheet given below:

Liabilities	A	B	Assets	A	B
Sundry creditors for purchases	1,10,000	47,000	Stock-in-trade	1,70,000	98,000
Sundry creditors for expenses	750	2,000	Sundry Debtors	89,000	37,000
Bills payable	12,500	-	Cash at bank	13,000	7,500
Capital *A/C*	1,53,000	95,500	Cash in hand	987	234
			Furniture and Fixtures	2,750	1,766
			Investments	513	—
	2,76,250	1,44,500		2,76,250	1,44,500

Both of them want to form a partnership firm from 1.4.2008 in the style of AB & Co. on the following terms:

(a) The capital of the partnership firm would be Rs 3,00,000 and to be contributed by them in the ratio of 2: 1.

(b) The assets of the individual businesses would be evaluated by C at which values, the firm will take them over and the value would be adjusted against the contribution due by A and B.

(c) C gave his valuation report as follows:

Assets of A : Stock-in trade to be written-down by 15% and a portion' of the sundry debtors amounting to Rs 9,000 estimated unrealisable; furniture and fixtures to be valued at Rs 2,000 and investments to be taken at market value of Rs 1,000.

Assets of B : Stocks to be written-up by 10% and sundry debtors to be admitted at 85% of their value; rest of the assets to be assumed at their book values.

(d) The firm is not to consider any creditors other than the dues on account of purchases made.

You are required to pass necessary Journal entries in the books of A and B. Also prepare the opening Balance Sheet of the firm as on 1.4.2008.

Solution

In the books of A

Journal

Date	Particulars		Dr. Rs	Cr. Rs
2008	Realisation A/c	Dr.	2,76,250	
Apr.1	To Stock-in-trade A/c			1,70,000
	To Sundry Debtors A/c			89,000
	To Cash at bank A/c			13,000
	To Cash in hand A/c			987
	To Furniture & Fixture A/c			2,750
	To Investments A/c			513
	(Transfer of different Assers to Realisation A/c)			
	Creditors for Goods A/c	Dr.	1,10,000	
	Creditors for Expenses A/c	Dr.	750	
	Bills Payable A/c	Dr.	12,500	
	To Realisation A/c			1,23,250
	(Transfer of different liabilities to Realisation A/c)			
	AB & Co. A/C (Note 1)	Dr.	1,18,987	
	To Realisation A/c			1,18,987
	(Purchase consideration due)			
	Capital A/c	Dr.	34,013	
	To Realisation A/c			34,013
	(Realisation loss transferred to Capital A/c)			
	Capital in AB & Co. A/c	Dr.	1,18,987	
	To AB & Co. A/c			1,18,987
	(Settlement of purchase consideration)			
	Capital A/c	Dr.	1,18,987	
	To Capital in AB & Co. A/c			1,18,987
	(Final adjustment to close the books of account)			

In the books of B

Journal

Date	Particulars		Rs	Rs
2008	Realisation A/c	Dr.	1,44,500	
Apr. 1	To Stock-in-trade A/c			98,000
	To Sundry Debtors A/c			37,000
	To Cash at bank A/c			7,500
	To Cash in hand A/c			234
	To Furniture & Fixture A/c			1,766
	(Transfer of different Assers to Realisation A/c)			
	Creditors for Goods A/c	Dr.	47,000	
	Creditors for Expenses A/c	Dr.	2,000	
	To Realisation A/c			49,000
	(Transfer of different liabilities to Realisation A/c)			
	AB & Co. A/c	Dr.	1,01,750	
	To Realisation A/c			1,01,750
	(Purchase consideration due)			
	Realisation A/c	Dr.	6,250	
	To Capital A/c			6,250
	(Realisation loss transferred to Capital A/c)			
	Capital in AB & Co. A/c	Dr.	1,01,750	
	To AB & Co. A/c			1,01,750
	(Settlement of purchase consideration)			
	Capital A/c	Dr.	1,01,750	
	To Capital in AB & Co. A/c			1,01,750
	(Final adjustment to close the books of account)			

Balance Sheet of AB & Co. as on 01.04.2008

Liabilities	Rs	Assets.	Rs
Capital Accounts:		Furniture & Fittings	3,766
A	2,00,000	Investments	1,000
B	1,00,000	Stock-in-trade	2,52,300
Sundry creditors for purchases.	1,57,000	Sundry Debtors	1,11,450
Bills payable	12,500	Cash at bank Rs(13000+7500+81013 - 1,750)	99,763
		Cash in hand (Rs 987 + 234)	1,221
	4,69,500		4,69,500

Working: Calculation of purchase consideration:

	A(Rs)	B(Rs)
Furniture	2,000	1,776
Investments	1,000	-
Stock-in-trade	1,44,500	1,07,800
Sundry Debtors	80,000	31,450
Cash at bank	13,000	7,500
Cash in hand	987	234
	2,41,487	1,48,750
Less: Sundry creditors for purchases	1,10,000	47,000
Bills payable (Assumed arising out of credit purchases)	12,500	-
Net assets taken over by the AB & Co.	1,18,987	1,01,750
Capital as per agreement	2,00,000	1,00,000
Less: Net assets taken over	1,18,987	1,01,750
Cash to be introduced (+)/ withdrawn(-)	(+)81,013	(-) 1,750

(B) When an existing partnership firm absorbs a sole proprietorship

When a sole proprietorship is taken over by an existing firm, the original business of the sole proprietor is dissolved and compensated by a share of the partnership firm which is acquiring it. In this case, assets and liabilities of the sole proprietorship business are taken over by the partnership firm at agreed values. The procedures for closing the books of account of the sole proprietorship are same as explained earlier.

However, the following points are to be noted:

(i) The assets and liabilities of the sole proprietorship taken over by the existing firm, are added with the existing assets and liabilities of the firm.

(ii) The capital of the new partner (the sole proprietorship) is equal to the purchase consideration agreed upon.

(iii) Calculation and treatment for goodwill and Capital reserve are same as explained in situation (A).

(iv) Before amalgamation, all the assets and liabilities of the firm may be revalued. Any profit or loss on revaluation is transferred to the Partners' Capital Accounts in the old profit-sharing ratio.

(v) Goodwill of the firm is to be adjusted by crediting the Partners' Capital Accounts in their old profit-sharing ratio.

(vi) Balance of reserve and surplus of the firm is also to be credited to partners' Capital Accounts in the old profit-sharing ratio.

Illustration 2 :

Following are the Balance Sheets of partners X and Y (sharing profits and losses in the ratio of their capital) and the sole proprietor Z as on 31.03.2008:

Liabilities	Partners X & Y	Sole Proprietor Z	Assets	Partners X & Y	Sole Proprietor Z
Capital X	15,000		Goodwill	-	2,000
Y	5,000	-	Building	25,000	-
Z	-	10,000	Stock	10,000	15,000
Creditors	26,000	13,000	Bills receivable	5,000	5,000
Loan	-	5,000	Debtors	4,000	6,000
			Cash in Hand	2,000	-
	46,000	28,000		46,000	28,000

The partners decided to admit Z as a partner and Z agreed to amalgamate his business with that of the partnership on the following terms :

1. The new profit-sharing ratio among X, Y, and Z will be in the ratio of their capitals.
2. The building is to be appreciated by Rs 15,000 and provision @ 5 % is to be created o n debtors.
3. The goodwill of the partnership is valued at Rs 10,000 and of the sole proprietor at Rs 1,500; both are to be recorded in the books.
4. Stock is to be taken at Rs 9,200 and Rs 16,800, respectively of the firm and the sole proprietor.

Prepare ledger accounts to close the books of Z, to make necessary Journal entries in the books of the firm and prepare the Balance Sheet of the re-constituted partnership.

Solution

Working Note:

Calculation of purchase consideration

Assets taken over:	Rs	Rs
Goodwill	1,500	
Stock	16,800	
Bills receivable	5,000	
Debtors	6,000	29 ,300
Less: Liabillties taken over:		
Creditors	13,000	
Loan	5,000	
Provision for bad debts	300	18,300
Purchase consideration		11,000

In the books of Z

Realisation Account

Dr Cr.

Date	Particulars	Rs	Date	Particulars	Rs
	To Goodwill A/c	2,000		By Creditors A/c	13,000
	To Stock A/c	15,000		By Loan A/c	5,000
	To Bills receivable A/c	5,000		By Partners X & Y A/c	11,000
	To Debtors A/c	6,000			
	To Capital A/c - Profit	1,000			
		29,000			29,000

Capital Account

Dr. Cr

Date	Particulars	Rs	Date	Particulars	Rs
	To Partners X & Y A/c	11,000		By Balance b/d	10,000
				By Realisation A/c	1,000
		11,000			11,000

Partners X & Y Account

Dr Cr

Date	Particulars	Rs	Date	Particulars	Rs
	To Realisation A/c	11,000		By Capital A/c	11,000
		11,000			11,000

In the Books of X & Y

Journals

Date	Particulars	L.F	Rs	Rs
	Building A/c	Dr.	15,000	
	To Revaluation A/c			15,000
	(Increase in the Value of Building)			
	Revaluation A/c	Dr.	1,000	
	To Stock A/c			800
	To Provision for Bad Debt A/c			200
	(Decrease in the value of assets)			
	Revaluation A/c	Dr.	14,000	
	To X Capital A/c			10,500
	To Y Capital A/c			3,500
	(Profit on revaluation transferred)			
	Goodwill A/c	Dr.	10,000	
	To X Capital A/c			7,500
	To Y Capital A/c			2,500
	(Goodwill raised in the books)			
	Goodwill *A/c*	Dr.	1,500	
	Stock A/c	Dr.	16,800	
	Bills Receivable *A/c*	Dr.	5,000	
	Debtors *A/c*	Dr.	6,000	
	To Loan *A/c*			5,000
	To Creditors *A/c*			13,000
	To Provision for Bad Debt *A/c*			300
	To Z Capital *A/c*			11,000
	(Assets and liabilities taken over)			

Balance Sheet of X, Y & Z (after absorption) as at 01.04.08

Liabilities	Rs	Assets		Rs
Capital Account		Goodwill		11,500
- X	33,000	Building		40,000
- Y	11,000	Stock		26,000
- Z	11,000	Bills Receivable		10,000
Loan	5,000	Debtors	10,000	
Crditors	39,000	Less: Provision	500	9,500
		Cash in hand		2,000
	99,000			99,000

(C) When one firm takes over another firm

In this case, the procedures for closing of books are same as earlier. The assets of the absorbed firm added with the firm who absorbed the firm.

The treatment for capital reserve and goodwill are same as before.

Illustration 3 :

Following is the Balance sheet of AB & Co. and CD & Co. as on 31.03.2007.

Liabilities	AB(Rs)	CD(Rs)	Assets	AB(Rs)	CD(Rs)
Bank Loan	10,000		Stock-in-trade	32,000	24,000
Bills Payable	30,000	40,000	Sundry Debtors	18,000	30,000
Capital A	60,000	-	Machinery	60,000	20,000
Capital B	30,000	-	Cash in hand	12,000	2,000
Capital C		36,000	Furniture	8,000	6,000
Capital D		24,000	Investments	-	18,000
	130,000	100,000		130,000	100,000

AB & Co. absorbed CD&Co.on 01.04.2007 on the following terms:

(a) that the value of the goodwill of CD & Co.would be Rs 12,000;

(b) that the investments of CD & Co. to be sold out for Rs 24,000 and the realised cash will be introduced in the acquiring business;

(c) that the stock of CD & Co. to be reduced to Rs 22,000;

(d) that the machinery of CD & Co. will be increased by 40%;

(e) that the Furniture of CD & Co. will be reduced by 10%.

It was further agreed that for AB & Co., following are the adjustments to be made:

(i) Assets are to be revalued as follows:

Goodwill- Rs 16,000; Stock - Rs 40,000; Machinery - Rs 84,000; Furniture - Rs 7,200;

(ii) Bank loan to be repaid

Show necessary Ledger Accounts to close the books of CD & Co. and to prepare necessary Journal entry and Balance Sheet of AB & Co. after absorption

Solution

Workings:

Calculation of purchase consideration

Assets taken over:

	Rs
Machinery	28,000
Furniture	5,400
Stock	22,000
Debtors	30,000
Cash (Rs 24,000 + Rs 2,000)	26,000
Goodwill	12,000
	1,23,400
Less: Liability taken over –	
Bills payable	40,000
Purchase consideration	83,400

In the books of CD & Co.

Realisation Account

Dr Cr

Date	Particulars	Rs	Date	Particulars	Rs
	To Stock-in-trade	24,000		By Bills Payable *A/c*	40,000
	" Sundry Debtors	30,000		By AB *& Co A/c*	83,400
	" Machinery	20,000			
	" Cash in hand	26,000			
	" Furniture	6,000			
	To Partners' Capital *A/cs:*				
	C- 8,700				
	D- 8,700	17,400			
		123,400			123,400

Cash Account

Dr Cr

Date	Particulars	Rs	Date	Particulars	Rs
	To Balance b/d	2,000		By Realisation *A/c*	26,000
	To Investments *A/c*	24,000			
		26,000			26000

Partners' Capital Accounts

Dr Cr

Date	Particulars	C	D	Date	Particulars	C	D
	To Capital in AB & co *A/c*	47,700	35,700		By Balance b/d	36,000	24,000
					By Profit on Sale of Investment *A/c*	3,000	3,000
					By Realisation *A/c*	8,700	8,700
		47,700	35,700			47,700	35,700

In the books of AB & Co.

Partners' Capital Accounts

Dr Cr

Date	Particulars	A	B	Date	Particulars	A	B
	To Balance c/d	83,600	53,600		By Balance b/d	60,000	30,000
					By Goodwill A/c	8,000	8,000
					By Revaluation A/c	15,600	15,600
		83,600	53,600			83,600	53,600

Balance Sheet as on 01.04.2008

Liabilities	Rs	Assets	Rs
Capital Accounts		Goodwill	28,000
A	83,600	Machinery	1,12,000
B	53,600	Furniture	12,600
C	47,700	Stock	62,000
D	35,700	Debtors	48,000
Bills payable	70,000	Cash	28,000
	2,90,600		2,90,600

Date	Particulars		Rs	Rs
2008	Bank Loan A/c	Dr.	10,000	
Apr1	To Cash A/c			10,000
	(Being the bank loan repaid)			
	Goodwill A/c	Dr.	16,000	
	To A's Capital A/c			8,000
	To B's Capital A/c			8,000
	(Being the goodwill raised)			
	Stock A/c	Dr.	8,000	
	Machinery A/c	Dr.	24,000	
	To Revaluation A/c			32,000
	(Being increase in the value of assets)			
	Revaluation A/c	Dr.	800	
	To Furniture A/c			800
	(Being the decrease in the value of furniture)			
	Revaluation A/c	Dr.	31,200	
	To A's Capital A/c			15,600
	To B's Capital A/c			15,600
	(Being the profit on revaluation transferred to Partners' Capital Acs in the profit-sharing ratio)			
	Goodwill A/c	Dr.	12,000	
	Machinery A/c	Dr.	28,000	
	Furniture A/c	Dr.	5,400	
	Stock A/c	Dr.	22,000	
	Debtors A/c	Dr.	30,000	
	Cash A/c	Dr.	26,000	
	To Bills Payable A/c			40,000
	To C 's Capital A/c			47,700
	To D's Capital A/c			35,700
	(Being the introduction of capital by C & D)			

(D) When two or more partnership firms form a new partnership firm

When two or more partnership firms amalgamate to form a new partnership firm, the books of account of the old firm is to be closed. In the books of each old firm, a Realisation Account to be opened. The accounting entries of the amalgamating firm is same as before as they were absorbed.

Illustration 4 :

Two partnership firms, carrying on business under the style of Red & Co. (Partners A & B) and White & Co. (Partners C & D) respectively, decided to amalgamate into RW & Co. with effect from 1 st April 2008. The respective Balance Sheets of both the firms as on 31st March, 2008 are in below:

Liabilities	R(Rs)	W(Rs)	Assets	R(Rs)	W(Rs)
Capital B	19,000	-	Goodwill	-	5,000
Capital C	-	10,000	Machinery	10,000	-
Capital D	-	2,000	Stock-in-trade	20,000	5,000
Bank Loan	15,000	-	Sundry Debtors	10,000	10,000
Creditors	10,000	9,500	Cash in hand	-	1,500
			Capital - A	4,000	-
	44,000	21,500		44,000	21,500

Profit sharing ratios are: A & B = 1:2; C & D = 1:1.

Agreed terms are:

1. All fixed assets are to be devalued by 20%.
2. All stock in trade is to be appreciated by 50%.
3. Red & Company owes Rs 5,000 to White & Co. as on 31 st March 2008. This is settled at Rs 2,000. Goodwill is to be ignored for the purpose of amalgamation.
5. The fixed capital accounts in the new firm (RW & Co.) are to be : Mr A Rs 2,000; Mr. B Rs 3,000; Mr C Rs 1,000 and D Rs 4,000.
6. Mr B takes over bank overdraft of Red & Co. and contributed to Mr. A the amount of money to be brought in by Mr. A to make up his capital contribution.
7. Mr C is paid off in cash from White & Co. and Mr. D brings in sufficient cash to make up his required capital contribution.

Pass necessary Journal entries to close the books of both the firms as on 31st March 2008.

Solution

Calculation of Purchase Consideration

Assets taken over:		Red & Co.	White & Co
Plant & Machinery		8,000	-
Stock-in-trade		30,000	7,500
Sundry Debtors [(* After adjustment (Rs 10,000 - 3000)]		10,000	*7,000
	(A)	48,000	14,500
Liability taken over:			
Sundry Creditors	(B)	7,000	9,500
Purchase consideration	(A-B)	41,000	5,000

In the books of Red & Co.

Journal

Date	Particulars		Rs	Rs
2008	Realisation *A/c*	Dr.	40,000	
Mar.	To Plant and Machinery A/c			10,000
31	To Stock-in-trade A/c			20,000
	To Sundry Debtors A/c			10,000
	(Different assets transferred)			
	Sundry Creditors A/c	Dr.	10,000	
	To Realisation A/c			10,000
	(Sundry creditors transferred to Realisation Account)			
	Bank Loan A/c	Dr.	15,000	
	To B Capital A/c			15,000
	(Bank overdraft taken over by B)			
	RW & Co. A/c	Dr.	41,000	
	To Realisation A/c			41,000
	(Purchase consideration due)			
	Realisation A/c (Note 2)	Dr.	11,000	
	To A Capital A/c			3,667
	To B Capital A/c			7,333
	(Profit on realisation transferred to partners capital in the ratio of 1:2)			
	B Capital A/c	Dr.	2,333	
	To A Capital A/c			2,333
	(Deficit in A's capital made good by B)			
	A Capital A/c	Dr.	2,000	
	B Capital *A/c*	Dr.	39,000	
	To RW & Co. A/c			41,000
	(Capital accounts of the partners closed by transfer to RW & Co.)			

Note: It should be noted that the credit balance in B's capital account is Rs *39,000*. His agreed capital in RW & Co is Rs 3,000 only. Since there is no liquid assets in Black & Co. from which B can be repaid, the excess amount of Rs *36,000* should be taken over by RW & Co. as loan from B.

In the books of White & Company

Journals

Date	Particulars		Rs	Rs
2008	Realisalion A/c	Dr.	20,000	
Mar.	To Goodwill A/c			5,000
31	To Stock-in-trade A/c			5,000
	To Sundry Debtors A/c			10,000
	(Different Assets transferred)			
	Sundry Creditors A/c	Dr.	9,500	
	To Realisation A/c			9,500
	(Sundry creditors transferred)			
	RW & Co. A/Cc	Dr.	5,000	
	To Realisation A/c			5,000
	(Purchase consideration due)			
	C's Capital A/c	Dr.	2,750	
	D's Capital A/c	Dr.	2,750	
	To Realisation A/c			5,500
	(Loss on realisation transferred to Capital Account equally)			
	Bank A/c	Dr.	4,750	
	To D's Capital A/c			4,750
	(Being the necessary amount brought in by D to make up his required capital contribution)			
	C's Capital A/c	Dr.	7,250	
	D's Capital A/c	Dr.	4,000	
	To RW & Co. A/c			5,000
	To Bank A/c			6,250
	(Capital accounts of the partners closed by transfer to RW & Co. and balance paid by cash)			

Realisation Account

Dr Cr

Particulars	Red & Co.	White & Co.	Particulars	Red & Co.	White & Co.
To Goodwill	-	5,000	Creditors	10,000	9,500
" Machinery	10,000	-	RW & Co.	41,000	5,000
" Stock-in-trade	20,000	5,000	C's Capital		2,750
" Sundry Drs	10,000	10,000	D's Capital		2,750
" Cash in hand	-				
" A's Capital	3,667				
" B's Capital	7,333				
	51,000	20,000		51,000	20,000

Illustration 5 :

M/s AB & Co., having A and B as equal partners, decided to amalgamate with M/s CD & Co., having C and D as equal partners on the following terms and conditions :

1. The new firm XY and Co. to pay Rs 12,000 to each firm for Goodwill.
2. The new firm to take over investments at 90% of the value, land at Rs 66,800, premises at Rs 53,000, machinery at Rs 9,000 and only the trade liabilities of both the firms and the debtors at book value. Typewriters, worth Rs 800, belonging to CD & Co., not appearing in the Balance Sheet. That is not taken over by the new firm.
4. Bills payable pertaining to trade transactions only.
5. All the four partners in the new firm to bring in Rs 1,60,000 as capital in equal shares.

The following were the Balance Sheets of both the firms on the date of amalgamation:

Liabilities	AB&Co. Rs.	CD&Co. Rs.	Assets		AB&Co. Rs.	CD&Co. Rs.
Trade creditors	20,000	10,000	Cash		15,000	12,000
Bills payable	5,000	-	Investments		10,000	8,000
Bank overdraft	2,000	10,000	Debtors	10,000		
A's Loan	6,000	-	Less: Provision	1,000	9,000	4,000
Capitals:			Furniture		12,000	6,000
A	35,000	-	Premises		30,000	-
B	22,000	-	Land		-	50,000
C	-	36,000	Machinery		15,000	15,000
D	-	20,000	Goodwill		9,000	9,000
General Reserve	8,000	3,000				
Investment Fluctuation Fund	2,000	1,000				
	1,00,000	80,000			1,00,000	80,000

Assuming immediate discharge of bank overdraft, pass necessary Journal entries to close the books *of* A B & Co. Also pass Journal entries in the books of XY & Co. and prepare the Balance Sheet of the firm.

Solution In the books of AB & Company

Journal

Date	Particulars		Rs	Rs
	Bank Overdraft A/c	Dr.	2,000	
	To Cash A/c			2,000
	(Payment *of* overdraft)			
	Realisation A/c	Dr.	99,000	
	To Cash A/c			13,000
	To Investments A/c			10,000
	To Debtors A/c			10,000
	To Furniture A/c			12,000
	To Premises A/c			30,000
	To Machinery *A/c*			15,000
	To Goodwill A/c			9,000
	(Transfer of different assets)			
	Provision for Bad Debts A/c	Dr.	1,000	
	Trade Creditors A/c	Dr.	20,000	
	Bills Payable A/c	Dr.	5,000	
	To Realisation A/c			26,000
	(Transfer of different Liabilities)			
	M/s Lucky & Co. A/c	Dr.	80,000	
	To Realisation A/c (Note 1)			80,000
	(Purchase consideration due)			
	A Capital A/c	Dr.	6,000	
	B Capital A/c	Dr.	6,000	
	To Realisation *A/c*			12,000
	(Furniture taken over by the partners)			
	General Reserve A/c	Dr.	8,000	
	Investment Fluctuation Fund A/c	Dr.	2,000	
	To A Capital A/c			5,000
	To B Capital A/c			5,000
	(Reserve and surplus distributed)			

	Realisation A / c Dr. To A Capital A / c To B Capital A / c (Profit on realisation transferred)	19,000	 9,500 9,500
	A's Loan A / c Dr. To A Capital A / c (A's loan transferred to his Capital A / c)	6,000	 6,000
	Cash A / c Dr. To B Capital A / c (Cash brought in by B)	9,500	 9,500
	Capital in M / s XY & Co. A / c Dr. To M / s XY & Co. A / c (Settlement of purchase consideration)	80,000	 80,000
	A Capital A / c Dr. To Capital in XY & Co. A / c To Cash A / c (Final adjustment to close the books)	49,500	 40,000 9,500
	B's Capital A / c Dr. To B's Cap. In XY & Co. A / c (Final adjustment to close the books)	40,000	 40,000

In the Books of XY & Co.

Journals

Date	Particulars		Dr Rs	Cr Rs
	Goodwill A/c	Dr	12,000	
	Cash A/c	Dr	13,000	
	Investments A/c	Dr	9,000	
	Debtors A/c	Dr	10,000	
	Premises A/c	Dr	53,000	
	Machinery A/c	Dr	9,000	
	To Provision for Bad Debts A/c			1,000
	To Trade Creditors A/c			20,000
	To Bills Payable A/c			5,000
	To A's Capital A/c			40,000
	To B's Capital A/c			40,000
	(Assets and liabilities taken over from AB & Co.)			
	Goodwill A/c	Dr	12,000	
	Investments A/c	Dr	7,200	
	Debtors A/c	Dr	4,000	
	Land A/c	Dr	66,800	
	To Trade Creditors A/c			10,000
	To C's Capital A/c			40,000
	To D's Capital A/c			40 ,000
	(Assets and liabilities taken over from CD & Co.)			

Balance Sheet as on .....

Liabilities	Rs	Assets	Rs
Partners' Capitals :		Goodwill	24,000
A	40,000	Land	66,800
B	40,000	Premises	53,000
C	40,000	Machinery	9,000
D	40,000	Investments	16,200
Creditors	30,000	Debtors	13,000
Bills Payable	5,000	Cash	13,000
	1,95,000		1,95,000

(E) Conversion or Sale of a Partnership Firm to a Company:

For various reasons, an existing partnership may sell its entire business to an existing Joint Stock Company. I*t* can also convert itself into a Joint Stock Company. The former case is the absorption of a partnership firm by a Joint Stock Company but the latter case is the flotation of a new Company to take over the business of the partnership.

In either of the above cases, the existing partnership firm is dissolved and all the books of account are closed. Broadly, the procedure of liquidation of the partnership business is same as what has already been explained in "Amalgamation of Partnership"

Some important points:

(l) The Purchase Consideration is satisfied by the Company either in the form of cash or shares or debentures or a combination of two or more of these. The shares may be equity or preference shares. The shares may be issued at par, at a premium or at a discount. For the partnership, the issue price is relevant which may form a part of the purchase consideration.

(2) In the absence of any agreement, share received from purchasing company should be distributed among the partners in the same ratio as profits and losses are shared.

Accounting Entries in the books of selling firms.

1. For transferring different assets to Realisation Account

   Realisation *A/c* Dr. [Individually]

   To Sundry Assets *A/c*

   (Assets transferred to Realisation Account at their book values)

2. For transferring different liabilities to Realisation Account

   Liabilities *A/c* Dr. [Individually]

   To Realisation *A/c*

   (Liabilities transferred to Realisation Account at their book values)

3. For purchase consideration due

   Purchasing Co. *A/c* *Dr*
   To Realisation *A/c*
   (Purchase consideration due from the new firm)

4. For assets taken over by the proprietor

   Capital *A/c* *Dr*
   To Realisation *A/c*
   (Assets taken over by the proprietor)

5. For realisation of assets not taken over by the Company

   Bank *A/c* *Dr.*
   To Realisation *A/c*
   (Realisation of assets not taken over by the new firm)

6. For recording unrecorded assets
   Assets *A/c* *Dr*
   To Capital *A/c*
   (Unrecorded assets recorded)

7. *For realisation of unrecorded assets*
   Bank *A/c* *Dr*
   To Assets *A/c*

8. For payment of liabilities not taken over
   Realisation *A/c* *Dr*
   To Bank *A/c*
   (Payment of liabilities not taken overby the new firm)

9. For recording unrecorded liabilities
   Capital *A/c* *Dr*
   To Liabilities *A/c*
   (Being the unrecorded liabilities recorded)

10. For payment of unrecorded liabilities
    Liabilities *A/c* *Dr*
    To Bank *A/c*
    (Payment of unrecorded liabilities)
    (Note: If unrecorded liabilities are taken over by the Comapny,
    it is also transferred to Realisation Account along with other liabilities.)

11. For liabilities taken over by the proprietor

Realisation *A/c* *Dr*

To Capital *A/c*

(Being liabilities assumed by the proprietor)

12. For realisation expenses

Realisation *A/c* *Dr*.

To Bank *A/c*

(Realisation expenses paid)

13. For profit on realisation

Realisation *A/c* *Dr*

To Capital *A/c*

(Profit on realisation transferred to Capital Account)

14. For loss on realisation

Capital *A/c* *Dr*

To Realisation *A/c*

(Loss on realisation transferred to Capital Account)

15. For accumulated profits / reserves

Reserves *A/c* *Dr*

Profit and Loss *A/c* *Dr*

To Capital *A/c*

(Undrawn profits transferred to Capital Account)

16. For Loss : Reverse entry of 15.

17. For transferring partners' current accounts (Credit balances) to capital accounts

Partners' Current *A/cs* *Dr*.

To Partners' Capital *A/cs*

If there is a debit balance in current account, the reverse entry shall be recorded.

18. For Settlement of purchase consideration by the company

Shares in Purchasing Co.	*Dr.*
Debentures in Purchasing Co.	*Dr.*
Cash *A/c*	*Dr.*
To Purchasing Company	

19. For final adjustment

Partners' Capital *A/cs*	*Dr.*
To Shares in Purchasing Co.	
To Debenture in Purchasing Co.	
To Cash *A/c*	

Accounting Entries in the books of the Purchasing Company

The purchasing company will record all the assets and liabilities at agreed values. Calculation of Goodwill and Capital Reserve same as explained earlier.

1. For assets and liabilities taken over:

(When net assets taken over is less than the Purchase consideration)

Assets *A/c*	Dr.	(Agreed Value)
Goodwill *A/c*	Dr.	(Balancing figure)
To Liabilities *A/c*		(Agreed Value)
To Firm A/c		(Purchase Consideration)
(Being different assets and liabilities taken over)		

(When net assets taken over is more than the Purchase consideration)

Assets A/c	Dr.	(Agreed Value)
To Liabilities A/c		(Agreed Value)
To Firm A/c		(Purchase Consideration)

To Capital Reserve A/c (Balancing Figure)

(Being different assets and liabilities taken over)

2. For discharge of Purchase Consideration:

Firm A/c Dr (P.C)

To Share Capital A/c (Face value of shares issued)

To Securities Premium A/c (if any)

To Debentures A/c

To Bank A/c

Illustration 6 :

X and Y were in partnership in XY & Co. sharing profits in the proportions 3:2. On 31st March 2008, they accepted an offer from P. Ltd. to acquire at that date their fixed assets and stock at an agreed price of Rs 7,20,000. Debtors, creditors and bank overdraft would be collected and discharged by the partnership firm.

The purchase consideration of Rs 7,20,000 consisted of cash Rs 3,60,000, debentures in P Ltd. (at par) Rs 1,80,000 and 12,000 Equity Shares of Rs 10 each in P. Ltd. A will be employed in P. Ltd. but, since B was retiring, A agreed to allow him Rs 30,000 in compensation, to be adjusted through their Capital Accounts. B was to receive 1,800 shares in P. Ltd. and the balance due to him in cash. The Balance Sheet of the firm as on 31.03.2008 is in below

Liabilities	Rs	Assets	Rs
X's Capital Account	1,20,000	Fixed Assets	4,80,000
Loan from X	2,10,000	Stock	45,000
Bank overdraft	1,50,000	Debtors	75,000
Creditors	1,80,000	Y's Capital Account	60,000
	6,60,000		6,60,000

The sale of the assets to P. Ltd. took place as agreed; the debtors realised Rs 60,000 and creditors were settled for Rs 1,71,000. The firm then ceased business. You are required to pass necessary Journal entries and show: (a) Realisation Account (b) Bank Account (c) Partners' Capital Accounts.

In the books of XY & Co.

Journals

Date	Particulars		Rs	Rs
2008	Realisalion A/c	Dr.	6,00,000	
Mar.	To Fixed Assets A/c			4,80,000
31	To Stock-in-trade A/c			45,000
	To Sundry Debtors A/c			75,000
	(Different Assets transferred)			
	Creditors A/c	Dr.	1,80,000	
	To Realisation A/c			1,80,000
	(Sundry creditors transferred)			
	P. Ltd A/c	Dr.	7,20,000	
	To Realisation A/c			7,20,000
	(Purchase consideration due)			
	Bank A/c	Dr	3,60,000	
	Debentures in P Ltd.	Dr	1,80,000	
	Shares in P Ltd.	Dr	1,80,000	
	To P. Ltd A/c			7,20,000
	(Purchase consideration Received)			
	Bank A/c	Dr	60,000	
	To Realisation A/c			60,000
	(Debtors realized)			
	Realisation A/c	Dr	1,71,000	
	To Bank A/c			1,71,000
	(Payment to Creditors)			
	Realisation A/c	Dr.	1,89,000	
	To X Capital A/c			1,13,400
	To Y Capital A/c			75,600
	(Profit on realisation transferred to Capital Account			
	Loan form X	Dr	2,10,000	
	To X Capital			2,10,000
	(Loan Balance transferred)			
	X Capital A/c	Dr.	30,000	
	To Y Capital A/c			30,000
	(adjustment for compensation))			

	X Capital A/c	Dr.	4,13,400	
	To Share in P Ltd			1,53,000
	To Debenture in P Ltd.			1,80,000
	To Bank A/c			80,400
	(Final settlement of accounts of X)			
	Y Capital A/c	Dr.	45,600	
	To Shares in P Ltd.			27,000
	To Bank			18,600
	(Fianal settlement of accounts of Y)			

Realisation Account

Dr Cr

Particulars	Rs	Particulars	Rs
To Fixed Assets A/c	4,80,000	By Creditors *A/c*	1,80,000
To Stock *A/c*	45,000	By Bank *A/c* (Debtors realised)	60,000
To Debtors *A/c*	75,000	By P Ltd *A/c* (Purch. Consid.)	
T Bank *A/c* (creditors payment)	1,71,000	Bank	3,60,000
To X's Capital A/c (profit)	1,13,400	Debentures in P Ltd	1,80,000
ToY's Capital A/c (profit)	75,600	Shares in P Ltd.	1,80,000
	9,60,000		9,60,000

Bank Account

Dr Cr

Particulars	Rs	Particulars	Rs
To Realisation *A/c* (Drs realised)	60,000	By Balance b/d	1,50,000
To S Ltd *A/c* (P.C.)	3,60,000	By Realisation *A/c* (Crs payment)	1,71,000
		By Capital *A/c* - X	80,400
		By Capital *A/c* - Y	18,600
	4,20,000		4,20,000

Partners' Capital Accounts

Dr. Cr.

Dt.	Particulars	X	Y	Dt.	Particulars	X	Y
	To Balance b/d	-	60,000		By Balance b/d	1,20,000	-
	To Y Capital A/c	30,000			By Loan from X	2,10,000	-
	To Shares in P Ltd	1,53,000	27,000		By Realisation A/c (profit)	1,13,400	75,600
	To Debentures in P Ltd A/c	1,80,000	-		By X 's Capital A/c	-	30,000
	To Bank A/c (final payment)	80,400	18,600				
		4,43,400	1,05,600			4,43,400	1,05,600

Note:

Value of equity shares		Rs
Total Purchase consideration		7,20,000
Discharged by:		
In Cash	3,60,000	
By Debentures	1,80,000	5,40,000
Balance by 12,000 Equity shares of Rs 10/ each		1,80,000

So the cost of each equity share be Rs 1,80,000/ 12000

= Rs 15 /per share.

Thus in the books of P Ltd. Security premium will be Rs 12000 X 5 =Rs 60,000

Illustration 7 :

A and B were carrying on business sharing profits and losses equally. The Firm's Balance Sheet as at 31.03.2008 was as below:

Liabilities		Rs	Assets		Rs
Creditors		60,000	Stock		60,000
Bank Loan		35,000	Machinery		1,50,000
Capital A/c s:	Rs		Debtors		70,000
A	1,40,000		Joint life Policy		9,000
B	1,30,000	2,70,000	leasehold Premises		34,000
			Profit & loss A/c(Dr)		26,000
			Drawings Accounts	Rs	
			A	10,000	
			B	6,000	16,000
		3,65,000			3,65,000

The business was carried on till 30.9.2008. The partners withdrew half the amount of profits made during the period of six months after charging depreciation at 10% p.a. on machinery and after writing off 5% on leasehold premises. In the half-year, sundry creditors were reduced by Rs 10,000 and bank overdraft by Rs 15,000.

On 30.9.2008, 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 that date and other items remained the same as at 31.03.2008.

On 30.9.2008, the firm sold the business to a Prix 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 30.9.2008.

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 30.9.2008;

(b) The Realisation Account;

(c) Partners' Capital Accounts showing the final settlement between them.

Solution

Workings:

(1) Ascertainment of profit for the 6 months ended 30th September, 2008

Closing Assets:	Rs	Rs
Stock		75,000
Debtors		60,000
Machinery less depreciation		1,42,500
Leasehold premises less written off		32,300
		3,09,800
Less: Closing liabilities:		
Creditors	50,000	
Bank Loan	20,000	70,000
Closing Net Assets		2,39,800
Less Opening combined capital:		
A - Rs (1,40,000 -13,000 -10,000)	1,17,000	
B - Rs (1,30,000 -13,000 - 6,000)	1,11,000	2,28,000
Profit before adjustment of drawings		11,800
Add : Combined drawings during the 6 months (equal to profit)		11,800
Profit for 6 months		23,600

2) Ascertainment of Purchase Consideration

Closing net asset (as above) Rs 2,39,800 + Goodwill Rs 1,00,000 = Rs 3,39,800.

Balance Sheet as on 30.09.2008

Liabilities'	Rs	Assets	Rs
A's Capital Account.	1,22,900	Machinery	1,42,500
B's Capital Account	1,16,900	Leasehold premises	32,300
Sundry Creditors	50,000	Stock	75,000
Bank overdraft	20,000	Sundry Debtors	60,000
	3,09,800		3,09,800

Realisation Account

Dr Cr

Particulars	Rs	Particulars	Rs
To Machinery A/c	1,42,500	By Creditors A/c	50,000
To Leasehold Premises A/c	32,300	By Bank Loan A/c	20,000
To Stock A/c	75,000	By Prix Ltd A/c	3,39,800
To Debtors A/c	60,000	(purchase consideration)	
To A Capital A/c	50,000		
To B Capital A/c	50,000		
	4,09,800		4,09,800

Capital Accounts

Dr Cr

Date	Particulars	A	B	Date	Particulars	A	B
1.4.08	To Profit & Loss A/c	13,000	13,000	1.4.08	By Balance b/d	1,40,000	1,30,000
	To Drawings A/c	10,000	6,000	30.9.08	By P/L Appro A/c	11,800	11,800
30.9.08	To Drawings A/c	5,900	5,900		(6 months' Profit)		
	To Bal c/d	1,22,900	1,16,900				
		1,51,800	1,41,800			1,51,800	1,41,800
				30.9.08	By Bal b/d	1,22,900	1,16,900
30.9.08	To Shares in Prix. Ltd	1,72,900	1,66,900		By Realisation A/c	50,000	50,000
		1,72,900	1,66,900			1,72,900	1,66,900

EXERCISE

Problem 1 :

Ram and Rahim have operated their own separate retailing businesses for many years. They decided to amalgamate their business and to form a partnership from 1 st April, 2008. The balance sheets in respect of the individual businesses as at 31 st March, 2008 are as follows.

Balance Sheet of Ram

Liabilities	Rs	Assets		Rs
Capital:	12,00,000	Freehold premises		5,00,000
Creditors	3,00,000	Machinery & Equipment (net)		2,00,000
Bills Payable	2,50,000	Furniture & fittings (net)		50,000
		Stocks		5,00,000
		Debtors	2,50,000	
		Less: Provision for bad debts	12,500	2,37,500
		Bills Receivable		1,50,000
		Bank		1,12,500
	17,50,000			17,50,000

Balance Sheet of Rahim

Liabilities	Rs	Assets		Rs
Capital	5,00,000	Furniture & Fittings		39,000
Bank overdraft	1,50,000	Stocks		3,75,000
Creditors	2,50,000	Debtors	3,00,000	
		Less. Provision for bad debts	15,000	2,85,000
		BilisReceivable		2,00,000
		Cash		1,000
	9,00,000			9,00,000

It was agreed by the partners that:

(a) Profits are to be shared in the proportion of 3/5 to Ram and 2/5 to Rahim.

(b) The debtors of Ram are valued at Rs 2,25,000, the bills receivable at Rs 1,37,500, stock at Rs 3,75,000, machinery and equipment at Rs 2,75,000 and free hold premises at Rs 8,75,000. The other remaining assets, including cash resources and liabilities, are to be taken over at book values.

(c) The debtors of Rahim are valued at Rs 2,62,500 and stock at Rs 3,00,000 and the furniture and fittings to be valued at Rs 52,500. The remaining assets, including cash resources, and liabilities are to be taken over at book values.

(d) Sufficient cash to be introduced by Rahim so that his capita1 contribution is in the same proportion as his share of profits.

You are required to:

Pass necessary Journal entries to close the books of Ram and Rahim; and

The Balance Sheet *of* the partnership as at 1st April, 2008.

(Profit on realization Ram - Rs 3,00,000; Rahim – Rs 66,000; Rahim introduced – Rs 4,34,000; B/S total – Rs 33,33,000.)

Problem 2 :

Paras and Paresh were both in business on their own account as retail grocers. They agreed to amalgamate as on March 31, 2008 and the new business was to be known as PP & Co. The Balance Sheets as on that date were as follows:

Liabilities	Paresh	Paras	Assets	Paresh	Paras
Capital Accounts	2,200	1,200	Freehold premises	3,700	-
Trade Creditors	1,000	1,500	Leasehold premises	-	1,500
Bank overdraft	1,100	-	Plant	400	500
			Stock	100	50
			Debtors	100	400
			Bank	-	250
	4,300	2,700		4,300	2,700

The amalgamation of the business was carried out on the following terms

(a) Profits and losses to be shared in the following ratio: Paresh 2/5, Paras 3/5.

(b) Goodwill to be valued at one year's purchase of the average net profits, less losses, of the previous three years. No account for goodwill is to be opened in the books of the business. Necessary adjustment being made between the partners' capital accounts.

(c) The loss on Paresh's freehold premises which were not required by the new business and which had been sold by him for Rs 3,200 was to be charged to his capital account. The sale was completed on April 1, 2008 and the proceeds of Rs 3,200 were paid into the new firms' bank account.

(d) Certain assets to be revalued, the new values to be as follows

	Leasehold Premises	Debtors	Plant
Paresh	-	-	500
Paras	2,000	300	-

The profits and losses of the two businesses for the 3 years ending March 31, 2006 were as follows:

Paresh- Ending 31 st March

2006-Rs 200 (Loss): 2007-Rs 2,100 (Profit): 2008-Rs 1,460 (Profit).

Paras- Ending 31 st March

2006 - Rs 1,000 (Profit); 2007 - Rs 1,500 (Profit); 2008 - Rs 1,700 (Profit).

You are required to prepare:

(i) The partners' Capital Account., recording these transactions as on April 1, 2008.

(ii) The Balance Sheet of the new firm as on April 1, 2008 after the adjustment of partners' capital account.

(Valuation of Goodwill: Paresh – Rs 1,120; Paras – Rs 1,400; B/S total – Rs 3,400)

Problem 3 :

A and B are partners sharing profits and losses in the ratio of 3:2. Their Balance Sheet as on 31.03.2008 was:

Liabilities	Rs	Assets	Rs
A's Capital	30,000	Goodwill	5,000
B's Capital	20,000	Other fixed assets	30,000
Reserve	15,000	Joint Life Policy	20,000
Current liabilities	30,000	other assets	40 ,000
	95,000		95,000

On 30.9.2008, AB Ltd. was formed to take over the partnership business up to that date, a net profit of Rs 10,000 was made after charging depreciation on fixed assets @10 % p.a. For the purpose of transfer, Goodwill was valued at Rs 30,000. The joint life policy was surrendered for Rs 15,000 and nothing was withdrawn by the partners.

Purchase consideration was paid by shares of Rs 10 each. The company also issued 15,000 shares of Rs 10 each to the public as fully paid. All shares were sold. Close the books of the firm and prepare the opening balance sheet of AB Ltd.

Problem 4 :

X, Y and Z are partners in Excellent & Co. sharing profit and losses in the proportion of 5 : 3 : 2 respectively.

Their Balance Sheet as on March 31, 2008 was as follows:

Liabililies	Rs	Assets	Rs
Capitals		Sundry assets	1,88,400
X	94,000	Cash	2,700
Y	61,000	Cash at Bank	5,500
Z	26,000		
Creditors	15,600		
	1,96,600		1,96,600

On April 1, 2008 they sold their business including the bank balance to ABC Ltd, on the following terms:

(a) The company to satisfy the purchase consideration by issue of Rs 25,000 6% debentures; 9,600 equity shares of Rs 8 each at a premium of Rs 2 per share; and Rs 72,000 8% preference shares of Rs 100 each.

(b) The partners will draw the cash before transfer to the company and divide the same equally among them.

(c) Out of the purchase consideration the debentures and the preference shares are agreed to be divided as follows: Debentures: X - Rs 16,000; Y - Rs 9,000. Preference Shares - To be shared by all in proportion to original capital amounts after adjustment of debenture value as above. Draw up Realisation Account and the Partners' Capital Accounts showing distribution of shares amongst them.

(Realisation profit – X Rs 7,350; Y – Rs 4,410; Z – Rs 2,940;)

Problem 5 :

Asis and Tapan were in partnership sharing profit and losses in the ratio of 3 : 1. The following is the Balance Sheet of the partnership as on March 31, 2008

Liabilities	Rs	Assets	Rs
Capital Accounts		Fixed assets	21,000
-- Lion	24,000	Stock	11,200
-- Tiger	8,000	Debtors	19,600
Current Accounts		Cash at bank	3,720
Lion	4,200		
Tiger	2,000		
Loan - Tiger	3,000		
Creditors	14,320		
	55,520		55,520

Suhas Ltd. agreed to take over stock and fixed assets, excluding the value of motor car Rs 4,100 for a consideration of Rs 48,000 which is to be satisfied by payment of cash Rs 16,000, allotment of 160 preference shares of Rs 100 each valued at Rs 75 per share, and the balance by allotment of 1,600 equity shares of the face value of Rs 10 each.

The debtors realised Rs 19,200 and the creditors were settled for Rs 14,000.

The following were agreed between the partners.

(a) The equity shares should be allotted in the ratio of the Partners' Capital Accounts as per the Balance Sheet.

(b) Asis to take over the motor car at an agreed value of Rs 4,200.

(c) The preference share to be allotted to Tapan to the value of his loan and the remainder to be allotted equally between the partners.

(d) Balance remaining to be settled in cash.

You are required to show: (i) The Realisation Account; (ii) Partners' Capital Accounts; (iii) Bank Account; (iv) Statement showing distribution of shares.

(Profit on realization – Rs 19,920)

STUDY NOTE - 5
BRANCH ACCOUNTS

- Study Note includes : Branch including Foreign Branch

Section 2(9) of the Companies Act, 1956 defines a Branch Office as-

- Any establishment described as a Branch by the Company
- Any establishment carrying on either the same or substantially the same activity as that carried on by the Head Office of the Company;any establishment engaged in any production, processing or manufacturing but does not include any establishment specified in the Central Governnent's Order u/s 8.

Classification of Branches :

A. Inland Branches:

(i) Dependent Branches : branches in respect of which the whole of the accounting records are kept at Head Office only.

(ii) Independent Branches : branches which maintain independent accounting records.

B. Foreign Branches : branches which are located in a foreign country(i.e. in a country other than in which the company is incorporated and registered)

Dependent Branches

Branch Accounts can be maintained at the Head Office, particularly when the business policies and administration of the Branch are wholly controlled by the Head office.
The Branch prepares the periodic returns based on which the accounting records are maintained at the Head Office.

Methods of Accounting :

(i) Final Accounts Method; (ii) Debtors Method and (iii) Stock and Debtors Method.

FINAL ACCOUNTS METHOD

Branch Trading and Profit & Loss Account

Particulars	Amt	Particulars	Amt
To Opening Stock at Branch (at Cost)	×××	By Sales made at Branch	
To Goods sent from Head Office	×××	(net of returns)	
Less: Goods returned to H.O	×××	—Cash	×××
To Purchases (made directly by	×××	—Credit	×××
Branch, if any)		By Closing Stock at Branch (at Cost)	×××
To Direct Expenses at Branch (if any)	×××		
To Gross proft c/d	×××		
	×××		×××
To Various expenses incurred at Branch	×××	By Gross profit b/d	×××
(including Bad Debts if any)			
To General P&L Account	×××		
(Net Profit transferred)			
	×××		×××

Note: If goods are invoiced above cost, the loading (i,e,profit element) on opening Stock, Goods Sent from Head office (net of returns) and Closing Stock are reversed, in ascertain the true profits.

Debtors Method : (for dependent branches)

Under the Debtors System, the Branch Account is prepared in the following format to ascertain the Net profit from Branch operations.

Particulars	Amt	Particulars	Amt
To balances b/d (Assets at Branch at beginning)	×××	By Cash —Remittances recd from Branch	×××
		By Goods sent to Branch (returns at cost)	×××
—Stock	×××	By balances b/d (Assets at Branch at end)	×××
— Debtors	×××	— Stock	×××
— Petty Cash at Branch	×××	— Debtors	×××
To Goods sent to Branch (at cost)	×××	— Petty Cash at Branch	×××
To Sundry Creditors (direct purchase by Branch)	×××		
To Bank — various expenses incurred at Branch	×××		
To General P & L Account (Net Profit transferred)	×××		×××
	xxx		xxx

Note : If goods are invoiced above cost, the loading (i.e. profit element) on opening stock, Goods sent from Head Office (net of returns) and Closing Stock are reversed, in order to ascertain the true profits.

Stock and Debtors Method : (for dependent branches)

1. Ledger Accounts : The following accounts are maintained by the Head office under the Stock and Debtors System–

   (a) Branch Stock Account (or Branch Trading A/c) — to ascertain Gross Profit

   (b) Branch Profit and Loss Account — to ascertain Net profit

   (c) Branch Debtors Account — to record Receivables / Credit Sales, if any.

   (d) Branch Expenses Account — to record expenses incurred at Branch

   (e) Branch Cash Account — to control Branch Cash position / remittances

   (f) Branch Adjustment Account — to reverse Loading i. e. unrealised profits, if any.

   (g) Goods sent to Branch Account — to record goods sent / returned

   (h) Branch Assets Account — to record Assets at Branch, if any.

2. Journal Entries :

No	*Transaction*	*Journal Entry*
	Transaction Entries	
(a)	Goods sent to Branch by HO	Branch Stock Account (total Value of goods) Dr. To Goods sent to Branch (at Cost) To Branch Adjustment A / c (loading, if any)
(b)	Goods returned by Branch to HO	Goods sent to Branch Account (at Cost) Dr. Branch Adjustment A / c (loading, if any) Dr. To Branch Stock A / c (total value of goods)
(c)	Assets provided by HO to Branch either by way of fresh purchase or by way of transfer from HO	Branch Assets Account Dr. To (Main) Cash Account / Vendor Account [or] To (HO) Assets Account (in case of transfer)
(d)	Cash sent to Branch for expenses	Branch Cash Accout Dr. To (Main) Cash Account
(e)	Cash Sales at the Branch	Branch Cash Account Dr. To Branch Stock Account
(f)	Credit Sales at the Branch	Branch Debtors Account Dr. To Branch Stock Account
(g)	Collection from Branch Debtors	Branch Cash Account Dr. To Branch Debtors Account
(h)	Sales Returns at the Branch	Branch Stock Account Dr. To Branch Debtors Account
(i)	Discounts / Bad Debts etc.	Branch Expenses Account Dr. To Branch Debtors Account
(j)	Various expenses incurred at Branch	Branch Expenses Account Dr. To Branch Cash Account
(k)	Branch Expenses directly met by HO	Branch Expenses Account Dr. To (Main) Cash Account
(l)	Remittances made by Branch to Head Office	(Main) Cash Account Dr. To Branch Cash Account
(m)	Goods Lost in Transit / Stolen etc.	Goods Lost in Transit A / c (at cost) Dr. Branch Adjustment (loading if any) Dr. To Branch Stock Account (total value of goods)

	At the End of the Year : Closing Entries	
(n)	Recording Closing Stock at Branch	Closing Stock at Branch Account (incl. Loading) Dr. To Branch Stock Account
(o)	Excess of Sale Price over Invoice Price	Branch Stock Account Dr. To Branch Adjustment Account
(p)	Recording Unrealised Profit on Closing Stock i.e. Stock Reserve (after this entry, the Branch Adjustment Account will show Gross Profit)	Branch Adjustment Account Dr. To Stock Reserve (closing) Note : Stock Reserve on Opening Stock is credited to Branch Adjustment A/c.
(q) (r) (s)	Recording Gross Profit at Branch Depreciation on Branch Assets, (if any) Transfer of Branch Expenses	Branch Adjustment Account Dr. To Branch P & L Account Branch Expenses Account Dr. To Branch Assets Account Branch P & L Account Dr. To Branch Expenses Account
(t)	Recording Net Profit at Branch	Branch P & L Account Dr. To General P & L Account

Double Column mothod of recording transactions : (Dependent Branches)

The Branch Account under this method will contain the following two columns to record the transactions i.e. Cost and Invoice Price.

(a) Cost Column: Entries recorded hereunder will part of Double Entry System and show the value of goods sent out to Branch at Cost.

(b) Invoice Price Column: This column will contain entries recorded at selling price. They do not form part of the entity's double entry system and do not disclose the Profit/Loss of the Branch. They would balance by including the value of closing stock provided there has been no physical loss of stocks.

Branch Account

Particulars	Invoice Price	Cost	Particulars	Invoice Price	Cost
To Balance b/d – Opening Stock	xxx	xxx	By Cash Sales	xxx	xxx
To Goods Sent to Branch	xxx	xxx	By Credit Sales	xxx	xxx
To Stock Adjustment A/c	xxx	xxx	By Balance c/d		
To Gross Profit – Tfd. to			– Closing Stock	xxx	xxx
P & L A/c.	xxx	xxx		xxx	xxx
Total	xxx	xxx	Total	xxx	xxx

INDEPENDENT BRANCHES

S No	Transaction	HO Books	Branch Books
1.	Goods sent by HO to Branch	Branch A/c Dr. To Goods Sent to Branch A/c	Goods Recd. from H.O. A/c. Dr. To HO A/c
2.	Goods returned by Branch to HO	Goods Sent to Branch A/c. Dr. To Branch A/c	HO A/c. Dr. To Goods Recd. from H. O. A/c
3.	Branch Expenses incurred at Branch Office	—	Expenses A/c Dr. To Cash / Bank A/c
4.	Branch expenses paid for by the Head Office	Branch A/c Dr. To Cash/Bank A/c	Expenses A/c. Dr. To HO A/c
5.	Purchases made from parties other than H.O. by Branch	—	Purchases A/c Dr To Bank/ Creditors A/c
6.	Sales effected by the Branch		Cash/Debtors A/c Dr To Sales A/c
7.	Collection from Debtors received directly by the H.O.	Cash/Bank A/c Dr. To Branch A/c	H.O. A/c Dr. To Sundry Debtors A/c
8.	Payment by H.O. for Purchase made by the Branch	Branch A/c Dr To Bank A/c	Purchases/Creditors A/c Dr. To Ho A/c
9.	Purchase of Asset by Branch	—	Sundry Assets A/c Dr To Bank/Liability
10.	Asset account maintained at Ho and asset purchased by Branch	Branch Asset A/c Dr. To Branch A/c	H.O. A/c Dr. To Bank/Creditors A/c
11.	Depreciation when asset account is maintained by H.O.	Branch A/c Dr To Branch Asset A/c	Depreciation A/c Dr. To H.O. A/c
12.	Remittance of Funds by H.O. to Branch	Branch A/c Dr. To Bank A/c	Bank A/c Dr. To H.O. A/c
13.	Remittance of Funds to H.O. by Branch	Bank A/c Dr To Branch A/c	Ho A/c Dr To Bank A/c
14.	Transfer of Goods between different branches	Recipient Branch A/c Dr. To Supplying Branch A/c	(i) Supplying Branch A/c Dr To Goods recd.from H.O. A/c (ii) Goods recd.from H.O. A/c Dr. To H.O. A/c
15.	Charging the Branch service charges by H.O.	Branch A/c Dr. (Expenses) A/c To Service Charges A/c	Expense A/c Dr. To H.O. A/c

ADJUSTMENTS

1. Goods in Transit : Goods dispatched by the Head Office and not yet received by the Branch and vice versa. These includes goods which are in transit and yet to reach the Branch and also those goods which are lost in transit.

2. Remittance in Transit : Amount remitted by the Head Office to the Branch and vice verse which remain in transit as at the closing date also contribute to disagreements in the two balances.

3. Proxy Transactions: Sometimes remittances are received or made by the Head Office on behalf of the Branch and vice versa, may go unrecorded at the other end, wherein they are normally recorded.

INCORPORATION OF BRANCH BOOKS IN H. O. BOOKS

Methods for Incorporation :

(i) Transfer of Profit / Loss Method.

(ii) Consolidation Method.

Trsnsfer to Profit/Loss Method :

1. This will be followed when separate Profit &Loss Accounts and Balance Sheet are prepared for the Branch and the Head office.

2. The profit / Loss for the period is transferred to the Head Office.

3. Journal Entry At Branch —

    1. For Transfer of Branch Profit:
       Profit & Loss A / c   Dr.
           To Head Office A / c

    2. For Transfer of Branch Loss:
       Head Office A / c   Dr.
           To Profit & Loss A / c

4. Journal Entry Head Office —

    1. For Transfer of Branch Profit:
       Branch A / c   Dr.
           To Profit & Loss A / c

    2. For Transfer of Branch Loss:
       Profit & Loss A / c   Dr.
           To Branch A / c

5. Net Effect —

   Branch : Balance Sheet would show the amount advanced by the Head Office to it, as Capital.

   H.O. : Balance Sheet would be shown as an advance to the Branch.

CONSOLIDATION METHOD

1. Separate financial statements are not prepared. The Head Office prepares the consolidated financial statements for the entity as a whole.
2. Balances in all the ledger accounts are transferred to the Head Office, where all the accounts are consolidated and financial statements prepared for the whole entity.
3. Journal Entry At Branch —

   1. For Transfer of Assets and Expenses :

      H. O. A/c Dr.
      To (individual) Assets A/c
      To (individual) Expenses A/c

   2. For Transfer of Liabilities and Income :

      (Indivivual) Liability A/c Dr.
      (Individual) Income A/c Dr
      To H. O. A/c

4. Journal Entry at Head Office —

   1. For Transfer of Assets and Expenses :

      (Individual) Asset A/c Dr.
      (Individual) Expense A/c Dr.
      To Branch A/c.

   2. For Transfer of Liabilities and lncome:

      Branch A/c Dr.
      To (Individual) Liability A/c
      To (Individual) Income A/c

5. Net Effect —

   The books of accounts will be closed fully and will be restarted at the beginning of the next year by passing the following entry :

   (Individual) Asset A/c Dr.
   To (Individual) Liability A/c
   To Ho A/c (Difference between Assets and Liabilities)

FOREIGN BRANCH

Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate.

Since the accounts are maintained in Foreign Currency they have to be translated into Reporting Currency i.e. the currency in which the Head Office transacts.

Exchange rate of Reporting Currency in not stable in relation to foreign currencies due to international demand and supply effects on various currencies. Therefore, different rates are assigned to different transactions and balances upon translation.

Applicable Exchange Rate :

Revenue Items	Average Rate for the year.
Opening Stock	Rates prevanlent at the commencement of the Accounting Period i.e. Opening Rate
Closing Stock	Rates prevalent at the close of the Accounting Period i.e. Closing Rate
Fixed Asset	Translated at the original rate. If there is a change in the value of the Foreign currency Liabilities, adjustment should be made to cost of fixed Assets in Rupees.
Depreciation	Rate used for translation of value of Fixed Assets on which the depreciation is calcutated.
Current Assets	Rates prevalent at the close of the Accounting Period i.e. Closing Rate
Current Liabilities	Rates prevalent at the close of the Accounting Period i.e. Closing Rate
Long Term Liabilities	Rate Prevalent at the close of the Accounting Period i.e. Closing Rate
Head Office Account	Balance in 'Head Office Account' in the Branch Books is taken at the Indian rupees for which 'Branch Account' in the head office books stands. It must be ensured that no transaction is left unaccounted in both the books.

Profit / Loss on Translation : Profit or Loss arising out of change in Exchange rate should be Credited / Debited to the Profit and Loss Account for the current period.

DEBTORS METHOD

Illustration 1.

1. From the following information, prepare Kolkata Branch Account in the books of head office for the year ending on 31st March 2008 :

	Rs.		Rs.
Opening Stock (at cost)	17,800	Discount allowed to Customers	50
Opening Debtors	1,400	Bad Debts written off	100
Opening Petty Cash	25	Credit Sales	72,940
Furniture (in the beginning)	600	Cash Sales	3,200
Opening Creditors	600	Petty Expenses paid by Branch	800
Goods sent to Branch (at Cost)	52,200	Cheques sent to Branch for expenses :	
Goods returned by Branch to		Salaries	3,000
H.O. (at cost)	780	Rent and Insurance	1,200
Goods returned by Customers		Petty Cash	787
to Branch	570		
Cash received by Branch from			
its Customers	61,100		

Goods are sold to customers at cost *puls* 50%. Depreciate the furniture @ 10% p.a.

Solution :

Dr. Kolkata Branch Account In the Books of H.O. ***Cr.***

Particulars		***Rs.***	***Particulars***	***Rs.***
ToBalance b/d :			By Balance b/d : creditors	600
Stock		17,800	By Bank A/c (Remittance from	
Debtors		1,400	Branch)	64,300
Petty Cash		25	By Goods sent to Branch A/c	
Furniture		600	(return by branch)	780
To Goods sent to Branch A/c		52,200	By Balance c/d :	
To Bank A/c (Remittance to Branch)			Stock	18,840
Salaries	3,000		Debtors	12,520
Rent and Insurance	1,200		Petty Cash	12
Petty Cash	787	4,987	Furnitue (Rs. 600 – Rs. 60)	540
To Banlance c/d (creditors)		600		
To Net profit t/f to General				
P & L A/c		19,980		
		97,592		97,592

Workings :

(i) **Dr.** Branch Stock Account **Cr.**

Particulars	***Rs.***	***Particulars***	***Rs.***
To Balance b/d	17,800	By Goods sent to Branch A/c (Return)	780
To Goods sent to Branch (Cost)	52,200	By Goods sold by Branch (Cost) [(3,200 + 72,940 – 570) × 100/150]	50,380
		By Balance c/d	18,840
	70,000		70,000

(ii) **Dr.** Branch Debtors Account **Cr.**

Particulars	***Rs.***	***Particulars***	***Rs.***
To Balance b/d	1,400	By Returns to Branch	570
To Credit Sales	72,940	By Discount allowed	50
		By Bad Debts	100
		By Cash received by Branch	61,100
		By Balance c/d	12,520
	74,340		74,340

(iii) **Dr.** Branch Pretty Cash Account **Cr.**

Particulars	***Rs.***	***Particulars***	***Rs.***
To Balance b/d	25	By Petty Expenses A/c	800
To Remittance from H.O.	787	By Balance c/d	12
	812		812

(iv) **Dr.** Branch Cash Account **Cr.**

Particulars	***Rs.***	***Particulars***	***Rs.***
To Cash Sales	3,200	By Remittance to H.O.	64,300
To Collection from Debtors	61,100		
	64,300		64,300

STOCK AND DEBTORS METHOD

Illustration 2.

Swapna Ltd has two branches, at Mumbai and at Delhi. Goods are invoiced to Branches at cost plus 50%. Goods are transferred by/to anther branch at its cost. Following information is available of the transactions of Mumbai for the year ended on 31st March 2008.

		Rs.
(a)	Opening Stock at its cost	26,700
(b)	Goods sent to Branch (including goods invoiced at Rs. 1,500 to Branch on 31st March but not received by Branch before closing)	78,300
(c)	Goods received from Delhi Branch	600
(d)	Goods transferred to Delhi Branch	5,100
(e)	Goods returned by Branch to H.O.	1,170
(f)	Goods returned by Credit Customers to Branch	570
(g)	Goods returned by Credit Costomers directly to H.O.	120
(h)	Agreed allowance to Customers off the selling price (already taken into account while invoicing)	100
(i)	Normal loss due to wastage and deterioration of stock (at cost)	150
(j)	Loss-in transit (at invoice price) Rs. 660 against which a sum of Rs.400 was recovered from the Insurance Company in full settlement of the claim.	
(k)	Cash Sales Rs. 3,200 and Credit Sales 72,940	
(l)	Branch Expenses (including Insurance charges)	5,000
(m)	Bad Debts Rs. 100 and Discount allowed to Customers 50	

Prepare Branch Stock Account, Branch Adjustment Account and Branch Profit and Loss Account in each of the following alternative cases :

Case I. If the Closing Stock at Branch at its cost as per physical verification amounted to Rs. 20,000.

Case II. If the Closing Stock at Branch at its cost as per physical verification amounted to Rs. 22,700.

Solution:

Case I

Dr. (i) Branch Stock Account Cr.

Pariculars	***Rs.***	***Pariticulars***	***Rs.***
To Balance b/d.	26,700	By Goods Sent to Branch A/c (Returns to H.O.)	1,170
To Goods Sent to Branch A/c	78,300	By Goods Sent to Branch A/c (Transfer to Delhi Branch)	5,100
To Branch Debtors A/c (Returns to Branch)	570	By Branch Cash A/c (Cash Sales)	3,200
To Goods Sent to Branch A/c (Transfer from Delhi Branch)	600	By Branch Debtors A/c (Credit Sales)	72,940

(*Contd.*)

(*Contd.*)

		By Branch Adjustment A/c (Load on Loss-in-transit)	220
		By Branch Profit and Loss A/c (Cost of Loss-in-transit)	440
		By Branch Adjustment A/c (Normal Loss)	150
		By Branch Adjustment A/c (Agreed Allowance Allowed)	100
		By Branch Adjustment A/c (Load on Shortage)	450
		By Branch Profit/Loss A/c (Cost of shortage)	900
		By Balance c/d:	
		In hand	20,000
		In transit	1,500
	1,06,170		1,06,170

Dr. Mumbai Branch Adjustment Account Cr.

Pariculars	*Rs.*	*Pariticulars*	*Rs.*
To Branch Stock A/c (Load on loss-transit)	220	By Stock Reserve A/c (Load on Op. Stock)	8,900
To Branch Stock A/c (Normal loss)	150	By Goods Sent to Branch A/c (Load on Net Goods Sent) [(Rs. 78,300+600–1,170 – Rs. 5,100 – 120) × 50/150)	24,170
To Branch Stock A/c (Agreed Allowance)	100		
To Branch Stock A/c (Load on Shortage)	450		
To Stock Reserve A/c (Load on Cl. Stock)	7,167		
To Gross Profit t/f to Branch P and L A/c	24,983		
	33,070		33,070

Dr. Mumbai Branch Profit and Loss Account Cr.

Pariculars	*Rs.*	*Pariticulars*	*Rs.*
To Branch Expense A/c	5,000	By Branch Adjustment A/c (Gross Profit)	24,983
To Branch Stock A/c (Cost of loss-in-transit)	440	By Bank A/c (Claim)	400
To Branch Stock A/c (Cost of shortage)	900		
To Bad Debts	100		
To Discount allowed	50		
To Net Profit t/f to General P and L A/c.	18,893		
	25,383		25,383

Case II

Dr. Mumbai Branch Stock Account Cr.

Pariculars	Rs.	Pariticulars	Rs.
To Balance b/d	26,700	By Goods Sent to Branch (Return to H.O.)	1,170
To Goods Sent to Branch A/c	78,300	By Goods sent to Branch A/c (Transter to Delhi Branch)	5,100
To Branch Debtors A/c (Returns to Branch)	570	By Branch Cash A/c (cash Sales)	3,200
To Goods sent to Branch A/c (Transfer from Delhi Branch)	600	By Branch Debtors A/c (Credit Sales)	72,940
To Branch Adjustment A/c (Surplus being Excess of Selling Price over invoice Price) (Balancing figure)	1,350	By Branch Adjustment A/c (Load on Loss-in-transit)	220
		By Branch Profit and Loss A/c (Cost of Loss-in-transit)	440
		By Branch Adjustment A/c (Normal Loss)	150
		By Branch Adjustment A/c (Agreed Allowance Allowed)	100
		By Balance c/d:	
		In hand	22,700
		In transit	1,500
	1,07,520		1,07,520

Dr. Mumbai Branch Adjustment Account Cr.

Pariculars	Rs.	Pariticulars	Rs.
To Branch Stock A/c (Load on loss-in-transit)	220	By Stock Reserve A/c (Load on Op. Stock)	8,900
To Branch Stock A/c (Normal Loss)	150	By Goods Sent to Branch A/c (Load on Net Goods Sent) (Rs. 78,300+600–1,170 – Rs. 5,100–120)×50/150)	24,170
To Branch Stock A/c (Agreed Allowance)	100		
To Stock Reserve A/c (Load On Cl. Stock)	8,067	By Branch Stock A/c (Surplus)	1,350
To Gross Profit t/f to Branch P and L A/c.	25,883		
	34,420		34,420

Dr. Mumbai Branch Profit & Loss Account Cr.

Paricular s	Rs.	Pariticulars	Rs.
To Branch Expenses A/c	5,000	By Branch Adjustment A/c (Gross Profit)	25,883
To Branch Stock A/c (Cost of loss-in-transit)	440	By Bank A/c (Claim)	400
To Bad Debts	100		
To Discount Allowed	50		
To Net Profit t/f to General P and A/c	20,693		
	26,283		26,283

Illustration 3.

ILLUSION Ltd, Ranchi, started on 1st April, 2007, has two branches at Gurgaon and Kachar. All goods sold at the branches are received from the Head Office invoiced at cost plus 25 percent. All expenses relating to Branches are paid by the Head Office. Each branch has its own sales Ledger and sends weekly statement. All cash collections are remitted daily to Head Office by the branches. The following particulars relating to the year ended 31st March, 2008 have been extracted from the weekly statement sent by the branches:—

Particulars	Gurgaon Rs.	Kachar Rs.
Credit Sales	1,10,000	1,25,200
Cash Sales	85,200	78,600
Sales Returns	1,200	2,300
Sundry Debtors	34,500	23,600
Rent and Rates	4,500	3,200
Bad Debts	—	6,000
Salaries	18,000	16,000
General Expenses	1,500	2,600
Goods received from H.O.	1,25,000	1,50,000
Advertisement	5,200	7,500
Closing Stock	35,000	45,000

You are required to prepare the Branch Account as they would appear in the books of the Head Office, showing the Profit or Loss for the period and the Trading and Profit and Loss Account separately for each Branch.

Solution :

Branch Trading and Profit and Loss Account

Dr. *for the year ended 31st March, 2008* *Cr.*

Pariculars	***Gurgaon Branch Rs.***	***Kachar Branch Rs.***	***Pariticulars***	***Gurgaon Branch Rs.***	***Kachar Branch Rs.***
To Goods received from H.O.	1,00,000	1,20,000	By Sales Credit	1,10,000	1,25,200
To Gross Profit c/d	1,22,000	1,17,500	Less: Sales Returns	1,200	2,300
			Add: Cash Sales	85,200	78,600
				1,94,000	2,01,500
			By Closing Stock	28,000	36,000
	2,22,000	2,37,500		2,22,000	2,37,500
To Salaries	18,000	16,000	By Gross profit b/d	1,22,000	1,17,500
To General Expenses	1,500	2,500			
To Bad Debts	—	6,000			
To Rent and Rates	4,500	3,200			
To Advertisement	5,200	7,500			
To Net Profit	92,800	82,200			
	1,22,000	1,17,500		1,22,000	1,17,500

Dr. Branch Account *Cr.*

Pariculars	***Gurgaon Branch Rs.***	***Kachar Branch Rs.***	***Pariticulars***	***Gurgaon Branch Rs.***	***Kachar Branch Rs.***
To Goods sent to Branch A/c	1,25,000	1,50,000	By Cash A/c (Remittance to H.O.)		
To Cash Account (Expenses)			Cash Sales	85,200	78,600
			Received from Debtors	85,200	82,400
Rent and Rates	4,500	3,200	By Goods sent to		
Salaries	18,000	16,000	Branch A/c	25,000	30,000
General Expenses	1,500	2,600	(Load on Goods sent)		
Advertisement	5,200	7,500	By Branch Debtors	23,600	34,500
To Stock Reserve A/c (Loading)	7,000	9,000	By Branch Stock	35,000	45,000
To P & L A/c	92,800	82,200			
	2,54,000	2,70,500		2,54,000	2,70,500

Working Notes :

Dr. Memorandum Branch Debtors Account *Cr.*

Pariculars	***Gurgaon Branch Rs.***	***Kachar Branch Rs.***	***Pariticulars***	***Gurgaon Branch Rs.***	***Kachar Branch Rs.***
To Sales	1,10,000	1,25,200	By Sales Returns	1,200	2,300
			By Bad Debts	—	6,000
			By Cash A/c (Balancing figure)	85,200	82,400
			By Balance c/d	23,600	34,500
	1,10,000	1,23,200		1,10,000	1,25,200

WHOLESALE BRANCH

Illustration 4.

A head office sends goods to its branch at 20% less than the list price. Goods are sold to customers at cost plus 100%. From the following particulars, ascertain the profit made at the head office :

	Head Office	Branch
	Rs.	*Rs.*
Purchases	2,00,000	—
Goods sent to/Received by Branch (Invoice Price)	80,000	—
Sales to Customers	1,70,000	80,000

Solution :

Dr. Branch Trading Profit and Loss Account *Cr.*

Particulars	*Rs.*	*Particulars*	*Rs.*
To Goods Sent to Branch A/c	80,000	By Salses	80,000
To Retail Profit t/f to Branch P & L A/c (b.f.)	16,000	By Closing Stock [See working note (ii)]	16,000
	96,000		96,000
To Net Profit subject to other Branch Expenses	16,000	By Gross Profit b/d	16,000
	16,000		16,000

Dr. Branch Stock Reserve Account *Cr.*

Particulars	*Rs.*	*Particulars*	*Rs.*
To Balance c/d	6,000	By H.O. P & L A/c (Provision for Unrealised Profit on Closing Stock) (Rs. 16,000×60/160)	6,000
	6,000		6,000

Dr. H. O. Trading and Profit & Loss Account *Cr.*

Particulars	*Rs.*	*Particulars*	*Rs.*
To Purchases	2,00,000	By Sales @ Rs. 200	1,70,000
To Gross Profit t/f to P & L A/c	1,15,000	By Goods sent to whole sale Branch @ Rs. 160	80,000
		By Closing Stock [See Working Note (iii)]	65,000
	3,15,000		3,15,000
To Stock Reserve on Branch Stock (16,000×60/160)	6,000	By Gross Profit b/d	1,15,000
To Net Profit	1,25,000	By Branch P & L A/c	16,000
	1,31,000		1,31,000

Working Notes :

(i) Calculation of Cost-price relationship

	Rs.
Cost Price	100
Add : Wholesale Profit (balancing figure)	60
Wholesale Price	160
Add : Retail Profit (20% of Rs. 200)	40
List Price	200

(ii) Closing Stock at Branch = Opening Stock (at W.P.) + Goods sent (at W.P.) — Wholesale price of goods sold

= Nil + Rs. 80,000 — (80,000 × 160/200) = 16,000

(iii) Closing Stock at H.O. = Opening Stock (at cost) + Purchases (at cost) — Cost of Goods sent to branch — Cost of Goods sold at H.O.
Nil + Rs. 2,00,000 – (Rs. 80,000 × 100/160) —
(Rs. 1,70,000 × 100/200) = Rs. 65,000

Illurstration 5.

Journalise the following transactions in the books of Head Office. Delhi Branch and Agra Branch :

(a) Goods worth Rs. 50,000 are supplied by Delhi Branch to Agra Branch under the instructions of Head Office. (b) Delhi Branch draws a bill receivable for Rs 40,000 on Agra Branch which sends its acceptance. (c) Delhi Branch received Rs 10,000 from Agra Branch. (d) Goods worth Rs. 20,000 were returned by a customer of Agra Branch to Delhi Branch. (e) Agra Branch collected Rs 20,000 from a customer of Delhi Branch.

Solution :

Journal of Head Office

Particulars	L.F.	Dr. (Rs)	Cr. (Rs)
(a) Agra Branch A/c Dr.		50,000	
To Delhi Branch A/c			50,000
(Being the goods supplied by Delhi Branch to Agra Branch)			
(b) Delhi Branch A/c Dr.		40,000	
To Agra Branch A/c			40,000
(Being a B/R drawn by Delhi upon Agra Branch)			
(c) Delhi Branch A/c Dr.		10,000	
To Agra Branch A/c			10,000
(Being Cash sent by Agra Branch to Delhi Branch)			
(d) Delhi Branch A/c Dr.		20,000	
To Agra Branch A/c			20,000
(Being the goods returned by customer of Agra Branch to Delhi Branch)			
(e) Agra Branch A/c Dr.		20,000	
To Delhi Branch A/c			20,000
(Being the Cash collected by Agra Branch from a customer of Delhi Branch			

Journal of Delhi Branch

Particulars	L.F.	Dr. (Rs)	Cr. (Rs)
(a) H.O. A/c Dr.		50,000	
To Goods sent to Branch A/c			50,000
(Being the goods supplied to Agra Branch)			
(b) Bills Receivable A/c Dr.		40,000	
To H.O. A/c			40,000
(Being the acceptance of a B/R received from Agra Branch)			
(c) Cash A/c Dr.		10,000	
To H.O. A/c			10,000
(Being the cash received from Agra Branch)			
(d) Goods Sent to Branch A/c Dr.		20,000	
To H.O. A/c			20,000
(Being the goods received from a customer of Agra Branch)			
(e) H.O. A/c Dr.		20,000	
To Debtors A/c			20,000
(Being the cash collected by Agra Branch from our customer)			

Journal of Agra Branch

Particulars		L.F.	Dr. (Rs)	Cr. (Rs)
(a) Goods sent to Branch A/c	Dr.		50,000	
To H.O. A/c				50,000
(Being the goods received from Delhi Branch)				
(b) H.O. A/c	Dr.		40,000	
To Bill Payable A/c				40,000
(Being a B/P accepted for Delhi Branch)				
(c) H.O. A/c	Dr.		10,000	
To Cash A/c				10,000
(Being cash paid to Delhi Branch)				
(d) H.O. A/c	Dr.		20,000	
To Debtors A/c				20,000
(Being the goods returned by customer of Delhi Branch)				
(e) Cash A/c	Dr.		20,000	
To H.O. A/c				20,000
(Being the Cash received from a customer of Delhi Branch				

Illustration 6.

A Delhi head office passes one entry at the end of each month toadjust the position arising out of inter-branch transactions during the month. From the following inter-branch transactions in April 2008, make the entries in the books of Delhi Head office.

(a) Kolkata Branch :
- (i) Received goods from Patna branch Rs. 9,000 and Ahmedabad branch Rs. 6,000.
- (ii) Sent goods to Ahmedabad branch Rs. 15,000 and Patna branch Rs. 12,000.
- (iii) Sent acceptances to Patna branch Rs. 6,000 and Ahmedabad branch Rs. 3,000.

(b) Kanpur branch [apart from (a) above] :
- (i) Sent goods to Ahmedabad branch Rs. 9,000.
- (ii) Recived B/R from Ahmedabad branch Rs. 9,000.
- (iii) Recived cash from Ahmedabad branch Rs. 5,000.

Solution :

Journal of Head Office

Particulars		L.F.	Dr. (Rs)	Cr. (Rs)
Kanpur Branch A/c	Dr.		12,000	
Nagpur Branch A/c	Dr.		2,000	
To Kolkata Branch A/c				12,000
To Ahmedabad Branch A/c				2,000
(Being the inter-branch transactions record based on the details in statement given below				

Statement of Inter-branch Transactions

Particulars	Kolkata		Kanpur		Patna		Ahmedabad	
	Dr. *Rs*	*Cr.* *Rs*	*Dr.* *Rs*	*Cr.* *Rs*	*Dr.* *Rs*	*Cr.* *Rs*	*Dr.* *Rs*	*Cr* *Rs*
Received Goods	15,000	–	–	–	–	9,000	–	6,000
Goods Sent	–	27,000	–	–	12,000	–	15,000	–
Sent Acceptance	–	9,000	–	–	6,000	–	3,000	–
Goods Sent	–	–	–	9,000	–	–	9,000	–
B/R Recd.	–	–	9,000	–	–	–	–	9,000
Recd. Cash	–	–	5,000	–	–	–	–	5,000
	15,000	36,000	14,000	9,000	18,000	9,000	27,000	20,000
Balance	21,000	–	–	5,000	–	9,000	–	7,000
	36,000	36,000	14,000	14,000	18,000	18,000	27,000	27,000

Kanpur Branch A/c	Dr.	5,000	
Patna Branch A/c	Dr.	9,000	
Ahmedabad Branch A/c	Dr.	7,000	
To Kolkata Branch A/c			21,000

Illustration 7.

Journalise the following transactions in the books of the Head Office.

(a) Goods returned by Thane Branch on 28th March, worth Rs. 10,000 to its Head Office not received by the head office upto 31st March.

(b) Goods worth Rs. 20,000 sent by the Head Office to its Coimbatore Branch on 29th March, were received on 3rd April following.

(c) Rs. 50,000 remitted by Coimbatore Branch to Head Office on 28th March was received on 4th April.

Solution :

Journal of Head Office

Particulars	*L.F.*	*Dr. (Rs)*	*Cr. (Rs)*
(a) Goods-in-transit A/c Dr.		10,000	
To Thane Branch A/c			10,000
(Being the goods returned by Thane Branch not yet received)			
(b) Goods-in-transit A/c Dr.		20,000	
To Coimbatore Branch A/c			20,000
(Being the goods sent to Coimbatore Branch not yet received by Branch)			
(c) Cash-in-transit A/c Dr.		50,000	
To Coimbatore Branch A/c			50,000
(Being the Cash sent by Coimbatore Branch not yet received)			

FOREIGN BRANCH

Illustration 8.

How will you translate the following items of the SingaporeBranch as on 31.03.2008.

Opening Stock $ 4,100, Goods from H. O. $ 29,400, Salaries & Wages $ 7,600, Sales $ 52,600, Closing Stock $ 1,200, Goods sent to London Branch in the H. O. Books amounted to Rs. 10,73,100, Exchanges Rates : on 1.4.2008 $ 1 = Rs. 26.40, on 31.03.2009 $ 1 = Rs. 42.20, Average of 2007-2008 $ 1 = Rs. 36.50 (Here, $ refers to Singapore Dollars)

Solution :

Statement showing the Translation into Rupees

Item	*$*	*Relevant Exchange Rate*	*Translated value in Rs.*
Opening Stock	4,100	Opening Rate as on 1.4.2008	4,100×Rs. 26.40 = Rs. 1,08,240
Goods from H.O.	29,400	To be taken at the Rupee	
		Value recorded in H.O. Books	Rs. 10,73,100
Salaries & Wages	7,600	Average Rate of 2007-2008	7,600 ×Rs. 36.50 = Rs. 2,77,400
Sales	52,600	Average Rate of 2007-2008	52,600×Rs. 36.50 = Rs. 19,19,900
Closing Stock	1,200	Closing Rate as on 31.3.2009	1,200 × Rs. 42.20 = Rs. 50,640

Illustration 9. How will you translate the following items of Singapore Branch for the year 2007-08:

Fixed Assets as on 31.3.2008 $ 70,000, Balance of Loan (taken to purchase the fixed Assets) on 31.3.2008 $ 52,000, Depreciation as on 31.3.2008 $ 10,000, Interest paid during 2008 $ 11,520.

Fixed Assets having useful life of 10 years were purchased for $ 1,00,000 on 1.4.2005 after taking a loan of $ 88,000 @ 18% interest p.a. Annual loan installment of $ 12,000 and interest were paid on 31st March each year. Exchange Rate 1.4.2005 $ 1 = Rs. 25.50, Average of 2005-06 $ 1 = 25.70, 31.3.2006 $ 1 = Rs. 26.10, Average of 2006-07 $ 1 = Rs. 26.20, 31.3.2007, $ 1 = Rs. 26.40, Average of 2007-08 $ 1 = Rs. 36.50, 31.3.2008, $ 1=Rs.42.20

Solution :

Statement showing the Translation of Fixed Assets and Depreciation

Particulars	2005-06 Rs.	2006-07 Rs.	2007-08 Rs.
A Book Value in the beginning of the year	25,50,000	23,42,520	21,02,507
B *Add* : Adjustment for increase in Foreign Currency liabilities 10,11,200	52,800		22,800
[Amount of outstanding Loan × (Closing Rate – Opening Rate)]			
C Adjusted Book Value of Fixed Assets (A+B)	26,02,800	23,65,320	31,13,707
D *Less* : Depreciation on Adjusted Book Value	2,60,280	2,62,813	3,89,214
(Adjusted Book Value/Remaining Useful life)			
E Adjusted Book Value of Fixed Assets at the end (C–D)	23,42,520	21,02,507	27,24,493

Statement showing the Translation of Long-term Loan and Interest

Particulars	*2005-06* *Rs.*	*2006-07* *Rs.*	*2007-08* *Rs.*
A Outstanding Long-term Loan in the beginning of the year (in foreign currency)	$ 88,000	$ 76,000	$ 64,000
B *Less* : Principal portion of the instalment paid (in foreign currency)	$ 12,000	$ 12,000	$ 12,000
C Outstanding Long-term Loan at the end of the year (in foreign currency) [A–B]	$ 76,000	$ 64,000	$ 52,000
D Outstanding Long-term Loan at the end of the year (in Indian Rupees) [O/s Long-term Loan (in foreign currency) × Closing Rate]	19,83,600	16,89,600	21,94,400
E Interest on outstanding Long-term Loan in the beginning (in foreign currency) [O/s Long-term Loan (in foreign currency) × 18%]	$ 15,840	$ 13,680	$ 11,520
F Interest on outstanding Long-term Loan in the beginning (in Indian Rupees) [Interest in foreign currency × Average Rate]	4,07,088	3,58,416	4,20,480

Illustration 10. A merchant of Kolkata opens a new branch in Mathura, which trades independently of the Head Office. The transactions of the Branch for the year-ended 31.3.2009 are as under :

Particulars	Rs.	Rs.
Goods supplied by Head Office		20,00,000
Purchases from outsiders :		
— Credit	15,55,000	
— Cash	3,00,000	18,55,000
Sales :		
— Credit	25,05,000	
— Cash	4,60,000	29,65,000
Cash received from Customers		30,45,000
Trade Creditors Paid		14,25,000
Expenses paid by Branch		8,95,000
Furniture purchased by Branch on credit		3,50,000
Cash received from Head Office initially		4,00,000
Remittances to Head Office		11,00,000

Prepare the Branch Final Accounts and the Branch Account in the Head Office Books on incorporation of the Branch Trial Balance in the Head Office Books, after taking the following into consideration :

1. The account of the Branch Fixed Assets are maintained in the Head Office books.
2. Write off depreciation on furniture at 5 percent per annum for full year.
3. A remmittance of Rs. 2,00,000 from the Branch to the Head Office is in transit.
4. The Branch value its closing stock at Rs. 12,00,000.

Solution :

IN BRANCH BOOKS

1. Trading and Profit and Loss Account for year ending 31.3.2009

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Goods Supplied by HO		20,00,000	By Sales :		
— Credit	15,55,000		— Credit	25,00,000	
— Cash	3,00,000	18,55,000	— Cash	4,60,000	29,65,000
To Gross Profit c/d		3,10,000	By Closing Stock		12,00,000
Total		41,65,000	Total		41,65,000
To Expenses		8,95,000	By Gross Profit b/d		3,10,000
To Depreciation on Furniture		17,500	By HO — Transfer of net loss		6,02,500
Total		9,12,500	Total		9,12,500

2. Branch Cash Account

Particulars	Rs.	Particulars	Rs.
To Head Office (initial Receipt)	4,00,000	By Cash Purchases	3,00,000
To Cash Sales	4,60,000	By Trade Creditors	14,25,000
To Tade Debtors	30,45,000	By Expenses	8,95,000
		By Head Office A/c	11,00,000
		— Rmittance	
		By Balance c/d	1,85,000
Total	39,05,000	Total	39,05,000

3. Head Office Account

Particulars	Rs.	Particulars	Rs.
To Creditors for Furniture	3,50,000	By Cash (Initial Receipt)	4,00,000
To Cash (remittance)	11,00,000	By Goods received	20,00,000
To Profit & Loss A/c	6,02,500	from HO A/c	
(Loss for the Year)		By Depreciation on Furniture	17,500
To Balance c/d	5,65,000	By Cash in Transit	2,00,000
— balancing			
Total	26,17,500	Total	26,17,500

4. Balance Sheet as on 31.3.2009

Particulars	Rs.	Particulars	Rs.
Sundry Trade Creditors	1,30,000	Closing Stock	12,00,000
(Rs. 15,55,000 - Rs. 14,25,000)			
Creditors for Furniture	3,50,000	Cash in Transit	2,00,000
Advances from Trade Debtors	5,40,000	Cash in Hand	1,85,000
(Rs. 30,45,000–Rs. 25,05,000)		(As per Cash Book)	
Head Office A/c	5,65,000		
Total	15,85,000	Total	15,85,000

IN THE BOOKS OF HEAD OFFICE

Mathura Branch Account

Particulars	Rs.	Particulars	Rs.
To Cash (Initial Investment)	4,00,000	By Branch Furniture	3,50,000
To Goods Sent to Branch A/c	20,00,000	By Cash (Remmittance	9,00,000
To Depreciation on Branch	17,500	(1100000 – Transit 200000)	
Furniture		By Branch Trading A/c	
To Branch Trading A/c		— Purchase	18,50,000
— Sale of Goods	29,65,000	— Goods Supplied by HO	20,00,000
— Closing Stock	12,00,000	By Branch P&L A/c	9,12,500
To Branch Trade Creditors	1,30,000	(for Expenses and Branch	
To Branch Creditors for Furniture	3,50,000	Furniture Depreciation)	
		By Branch Stock	12,00,000
To Branch Trade Debtors (Advances)	5,40,000	By Branch Cash	1,85,000
		By Cash in Transit	2,00,000
Total	76,02,500	Total	76,02,500

Illustration 11. The Head Office of Z Ltd. and its Branch keep their own books prepare own Profit and Loss Account. The following are the balances appearing in teh two sets of the books as on 31.3.2009 after ascertainment of profits and after making all adjustments except those referred to below :

Particulars	Head Office		Branch Office	
	Dr.	Cr.	Dr.	Cr.
Capital	—	1,00,000	—	—
Fixed Assets	36,000	—	16,000	—
Stock	34,200	—	10,740	—
Debtors & Creditors	7,820	3,960	4,840	—
Cash	10,740	—	1,420	—
Profit & Loss	—	14,660	—	3,060
Branch Account	29,860	—	—	—
Head Office Account	—	—	—	28,020
Total	1,18,620	1,18,620	33,000	33,000

Prepare the Balance Sheet of the business as on 31.3.2009 and the journal entries necessary (in both sets of books) to record the adjustments dealing with the following :

1. On 31.3.2009, the branch had sent a cheque for Rs. 1,000 to the head office, not received by them nor credited to the branch till next month.

2. Goods valued at Rs. 440 had been forwarded by the head office to the branch and invoiced on 30.3.2009, but were not received by the branch nor dealt with in their books till next month.
3. It was agreed that the branch should be charged with Rs. 300 for Administration Services, rendered by the Head Office during the year.
4. Stock stolen in transit from the Head Office to the Branch and charged to the Branch by the Head Office but not credited to the Head Office in the Branch Books as the Manager declined to admit any liability, Rs. 400 (not covered by insurance).
5. Depreciation of Branch Assets, of which accounts are maintained by the Head Office, not provided for Rs. 250.
6. The balance of Profits shown by the Branch is to be transferred to HO Books.

Solution :

1. Balance Sheet of Z Ltd. as at 31.03.2009

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital		1,00,000	Fixed Assets :		
Add : Net Profit of :			—Head Office	36,000	
—Head Office	14,560		—Branch	16,000	
—Branch	2,510	1,17,070	Less : Depreciation	(250)	51,750
Creditors :			Stock :		
—Head Office	3,960		—Head Office	34,200	
—Branch	1,920	5,880	—Branch	10,700	45,380
			Debtors :		
			—Head Office	7,820	
			—Branch	4,840	12,660
			Cretors :		
			—Head Office	10,740	
			—Branch	1,420	
			—In Transit	1,000	13,160
Total		1,22,950	Total		1,22,950

2. Journal Entries in the books of Head Office

S. No.	Particulars	Dr.	Cr.
1	Goods in Transit A/c Dr. To Branch A/c (Being the goods invoiced on 30.3.2009 not yet received by the branch as the Balance Sheet date)	440	 440
2	Branch A/c Dr. To Profit & Loss A/c (Being amount of Administrative Services rendered by the HO to the Branch)	300	 300
3	Profit & Losss A/c Dr. To Branch A/c (Being the amount of uninsurd stock stolen on way to Branch)	400	 400
4	Branch A/c Dr. To Branch Fixed Assets (Being depreciation on Branch Fixed Assets for which accounts are maintained in the Head Office books)	250	 250
5	Branch Profit & Loss A/c Dr. To Profit & Loss A/c (Being Profit shown by the Branch Profit & Loss Account transferred to (General) Profit & Loss Account)	2,510	 2,510

3. Head Office Profit and Loss Account

Particulars	Rs.	Particulars	Rs.
To Branch — Uninsured Stock stolen	400	By Balance b/d	14,660
To Profit—Transferred	14,560	By Branch Administration Expenses	300
Total	3,060	Total	3,060

4. Journal Entries in the books of Branch Office

S. No.	Particulars	Dr.	Cr.
1	Cash in Transit A/c Dr. To Head Office A/c (Being cash sent on 31.3.2009 not yet received by the HO)	1,000	 1,000
2	Profit & Loss A/c Dr. To Head Office A/c (Being administrative services rendered by the Head Office)	300	 300
3	Profit & Loss A/c Dr. To Head Office A/c (Being depreciation on Branch Fixed Assets for which accounts are maintained in the Head Office books)	250	 250
4	Profit & Loss Account Dr. To Head Office A/c (Bieng profit transferred to Head Office Account)	2,510	 2,510

5. Branch Profit and Loss Account

Particulars	Rs.	Particulars	Rs.
To HO A/c–Administrative Services	300	By Balance b/d	3,060
To HO A/c–Depn. on Branch Assets	250		
To Profit–Transferred to HO Account	2,510		
Total	3,060	Total	3,060

EXERCISE

Problem 1. The following information and particulars relate to Bangalore Branch for the year 2007-2008.

	31.3.2007	*31.3.2008*
Stock	Rs 50,000	Rs.75,000
Debtors	Rs.70,000	Rs.95,000
Petty Cash	Rs. 250	Rs. 120

Goods costing Rs. 5,50,000 were sold by the Branch @25% on cost. Cash sales amounted to Rs. 1,50,000 and the rest were credit sales. Branch spent Rs. 30,000 for Salaries, Rs. 12,000 for Rent and Rs. 8,000 for Petty expenses. All expenses were remitted by H.O. Branch receives all goods from H.O. Show the Bangalore Branch Account.

[Net Profit Rs. 87,500, Total Sales Rs. 6,87,500 ; Credit Sales Rs. 5,37,500]

Problem 2. From the folloing details relating to the Delhi Branch for the year ending on 31st March 2008, prepare the Branch Account in the books of the Head Office.

	Rs.		***Rs.***
Opening Stock	25,000	Cash received from Debtors	65,000
Opening Debtors	10,000	Cash paid by Debtors directly to H.O.	5,000
Opening Furniture	6,000	Closing Stock	15,000
Opening Petty Cash	1,000	Goods returned by Branch	2,000
Prepaid Insurance in the begnning	300	Goods returned by Debtors	1,000
Salaries outstanding in the beginning	4,000	Cash sent to Branch for Expenses :	
Goods sent to Branch	2,00,000	Rent (Rs. 800 p.m.)	9,600
Cash Sales during the year	2,70,000	Salary (Rs. 4,000 p.m.)	48,000
Total Sales	3,50,000	Petty Cash	2,000
Petty Cash Expenses	2,200	Insurance (upto June, 2008)	1,200
Discount allowed to Debtors	500		

Good costing Rs. 2,500 were damaged in transit and a sum of Rs. 2,000 was recovered from the insurance company in full settlement of the claim. Depreciate the Furniture @ 10%. p.a.

[Net Profit Rs. 80,900]

Problem 3. Orissa had office supplies goods to its Kalikut Branch at invoice price which is cost plus 50%. All cash received by branch is remitted to H. O. and all branch expenses are paid by the head office. From the following particulars related to Kalikut branch for the year 2008. prepare Kalikut Branch Account.

	Rs.				Rs.
Opening Stock at Branch	60,000	Discount allowed to Debtors			2,400
Opening Branch Debtors	12,000	Expenses (Cash paid by Head Office):			
Opening Petty Cash Balance	10	Head Office):			
Goods received from Head office	1,86,000	Rent	Rs.	2,400	
Goods returned to Head office	3,000	Salaries	Rs.	24,000	
Allowance to Customer off		Petty Cash	Rs.	1,000	27,400
Selling Price		Cash Sales			1,04,000
(already adjusted while invoicing)	1,000	Closing Petty Cash Balance			100
Cash received from Debtors	90,000	Closing Branch Debtors			3,600

Net Profit Rs. 32,200; Credit Sales Rs. 84,000; Closing Stock Rs. 54,000.

Problem 4. Rosy (India) Ltd. of Delhi operates a retail branch at Madras. The head office make all the purchases and the branch is charged at cost price plus 50%. All cash received by the Madras branch is remitted to Delhi. Branch expenses are paid by the branch out of an imprest account which is reimburses by Delhi H.O. monthly.

The branch keeps a sales ledger and certain essential subsidiary book, but otherwise all branch transactions are recorded at Delhi. On 1st April, 2007 stock in trade at the branch at selling price amounted to Rs. 6,000 and debtor's balance were Rs. 4,000

During the year ended 31st March 2008, the following branch transactions were made.

	Rs.		Rs.
Good received from Delhi	15,000	Cash received from debtors	4,800
Cash Sales	6,900	Debtors written off as irrecoverable	250
Goods returned to Delhi	300	Cash Discounts allowed to debtors	100
Closing Debtors	5,150		
Authorised reductions in selling price of goods sold	150		

A consignment of goods despatched so the branch on 28th March, with a selling price of Rs. 180 was not received until, 5th April, and had not been included in stock figure, which at selling price was 7,290. The expense relating to the branch for the year ended 31st March 2008 amounted to Rs. 1,800.

You are required: (a) to write up the Branch stock account and Branch debtors account maintained at Delhi with a view to control stock and debtors, and (b) to prepare the trading and profit and loss account of the branch for the year ended 31st March, 2008.

Note : Any stock unaccounted for is to be regarded as normal wastage and pilferage.

Net Profit Rs. 2,110; Credit Sales Rs. 6,300; Branch Adjustment for Normal Loss Rs. 60.

Problem 5. Subhas Electrical has its branches at Chandigrah and Gwalior to whom goods are invoiced at cost plus 25%. Following information is avaliable of the transactions at Chandigarh Branch for the year ending 31st March. 20X2.

Balances	***As at 1.4.2007***	***As at 31.3.2008***
	Rs.	***Rs.***
Stock at invoice price	40,000	?
Debtors	12,000	11,000
Petty Cash	150	250

Transactions during 2007-08:	***Rs.***
Goods sent to branch	4,20,000
Goods returned to Head Office	15,000
Cash Sales	1,05,000
Credit Sales	1,80,000
Normal Loss (at cost)	280
Goods pilfered (at invoice price)	3,000
Goods lost in fire (at invoice price)	4,000
Insurance company paid to Head Office for loss by fire at Gwalior 3,000	
Cash sent for petty expenses	32,000
Bad debts at Gwalior Branch	400
Goods transferred to Pune Branch under instructions from Head Office at invoice price	200
Insurance charges paid by Head Office.	12,000
Goods returned by debtors	500

Note : Goods transferred to Pune Branch (given above) were in transit on 31st March 20X2. Propare : (i) Branch Stock Account; (ii) Branch Adjustment Account; (iii) Branch Profit and Loss Account; and (iv) Stock Reserve Account.

[Net Profit : Branch Stock Rs. 1,41,150; Gross Profit Rs. 56,620; Net Profit Rs. 21,520]

Problem 6. Ltd. sends goods to its Madras Branch at cost plus 25 per cent. The following particulars are available in respect of the Branch for the year ended 31st March. 20X1.

	Rs.		***Rs.***
Opening Stock at Branch at coat to Branch	80,000	Closing stock at branch at cost to Branch	40,000
Loss-in-transit at invoice price	15,000	Expenses	60,000
Pifferage at invoice price	6,000	Sales	12,19,000
Recovered from Insurnace Company against loss-in-transit	10,000		

Prepare (a) Branch Stock Account (b) Branch Adjustment Account (c) Branch Profit and Loss Account (d) Goods sent to Branch Account.

[Net Profit : Rs. 2,43,800; Net Profit Rs. 1,77,000]

5.2. DEPARTMENTAL ACCOUNTS

Introduction :

Departmental Accounts helps in identifying the performance of each department. Each department is considered to be an Activity Centre. It is a tool which helps management in decision-making.

Departmentation offers the following advantages —

a. Proper Allocation : Expenses that relate to a particular department are estimated on an exact basis. Hence, cost and profits of each department is estimated more accurately.
b. Control : Availability of separate cost and profit figures for each department facilitates control. Proper control and fixation of responsibility is easier.
c. Proper absorption : The processing times of different products in different departments may vary. Specific cost analysis on a department-wise basis facilitates scientific cost absorption and cost assignment. This provides the right platform for product- pricing decisions also.

Bases of Appointment of Expenses :

Nature of Expense	Treatment	Examples
Specific Charge	When a certain expense is specifically incurred for one department, it should be charged in full to that department only.	• Depreciation of machinery on value of machinery; • Insurance on stock on the value of stock.
Shared Common Expenses	When benefits of certain expenses are shared by all departments and are capable of precise allocation, they should be apportioned to all depart-ments on an appropriate and equitable basis.	• Rent is apportioned based on Floor Space occupied by each department. • Lighting Expenses is apportioned basis of on the number of light points (or) on the basis of floor area. • Canteen subsidy on the basis of No. of workers.
General Expenses	Common expenses which are not capable of accurate apportionment to various departments are dealt with judiciously, based on facts and circumstances of each case.	• Administration Expenses like Office Salaries may be apportioned equally among all departments or alternatively debited to General P&L Account. • Selling and Distribution Expenses may be apportioned based on Sales ratio.

Inter-Departmental Transfer :

1. Methods of Transfer Pricing : Transfers made by one department to another may be recorded either at (a) Cost or (b) Market Price or (c) any other appropriate method e.g. Cost + Agreed Profit Mark Up.

2. Accounting : When transfers are made, their value should be credited as Income of the Transferring Department and debited as cost of the Recipient Department. When profit is added in the inter-departmental transfers, the loading (unrealised profit) included in the Closing Stock should be reversed, by debiting the General P&L Account and crediting Stock Reserve Account.

Illustrations 1 :

Snow White Ltd has two departments — Cloth and Readymade Clothes. Ready Made Clothes are made by the Firm itself out of cloth supplied by the Cloth Department at its usual selling price. From the following figures, prepare Departmental Trading and Profit and Loss Accounts for the year ended 31st March :

Particulars	Cloth Dept	Readymade Clothes
Opening Stock on 1st April	3,00,000	50,000
Purchases	20,00,000	15,000
Sales	22,00,000	4,50,000
Transfer to Readymade Clothes Department	3,00,000	—
Expenses -Manufacturing	—	60,000
Selling	20,000	6,000
Closing Stock on 31st March	2,00,000	60,000

The Stock in the Readymade Clothes Department may be considered as consisting of 75% Cloth and 25% other expenses. The Cloth Department earned Gross Profit at the rate of 15% during the year. General Expenses of the business as a whole came to Rs.1,10,000.

Solution :

Dr. Departmental Trading and Profit and Loss A/c for the year ending 31st March (Rs.) Cr.

Particulars	Cloth	RM	Total	Particulars	Cloth	RM	Total
To Opg. Stock	3,00,000	50,000	3,50,000	By Sales	22,00,000	4,50,000	26,50,000
To Purchases	20,00,000	15,000	20,15,000	By Tfr. to RM	3,00,000	—	3,00,000
To Tfr from Cloth Dept.	—	3, 00,000	3,00,000	By Closing Stock	2,00,000	60,000	2,60,000
To Mfg. Exps.		60,000	60,000				
To Gross Profit	4, 00,000	85,000	4,85,000				
Total	27,00,000	5,10,000	32,10,000	Total	27,00,000	5,10,000	32,10,000
To Selling Exp.	20,000	6,000	26,000	By Gross Profit	4,00,000	85,000	4,85,000
To Profit c / d	3,80,000	79,000	4,59,000				
Total	4,00,000	85,000	4,85,000	Total	4,00,000	85,000	4,85,000
To Gen. Exp.			1,10,000	By Profit b / d			4,59,000
To Stock Reserve (See Note below)			1,575				
To Net profit			3,47,425				
Total			4,59,000	Total			4,59,000

Note 1 : Stock Reserve to be additionally provided is 7,200 – 5,625 = Rs. 1,575; calculated as under :

Particulars	On Opg Stock	On Closing Stock
Rate of GP on Sales in Cloth Dept	Given = 15%	4,00,000 ÷ 25,00,000 = 16%
Element of Cloth Stock in Readymade Clothes	75% of 50,000 = 37,500	75% of 60,000 = 45,000
Stock Reserve required to be maintained	37,500 × 15% = 5,625	45,000 × 16% = 7,200

Note 2: In this case, it is possible to ascertain the Reserve already created against Unrealised Profit in the Opening Stock. In the absence of information, the Reserve should be calculated on the difference in the Opening and Closing Stocks i.e. Rs. 10,000 in this question. Since the Closing Stock has increased, the Reserve calculated would be debited to P&L A/c. In case of decrease in Stocks, the Reserve would be credited to P&L A/c.

Illustration 2 :

The Trading and Profit & Loss Account of Bindas Ltd. for the year ending 31st March is as under :

Purchases	Rs.	Sales	Rs.
Transistors (A)	1,60,000	Transistors (A)	1,75,000
Tape Recorders (B)	1,25,000	Tape Recorders (B)	1,40,000
Spare parts for servicing and repair job (C)	80,000	Servicing and repair jobs (C)	35,000
Salaries and wages	48,000	Stock on 31st March Transistors (A)	60,100
Rent	10,800	Tape Recorders (B)	20,300
Sundry Expenses	11,000	Spare parts for servicing & repair jobs	44,600
Net Profit	40,200		
Total	4,75,000	Total	4,75,000

Prepare Departmental Accounts for each of the three Departments A, B and C mentioned above after taking into consideration the following :

(a) Transistors and Tape Recorders are sold at the Showroom. Servicing and Repairs are carried out at the Workshop.

(b) Salaries and wages comprise as follows: Showroom 3/4th and Workshop 1/4th

It was decided to allocate the Showroom Salaries and Wages in ratio 1:2 between Departments A and B.

(c) Workshop Rent is Rs.500 per month. Showroom Rent is to be divided equally between Departments A and B.

(d) Sundry Expenses are to be allocated on the basis of the turnover of each Department.

Solution :

Dr. Departmental P&L Accounts for the year ending 31st March (Amount in Rs.) Cr.

Particulars	A	B	C	Particulars	A	B	C
To Purchases	1,60,000	1,25,000	—	By Sales	1,75,000	1,40,000	—
To Spares	—	—	80,000	By Services	—	—	35,000
To Sal. & Wages	12,000	24,000	12,000	By Closing Stock	60,100	20,300	44,600
To Rent	2,400	2,400	6,000	By Net Loss			19,500
To Sundry Exps.*	5,500	4,400	1,100				
To Net Profit	55,200	4,500					
Total	2,35,100	1,60,300	99,100	Total	2,35,100	1,60,300	99,100

Note : Sundry Expenses are apportioned in the ratio of Turnover (5: 4: 1) i.e. 1,75,000: 1,40,000: 35,000.

Illustration 3 :

Samudra & Co, a Partnership Firm has three departments viz. K, L, M which are under the charge of the Partners B, C and D respectively. The following Consolidated P&L Account is given below :

Dr. Cr.

Particulars		Rs.	Particulars		Rs.
To Opening Stocks	(Notel)	81,890	By Sales	(Note 7)	4,00,000
To Purchases	(Note 2)	2,65,700	By Closing Stocks	(Note 8)	89,000
To Salaries and Wages	(Note 3)	48,000	By Discounts Received	(Note10)	800
To Rent Expenses	(Note 4)	10,800			
To Selling Expenses	(Note 5)	14,400			
To Discount Allowed	(Note 5)	1,200			
To Depreciation	(Note 6)	750			
To Net Profit for the year		67,060			
Total		4,89,800	Total		4,89,800

From the above Account and the following additional information, prepare the Departmental P&L Accounts for the year ended 31st March -

1. Break up of Opening Stock Department wise is: K - Rs.37,890; L - Rs.24,000 and M - Rs. 20,000.
2. Total Purchases were as under: K - Rs.1,40,700; L - Rs.80,600; M - Rs.44,400.
3. Salaries and Wages include Rs. 12,000 wages of Department M. The balance Salaries should be apportioned to the three departments as 4:4:1.
4. Rent is to be apportioned in the ratio of floor space which is as 2:2:5.
5. Selling Expenses and Discount Allowed are to be apportioned in the ratio of Turnover.
6. Depreciation on assets should be equally charged to the three departments.
7. Sales made by the three departments were: K - Rs.1,80,000; L - Rs.1,30,000 and M - Rs.90,000.
8. Break up of Closing Stock Department wise is: K - 45,100; L - Rs.22,300 and M - Rs.21,600. The Closing Stock of Department M includes Rs.5,700 goods transferred from Department

K. However, Opening Stock does not include any goods transferred from other departments.

9. Departments K and L sold goods worth Rs.10,700 and Rs.600 respectively to Department M.
10. Discounts received are traceable to Departments K, L and M as Rs.400; Rs.250 and Rs.150 respectively.
11. Partners are to share the profits as under: (a) 75% of the Profits of Departments K, L and M to the respective Partner in Charge, (b) Balance Profits to be credited as 2:1:1.

Solution :

Dr. 1. Departmental P&L Accounts for the year ending 31st March (Amount in Rs.) Cr.

Particulars	K	L	M	Particulars	K	L	M
To Opening Stock	37,890	24,000	20,000	By Sales	1,80,000	1,30,000	90,000
To Purchases	1,40,700	80,600	44,400	By Transfer	10,700	600	—
To Inter-Dept Trf	—	—	11,300	By Closing Stock	45,100	22,300	21,600
To Wages	—	—	12,000				
To Gross Profit c/d	57,210	48,300	23,900				
Total	2,35,800	1,52,900	1,11,600	Total	2,35,800	1,52,900	1,11,600
To Salaries (4:4:1)	16,000	16,000	4,000	By Gross Profit b/d	57,210	48,300	23,900
To Rent (2:2:5)	2,400	2,400	6,000				
To Selling Exp	6,480	4,680	3,240	By Discounts reed	400	250	150
To Disc. (18:13:9)	540	390	270				
To Depreciation	250	250	250				
To Net Profit c/d	31,940	24,830	10,290				
Total	57,610	48,550	24,050	Total	57,610	48,550	24,050

2. Computation of Stock Reserve

From the above profits, Stock Reserve should be eliminated on the Closing Stock.

- GP Rate in Department K = 57,210 - 1,90,700 = 30%.
- Stock Reserve = 30% on Rs.5,700 = Rs.1,710.

Dr. 3. Profit and Loss Appropriation Account (Rs.) Cr.

Particulars	Rs.	Particulars	Rs.
To Stock Reserve	1,710	By Profit b/d	67,060
To Profits transferred to Capital:		(31940 + 24830 +10290)	
B : 75% of 31,940 = 23,955			
C : 75% of 24,830 = 18,623			
D : 75% of 10,290 = 7,718	50,296		
To balance profits trfd in 2: 1: 1			
B : 50% of 15,054 = 7,527			
C : 25% of 15,054 = 3,764			
D : 25% of 15,054= 3,764 (bal.fig)	15,054		
Total	67,060	Total	67,060

Illustration 4 :

Anand Ltd, has 3 departments X, Y and Z The following information is provided:

Particulars	X	Y	Z
Opening Stock	3,000	4,000	6,000
Consumption of direct materials	8,000	12,000	—
Wages	5,000	10,000	—
Closing Stock	4,000	14,000	8,000
Sales	—	—	34,000

Stocks of each Department are valued at cost to the Department concerned. Stocks of X are transferred to Y at a margin of 50% above Department cost. Stocks of Y are transferred to Z at a margin of 10% above departmental cost.

Other expenses were :

Salaries	2,000
Printing and Stationery	1,000
Rent	6,000
Interest paid	4,000
Depreciation	3,000

Allocate expenses in the ratio of Departmental Gross Profits. Opening figures of reserves for unrealised profits on departmental stocks were: Department Y-Rs.1,000; Department Z-Rs.2,000. Prepare Departmental Trading and Profit and Loss Account for the year.

Solution :

Dr. 1. Departmental Trading Account for the year (Rs.) Cr.

Particulars	X	Y	Z	Total	Particulars	X	Y	Z	Total
To Opening Stock	3,000	4,000	6,000	13,000	By Internal Transfer	18,000	33,000	—	51,000
To Direct Material	8,000	12,000	—	20,000	By Sales	—	—	34,000	34,000
To Wages	5,000	10,000	—	15,000	By Closing Stock	4,000	14,000	8,000	26,000
To Intl. Transfer	—	18,000	33,000	51,000					
To Gross Profit	6,000	3,000	3,000	12,000					
Total	22,000	47,000	42,000	1,11,000	Total	22,000	47,000	42,000	1,11,000

Dr. 2. Departmental Profit and Loss Account for the year (Rs.) Cr.

Particulars	X	Y	Z	Total	Particulars	X	Y	Z	Total
To Salaries	1,000	500	500	2,000	By Gross Profit b / d	6,000	3,000	3,000	12,000
To Prntg. & Stnry.	500	250	250	1,000	By Net loss	2,000	1,000	1,000	4,000
To Rent	3,000	1,500	1,500	6,000					
To Interest paid	2,000	1,000	1,000	4,000					
To Depreciation	1,500	750	750	3,000					
Total	8,000	4,000	4,000	16,000	Total	8,000	4,000	4,000	16,000

3. Calculation of Unrealised Profit on Closing Stock of Dept Y

Particulars	Department Y
Value of Closing Stock as given above	14,000
Total Cost of the Department	12,000 + 10,000 + 18,000 = 40,000
Cost of Internal Transfer in above	18,000
Value of Transferred Material in Closing Stock	14,000 × 18,000 / 40,000 = 6,300
Unrealised Profit of Dept X included in above	6,300 × 50/150 = 2,100

4. Calculation of Unrealised Profit on Closing Stock of Dept Z

Particulars	Department Z
Value of Closing Stock as given above	8,000
Profits of Department Y included in above	10% Margin = 8,000 x 10/110 =727
Profits of Department X included in above	(8,000 – 727)×18,000/40,000×50/150 = 1,091
Total Unrealised Profit included in Dept Z Stock	1,818

Dr. 5. Adjustment of Reserves on Opening and Closing Stocks Cr.

Particulars	Rs.	Particulars	Rs.
To Net Loss b/d	4,000	By Reserve on Opening Stock (1000 + 2000)	3,000
To Reserve on Closing Stock	3,918	By Net Loss after adjustment of Reserves	4,918
Total	7,918	Total	7 918

Illustration 5 :

Pooma Ltd. has 2 departments M & S. From the following particulars, prepare Departmental Trading Account & Consolidated Trading Account for the year ending 31st March.

Particulars	M	S
Opening Stock	20,000	12,000
Purchases	92,000	68,000
Carriage Inwards	2,000	2,000
Wages	12,000	8,000
Sales (excluding inter departmental transfers)	140,000	112,000
Purchased Goods transferred		
By S to M	10,000	—
By M to S	—	8,000
Finished Goods transferred		
By S to M	35,000	—
By M to S	—	40,000
Return of Finished Goods		
By M to S	10,000	—
By S to M	—	7,000
Closing Stock		
Purchased Goods	4,500	6,000
Finished Goods	24,000	14,000

Purchased Goods have been transferred at their respective departmental Purchase Cost & Finished Goods at Departmental Market Price. 20% of Finished Stock (Closing) at each Department represented Finished Goods received from the other Department.

Solution :

Dr. 1. Departmental Trading, Profit & Loss Account for the year ended 31st March Cr.

Particulars	M	S	Particulars	M	S
To Opening Stock	20,000	12,000	By Sales	140,000	112,000
To Purchases	92,000	68,000	By Transfer:		
			Purchased Goods	8,000	10,000
			Finished Goods	35,000	40,000
To Transfer :			By Closing Stock		
Purchased Goods	10,000	8,000	Purchased Goods	4,500	6,000
Finished Goods	40,000	35,000	Finished Goods	24,000	14,000
To Wages	12,000	8,000	By Return of	10,000	7,000
To Carriage Inwards	2,000	2,000	Finished Goods		
To Return of Finished Goods	7,000	10,000			
To Gross Profit	38,500	46,000			
Total	221,500	189,000	Total	221,500	189,000

2. Calculation of Gross Profit Ratio

Particulars	M	S
Sales	140,000	112,000
Add: Transfer of Finished Goods	35,000	40,000
Less: Return of Finished Goods	(7,000)	(10,000)
Net Sales [A]	168,000	142,000
Gross Profit [B] as calculated below	38,500	46,000
Gross Profit Ratio [B ÷ A]	22.9%	32.4%

Dr. 3. Consolidated Trading Account for the year ended 31st March Cr.

Particulars	Amount	Particulars	Amount
To Opening Stock	32,000	By Sales (1,40,000+1,12,000)	2,52,000
To Purchases	160,000	By Closing Stock	
To Wages	20,000	By Purchase Goods 10,500	
To Carriage Inwards	4,000	By Finished Goods 38,000	48,500
To Stock Reserve			
[24,000×20%] × 32.4%	1,555		
[14,000×20%] × 22.9%	641		
To Net Profit	82,304		
Total	300,500	Total	300,500

Illustration 6 :

Khushi & Co has 2 departments A & B. Department A sells goods to Department B at normal selling prices. From the following particulars prepare Departmental Trading & Profit & Loss Account for the year ended 31st March & also ascertain the Net Profit to be transferred to Balance Sheet.

Particulars	A	B
Opening stock	NIL	1,00,000
Purchases	2,00,000	23,00,000
Goods from Department B	7,00,000	—
Wages	1,60,000	1,00,000
Travelling Expenses	1,40,000	10,000
Closing stock at cost to the Department	1,80,000	5,00,000
Sales	15,00,000	23,00,000
Printing & Stationery	16,000	20,000

The following expenses incurred for the both departments were not apportioned between the departments :

Particulars	Amount
Salaries	2,70,000
Advertisement Expenses	90,000
General Expenses	8,00,000

Depreciation should be charged at 25% on the machinery value of Rs.48,000. Advertisement Expenses are to be apportioned in the turnover ratio, Salaries in 1:2 ratio & Depreciation in 1:3 ratio between Departments A & B. General Expenses are to be apportioned in 1:3 ratio.

Solution :

1. Departmental Trading, P&L Account of Khushi & Co for the year ended 31st March

Dr. (Rs.) Cr.

Particulars	A	B	Particulars	A	B
To Opening Stock		1,00,000	By Sales	15,00,000	23,00,000
To Purchases	2,00,000	23,00,000	By Internal Transfer	—	7,00,000
To Wages	1,60,000	1,00,000	By Closing Stock	1,80,000	5,00,000
To Internal Transfer	7,00,000	—			
To Gross Profit	6,20,000	10,00,000			
Total	16,80,000	35,00,000	Total	16,80,000	35,00,000
To Traveling Expenses	1,40,000	10,000	By Gross Profit b/d	6,20,000	10,00,000
To Printing & Stationery	16,000	20,000			
To Salaries	90,000	1,80,000			
To Advertisement Exp.	35,526	54,474			
To General Expenses	2,00,000	6,00,000			
To Depreciation (1:3)	3,000	9,000			
To Net Profit	1,35,474	1,26,526			
Total	6,20,000	10,00,000	Total	6,20,000	10,00,000

Note :

1. GP Ratio of Department B = Gross Profit * Total Sales = 10,00,000 ÷ (23,00,000 + 7,00,000) = 33.33%
2. Advertisement Expenses are apportioned in the ratio of External Sales i.e. 15 : 23.

2. Computation of Unrealised Profit on Closing Stock :

Particulars		Department A
Value of Closing Stock as given above		1,80,000
Total Material Cost of Department A	2,00,000 + 7,00,000 =	9,00,000
Material Cost of Internal Transfer in above		7,00,000
Value of Transferred Material in Closing Stock	1,80,000×7,00,000 / 9,00,000 =	1,40,000
Unrealised Profit of Dept B included in above (GP Ratio of Department B = 33.33% or l / 3rd)	1,40,000×1 / 3 =	46,667

Dr. 3. Profit after adjustment of Unrealised Profit Cr.

To Stock Reserve (as calculated above)	46,667	By Net Profit b / d	2,62,000
To Net Profit c / d to Balance Sheet	2,15,333	[1,26,526+1,35,474]	
Total	2,62,000	Total	2,62,000

Illustration 7 :

Department X sells goods to Department Y at a profit of 25% on cost & to Department Z at a profit of 10% on cost. Department Y sells goods to X & Z at a profit of 15% & 20% on sales, respectively. Department Z charges 20% & 25% profit on cost to Department X & Y, respectively.

Department Managers are entitled to 10% Commission on Net Profit subject to Unrealised Profits on Departmental sales being eliminated.

Departmental profits after charging manager’s commission, bur before adjustment of unrealised profits are : X = Rs. 36,000; Y = Rs. 27,000; Z = Rs. 18,000

Stocks lying at different departments at the year end are as under :

Particulars	X	Y	Z
Transfer from Department X	—	15,000	11,000
Transfer from Department Y	14,000	—	12,000
Transfer from Department Z	6,000	5,000	—

Find out the correct Departmental Profits after charging Managers’ Commission.

Solution :

1. Computation of Unrealised Profits

Particulars of transfer to	Department X	Department Y	Department Z	Total
From Department X to Y and Z at 25% and 10% of Cost	Nil	15,000 × 25 / 125 =3,000	11,000 × 10 / 110 =1,000	4,000
From Department Y to X and Z at 15% and 20% of Sales	14,000 × 15 / 100 =2,100	12,000 × 20 / 100 Nil	=2,400	4,500
From Department Z to X and Y at 20% and 25% of Cost	6,000×20 / 120 =1,000	5,000×25 / 125 =1,000	Nil	2,000

2. Computation of Correct Departmental Profits after charging Manager's Commission correctly

	Particulars	Department X	Department Y	Department Z
	Profits after charging Mgr Commission	36,000	27,000	18,000
Add :	Wrong Commission = 10% of Profits =	1/9 × 36,000	1/9 × 27,000	1/9 × 18,000
	1/10 on Profits before charging commission	=4,000	=3,000	=2,000
	= 1/9 on Profits after charging commission			
	Profits before charging commission	40,000	30,000	20,000
Less :	Unrealised Profits i.e. Stock Reserve	4,000	4,500	2,000
	Profits qualifying for commission	36,000	25,500	18,000
Less :	Commission at 10% of above	3,600	2,550	1,800
	Correct Profits after charging commission	32,400	22,950	16,200

Illustration 8 :

The following details are available in respect of a business for a year.

Department	Opening Stock	Purchase	Sales
X	120 units	1,000 units	1,020 units at Rs.20.00 each
Y	80 units	2,000 units	1,920 units at Rs.22.50 each
Z	152 units	2,400 units	2,496 units at Rs.25.00 each

The total value of purchases is Rs.1,00,000. It is observed that the rate of Gross Profit is the same in each department. Prepare Departmental Trading Account for the above year.

Solution :

1. Computation of Closing Stock Quantity (in units)

	Particulars	X	Y	Z
	Opening Stock	120	80	152
Add:	Purchases	1,000	2,000	2,400
Less :	Units Sold	(1,020)	(1,920)	(2,496)
	Closing Stock	100	160	56

2. Computation of Gross Profit Ratio

We are informed that the GP Ratio is the same for all departments. Selling Price is given for each department's products but the Sale Quantity is different from that of Purchase Quantity. To find the Uniform GP Rate, the sale value of Purchase Quantity should be compared with the Total Cost of Purchase, as under:

Assuming all purchases are sold, the sale proceeds would be

	Particulars	Sale Value of Purchase Quantity	Amount
	Department X	1,000 units at Rs.20.00	20,000
	Department Y	2,000 units at Rs.22.50	45,000
	Department Z	2,400 units at Rs.25.00	60,000
	Total Sale Value of Purchase Quantity	125,000	
Less :	Cost of Purchase	1,00,000	
	Gross Profit Amount	25,000	
	Gross Profit Ratio	25,000 ÷ 1,25,000	20% of Selling Price

3. Computation of Profit and Cost for each article

Department	Selling Price	Profit at 1/5 of SP	Cost = Sales – Profit
Department X	Rs.20.00	1/5 of Rs.20.00 = 4.00	Rs. 16.00
Department Y	Rs.22.50	1/5 of Rs.22.50 = 4.50	Rs.18.00
Department Z	Rs.25.00	1/5 of Rs.25.00 = 5.00	Rs.20.00

Dr. 4. Departmental Trading Account for the year Cr.

Particulars	X	Y	Z	Total	Particulars	X	Y	Z	Total
To Opg. stock	1,920	1,440	3,040	6,400	By Sales	20,400	43,200	62,400	126,000
To Purchase	16,000	36,000	48,000	100,000	By Clg. stock	1,600	2,880	1,120	5,600
To Gross Profit	4,080	8,640	12,480	25,200					
Total	22,000	46,080	63,520	131,600	Total	22,000	46,080	63,520	131,600

Opening and Closing Stocks are valued at Cost as indicated in WN 3 above. Sale Amount in the Trading Account is computed for the Sale Quantity only. Gross Profit is calculated at 20% of Sale Value.

Illustration 9 :

Anumod Ltd. is a retail store having 2 Departments P and Q. The Company maintains a Memorandum Stock Account & Memorandum Mark Up Account for each of the Departments. Supplies issued to the Departments are debited to the Memorandum Stock Account of the Department at Cost plus Mark Up, and Departmental Sales are credited to this Account. The Mark Up on supplies issued to the Departments is credited to the Mark Up Account for the Department. When it is necessary to reduce the Selling Price below the Normal Selling Price, i.e. Cost plus Mark Up, the reduction (Mark Down) is entered in the Memorandum Stock Account & Mark Up Account. Department P has a mark up of 33-1/3% on Cost, and Department Q has a mark-up of 50% on cost.

The following information has been extracted from the records of the Company for a year ending 31st December.

Particulars	P	Q
Opening Stock (at Cost)	24,000	36,000
Purchases	162,000	190,000
Sales	210,000	285,000

1. Opening Stock of Department P includes goods on which the Selling Price has been marked down by Rs.510. These goods were sold in January at the reduced Selling Price.
2. Certain goods purchased during the year for Rs.2,700 for Department P, were transferred during the year to Department Q & sold for Rs.4,500. Purchases & Sales are recorded in the Purchases of Department P & the Sales of Department Q respectively, but no entries have been made in respect of the transfer.

3. Goods purchased during the year were marked down as follows:

Particulars	P	Q
Cost	8,000	21,000
Mark down	800	4,100

At the end of the year there were some items in the stock of Department Q, which had been marked down to Rs.2,300. With this exception, all goods marked down during the year were sold during the year at reduced prices.

4. During stock-taking at the end of the year, goods which had cost Rs.240 were found to be missing in Department P. It was determined that loss should be regarded as irrecoverable.
5. The Closing Stock in both Departments are to be valued at Cost for the purpose of the annual accounts.

Prepare for the year ended 31st December the following accounts - (a) Trading Account; (b) Memorandum Stock Account and (c) Memorandum Mark Up Account.

Solution :

Dr. 1. Memorandum Stock Account (in Rs.) Cr.

Particulars	P	Q	Particulars	P	Q
To balance b/d (givgn cost + 33-1/3% & 50% m-up)	32,000	54,000	By balance b/d (mark down - given)	510	
To Purchases (given)	162,000	190,000	By Sales (given)	210,000	285,000
To Memorandum Mark Up (33-1/3% & 50% on pur.)	54,000	95,000	By Internal Transfer -per contra	2,700	—
To Internal Transfer - per contra	—	2,700	By Memorandum Mark Up (M-up on Transfer)	900	—
To Memorandum Mark Up (50% on Internal Tfr)	—	1,350	By Memorandum Mark Up (Mark Down - given)	800	4,100
To Memorandum Mark Up (on Marked Down Goods still in stock - See Note 1)	—	344	By Abnormal Loss-Cost transferred to P & L A/c	240	—
			By Memorandum Mark Up (M-up on Stock Lost)	80	—
			By balance c/d (Closing Stock - balancing figure)	32,770	54,294
Total	248,000	343,394	Total	248,000	343,394

Note 1 : Mark Down in Unsold Stock of Department Q

$$\frac{\text{Total Mark down} \times \text{Value of Stock}}{\text{Value of Mark down goods}} = \frac{4{,}100 \times 2{,}300}{27{,}400^*} = \text{Rs.}344$$

* Value of Mark Down Goods = Cost Add: Normal Mark Up 50% Less: Amount Marked Down

= Rs.21,000 Add: Rs. 10,500 Less: Rs.4,100 (given) = Rs.27,400

Note 2 : Valuation of Closing Stack at cost :

Department	P	Q
Closing Stock at Invoice Price as per Memorandum Stock A/c	32,770	54,294
Closing Stock at Cost after reducing 1/3 and 1/2 on cost = 1/4 and 1/3 on the Invoice Price respectively	32,770 – 1/4 thereon = 24,578	54,294 - 1/3 thereon = 36,196

Dr. 2. Trading Account for the year ended 31st December (in Rs.) Cr.

Particulars	P	Q	Particulars	P	Q
To Opening Stock	24,000	36,000	By Sales	210,000	285,000
To Purchases	162,000	190,000	By Internal Transfer	2,700	—
To Internal Transfer	—	2,700	By Abnormal Loss	240	—
To Gross Profit	51,518	92,496	By Closing Stock (Note 2)	24,578	36,196
Total	237,518	321,196	Total	237,518	321,196

Dr. 3. Memorandum Mark Up Account (in Rs.) Cr.

Particulars	P	Q	Particulars	P	Q
To balance b/d (Mark Down-given - per contra)	510	—	By balance b/d (33-1/3% and 50% on cost given)	8,000	18,000
To Memorandum Stock A/c (M-up on Transfer)	900		By Memorandum Stock (Mark Up on Purchase)	54,000	95,000
To Memorandum Stock A/c (Mark Down - given)	800	4,100	By Memorandum Stock (Mark Up on Int. transfer)	1,350	
To Memorandum Stock A/c (M-up on Goods Lost)	80	—	By Memorandum Stock A/c (marked down goods still in stock)	344	
To Gross Profit (as above)	51,518	92,496			
To balance c/d (bal. fig.)	9,886	16,404			
Total	63,694	1,13,000	Total	63,694	1,13,000

4. Confirmation / Verification of Gross Profit

Department		P	Q
	Sales (given)	210,000	285,000
Add back :	Reduction/Mark down	510+800 = 1,310	4,100-344 = 3,756
	Total	211,310	288,756
	Normal Gross Profit at 1/4 and 1/3 of above	(1/4) = 52,828	(1/3) = 96,252
Less :	Reduction / Mark down	1,310	3,756
	Gross Profit (as per Memo Mark Up a/c)	51,518	92,496

Illustration 10 :

Z Ltd., has 3 departments, X, Y, Z. The following information is provided :

	X	*Y*	*Z*
	Rs.	*Rs.*	*Rs.*
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 connected. Stocks of X department are transferred to Y at a margin of 50% above departmental cost. Stocks of Y department are transferred to Z department at a margin of 10% above departmental cost. Other expenses were : Salaries Rs. 2,000, Pringing & Stationery Rs. 1,000, Rent Rs. 6,000, Interest paid Rs. 4,000, Depreciation Rs. 3,000, Allocate expenses in the ratio of departmental gross profit. Opening figures of reserve for unrealised profits on departmental stocks were : Department Y Rs. 1,000 ; Department Z Rs. 2,000.

Required : Prepare Departmental Trading and Profit & Loss Accounts for the year ended March 31, 2008.

Departmental Trading and Profit & Loss Account

Dr. *for the year ended 31st March, 2008* *Cr.*

Particulars	*X* *Rs.*	*Y* *Rs.*	*Z* *Rs.*	*Total* *Rs.*	*Particulars*	*X* *Rs.*	*Y* *Rs.*	*Z* *Rs.*	*Total* *Rs*
To Opening Stock :	3,000	4,000	6,000	13,000	By Internal b/d	18,000	33,000	—	51,000
To Direct Material					By Sales	—	—	34,000	34,000
considered	8,000	12,000	—	20,000	By Closing Stock	4,000	14,000	8,000	26,000
To Wages	5,000	10,000	—	15,000					
To Internal Transfer	—	18,000	33,000	51,000					
To Gross Profit c/d	6,000	3,000	3,000	12,000					
	22,000	47,000	42,000	1,11,000		22,000	47,000	42,000	1,11,000
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 c/d	2,000	1,000	1,000	4,000
To Rent	3,000	1,500	1,500	6,000					
To Depreciation	1,500	750	750	3,000					
To Interest paid	2,000	1,000	1,000	4,000					
	8,000	4,000	4,000	16,000		8,000	4,000	4,000	16,000
To Net Loss b/d				4,000	By Provision for				
To Provision for					unrealised profit				
unrealised profit					on Opening Stock				3,000
on Closing Stock				3,918	By Balance transferred to				
					Profit & Loss A/c				4,918
				7,918					7,918

Working Notes :

(i) FIFO method for stock issue has been assumed. Alternatively this question could have been solved by assuming other methods for stock issue like LIFO Basis, Weighted Average basis, etc.

(ii)	*Calculation of unrealised profit on Closing Stock of Deptt. Y*	*Rs.*
	Current cost incurred by Dept. Y (Rs. 12,000 + Rs. 10,000 + Rs. 18,000)	40,000
	Profit included in Above (Rs. 18,000 × 50 / 150)	6,000
	Profit included in Closing Stock of Rs. 14,000 (Rs. 6,000 × Rs. 14,000 / Rs. 40,000)	2,100
(iii)	*Calculation of unrealised profit on Closing Stock of Dept C*	*Rs.*
	Current Cost incurred by Dept. Z	33,000
	Profit of Dept. B included in above (Rs. 33,000 × 10 / 110)	3,000
	Cost element of Dept. Y included in current cost (Rs. 33,000 – 3,000)	30,000
	Profit of Dept. a included in above cost (Rs. 6,000 × Rs. 30,000 / Rs. 40,000)	
	Total Profit included in current cost of Dept. Z (Rs. 3,000 + Rs. 4,500)	7,500
	Unrealised profit included in closing stock of Rs. 8,000 (Rs. 7,500×Rs. 8,000 / Rs. 33,000)	1,818
(iv)	Total unrealised profit (Rs. 2,1000 + Rs. 1,818)	3,918

Illustration 11 :

X Limited is a retail organisation with several departments. Goods supplied to each department are debited to a Memorandum Departmental Stock Account at cost, *plus* fixed percentage (make-up) to give the normal selling price. The mark up is credited to a Memorandum Departmental "Mark-up Account". Any reduction in selling prices (mark-down) will require adjustment in the stock account and in mark-up account. The mark up for Department A for the last three years has been 40%. Figures relevant to Department A for the year ended 31st Dec. 2008 were as follows :

Stcok 1st January 2008 at Cost, Rs. 80,000, Purchases at Cost Rs. 1,80,000, Sales Rs. 3,20,000.

It is further ascertained that :

(a) Goods purchased in the period were marked down by Rs. 1,400 from a cost of Rs. 16,000. Marked-down stock costing Rs. 4,000 remained unsold on 31st December 2008.

(b) Stock shortages at the year end, which had cost Rs. 1,200 were to be written off.

(c) Stock at 1st Jan. 2008 including goods costing Rs. 8,200 had been sold during the year and has been mark down in the selling price by Rs. 740. The ramaining stock had been sold during the year.

(d) The departmental closing stock is to be valued at cost subject to adjustments for mark-up and mark-down.

Required : Prepare (i) A Departmental Trading Account (ii) A Memorandum Stock Account (iii) A Memorandum Mark-up Account for the year 2008.

Solution :

(i) Departmental Trading Account

Dr. *for the year ended 31st December, 2008* *Cr.*

Particulars	*Rs.*	*Particulars*	*Rs.*
To Opening Stock	80,000	By Sales	3,20,000
To Purchases	1,80,000	By Sortage	1,200
To Gross Profit c / d	90,150	By Closing stock	
		(Rs. 40,180 – Rs. 11,230)	28,950
	3,50,150		3,50,150

Dr. (ii) Memorandum Departmental Stock Account (At Selling Price) Cr.

Particulars	*Rs.*	*Particulars*	*Rs.*
To Balance b/d		By Profit & Loss A/c	1,200
(Rs. 80,000 + Rs. 32,000)	1,12,000	(Cost of Shortage)	
To Purchases		By Memorandum Departmantal	
(Rs. 1,80,000 + Rs. 72,000)	2,52,000	Mark-up A/c	480
		(Load on Shortage)	
		By Mark-up A/c	1,400
		(Mark Down in Current Purchases)	
		By Debtors A/c (Sales)	3,20,000
		By Mark-up A/c	740
		(Mark Down on Opening Stock)	
		By Balance c/d	40,180
	3,64,000		3,64,000

Dr. (iii) Memorandum Departmental Mark up Account Cr.

Particulars	*Rs.*	*Particulars*	*Rs.*
To Memorandum Departmental		By Balance b/d	
Stock A/c (Rs. 1,200×40/100)	480	(Rs. 1,12,000×40/140)	32,000
To Memorandum Departmental		By Memorandum Departmental	
Stock A/c	1,400	Stock A/c	72,000
To Memorandum Departmental		(Rs. 2,52,000×40/140)	
Stock A/c	740		
To Gross Profit transferred to			
Profit & Loss A/c	90,150		
To Balance c/d			
[(Rs. 40,180+Rs. 350)×40/140			
– (Rs. 350)	11,230		
	1,04,000		1,04,000

Working Note :

		Rs.
(i)	*Calculation of Cost of sales*	*Rs.*
	a.Sales as per Books	3,20,000
	b.Add : Mark-down in opening stock (given)	740
	c.Add : Mark-down in sales out of current Purchases (Rs. 1,400×12,000/16,000)	1,050
	d.Value of sales if there was no mark-down (a+b+c)	3,21,790
	e.Less : Gross Profit (40/140 of Rs. 3,21,790) subject to Mark Down (Rs. 740 + Rs. 1,050)	91,940
	f.Cost of sales (d - e)	2,29,850
(ii)	*Calculation of Closing Stock*	*Rs.*
	a.Opening Stock	80,000
	b.Add : Purchases	1,80,000

c. *Less* : Cost of Sales	2,29,850
d. *Less* : Shortage	1,200
e. Closing Stock (a+b–c–d)	28,950

Illustration 12 :

Southern Store Ltd. is a retail store operating two departments. The company maintains Memorandum Stock account and Memorandum Mark-up account for each of the departments. Supplies issued to the department are debited to the Memorandum Stock account of the department at cost *plus* the Mark-up, and departmental sales are credited to this account. The mark-up on supplies issued to the departments is credited to the Mark-up account for the department. When it is necessary to reduce the selling price below the normal selling price, i.e. cost *plus* Mark-up, the reduction (mark down) is entered in the Memorandum Stock account and in the mark-up account. Department *Y* has Mark-up of 33-1/3% on cost, and Department *Z* 50% on cost. The following information has been extracted from the records of Southern Store Ltd. for the year ended 31st December, 2008.

	Department Y	*Department Z*
	Rs.	*Rs.*
Stock, 1st January, 2008 at cost	24,000	36,000
Purchases	1,62,000	1,90,000
Sales	2,10,000	2,85,000

(a) The stock of Department *Y* on 1st january, 2008 included goods on which the selling price has been marked down by Rs. 510. These goods were sold in January, 2008 at the reduced price.

(b) Certain goods purchased in 2008 for Rs. 2,700 for Department *Y*, were transferred during the year to Department *Z*, and sold for Rs. 4,050. Purchase and sale are recorded in the purchases of Department *Y* and the sales of Department *Z* respectively, but no entries in respect of the transfer have been made.

(c) Goods purchased in 2008 were marked down as follows :

	Department Y	*Department Z*
	Rs.	*Rs.*
Cost	8,000	21,000
Mark down	800	4,100

At the end of the year there were some items in the stock of Department *Z*, which had been marked down to Rs. 2,300. With this exception all goods marked down in 2008, were sold during the year at the reduced prices.

(d) During stock taking on 31st December 2008, goods which had cost Rs. 240 were found to be missing in department *Y*. It was determined that the loss should be regarded as irrecoverable.

(e) The closing stock in both departments are to be valued at cost for the purpose of the annual accounts.

Required : Prepare for each department for the year ended 31st December, 2008 :

(i) a Trading Account, (ii) a Memorandum Stock Account, and (iii) a Memorandum Mark-up Account.

Solution :

Southern Stores Ltd.

Dr. Trading Account for the year ended 31st December, 2008 *Cr.*

Particulars	*Dept. Y* *Rs.*	*Dept. Z* *Rs.*	*Particulars*	*Dept. Y* *Rs.*	*Dept. Z* *Rs.*
To Opening Stock	24,000	36,000	By Sales	2,10,000	2,85,000
To Purchases	1,62,000	1,90,000	By Transfer to Dept. Z	2,700	—
To Transfer from Y Dept.	—	2,700	By Goods Lost	240	—
To Gross Profit c/d	51,518	92,496	By Closing Stock		
			(at cost)	24,578	36,196
	2,37,518	3,21,196		2,37,518	3,21,196

Dr. Memorandum Stock Account (At Selling Price) *Cr.*

Particulars	*Dept. Y* *Rs.*	*Dept. Z* *Rs.*	*Particulars*	*Dept. Y* *Rs.*	*Dept. Z* *Rs.*
To Balance b/d			By Balance b/d	510	—
(Cost + Mark-up)	32,000	54,000	By Sales	2,10,000	2,85,000
To Purchases			By Transfer	2,7000	—
(Cost)	1,62,000	1,90,000	By Memorandum		
To Memorandum			Mark-up A/c		
mark-up A/c			(on transfer)	—	900
(on purchases)	54,000	95,000	By Memorandum		
To Transfer	—	2,700	Mark-up A/c	800	4,100
To Memorandum			(Marked down on		
Mark-up A/c (on t/f)	—	1,350	current purchasers)		
			By P & L A/c		
			(Cost & Shortage)	240	
To Memorandum			By Memorandum		
Mark-up A/c			Mark-up A/c		
(on Marked down			(on lost Stock)	80	
goods still in Stock)	—	344	By Balance c/d		
			(Closing Stock)	32,770	54,294
	2,48,000	3,43,394		2,48,000	3,43,394

Dr. Memorandum Mark-up Account Cr.

Particulars	Dept. Y Rs.	Dept. Z Rs.	Particulars	Dept. Y Rs.	Dept. Z Rs.
To Balance b/d	510		By Balance b/d	8,000	18,000
To Memorandum Stock A/c (Mark-up on Transfer)	900		By Memorandum Stock A/c (purchase)	54,000	95,000
To Memorandum Stock A/c (Mark down on Current Purchases)	800	4,100	By Memorandum Stock A/c (Mark-up on transfer)		1,350
To Memorandum Stock A/c (Mark down on goods lost)	80		By Memorandum Stock A/c (Marked down on goods still in Stock)		344
To Gross Profit (Balancing Figure)	51,518	92,496			
To Balance c/d	8,192	18,098			
	62,000	1,14,694		62,000	1,14,694

Working Notes :

(i) *Calculation of Closing Stock at Cost* — *Y Dept.* (Rs.) — *Z Dept.* (Rs.)

	Y Dept. (Rs.)	Z Dept. (Rs.)
Calculation of Closing Stock at Invoice price	32,770	54,294
Calculation of Closing Stock at Cost	32,770×3/4 = Rs. 24,578	54,294×2/3 = 36,196

(ii) $$\frac{\text{Total Mark down} \times \text{Value of Stock}}{\text{Value of Mark down goods}} = \frac{4{,}100 \times 2{,}300}{27{,}400^*} = \text{Rs.}344$$

(iii) *Verification of Gross Profit*

	Y Dept. (Rs.)	Z Dept. (Rs.)
Sales	2,10,000	2,85,000
Add : Reduction	510	—
Add : Mark down	800	3,756
	2,11,310	2,88,756
Gross Profit	(1/4) 52,828	(1/3) 96,252
Less : Mark down	1,310	3,756
Gross Profit as per Memorandum Mark up Account	51,518	92,496

Illustration 13 :

X Ltd., has a factory with two manufacturing Departments '*X*' and '*Y*'. Part of the output of Department *X* is transferred to Department *Y* for further procesing and the balance is directly transferred to selling Department. The entire production of Department *Y* is directly transferred to the selling Department. Inter departmental stock transfers are made as follows :

X Department to *Y* Department at 33-1,3% over Departmental Cost.

X Department to selling department at 50% over Departmental Cost.

Y Department to selling department at 25% over Departmental Cost.

The following information is given for the year ended 31st March, 2008.

Particulars	*Detp. X*		*Dept. Y*		*Selling Dept.*	
	Units	*Rs.*	*Units*	*Rs.*	*Units*	*Rs.*
Opening Stock of Finished Goods	60	60,000	20	40,000	50	1,28,000
Opening Stock of Raw Materials	—	—	—	—	—	
Raw material Consumed	—	1,82,000	—	20,000	—	—
Labour Charges	—	70,000	—	32,000	—	—
Sales	—	—	—	—	120	4,80,000
Closing Stock of Finished Goods	40	—	50	—	60	—

Out of the total transfer by *X* Department, 30 units were transferred to selling department, while the reamining to Department *Y*. The per unit material and labout consumption in *X* Department on production to be transferred directly to selling department is 300 per cent of the labour and material consumption on units transferred to *Y* Department. General Administration expenses Rs. 80,000.

Required : Prepare Departmental Profit and Loss Account and General Profit and Loss Account for the year ended 31.3.2008.

Solution :

Departmental Profit and Loss Account

Dr. *for the year ended 31st March, 2008* *Cr.*

Particulars	*X Dept.*		*Y Dept.*		*Selling Dept.*		*Particulars*	*X Dept.*		*Y Dept.*		*Sell Dept.*	
	Qty.	*Rs.*	*Qty.*	*Rs.*	*Qty.*	*Rs.*		*Qty.*	*Rs.*	*Qty.*	*Rs.*	*Qty.*	*Rs.*
To Opening stock	60	60,000	20	40,000	50	1,28,000	By Stock	160	3,70,000	100	2,50,000	—	—
To Raw Material consumed		1,82,000	—	20,000	—	—	By Sales	—	—	—	—	120	4,80,000
To Units produced	140	—	—	—	—	—	By Closing Stock	40	48,000	50	1,00,000	60	1,80,000
To Labour Charges		70,000	—	32,000	—	—							
To Stock Transferred From *X* Dept.			130	2,08,000	30	1,62,000							
To Stock Transferred From *Y* Dept.					100	2,50,000							
To Departmental Profit t/f to General P & L A/C		1,06,000	—	50,000	—	1,20,000							
	200	4,18,000	150	3,50,000	180	6,60,000		200	4,18,000	150	3,50,000	180	6,60,000

General Profit and Loss Account
Dr. *for the year ended 31st March, 2008* *Cr.*

Particulars	*Rs.*	*Particulars*	*Rs.*
To General Adm. Expenses	80,000	By Profit transferrd from :	
To Stock Reserve for Closing Stock		X Dept.	1,06,000
on Dept. Y	12,000	Y Dept.	50,000
on Selling Dept.	18,175	Selling Dept.	1,20,000
To Net profit	1,65,825		
	2,76,000		2,76,000

Working Notes :

(a) Selling Dept.

Dr. *Cr.*

Particulars	*Units*	*Particulars*	*Units*
To Opening Stock	50	By Sales	120
To T/f from X Dept.	30	By Closing Stock	60
To T/f from Y Dept. (Balancing figure)	100		
	180		180

(b) ***Y*** Dept.

Dr. *Cr.*

Particulars	*Units*	*Particulars*	*Units*
To Opening Stock	20	By T/f to Selling Dept.	100
To T/f from X Dept.	130	By Closing Stock	50
	150		150

(c) ***X*** Dept.

Dr. *Cr.*

Particulars	*Units*	*Particulars*	*Units*
To Opening Stock	60	By T/f to Selling Dept.	30
To Production (Balancing figure)	140	By T/f to Y Dept.	130
		By Closing Stock	40
	200		200

(d) Total Equivalent units produced in *X* Dept. in terms of those t/f to *Y* Dept.

= Equivalent units of those t/f to Sell Dept. + t/f to Y Dept. + Closing Stock.

$= (30 \times 300/100) + 130 + 40 = 260$

(e) Calculation of Transfer Prices and Closing Stock.

		X Dept. Rs.	Y Dept. Rs.	Selling Dept. Rs.
A	Cost of Opening Stock	60,000	40,000	1,28,000
B	*Add* : Cost of Raw Materials Consumed	1,82,000	20,000	—
C	*Add* : Labour Charges	70,000	32,000	—
D	*Add* : T/f from X Dept.	—	2,08,000	1,62,000
E	*Add* : T/f form Y Dept.	—	—	2,50,000
F	Total Cost (A+B+C+D+E)	3,12,000	3,00,000	5,40,000
G	Equivalant Units	260	150	180
H	Average Cost per Equivalent Unit (F/G)	1,200	2,000	3,000
I	Transfer Price of 130 Units t/f to Dept. Y			
	(a) Cost of 130 Units (130×Rs. 1,200)	1,56,000		
	(b) *Add* : Profit element @ 33-1/3%	52,000		
		2,08,000		
J	Transfer Price of Units t/f to Selling Dept.			
	(a) Cost of Units t/f	1,08,000		
	(b) *Add* : Profit element	54,000	50,000	
		1,62,000	2,50,000	
K	Closing Stock	48,000	1,00,000	1,80,000
		(40×Rs. 1,200)	(50×Rs. 2,000)	(60×Rs. 3,000)

(f) *Unrealised Profit on Increase in Closing Stock of Y Dept.* (Rs. 1,00,000 – Rs. 40,000)

A Current Cost incurred by Dept. *Y*

= Rs. 20,000 + Rs. 32,000 + Rs. 2,08,000 = Rs. 2,60,000

B Profit charged by Dept. *X* included in above (Rs. 2,08,000 × 1/4) = Rs. 52,000

C Profit included in Increase in Closing Stock.

= (Rs. 52,000 × Rs. 60,000/Rs. 2,60,000) = Rs. 12,000

(g) *Profit Included in output transferred by Y Deptt. to Selling Dept.*

A Transfer Price = Rs. 2,50,000

B Profit of Dept. *Y* included in Above (Rs. 2,50,000 × 25/125) = Rs. 50,000

C Cost Element of Dept. *X* in Transfer Price (Rs. 2,50,000 – Rs. 50,000) = Rs. 2,00,000

D Profit of Dept. *X* included in above

(Rs. 2,00,000 × Rs. 52,000/Rs. 2,60,000) = Rs. 40,000

E Total Profit Included in Transfer price (Rs. 50,000 + Rs. 40,000) = Rs. 90,000

(h) Profit Included in output transferred by *X* Dept. to Selling Dept.

= (Rs. 1,62,000 × 50/150) = Rs. 54,000

(i) Total Profit included in output transferred to Selling Dept.

= Rs. 90,000 + Rs. 54,000 = Rs. 1,44,000

(j) Total Transfer Price for the Transfer made by *X* Dept. and *Y* Dept.

= Rs. 1,62,000 + Rs. 2,50,000 = Rs. 4,12,000

(k) Unrealised Profit included in increas in Closing Stock of Sell Dept.

= Rs. 1,44,000 × Rs. 52,000/Rs. 4,12,000 = Rs. 18,175

EXERCISE

Problem 1 : X Ltd. provides you the following information.

	Stock as on 1.1.2008	Purchase (for Rs. 4,00,000)	Sales
Department A	120 units	1000 Units	1020 units @ Rs. 80.00
Department B	80 units	2000 Units	1920 units @ Rs. 90.50
Department C	152 units	2400 Units	2496 units @ Rs. 100.00

The rate of gross profit is the same in each case.

Required : Prepare Departmental Trading Account for the year 2008.

Problem 2 : Zeenat is earning uniform rate of gross profit in all three departmens he is handing. Following are the relevant details :

Purchase :	Dept. A	15,000 cartons
	Dept. R	20,000 cartons
	Dept. Z	15,000 cartons

The total cost of the purchase amounted to Rs. 6,00,000.

Sales :	Dept. A	16,000 cartons at Rs. 20 per carton
	Dept. R	22,000 cartons at Rs. 15 per carton
	Dept. Z	17,000 cartons at Rs. 10 per carton

Details of opening stock :	Dept. A	4,000 cartons
	Dept. R	5,000 cartons
	Dept. Z	4,000 cartons

Required : Prepare the trading account for three department :

Problem 3 : Messers D, B and R carried on a business of Drapers and Tailors in Delhi; D was in charge of Department "A" dealing in cloth. B of Department "B" for selling garments and R of Department "C" the tailoring section. It had been agreed that each of the three partners would reveive 75% of the profits disclosed by accounts of the department of which he was in charge and the balance of the profits would be shared in the proportion : D 1/2, B 1/4 and R 1/4. The following is the Trading and Profit and Loss Account of the firm for the six months ended 30th September, 2008.

Dr. Trading and Profit and Loss Account *Cr.*

for the year ended 30.09.08

	Particulars	*Rs.*		*Particulars*	*Rs.*
To	Opening Stock :		By	Sales :	
	Cloth (A)	37,890		Cloth (A)	1,80,000
	Ready-made Garments (B)	24,000		Ready-made Garments (B)	1,30,000
	Tailoring Jobs (C)	20,000		Tailoring Jobs (C)	90,000
To	Purchases :		By	Discount received	800
	Cloth (A)	1,40,700	By	Closing Stock :	
	Ready-made Garments (B)	80,600		Cloth (A)	45,100
	Tailoring Goods (c)	44,400		Ready-made Garments (B)	22,300
To	Salaries and Wages	48,000		Tailoring Jobs (C) including	
To	Advertising	2,400		Rs. 5,700 for goods transferred	
To	Rent	10,800		from department (A)]	21,600

To Discount Allowed	1,200	
To Sundry Expenses	12,000	
To Depreciation on Furniture and Fittings	750	
To Net Profit	67,060	
	4,89,800	4,89,800

After consideration of the following, prepare Departmental Accounts and Profit and Loss Appropriation Account.

(i) Cloth of the value of Rs. 10,700 and other goods of the value of Rs. 600 were transferred at selling price by Departments A and B respectively to Department C.

(ii) Cloth and garments are sold in the show-room. Tailoring work is carried out in the workshop.

(iii) The details of salaries and wages were as follows :

(a) General Office 50%, show-room 25% and 25% for workshop 75% of which is for tailoring alone.

(b) Allocate General Office Expenses, in the proportion of 3 : 2 : 1 among the Departments A, B, C.

(c) Distribute show-room expenses in the proportion of 1 : 2 between Departments A and B.

(d) the workshop rent is Rs. 1,000 per month the rent of the General Office and Show-room is to be divided equally between Department A and B

(e) Depreciation charges are to be allocated equally amongst the three Departments.

(f) All other expenses are to be allocated on the basis of turnover.

(g) Discounts received are to be credited to the three Departments as follows : A Rs. 400; B Rs. 250; C Rs. 150.

(h) The opening stock of Department C does not include any goods transferred from Department A.

Problem 4 : M/s Bright and Co, had four departments A, B, C and D. Each department being managed by a departmental managar whose commission was 10% of the respective departmental profit, subject to a minimum of Rs. 6,000 in each case. Interdepartmental transfers took place at a 'loaded' price as follows :

From Department	A to Department B 10% above cost
From Department	A to Department D 20% above cost
From Department	C to Department D 20% above cost
From Department	C to Department B 20% above cost

For the year ending on 31st March, 2008 the firm had already prepared and closed the departmental Trading and Profit and Loss Account. Subsequently, it was discovered that the closing stocks of departments had included interdepartmentally transferred goods at loaded price instead of cost price. From the following information, prepare a statement recomputing the departmental profit or loss :

	Dept. A *Rs.*	*Dept. B* *Rs.*	*Dept. C* *Rs.*	*Dept. D* *Rs.*
Final Profit (Loss)	(38,000)	50,400	72,000	1,08,000
Inter departmental transfers included at loaded price in the departmental stock		70,000 (Rs. 22,000 from Dept. A and Rs. 48,000 from Dept. C	—	4,800 (Rs. 3,600 from Dept. C and Rs. 1,200 from Dept. A)

Problem 5 : *X* Ltd., has two departments A and B. From the following particulars, prepare the Consolidated Trading Account and Departmental Trading Account for the year ending on 31st Dec., 2008.

	A	*B*
	Rs.	*Rs.*
Opening stock (at cost)	20,000	12,000
Purchases	92,000	12,000
Sales	1,40,000	1,12,000
Wages	12,000	8,000
Carriage	2,000	2,000
Closing Stock :		
(i) Purchased goods	4,500	6,000
(ii) Finished goods	24,000	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	
by B to A		40,000
Return of finished goods :		
by A to B	10,000	
by B to A		7,000

You are informed that purchased goods have been transferred mutually at their respective departmental purchased 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.

Problem 6 : Department *X* sells goods to Department *Y* at a profit of 25% on cost and to Department Z at 10% profit on cost. Department *Y* sells goods to *X* and *Z* at a profit of 15% and 20% on sales, respectively. Department *Z* charges 20% and 25% profit on cost to Department *X* and *Y*, respectively.

Department Managers are entitled to 10% commission on net profit subject to unrealised profit on departmental sales being eliminated. Departmental profits after charging Managers' commission, but before adjustment of unrealised profit are as under :

	Rs.
Department *X*	36,000
Deapartment *Y*	27,000
Department *Z*	18,000

Stock lying at different departments at the end of the year are as under :

	Dept. X	*Dept. Y*	*Dept. Z*
	Rs.	*Rs.*	*Rs.*
Transfer from Department *X*	—	15,000	11,000
Transfer from Department *Y*	14,000	—	12,000
Transfer from Department *Z*	6,000	5,000	—

STUDY NOTE - 6

ACCOUNTING STANDARDS

This Study Note includes

- Accounting Standards - Applicability, Interpretation, Scope and Compliance

Introduction

Accounting standards are written , policy documents issued by expert accounting body or by Government or other regulatory authorities covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transaction in the financial statement.

The main purpose of formulating accounting standard is to standardize the diverse accounting policies with a view to eliminate to the extent possible the incomparability of information provided in financial statements and add reliability to such financial statements. To discuss on whether such standards are necessary in present days it will be beneficial to go through the advantages and disadvantages which they are said to provide.

ADVANTAGES :

1. It provides the accountancy profession with useful working rules.
2. It assists in improving quality of work performed by accountant.
3. It strengthens the accountant's resistance against the pressure from directors to use accounting policy which may be suspect in that situation in which they perform their work.
4. It ensures the various users of financial statements to get complete crystal information on more consistent basis from period to period.
5. It helps the users compare the financial statements of two or more organisaitons engaged in same type of business operation.

DISADVANTAGES :

1. Users are likely to think that said statements prepared using accounting standard are infallible.
2. They have been derived from social pressures which may reduced freedom.
3. The working rules may be rigid or bureaucratic to some user of financial statement.
4. The more standards there are, the more costly the financial statements are to produce.

Accounting Standard No.	Title of Accounting Standard
AS-1	Disclosure of Accounting Policies
AS-2	Valuation of Inventories (Revised)
AS- 3	Cash Flow Statements (Revised)
AS-4	Contingencies and Events (Occurring after the Balance Sheet Date)
AS-5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (Revised)
AS-6	Depreciation Accounting
AS-7	Construction Contracts (Revised)
AS- 8	Accounting for Research and Development (stands withdrawn after introduction of AS-26)
AS-9	Revenue Recognition
AS-10	Accounting for Fixed Assets.
AS-11	The Effect of Changes in Foreign Exchange Rates (Revised)
AS-12	Accounting for Government Grants
AS-13	Accounting for Investments
AS-14	Accounting for Amalgamations
AS-15	Employee Benefits (Revised)
AS-16	Borrowing Cost
AS-17	Segment Reporting
AS-18	Related Party Disclosures
AS-19	Leases
AS-20	Earnings Per Share
AS-21	Consolidated Financial Statements
AS-22	Accounting for Taxes on Income
AS-23	Accounting for Investment in Associates in Consolidated Financial Statements
AS-24	Discontinuing Operations
AS-25	Interim Financial Reporting
AS-26	Intangible Assets
AS-27	Financial Reporting of Interests in Joint Venture

AS-28	Impairment of Assets
AS-29	Provisions, Contingent Liabilities and Contingent Assets
AS-30	Financial Instruments: Recognition and Measurement
AS 31	Financial Instruments: Presentation
AS 32	Financial Instruments: Disclosures

Applicability of Accounting Standards:

A three tier classification has been framed to ensure compliance of accounting standards for reporting enterprises.

Level I Enterprises:

- Enterprises whose equity or debt securities are listed whether in India or outside India.
- Enterprises which are in the process of listing their equity or debt securities as evidenced by the Board resolution in this regard.
- Banks including co-operative banks
- Financial institutions
- Enterprises carrying insurance business
- Enterprises whose turnover exceeds Rs.50 crores
- Enterprises having borrowings in excess of Rs.10 crores at any time during the accounting period.
- Holding companies and subsidiaries of enterprises falling under any one of the categories mentioned above.

Level II Enterprises:

- Enterprises whose turnover exceeds Rs.40 lakhs but does not exceed Rs.50 crores.
- Enterprises having borrowings in excess of Rs.1 crore but not in excess of Rs.10 crores at any time during the accounting period.
- Holding companies and subsidiaries of enterprise falling under any one of the categories mentioned above.

Level III Enterprises:

- Enterprises which are not covered under Level I and Level II.

Accounting Standard	Applicability (Based on the three tier classification)
AS1,2,4-16,22,26,28	All Enterprises
AS 3,17,18,24,	Not applicable to Level II and Level III enterprises in their entirety.
AS 19,20,29	All enterprises but relaxation given to Level I and Level II enter prises for certain disclosure requirements.
AS 21,23,27	Not applicable to Level II and Level III enterprises
AS 25	Not mandatorily applicable to Level II and Level III enterprises
AS 30,31,32	W.e.f. accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years.

It will be mandatory for on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity.

AS-1: DISCLOSURE OF ACCOUNTING POLICIES

This standard deals with disclosure of significant accounting policies followed in the preparation and presentation of the financial statements and is mandatory in nature.

The accounting policies refer to the specific accounting principles adopted by the enterprise.

Proper disclosure would ensure meaningful comparison both inter/intra enterprise and also enable the users to properly appreciate the financial statements.

Financial statements are intended to present a fair reflection of the financial position financial performance and cash flows of an enterprise.

Areas involving different accounting policies by different enterprises are

- Methods of depreciation, depletion and amortization
- Treatment of expenditure during construction
- Treatment of foreign currency conversion/translation, Valuation of inventories

- Treatment of intangible assets
- Valuation of investments
- Treatment of retirement benefits
- Recognition of profit on long-term contracts Valuation of fixed assets
- Treatment of contingent liabilities

Factors governing the selection and application of accounting policies are:

- *Prudence:* Prudence means making of estimates, which is required under conditions of uncertainty. Profits are not anticipated till certain for realization, while provisions are made for all known liabilities ascertainable or based on estimates (e.g. warranty expenses).
- *Substance over form:* It means that transaction should be accounted for in accordance with actual happening and economic reality of the transactions, i.e. events governed by substance and not merely by the legal form
- *Materiality :*
    - a) As to the disclosure of all material items, individually or in aggregate in the context of fair presentation of financial statements as a whole if its omission or misstatement could influence the economic or financial decision of the user relying upon the financial statements
    - b) Depends on the size of the items or errors judged in the particular circumstances of its omissions or misstatements.
    - c) Is a cutoff point rather than being a primary qualitative characteristic which information must have.
    - d) This is a matter of judgment, varies from one entity to another and over one period to another.

AS-1 requires that all "significant" (i.e. only accounting policy that is useful for an understanding by the user of the financial statements) accounting policies adopted in the preparation and presentation of financial statements, should be disclosed by way of 'Note in one place as the note No I (this is the basis of the preparation of financial statements.)

Changes in Accounting Policies:

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in the later period should be disclosed.

In the case of a change in accounting policies, having material effect in the current period, the amount by which any item in the financial statements, is affected by such change should also be disclosed to the extent as ascertainable, otherwise the fact that the effect is not (wholly or partially) ascertainable, should be disclosed.

The following are not considered as changes in accounting policies:

a) Accounting policies adopted for events or transactions that differ in substance at present (introducing Group Gratuity Scheme for employees in place of adhoc ex-gratia payment earlier followed.)

b) Accounting policies pertains to events or transactions which did not occur previously or that were immaterial.

Fundamental Accounting Assumptions

Certain basic assumptions, in the preparation of financial statements are accepted and their use are assumed, no separate disclosure is required except for noncompliance in respect of-

a) *Going Concern:* continuing operation in the foreseeable future and no interim necessity of liquidation or winding' up or reducing scale of operation.

b) *Consistency:* accounting policies are consistent from one period to another

c) *Accrual:*

   i) Revenues and costs are accrued i.e. they are earned or incurred (not actually received or paid) and recorded in the financial statements

   ii) Extends to matching revenue against relevant costs.

PROBLEMS

1. The gross block of fixed assets are shown at the cost of acquisition, which includes tax, duties (net of MODVAT and set off availed) and other identified direct expenses. Interest on borrowing to finance the fixed assets is considered as revenue.

Answer: The policy appears to be correct.

2. Compensation payable to employees under voluntary retirement scheme has been deferred to be written off over a period of four years as against the past practice of charging out the same on payment / due basis. Comment.

Answer: The reason for change must be incorporated with notes to accounts.

3. Sales includes inter-departmental transfers, sales during trial run and are net of discounts. Comment.

Answer: The policy is not as per AS-9, Revenue Recognition.

AS-2: VALUATION OF INVENTORIES

At the outset AS -2 excludes the following though appears to be inventory in common parlance:

a) Work-in-progress in construction contract and directly related service contract (ref: AS-2), inventories not forming part of construction work-in-progress will attract AS-2

b) Work-in-progress arising in the ordinary course of business of service providers Shares, debentures and other financial instruments held as stock-in-trade (ref: AS-13 as Current Investments)

c) Livestock, agricultural and forest product, mineral oil / gasses as measured at net realizable value as per trade practices at certain stage of production.

AS-2 covers inventories as an item of assets which are

a] held for sale in the ordinary course of business

b] in the process of production for such sale

c] in the form of material or supplies for the process of production or rendering of service

Inventories are valued at lower of cost or net realizable value (NRV)

a) Cost to include purchase price, conversion and other costs incurred in bringing the inventories to their present location and condition.

   An enterprise should use the same cost formula for all inventories having similar nature and use - specific cost, FIFO, weighted average, standard cost, adjusted selling price

b) Net realizable value is the estimated selling price in the ordinary course of business reduced by the estimated cost to bring the item in saleable condition, considered on each balance sheet date, usually on item by item basis or under suitable group of similar or related item.

Disclosure under AS-2

a) the accounting policy adopted in measuring inventories

b) the cost formula used

c) carrying amount (value) of inventory commonly classified under Raw Material and Components, Work in Progress, Finished goods and Stores, Spares and Loose tools.

d) Schedule-VI and AS-2 disclosure are at par

PROBLEMS

1. Raw materials purchased at Rs.10 per kg. price of materials is on the decline. The finished goods in which the raw material is incorporated are expected to be sold at below cost. 1,000 kgs of raw material is in stock at the year-end. Replacement cost is Rs.8 per kg. How will you value the inventory?

   Answer: As per para 24 of AS-2, on valuation of inventories, material and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there is a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value.

Hence, the value of stock of 1,000 kgs. of raw materials will be valued at Rs.8 per kg. The finished stock should be valued at cost or net realizable value, whichever is lower.

2. Inventories are valued at cost except for finished goods and by products, finished goods are valued at lower of cost of realizable values and by products are valued at realizable value. Comment on the accounting policy.

   Answer: The accounting policy followed by the company is at par with AS-2.

3. Cost of Production of product A is given below:

Raw material per unit	Rs.150
Wages per unit	Rs.50
Overhead per unit	Rs.50
	Rs.250

As on the balance sheet date the replacement cost of raw material is Rs.110 per unit. There are 100 units of raw material on 31.3.08.

Calculate the value of closing stock of raw materials in the following conditions:

(i) If finished product is sold at Rs.275 per unit, what will be the value of closing stock of raw material?

(ii) If finished product is sold at Rs.230 per unit, what will be the value of closing stock of raw material?

Answer: (i) The realizable value of the product is more than the total cost of the product. The cost of raw material per unit is more than the replacement cost, hence, raw materials should be valued on actual cost.

Therefore, the value of raw materials: 100 units x Rs.150 per unit= Rs.15,000

(ii) The realizable value of the product is less than the total cost of the product. Though the cost of raw material per unit is more than the replacement cost, hence, raw materials should be valued on replacement cost.

Therefore, the value of raw materials: 100 units x Rs.110 per unit= Rs.11,000

AS-3 (REVISED): CASH FLOW STATEMENT

Cash Flow Statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

- Cash comprises cash on hand and demand deposits with banks.
- Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.
- Cash flows are inflows and outflows of cash and cash equivalents.
- Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
- Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Methods of preparing Cash Flow Statement:

1. Direct Method: In this method major classes of gross cash receipts and gross cash payments are disclosed.
2. Indirect Method: Under this method, the following adjustment to reported net profit or loss to be made:
    - Effects of transactions of non-cash nature.
    - Deferrals in accruals of past or future operating receipt or payments.
    - Changes in current assets and liabilities
    - Income & expenses associated with investing and financing cash flows.

PROBLEMS

1. Oriental Bank of Commerce, received a gross Rs.4,500 crores demand deposits from customers and customers withdrawn Rs.4,000 crores of demand deposits during the financial year 2007-08. How would you classify such cash flows?

   Answer: It will be treated as an Operating activity, on net basis Rs.500 crores,inflow.
2. Consider a hypothetical example on the preparation of cash from operating activities under both direct and indirect method of preparing cash flow statement.

Direct Method Cash Flow Statement [Paragraph 18(a)] (Rs. '000)

Cash flows from operating activities

Cash receipts from customers	33,150
Cash paid to suppliers and employees	(29,600)
Cash generated from operations	3,550
Income taxes paid	(1,860)
Cash flow before extraordinary item	1,690
Proceeds from earthquake disaster settlement	180
Net cash from operating activities	1,870

Indirect Method Cash Flow Statement [Paragraph 18(b)] (Rs. '000)

Cash flows from operating activities

Net profit before taxation, and extraordinary item	3,350
Adjustments for:	
Depreciation	450
Foreign exchange loss	40
Interest income	(300)
Dividend income	(200)
Interest expense	400
Operating profit before working capital changes	3,740
Increase in sundry debtors	(500)
Decrease in inventories	1,050
Decrease in sundry creditors	(740)
Cash generated from operations	3,550
Income taxes paid	(1,860)
Cash flow before extraordinary item	1,690
Proceeds from earthquake disaster settlement	180
Net cash from operating activities	1,870

AS-4(REVISED): CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

A contingency is a condition or situation, the ultimate outcome of which, gain or loss will be known or determined only on the occurrence / non-occurrence of one or more uncertain future events.

For the purpose of AS-4 the meaning is restricted to condition or situation at the Balance Sheet date, the financial effect of which is to be determined by future events which may or may not occur.

AS-4 does not deal with the following subjects, though may result in contingencies in respect of:

a) Liabilities of Life and General Insurance out of policies issued by the enterprise.
b) Obligations under retirement benefit plan / scheme
c) Commitment arising from long-term lease contract

Estimates are required to be made for the amounts to be stated in the financial statement for many ongoing and recurring activities of an enterprise. Distinction should be made between an event that is certain and that is uncertain.

Contingent losses depend on the outcome of the contingencies. It should be provided by way of a charge in the statement of profit / loss

a) if it is probable that future events will confirm after taking into account the probable recovery in this respect, that an asset has been impaired or a liability has been incurred as at the B / S date, and
b) a reasonable estimate of the resulting loss can be estimated otherwise the existence of the contingent loss should be disclosed in the financial statements.

Provisions for contii1gencies are not made in respect of general or unspecified business risk since they do not relate to conditions or situations existing at the B / S date

The disclosure requirements apply only for those contingencies or events which affect the financial position of the enterprise to a material extent stating:

a) The nature of contingency;
b) The uncertainty which may affect the future outcome;
c) The estimate of the financial effect;
d) A statement that such an estimate cannot be made;

Contingent gains are not recognized because of uncertainty of realization; however, there is no restriction to disclose as such in the 'Notes to Accounts' in a manner not likely to mislead the users of the financial statements.

Events occurring after the B/S date or those significant events, both favourable and unfavourable that occur between the B/S date and the date of approval of the financial statements by the appropriate authority (e.g. Board of Directors of a company) can be of

a) Those which provide further evidence of condition that existed at the B/S date adjusting events (e.g. insolvency of a customer that occur after B/S date)
b) Those which are indicative of conditions that arose subsequent to the B/S date non-adjusting events (loss due to earthquake, war)

Events occurring after the B/S date but indicative of the enterprise ceases to be a going concern (destruction of major production plant by fire after B/S date) needs to be considered and evaluated to justify "going concern concept" for preparation of Financial statements.

PROBLEMS

1. The assets in a factory of a limited company was damaged due to a fire break out on 15th April. The Loss is estimated at Rs. 50 crores out of which Rs.35 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final account for the previous year.

   Answer: This has to be shown as a disclosure by way of note to account.
2. Board of Directors of a limited company approved the financial account for the year 2007-08 on 31st July,2008. The following events occurred before the approval of financial statements by Board of Directors. State how would you deal with these situations:

   (a) The Board of Directors at their meeting on June 30, 2008 has recommended a dividend of 10% to be paid to the shareholders after it is approved at the annual general meeting.

   Answer: Proposed Dividend must be shown in the Balance Sheet.

   (b) A debtor, who was declared insolvent on 10th July 2008. The total outstanding amount was Rs.2 lacs as on 31st March,2008.

   Answer: A provision for loss should be provided in the books.

A5-S (REVISED): NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES.

The statement requires the classification and disclosure of extraordinary and prior period items and the disclosure of certain items within the profit or loss from ordinary activities and also accounting treatment for changes in the accounting estimate, and disclosure regarding changes in Accounting Policies in the financial statement.

To ensure preparation of Profit or Loss statement on a uniform basis, in turn to enhance better comparability of the enterprise over time and with other enterprises.

All items of income and expense, which are recognized in a period, are normally included for the determination of the Net Profit/Loss for the period unless otherwise permitted (AS-22 exception for deferred tax in the income tax)

Each extraordinary items, both income and expense arises from events/transactions, which are clearly distinct from ordinary activities and not ex petted to recur frequently or regularly, should be disclosed as apart of net profit/loss for the period in a distinct manner to understand the impact on current profit/loss

An event or transaction may be extraordinary for one enterprise but not for the other because of difference between their respective ordinary activities.

Only on rare occasion does an event/transaction give rise to extraordinary items.

Ordinary activities are those undertaken as part of business of ail enterprise and related activities for furtherance of, incidental to or arising from these activities. Frequency of occurrence is not the sole criteria to determine extraordinary or ordinary nature.

However, when items of income or expense within profit/loss from ordinary activities are of such a size, nature or incidence that their disclosure is relevant to explain the performance for the period the nature and amount of such items should be disclosed separately as exceptional items (distinct from extraordinary items) e.g.

a) write off/ write back of inventories to Net Realizable Value, provision/write back of cost of restructuring

b) disposal of fixed asset/long term investments

c) effect of legislative changes with retrospective application

d) settlement of litigation

e) other reversal of provisions

Prior period items (income/expense) arise in the current period as a result of errors/ omissions in the preparation of the financial statements, in one or more prior period are generally infrequent in nature and distinct from changes in accounting estimates.

Prior period items are normally included in the determination of net profit/loss for the current period shown after determination of current period profit/loss. The objective is to indicate the “effect of such items in the profit/loss. The separate disclosure is intended to show the impact on the current profit/loss. Disclosure is made

a) by showing the prior period items distinctively under the relevant head of income/ expenditure

b) by putting under “Prior Period Adjustment A/c either in the main statement of P/L or in a schedule containing the respective details with the net figure in the P/L A/c of current period in compliance with schedule VI part II requirement.

Notes to the Accounts should provide detail description with impact on the current period and tax implication arising thereof (e.g. stock valuation not correctly made in the previous period).

The use of reasonable estimate based on then available information circumstances are an essential part of the preparation of financial statement. There may arise a need to change the estimate on the basis of new information more experience or subsequent development. The revision in estimate does not bring the adjustment within the definition of an extraordinary item or prior period item.

The effect of change in Accounting Estimate should be included in the determination of net profit / loss

a) in the period of change (if restricted for the period only)

b) in the period of change and future period (if the change affects both) (e.g. estimate of bad debt for (a) and change in estimated life of a depreciable asset in terms of depreciation for (b»

Classification as to ordinary or extraordinary as previously followed should be maintained to disclose the effect of changes in accounting estimate for better comparability.

The nature and change in an accounting estimates having material effect in the current period or in subsequent period should be disclosed. If quantification is not predictable such fact should also be disclosed.

If it is difficult to distinguish between a change in Accounting Policy and change in Accounting Estimate the change is recognized as change in Accounting Estimate with appropriate disclosure.

Example of various disclosures under AS-5

1. change in depreciation method: change in accounting policy
2. useful life reduced but no change: change in accounting estimate in depreciation method
3. arithmetical error in depreciation computation: prior period item
4. due to oversight depreciation incorrectly computed: prior period item
5. fixed asset destroyed in earth quake: extraordinary item
6. major disposal of fixed items: ordinary activity (exceptional item)
7. maintenance provision no longer required since major part of the assets no longer exist: the write-back. if material should be disclosed as exceptional item and not as extraordinary' or prior period item.

PROBLEMS

1. Mr.Pradip an employee of CCL Ltd.went on leave with a pay for 9 months on 1.1.2008 upto 30.9.2008. His monthly pay was Rs.25,000. While preparing the financial statement on 30.6.2002 for the year ended 31.3.08, the expense of salary of Mr.Pradip for 3 months (1.1.08 to 31.3.08) was not provided due to omission. When Mr.Pradip joined on 1.10.08, the whole salary for 9 months was duly paid to him.

   In this case, three months salary of Rs.75,000 is prior period expense and following entry should be passed:

   Salary A/c Dr. 1,50,000

   Prior period expense (Salary) A/c Dr. 75,000

   To Bank A/c 2,25,000

   If Mr. Pradip was terminated from service on 1.1.08 and was re-instated in service by the Court on 30.9.08 with full pay protection(i.e. total salary was rewarded to him). As the employee was re-instated in service as per the Court's Order as on 1.10.2008, the following entry should be made:

   Salary A/c Dr. 2,25,000

   To Bank A/c 2,25,000

In such a case, there shall arise no error or omission while preparing the financial statements for the earlier years.

AS -6 (REVISED) DEPRECIATION ACCOUNTING

Deprecation is a measure of the wearing out consumption or other loss of value of a depreciable asset due to use efflux of time or obsolescence through technology and market changes and also includes amortization of assets having predetermined life.

Different accounting policies are followed by different enterprises, hence disclosure is necessary to appreciate the view presented in the financial statements.

Depreciation has a significant effect in determining and presenting financial position and operating results.

A depreciable asset must fulfill the following criteria:

a) expected to be used for more than one accounting period

b) limited useful life

c) held for use in the production or supply of goods and services, for rental, for administrative purposes, and not for sale in the ordinary course of business.

Specific exclusions from the scope of AS-6:

1. Forest, plantation and similar regenerative resource
2. Wasting asset, expenditure or a exploration for and extraction of minerals, oils natural gas and similar non-regenerative resources.
3. R&D expenditure
4. Goodwill
5. Livestock

Depreciation charge for a period is usually recognized as an expense unless included in carrying amount (e.g. depreciation of manufacturing plant is included in the cost of conversion of inventories or depreciation of assets used for development activities may be treated as an intangible assets or capital reduced)

Useful life is either:

(a) the period over which a depreciable asset is expected to be used by the enterprise or (b) on the basis of production or similar units obtainable from the use of assets.

A change in depreciation method will arise in the following situation:

a) adoption is required by the statute, or

b) for compliance with the relevant AS, or

c) it is considered that the change would result in more appropriate presentation of the financial statements

When the change is adopted, the depreciation is reworked with reference to the date of the asset put to use by the enterprise, the deficiency / surplus is adjusted in the P / L A / c in the year *of* change given effect with appropriate disclosure since as per AS 6. This is considered as a change in the Accounting Policy.

Change in depreciation method always applies retrospectively.

Disclosure under AS-6: The following information should be disclosed in the financial statement

1) Historical cost / substituted cost *of* each class of depreciable asset
2) Total depreciation for the period with respect to (1)
3) Accumulated depreciation: Additional disclosure as part of disclosure of other accounting policies

a) Depreciation method used

b) Depreciation rate or the useful lives of the assets, if they differ from rates specified in the governing statute If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material should be disclosed separately (in contrast with the concept of Block under I.T Act '61)

In case the depreciable assets are revalued, the depreciation should be provided as the revalued amount on the estimate of remaining useful life of such assets. Disclosure should be made in the year of revaluation, if the same has a material effect on the amount of depreciation.

PROBLEMS

1. Plant has useful life of 10 years. Depreciable amount of Rs.30 lakhs. The company has charged depreciation under SLM. At the end of the 6th year, the balance useful life was re-estimated at 8 years. The depreciation will be charged from the 7th year:

$$= \frac{30 - (30/10) \times 6}{8} = 1.5$$

2. B Ltd. Purchased certain plant and machinery for Rs.50 lakhs. 20% of the cost net of CENVAT credit is the subsidy component to be realized from a State Government for establishing industry in a backward district. Cost includes excise Rs. 8 lakhs against which CENVAT credit can be claimed. Compute depreciable amount.

Answer: We shall have to determine the historical cost of the plant and machinery.

Purchase Price	Rs.50 lakhs
Less: Specific Excise duty against which CENVAT is available	Rs. 8 lakhs
Original Cost of the machinery for accounting purposes	Rs. 42 lakhs
Less: Subsidy @ 20% of Rs.42 lakhs	Rs. 8.4 lakhs
Depreciable Amount	Rs. 33.6 lakhs

Note: As CENVAT Credit on Capital Goods can be availed upto 50% in the first year of acquisition and the balance in the next year, an alternative treatment may also be considered.

The original cost of the plant and machinery can be taken at Rs. 50 lakhs and a sum of Rs.8.4 lakhs can be transferred to deferred income account by way of subsidy reserve. The portion of unavailed CENVAT Credit is also required to be reduced from cost.

AS-7(REVISED): ACCOUNTING FOR CONSTRUCTION CONTRACTS

The statement applies to accounting for construction contracts, in the financial statements of contractors,

A construction contract may be related to the construction of single asset or a number of assets closely, interrelated or interdependent in terms of the scope of the contract.

For the purpose of this statement construction contract covers:

a) Contracts for rendering of services directly related to the construction of the asset e.g. service of project-managers, architects etc.

b) Contracts for destruction / restoration of assets and restoration of environments following demolition

c) Consultancy contracts in project management, designing, computers where such contracts are related to the construction of the asset.

d) Those long-term contracts not relating to construction of an asset.

A construction contract may be

a) a fixed-price contract with / without escalation

b) a cost-plus contract (provision for reimbursement of overhead on agreed basis in addition to fixed price / fees)

c) a mix of both (a cost-plus contract with a minimum agreed price)

The statement usually apply to each contract separately, however, sometimes it is necessary to apply the statement to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance. When a contract covers

a) *Number of assets:* each asset treated as separate contract when the proposal, negotiation and cost / revenue can be identified distinctly

b) *Negotiated single package of interrelated identifiable with an overall profit margin performed concurrently or continuous sequence:* treated as a single contract whether a single customer or a group of customers.

c) *Construction of an additional asset as the provision of the contract:* treated as separate contract if there is significant change in design, technology or transaction from original contract in terms of the scope and / or price.

   Additional asset should be treated as a separate construction contract if there is significant change in design, technology or function from the assets covered in the original contract price.

Contract revenue comprises of

a) revenue agreed in the contract

b) variations in the scope of contract, adverse / favourable

c) incentive payment (degree of certainty and reliability)

d) penalties due to delay in execution

Contract costs comprise of

a) directly related to specific contract

b) attributable cost relating to contract activity in general and precisely allocable to the contract as reduced by incidental income not included in contract revenue (sale of surplus material, disposal of contract specific plants etc).

Contract cost and revenue are recognized for accounting only when the outcome of the construction contract can be measured reliably with regard to the stage of completion of the contracts activity at its B/S date. All expected losses should recognized as an expense for the contract.

Under the percentage completion method, contract revenue is recognized in the P/L in the accounting period in which the work is performed and the related contract cost is shown as an expense. However, expected excess of total contract is recognized as an expense immediately. Revenue earlier recognized or becoming doubtful/uncollectable should be treated as an expense.

A long-term contract is subject to fluctuation for various reasons in the original estimation thus likely to affect the determination of contract results. It is necessary that an annual review of the cost already incurred and future cost required to complete the project on schedule. While estimating the future cost care should be taken for foreign exchange rate fluctuation, labour problem, changes in material price etc.

Disclosure under AS** -7 **(on reporting date by an enterprise)

A) An enterprise should enclose

a) The amount of contract revenue recognized as revenue in the period

b) The methods used to determine the contract revenue recognized in the period

c) Method used to determine the stage of completion of contract in progress

B) An enterprise should disclose the following for contracts in progress at the reporting date

1. The aggregate amount of costs incurred and recognized profit less recognized losses upto reporting date.
2. The amount of advance received and amount retained

C) An enterprise should present

a) Gross amount due from customer is an asset

b) Gross amount due to customer is a liability

c) Contingencies as per AS-4 (warranty cost, penalties, guarantee issued by banks against counter indemnity of contractor)

PROBLEM

A Company undertook to pay contract for a building for Rs.40lakhs. As on 31.3.2008, it incurred it incurred a cost of Rs.6 lakhs and expects that there will be Rs.36 lakhs more for completing the building. It has received Rs.4 lakhs as progress payment. What is the degree of completion?

$$\text{Percentage of Completion} = \frac{\text{Cost to date}}{\text{Cumulative cost incurred + Estimated cost to complete}} \times 100$$

$$= 6/(6 + 36) \times 100 = 14.28\%$$

AS-8 ACCOUNTING FOR RESEARCH & DEVELOPMENT

(STANDS WITHDRAWN ON INTRODUCTION OF AS-26 INTANGIBLE ASSETS)

AS-9 REVENUE RECOGNITION

The statement covers the recognition of revenue arising in the course of ordinary activities. of the enterprise *from*

a) sale of goods

b) rendering of service

c) outsourcing of resources yielding interest, royalties and dividend Specific exclusion *from* the standard pertains to

a) construction contracts

b) lease / hire purchase agreement

c) govt. grants / subsidies

d) insurance contract of insurance companies

Essential criterion for recognition for revenue *from* ordinary activities as aforesaid is that the consideration is reasonably determinable even though the payments are made by installments. In the event of uncertainty, the recognition is postponed and considered as revenue of the period in which it is properly recognized.

The standard requires, in addition to the AS- I, that an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending resolution of significant uncertainties.

<u>NOTE:</u>

Revenue include the gross inflow of economic benefits only accrued to an enterprise on its own e.g. sales tax, service tax, VAT etc. do not accrue to the enterprise and thus not considered as revenue under IAS-18 and US GAAP. Practices vary in India and tend to show larger gross turnover for the enterprise (incidentally section 145A of the Income Tax Act '61 require purchase, inventory and turnover inclusive of Tax, duty and cess)

ICAI recommends disclosure in the manner :

Turnover (gross)	xxx
Less Excise duty	xxx
Net Turnover	xxx

PROBLEMS

1. AB Ltd. Seeks you advise about the treatment of the following in the final statement of accounts for the year ended 31st March 2008:

   " As a result of a recent announced price revision, granted by the Government of India with effect from 1st July,2007, the company stands to receive Rs. 6 lakhs from its customers in respect of sales made in 2007-08"

   Answer: The company is preparing the financial statements for the year ended 31.3.08. Due to price revision granted by the Government of India, the company has to receive an additional sales revenue of Rs. 6 lakhs in respect of sales made during the year 2007-08.

   As per AS-9, where uncertainty exists in collection of revenue, its recognition is postponed to the extent of uncertainty involved and it should be recognized as revenue only when it is reasonably certain about its collection.

   In view of the above statement, if there is no uncertainty exists as to the collect ability of Rs. 6 lakhs, it should be recognized as revenue in the financial statements for the year ended 31.3.08.

2. Advise D Ltd.about the treatment of the following in the final statement of accounts for the year ended 31st March,2008.

   A claim lodged with the Railways in March,2006 for loss of goods of Rs.5 lakhs had been passed for payment in March,2008 for Rs.4 lakhs. No entry was passed in the books of the company, when the claim was lodged.

   Answer: The financial statements of the company are prepared for the year ended 31.3.08.

   There was a loss of goods of Rs.5 lakhs in 2005-06 and the claim was lodged in March 2006 with the Railway authorities. No entry was passed in the books of the company when the claim was lodged and the said treatment was correct in view of AS-9, which states that if uncertainty exists as to collectability, the revenue recognition should be postponed.

   Since, the claim is passed for payment of Rs.4 lakhs in March,2008, it should be recognized as revenue in the financial statements prepared for the year ended 31.3.08.

   As per AS-5 Revised, the claim amount received will not be treated as extraordinary item. AS-5 Revised further states that when items of income and expense within profit 0r loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Accordingly, the nature and amount of this item should be disclosed separately.

AS-10: ACCOUNTING FOR FIXED ASSETS

Fixed assets for the purpose of the statement are those held by an enterprise with the intention of being used for the purpose of producing or providing goods or services and not held for sale in the normal course of business and applies to financial statements prepared on historical cost/substituted cost basis.

The following items need special consideration and normally not covered under this statement. unless the expenditure on individual items are separable and identified.

a) forest plantation and regenerative natural resources

b) wasting assets and non-generative resources (mineral rights. exploration of mineral, oil and natural gas)

c) expenditure on real estate development

d) livestock

Apart from direct cost, all directly attributable cost to bring the asset concerned to their working condition for intended use also forms the part of fixed asset.

Subsequent expenditure after the initial capitalization that increases the future benefits from the existing assets beyond the previously assessed standard of performance (e.g. increase in" quality of output, substantial reduction in operating cost) is capitalized to form the gross book value.

Financial statements are normally prepared on the basis of historical cost but sometimes a part or all of fixed assets, are restated (revalued) and substituted for historical cost. The commonly accepted and preferred method of restating is by appraisal by a competent valuer.

As per Schedule VI, every B/S subsequent to revaluation shall disclose the increased figure with the date of increase in place of the original cost for the first 5(five) years, but the fact of such revaluation will continue to be disclosed till such time such assets appear in the B/S.

Revaluation is made for an entire class of assets or the selection of assets on a systematic basis (fact of which should be appropriately stated).

An increase in net book value arising on revaluation of fixed assets should be credited to "Owner's Fund" under "Revaluation Reserve" unless the decrease on any previously revaluation recorded as a change in P/L A/c or "Revaluation Reserve" if increase in previous occasion was credited thereto.

All material items retired from active use and not disposed off should be stated at the lower of net book value or net realizable value as a separate item in the Schedule of Fixed Assets.

Depreciation as per AS-6 should be charged on the total value of fixed assets including revalued portion.

Disclosure in addition to AS-1 and AS-6, should be made under AS-l0 in the following lines:

a) Gross and net book value of fixed assets at the beginning and end of an accounting period with additions, disposals, acquisitions and other movements.

b) Expenditures incurred on account of fixed assets in the course of constructional acquisition

c) Revalued amounts substituted for historical cost, the basis of selection for revaluation, the method adopted, the year of appraisal, involvement of external valuer.

d) The revalued amounts of each class of fixed assets are presented in the B/S separately without netting off the result of revaluation of various classes of fixed assets.

PROBLEMS

1. A company has scrapped a semi-automatic part of a machine(not written off) and replaced with a more expensive fully automatic part, which has doubled the output of the machine. At the same time the machine was moved to more suitable place in the factory, which involved the building of new foundation in addition to the cost of dismantling and re-erection. The company wants to charge the whole expenditure to revenue. As an auditor, what would you do in this situation?

   Answer: If the subsequent expenditure increases the expected future benefits from the asset beyond its pre-assessed standard of performance then as per AS-10 it should be capitalized. Otherwise, it should be treated as an expense. In this case, the replacement of semi-automatic part with a fully automatic part has doubled the output of the machine thus, it has increased future benefits beyond the machines pre-assessed standard performance, hence this expenditure should be capitalized as part of cost of the machine. However, the expenses for shifting the machine and building of a new foundation in addition to the cost of dismantling and re-erection do not contribute to any new future benefits from the existing asset. They only serve to maintain performance of the machine. Hence, this cost should be charged to revenue.

2. A publishing company undertook repair and overhauling of the machinery at a cost of Rs.5 lakhs to maintain them in good condition and capitalized the amount, as it is more than 25% of the original cost of the machinery. Advice.

   Answer: The size of the expenditure is not the criteria to decide whether subsequent expenditure should be capitalized. The important question is whether the expenditure increases the future benefits from the asset beyond its pre-assessed standard of performance as per AS-10. Only then it should capitalize. Since, in this case, only the benefits are maintained at existing level, the expenditure should not be capitalized.

3. Hero Ltd. purchased a machine of Rs.50 lakhs including excise duty of Rs. 10 lakhs. The excise duty is Cenvatable under the excise laws. The enterprise intends to avail CENVAT credit and it is reasonably certain to utilize the same with reasonable time. How should the excise duty of Rs.10 lakhs be treated?

   Answer: The following journal entries should be recorded:

In the year of acquisition:	(Rs. Lakhs)	
Machinery A/c	Dr. 40	
CENVAT Credit Receivable A/c	Dr. 5	
CENVAT Credit Deferred A/c	Dr. 5	
To Supplier's A/c		50
In the next year:		
CENVAT Credit Receivable A/c	Dr. 5	
To CENVAT Credit Deferred A/c		5

4. A company purchased a machinery in the year 2005-06 for Rs.90 lakhs. A balance of Rs. 10 lakhs is still payable to the suppliers for the same. The supplier waived off the balance amount during the financial year 2007-08. The company treated it as income and credited to profit and loss account during 2007-08. whether accounting treatment of the company is correct?

   Answer: As per para 9.1 of AS-10, the cost of fixed assets may undergo changes subsequent to its acquisition or construction on account of exchange fluctuation, price adjustments, changes in duties or similar factors. Considering para 9.1 the treatment done by the company is not correct. Rs.10 lakhs should be deducted from the cost of the fixed assets.

5. Z Ltd.purchased a machine costing Rs.5 lakhs for its manufacturing operations and paid transportation costs Rs.80,000. Z Ltd. spent an additional amount of Rs.50,000 for testing and preparing the machine for use. What amount should Z Ltd. record as the cost of the machine?

   Answer: As per Para 20 of AS-10, the cost of the fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use. In this case, the cost of machinery includes all expenditures incurred in acquiring the asset and preparing it for use. Cost includes the purchase price, freight and handling charges, insurance cost on the machine while in transit, cost of special foundations, and costs of assembling, installation and testing. Therefore, the cost to be recorded is Rs.6,30,000(= 5,00,000 + 80,000 + 50,000)

AS-11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

The statement applies mandatorily in respect of:

a) Accounting for transaction in foreign currencies

b) Translating the financial statements of foreign branches for inclusion in the financial statements of the reporting enterprise.

A transaction in a foreign currency is recorded in the financial records of an enterprise normally at the rate

a) On the date of transaction i.e. spot rate,

b) Approximate actual rate i.e. averaging the rates during the week/month in which transactions occur if there is no significant fluctuations.

c) Weighted average in the above line.

However, for interrelated transaction (by virtue of being set off against receivables and payables) it is translated with reference to the net amount on the date of transaction.

After initial recognition, the exchange difference on the reporting date of financial statement should be treated as under:

a) Monetary items like foreign currency balance, receivables, payables, loans at closing rate (in case of restriction or remittance other than temporary or when the closing rate is unrealistic, it is reported at the rate likely to be realized)

b) Non-monetary items like fixed assets, which are recorded at historical cost, should be made at the rate on the date of transaction.

c) Non-monetary items other than fixed assets are carried at fair value or net realizable value on the date which they are determined i.e. B/S date (inventories, investments in equity-shares)

Exchange difference on repayment of liabilities incurred for acquiring fixed assets should be adjusted in the carrying amount of fixed assets on reporting date. The same concept applies to revaluation as well but in case such adjustment on revaluation should result into showing the actual book value of the fixed assets/ or class of, exceeding the recoverable amount, the remaining amount of the increase in liability should be debited to Revaluation Reserve or P/L Statement in case of inadequacy/ absence of Revaluation Reserve.

Except as stated above (fixed assets) other exchange difference should be recognized as income or expense in the period in which they arise or spread over to pertaining accounting period.

Depreciation as per AS-6 should be provided on the unamortised carrying amount of depreciable assets (after taking into account the effect of exchange difference)

Disclosure under AS -11: An enterprise should disclose:

a) The amount of exchange difference included in the net profit or loss for the period.

b) The amount of exchange difference adjusted in the carrying amount of fixed assets during the accounting period.

c) The amount of exchange difference in respect of forward contracts to be recognized in the profit / loss for one or more subsequent accounting period.

d) Foreign currency risk management policy.

PROBLEMS

1.	Exchange Rate
Goods purchased on 24.3.07 of US $1,00,000	Rs.46.60
Exchange rate on 31.3.2007	Rs.47.00
Date of actual payment 5.6.08	Rs.47.50

Calculate the loss / gain for the financial years 2006-07 and 2007-08.

Answer: As per AS-11, all foreign currency transactions should be recorded by applying the exchange rate at the date of transaction. Therefore, goods purchased on 24.3.07 and corr sponding creditor would be recorded at Rs.46.60

= 1,00,000 x 46.60 = 46,60,000

As per AS-11, at the balance sheet date all monetary items should be reported using the closing rate. Therefore, the creditors of US $1,00,000 outstanding on 31.3.07 will be reported as:

1,00,000 x 47.00= 47,00,000.

Exchange loss Rs. 40,000(=47,00,000 – 46,60,000) should be debited in profit and loss account for 2006-07.

As per AS-11, exchange difference on settlement on monetary items should be transferred to profit and loss account as gain or loss thereof:

1,00,000 x 47.50 = 47,50,000 -47,00,000 = Rs.50,000 should be debited to profit or loss for the year 2007-08.

2. Z Ltd. acquired a machine on 1.4.2006 costing US $ 1,00,000. The suppliers agreed to the follwing terms of payment:

1.4.2006	: down payment	50%
1.4.2007	:	25%
1.4.2008	:	25%

The company depreciates machinery @ 10% on the Straight Line Method. The rate of exchange is steady at US $ 1= Rs.40 upto 30.9.2007. On 1.10.07, due to an official revaluation of rates, the exchange rate is adjusted to US $ 1= Rs.48.

Show the extracts of the relevant entries in the Profit and Loss Account for the year ending 31st March,2008 and the Balance Sheet as on that date, showing such workings as necessary.

Working Notes:

2006-07:

1. Original Cost of the machine = $1,00,000 x Rs.40 = Rs.40,00,000

2. Depreciation (SLM) @ 10% = Rs.4,00,000

2007-08:

1. Original Cost of the machine upto 30/9/2007 = Rs.40,00,000

2. Revised cost of the machine as on 1.10.2007

Due to official revaluation of exchange rates, the US $ 1 = Rs.48. There is a foreign exchange loss of Rs. 8 for each dollar liability. The total loss on foreign currency fluctuation was $25,000 x Rs.8 = Rs.2,00,000. This has to be added to the original cost of the machine. Therefore, revised cost of the machine as on 1.10.2007 is Rs.42,00,000 (i.e. Rs.40,00,000 + Rs.2,00,000)

The revised cost of the machine as on 1.10.2007 :

		Rs.
Original Cost on 1.4.2006		40,00,000
Less: Depreciation:		
1.4.2006 to 31.3.2007	4,00,000	
1.4.2007 to 30.9.2007	2,00,000	6,00,000
		34,00,000
Add: Loss on foreign exchange fluctuation as on 1.10.2007		2,00,000
		36,00,000

Depreciation:

1.4.2007 to 30.9.2007	(40,00,000 x 10 / 100 x 6 / 12)	2,00,000
1.10.2007 to 31.3.2008	$\left(\frac{36,00,000 \times 6}{8.5 \times 12}\right)$	2,11,765
Total Depreciation for the year 2007-08		4,11,765

Note: As per AS-6 Revised, 'Depreciation Accounting', in case of change in historical cost due to foreign exchange fluctuation, depreciation on the revised unamortized depreciable amount should be provided prospectively over the residual life of the asset. In this case, the residual life is 8.5 years.

Profit and Loss Account (extract)

for the year ended 31st March, 2008

Particulars	Rs.	Particulars	Rs.
To Depreciation on Machinery	4,11,765		

Balance Sheet (extract) as at 31st March,2008

Liabilities	Rs.	Assets	Rs.
Current Liabilities Creditors for Supply of Machinery	12,00,000	Fixed Assets Machinery (at cost) 40,00,000 Add: Adj.for foreign Exchange fluctuation 2,00,000	42,00,000
		Less: Accumulated Depreciation 8,11,765	33,88,235

AS -12: ACCOUNTING FOR GOVERNMENT GRANTS

Government refers to Union / State, Govt. Agencies and similar bodies - Local, National or International.

Grants also include subsidies, cash incentive, and duty drawback either in cash or kind / benefits to an enterprise on recognition of compliance in the past or future compliance with condition attached to it.

The accounting for the grant should be appropriate to reveal the extent of benefit accrued to the enterprise during the reporting period.

For the purpose of the statement, following are not dealt with.

a) Effects of changing prices or in supplementary information
b) Government assistance other than grants.
c) Ownership participation by government.

In order to recognize the income there should be conclusive evidence that conditions attached to the grant have been or will be fulfilled to account for such earned benefits estimated on a prudent basis, even though the actual amount may be finally settled / received after the accounting period. Mere receipt would not suffice for income recognition.

AS-4 (contingencies etc) and AS-5 (Prior period etc) would be applicable as the case may be.

The accounting for Govt. grants should be based on the nature of the relevant grant:

a) In the nature of promoter's contribution as shareholder's fund (capital approach)

b) Otherwise as Income Approach to match with related cost recognizing AS-1 accrual concept disclosure.

Government grants in the form of non-monetary assets e.g. land or other resources is accounted for at the acquisition cost or recorded at nominal value if it is given free of cost.

Grants received specifically for fixed asset is disclosed in the financial statement either

a) by way of deduction from the gross block of the asset concerned, thus grant is recognized in P / L Account through reduced depreciation (in case of funding of specific asset Cost entirely, the asset should be stated at a nominal value in B / S); or
b) the grant treated as deferred revenue income and charged off on a systematic and rational basis over the useful life of the asset, until appropriated disclosed as "Deferred Govt. grant under Reserve and Surplus in the B / S (grants relating to depreciable assets should be credited to Capital Reserve and suitably credited to P / L Account to offset the cost charged to income).

Disclosure under AS-12

a) the accounting policy, method of presentation in the financial statements.

b) the nature and extent of Govt. grants recognized in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

PROBLEMS

1. Z Ltd. has set up its business in designated backward area which entitles it to receive as per a public scheme announced by the Government of India, a subsidy of 25% of the cost of investment. Having fulfilled the conditions laid down under the scheme, the company on its investment of Rs.100 lakhs in capital assets during its accounting year ending on 31st March,2008, received a subsidy of Rs.25 lakhs in January,2008 from the Government of India. The Accountant of the company would like to record the receipt as an item of revenue and to reduce the losses on the Profit and Loss Account for the year ended 31st March,2008. Is his action justified?

   Answer: As per AS-12, the Government grants related to depreciable fixed assets to be treated as deferred income which should be recognized in the Profit and Loss Account on a systematic and rational basis over the useful life of the asset. Such grants should be allocated to income over the periods and in proportions in which depreciation on those assets is charged.

   The company has received Rs.25 lakhs subsidy for investment in capital assets which are depreciable in nature. In view of the provisions under AS-12, the subsidy amount Rs.25 lakhs received should not be credited to the Profit and Loss Account for the year ended 31st March,2008. the subsidy should be recognized and credited to the Profit and Loss Account in the proportion of depreciation charge over the life of the subsidized assets.

2. Hero Ltd. belongs to the engineering industry. The Chief Accountant has prepared the draft accounts,taking note of the mandatory accounting standards.

   "The company purchased on 1.4.2007 a special purpose machinery for Rs.50 lakhs. It received a Central Government grant for 20% of the price. The machine has an effective life of 5 years".

   Answer: AS-12 prescribes two methods in accounting treatment of Government grants for specific fixed assets.

   Method I: Government grants related to depreciable fixed assets to be treated as deferred income which is to be recognized in the Profit and Loss Account in proportion in which depreciation on those assets is charged over the useful life of the asset. The deferred income pending its apportionment to Profit and Loss Account to be disclosed in the balance sheet separately with a suitable description,e.g. Deferred Government Grants, to be shown after "Reserves & Surplus" but before " Secured Loans".

AS-13: ACCOUNTING FOR INVESTMENTS

The Standard deals with accounting for investments in the financial statements of an enterprise and relevant disclosure requirement. Investments are assets held for earning income, capital appreciation or for other benefits to the investing enterprise, obviously investments held as 'stock-in-trade' are not 'Investments'.

The following are outside the purview of AS-13:

a) Recognition of income on investment as dealt with under AS-9 (Revenue Recognition)
b) Operating or Finance Lease.
c) Investment of retirement benefit plans and Life Insurance Enterprise.
d) Mutual fund, Asset Management Companies, Banks, Public Financial Institution, enacted under specific Act / Companies Act, 1956.

Reasons, type, purposes etc varies widely and for this the standard is set to harmonize the accounting.

Cost of investment, means and includes,

a) Acquisition charges e.g. brokerage, fees, duties etc.
b) If acquired by issue of shares / securities, the acquisition cost is the fair market value, may be with reference to issue price determined by statutory authorities.

Fair market value may be determined with reference to market value or net realizable value (net of expenses to be incurred) or net of recovery of cost (dividend or interest accrued and included in the price of investments).

Current investment/Short term investment:

a) Readily realizable and not intended to be held for more than a year from date of investment.
b) The carrying amount on the reporting date is taken at lower of cost or fair value to prudently account for the unrealized losses but not the unrealized gains, considering individual or category of investments (not on overall basis).
c) Any reduction to the fair value and any reversal to such reduction is included in the P / L Account.

Long-term investment:

a) Investments held otherwise even if readily marketable are long term investments
b) Intended to protect, facilitate and furtherance to existing operation, also known as Trade investments (not meant to provide additional cash resources)
c) Long-term investments are normally carried at cost unless there is a permanent diminution in the value when the same is recognized in the carrying amount by charging or reversing through P / L Account.
d) The carrying amount is determined on individual investment basis.

   On disposal, the difference between the carrying amount and the net proceed of disposal is recognized in the P / L Account.

   Investment in Property is in Land or Building, not intended for occupation substantially for use by or in the operation of the Investing Enterprise, should be treated as long-term investment.

Reclassification of Investments:

1) Long term to current : Take lower of cost and "carrying amount"

2) Current to Long term: Take lower of cost and " fair value"

Disclosure under AS-13:

a) Accounting policy for determination of carrying amount

b) Income separately for long-term and current investments, at gross i.e. inclusive of TDS.

c) Profit or loss on disposal and changes in carrying amount separately for long term and current investments.

d) Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.

e) The aggregate amount of quoted and unquoted investments and aggregate market value of quoted investments.

f) other specific disclosure as required by Statute governing the enterprise, (e.g. Schedule VI requires classifications to be disclosed in terms of Govt. or Trust securities, shares, debentures or bonds, investment properties others)

PROBLEMS

1. In preparing the financial statements of X Ltd.for the year ended 31st March,2007, you come across the following information. State with reasons, how would you deal with them in the financial statements:

   " An unquoted long term investment is carried in the books at a cost of Rs.5 lakhs. The published accounts of the unlisted company received in June 2008 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than Rs.1 lakh".

   Answer: As per AS-13, the long term investments should be carried in the financial statements at cost. If there is a diminution in the value of long term investments, which is not temporary in nature, provision should be made for each investment individually. Any reduction in the carrying amount should be charged to the Profit and Loss Account.

   The long term investments are carried at a cost of Rs.5 lakhs in the books of accounts. The value of investments fall down to Rs.1 lakh due to cash losses and the declining market share of the company in which the investments were made.

   In view of the provision contained in AS-13, the carrying amount of long-term investments should be brought down to Rs.1 lakh and Rs.4 lakhs should be charged to Profit and Loss Account for the year ended 31st March,2008.

2. A company has invested a substantial amount in the shares of another company under the same management. The market price of the shares of the aforesaid company is about

half of that at which these shares were acquired by the company. The management is not prepared to provide for the fall in the value of shares on the ground that the loss is only notional till the time the shares are actually sold?

Answer: As per AS-13, for the purpose of determining carrying amount of shares the investment has to be classified into long-term and current; in the instant case, it appears that the investment is long-term, hence it should be carried at cost, unless there is a permanent diminution in value of investment. At the market price, investment is half of its cost. The reduction appears to be heavy and permanent, hence the provision for permanent diminution(decrease) in value of investment should be made. The contention of management is not as per AS-13.

3. MAGIC Bank has classified its total investment on 31.3.2008 into three categories: (a) held to maturity (b) available for sale (c) held for trading.

Held to maturity investment is carried at acquisition cost less amortised amount. Available for sale are carried at marked to market. Held for trading investments are valued at weekly intervals at market rates or as per the prices declared by FIMMDA. Net depreciation, if any, is charged to revenue and net appreciation, if any, is ignored. Comment on the policy of the bank in accordance with AS-13.

Answer: As per para 2(d) of AS-13, the accounting standard is not applicable to bank, insurance company, mutual funds. In this case, MAGIC Bank is a bank, therefore AS-13 does not apply here. For the banks, the RBI has issued guidelines for classification and valuation of the investment. Therefore, the MAGIC Bank should comply with RBI guidelines.

AS -14: ACCOUNTING FOR AMALGAMATIONS

Amalgamation refers to an amalgamation as per the provision of the Companies Act,1956 or any other law applicable to Companies. Sections 391 to 394 if Companies Act,1956 governs the provisions of amalgamation.

Amalgamation may be categorized broadly as:

I) Merger : - genuine pooling of assets and liabilities and shareholder’s interest of the amalgamation companies.

II) Purchase: - the shareholder of the acquired company do not continue to have proportionate share in the combined company or where the business of the former is not intended to be continued.

Amalgamation in the nature of merger:

a) All the assets and liabilities of the transferor company are taken over by the transferee company.

b) Such assets and liabilities are incorporated without any adjustment (except to ensure uniformity of accounting policies) in the financial statements of the transferee.

c) At least 90 percent equity holders of transferor become equity shareholders of transferee by virtue of the amalgamation.

d) The consideration for the amalgamation is discharged by equity shareholders in the transferee, except for fractional shares by cash.

e) The business of the transferor is intended to be carried on by the transferee.

Amalgamation in the nature of Purchase:

Absence / non-fulfillment of one or more conditions as above will make the amalgamation in the nature of purchase.

Accounting methods:

1) Merger - Pooling of interest method: -

(a) In preparing the balance sheet of the transferee company after amalgamation, line by line addition of the respective assets and liabilities of the transferor and transferee company should be made except for share capital;

(b) If Purchase Consideration is more than Share capital(equity + preference) of the transferor company, the difference will be adjusted with Reserves. No goodwill can be created or recognized since there is no acquisition. If Purchase consideration is less than share capital, such shall be recognized as Capital Reserve, as per the Expert Advisory Committee (EAC) of the ICAI, April 2004.

2) Purchase method:

a) The transferee record the assets and liabilities at their existing carrying amount or by allocating the consideration to individual identifiable assets and liabilities (even may be unrecorded in transferors' financial statements) at fair value on the date of amalgamation;

b) If Purchase consideration is more than the value of net asset acquired by transferee be recognized as "Goodwill" in the financial statement. (if feasible and practicable, the goodwill is amortised over the useful life, otherwise over a period of not exceeding 5 years). In a reverse situation it is Capital Reserve which cannot be transferred to General Reserve.

c) In case of amalgamation in the nature of purchase the identity of reserves other than Statutory Reserve (Development Allowance / Investment Allowance Reserve under I.T Act), is not preserved.

Disclosure under AS-14 (in the first financial statement after the amalgamation)

a) Names and general nature of business of the amalgamating companies

b) Effective date of amalgamation for accounting purpose

c) The method of accounting used

d) Particulars of the scheme sanctioned under statute

e) Additional disclosure for merger

1. Description and number of shares issued
2. Percentage of each company's equity shares exchanged under amalgamation
3. The amount of difference between the consideration and the value of net identifiable assets acquired and treatment thereof

f) Additional disclosure under 'Purchase' method

1. Consideration for the amalgamation and a description of the consideration paid or contingently payable
2. Amount of difference as above and the treatment / amortization period for goodwill

g) Where the scheme sanctioned under a statute prescribes a different treatment other than AS-14, for better understanding:

1. A description of the accounting treatment and reasons for variation with AS-14
2. Deviation in the accounting treatment as prescribed in he scheme under statute as compared to AS-14, if followed had there been no treatment prescribed by the scheme.

PROBLEMS

1) X Ltd. having a share capital of Rs.20 lakhs and Y Ltd.having a share capital of Rs.30 lakhs. Z Ltd. was formed to take over the business of X Ltd and Y Ltd. at a purchase consideration of Rs. 25 lakhs and Rs.28 lakhs, payable in shares of Z Ltd. The assets and liabilities were taken at their carrying amounts.

Solution: Since the purchase consideration is payable in shares of the transferee company and all the assets and liabilities are taken over at their carrying amounts, the amalgamation is in the nature of merger, i.e. pooling of interests method.

For X Ltd. Purchase consideration = Rs.25 lakhs

Less: Share capital of X Ltd = Rs.20 lakhs

Excess of purchase consideration = Rs.5 lakhs. This shall have to be adjusted against the Reserves of Z Ltd.

For Y Ltd. Purchase Consideration = Rs.28 lakhs

Less: Share Capital of Y Ltd = Rs.30 lakhs

since purchase consideration is less than share capital of the transferor company, Rs.2 lakhs shall be treated as Capital Reserve.

Note: In case of amalgamation in the nature of purchase, goodwill shall have to be shown in the Balance Sheet of the Transferee company. Such goodwill shall have to be written off over a maximum period of 5 years.

2) Net Assets of the Transferor Campany : Rs. 20 lakhs. If Purchase Consideration is (i) Rs. 18 lakhs (ii) Rs.23 lakhs & amalgamation is in the nature of purchase.

Answer: (i) Net Assets Rs.20 lakhs > Purchase Consideration Rs.18 lakhs. So, Rs.2 lakhs will be treated as Capital Reserve.

(ii) Net Assets Rs20 lakhs < Purchase Consideration Rs.23 lakhs. So, Rs.3 lakhs will be treated as Goodwill.

AS-15: EMPLOYEE BENEFITS

The statement applies to benefit usually comprising of Provident Fund, Superannuation / Pension Fund, Gratuity, Leave encashment or retirement, Post retirement health and welfare schemes and other benefits provided by an employer to employees either in pursuance of legal requirement or otherwise, but does not extend to employers' obligation which cannot be reasonably estimated (e.g. ex-gratia ad-hoc on retirement).

There may be obligation on the part of the employer either against defined contribution plan or defined benefit schemes as elaborated below:

a) Defined Contribution Plans (DCP):

1) Retirement benefit is determined by contribution at agreed / specified rate to the Fund together with earnings thereof.

2) Contribution (e.g. PF) whether paid or payable for the reporting period is charged to P / L statement

3) Excess if any is treated as prepayment

b) Defined Benefit Plans (DBP):

1) Amount paid is usually determined with reference to employee's earnings and / or years of service (if the basis of contribution are determined, it will be treated as defined contribution scheme)

2) However, if the employer's responsibility is subject to specified benefits or a specified level of benefits, it is defined benefit scheme.

3) The extent of employer's obligation is largely uncertain and subject to estimation of future condition and events beyond control.

Accounting treatment for Gratuity benefit and other defined benefit schemes depends on the arrangement made by the employer:

a) No separate fund i.e. out of nonspecific own fund:

1) Provision for accruing liability in the P / L Account for the accounting period is made.

2) The provision is based on an actuarial method or some other rational method (assumption that all employers are eligible at the end of the accounting period)

b) *Own separate/specific fund established through Trust:*

The amount required to be contributed on actuarial basis is certified by the Actuary, and the actual contribution plus and shortfall to meet the actuarial amount is charged to P / L Account for the accounting period, any excess payment treated as prepayment.

c) *Fund established through Insurer:* in the same manner as in (b) above

Actual valuation may be carried out annually (cost can be easily determined for the purpose of contribution as a charge to P / L) or periodically (say, once in 3 years) where

Actuary's certificate specifies contribution on annual basis during inter-valuation period.

Leave encashment is an accrued estimated liability based on employers' past experience as to such benefit actually availed off and probability of encashment in future and therefore should relate to the period in which relevant service is rendered in compliance with section 209(3) - accrual basis and AS-15.

Disclosure under AS-15:

a) In view of the varying practices, adequate disclosure of method of accounting for an understanding of the significance of such costs to an employer.
b) Disclosure separately made for statutory compliance or otherwise the retirement benefit costs are treated as an element of employee remuneration without specific disclosure.
c) Financial statements should disclose whether actuarial valuation is made at the end of the accounting period or earlier (in which case the date of actuarial valuation and the method used for accrual period if not based on actuary report)

Treatment of Voluntary Retirement scheme payments:

1) Termination benefits to be paid irrespective of the voluntary retirement scheme i.e. balance in P.F, leave encashment; gratuity etc.
2) Termination benefits which are payable on account of VRS i.e. monetary payment on the basis of years of completed service or for the balance period of service whichever is less and notice pay.

Expert Advisory Committee (EAC) opines in favour of treating the costs (except gratuity which should have been provided for in the respective accounting period) as deferred revenue expenditure since it is construed upon as saving in subsequent periods, on some rational basis over a period, preferably over 3 - 5 year. However, the terminal benefit is, to the extent these are not deferred should be treated as expense in the P/L Account with disclosure.

PROBLEMS

1. ZERO Bank has followed the policies for retirement benefits as under:

    (a) contribution to pension fund is made based on actuarial valuation at the year end. In respect of employees who have opted for pension scheme.

    (b) Contribution to the gratuity fund is made based on actuarial valuation at the year end.

    (c) Leave encashment is accounted for on "PAY-AS-YOU-GO" method.

    Comment whether the policy is in accordance with AS-15.

Answer:

(a) As the contribution to Pension Fund is made on actuarial basis every year, there fore the policy is as per AS-15, which is based on actuarial basis of a counting.

(b) As the contribution is being made on annual basis to gratuity fund on actuarial basis, the policy is in accordance with AS-15.

(c) As regard leave encashment, which is accounted for on PAY-AS-YOU-GO basis, it is not in accordance with AS-15. It should be accounted for on accrual basis.

2. In the context of relevant Accounting Standards, give your comment on the following matter for the financial year ending 31st March,2008:

" Increase in pension liability on account of wage revision in 2007-08 is being provided for in 5 instalments commencing from that year. The remaining liability of Rs.300 lakhs as redetermined in actuarial valuation will be provided for in the next 2 years"

Answer: As per AS-15, the costs arising from an alteration in the retirement benefits to employees should be treated as follows:

(i) The cost may relate to the current year of service or to the past years of service.

(ii) In case of costs relating to the current year, the same may be charged to Profit and Loss Account

(iii) Where the cost relates to the past years of service these should be charged to Profit and Loss Account as 'prior period' items in accordance with AS-5.

(iv) Where retirement benefit scheme is amended in a manner which results in additional benefits being provided to retired employees, the cost of the additional benefits should be taken as " Prior Period and Extraordinary Items" as per AS-5.

In view of the above, the method adopted for accounting the increase in pension liability is not in consonance to the provisions mentioned in AS-15.

AS-16: BORROWING COST

Borrowing costs are interests and other costs incurred by an enterprise in connection with the borrowing of funds.

A qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use of sale.

Examples of qualifying assets:

- Any tangible fixed assets, which are in construction process or acquired tangible fixed assets, which are not ready for use or resale. Such as plants and machinery.
- Any intangible assets, which are in development phase or acquired but not ready for use or resale, such as patent.
- Investment property.
- Inventories that require a substantial period(i.e. generally more than one accounting period) to bring them to a saleable condition.

The Statement is applied in accounting for borrowing costs which include:

1. Interest and commitment charges on bank borrowing and other short term borrowings
2. Amortization of discounts / premium relating to borrowings
3. Amortization of ancillary cost incurred in connection with arrangement of borrowings
4. Finance charges for assets acquired under finance lease or other similar arrangement
5. Exchange difference in foreign currency borrowing to the extent it relates to interest element

Borrowing cost incurred on assets, which takes substantial period, is treated as cost of that asset in respect of (1) above.

As per the Guidance Note on Audit of Miscellaneous Expenditure issued by ICAI, deferment for amortization cost upto the time the asset is put to use, in respect of (2) and (3), should be capitalized (see below for AS-16 provision).

Finance charges as in (4) can be capitalized upto the time the asset is put to use (AS-19 deals with elaborate provision)

Conditions for capitalization of borrowing costs:

- Directly attributable costs for acquisition, construction or production of qualifying asset, are eligible for capitalization.
- Qualifying assets will render future economic benefit to the enterprise and the cost can be measured reliably.

Amount of borrowing costs eligible for capitalization (specific borrowing):

- Amount of borrowing eligible for capitalization = Actual borrowing cost incurred during the period less income generated on the temporary investment of amount borrowed.

All other borrowing costs are charged to P/L Account:

AS-16 establishes a key test for capitalization which states that "borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those costs that would have been avoided if the expenditure on the qualifying asset had not been made".

Accounting treatment of borrowing cost as per AS-16:

a) Borrowing costs should either be capitalized or charged to P/L Account depending on the situation but deferment is not permitted.
b) Borrowing costs are capitalized as part of cost of qualifying asset when it is probable that they will result in future economic benefits and cost can be measured reliably - other borrowing costs are charged to P/L Account in the accounting period in which they are incurred.
c) Capitalization, on one hand reflects closely the total investment in the asset and on the other hand to charge the cost to future period against accrual of revenue.
d) Notional interest cost are not allowed to be capitalized.
e) A qualifying asset is an asset that necessarily takes a substantial period of time (usually a period of 12 months unless otherwise justified on the basis of facts and circumstances) to get ready for its intended use or sale.
f) Capitalization should be suspended during extended period in which active development is interrupted.
g) Capitalization should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
h) Capitalization also ceases 'when part is completed, which is capable of being used independent of the whole.

Disclosure under AS- 16

a) Accounting Policy adopted
b) Amount of borrowing cost capitalized during the accounting period

PROBLEMS

1. A company capitalizes interest cost of holding investments and adds to cost of investment every year, thereby understating interest cost in profit and loss account. Whether it leads to unusual accounting?

   Answer: The Accounting Standard Board(ASB) has opined that investments other than investment properties are not qualifying assets as per AS-16, Borrowing Costs. Therefore, interest cost of holding such investments cannot be capitalized. Further, even interest in respect of investment properties can only be capitalized if such properties meet the definition of qualifying assets, namely, that it necessarily takes a substantial period of time to get ready for its intended use or sale, even where the investment properties meet the definition of "qualifying asset", for the capitalization of borrowing costs the other requirements of the standard such as that borrowing costs should be directly attributable to the acquisition or construction of the investment property and suspension of capitalization as per paragraphs 17 and 18 of AS-16 have to be complied with.

2. X Ltd. has obtained an institutional loan of Rs. 800 lakhs for modernization and renovation of its machinery. Machinery acquired under the modernization scheme and installation completed on 31.3.08 amounts to Rs.600 lakhs. Rs.80 lakhs has been advanced to suppliers for additional assets and balance loan of Rs.120 lakhs has been utilized for working capital purpose. The total interest paid for the above loan amounted to Rs.80 lakhs during 2007-08.

   You are required to state how the interest on the institutional loan is to be accounted in the year 2007-08.

   Answer: The total interest of Rs.80 lakhs is related to two periods. Upto the date of installation of the machinery, amount disbursed is Rs.680 lakhs(Rs.600 + 80). Interest on such amounting to Rs.68 lakhs should be capitalized and the balance of the interest Rs.12 lakhs (i.e. Rs.80-68) should be treated as an expense.

3. Happy Ltd.has taken a loan of US $10 lakhs on 1st April,2007, for a specific project at an interest rate of 10% p.a., payable annually. On 1st April,2007, the exchange rate between the currencies was Rs.45 per US $. The exchange rate, as at 31stMarch,2008, is Rs.48 per US $. The corresponding amount could have been borrowed by Happy Ltd. in local currency at an interest rate of 15% p.a. as on 1st April,2007.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS-16.

(a) Interest for the period = US $10,00,000 x 10% x Rs.48 per US $ = Rs. 48,00,000

(b) Increase in the liability towards the principal amount= US $ 10,00,000 x (48-45)= Rs.30,00,000.

(c) Interest that would have resulted if the loan was taken in Indian currency = US $ 10,00,000 x 45 x 15% = Rs.67,50,000

(d) Difference between interest on local currency borrowing and foreign currency borrowing = Rs.67,50,000 – Rs. 48,00,000 = Rs,19,50,000

Therefore, out of Rs.30,00,000 increase in the liability towards principal amount, only Rs. 19,50,000 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs.67,50,000 being the aggregate of interest of Rs.48,00,000 on foreign currency borrowings (as per Para 4(a) of AS-16) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs.19,50,000. Thus, Rs.67,50,000 would be considered as the borrowing cost to be accounted for as per AS-16 and the remaining Rs.10,50,000 would be considered as the exchange difference to be accounted for as per AS-11 “The Effects of Changes in Foreign Exchange Rates”.

4. On 30.4.2008 MNC Ltd.obtained a loan from the bank for Rs.50 lakhs to be utilized as under:

(i) Construction of a factory shed	Rs.2 crores.
(ii)Purchase of Machinery	Rs. 1.5 crores.
(iii)Working Capital	Rs. 1 crore.
(iv)Advance for Purchase of truck	Rs. 50 lakhs.

In March 2008, construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ended 31.3.08 was Rs.90 lakhs. Show the treatment of interest as per AS-16.

Answer: As per AS-16, borrowing cost(interest) should be capitalized if borrowing cost is directly attributable to the acquisition, construction or production of qualifying asset. Rs.5 crores borrowed from Bank was utilized for four different purposes, only construction of factory shed is a qualifying asset as per AS-16, while the other three payments are not for the qualifying asset. Therefore, borrowing cost attributable to the construction of a factory shed should only be capitalized which will be equal to Rs. 90 lakhs x 2/5= Rs.36 lakhs.

The balance of Rs. 54 lakhs (Rs.90 lakhs – Rs.36 lakhs) should be treated as an expense and debited to Profit and Loss Account.

AS 17: SEGMENT REPORTING

In view of the complexities of types of businesses, the aggregated financial information is not adequate to evaluate a company's and management's operating and financial strategies with regard to specific or distinct line of activities i.e. segment. As an enterprise deals in multi-product/ multiple services and operates in different geographical areas, the degree of risk and return also varies considerably.

Segment information will enable the users to understand better and also to assess the underlying risks and returns of an enterprise.

Initially the segment needs to be broadly classified into either 'Business Segments' or 'Geographical Segments' before being slotted as 'Primary' or 'Secondary' for reporting in the financial statements as per AS- 7.

A 'Business Segment' is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of products or services, and that is subject to risk and return as distinctly different from those of other business segments. For grouping related products or services, following factors are considered:

a) The nature of product/service;
b) The nature of production processes (e.g. labour or capital intensive);
c) The type or Class of customer (e.g. gender, income).

d) The method used to describe the products or provide services (e.g. wholesaler, franchisee, dealer) similarity of economic and political condition relationship between operations in different geographical areas proximity of operation special risks associated with operation in a particular area exchange control regulation underlying currency risk (geographical location means the location of production or service facilities and other assets of an enterprise and the location of markets and customers.)

e) Nature of regulatory environment e.g. insurance, banking, public utilities etc the majority of the factors will be considered to form a single segment even though, there may be dissimilarities and a single business segment does not include products and services with significant differing risks and returns (risk in investment and potential earnings as reward).

A 'Geographical segment' is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risk and returns that are different from those of components operating in other economic environments. Factors for identification of geographical segments are:

a) Significant difference in risk and rewards;
b) Internal MIS and organization structure;
c) Essential factors that defines a business segment.

Segment accounting policies: AS-17 does not require that the enterprise apply accounting policies to reportable segments on stand-alone reporting entities, hence, additional segment information may be disclosed provided that:

i) Information is reported internally to the Board or CEO for the purpose of making decisions about allocating resources to the segment and assessing its performance.
ii) The basis of measurement for additional information is closely described.

Segment Revenue is the aggregate of the portion of enterprise's total revenue that is attributable to a segment on a reasonable basis as distinct from other segments including inter-segment transfer with the exception of

a) extra ordinary item as AS-5
b) income by way of interest / dividend etc unless the operation of the segments are primarily of a financial nature
c) gains or sale of investment or on extinguishments of debts unless the operation of the segment, are primarily of a financial nature

Inter-segment transfer should be made on the basis that is actually used to price those transfers i.e. at cost, below cost or market price and the same should be disclosed and followed consistently.

Segment result is segment revenue less segment expense

Segment Assets comprise of directly attributable or reasonably allocable operating asset to the segment as reduced by related allowances or provisions pertaining to those assets including allocable common assets, however exclude:

a) income tax asset

b) general enterprise asset / H.O asset

Segment liabilities are worked out or above basis but excluding:

a) income tax liabilities

b) general enterprise liabilities / H.O lease liabilities.

For primary segment disclosure required for:

a) segment revenue with a break-up of sales to external customers and inter segment result deduction made to arrive at segment result in respect of total amount of non cash expenses (provisions, unrealized foreign exchange gain / loss as included in segment expenses);

b) total amount of depreciation and amortization in respect of segment assets (not required if cash flow of the enterprise reports operating, investing and financing activities;

c) total carrying amount of segment assets;

d) total amount of segment liabilities;

e) total cost incurred during the period to acquire segment assets that are expected to be used for more than one period (both fixed assets and intangible assets).

For secondary segment, disclosure required for:

a) If primary format for reporting segment is business segment, it should also report;

   1. segment revenue from external customers by geographical location of customers for each geographical segment consisting 10 percent or more of enterprise revenue.
   2. total carrying amount of segment assets, by geographical location of assets for each of such geographical segment accounting for 10 percent or more of the total assets of all geographical segments.
   3. total cost incurred during the accounting period to acquire segment assets, which are expected to be used for more than one accounting period with 10 percent more criteria as in the aforesaid line.

b) where primary format is geographical, disclosure also required for each business segment accounting for 10 percent or more of revenue from sales to external customers of enterprises' total revenue or whose segment assets are 10 percent or more of the total assets of all business segments:

   1. segment revenue from external customers
   2. total carrying amount of segment assets
   3. total cost incurred during the accounting period to acquire segment assets with expected use extending beyond one accounting period (both tangible and intangible) of all geographical location where geographical segment used for primary format is based on a location, of assets which is different from location of customers.

Additional disclosure required for

1) revenue from sales to external customers for each customer based geographical segment whose revenue from sales to external customers constitutes 10 percent or more of enterprise's revenue.
2) in a reverse situation, disclosure for
   - i) total carrying amount of segment assets by geographical location of assets
   - ii) total cost incurred during the accounting period to acquire segment assets expected to be used for more than one accounting period both tangible and intangible by location of assets.

AS -18: RELATED PARTY DISCLOSURE

The scope and objective of the standard is to establish requirements for disclosure of (a) related party relationship (b) transaction between a reporting enterprise and its related parties.

This disclosure would make the financial statements of the reporting enterprise more transparent and allow the users to compare both intra-enterprise with corresponding earlier accounting period and inter-enterprise as well.

However disclosure is not required

(i) if there is statutory bar on the reporting enterprise on confidentiality (banks) in respect of constituents

(ii) in case of consolidated financial statements in respect members of the group (holding & subsidiary) with exception for transaction with Associated Enterprise accounted for under equity method

(iii) in the financial statement of State (Central or State) controlled enterprises with other state controlled enterprise even related party relationship exists. When parties are considered related?

If at any time during the reporting period one party has the ability

(a) to control the other party

(b) to exercise significant influence over the other party in making financial and / or operating decisions, then by virtue of AS -18 both parties would be considered as related.

Definition

a) Control:

(i) ownership directly or indirectly, of more than 50 percent of the voting power of an enterprise

(ii) the composition of the board of directors (company) or the Governing Body (other enterprise)

(iii) a substantial interest in voting power and the power to direct by Statute or by agreement, the financial / operating policies of the enterprise (20 percent or more interest in voting power)

b) Significant Influence:

(i) refers to participation in the financial and / or operating policy decisions of an enterprise but not control of those policies.

(ii) may be gained by ownership in share (including investment through intermediaries restricted to mean subsidiaries as defined in AS-21 Consolidated Financial Statement)

Related party disclosures are applicable only to the following related party relationships:

1. enterprises that directly or indirectly through one or more intermediaries control or are controlled by or under common control with the reporting enterprise

2. associates and joint venturers of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or joint venturer, .

3. individuals owning directly or indirectly an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise and relatives of any such individual

4. key management personnel and relatives of such individuals.

5. enterprise over which any person in (3) and (4) is able to exercise significant influence (including enterprise owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise).

Related party transactions involve transfer of resources or obligations between related parties, regardless of whether or not .a price is charged, e.g. use of logo / brand name provision of management services, providing financial guarantee use of common infrastructure etc.

Type of disclosure under AS-18

a) in case of related party relationship by virtue of significant influence (not control) e.g. those of associates, key management personnel, relatives, there is no need. to disclose the related party relationship unless there have been actual transaction during the reporting period with such related parties

b) in the event of transaction between related parties during the existence of a related party relationship (control or significant influence) the reporting enterprise should disclose

(i) the name of transacting related party

(ii) description of the relationship between parties

(iii) description of nature of transaction

(iv) volume of transaction, either in amount or approximate proportions

(v) any other element of the related party transactions necessary for understanding of financial statements (e.g. transfer of major asset taken at price different from normal commercial terms i.e. not at fair value)

(vi) either in amount or proportion of outstanding items and provisions for doubtful debts pertaining to related parties on B/S date.

(vii) amounts written off/back in the accounting period in respect of debts due from or to related parties.

AS -19: LEASES

Lease is an arrangement by which the "Lessor" gives the right to use an asset for given period of time to the "Lessee" on rent.

It involves two parties, a Lessor and a Lessee and an asset which is to be leased. The Lessor, who owns the asset, agrees to allow to the Lessee to use it for a specified period of time in return for periodic rent payments.

Types of lease

(a)***Finance Lease*** – It is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the Lessee by the Lessor but not the legal ownership. In following situations, the lease transactions are called Finance Lease.

- The lessee will get the ownership of leased asset at the end of the lease tern.
- 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 at the date on which option will be exercised.
- The lease term covers the major part of the life of asset.
- At the beginning of lease term, present value of minimum lease rental covers substantially the initial fair value of the leased asset.
- The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.

(b) ***Operating Lease*** – It is a lease which does not transfer substantially all the risk and reward incidental to ownership.

Classification of lease is made at the inception of the lease; if at any time the Lessee and Lessor agree to change the provision of lease and it results in different category of lease, it will be treated as separate agreement.

Applicability

The Accounting Standard is not applicable to following types of lease:

- Lease agreement to explore natural resources such as oil, gas, timber, metal and other mineral rights.
- Licensing agreements for motion picture film, video recording, plays, manuscripts, patents and other rights.
- Lease agreement to use land.

Definitions

1. Guaranteed Residual value – (G.R.V.)

- In respect of Lessee: Such part of the residual value (R.V.), which is guarantee by or on behalf of the lessee.

- In respect of Lessor: Such part of the residual value, which is guaranteed by or on behalf of the lessee or by an independent third party.

For the Lessor the residual value guaranteed by the third party can arise when the asset is leased to the third party after the first lease has expired and therefore it can be called the residual value guaranteed by the third party to the Lessor.

2. ***Unguaranteed Residual Value (U.R.V)*** – The difference between residual value of asset and its guaranteed residual value is unguaranteed residual value. [R.V- G.R.V.]

3. ***Gross Investment (=MLP+URV)*** – Gross investment in lease is the sum of the following:

- Minimum lease payment (from the standpoint of Lessor) and

- Any unguaranteed residual value accruing to the Lessor.

4. ***Interest rate implicit in the lease*** – When the Lessor gives an asset on lease (particularly on finance lease), the total amount, which he receives over lease period by giving the asset on lease, includes the element of interest plus payment of principal amount of asset. The rate at which the interest amount is calculated can be simply called implicit rate of interest. It can be expressed as under:-

It is the discount rate at which

Fair Value of leased Asset =Present value of [Minimum lease payment (in respect of Lessor)]

(At the inception of lease) + Any unguaranteed residual value accruing to the Lessor.

5. ***Contingent Rent*** – Lease Rent fixed on the basis of percentage of sales, amount of usage, price indices, market rate of interest is called contingent rent. In other words, lease rent is not fixed, but it is based on a factor other than time.

6. ***Minimum lease payments [MLP]***

- For Lessor = Total lease rent to be paid by lessee over the lease terms + any guaranteed residual value (by or on behalf of lessee) – contingent Rent – cost for service and tax to be paid by the reimbursed to Lessor + residual value guaranteed by third party.

- For Lessee = Total lease rent to be paid by lessee over the lease terms + any guaranteed residual value (for lessee) – contingent rent – cost for service and tax to be paid by and reimbursed to Lessor.

7. ***Lease includes Hire Purchase*** – The definition of a 'lease' includes agreements for the hire of an asset, which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements.

Accounting for Finance Lease In the books of Lessee

- Leased asset as well as liability for lease should be recognized at the lower of –
    - o Fair value of the leased asset at he inception of lease or
    - o Present value of minimum lease payment from the lessee point of view.
- Apportionment of lease payment-Each lease payment is apportioned between finance charge and principal amount.
- The lessee in its books should charge depreciation on finance lease asset as per AS-6(in this case, straight line method will be followed)
- Initial direct cost for financial lease is included is asset under lease.

Accounting for Finance Lease In the books of Lessor

- The Lessor should recognize asset given under finance lease as receivable at an amount equal to net investment in the lease and corresponding credit to sale of asset.

  Net Investment =Gross Investment – Unearned Finance Income.

  Gross Investment =Minimum lease payment from Lessor point of view + Unguaranteed residual value.

  Unearned Finance Income=Gross Investment – Present Value of Gross Investment.

- Recognition of Finance Income

  The Lessor should recognize the finance income based on a pattern reflecting, constant periodic return on the net investment outstanding in respect of the finance lease. In simple words interest / finance income will be recognized in proportion to outstanding balance receivable from lease over lease period.

Accounting for Operating Lease- In the books of Lessor:

- Record leased out asset as the fixed asset in the balance sheet.
- Charge depreciation as per AS-6

- Recognize lease income in profit & loss account using straight line method. If any other method reflects more systematic allocation of earning derived from the diminishing value of leased out asset, that approach can be adopted.
- Other costs of operating lease should be recognized as expenses in the year in which they are incurred.
- Initial direct cost of the lease may be expensed immediately or deferred.

<u>Accounting for operating lease In the Books of Lessee</u>

Lease payments should be recognized as an expense in the profit and loss account on a straight line basis over the lease term. If any other method is more representative of the time pattern of the user's benefit, such method can be used.

"Sale and Lease back"

A sale and lease back transaction involves the sale of an asset by vendor and leasing of the same asset back to the vendor.

Accounting treatment of Sale and Lease back

1. ***If lease back is Finance Lease***

- Any profit or loss of sale proceeds over the carrying amount should not be immediately recognized as profit or loss in the financial statements of a seller-lessee.
- It should be deferred and amortized over lease term in proportion to the depreciation of leased asset.

Example 1 H Ltd. Sells machinery, WDV of which was Rs. 400 lakhs for Rs. 500 lakhs to B Ltd. The same machinery was leased back to H Ltd. by BLtd. for 10 years resulting in finance lease. What should be the treatment of profit in the books of seller lessee (H Ltd.)?

The profit of Rs.10 lakhs on sale of machinery by H Ltd. (seller lessee) should not be immediately recognized in books rather it should be deferred and amortized over 10 years in proportion of the depreciation amount to be charged by the H Ltd. on the machinery.

2. ***If lease back is Operating Lease***

Any profit or loss arising out of sale transaction is recognized immediately when sale price is equal to fair value.

(A) ***If Sale price" below" fair value***

- Profit – i.e. carrying amount (=book value or value as per balance sheet) is less than the sale value, recognize profit immediately.
- Loss – i.e. carrying amount is more than the sale value, recognize loss immediately, provided loss is not compensated by future lease payment.
- Loss – i.e. carrying amount is more than sale price defer and amortize loss if loss is compensated by future lease payment.

(B)If Sale price "above" fair value

- If carrying amount is equal to fair value which will result in profit, amortize the profit over lease period.
- Carrying amount less than fair value will result in profit – amortize and defer the profit equal to "sale price less fair value" and recognize balance profit immediately.
- Carrying amount is more than the fair value – which will result in loss equal to – (carrying amount less than fair value), should be recognized immediately. Profit equal to – selling price less fair value – should be amortized.

Example 2: H Ltd. sold machinery having WDV of Rs. 400 Lakhs to B Ltd. for Rs. 500 Lakhs and the same machinery was leased back by B Ltd. to H Ltd. The Lease back is operating lease. Comment if –

a) Sale price of Rs. 500 lakhs is equal to fair value

b) Fair value is Rs. 600 lakhs

c) Fair value is Rs. 450 lakhs and sale price is Rs. 380 lakhs

d) Fair value is Rs. 400 lakhs and sale price is Rs. 500 lakhs

e) Fair value is Rs. 460 lakhs and sale price is Rs. 500 lakhs

f) Fair value is Rs. 350 lakhs and sale price is Rs. 390 lakhs

Answer:

a) H ltd. should immediately recognize the profit of Rs. 100 lakhs in its books.

b) Profit Rs. 100 lakhs should be immediately recognized by H Ltd.

c) Loss of Rs. 20 lakhs to be immediately recognized by H Ltd. in its books provided loss is not compensated by future lease payment.

d) Profit of Rs. 100 lakhs is to be amortized over the lease period.

e) Profit of Rs. 60 lakhs (460-400) to be immediately recognized in its books and balance profit of Rs. 40 lakhs (500-460) is to be amortized / deferred over lease period.

f) Loss of Rs. 50 lakhs (400-350) to be immediately recognized by H Ltd. in its books and profit of Rs. 40 lakhs (390-350) should be amortized / deferred over lease period.

AS -20: EARNING PER SHARE (EPS)

Disclosure under AS-20:

a) The applicability of the standard is mandatory with effect from accounting year commencing on or after 01-04-2001 in respect of enterprises whose equity shares or potential equity shares are listed on a recognized stock exchange in India.

b) However under Part IV of Schedule VI of the Companies' Act '56 every company is required to disclose EPS in accordance with AS-2O, whether listed on a recognized stock exchange or not.

c) Presentation of EPS is required to be made both on the basis of consolidated financial statement, as well as individual financial statements of the parent company.

d) Presentation should be made in terms of Basic and Diluted EPS on the face of 'the Profit & Loss Account for each class of equity share that has a different right to share in the net profit for the accounting period. For equity shares having different nominal value but carrying same voting rights should be covered into equivalent number of shares of the same nominal value.

e) Both Basic and Diluted EPS should be presented with equal prominence for all periods even if the amounts are negative (a loss per share).

f) In addition to above, following are also disclosed:

1. the amount used as the numerator and a reconciliation of those amounts to the net profit/loss for the accounting period.
2. the weighted average number of equity shares used as the denominator and a reconciliation of those denominator to each other.
3. the nominal value of shares along with EPS figure.

g) Disclosure may also be made of terms and conditions of contracts generating potential equity which affect the basic and diluted EPS both on the weighted average number of shares outstanding and any consequent adjustments to net profit attributable to equity shareholders, following the computation of the denominator in accordance with AS-20.

Basic EPS:

a) Basic EPS is worked out by dividing the net profit /loss for the accounting period by the equity share using weighted average number of equity shares outstanding during the same period.

b) Net profit or loss should be arrived at after considering all income and expense recognized during the period including tax expense extraordinary as reduced by preference dividend in respect of non cumulative and cumulative for the period

c) Disclosure as an alternative maybe presented for basic and diluted on the basis of earning excluding extraordinary items (net of tax expenses).

Impact of bonus element in rights issue on EPS denominator:

In a right issue the exercise price in often less than fair value of shares thus it includes a bonus element and moreover, an adjustment is needed to recompute the fair value in relation to theoretical ex-right value per share.

Diluted EPS indicates the potential variability or risk attached to the basic EPS as a consequence of the issue of potential equity shares and potential dilutive securities having significant impact on lowering EPS. However, no potential equity shares be included in the computation of any diluted per share amount in case of continuing loss from operation, even though the entity reports an overall net profit.

i) Adjustments should be made both in numerator and denominator consequent upon the conversion of potential dilution to arrive at diluted EPS in keeping with the nature of conversion including tax implication thereon in the respective year

ii) Potential equity shares are:

a) debt instruments/preference share convertible into equity shares

b) share warrants

c) employees and other stock option plans which entitles them to receive equity shares as part of their remuneration and other similar plans

d) contingently issuable shares under contractual arrangements e.g. acquisition of a business/assets, loan converted to equity on default

e) share application pending allotment if not statutorily required to be kept separately and is being utilized for business is treated as potential (dilutive) equity share.

PROBLEMS

1. Weighted avg. number of equity shares has been illustrated in AS-20 in the following line:

Accounting year: 2007-08				
Date	Description	Shares Issued (Nos)	Buyback (Nos)	O/S
01/04/2007	Op. Balance	1800	-	1800
30/09/2007	Issued for Cash	600	-	2400
29/02/2008	Buyback	-	300	2100
31/03/2008	C1. Balance	2400	300	2100

<u>Weighted average number</u>

a) (1800 x 5/12) + (2400 x 5/12) + (2100 x 2/12) i.e. 2100 shares

or

b) (1800 x 12/12) + (600 x 7/12) - (300 x 2/12) i.e. 2100 shares

2. Net profit for 2006-07: Rs 18,00,000; Net profit for 2007-08: Rs 60,00,000; No. of equity shares as on 31.12.07: Rs.20,00,000.

Bonus issued on 1-1-08 : 2 equity shares for each Equity Share outstanding at 31-12-08 i.e. Rs. 40,00,000.

Answer:

EPS for 2007-08: (Rs 60,00,000) / (20,00,000+40,00.000) = Re 1.00

Adjusted EPS for 2006-07: (earliest period reported) (Rs 18,00,000) / 60,00,000 = Re 0.30

3. Compute EPS:

a) Net profit for 2006 Rs 11,00,000

   Net profit for 2007 Rs 15,00,000

b) Nos. of shares outstanding prior to Right Issue: 5,00,000 shares

c) Right Issue: one new share for 5 outstanding i.e. 1,00,000 new shares

d) Right price: Rs 15/-

e) Last date of right option: 1st March 2007

f) Fair value prior to the right option on 1st march 2007: Rs 21/- per equity share

Computation:

1) Theoretical ex-right fair value per share:

   [(Rs 21 x 5,00,000) + (Rs 15 x 1,00,000)] / (5,00,000+ 1,00,000)

   i.e. 1,20,00,000/6,00,000 = Rs 20/

2) Adjustment factor:- fair value prior to exercise of rights/theoretical ex-right value. i.e. 21/20=1.05

3) Computation of EPS:

Year 2006	*Year 2007*
EPS as originally reported	
Rs. 11.00,000/5,00,000 shares	Rs 2.20
EPS restated for right issue	
Rs. 11,00,000/(5,00,000xRs 1.05)	Rs 2.10
EPS-for 2007 including rights	
Rs. 15,00,000/(5,00,000x 1.05x2/12)+(6.00,000x 1 0/12)	Rs 2.25

AS -21: CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements are presented by the parent or holding enterprise to provide financial information about the economic activities of its group - information about the parent and subsidiaries as a single economic entity revealing economic resources controlled by the group, the obligation of the group and the result that the group achieved with its resources.

AS-21 lays down the principles and procedures for preparation and presentation of consolidated financial statements in the backdrop of the facts that the Company's Act '56 doesn't provide for consolidation vis-à-vis the compliance to be made by listed companies in terms of AS-21.

Thus in parent enterprise's separate financial statements, investment in subsidiaries should be accounted for as per AS-l3, i.e. Accounting for Investments.

The consolidated financial statements even if made voluntarily should comply with AS -21.

The key note is the control by the parent which means and includes:

i) the ownership, directly or indirectly through subsidiary / subsidiaries of more than 50% of the voting power of an enterprise or,

ii) control of the composition of the Board of Directors or Governing Body (e.g. in the form of restriction, holding a position and right in nomination exercisable by the parent with reference to the subsidiary) as the case may be so as to obtain economic benefits from its activities.

Further "Control" is also further screened to exclude a subsidiary if;

a) it is intended to be temporary i.e. the subsidiary is acquired and held exclusively with a view to subsequent disposal in near further, in other words not intended for long term purpose.

b) there is long term restriction on the subsidiary which significantly impair its ability to transfer funds to the parent enterprise. (e.g. embargo on fund transfer by foreign subsidiary-severe devaluating currency)

In above cases investment would be valued as per AS -13 and not AS-21. AS-2) does not deal with the specific AS as under:

i) AS-14 - Accounting for Amalgamation

ii) AS-23 - Accounting for Investment in Association

iii) AS-27 - Accounting for investment in Joint Venture

Since schedule VI is not tailored to the presentation of consolidated financial statement. ICAI has provided general guideline vide GC-5 / 2002 which broadly states that the following principles should be served:

a) notes which are necessary for presenting a true and fair view of the consolidated finance statements should be included as an integral part thereof.

b) Only the notes involving items, which are material, need to be disclosed and the materiality is judged in the context of consolidated financial statement. Applicability of other Accounting Standard, in the preparation and presentation of consolidated statements are stated below:

a) irrespective of the format followed, the minimum disclosure under various mandatory standards should be made.

AS-1: disclosure of accounting policies (e.g. going concern)

AS-22: accounting for taxes and income as applicable to the individual entity only cannot be given setoff treatment in CFS.

Specific items to AS in respect of balances of individual enterprise and not as a group e.g. “Current Investment valued at lower of cost or market price” Segmental information on consolidated numbers of individual enterprise in the group only.

Disclosure relating -to operating lease (AS-19) would not be required since the same is setoff and eliminated at consolidated level.

Related party transaction, within the group would not require discloser since eliminated at consolidated level.

Accounting related treatment for in consolidated financial statements:

a) Consolidation should be made on line by line basis by adding together like items- assets, liabilities, income and expense

b) All group balances and group transactions and unrealized profits arising thereon should eliminated

c) Dividend - minority share when paid is deduced from opening “Minority Interest” A / c and the portion attributable to parent is eliminated from Consolidated Reserves.

d) Excess of cost to the parent of its investment in a subsidiary over the parent’s portion of equity of the subsidiary on date of investment is recognized as ‘goodwill’ or in reverse situation as ‘capital reserve’ and the ‘minority interest’ as a liability separately in the consolidated financial statement as a distinct item.

e) When carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered

f) Usually consolidated financial statements are drawn upto the same date for reporting. In case, the reporting dates are different, the subsidiary normally prepares statements as at the same date of the parent. However, impracticable, different dates may be reported but the difference should not be more than six months with adjustments made for the effects, of significant transactions during the intervening period in respect all the items in the financial statements pertaining to that transaction e.g. cost of sales, inventory, unrelated gains, inter group balances. If not material otherwise, may be adjusted in income statement.

g) AS-21 permits the use of different accounting policies and estimates between group members, as long as the proportion of these in the in the context of the CFS are properly disclosed and explained.

h) AS-21 allows the use of financial statements of the subsidiary for the immediately preceding period if the financial statements as on the date of investments are not available or impracticable to draw the financial statements as on that date. As stated earlier, effects of significant transactions or events occur between the two dates are made.

i) I several investments are Trade over time to make it 51 % control, goodwill may be determined when the last investment is made to bring the slake to 51 % or alternatively on each step-up investment basis.

j) Goodwill is determined on the basis of carrying value of assets / liabilities of the subsidiary at the balance sheet date, thus fair value accounting for acquisition is not permitted under AS-21.

k) Where a group has acquired several subsidiaries, some resulting in goodwill and others a capital reserve, set off is not made for consolidation purpose.

Disclosure in terms of AS-21

a) Disclosure should be made in accordance with the format of the parent company's financial statements. Further disclosure under all the mandatory accounting standards when material and also compliance with General Classification no. 5 / 2002 should be made in order to ensure comparability for one period to the next, supplementary information about the effect of acquisition and disposal of subsidiaries on the financial position at the reporting date and results for the reporting period with comparative preceding period amount, should be disclosed.

b) Reasons for exclusion from consolidation of subsidiaries should be disclosed. List of all subsidiaries- name, country of incorporation / residence, proportion of ownership interest and if different proportion of voting power.

c) Nature of relationship if the parent does not own directly or indirectly more than 50% of voting power of the subsidiary.

d) Names of subsidiary / subsidiaries of which reporting dates are different from that of the parent and the difference in reporting dates.

AS-22: ACCOUNTING FOR TAXES ON INCOME

The need for establishing a standard arises due to difference between profit computed for accounting and that for tax purpose. As per this standard, the income tax-expense should be treated just like any other expenses on accrual basis irrespective of the timing of payment of tax.

Tax expense = current tax + deferred tax

Current tax is the amount of income-tax determined to be payable(recoverable) in respect of the taxable income (tax loss) for a period.

Deferred tax is the tax effect of timing difference.

The difference accounts for:

a) treatment of revenue and expenses as appearing in the profit and loss Ale and as considered for the tax purpose.

b) the amount of revenue or expenses as recognized in the P / L A / c and as allowed for tax purpose.

The difference as arising in the above context gives rise to 'deferred tax' and it needs to be ensured that the tax charges in future accounting period is not vitiated.

The difference in accounting profit and taxable profit can be broadly categorized into two:

a) *Permanent difference:* which originates in one period and do not reverse in subsequent periods, e.g. personal expenses disallowed, interest/penalty disallowed as expense or tax-free agricultural income, various deduction under section 10, benefit/reliefs under section 80 in computing taxable income.

Permanent differences do not result in deferred taxes.

b) *Timing difference:* which originates in one period and is capable of reversal in subsequent period(s):

- difference in net block of fixed assets as per accounts and as per tax due to difference in the rate and method of depreciation;
- provision for doubtful debts and advances, provision for warranties, provision for VRS, provision for asset write-off, disallowed payments under 43B of Income Tax Act, provision for excise liabilities, provision for diminution in value of investments, scientific research expenditure (not weighted deduction which is a permanent difference), section 350 deduction, amortization of deferred revenue expenditure, lease income.

Situations which leads to Deferred Tax:

Deferred tax is the tax effect due to timing difference. They arise due to the following reasons:

- Accounting Income less than Tax Income
- Accounting Income more than Tax Income
- Income as per Accounts but loss as per IT Act
- Loss as per Accounts but income as per IT Act

Impact of such timing differences may lead to:

- Deferred Tax Liability (DTL): postponement of tax liability, which states Save Now, Pay Later.

  Profit and Loss A/c………..Dr

  To Deferred Tax Liability A/c

- Deferred Tax Asset (DTA): pay you tax liability in advance, which states Pay Now, Save Later.

  Deferred Tax Asset A/c……….Dr

  To Profit and Loss A/c

In the year of reversing time difference, either DTL is written back to profit and loss or the DTA is reversed by debiting profit and loss account.

For the recognition of DTA, prudence should be applied. Such recognition is based on " reasonable certainty" that sufficient taxable income would be available in the future to realize the DTA.

In case of unabsorbed depreciation and carry forward losses, DTA should only be recognized to the extent that there is "virtual certainty" that in future sufficient taxable income would be available to realize the DTA.

Reasonable certainty shall be deemed to be in existence if the probability of future taxable income is greater than 50%.

Virtual certainty shall be deemed to be in existence only when the evidence suggests that there will be sufficient taxable income in the future.

Disclosure under AS-22 Mandatory :

a) Break up of the deferred tax asset/liability.

b) DTL should be shown after the head "Unsecured Loans" and DTA after the head "Investments" with a separate heading.

PROBLEMS

1. From the following information for R Ltd. for the year ended 31st March,2008, calculate the deferred tax asset/liability as per AS-22

Accounting Profit	Rs.10,00,000
Book Profit as per MAT(Minimum Alternate Tax)	Rs.9,00,000
Profit as per Income Tax Act	Rs.1,00,000
Tax Rate	30%
MAT Rate	10%

Answer:

Tax as per accounting profit: 10,00,000 x 30%= 3,00,000

Tax as per Income Tax profit : 1,00,000 x 30% = 30,000

Tax as per MAT : 9,00,000 x 10% = 90,000

Tax expense = Current tax + deferred tax

3,00,000 = 30,000 + deferred tax

Therefore, Deferred Tax Liability as on 31.3.08 = Rs.3,00,000 – Rs.30,000 = Rs.2,70,000.

Amount of tax to be debited in Profit and Loss Account for the year 31.3.08:

= Current tax + deferred tax liability + Excess of MAT over current tax

= 30,000 + 2,70,000 + (90,000 – 30,000)

= 3,60,000

2. Z Ltd,has provided depreciation as per accounting records Rs.40 lakhs but as per tax records Rs.60 lakhs. Unamortized preliminary expenses, as per tax records is Rs.20,000. there is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment? Tax rate 30%.

Answer: As per Para 13 of AS-22, deferred tax should be recognized for all the timing differences. In this situation, the timing difference i.e. the difference between taxable income and accounting income is :

Excess depreciation as per tax Rs. (60 – 40) lakhs	= Rs.20.00 lakhs
Less: Expenses provided in taxable income	= Rs. 0.20 lakhs
Timing difference	Rs.19.80 lakhs

As tax expense is more than the current tax due to timing difference of Rs.19.80 lakhs, therefore deferred tax liability = 30% of Rs.19.80 lakhs = Rs.5.94 lakhs.

Profit and Loss A/c…………Dr	5.94	
To Deferred Tax Liability A/c		5.94

AS-23: ACCOUNTING FOR INVESTMENTS IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS (CFS)

An enterprise that presents CFS should account for investments in Associates as per this standard.

This standard is not applicable for preparing and presenting stand-alone Investors' financial statement (in such cases AS] 3 is followed).

An Associate is an enterprise in which the investor has significant influence (power to participate in the financial/operating policy decisions of the investee but not control over those policies) and which is neither a subsidiary nor a joint venture of the Investor. The 'control' for the purpose of AS-23 is similar to that of AS-21.

Significant influence may be evidenced in one or more ways in the following line:

a) Representation on the Board of Directors or Governing Body of the Investee.

b) Participation in policy making process

c) Material transaction between investor and investee.

d) Interchange of managerial personnel

e) Provision of essential technical information

But it does not extend to power to govern the financial and / or operating policies of an enterprise.

Significant influence may be gained through share ownership, statute or agreement:

a) For share ownership, 20% or more in voting power in investee (held directly or indirectly through subsidiary) indicates significant influence but that is not the ultimate, the significant influence must be clearly demonstrated.

b) A substantial or majority ownership by another investor in the investee does not necessarily preclude an investor to have significant influence.

c) Voting power is determined on the basis of current outstanding securities and not potential equity.

Non applicability of AS-23:

1) Investment in associates are accounted for using the 'equity method' in the CFS except when,

   a) the investment is made and held exclusively with a view to subsequent disposal in the near future, or

   b) the associate operates under severe long-term restrictions that significantly impairs its ability to transfer funds to investor. Investments in such a situation is accounted for in accordance with AS-3 in CFS.

2) Equity method of accounting is also not applicable if

   a) it has no investment in Association

   b) it has investment in Association but has no subsidiaries, CFS is not required

   c) it has subsidiaries and associates but these are not material, hence CFS is not prepared.

   d) It is not listed enterprise hence not mandatory to present CFS or has not chosen voluntarily to present CFS.

Equity method of accounting recognizes the investment initially recorded at cost identifying goodwill / capital reserve at the time of acquisition. The carrying amount of investment is thereafter adjusted for the post-acquisition charge in the investor's share of net assets of the investee and consolidated P / L A / c reflect the investor's shares in the result of operation of the investee. Further any permanent decline in the value of investment is reduced to arrive at the carrying amount for each such investment.

Except inconsistent with AS-23, other accounting treatment would follow AS-21 Disclosure under AS-23

a) Reasons for not applying Equity Method in accounting for investments in associates in CFS .

b) Goodwill / capital reserve as included in the carrying amount of investment in Associates disclosed separately.

c) Description of associates, proportion of ownership interest and if different proportion of voting power held disclosed in CFS.

d) Investment using equity method should be classified as long-term investment in consolidated balance sheet, similarly investor's share in profit/loss in consolidated P/L Account and also investor's share of extraordinary or prior period items should be disclosed separately.

e) The names of associates of which reporting date is different from that of the financial statements of the investor and difference in reporting date should be disclosed in CFS.

f) Difference in the accounting policies if not practicable for appropriate adjustment in Associate's financial statement for being adjusted in CFS, the fact as such with description of difference in accounting policies should be disclosed.

g) In compliance with AS-4, Contingencies and events occurring after the balance sheet date, the investor discloses in the CFS:

(i) its share of contingencies and capital commitments of an Associate for which the investor is contingently liable, and

(ii) those contingencies that arise because the investor is severely liable for the liabilities of the associate.

PROBLEMS

1. X holds, 25% share in Y Ltd at a cost of Rs 5 lakhs as on 31-03-2001. Out of Y's shares capital and reserve Rs 20 Lakh each.

For the year ended 31-03-08 Y made a profit of Rs 80,000 and 50% distributed as dividend. In the CFS, the value (carrying amount) as at 31-03-2008 will be as under:

	Rs in Lakhs
Cost of shares in Y Ltd.	5.00
Share of Reserve	5.00
Share of profit	0.20
	10.20
Less: dividend received	0.10
Value of investment as at 31.03.08	10.10

2. Style Ltd. acquired 30% of Ugly Ltd.'s shares on April 10,2007, the price paid was Rs.20,00,000.

	Rs.
Equity shares(Paid up)	5,00,000
Securities Premium	5,00,000
Reserve	5,00,000
	25,00,000

Further, Ugly Ltd reported a net income of Rs.3,00,000 and paid dividends of Rs.1,00,000. Style Ltd. has subsidiary on 31.3.08. Calculate the amount at which the investment in Ugly Ltd should be shown in the consolidated Balance Sheet of Style Ltd. as on 31.3.08

Answer: As per AS-23, when the investor company prepares the consolidated Balance Sheet, the investment in associate i.e. Ugly Ltd. shall be carried by equity method and goodwill and capital reserve to be identified and disclosed separately.

Value of the investment as per equity method

= 20,00,000 + 30% (3,00,000 – 1,00,000)= Rs.20,40,000.

Goodwill identified = (20,00,000 – 30% of 25,00,000) = Rs. 12,50,000

AS-24: DISCONTINUING OPERATION

AS-24 requires disclosure to be made when the discontinuation is in process and not merely once it has been fully completed for reporting information, to enhance the ability of the user of the financial statements to study projection of cash flow, earnings generating capacity and financial information differentiating between 'continuing' and 'discontinuing' operation.

Prerequisites to determine 'discontinuing operation' –

1. The enterprise in term a single plan:

    a) disposing substantially in its entirety e.g. by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholder, or

    b) disposing in piecemeal manner e.g. selling off the assets-and settling its liabilities individually or

    c) terminating through abandonment

2. That represent, a separate major line of business or geographical area of operation, and

3. That can be distinguished operationally for financial reporting purpose.

A restructuring event or transaction that does not meet with the definition of a 'discontinuing operation' within the ambit of AS-24, should not be called or treated as discontinuing operation. Typical example of instances which by itself does not mean 'discontinuing operation' but may lead to such in combination with other circumstances:

a) gradual or evolutionary phasing out of a product line or class of service

b) abrupt discontinuing of several products within an ongoing line of business

c) shifting of some production or marketing activities for a particular line of business from one location to another

d) closing of a factory to achieve productivity improvements or other cost savings. 'discontinuing operation' are expected to occur infrequently, but resulting income or expenses arising thereof needs to be disclosed in terms of AS-5 ~o explain the performance of the enterprise for the period.

Above all any transaction or event or in combination in order to be treated as 'discontinuing operation.' must be in terms of an overall plan falling within the prerequisites of 'discontinuing operation.

AS- 17 for segment reporting would normally satisfy the definition of 'discontinuing operation', but the significance for reporting under AS-24 will depend on individual judgment e.g. an enterprise operates in a single business / geographical segment though not reportable under AS- 17 may fall within the ambit of AS-24.

The criteria of discontinuation which can be distinguished operationally and for financial repotting purpose must fulfill the following:

a) the operating assets / liabilities of the component can be directly attributed to it.

b) revenue can be directly attributed to it

c) at least a majority of operating expenses can be directly attributed to it.

Going concern concept is not disturbed if an enterprise merely disposes off few of its segments but continues to operate its other business profitably, on the other hand if a substantial part of its operation is discontinued and there is no operation to carry as a result, it will cease to be going concern.

Discontinuing process need not necessarily arise out of binding sale agreement but relates back to the announcement of a detailed, formal plan approved by the Board of Directors / Governing Body, if precedes sales agreement and therefore require initial disclosure event / transaction. However the announcement must demonstrate the commitment to discontinue resulting into a constructive obligation for the enterprise. Requirement of initial disclosure in the financial statement for the period in which the event of discontinuing operation occur, are:

I. A description of discontinuing operation

2 The date and nature of initial disclosure event

3. Probable date or period by which the discontinuance is expected to be completed

4. Carrying amount of the total of assets to be disposed off and the total of liabilities to be settled as of the Balance sheet date

5. The amount of revenue and expenses in respect of ordinary activities attributable to the discontinuing operation during the current financial reporting period.

   the pre-tax profit / loss and tax expense (AS-22) in the above line. the amount of net cash flow attributable to the operating / investing / financing activities of the discontinuing operation during the current financial reporting period. If the initial disclosure event occurs in between the balance sheet date and the date of approval of financial statements by the board of directors / corresponding approving authority, disclosure compliance should be made as per AS-4 not under AS-24. Disclosure should continue till the discontinuance is substantially completed or abandoned, irrespective of receipt of payments from its buyer.

In case the discontinuance plan is abandoned or withdrawn as previously reported, the fact, reasons and effects thereof including reversal of any prior impairment of loss or provision that was recognized in the plan, should be disclosed.

Disclosure under AS-24

1. By way of a note in the financial statement in respect of each discontinuing operation, in addition to disclosure on the face of the statements of profit / loss in respect of:

a) the amount of pre-tax profit / loss from ordinary activities, income tax expense as attributable to discontinuing operation, during the current financial reporting period; and

b) the amount of pre-tax gain or loss recognized on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

2. Comparative information for prior period that is presented in financial statements prepared after the initial disclosure should be restated to segregate assets, liabilitiesrevenue expense and cash flows of continuing and discontinuing operations.

3. AS-24 does not provide for the principles to recognize and measure profit / loss in respect of discontinuing operation and therefore, other accounting standards would be applicable e.g. AS-4, AS-10 and other AS as and when applicable.

PROBLEMS

1. A FMCG company is manufacturing two brands of soap. Cinthol and Breeze. Company has gradually planned to shift all the manufacturing operation engaged in two soaps to manufacture only ‘Breeze Soap’ without closing the factory / plant producing the ‘Cinthol Soap’, rather utilizing the production facilities of ‘Cinthol Soap’ for producing the ‘Breeze Soap’. Can we consider the operation to have been discontinued ?

Answer: Discontinuing operation is relatively large component of an enterprise which is major line of business or geographical segment, that is distinguishable operationally or for financial reporting such component of business is being disposed on the basis of an overall plan in its entirety or in piecemeal. Discontinuance will be carried either through demerger or spin-off, piecemeal disposal of assets and settling of liabilities or by abandonment.

In the given case, it is not a discontinuing operation.

2. B Ltd. is a software company, has subsidiary C Ltd. B Ltd.hold 70% shares in C Ltd. During 2007-08, B Ltd. sold its entire investment in C Ltd. Is it a discontinuing operation?

Answer: As per the definition and scope of ‘discontinuing operation’, the sell of investments in subsidiary company does not attract the provisions of AS-24.

Hence, it is not a discontinuing operation.

3. C Ltd.has three major lines of business: steel, tea and power generation. It has decided to sell the tea division during the financial year 2007-08. A sale agreement has been entered into on 30th September 2007 with P Ltd. under which the tea division shall be transferred to P Ltd. on 31st March,2008. Is it a discontinuing operation?

Answer: This is a case of disposing of the tea division substantially and in its entirety. It will be considered as a discontinuing operation.

However, if a special resolution is passed for sale of various assets and to repay the various liabilities individually of the tea division, it is a case of "disposing by piecemeal" and not a "discontinuing operation".

Note: Any planned change in the product line may not be treated as a discontinuing operation.

AS-25: INTERIM FINANCIAL REPORTING

Interim financial reporting is the reporting for periods of less than a year, generally for a period of 3 months. As per Clause 41 of listing agreement the companies are required to publish the financial results on a quarterly basis.

AS-25 prescribe minimum content of an interim financial report and principles for recognition and measurement in a complete or condensed financial statement for an interim period or specific dates in respect of asset, liability, income and expense.

There are certain typical problems not faced while preparing annual account as the reporting period is shortened, the effect of errors in estimation and allocation are magnified e.g.

i) accrual of tax credits in different interim period, makes determination of tax expense often difficult, one period may reveal tax profit while the other interim period have tax losses;

ii) benefit of expenses spread beyond interim period e.g. advertising expenses, major repair and maintenance expenses;

iii) determination of approximate amount of provisions, e.g. warranties, pension, gratuity, maybe complex 'and time consuming;

iv) revenue may be seasonal or cyclical, hence concentration falls in certain interim periods;

v) inter-company reconciliation, full stock-taking and valuation may be cumbersome and time consuming;

vi) transaction based on Annual Targets e.g.: bonus or incentives would be difficult to estimate.

The standard itself does not categorize the enterprise or frequency of interim financial report and the time limit for presentation from the end of an interim period, but if it is required to prepare and present, it should comply with AS-25.

Instances for interim financial report:

(i) quarterly report to the board of directors or bank

(ii) incase of merger and amalgamation

(iii) for IPO purpose

(iv) for consolidation of parent and subsidiary when year ends are different

(v) for declaring interim dividend' Accounting for interim transaction:

(a) interim period is considered as integral part of annual accounting period e.g. annual operating expc!1ses are estimated and then allocated to the interim period based on estimated sales or other parameters and results of subsequent interim periods are adjusted for estimation errors (integral approach)

(b) each interim period is considered as discrete and separate accounting period like a full accounting period e.g. no estimation or allocation and operating expenses are recognized in the concerned interim period irrespective of benefit accruing to other interim period (discrete approach).

Form and contents of interim financial statement:

a) AS 25 doesn't prohibit an enterprise from presenting a complete set of financial statements (e.g. balance sheet, profit & loss statement, cash flow statement notes to account and accounting policies, other statements and other explanatory' materials as forming integral part of the financial statement).

b) The recognition and measurement principles as stated in AS-25 also apply to complete set of financial statements for an interim period, full disclosure under this statement and other accounting standard will be required.

c) Alternatively, the statement allows preparation and presentation 'of interim financial report in a condensed form, containing as a minimum, a set of condensed financial statements, providing update on the latest annual financial statements (does not duplicate the information already reported)

Contents of a condensed Interim Financial Statements as a minimum:

1. A statement that the same accounting policies are followed as in the most recent annual financial statements - for change, description of the nature and effect of the change.

   Explanatory comment, about the seasonality of the interim operations the nature and amount of items affecting assets, liability, equity, net income or cash flows that are unusual because of their nature, size or incidence.

2. The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amount reported in prior financial year - if the those changes have a material effect in the current interim period.

3. Issues, buy-back, repayment and restructuring of debt, equity and potential equity shares.

4. Dividends, aggregate per share (in absolute or percentage) separately for equity and other shares

5. If compliance required under AS-17, segment revenue, segment capital employed and segment result for Business or Geographical segments (whichever is primary for reporting).
6. Effect of changes in the composition of the enterprise during the interim period (e.g. amalgamation, acquisition. or disposal of subsidiaries and long term investments, restructuring and discontinuing operation.
7. Material change in contingent liabilities since last annual *B/S* date.

The above selected explanatory notes should normally be reported on a financial year to date basis.

Period of Interim Financial Statement: interim reports should include interim financial statements (condensed or complete) for periods as follows:

a) Balance Sheet:

(1) As at the end of current interim period

(2) As at the end of the immediately preceding financial year

b) Statement of Profit and Loss:

(1)For the current period

(2)Cumulative for the current financial year to date

(3) Comparative for the comparable interim period (current arid year to date

c) Cash flow Statement:

(1)Current financial year to date

(2)Comparative for the comparable year to date for immediately preceding financial year.

PROBLEMS

1. S Ltd. presents interim financial report quarterly on 1.4.2008. S Ltd.has carried forward loss of Rs.800 lakhs for income tax purpose for which deferred tax asset has not been recognized. S Ltd.earns Rs. 600 lakhs; Rs.700 lakhs; Rs.750 lakhs and Rs.800 lakhs respectively in the subsequent quarters, excluding the carried forward losses. Income tax rate is 30%. Calculate the amount of tax expense to be reported in each quarter.

Answer: The estimated payment of the annual tax on Rs.2850 lakhs earnings for the current year = Rs.(2,850 – 800) lakhs = Rs.2,050 lakhs.

Therefore, tax = 30% of Rs.2,050 lakhs = Rs.615 lakhs.

Average annual effective tax rate = (615 / 2,850) x 100 = 21.58%

Tax expense to be shown: Rs.lakhs

1st quarter= 600 x 21.58%=129.48

2nd quarter= 700 x 21.58%=151.06

3rd quarter = 750 x 21.58%=161.85

4th quarter = 800 x 21.58%=172.64

2. M Ltd. presents interim financial report(IFR) quarterly, earns Rs.800 lakhs pre-tax profit in the first quarter ending 30.6.08 but expect to incur losses of Rs.250 lakhs in each of the remaining three quarters. Effective income tax rate is 35%. Calculate the income-tax expense to be reported for each quarter as per AS-25.

Answer: Tax expense to be reported in each of the quarters are:

1st quarter= 800 x 35%=Rs.280.00 lakhs

2nd quarter= (250) x 35%=Rs. (87.5)lakhs

3rd quarter = (250) x 35%=Rs. (87.5)lakhs

4th quarter = (250) x 35%=Rs.(87.5) lakhs

Annual Tax Expense = Rs.17.5 lakhs

AS – 26: INTANGIBLE ASSETS

An intangible asset is an identifiable non-monetary asset, without physical substance held for production or supply of goods and services for rental to others or for administrative purposes.

AS-26:

(i) prescribes the accounting treatment for intangible assets that are not specifically covered in other accounting standard;

(ii) recognizes an intangible asset on fulfillment of certain criteria;

(iii) deals with deferment of expenses except in a few specific instances.

However AS -26 does not apply to:

a) Intangible assets covered by other accounting standards e.g. AS-2 (valuation of inventories), AS-7 (accounting for construction contracts), AS-22(accounting for taxes on income), leases falling within scope of AS-19, goodwill on amalgamation (AS-14) and on consolidation (AS-21).

b) Mineral rights and expenditure on the exploration .for or development and extraction of minerals, oils, natural gas and similar non-generative resources and intangible assets arising in insurance enterprises from contracts with policy holders however, computer software expenses, start up cost pertaining to above activities are covered by AS-26)

c) Discount Premium on borrowings.

AS-26 applies, among other things, to expenditure on advertisement, training, startup, R&D activities, Rights under Licensing Agreement for motion picture video recording, plays, manuscript, patents and copyrights, the criteria is that expenditure should provide future economic benefits to an enterprise.

Sometimes, an asset may incorporate both tangible and intangible component and it is practically inseparable. "Judgment is required to determine the applicability of AS-10 (fixed asset) and AS-26 (intangible asset).

Example:

(1) computer software which is integral part and without that the computer-controlled machine cannot operate - treated as fixed asset.

(2) computer software, not an integral part of related' hardware - treated as. an intangible asset,

Essential criteria for recognition of an intangible asset:

a) *identifiable:*- It must be separate from goodwill and the enterprise could rem. sell: exchange or distribute the future economic benefits attributable to the asset without disposing of future economic benefits that flow from other assets in the same revenue earning activity - but goodwill cannot be meaningfully transferred to a new owner without also selling the other assets or the operation of the business. e.g. patents, copyrights, license, brand name, import quota, computer software, lease hold right, marketing rights, technical know-how etc.

b) *control:*- The enterprise has the power to obtain the future economic benefits, flowing from the underlying resources and also can restrict the access of others I to those benefits (not necessarily legal right and may be in some other way – I market and technical knowledge may give rise to future economic benefit) . I

c) *future economic benefits:*- An enterprise should asses the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset on the basis of weight age to external evidence available at the time of initial recognition..

d) Cost can be measured reliably :

   i) Initially recognized at cost - purchase price, taxes duty and other directly attributable expenses to make the asset ready for its intended use, if acquired separately - purchase consideration in the form of cash or other monetary asset.

   ii) In exchange for shares or securities at fair value of those shares or securities.

   iii) In exchange or part exchange for another asset - as per AS-l0.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis for creating, producing and making the asset ready for its intended use, but in no case once treated as an expense, cannot be reversed for capitalization even if the essential criteria for recognition are complied with a later date.

Normally the following cost are not recognized for internally generated intangible asset:

1) selling, administrative and other general overhead unless directly attributable.
2) clearly identified inefficiencies and initial operating loses incurred before an asset achieves planned performance.
3) expenditure on training the staff to operate the asset.

Subsequent expenditure on an internally generated intangible asset after its purchase or completion is normally treated as expense unless it is assessed to generate future economic benefits over and above the originally assessed standard of performance or it can be measured and reliably attributed to the concerned intangible asset.

Amortization is the systematic allocation of the depreciable amount (cost less residual value usually "NIL" unless determined in terms of committed value by a third party or determined by active market price) of an intangible asset over its useful life (period of time for use, number of production or other similar units expected to obtain or legal restriction).

Under AS-26, useful life shall not exceed 10 years from the date the asset is available for use unless there is persuasive evidence to establish useful life longer than 10 years provided the enterprise

(a) amortizes over the best estimated useful life

(b) estimates the recoverable amount at least annually to identify the impairment loss

(c) disclose the reasons and factors in determining a longer life.

The amortization period and the amortization method should be reviewed at least at each, financial year and if the expected life is revised, the amortization period is revised accordingly but in no case it would tantamount to inappropriate deferment to later years.

AS-5 will be relevant in this regard as to what constitutes a change in accounting policy and what constitutes a change in estimate e.g. a change from straight-line to diminishing method or vice-versa would be change in accounting policy whereas reduction in the amortization period is change in accounting estimate.

Disclosure under AS-26

A) General

1. for each class of intangible asset distinguishing between internally generated and others

(a) useful lives and amortization rates used

(b) amortization method used

(c) gross carrying amount and the accumulated amortization including impairment loss at the beginning and end of the reporting period

(d) a reconciliation of the carrying amount (opening balance / addition / disposal / impairment / loss charged / reversed / amortization for the period and other changes)

2. class of intangible asset by grouping of a similar nature and use by the enterprise informa tion on impaired intangible asset under AS-28 change in accounting policy or account ing estimate as per AS-5 reasons for amortization beyond 10 years with list of factors considered in determining the useful life.
3. Description, the carrying amount and remaining amortization period of any individual asset what is material to the financial statement as a whole.
4. Existence and carrying amount of intangible assets whose title is restricted and the carrying amount of intangible asset pledged as security for liabilities.
5. Amount of commitments for acquisition of intangible assets.

B) R&D expenditure: R&D expense (that is directly attributable or reasonably allocated on a consistent basis) recognized as an expense during the period.

C) Other information: encouraged to disclose a description of only fully amortized intangible asset but still in use.

Specific guideline for internally generated computer software - criteria for capitalization: apart from the broad recognition principles, AS-26 provides for specific guidance on internally generated computer software.

(a) At preliminary project stage, it is not recognized as an asset since the enterprise cannot demonstrate then exists as an asset from which future economic benefit will follow (making strategic decision, determination of performance requirements alternative means to achieve specified performance requirements. determination of technology to achieve performance requirements and selection of consultant to assist in development and / or installation of the software)

(b) At development stage involving detailed program design, coding working model in operative version for all major planned function and testing to bring it to acompleted version together with related documentation and training material.

At this stage the internal1y generated computer software can be recognized as an asset on satisfying

1. The technical feasibility to make it available for internal use
2. Intention to complete to perform individual functions e.g. commitment for funding the project.
3. Ability to use the software
4. Usefulness of the software to generate future economic benefit
5. Availability of technical, financial and other resources to complete the development and use
6. Reliably measure the expenditure to the software development b) cost has some connotation as described earlier in the standard.

c) Accounting for software acquired or purchased should meet with the basic principle of AS-26 as discussed elsewhere in this standard.

For computer software considering the fact technological change and obsolescence.It is 3-5 years of useful life, which needs to be reasoned in the disclosure.

Expenditure for Website:

The expenditure for purchasing, developing, maintaining and enhancing hardware (servers, internet connection) related to web site are accounted for under AS-10 (fixed asset).

The expenditure may be incurred internally when developing enhancing and maintaining its own website in the context of planning, application and infrastructure development, graphical design and content development and operating stage which are directly attributable or allocable on a reasonable basis to creating, producing and preparing the asset for intended use. The nature of each activity should be evaluated to decide web site stage of development.

Accounting treatment and recognition:

a) planning stage expenditure are akin to research cost and recognized as expense when incurred.

b) expenditure arising onward development stage complying with the development criteria (refer to computer software) should be recognized as an Intangible asset.

PROBLEMS

1. On February 2008, J Ltd.bought a trademark from I Ltd. for Rs.50 lakhs. J Ltd. retained an independent consultant, who estimated the trademark's remaining life to be 14 years. Its unamortized cost on I ltd. records was Rs.35 lakhs. J Ltd.decided to amortize the trademark over the maximum period allowed. In J Ltd.'s Balance Sheet as on 31st December 2008, what amount should be reported as accumulated amortization?

   Answer: As per para 23 of AS-26, intangible assets should be measured initially at cost therefore. J Ltd. should amortize the trademark at its cost of Rs.50 lakhs. The unamortized cost on the seller's books Rs.35 lakhs is irrelevant to the buyer. Although the trademark has a remaining useful life of 14 years, intangible assets are generally amortized over a maximum period of 10 years as per AS-26. Therefore, the maximum amortization expense and accumulated amortization is Rs.5 lakhs (Rs.50 lakhs / 10)

2. During 2007-08, A Ltd.incurred organization costs / preliminary expenses of Rs.40,000. What portion of the organization costs will A Ltd. defer to years subsequent to the 2007-08?

   Answer: As per para 56(a) of AS-26, organization costs / preliminary expenses are those incurred in the formation of a corporation. Since uncertainty exists concerning the future benefit of these costs in future years, they are properly recorded as an expense in 2007-08.

3. D Ltd. is developing a new distribution system of its material, following the costs incurred at different stages on research and development of the system:

Year ended 31.3.	Phase/Expenses	Amount(Rs. In lakhs)
2004	Research	8
2005	Research	10
2006	Development	30
2007	Development	36
2008	Development	50

On 31.3.08, D Ltd. identified the level of cost savings at Rs. 16 lakhs expected to be achieved by the new system over a period of 5 years, in addition this system developed can be marketed by way of consultancy which will earn cash flow of Rs.10 lakhs per annum. D Ltd.demonstrated that new system meet the criteria of asset recognition as on 1.4.2006.

Determine the amount/cash which will be expensed and to be capitalized as intangible assets, presuming that no active market exist to determine the selling price of product i.e. system developed. System shall be available for use from 1.4.2008.

Answer: As per AS-26, research cost of Rs.18 lakhs to be treated as an expense in respective year ended 31st March 2004 and 2005 respectively.

The development expenses can be capitalized from the date the internally generated assets (new distribution system in this given case) meet the recognition criteria on and from 1.4.2006. Therefore, cost of Rs.30+ 36+ 50= Rs.116 lakhs is to be capitalized as an intangible asset.

However, as per para 62 of AS-26, the intangible asset should be carried at cost less accumulated amortization and accumulated impairment losses.

At the end of 31st March,2008, D Ltd. should recognize impairment loss of Rs.22.322 lakhs (= 116 - 93.678) and carry the new distribution system at Rs. 93.678 lakhs in the Balance Sheet as per the calculation given below:

Impairment loss is excess of carrying amount of asset over recoverable amount. Recoverable amount is higher of two i.e. value in use(discounted future cash inflow) and market realizable value of asset.

The calculation of discounted future cash flow is as under assuming 12% discount rate.

(Rs. Lakhs)

Year	Cost Savings	Inflow by introducing the system	Total cash inflow	Discounted at 12%	Discounted cash flow
2009	16	10	26	0.893	23.218
2010	16	10	26	0.797	20.722
2011	16	10	26	0.711	18.486
2012	16	10	26	0.635	16.51
2013	16	10	26	0.567	14.742
					93.678

No amortization of asset shall be done in 2008 as amortization starts after use of asset which is during the year 2008-09.

AS-27: FINANCIAL REPORTING OF INTEREST IN JOINT VENTURE

AS-27 is applicable for accounting in joint venture interest and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturer and investors, regardless of the structure or forms under which the joint venture activities take place,

The statement provides for display and disclosure requirement for accounting for the investment in the stand-alone and consolidated financial statements of the venturer.

A joint venture is a contractual arrangement between two or more parties undertaking an economic activity, subject to joint control (control is the power to govern the financial and operating policies of an economic activity to obtain benefit from it).

The arrangement may be:

a) Jointly controlled operations

b) Jointly controlled asset

c) Jointly controlled entities

In the event an enterprise by a contractual arrangement establishes joint control over an entity which is a subsidiary of that enterprise within the meaning of AS-21(CFS), it will be treated as joint venture as per AS-27. Joint control requires all the venturers to jointly agree on key decisions, else decision cannot be taken, as such even a minority holder (owner) may enjoy joint control.

Contractual arrangement is normally made in writing touching upon:

(a) The activity, duration and reporting obligation

(b) The appointment of the board of director / governing body and the respective voting rights / capital contribution / sharing by ventures of the output, income, expenses or results of the joint venture.

Contractual arrangement and joint control together makes an activity a joint venture, (investment in Associates in which the investor has significant influence is covered by AS-23)

Some joint ventures involve use of own fixed assets and other resources on its own and obligation of its own.

For its interest in jointly controlled operations, a venturer should recognize in its separate financial statements and consequently in its CFS,

(a) the assets that it controls and the liabilities it incurs

(b) the expense it incurs and the share of income earned from the joint venture.

As the above are already recognized in stand-alone financial statements of the venturer and consequently in the CFS, there us no requirement for adjustment or other consolidation procedure, when the venturer present the CFS. Separate accounting records may not be required for the joint venture itself and financial statements may not be prepared for the joint venture.

Some joint ventures involve joint control; by means of joint ownership by the venturers of one or more assets contributed / acquired for the purpose of joint venture - the asset are used to obtain economic benefit for the venturers, agreeing to share the output from the assets and sharing of expenses incurred.

In respect of jointly controlled assets, each venturer recognize in its separate financial statement and consequently in its CFS:

a) Share of the jointly controlled assets under distinct head of each asset and not as an investment

b) Any liability incurred (e.g. financing its share of the assets)

c) Share of joint liability in respect of the venturer

d) Any income from sale or use of its share of the output in the joint venture and share of expenses.

e) Expense is incurred in respect of its in the joint ventures e.g. financing the venturer’s interests in the asset and selling its share of output The treatment of jointly controlled assets, recognizes the substance and economic reality (legal from of the joint venture) separate financial statements may not be prepared for the joint venture itself.

A jointly controlled entity involves the establishment of a corporation, partnership or lither entity in which each venturer has an interest as per contractual arrangement.

a) in a separate / stand alone financial statement of each venturer, the interest in a jointly controlled entity should be accounted for as an investment as per AS-13 only the resources contributed, forms a part of the investment and the share' of joint venture result is treated in the income statement of the venturers.

b) proportionate consolidation for joint venture is applied in case where the preparation and presenting a CFS is required, reflecting the substance and economic reality of the arrangement in the CFS. Many of the procedure in this regard are similar to AS-21 and require to be followed for treatment and disclosure.

Joint venture interest in the financial statements, of an investor is treated appropriately in terms of AS-13, AS-21 or AS-23 in CFS but for separate financial statements is should be accounted for as per *AS-13.*

Disclosure under AS-27:

I. In separate and CFS in respect of:

a) Aggregate amount of contingent liabilities unless the probability of loss is remote separately from other contingent liabilities in relation to:

1. Its interest in joint venture and its share in each of the contingent liabilities incurred jointly
2. Its share of the contingent liability of the joint ventures themselves for which it is contingently liable.
3. Those liabilities which arise because of the venturer is contingently liable for the liability of other venturers.

b) Aggregate of commitments in respect of joint venture separately from other commitments in respect of:

1. Capital commitment of its own and shares in the capital commitment incurred jointly with other ventures in relation to the joint venture.
2. Share of capital commitment of the joint ventures themselves

c) A list of all joint ventures and description of interest in significant joint venture and for jointly controlled entities the properties of ownership interest name of the country of incorporation / residence.

PROBLEMS

1. N Ltd has 80% shares in a joint venture with Suzuki Ltd. N Ltd. sold a plant WDV Rs.20 lakhs for Rs.30 lakhs. Calculate how much profit N Ltd. should recognize in its book in case joint venture is:

(a) jointly controlled operation;

(b) jointly controlled asset;

(c) jointly controlled entity.

Answer: As per AS-27, in case of jointly controlled operation and jointly controlled assets joint venture, the venture should recognize the profit to the extent of other venturer's interest.

In the given case, N Ltd. should recognize profit of:

= Rs.(30 – 20)lakhs = Rs.10 x 20%= Rs.2 lakhs only.

However, in case of jointly controlled entities N Ltd. should recognize full profit of Rs.10 lakhs in its separate financial statement. However, while preparing consolidated financial statement it should recognize the profit only to the extent of 20% i.e. Rs. 2 lakhs only.

AS-28: IMPAIRMENT OF ASSETS

An asset is impaired if its carrying amount exceeds the amount to be recovered through use or sale of the asset and given the situation the standard requires the enterprise to recognize an impairment loss i.e. the amount by which the carrying amount of an asset exceeds its recoverable amount.

Impairment loss is a normal expense and thus will have impact on distributable profit and other provisions of the company's act and applicable enactment (Acceptance of Deposit Rules, BIFR etc)

Impairment loss may be discussed in the following areas:

1) Impairment loss on a specific asset;

2) Impairment loss for a cash generating unit;

3) Impairment loss for discontinuing operation.

Impairment Loss = Carrying amount of the Asset – Recoverable amount.

Carrying amount is the amount at which asset is shown in the Balance Sheet.

Recoverable amount of an asset is higher of:

- Net selling price
- Value in use

Net Selling Price= Expected realizable value of an asset – cost of disposal

Net Selling price can be obtained from:

- Active market for the asset
- Binding sale agreement
- Best estimate based on information

Value in Use= Present value of estimated future cash flow arising from the use of asset + residual value at the end of its useful life.

Present value is calculated by applying discount rate to future cash flows.

Estimated cash flows includes :

- Cash inflows from continuing use of the asset
- Projected cash outflows to generate cash inflows from continuing use of the asset.
- Net cash flows if any to be received(or paid) for the disposal of the asset at the end of its useful life.

Estimated cash flows excludes:

- Cash flows from financing activities
- Payment / refund of income tax

Discount rate: It is the cost of capital to be applied to calculate the present value of estimated cash flows and is based on the following factors:

- Pre-tax rate
- Current market assessment of time value of money after considering specific risk of the asset
- Enterprises weighted average cost of capital or incremental financial cost.
- The current rate of inflation is also considered.

AS-28 does not apply to:

- inventories (as per AS 2);
- construction contract assets (as per AS 7);

- deferred tax assets (as per AS 22);
- investments covered by AS-13 and financial instruments, because other AS provide for recognizing and measuring these assets.

1) Assessment for impairment of assets needs to be made at the B/S date: as to any indication in this context based on external or internal source of information.

External sources:

- Market value changes with passage of time or normal use (typewriter on invention of computer)
- Adverse effect in the light of technological, market, economic, or legal environment in which the enterprise operates.
- Change in market rate of interest or returns on investment affect the discount rates used to assess an assets value in use (if the effect is not a short-term phenomenon)
- Carrying amount of the net asset, exceeds its market capitalization (determined by future growth, profitability, threat of new products / entrants etc)

Internal sources:

- Obsolescence / physical damage is evident
- Indication obtained internally that economic performance of an asset has worsened or likely to worse than expected.
- Continuous cash loss may indicate that one or more of the business division is impaired.

Assessment for impairment should be made on individual asset basis, except when;

(i) The asset value in use cannot be estimated to be close to the net se1ling price i.e. future cash flow from continuing use of the asset cannot be estimated to be negligible or there is no plan to dispose of the assets in near future.

(ii) The asset does not generate cash inflows from continuing use that are largely independent of those from other assets.

In the exceptional case as above, the value in use / recoverable amount can be determined with regard assets cash generating units (generate cash inflows from outside the reporting enterprise and independent of cash inflows from other assets / group of assets

2) Impairment Loss to a cash generating unit :

Cash generating unit (CGU): The smallest group of an asset for which cash flows can be determined independently.

Even if the cash flows can determined independently, aggregation of cash generating units becomes necessary in some situations.

To determine impairment loss of a CGU, we have to follow 'bottom up' or 'top down' test.

[These two tests are discussed in Paper 16: Advanced Financial Accounting and Reporting, in details.]

3) Impairment Loss for discontinuing operation :

In this type of situation, the impairment loss shall depend on the way the discontinuing operation is disposed off:

a) substantially in its entirety;

b) as piecemeal sales;

c) by abandonment.

PROBLEMS

1. X Ltd.purchased a machinery on 1.1.2002 for Rs.20 lakhs. WDV of the machine as on 31.3.08 Rs.12 lakhs. The Recoverable amount of the machine is Rs.11 lakhs. What is the impairment loss?

Answer: Impairment Loss = Carrying amount – Recoverable Amount

= Rs.12 lakhs – Rs.11 lakhs = Rs. 1 lakh.

2. Carrying amount Rs.200 lakhs. Net Selling Price Rs.210 lakhs. Value in use Rs. 220 lakhs. What is the impairment loss?

Answer: Carrying amount Rs.200 lakhs

Recoverable amount Rs. 220 lakhs (being the higher of net selling price and value in use)

Since, recoverable amount is more than carrying amount of the asset, there will arise no impairment loss.

3. C Ltd.acquired a machine for Rs.3.2 crores on 1.1.2005. It has a life of 5 years with a salvage value of Rs.40 lakhs. Apply the test of impairment on 31.3.2008:

(a) Present value of future cash flow Rs.1.3 crores

(b) Net selling price Rs.1.2crores

Answer: Carrying amount of the asset: [3.2 – (3.2 – 0.4) x 39/60] = 1.38 crores.

Time period for use of the asset: 1.1.2005 to 31.3.2008 = 39 months

Total life period of the asset= 5 years = 60 months.

Recoverable amount: being the higher of present value and net selling price = Rs.1.3 crores.

Impairment Loss= Rs(1.38 – 1.3) crores= Rs.0.08 crores.

AS 29: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

The objective of this Standard is also to lay down appropriate accounting for contingent assets.

This standard is not applicable to:

- Financial instruments carried at fair value
- Insurance enterprises
- Contract under which neither party has performed any of its obligations or both parties have partially performed their obligation to an equal extent
- AS 7,AS 15,AS 19 and AS 22.

A provision is a liability which can be measured only by using a substantial degree of estimation.

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A contingent liability is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not

recognized because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation;
or

(ii) a reliable estimate of the amount of the obligation cannot be made.

A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the enterprise.

Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A restructuring is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.

Past Event- A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Best Estimate: The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

Risks and Uncertainties: The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

Future Events : Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Disclosure:

For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e. incurred and charged against the provision) during the period; and

(d) unused amounts reversed during the period.

An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in paragraph 41; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

PROBLEMS

1.There is a income tax demand of Rs.2.5 lakhs against the company relating to prior years against which the company has gone on appeal to the appellate authority in the department. The ground of appeal deals with the points covering Rs.1.8 lakhs of the demand. State how the matter will have to be dealt with in the financial account for the year.

Answer: A provision of Rs.0.7 lakhs and a contingent liability of Rs. 1.8 lakhs should be provided in the financial accounts for the year.

2. A company follows a policy of refunding money to the dissatisfied customers if they claim within 15 days from the date of purchase and return the goods. It appears from the past experience that in a month only 0.10% of the customers claim refunds. The company sold goods amounting to Rs.20 lakhs during the last month of the financial year. Is there any contingency?

Answer: There is a probable present obligation as a result of past obligating event. The obligating event is the sale of the product. Provision should be recognized as per AS-29. The best estimate for provision is Rs. 2,000 (Rs.20 lakhs x 0.1%)

AS-30: FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

Requirements for presenting information about financial instruments are in Accounting Standard (AS) 31, *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in Accounting Standard (AS) 32, *Financial Instruments:*

Definitions:

The terms defined in AS 31, *Financial Instruments: Presentation* are used in this Standard with the meanings specified in paragraph 7 of AS 31. AS 31 defines the following terms:

- financial instrument
- financial asset
- financial liability
- equity instrument

and provides guidance on applying those definitions.

Definition of a Derivative:

A derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date.

Definitions of Four Categories of Financial Instruments :

A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:

(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; or

(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

(iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss.

Accounting Standard (AS) 32, Financial Instruments: Disclosures , requires the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and

ability to hold to maturity other than:

(a) those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that meet the definition of loans and receivables; and

(c) those that the entity designates as available for sale.

An entity should not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

(a) those that the entity intends to sell immediately or in the near term, which should be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that the entity upon initial recognition designates as available for sale; or

(c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which should be classified as available for sale.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments, or (c) financial assets at fair value through profit or loss.

Definition of a financial guarantee contract

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Definitions Relating to Recognition and Measurement

The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Definitions Relating to Hedge Accounting

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

A forecast transaction is an uncommitted but anticipated future transaction.

Functional currency is the currency of the primary economic environment in which the entity operates.

A hedging instrument is (a) a designated derivative or (b) for a hedge of the risk of changes in foreign currency exchange rates only, a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

Embedded Derivative:

An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

AS 31: FINANCIAL INSTRUMENTS: PRESENTATION

The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in Accounting Standard (AS) 30.

Definitions

The following terms are used in this Standard with the meanings specified:

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

A financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity 's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial Instruments: Recognition and Measurement and are used in this Standard with the meaning specified in AS 30.

- amortised cost of a financial asset or financial liability
- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale
- transaction costs.

In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

In this Standard, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies.

AS 32: FINANCIAL INSTRUMENTS: DISCLOSURES

The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The principles in this Accounting Standard complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Accounting Standard

(AS) 30, Financial Instruments: Recognition and Measurement and Accounting Standard (AS) 31, Financial Instruments: Presentation.

Significance of financial instruments for financial position and performance

An entity should disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

Balance sheet

Categories of financial assets and financial liabilities

The carrying amounts of each of the following categories, as defined in AS 30, should be disclosed either on the face of the balance sheet or in the notes:

(a) financial assets at fair value through profit or loss, showing separately

(i) those designated as such upon initial recognition and

(ii) those classified as held for trading in accordance with AS 30;

(b) held-to-maturity investments;

(c) loans and receivables;

(d) available-for-sale financial assets;

(e) financial liabilities at fair value through profit or loss, showing separately

(i) those designated as such upon initial recognition and

(ii) those classified asheld for trading in accordance with AS 30; and

(f) financial liabilities measured at amortised cost.

Financial assets or financial liabilities at fair value through profit or loss

If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it should disclose:

(a) the maximum exposure to credit risk of the loan or receivable (or group of loans or receivables) at the reporting date.

(b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

(c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:

(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

(ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset. Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

If the entity has designated a financial liability as at fair value through profit or loss in accordance with AS 30, it should disclose:

(a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:

(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk ,or

(ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

(b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

Reclassification

If the entity has reclassified a financial asset as one measured:

(a) at cost or amortised cost, rather than at fair value; or

(b) at fair value, rather than at cost or amortised cost,

it should disclose the amount reclassified into and out of each category and the reason for that reclassification .

STUDY NOTE - 7

JOINT STOCK COMPANIES

This study note includes

- Introduction
- Shares
  - Issue of Shares at par, Discount & Premium, Forfeiture, Reissue of Shares.
  - Right issue.
  - Buy Back of Shares.
  - Redemption of Preference Shares.
- Profit Prior to Incorporation.
- Debentures
  - Issue and Redemption.

7.1. INTRODUCTION

Meaning of a Company

A company is a voluntary and autonomous association of certain persons with capital divided into numerous transferable shares formed to carry out a particular purpose in common. It is an artificial person created by law to achieve the object for which it is formed. Section 3(1) (i) of the Companies Act, 1956 defines a company as "Company formed and registered under this Act or an existing company." An existing company means a company formed and registered under any of the former Companies Acts. Thus it is an abstract person, invisible, intangible and existing only in contemplation of law. It can hold, purchase or sell both movable and immovable property, incur and pay debts, open a bank account in its own name and sue and be sued in the same manner as an individual. Law creates it and law only can dissolve it. Its existence is altogether independent of the life of its members. Members may come and go but the company would go on for ever. Transferability of shares has given perpetual succession to a company. Death, insanity or insolvency of a member or any member will not affect the existence of the company at all. A company is a legal entity quite distinct and separate from the persons who are its members. A company cannot ordinarily buy its own shares. A shareholder is not the agent of the company. He cannot incur any debt so as to bind the company. They cannot bind the company by their acts. The same person can be a shareholder and a creditor of the company. The ownership is divorced from management because a joint stock company is' managed by a Board of Directors elected by the shareholders (i.e. owners).

Characteristics of a Company

The main characteristics of a company are:

(i) It is a distinct legal person existing independent of its members

(ii) Liability of the members is limited to the extent of the face value of shares held by them.

(iii) It has a perpetual succession, i.e, the members of the company may keep on changing from time to time but this does not affect the company's continuity.

(iv) The shares of a company are freely transferable except in case of a Private limited Company.

(v) A company being a legal person is capable of owing, enjoying and disposing of the property in its own name.

(vi) A company, being a separate body can sue and be sued in its own name.

(vii) Though a company is an artificial person yet it acts through human beings who are called directors of the company. There is a divorce between ownership and the management.

(viii) It is a voluntary association of persons usually for profit.

Statutory Books

Statutory books are those which a limited company is under statutory obligation to maintain at its registered office. The main statutory books are :

(i) Register of Investments held and their names

(ii) Register of charges

(iii) Register of Members

(iv) Register of debenture holders

(v) Annual returns

(vi) Minutes books

(vii) Register of contracts

(viii) Register of Directors

(ix) Register of shareholdings of the directors

(x) Register of loans to companies under the same management

(xi) Register of Investment in the shares of other companies.

Books of Account

Every company is required to keep at its registered office books of account.
These books are to be maintained in such a way so as to disclose

(a) The sums of money received and expended by the company and the matter in respect of which the receipt and expenditure has taken place.

(b) All sales and purchases of goods of the company.

(c) All assets and liabilities of the company.

Long term Sources of Finance

- Issue of shares
  - Equity
    - Initial Public offering (IPO)
    - Rights Issue
    - ESOS/ESOP
  - Preference
- Debenture
- Loans
- Ploughing back of profits

7.2. SHARE CAPITAL

No trading concern can run without capital. The divisions of share capital are:

(i) Nominal or Registered or Authorized Capital. The amount of capital with which the company intends to be registered is called registered capital. It is the maximum amount which the company is authorized to raise by way of public subscription. There is no legal limit on the extent of the amount of authorized capital.

(ii) Issued Capital. That part of the authorized capital which is offered to the public for subscription is called issued capital.

(iii) Subscribed Capital. That part of the issued capital for which applications are received from the public is called the subscribed capital.

(iv) Called up Capital. The amount on the shares which is actually demanded by the company to be paid is known as called up capital.

(v) Paid up Capital. The part of the called up capital which is offered and is actually paid by the members is known as paid up capital. The sum which is still to be paid is known as *calls in arrears.*

(vi) Reserve Capital. A company may determine by a special resolution that any portion of its share capital which has not been already called up shall not be capable of being called-up except in the event of winding up of the company. Such type of share capital is known as reserve capital.

Application for Shares

Whenever shares are to be issued by a company, an advertisement in a leading newspaper is given for the information of the general public alongwith some important extracts of the prospectus. Those who are interested to purchase the shares on the basis of that information may have the prospectus for detailed information and application form. If a person is satisfied with the profitability and other things he is required to fill up the application form and to deposit this alongwith the requisite amount (known as application money) with the prescribed scheduled bank. The application money should at least be 5 per cent of the face value of the share. The scheduled bank will send this application money alongwith a list of applicants to the company. The company will ultimately record these in the "Application and Allotment Book"

Allotment of Shares

After receiving the applications the directors take steps to allot the shares. Allotment of shares means acceptance of the offer of the applicant for the purchase of shares. Directors have discretionary power either to reject or to accept partially the applications. There are no restrictions on the rights of a private company to allot its shares. But the public company cannot allot its shares unless:

i. The minimum subscription stated in the prospectus has been subscribed by the public.

ii. A prospectus or a statement in lieu of prospectus has been filed with the Registrar before making the first allotment.

iii. The amount of application, *i.e.,* at least 5% of the face value has been received.

The applicants, to whom shares are allotted, will be sent allotment letters. After allotment, they become the shareholders of the company. Those to whom shares could not be allotted will be sent a letter of regret alongwith refund of their application money. The shareholders will be required to pay the allotment money on allotment of shares which will also be recorded in the Application and Allotment Book.

Calls on Shares

Out of the face value of the shares, 5% is payable with application, some money will be paid on allotment and rest money will be paid as and when calls are made by the company. Generally the prospectus gives the dates of different calls alongwith the amount of the calls by shareholders. In case it is not given in the prospectus, the directors have the discretion to call it in one call or more than one call. For this a resolution of the Board of Directors must be passed and a notice is sent to the shareholders with a request to pay the amount of the call. As soon as a call notice is sent, its particulars are entered in a separate book known as Share Call Book, a specimen of which is given on the next page.

Journal Entries for Issue of Shares

(1) On Receipt of Application Money

Bank A/c Dr

To Share Application A/c

(2) For excess share application money refunded :

Share Application A/c Dr

To Bank A/c

(3) For Share application money transferred to share capital

Share Application A/c Dr

To Share Capital A/c

To Securities Premium A/c (if application money includes premium)

(4) For Share allotment Money due :

Share Allotment A/c Dr.

Discount on Issue of shares A/c Dr (if issued at a discount)

To Share Capital A/c

To Securities Premium (if issued at a premium)

(5) For Share allotment money received :

Bank A/c Dr

Calls-in-Arrear A/c Dr. (if allotment money not received)

To Share Allotment A/c

To Calls-in-Advance A/c (if call money received in advance alongwith allotment)

(6) For Share Call money due :

Share Call A/c Dr.

To Share Capital A/c

(7) For Call money received :

Bank A/c Dr

Call-in-Arrear A/c Dr. (if call money not received)

Calls-in-Advance A/c Dr. (adjustment of share call money received earlier)

To Share Call A/c

Note : For every subsequent calls, entry no. (6) & (7) share have to be recorded.

(8) For forfeiture of shares :

Share Capital A/c Dr (No. of shares forfeited × Called up value per share)

Securities Premium A/c Dr. (if issued at a premium and premium not received)

To Calls-in-Arrear A/c (amount not received on forfeited shares)

To Shares Forfeited A/c (amount received on forfeited shares)

To Discount on Issue of Shares A/c (if issued at a discount)

(9) For reissue of forfeited shares

Bank A/c Dr (No. of Shares Reissued × Reissue Price/Share)

Discount on Issue of Shares A/c Dr (No. of shares Reissued × Discount per share, if originally issued at a discount)

Shares Forfeited A/c Dr. (No. of shares × Further discount on reissue)

To Share Capital A/c (No. of shares Reissued × Paid up value per share)

To Securities Premium A/c (if reissued at a premium)

(10)For transferring profit on reissue of forfeited shares

Shares Forfeited A/c Dr. (Profit on Forfeiture— Further discount on reissue of such forfeited share)

To Capital Reserve

Note :

If part of the forfeited shares are reissued, then profit shall have to be calculated proportionately as follows :

Profit on Reissue of Forfeited Shares :

$$\frac{\text{Total Profit on forfeiture of shares}}{\text{No. of shares forfeited}} \times \text{No. of Shares Reissued} \qquad = \text{xxx}$$

(–) Further discount on reissue = (x)

Transfer to Capital Reserve = xxx

Illustration 1:

PK Ltd. made an issue of 10,00,000 equity shares of Rs. 10 each, payable Rs. 2 on application, Rs. 4 on allotment and Rs. 4 on call. All the shares are subscribed and amounts duly received. Pass journal entries to give effect to these. Also show relevant items in the Balance Sheet.

Solution :

P K Ltd.

JOURNALS

Particulars		Rs.'000	Rs.'000
Bank Account To Equity Share Application Account (Share application money on 10,00,000 equity shares @ Rs. 2 each received)	Dr.	2000	2000
Equity Share Application Account To Equity Share Capital Account (Share application money transferred to share capital account as per Board's resolution no. ……………. dated ………)	Dr.	2,000	2,000
Equity Share Allotment account To Equity Share Capital Account (Share Allotment due on 10,00,000 shares @ Rs. 4 per share as per Board's resolution no. ……… dated……)	Dr.	4,000	4,000
Bank Account To Equity Share Allotment Account (Allotment money received)	Dr.	4,000	4,000
Equity Share First and Final Call A/C To Equity Share Capital Account (Share 1st and Final Call due on 10,00,000 shares @ Rs.4/ share as per Board's resolution no. ……… dated……)	Dr.	4,000	4,000
Bank Account To Equity Sh. First and Final Call A/C (For shares First and Final Call money received on 10,00,000 shares @ Rs. 4 per share)	Dr.	4,000	4,000

BALANCE SHEET OF PK LTD. as at …….

Liabilities	Rs'000	*Assets*	Rs'000
Issued, Subscribed and Paid up Capital:		Cash at Bank	10,000
10,00,000 equity shares of Rs. 10 each fully called and paid up	10,000		
	10,000		10,000

When Both Preference and Equity Shares are Issued

When a company issues both preference and equity shares then it is desirable that the entries for application money, allotment money and calls money should be separately passed for each type of share capital. The word Equity or Preference must invariably be used in all the circumstances.

Issue of Shares for Purchase of Assets

If the shares have been allotted to any person or firm from whom the company has purchased any asset, the following entry will be passed:

Asset Account Dr.

To Share Capital Account

(Being ... shares allotted……in consideration of purchase of an asset for the company)

This fact should also be disclosed in the Balance Sheet while showing the issued, subscribed and paid up capital.

Issue of Shares at Premium

A company may issue shares at a premium, *i.e.*, at a value greater than its face value. The power to issue shares at a premium need not be given in the Articles of Association. Premium so received shall be credited to a separate account called Securities Premium Account. Section 78 of the Companies Act, 1956 gives the purposes for which share premium account may be applied by the company. These are:

(i) For the issue of fully paid bonus shares to the members of the company;

(ii) For writing off preliminary expenses of the company;

(iii) For writing off the expenses of the commission paid or discount allowed on any issue of shares or debentures of the company; and

(iv) For providing premium payable on the redemption of any redeemable preference shares or debentures of the company.

Illustration 2:

AB & Co. Ltd. issued 500,00,000 Equity shares of Rs. 10 each at a premium of Rs 4 per share payable Re.1 per share on application. Rs. 6 per share on allotment (including premium), Rs. 3 on first call and the balance on final call. The shares were all subscribed and all money due was received except the first call money on 1,00,000 shares and the Final call money on 1,50,000 shares.

Give the Cash Book and Journal entries to record the above transactions.

Solution :

Dr. CASH BOOK **Cr.**

	Rs./Lakh		Rs/Lakh
To Equity Share Application	500	By Balance c/d	6,991
To Equity Share Allotment	3,000		
To Equity Share 1st Call	1,497		
To Equity Share Final Call	1,994		
	6,991		6,991

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		Rs/Lakh	Rs/Lakh
Equity Share Application A/c	Dr.	500	
To Equity Share Capital A/c			500
Equity Share Allotment A/c	Dr.	3,000	
To Equity Share Capital A/c			1,000
To Securities Premium A/c			2,000
Equity Share 1st Call A/c	Dr.	1500	
To Equity Share Capital A/c			1500
Calls in Arrear A/c	Dr	3	
To Equity Share 1st Call A/c			3
Equity Share Final Call A/c	Dr.	2,000	
To Equity Share Capital A/c			2,000
Calls in Arrear A/c	Dr.	6	
To Equity Share Final Call A/c			6
		7,009	7,009

Issue of Shares at a Discount (Section 79)

A company can issue shares at a discount, *i.e.*, value less than the face value subject to the following conditions:

(i) The issue of shares at a discount is authorised by a resolution passed by the company in general meeting and sanctioned by the Central Government.

(ii) The resolution must specify the maximum rate of discount which should not exceed 10 per cent of the nominal value of shares or such higher percentage as the Central Government may permit.

(iii) One year must have been elapsed since the date at which the company was allowed to commence business.

(iv) Issue must take place within two months after the date of the sanction by the court or within such extended time as the court may allow.

(v) Every prospectus relating to the issue of shares and every balance sheet after the issue of shares contains particulars of the discount allowed and so much of the discount as has not been written off.

Adjustment of Excess Money towards the Amount due on the Allotment and Calls

Sometimes a Company may not allot all the shares for which applications have been received. Because of over subscription, allotment is either made of less number of shares or on pro-rata basis. For example, if the company offered 100,00,000 shares of Rs.l0 each but applications for 200,00,000 shares were received by company. The directors sent letters of regret to applicants of 50,00,000 shares and applicants of 150,00,000 shares were allotted the 100,00,000 shares on *pro-rata* basis. In such a case, application money of 50,00,000 shares will be adjusted either on allotment and on calls, if there is still surplus money after adjusting the allotment and call money due from shareholders it will be refunded in cash.

Forfeiture of Shares

When a shareholder fails to pay calls, the company, if empowered by its articles, may forfeit the shares. If a shareholder has not paid any call on the day fixed for payment thereof and fails to pay it even after his attention is drawn to it by the secretary by registered notice, the Board of Directors pass a resolution to the effect that such shares be forfeited. Shares once forfeited become the property of the company and may be sold on such terms as directors think fit. Upon forfeiture, the original shareholder ceases to be a member and his name must be removed from the register of members.

Surrender of Shares

After the allotment of shares, sometimes a shareholder is not able to pay the further calls and returns his shares to the company for cancellation. Such voluntary return of shares to the company by the shareholder himself is called surrender of shares. Surrender of shares has no separate accounting treatment but it will be like that of forfeiture of shares. The same entries (as are passed in case of forfeiture of shares) will be passed in case of surrender of shares.

Reissue of Forfeited Shares

Forfeited shares may be reissued by the company directors for any amount but if such shares are issued at a discount then the amount of discount should not exceed the actual amount received on forfeited shares. The purchaser of forfeited reissued shares is liable for payment of all future calls duly made by the Company.

When all Forfeited Shares are not Issued

When all forfeited shares are not issued, *i.e.*, only a part of such shares is issued, it is desirable to spread the amount of shares forfeited account on all such forfeited shares and of the amount relating to that part of forfeited shares which has been reissued, discount on reissue of shares should be deducted from such amount and the balance is transferred to capital reserve being capital profit. The amount relating to that part of shares forfeited account which has not been reissued should be shown on the liabilities side of Balance Sheet as Shares Forfeited Account.

Illustration 3 : A Company invited the public to subscribe for 10,000,000 Equity Shares of Rs.100 each at a premium of Rs. 10 per share payable on allotment. Payments were to be made as follows: On application Rs. 20; on allotment Rs. 40; on first call Rs. 30 and on final call Rs.20. Applications were received for 13,000,000 shares; applications for 2,000,000 shares were rejected and allotment was made proportionately to the remaining applicants. Both the calls were made and all the moneys were received except the final call on 300,000 shares which are forfeited after due notice. Later 200,000 of the forfeited shares were re-issued as fully paid at Rs. 85 per share. Pass Journal entries.

Solution :

JOURNALS

Particulars		Rs.'000	Rs.'000
Bank Account	Dr.	2,60,000	
To Equity Share Application Account			2,60,000
Share application money received on 13,000,000 equity shares @ Rs.20 each			
Equity Share Application Account	Dr.	40,000	
To Bank Account			40,000
(Application for 2,000,000 rejected)			
Equity Share Application Account	Dr.	2,20,000	
To Equity Share Capital Account			2,00,000
To Equity Share Allotment account			20,000
(Share application money transferred to share capital account and excess money used for share allotment.)			
Equity Share Allotment account	Dr.	4,00,000	
To Equity Share Capital Account			3,00,000
To Security Premium Account			1,00,000
(Share Allotment due on 10,000,000 shares @ Rs. 40 per share as per the resolution of the Board of Directors)			
Bank Account	Dr.	3,80,000	
To Equity Share Allotment Account			3,80,000
(Allotment money received)			
Equity Share first call Account	Dr	3,00,000	
To Equity Share Capital Account			3,00,000
(First call money due)			
Bank Account	Dr	3,00,000	
To Equity Share First call Account			300,000
(First call money received)			

Equity Share Final Call Acccount To Equity Share Capital Account (Share Final Call due)	Dr.	2,00,000	 2,00,000
Bank Account To Equity Sh. Final Call Acccount (Final Call money received except 300,000 Shares)	Dr.	1,94,000	 1,94,000
Equity Share Capital Account To Equity Sh. Final Call Acccount To Forfeited share Account (300,000 shares forfeited for non payment of final call money)	Dr.	30,000	 6,000 24,000
Bank Account	Dr.	17,000	

Working :

1 . On 300,000 forfeited shares, the total amount forfeited is Rs. 24,000.
For 200,000 such shares the amount will be

	Rs'000
(200,000 / 300,000) x 24,000 =	16,000
Less, Discount on Reissue	3,000
Transferred to Capital Reserve	13,000

Balance of Forfeited share account will be shown in balance sheet as 'Forfeited Share Account" in liability side.

Illustration 4 :

Give journal entries for the following :

a) PK Ltd. forfeited 10,000 equity shares of Rs 10 each for non payment of first call of Rs 2 and final call of Rs 3 per share. These shares were reissued at a discount of Rs 3.50 per share.

b) KP Ltd. forfeited 20,000 equity shares of Rs 15 each (including Rs 5 per share as premium), for non payment of final call of Rs 3 per share. Out of these 10,000 shares were reissued at a discount of Rs 4 per share.

c) KP Ltd. forfeited 15,000 equity shares of Rs 15 each (including Rs 5 per share as premium), for non payment of allotment money Rs 8 (including premium money) and first & final call of Rs 5 per share. Out of these 10,000 shares were reissued at Rs 14 per share.

d) PK Ltd. forfeited 10,000 equity shares of Rs 10 each issued at a discount of Re 1 per share, for non payment of first call of Rs 2 and final call of Rs 3 per share. Out of these 6,000 shares were reissued at Rs 8 per share and the balance shares were re-issued at Rs 7 per share.

Solution :

Journal Entries

	Particulars		Rs	Rs
a)	Equity Share Capital Account	Dr.	100,000	
	To Equity Sh. First Call Account			20,000
	To Equity Sh. Final Call Account			30,000
	To Forfeited share Account			50,000
	(10,000 shares forfeited for non payment of first and final call money)			
	Bank Account	Dr.	65,000	
	Forfeited Share Account	Dr.	35,000	
	To Equity Share Capital Account			100,000
	(Reissue of 10,000 sh. @ Rs. 6.50 each)			
	Forfeited Share Account	Dr.	15,000	
	To Capital Reserve Account			15,000
	(Balance of Forfeited share Account transferred)			
b)	Equity Share Capital Account	Dr	200,000	
	To Equity Sh. Final Call Account			60,000
	To Forfeited share Account			140,000
	(20,000 shares forfeited for non payment of final call money)			
	Bank Account	Dr.	60,000	
	Forfeited Share Account	Dr.	40,000	
	To Equity Share Capital Account			100,000
	(Reissue of 10,000 sh. @ Rs. 6 each)			
	Forfeited Share Account	Dr.	30,000	
	To Capital Reserve Account			30,000
	(Balance of Forfeited share A/c relating to 10,000 shares transferred)			
c)	Equity Share Capital Account	Dr.	150,000	
	Securities Premium Account	Dr.	75,000	
	To Equity Sh. Allotment Account			120,000
	To Equity Sh. First & Final Call Account			75,000
	To Forfeited share Account			30,000
	(15,000 shares forfeited for non payment of allotment and first and final call money)			

	Bank Account	Dr.	140,000	
	To Security Premium Account			40,000
	To Equity Share Capital Account			100,000
	(Reissue of 10,000 sh. @ Rs. 15 each)			
	Forfeited Share Account	Dr.	20,000	
	To Capital Reserve Account			20,000
	(Balance of Forfeited share A/c on 10,000) shares transferred)			
d)	Equity Share Capital Account	Dr.	100,000	
	To Discount on issue of shares Account			10,000
	To Equity Sh. First Call Account			20,000
	To Equity Sh. Final Call Account			30,000
	To Forfeited share Account			40,000
	(10,000 shares forfeited for non payment of first and final call money)			
	Bank Account	Dr.	48,000	
	Discount on issue of shares Account	Dr.	6,000	
	Forfeited Share Account	Dr.	6,000	
	To Equity Share Capital Account			60,000
	(Reissue of 6,000 sh. @ Rs. 8 each)			
	Forfeited Share Account	Dr.	18,000	
	To Capital Reserve Account			18,000
	(Balance of Forfeited share A/c on 6,000 shares transferred)			
	Bank Account	Dr.	28,000	
	Discount on issue of shares Account	Dr.	4,000	
	Forfeited Share Account	Dr.	8,000	
	To Equity Share Capital Account			40,000
	(Reissue of 4,000 sh. @ Rs. 7 each)			
	Forfeited Share Account	Dr.	8,000	
	To Capital Reserve Account			8,000
	(Balance of Forfeited share A/c on 4,000 shares transferred)			

Illustration 5 :

X Ltd. issued 10,000 Equity shares of Rs. 10 each at a premium of Rs. 2 per share, payable : Rs. 3 on application (including premium of Re. 1); Rs. 4 on allotment (including the balance of premium) and the balance in a call. Public subscribed for 12,000 shares. Excess application money was refunded. One shareholder Mr. A holding 50 shares paid the call money alongwith allotment. Another Mr. B failed to pay allotment & call on 30 shares.

These shares were forfeited after the call and 25 of those were reissued at Rs. 9 each.

Pass Journals and prepare the Balance sheet of the company.

X Ltd.

Journal Entries (without narration)

	Rs.	Rs.
(1) Application Money Received		
Bank A/c Dr.	36,000	
(12000×3) To Equity Shares Application A/c		36,000
(2) Refund of excess application money		
Equity Share Application A/c Dr.	6,000	
(2000×3) To Bank A/c	6,000	
(3) Transfer of share application to share capital		
(10,000×3) Equity Shares Application A/c Dr.	30,000	
(10000×2) To Equity Shares Capital A/c		20,000
(10,000×1) To Securities Premium A/c		10,000
(4) Allotment Money Due		
(10000×4) Equity Shares Capital A/c Dr.	40,000	
(10000×3) To Equity Share Capital A/c		30,000
(10000×1) To Securities Premium A/c		10,000
(5) Allotment Money Received		
[9,970×4 + 50×5] Bank A/c Dr.	40,130	
(30×4) Calls-in-Arear A/c Dr.	120	
To Equity Share Allotment A/c		40,000
(50×5) To Calls-in-Advance A/c		250
(6) Share Call Money Due		
(10,000×5) Equity Share Final call A/c Dr.	50,000	
To Equity Share Capital A/c		50,000
(7) Call Money Received, Adjustment of Calls-in-Advance		
(9,920×5) Bank A/c Dr.	49,600	
(30×5) Calls-in-Arrear A/c Dr.	150	
Calls-in-Advance A/c Dr.	250	
(Received with Allotment, now adjusted)		
To Equity Shares First & Final Call A/c		50,000

(8) Forfeiture of Shares		
(30×10) Equity Share Capital A/c Dr.	300	
(30×1) Securities Premium A/c Dr.	30	
To Calls-in-Arrear A/c		270
To Shares Forfieted A/c		60
(9) Reissue of Forfeited Shares		
(25×9) Bank A/c Dr.	225	
(25×1) Shares Forfeited A/c Dr.	25	
(25×10) To Equity Shares Capital A/c		250
(10) Transfer of Profit on Reissue of Forefeited shares		
Shares Forfeited A/c Dr.	25	
To Capital Reserve A/c		25

Note : Proportionate Profit on reissue :

Profit on forfeiture Rs. 60

Therefore, Proportionate profit on 25 shares (those are reissued)

= 60/30 ×25 = 50

Less : Discount on Reissue (25×1) = 25

Transfer to Capital Reserve 25

X Ltd.
Balance Sheet as at ....

Liabilities *Rs.*	*Amount* *Rs.*	*Amount* *Rs.*	*Assets* *Rs.*	*Amount Amount*
Authorised Capital	10,000×10	1,00,000	Fixed Assets	
Issued, Subscribed, Called up & Paid up Capital			Investments	
			Current Assets, Loans & Advances	
9,995 shares @ Rs. 10 each		99,950	Cash at Bank	1,19,955
Reserves & Surplus				
Securities Premium		19,970	Miscellaneous Expenditure (to the extent not written off)	
Shares forfeited A/c		10		
Capital Reserve		25		
		1,19,955		1,19,955

llustration 6 :

B Ltd. issued 5,000 Equity shares of Rs. 100 each at a discount of 10%, payable as follows : on Application : Rs. 25; on Allotment : Rs. 40; on Call : the balance.

Public subscribed for 4,800 shares and allotment was made in full. One shareholder holding 25 shares failed to pay the allotment and calls. These were forfeited and 20 of those shares were reissued at Rs. 88 each.

Pass journal entries and prepare Balance Sheet.

Solution :

B Ltd.

Journal Entries

Particulars		Rs.	Rs.
(1) Bank A/c	Dr.	1,20,000	
To Equity Share Application A/c 1,20,000			
(Being equity share application money received on 4,800 shares @ Rs. 25 per share)			
(2) Equity shares Application A/c	Dr.	1,20,000	
To Equity Share Capital A/c			1,20,000
(Being share application money transferred to share capital as per Board's resolution no... dated)			
(3) (4800×40) Equity Share Allotment A/c	Dr.	1,92,000	
(4800×10) Discount on Issue of Shares A/c	Dr.	48,000	
To Equity Share Capital A/c			2,40,000
(Being allotment money due on 4800 shares @ Rs. 40 per share, Rs. 10 as discount, as per Board's resolution no..dated)			
(4) (4775×40) Bank A/c	Dr.	1,91,000	
(25×40) Calls-in-Arrear A/c	Dr.	1000	
To Equity Share Allotment A/c			1,92,000
(Being shares allotment money received except on 25 Shares)			
(5) Equity Share First & Final Call A/c	Dr.	1,20,000	
To Equity Share Capital A/c			1,20,000
(Being share call money due on 4,800 shares) @ Rs. 25 per share as per Board's resolution no. dated)			
(6) (4775×25) Bank A/c	Dr.	1,19,375	
(25×25) Calls-in-Arrear A/c	Dr.	625	
To Equity Share First & Final Call A/c			1,20,000
(Being share call money received except on 25 shares)			
(7) (25×100) Equity Shares Capital A/c	Dr.	2,500	
(1000+625) To Calls-in-Arrear A/c			1,625
(25×10) To Discount on Issue of Shares A/c			250
(25×25) To Shares Forfeited A/c			625
(Being 25 shares forfeited as per Board's resolution no. dated)			

(8)	(20×88) Bank A/c	Dr.	1760	
	(20×2) Discount on Issue of Shares A/c	Dr.	40	
	(20×10) Shares Forfeited A/c	Dr.	200	
	(20×100) To Equity Share Capital A/c			2,000
	(Being 20 forfeited Shares reissued at Rs. 88 each, as per Board's resolution no... dated.)			
(9)	Shares Forfeited A/c	Dr.	460	
	To Capital Reserve A/c			460
	(Being profit on reissue of forfeited share transferred to Capital Reserve)			

Note : Profit on Reissue of Forfeited Shares :

Amount received on Forfeiture Rs. 625
Therefore, Proportionate amount of forfeiture on 20 shares :

= {(625 / 25) x 20}	= 500
Less : Further discount on reissue (20×2)	= 40
	= 460

X Ltd.
Balance Sheet as at ....

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
<u>Authorised Capital :</u>			Fixed Assets		
5,000 Eq. shares of			Investments		
Rs. 100 each		5,00,000			
Issued, Subscribed,			Current Assets,		
Called up &			Loans & Advances		
<u>Paid up Capital</u>					
4,795 Equity Shares					
@ Rs. 100		4,79,500	Cast at Bank		4,32,135
Reserves & Surplus			Miscelleaneous		
Capital Reserve		460	Expenditure		
Shares Forfeited A/c		125	(to the extent		
Secured & Unsecured			not written off)		
Loans		xxx	Discount on Issue		
Current Liabilities &			of Shares		47,950
Provisions		xxx			
		4,80,085			4,80,085

Illustration 7:

B Ltd issued 2,000 shares of Rs. 100 each at a premium of 10% payable as follows :-

On application Rs 20 (1st Jan. 2008). On allotment Rs.40 (including premium) (1st April 2008). On First Call Rs. 30 (1st June 2008). On Second & Final call Rs. 20 (1st Aug 2008).

Applications were received for 1,800 shares and the directors made allotment in full. One shareholder to whom 40 shares were allotted paid the entire balance on his share holdings with allotment money and another share holder did not pay allotment and 1st call money on his 60 shares but which he paid with final call.

Required: Calculated the amount of interest paid and received on calls -in- advance and calls in arrears respectively on 1st Aug. 2008.

Solution :

Calculation of Interest on Calls-in-advance

On Rs. 1200 (i.e. 40 x Rs. 30) for 2 months @ 6% p.a.	Rs. 12
On Rs. 800 (i.e. 40 x Rs.20) for 4 months @ 6% p.a.	Rs. 16
	Rs. 28

Calculation of Interest on Calls-in-arrears

On Rs. 2400 (i.e. 60 x Rs. 40) for 4 months @ 5% p.a.	Rs. 40
On Rs. 1800 (i.e. 60 x Rs.30) for 2 months @ 5% p.a.	Rs. 15
	Rs. 55

Illustration 8 :

A limited Company was registered with a capital of Rs. 5,00,000 in share of Rs. 100 each and issued 2,000 such shares at a premium of Rs.20 per share, payable as Rs.20 per share on application, Rs. 50 per share on allotment (including premimu) and Rs. 20 per share on first call made three months later. All the money payable on application, and allotment were duly received but when the first call was made, one shareholder paid the entire balance on his holding of 30 shares, and another shareholder holding 100 shares failed to pay the first call money.

Required: Give Journal entries to record the above transactions and show how they will apperar in the company's Balance Sheet.

Second Call information is not given.

Second Call @ Rs. 30 per share.

Solution :

Journal

Particulars	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
Bank A/c Dr To Share Application A/c [Being the issue of 2,000 shares and application mony received @ Rs 20 per share]		40,000	 40,000
Share Application A/c Dr To Share Capital A/c [Being the transfer of application money on 2,000 shares @ Rs. 20 per share to Share Capital A/c)		40,000	 40,000
Share Allotment A/c Dr To Share Capital A/c To Securities Premium A/c [Being the allotment mony on 2,000 shares @ Rs 50 including premium made due)		1,00,000	 60,000 40,000
Bank A/c Dr To Share Allotment A/c [Being the allotment money on 2,000 shares @ Rs. 50 per share received)		1,00,000	 1,00,000
Share First Call A/c Dr To Share Capital A/c [Being the first call mony on 2,000 shares @ Rs 20 per share made due)		40,000	 40,000
Bank A/c Dr To Share First Call A/c To Call-paid-in-advance A/c (Being the first call money on 1,900 shares @ Rs. 20 per share and share Second call money on 30 shares @ Rs. 30 per share received)		38,900	 38,000 900

Balance sheet as at...

Liabilities		Amount Rs.	Assets	Amount Rs.
Share Capital			***Current Assets, Loans & Advances:***	
Authorised Capital			*Current Assets:*	
5,000 shares of Rs.100 each		5,00,000	Cash at Bank	1,78,900
Issued Capital				
2,000 shares of Rs. 100 each		2,00,000		
Subscribed Capital				
2,000 shares of Rs.100 each Rs. 70 per share Capital paid up	1,40,000			
Less: Calls unpaid	2,000	1,38,000		
Reserves & Surplus:				
Securities Premium		40,000		
Current Liabilities:				
Calls paid-in-advance		900		
		1,78,900		1,78,900

Illustration 9: B Ltd purchase the assets of Rs. 10,80,000 from C Ltd. The cosideration was payable in fully paid equity shares of Rs. 100 each.

Required: Show the necessary journal entries in books of B Ltd. assuming that —

a) Such shares are issued at par

b) Such shares are issued at premium of 20%

c) Such shares are issued at discount of 10%

Solution :

Journal

Particulars		L.F.	Dr. Amount Rs.	Cr. Amount Rs.
Entry in all cases				
Sundry Assets A/c	Dr		10,80,000	
To *C* Ltd.				10,80,000
[Being the purchase of assets from *Y* Ltd. as per agreement dated...)				

(Contd.)

Case (a) When Shares are issued at par			
C Ltd. Dr		10,80,000	
To Equity Share Capital A/c			10,80,000
(Being the issue of 10,800 shares at par to *C* Ltd. as per agreement dated...)			
Case (b) When Shares are issued at a premlum of 20%			
C Ltd. Dr		10,80,000	
To Equity Share Capital A/c			9,00,000
To Securities Premium A/c			1,80,000
(Being the issue of 9,000 shares at 20% premium to *C* Ltd. as per Board's Resolution dated...)			
Case (c) When Shares are issued at a discount of 10%			
C Ltd. Dr		10,80,000	
Discount on Issue of Shares A/c Dr		1,20,000	
To Equity Share Capital A/c			12,00,000
(Being the issue of 12,000 shares at a discount of 10% to *C* Ltd., as per Board's Resolution dated...)			

Working Note: *Calculation of No. of Shares to be issed in different cases*

	At Par	At a Premium	At a Discount
A. Amount to be paid (Rs)	10,80,000	10,80,000	10,80,000
B. Issue Price Per Share (Rs)	100	120	90
C. No. of Shares tobe issued (A/B)	10,800	9,000	12,000

Illustration 10: DLtd. issued 2,000 shares of Rs 100 each credited as fully paid to the promoters for their services and issued 1,000 shares of Rs 100 each credited as fully paid to the underwriters for their underwriting services. Journalise these transactions.
Solution:

Journal

Particulars	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
Goodwil A/c Dr		2,00,000	
To Share Capital A/c			2,00,000
[Being the issue of 2,000 shares of Rs 100 each at par to promoters as per Board's Resolution dated...)			

(Contd.)

(Contd.)

Underwriting Commission A/c Dr To Underwriter's A/c (Being the Underwriting commission due on shares)		1,00,000	 1,00,000
Underwriter's A/c Dr To Share Capital A/c (Being the the issue of 1,000 shares of Rs 100 each at par to Underwriters as per the Board's Resolution dated...)		1,00,000	 1,00,000

Illustration 11: On 1st May 2008 Superman Ltd. issued 5,000 Equity Shares of Rs 100 each payable as follows:

	Rs		Rs	
On application	20	On 1st Call	20	(Last date fixed for payment 31st July)
On allotment	30	On Final Call	30	(Last date fixed for payment 30th August)

Applications were received on 15th May 2008 for 6,000 shares and allotment was made on 1st June 2008. Applicants for 2,500 shares were allotted in full, those for 3,000 shares were allotted 2,500 shares and applications for 500 shares were rejected.

Balance of amount due on allotment was received on 15th June.

The calls were duly made on 1st July,2008 and 1st August 2008 respectively. One shareholder did not pay the 1st Call money on 150 shares which he paid with the final call together with interest at 5% p.a. Another shareholder holding 100 shares did not pay the final call money till end of the accounting year which ends on 31st October.

Required: Show the Cash Book and Journal Entries.
Solution:

Journal Proper

Date	*Particulars*	*L.F.*	*Dr. (Rs)*	*Cr. (Rs)*
1.6.08	Equity Share Application A/c Dr.		1,20,000	
	To Equity Share Capital A/c			1,00,000
	To Share Allotment A/c			10,000
	To Share Allotment A/c			10,000
	(Being the the transfer of application money @ Rs 20 per share on 5,000 shares transferred to Share Capital A/c and @ Rs 20 on 500 t/f to Share Allotment A/c and application money on 500 Share refunded			
1.6.08	Equity Share Allotment A/c Dr.		1,50,000	
	To Equity Share Capital A/c			1,50,000
	(Being the transfer of allotment money @ Rs 30 per share transferred to Share Capital A/c)			
1.7.08	Equity Share First Call A/c Dr.		1,00,000	
	To Equity Share Capital A/c			1,00,000
	(Being the transfer of 1st call money @ Rs 20 per share t/f to Share Capital A/c			
1.8.08	Calls-in-Arrear A/c Dr.		3,000	
	To Equity Share 1st call A/c			3,000
	(Being the transfer of 1st Call money on 150 equity shares @ Rs 20 per share)			
1.8.08	Equity Share Final Call A/c Dr.		1,50,000	
	To Equity Share First Call A/c			1,50,000
	(Being the transfer of final call money @ Rs 30 per share t/f to Share Capital A/c			
1.9.08	Calls-in-Arrear A/c Dr.		3,000	
	To Equity Share Final Call A/c			3,000
	(Being the transfer of final call money on 100 equity shares @ Rs 30 per shares)			
1.9.08	Sundry Shareholders A/c Dr.		25	
	To Interest on Calls-in-Arrears A/c			25
	(Being the interest due on Rs 3,000 @ 5% for two months)			

Dr. Cash Book (Bank Column) *Cr.*

Date	*Particulars*	*Rs*	*Date*	*Particulars*	*Rs*
15.5.08	To Equity Share Application A/c (Application money @ Rs 20 per share on 6,000 shares)	1,20,000	1.9.08	By Equity Share Application A/c (Refund of application money @ Rs 20 per share on 500 shares rejected)	10,000
15.6.08	To Equity Share Allotment A/c (Balance of allotment money)	1,40,000	31.10.08	By Balancec/d	4,97,025.00
1.8.08	To Equity Share 1st Call A/c (1st Call money on 4,850 shares)	97,000			
1.9.08	To Equity Share Final A/c (Final call money on 4,900 Shares)	1,47,000			
1.9.08	To Calls-in-Arrear (Arrear of 1st Call money @ Rs 20 per Share on 1,50 Shares)	3,000			
1.9.08	To Interest on Calls-in-Arrear A/c (Interest on Rs 3,000 for two months @ 5% p.a.)	25.00			
		5,07,025.50			5,07,025.50

Statement of shares applied, alloted and amounts adjusted

Catetories

	A	B	C
(a) Applied (No.of shares)	2,500	3,000	500
(b) Alloted (No.of shares)	2,500	2,500	Nil
	Rs.	Rs.	Rs.
(c) Application money received [(a) x Rs.20 per share]	50,000	60,000	10,000
(d) Application money required [(b) x Rs.20 per share]	50,000	50,000(Refunded)	

(e) Excess Application money to be adjusted with allotment [(c)- (d)]	Nil	10,000	—
(f) Allotment money due [(b) x Rs.30 per share]	75,000	75,000	—
(g) Amount received on allotment [(f) -(e)]	75,000	65,000	—

Illustration 12: Priyanka Industries Ltd. has an authorised capital Rs 2,00,000 divided into shares of Rs 100 each. Of these, 600 shares were issued as fully paid for payment of machinery purchased from Z Ltd. 800 shares were subscribed for by the public and during the first year Rs 50 per share was called up payable Rs 20 on application, Rs. 10 on allotment, Rs. 10 on the first call and Rs. 10 on second call. The amounts received in respect of these shares were as follows:-

On 600 Shares	Full amount called up
On 125 Shares	Rs 40 Per Share " "
On 50 Shares	Rs 30 Per Share " "
On 25 Shares	Rs 20 Per Share " "

The directors forfeited the 75 shares, on which less than Rs 40 per share had been paid.

Required: Give Journal Entries recording the above transactions (including cash transactions) and show how Share Capital would appear in the Balance-Sheet of the Company, in accordance with Part 1 of Schedule VI to the Companies Act.

Solution:

Journals

Particulars		*L.F.*	*Dr. (Rs)*	*Cr. (Rs)*
Machinery A/c	Dr		60,000	
To *Z* Ltd.				60,000
(Being the purchase of machinery from *Z* Ltd. as per agreement dated...)				
Z Ltd.	Dr		60,000	
To Share Capital A/c				60,000
(Being the issue of 600 shares at par)				
Bank A/c	Dr		16,000	
To Share Application A/c				16,000
(Being the application money received)				
Share Application A/c	Dr		16,000	
To Share Capital A/c				16,000
(Being the application money adjusted)				

(Contd.)

(Contd.)

Share Allotment A/c To Share Capital A/c (Being the allotment money due)	Dr		8,000	 8,000
Bank A/c To Share Allotment A/c (Being the allotment money received on 775 shares)	Dr		7,750	 7,750
Share First Call A/c To Share Capital A/c (Being the first call due)	Dr		8,000	 8,000
Bank A/c To Share First Call A/c (Being the first call received on 725 shares)	Dr		7,250	 7,250
Share Second Call A/c To Share Capital A/c (Being the second call due)	Dr		8,000	 8,000
Bank A/c To Share Second Call A/c (Being the second call received on 600 shares)	Dr		6,000	 6,000
Share Capital A/c To Forteited Share A/c To Share Allotment A/c To Share First Call A/c To Share Second Call A/c (Being 75 shares forteited as per Board's resolution dated...)	Dr		3,750	 2,000 250 750 750

Balance Sheet as at...

Liabilrties	*Rs*	*Assets*	*Rs*
Share Capital:		Fixed Assets:	
Authorised Capital		Machinery	60,000
2,000 Shares of Rs 100 each	2,00,000	Current Assets:	
Issued Capital:		Cash at Bank	37,000
1,400 Shares of Rs 100 each	1,40,000		
Subscribed Capital:			
600 Shares of Rs 100 each	60,000		
725 Shares of Rs 100 each,			
Rs 50 per share called up	36,250		
(Of the above shares 600			
shares are allotted as fully paid			

(Contd.)

(Contd.)

up pursuant to a contract without payments being received in cash)	96,250		
Less: Calls Unpaid	1,250		
	95,000		
Add: Forfeited Shares	2,000		
	97,000		97,000

Illustration 13: SOS Limited issued a prospectus inviting applications for 6,000 shares of Rs 10 each at a premium of Rs 2 per share, payable as follows;

On application Rs 2 per share; On allotment Rs 5 per share (including premium): On 1st call Rs 3 per share; On Second and Final Call Rs 2 per share.,

Applications were receive for 9,000 shares and allotment was made *prorata* to the applicants of 7,500 shares, the remaing applicants were refused allotment. Money overpaid on applications were applied towards sums due on allotment.

D to whom 100 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited. *Z*,the holder of 200 shares, failed to pay both the calls, and his shares were forfeited after the second and final call.

Of the shares forfeited 200 shares were sold to *C* credited as fully paid up for Rs 8.50 per share, the whole of *D*'s shares being included.

Required: Show Journal and Cash Book enteries in the books of the company.

Solution:

Dr. Cash Book (Book Column) Cr.

Particulars	*Rs*	*Particulars*	*Rs*
To Share Capital: (Rs. 2 on 9,000 shares)	18,000	By Share Application A/c	3,000
To Share Allotment A/c (allotment money received)	26,550	By Balance c/d	71,750
To Share 1st Call A/c (Rs. 3on 5,700 shares)	17,100		
To Share 2nd & Final Call A/c	11,400		
To Share Capital A/c (Rs. 8.50 on 200 shares)	1,700		
	74,750		74,750

Journals

Particulars		*L.F.*	*Dr. (Rs)*	*Cr. (Rs)*
Share Application A/c	Dr.		12,000	
To Share Capital				12,000
(Being Share application money transferred to Share Capital Account)				
Share Application A/c	Dr.		3,000	
To Share Allotment A/c				3,000
(Being Share application money at Rs.2 on 1,500 shares adjusted against allotment.)				

(Contd.)

Share Allotment A/c Dr		30,000	
To Share Capital A/c			18,000
To Securities Premium A/c			12,000
[Being the allotment money due]			
Share First Call A/c Dr		18,000	
To Share Capital A/c			18,000
[Being the first call money due]			
Share Capital A/c Dr		800	
Securities Premium A/c Dr		200	
To Forefeited Share A/c			250
To Share Allotment A/c			450
To Share First Call A/c			300
[Being 100 shares of Rs. 10 each, Rs. 8 per Share called up, forfeited for non payment of allotment and first call]			
Share Second and Final Call A/c Dr		11,800	
To Share Capital A/c			11,800
[Being the second and final call money due on 5,900 Shares]			
Share Capital A/c Dr		2,000	
To Forfeited Share A/c			1,000
To Share First Call A/c			600
To Share Final Call A/c			400
[Being 200 shares of Rs. 10 each forfeited for non-payment of first and final call]			
Forfeited Share A/c Dr		300	
To Share Capital A/c			300
[Being 200 shares re-issued]			
Forfeited Share A/c Dr		450	
To Capital Reserve A/c			450
[Being the transfer of profit on re-issue]			

Working Notes : *(i) Calculation of the amount due but no paid on allotment in Case of D.*

No. of applied Shares by Mr. D. (100 x 7500/6,000) 125

Total money sent on application by Mr. D. (125 x 2)	Rs. 250
Excess application money [Rs 250 - (100 x Rs. 2)]	Rs. 50
Total amount due on allotment (100 x Rs. 5)	500
Amount due but not paid on allotment (Rs. 500 —Rs 50)	Rs.450

(ii) Calculation of allotment money received later on

Total allotment money due		Rs. 30,000
Less (a) Already received	Rs. 3,000	
(b) Not received (as per note 1)	Rs. 450	3,450
		26,550

Illustration 14: Alpha Ltd issued a prospectus inviting applications for 2,000 shares of Rs. 10 each at a premium of Rs. 2 per share, payable as follows :

On Application Rs.2 On Allotment Rs 5 (including premium)

On First Call Rs.3 On Second & Final Call Rs. 2

Applications were received for 3,000 shares and *pro rata* allotment was made on the applications for 2,400 shares. It was decided to utilise excess application money towards the amount due on allotment.

Mohit, to whom 40 shares allotted, failed to pay the allotment money and on his subsequent filure to pay the first call, his shares were forfeited.

Jagat, the holder of 60 shares failed to pay the two calls and on his such failure, his shares were forfeited.

Of the shares forfeited, 80 shares were sold to Rishav credited as fully paid for Rs. 9 per share, the whole of Mohit's shares being included.

Required: Give Journal Entries to record the above trasactions (including cash transactions)

Solution :

Journals

Particulars	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
Bank A/c Dr To Share Application A/c [Being the application money received on 3,000 shares)		6,000	 6,000

(Contd.)

Share Application A/c Dr		6,000	
To Share Capital A/c			4,000
To Bank A/c			1,200
To Share Allotment A/c			800
[Being the application money received on 3,000 shares]			
Share Allotment A/c Dr		10,000	
To Share Capital A/c			6,000
To Securities Premium A/c			4,000
[Being the allotment money due]			
Bank A/c Dr		9,016	
To Share Allotment A/c			9,016
[Being the remaining allotement money received on 1,960 shares]			
Share First Call A/c Dr		6,000	
To Share Capital A/c			6,000
[Being the first call money due]			
Bank A/c Dr		5,700	
To Share First Call A/c			5,700
[Being the first call money received on 1,900 shares @ Rs.3 per share]			
Share Capital A/c Dr		320	
Securities Premium A/c Dr.		80	
To Share Allotment A/c			184
To Share First Call A/c			120
To Forfeited Share A/c			96
[Being 40 shares forfeited for non-payment of full allotment money and the first call money]			
Share Second & Final Call A/c Dr		3,920	
To Share Capital A/c			3,920
[Being the second and final call due on 1,960 share]			

(Contd.)

(Contd.)

Bank A/c Dr		3,800	
To Share Second and Final Call A/c			3,800
[Being the second and final call received on 1,900 shares]			
Share Capital A/c Dr		600	
To Share First Call A/c			180
To Share Second and Final Call A/c			120
To Forfeited Shares A/c			300
[Being 60 shares forfeited for non-payment on the first call and final call]			
Bank A/c Dr		720	
Forfeited Shares A/c Dr.		80	
To Share Capital A/c			800
[Being the reissued of 80 shares @ Rs.9 as fully paid up]			
Forfeited Shares A/c Dr.		216	
To Capital Reserve A/c			216
[Being the transfer of profit on re-issue]			

Working Notes : *(i) Calculation of the amount due but not paid on allotment in Case of Mohit*

			Rs.
Total No. of shares applied by Mohit (40 × 2,400/2,000) 48			
Total money sent on application by Mohit (48 × Rs. 2)			96
Excess application money [Rs 96 – (40 × Rs. 2)]			16
Total amount due on allotment (40 × Rs. 5)			200
Amount due but not paid on allotment (Rs. 200 – Rs. 16)			184

(ii) Calculation of allotment money received later on

Total allotment money due (2,000 × Rs.5)			10,000
Less: (a) Already received	Rs.	800	
(b) Not received (as per note 1)	Rs.	184	984
			9,016

(iii) Since the question is silent as to the utilization of Rs. 16 (received from Mohit) between share capital and securities premium, it has been assumed that the entire excess of Rs. 16 is exclusively for share capital and hence credited to Forfeited Shares Account in full.

Illustration 15: Nivedita Fertilisers Ltd. issued a prospectus invitng applications for 20,000 shares of Rs.10 each at a premium of Rs. 2 per share, paybale as follows :

	Rs.
On Application	3 (including Re.1 premium)
On Allotment	4 (including Re.1 premium)
On First Call	3
On Second & Final Call	2

Applications were received for 30,000 shares and *pro rata* allotment was made on the applications for 24,000 shares. It was decided to utilise excess application money towards the amlount due on allotment.

Arunavo, to whom 400 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited.

Victor, who applied for 720 failed to pay the two calls and on his such failure, his shares were forfieted. Of the shares forfeited, 800 shares were sold to Srijita credited as fully paid for Rs.9 per share, the whole of Arunavo's shares being included.

Required: Give Journal Entries to record the above trasactions (including cash transactions)

Solution :

Journals

Particulars	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
Bank A/c Dr		90,000	
To Share Application A/c			90,000
(Being the application money received on 30,000 shares)			
Share Application A/c Dr		90,000	
To Share Capital A/c			40,000
To Securities Premium A/c			20,000
To Bank A/c			18,000
To Share Allotment A/c			12,000
(Being the application money adjusted and surplus refunded)			

(Contd.)

Share Allotment A/c Dr To Share Capital A/c To Securities Preimum A/c (Being the allotment money due)		80,000	 60,000 20,000
Bank A/c Dr To Share Allotment A/c (Being the remaining allotment money received on 19,600 shares)		66,640	 66,640
Share First Call A/c Dr To Share Capital A/c (Being the first call money due)		60,000	 60,000
Bank A/c Dr To Share First Call A/c (Being the first call money received on 19,000 shares @ Rs.3 per shares)		57,000	 57,000
Share Capital A/c Dr Security Premium A/c Dr To Share Allotment A/c To Share First Call A/c To Forfeited Shares A/c (Being 400 shares forfeited for non-payment of full allotment money and the first call money)		3200 400	 1360 1200 1040
Share Second and Final Call A/c Dr To Share Capital A/c (Being the second and final call due on 19,600 shares)		39,200	 39,200
Bank A/c Dr To Share Second and Final Call A/c (Being the second and final call received on 19,000 shares)		38,000	 38,000
Share Capital A/c Dr To Share First Call A/c To Share Second and Final Call A/c To Forfeited Shares A/c (Being 600 shares forfeited for non-payment of the first call and final call)		6000	 1800 1200 3000

(Contd.)

Bank A/c Dr		7,200	
Forfeited Shares A/c Dr		800	
To Share Capital A/c			8,000
[Being the reissue of 800 shares @ Rs.9 as fully paid up)			
Forfeited Shares A/c Dr		2240	
To Capital Reserve A/c			2240
[Being the transfer of profit on re-issue)			

Working Notes : *(i) Calculation of the amount due but not paid on allotment in Case of Arunavo*

		Rs.
Total No.of shares applied by Arunavo (400x24,000/20,000)		480
Total money sent on application by Arunavo (480x Rs.3)		1440
Excess applicaiton money [Rs. 1440 - (Rs. 400 x Rs.3)		240
Total amount due on allotment (Rs.1600 - Rs.240)		1360

(ii) Calculation of allotment money received latter on

Total allotment money due (20,000 x Rs.4)		80,000
Less : (a) Already received (4,000 x 3)	12,000	
(b) Not received (as per note I)	1,360	13,360
		66,640

(iii) Since the question is silent as to the utilization of Rs.240 (received from Arunavo) between share capital and Securities premium, it has been assumed that the entire excess of Rs. 240 is exclusively for share capital and hence credited to Forfeited Shares Account in full.

Illustration 16: Hero Limited issued 10,000 equity shares of Rs. 100 each at premium of Rs. 25 per share. Under the terms of the isue, the shares were to be paid for as follows :

	Rs.
2008 January 1, on application (including Rs. 25 premium on issue per share)	50
February 1, on allotment	50
April 1, balance of	25

The issue was over subscribed. The applications received are summarised below :

	A	***B***	***C***
Number of applicants in categories	40	20	1
Applied for by each applicant in the three categories	200	2000	8000
Issued to each applicant	100	200	2000

One of the conditions of the issue was that amounts over-paid on application were to be retained by the company and used in redudction of further sums due on shares allotted. All surplus contributions were refunded on 15th February, 2008.

Ramesh who had subscribed 100 on an application for 200 shares was unable to meet the claim due on April 1. On May 5, the directors forfeited his shares. All other shareholders paid the sums requested on the due dates. On June 10, 2008 the directors re-issued the forfeited shares as fully paid to Mohan, on receiving a payment of Rs. 10,500.

(a) To prepare a statement as on February 1, 2008, showing the over-payment, under-payment to in respect of category of applicants : and
(b) To show how the above transactions would appear in the journal of the company.

Solution :

(a) Hero Ltd.

Statement of Shares Applied, Allotted and Amounts Adjusted

	Catetories		
	A	B	C
(a) Applied (Nos.)	8,000	40,000	8,000
(b) Allotted (Nos.)	4,000	4,000	2,000
	Rs.	Rs.	Rs.
(c) Application money Received (Applied ×Application per share)	4,00,000	20,00,000	4,00,000
(d) Application Money required (Alloted × Application per share)	2,00,000	2,00,000	1,00,000
(e) Excess Application Money to be Adjusted with Allotment [c-d]	2,00,000	18,00,000	3,00,000
(f) Allotment Money Due (Alloted × Allotment per share)	2,00,000	2,00,000	1,00,000
(g) Balance of Excess Application Money for Adjustment with calls [e-f]	Nil	16,00,000	2,00,000
(h) Call Money Due (Allotment × Call per share)	1,00,000	1,00,000	50,000
(i) Excess/(Shortage)	(1,00,000)	15,00,000	1,50,000

In case of shortage, the shareholders will deposit the dues.

(b) Journals

2008	*Particulars*	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
Jan. 01	Bank A/c Dr.		28,00,000	
	To Equity Share Application A/c			28,00,000
	(Application money received on 56,000 shares @ Rs. 50 per share)			
Feb. 01	Equity Share Application A/c Dr.		5,00,000	
	To Equity Share Capital A/c			2,50,000
	To Securities Premium A/c			2,50,000
	(Being application money on 10,000 shares transferred to share Capital and Securities Premium vide Board's resolution no. dated...)			
	Equity Share Application A/c Dr.		16,50,000	
	To Bank A/c			16,50,000
	(Being excess application money refunded of vide Board's resolution no. dated...)			

(*Contd.*)

(*Contd.*)

	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Being allotment money due on 10,000 shares @ Rs. 50 per share vide Board's resolution no. dated...)		5,00,000	 5,00,000
	Equity Share Application A/c Dr. To Equity Share Allotement A/c Dr. (Being excess of Equity share application money adjusted with allotment)		5,00,000	 5,00,000
	Equity Share First & Final Call A/c Dr. To Equity Share Capital A/c (Being first & final call money due on 10,000 shares @ Rs. 25 per share vide Board's resolution no. dated...)		2,50,000	 2,50,000
Apr. 01	Bank A/c Dr. Calls in Arrear A/c Dr. Equity Share Application A/c Dr. To Equity Share First & Final Call A/c (Being amount received and adjusted, except a holder of 100 share who failed to pay the call)		97,500 2,500 1,50,000	 2,50,0000
	Equity Share Capital A/c Dr. To Shares Forfeited A/c Dr. To Calls in Arrear A/c (Being 100 shares held by Ramesh forfeited for non-payment of call @ Rs. 25 per share vide Board's resolution no. dated...)		10,000	 7,500 2,500 7,500
May 05	Bank A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being 100 forfeited shares resissued at Rs. 10,500)		10,500	 10,000 500
	Share Forfeited A/c Dr. To Captial Reserve (Being balance of shares forfeited transferred to captial reserve)		7,500	 7,500

Rights Issue

Issue of shares by an existing company to the existing equity shareholders is known as rights issue.

Section 81 of the Companies Act, 1956 provides: Where at any time after the expiry of two years from the formation of a company or the expiry of one year from the first allotment of shares in the company, whichever is earlier, if the Board of Directors, decide to increase the subscribed capital of the company by the allotment of further shares, then :

(a) Such further shares shall be offered to the persons who on that date are the holders of equity shares of the company proportionately to their equity holdings on that date.

(b) The offer shall be made by a notice specifying the number of shares offered and limiting a time not being less than 15 days from the date of the offer, within which the offer, if not accepted, will be deemed to have been declined.

(c) Unless the Articles of Association of the company otherwise specify, the offer shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice referred to in clause *(b)* shall contain a statement of this right.

(d) After the expiry of the time specified in the notice referred to above, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may proceed to dispose of such shares offered in such manner as they consider most beneficial to the company.

The new shares issued need not be offered to the existing equity shareholders, if the company in general meeting has so decided by a special resolution, or, if the company in general meeting has so decided by ordinary resolution and the same has been approved by the Central Government.

"Nothing in section 81 shall apply:

(a) to a private Company; or

(b) to the increase of the subscribed capital of a public company caused by the exercise of an option attached to debentures issued or loans raised by the company:

    (i) to convert such debentures or loans into shares in the company, or

    (ii) to subscribe for shares in the company.

Advantages of Rights Issue

The following can be the advantages which accrue as a result of issuing further shares to the existing shareholders only :

1. Control of the company is retained in the hands of the existing shareholders. Issue of right shares makes possible equitable distribution of shares without disturbing the established equilibrium of shareholdings because right shares are offered to the persons who on the date of rights issue are the holders of equity shares of the company proportionately to their equity shares on that date.
2. The existing shareholders do not suffer on account of dilution in the value of their holdings if fresh shares are offered to them because value of the shares is likely to fall with fresh issue. This decrease in the value of the shares will be compensated by getting new shares at a price lower than the market price. They are likely to suffer on account of the dilution in the value of their holdings if fresh shares are offered to the general public.
3. The expenses to be incurred, if shares are offered to the general public, are avoided.
4. Image of the company is bettered when rights issues are made from time to time and existing shareholders remain satisfied.

5. There is more certainty of getting capital when fresh issue of shares is made to the existing shareholders instead of to the general public.
6. Directors cannot misuse the opportunity of issuing new shares to their friends and relatives at lower prices and at the same time retaining more control in their hands when right shares are issued because in rights issue shares are offered proportionately to the existing shareholders according to their existing holdings.

Valuation of Rights

Usually a company offers rights issue at a price which is lower than the market price of the shares so that existing *(i.e.,* old) shareholders may get the monetary benefit of being associated with the company for a long time. Existing shareholders who have been offered right shares and do not want to purchase these offered shares may renounce their right shares in favour of some other persons within the specified period as mentioned earlier. In such a case, the existing shareholders can make a profit by selling his right to such other person. This right can be valued in terms of money as below:

(a) Calculate the market value of shares which an existing shareholder is required to have in order to get fresh shares.

(b) Add to the above price paid for the fresh shares.

(c) Find out the average price of existing shares and fresh shares.

(d) The average price of the share should be deducted from the market price and the difference thus ascertained is value of right.

Illustration 17.

A Company is planning to raise funds by making rights issue of equity shares to finance its expansion. The existing equity share capital of the company is Rs. 50,00,000. The market value of its share is Rs. 42. The company offers to its shareholders the right to buy 2 shares at Rs. 11 each for every 5 shares held. You are required to calculate :

(i) Theoretical market price after rights issue;

(ii) The value of rights; and

(iii) Percentage increase in share capital.

Solution :

	Rs.
Market value of 5 shares already held by a shareholder @ Rs. 42	210
Add : Price to be paid by him for acquiring 2 more shares @ Rs. 11 per share	22
Total price of 7 shares after rights issue	232

(i) Therefore, theoretical market price of one share, *(i.e.,* 232/7) = 33.14

(ii) *Value of* Rights = Market Price - Theoretical Market Price= Rs. 42 - Rs. 33.14. = Rs. 8.86

(iii) Percentage Increase in Share Capital

Present Capital	50,00,000
Rights Issue Rs. 50,00,000 × 2/5	20,00,000
% Increase In Share Capital (20,00,000/50,00,000) × 100 40%	

Buy-back of Shares

Introduction

By virtue of section 77(1) of the Companies Act, 1956, a company limited by shares could not buy its own shares as the same would amount to illegal reduction of capital. This section specifically laid down that "no company limited by shares and no company limited by guarantee and having a share capital, shall have power to buy its own shares, unless the consequent reduction of capital is effected and sanction obtained in pursuance of sections 100 to 104 and section 402".

In response to the persistent demand from the corporate sector for buyback, the Central Government promulgated the Companies (Amendment) Ordinance, 1998, permitting companies to buy-back their own shares. The Ordinance, which amended the Companies Act to become Companies (Amendment) Act, 1999, made provision for the insertion of three new sections, *viz.*, section 77A, 77AA and 77B which authorize companies to buy-back their shares subject to fulfillment of the conditions laid down therein. Besides that, SEBI has also issued its own guidelines seeking to regulate buy-back of securities.

What is buy-back?

Buy-back of securities is similar to a company purchasing its own debentures for cancellation or redemption of preference shares.

In the case of buy-back, the company, which has issued shares to the public, repurchases its own shares.

How buy-back?

As shares may be issued at par, at a premium or at a discount, re-purchase may also be done at par, at a premium or at a discount.

This method may also be resorted to in order to increase the share value, by enhancing the earning per share.

Conditions of buy-back.

As per Section 77A(2) of the Companies Act,1956 the conditions for buy-back are:

The company's articles should authorize the buy-back. If not, the same has to be amended to include a provision to that effect;

A special resolution should be passed in the general meeting authorizing the buy-back;

a. The buy-back should be less than 25% of the total paid-up capital and free reserves of the company;
b. The buy-back of equity shares in any financial year should not exceed 25% of its total paid-up equity capital in that financial year;
c. The Companies (Amendment) Act, 2001 has authorized the buy-back by means of a resolution at the company's Board provided the buy-back does not exceed 10% of the total paid-up equity capital and free reserves of the company. But, there cannot be more than one such buy-back in a period of 365 days.
d. *D*ebt-equity ratio shall not exceed 2:1 after such buy-back. The Central Government may however, prescribe a higher ratio for a class or classes of companies;

e. All the shares or other specified securities are fully paid up;

f. The buy-back of the shares or other securities listed on any recognized stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;

g. The buy-back of shares or other securities not listed on any recognized stock exchange is in accordance with the guidelines as may be prescribed.

Notice of the meeting.

The notice of the meeting at which the special resolution on buy-back is proposed to be passed, shall be accompanied by an explanatory statement mentioning:

A full and complete disclosure of all material facts regarding;

1) The necessity *for* the buy-back;
2) The class of security intended to be purchased under the buy-back;
3) The amount to be invested under the buy-back;
4) The time limit for completion of buy-back;
5) The price at which buy-back of shares is to be made;
6) If the promoters intend to offer their shares:
   a) The quantum of shares proposed to be tendered, and
   b) The details of their transactions and their holdings *for* the last six months prior to the passing of the special resolution including information on the number of shares acquired, the price and the date of acquisition.
7) Every buy-back should be completed within 12 months *from* the date of passing the special resolution.

Where a company has passed a special resolution or the Board has passed a resolution to buy-back its own shares or other securities, it shall before making such buyback,

a. File with the Registrar and the Securities and Exchange Board of India. a declaration of solvency in the form as may be prescribed; and
b. verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities; and
c. will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board; and
d. signed by at least two directors of the company, one of whom shall be the managing director, if any.
e. No such declaration of solvency need to be filed with the Securities and Exchange Board of India by a company the shares of which are not listed *on* any recognized stock exchange.

Another condition to be complied with by a company buying back its *own* shares is that the company shall after buy-back extinguish and physically destroy the securities so bought within seven days *of* the last date *of* completion of buy-back.

The SEBI guidelines in this regard stipulate that the securities bought back should be destroyed in the presence *of* a Registrar / Merchant Banker, and the statutory auditor.

A certificate to this effect shall be furnished to the SEBI duly signed by two whole time directors including the managing director and verified by the Registrar/Merchant Banker and statutory auditor.

No further issue within six months.

After completing buy back of shares or other securities, a Company can not make further issue of the same kind of shares including by way of rights or other specified securities within a period of six months.

However, this rule is not applicable in case of bonus issue or in the discharge of subsisting obligations such as conversion of warrants; stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

Maintenance of Register.

The Company should maintain a register of the securities so bought under this scheme, the consideration paid for Buy Back, the date of cancellation of securities, the date of extinguishing and physically destroying the securities and such other particulars as may be prescribed.

A company shall after buy-back is completed under this section, file with the Registrar and the Securities and Exchange Board of India a return containing such particulars relating to the buy-back within thirty days of such completion as may be prescribed. No such return need be filed with the SEBI if the company buying back is an unlisted company.

In case a company makes default in complying with the provisions of this section or any rules and regulations made thereunder, the company or any officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years or with fine which may extend to Rs. 50,000 or with both.

Prohibition of Buy-Back.

According to Section 77B of the Companies Act, no company shall directly or indirectly purchase its own shares or other specified securities:

(a) through any subsidiary company including its own subsidiary companies; or

(b) through any investment company or group of investment companies; or

(c) if a default by the company, in repayment of deposit or interest payable thereon redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institution or bank is subsisting;

(d) in case it has not complied with the provisions of Section 159 with regard to annual return. Section 207 with regard to failure to distribute dividends within the specified time and Section 211 with regard to the form and contents of balance sheet and profit and loss account and compliance with the Accounting Standards.

In the following cases, however, a company is not considered to be purchased its own shares:

a. When redeemable preference shares are redeemed;

b. When shares are forfeited for non-payment of calls. Or

c. When it has accepted a valid surrender of shares.

Prohibition of Financial Assistance.

According to Section 77(2) a public company cannot give loan or provide financial assistance to any person to enable him to purchase company's own shares or shares of its holding company. However, this provision is not applicable in case of:

(a) the lending of money, by a banking company in the ordinary course of its business or

(b) the provision of money by a company for the purchase of fully paid up shares in the company or its holding company for the benefit of employees of the company including any director holding a salaried office or employment in the company;

(c) the making by a company of loans to persons other than directors or managers bonafide in the employment of the company to enable them to purchase fully paid up shares in the company or its holding company to be held by themselves by way of beneficial ownership.

However, the loan made to any employee for this purpose shall not exceed his salary or wages at that time for a period of six months.

Sources of Buy-Back.

Section 77 A read with Section 77B(2) permits a company to buy its own shares or other specified securities out of:

(i) its free reserves: or

(ii) the securities premium account; or

(iii) the proceeds of any shares or other specified securities.

However, no buy-back shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

The expression 'specified securities' includes employees' stock option or other securities as may be notified by the Central Govemment from time to time. 'Free reserves' means those reserves which, as per the latest audited balance sheet of the company, are free for distribution as dividend and shall include balance to the credit of securities premium account but shall not include share application money.

SEBI Guidelines.

The Securities and Exchange Board of India, has issued the following guidelines with regard to buy-back of shares or other specified securities by companies, having been empowered to do so by the Companies (Amendment) Act, 1999. These guidelines came into effect from 14-11-1998.

Modes of buy-back.

Buy-back is permissible:

(a) from the existing security holders on a proportionate basis through the tender offer; or

(b) from the open market through

1. book-building process,
2. stock exchange;

(c) from odd lots, that is to say, where the lot of securities of a public company whose shares are listed on a recognized stock exchange is smaller than such marketable lot as may be specified by the stock exchange: or

(d) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

Where a company proposes to buy-back its own shares. it shall after passing the special resolution or resolution of its Board of Directors make a public announcement in at least one English National Daily one Hindi National Daily and Regional Language Daily with wide circulation at the place where the registered office of the company is located.

The public announcement shall specify a date which shall be the 'specified date' for the purposes of determining the names of the shareholders to whom the letter of offer shall be sent. The specified date cannot be earlier than 30 days and not later than 42 days from the date of such public announcement. The letter of offer shall be despatched not earlier than 21 days from the submission of its draft with SEBI through the merchant banker. The date of opening of the offer shall not be earlier than 7 days or later than 30 days after the specified date. Companies buying back through the tender offer have to open an escrow account.

A company cannot buy-back its shares from any person:

(a) through negotiated deals whether on or off the stock exchange; or

(b) through spot transactions; or

(c) through any private arrangements.

Price at which shares shall be bought back has to be determined by shareholders through a special resolution. A copy of their resolution has to be filed with the SEBI as well as the stock exchanges where the shares of the company are listed, within 7 days from the date of passing the resolution. Companies buying back through stock exchanges should disclose purchases daily. Buy-back offer shall remain open for not less than 15 days and not more than 30 days. The verification of shares bought back has to be completed within 15 days of the closure of the offer and payments made within 7 days. The onus of complying with the SEBI guidelines is on the merchant banker who has to file a 'due diligence certificate' with the SEBI.

Escrow Account.

Regulation 10(1) of the Securities and Exchange Board of India provides that a company shall, as and by way of security for performance of its obligations on or before the opening of the offer of re-purchase, deposit in an escrow account such sum as is specified in 10(2), that is:

(i) If the consideration payable does not exceed Rs. 100 crores, 25% of the consid eration;

(ii) If the consideration payable exceeds Rs. 100 crores, 25% up to Rs. 100 crores, and 10% thereafter.

Escrow account means an account in which money is held until a specified duty is performed, *i.e.,* till the consideration for buy-back of shares is paid to the shareholders. This account consists of cash deposited with a scheduled commercial bank, or bank guarantee in favour of the merchant banker, or deposit of acceptable securities with appropriate margin, with the merchant banker, or combination of these.

Advantages of Buy-back.

Buy-back have the following advantages:

(i) A company with capital, which cannot be profitably employed, may get rid of it by resorting to buy-back, and re-structure its capital.

(ii) Free reserves which are utilized for buy-back instead of dividend enhance the value of the company's shares and improve earnings per share.

(iii) Surplus cash may be utilized by the company for buy-back and avoid the payment of dividend tax.

(iv) Buy-back may be used as a weapon to frustrate any hostile take-over of the company by undesirable persons.

Accounting for Buy-back.

Buy-back of shares is just the opposite of issue of shares. Just as shares may be issued at par, at a premium or a discount, even buy-back may be at par, at a premium or at a discount. The basis of accounting for buy-back is Section 77 A of the Amended Companies Act. This Section not only permits a company to buy-back or redeem its equity shares, but also specifies the sources from out of which re-purchase is to be effected.

According to this Section, a company may buy-back its shares or other specified securities from out of

1. Its free reserves, or
2. The securities premium account, or
3. The proceeds of any shares or other specified securities like employees' stock option.

However, no buy-back of shares shall be made out of the proceeds of an earlier issue of the same kind of shares. This Section also lays down that all the shares or other specified securities for buy-back are fully paid up.

As per to Section 77 AA, When a company purchases its own shares out of free reserves. then a sum equal to the nominal value of the shares so purchased shall be transferred to the capital redemption reserve account and details of such transfer should be disclosed in the balance sheet.

Buy-back of Shares

Determination of quantum for buy-back. Sec. 77A

The maximum number of shares to be bought back is determined as the least number of shares arrived by performing the following tests :

(1) Share outstanding test

(2) Resource test

(3) Debt-Equity Ratio test.

(1) Share Outstanding test :

(a) Ascertain the number of shares

(b) 25% of the number of shares is eligible for buy back with the approval of shareholders.

(2) Resource test :

(a) Ascertain sharehooders fund (Capital + Free Reserves)

(b) No. of shares held for buyback

$$= \frac{\text{Shareholders funds}}{\text{Buy back price}}$$

Free Reserve includes Securities Premium, General
Reserve, Revenue Reserves, Profit & Loss A/c (Cr. Balance)
excludes Revaluation Reserve, any other specific reserves.

Accounting — Buy back of Shares

(i) Shares held for buy-back

Equity Share Capital A/c Dr.

Premium on Buyback A/c Dr.

To Equity Shareholders A/c

or Shares bought back A/c

(ii) Adjustment of premium on buyback

Securities Premium A/c Dr.

General Reserve A/c Dr.

To Premium on Buyback A/c

(iii) Transfering reserves to the extent of capital redeemed

Reserves A/c Dr.

Profit Loss A/c Dr.

To Capital Redemption Reserve

(iv) On buy-back of shares

Equity Shareholders A/c Dr.

or Shares bought back A/c Dr.

To Bank A/c

Illustration 1.

(Buy-back** at **par)

X Co. Ltd. buys back its own 2,00,000 equity shares of Rs. 10 each at par. The company has sufficient profits otherwise available for dividend besides general reserve. No fresh issue of shares is made for this purpose. The shares are fully paid up.

Journalise the transactions.

Solution.

In the Books of *X* Co. Ltd.

JOURNAL ENTRIES

Date	*Particulars*		*Debit* *Rs.*	*Credit* *Rs.*
	Equity Share Capital A/c	Dr.	20,00,000	
	To Bank A/c			20,00,000
	(Buying-back 2,00,000 equity shares of Rs. 10 each, at par)			
	General Reserve A/c	Dr.	20,00,000	
	To Capital Redemption Reserve A/c			20,00,000
	(Transfer of nominal value of shares bought back)			

Illustration 2.

(Where shares are partly paid up).

The BCG Co. Ltd. resolved by a special resolution to buy-back 2,00,000 of its equity shares of the face value of Rs. 10 each on which Rs. 8 has been paid up. The general reserve balance of the company stood at Rs. 50,00,000 and no fresh issue of shares was made.
Journalize the transactions.

Solution.

In the Books of BCG Co. Ltd.

JOURNAL ENTRIES

Date	*Particulars*		*Debit* *Rs.*	*Credit* *Rs.*
	Equity Share Final Call A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Final call of Rs. 2 per share due on 2,00,000 equity shares as per Board resolution)			
	Bank A/c	Dr.	4,00,000	
	To Equity Share Final Call A/c			4,00,000
	(Final call money on2,00,000 shares received)			

	Equity Share Capital A/c Dr. To Equity Shareholders A/c (Amount due to equity shareholders transferred to their account for Buy Back)	20,00,000	20,00,000
	Equity Shareholders A/c Dr. To Bank A/c (Payment to shareholders towards buy-back)	20,00,000	20,00,000
	General Reserve A/c Dr. To Capital Redemption Reserve A/c (Transfer of nominal value of shares Bought-back.)	20,00,000	20,00,000

Illustration 3

(Where shares are ***bought-back*** at a premium).

The share capital of Beta Co. Ltd consists of 100,000 equity shares of Rs. 10 each, and 25,000 preference shares of Rs. 100 each, fully called up. Besides, its securities premium account shows a balance of Rs. 40,000 and general reserve of Rs. 7,00,000. The company decides to buy-back 30,000 equity shares of Rs. 12 each. For this purpose, it utilises the securities premium in full and general reserve to the extent necessary.
Pass the necessary journal entries.

Solution.

In the Books of Beta Co. Ltd.

JOURNAL ENTRIES

Date	*Particulars*		*Debit Rs.*	*Credit Rs.*
	Equity Share Capital A/c Securities Premium A/c General Reserve A/c To Equity Shareholders A/c (Amount due to equity shareholders for buying-back of 30,000 equity shares)	Dr. Dr. Dr.	3,00,000 40,000 20,000	 3,60,000

	Equity Shareholders A/c Dr. To Bank A/c (Payment to shareholders on account of buy-back)	3,60,000	 3,60,000
	General Reserve A/c Dr. To Capital Redemption Reserve A/c (Transfer of nominal amount of equity shares Bought-back.)	3,00,000	 3,00,000

Illustration 4.

(Where shares are bought-back at a discount).

The PTC Co. Ltd. has a share capital of Rs. 15,00,000, comprising 1.00.000 equity shares of Rs. 10 each. and 50,000 8% preference shares of Rs. 10 each, both of which fully called up and paid up. The company has sufficient general reserve to its credit to enable it to comply with the legal formalities connected with buy-back of shares. It decides to buy-back 20% of its equity share capital at Rs. 9 per share. Record the transactions in the books of the company.

Solution.

In the Books PTC Co. Ltd.

JOURNAL ENTRIES

Date	*Particulars*	*Debit Rs.*	*Credit Rs.*
	Equity Share Capital A/c Dr To Equity Shareholders A/c To Capital Reserve A/c (Amount due to equity shareholders for buy-back of 20,000 shares @Rs.9)	2,00,000	 1,80,000 20,000
	Equity Shareholders A/c Dr To Bank A/c (Payment to equity shareholders the amount due to them)	1,80,000	 1,80,000
	General Reserve A/c Dr To Capital Redemption Reserve A/c (Transfer of nominal amount of shares bought-back.	2,00,000	 2,00,000

Illustration 5.

(Fresh issue of shares for purposes ***of buy-back*)**.

Alpha Co. Ltd. has a paid up equity share capital of Rs. 20,00,000 in 2,00,000 shares of Rs. 10 each. It resolved to buy-back 50,000 equity shares at Rs. 15 per share. For this purpose. it issued 20,000 12% preference shares of Rs. 10 each, at par, payable along with application. The company has to its credit Rs. 2,50,000 in securities premium account and Rs. 10,00,000 in the general reserve account. The company utilized the whole of the securities premium and for the balance, general reserve. Pass the necessary journal entries.

Solution.

In the Books of ABC Co. Ltd.

JOURNAL ENTRIES

Date	*Particulars*		*Debit Rs.*	*Credit Rs.*
	Bank A/c To Preference Share Application A/c (Application money on 20,000 preference shares at Rs. 10 each)	Dr.	2,00,000	 2,00,000
	Preference Share Application A/c To Preference Share Capital A/c (Transfer of application money to preference share capital account on shares being allotted)	Dr.	2,00,000	 2,00,000
	Equity Share Capital A/c Securities Premium A/c To Equity Shareholders A/c (Amount due to equity shareholders consequent upon buy-back of 50,000 Shares at Rs. 15)	Dr. Dr.	5,00,000 2,50,000	 7,50,000
	Equity Shareholders A/c To Bank A/c (Payment to equity shareholders for amount due to them)	Dr.	7,50,000	 7,50,000
	General Reserve A/c To Capital Redemption Reserve A/c (Transfer of the nominal value of shares Bought back.)	Dr.	3,00,000	 3,00,000

Illustration 6.

(***Buy-back at*** a premium and ***issue of bonus shares***) .

On 31st March, 2009 following was the balance sheet of Ispat Ltd. :

(Rs. in lakhs)

Liabilities	*Rs.*	*Assets*	*Rs.*
Equity share capital (fully paid-up shares of Rs 10 each)	2,400	Machinery	3,600
		Furniture	452
Securities Premium	350	Investments	148
General Reserve	930	Stock	1,200
Profit and Loss Account	340	Debtors	520
12% Debentures	1,500	Cash at bank	740
Sundry Creditors	750		
Sundry Provisions	390		-
	6,660		6,660

On 1st April, 2009. the company announced the buy-back of 25% of its equity shares @ Rs. 15 per share. For this purpose, it sold all of its investments for Rs. 150 lakhs and issued 2,00,000 14% preference shares of Rs. 100 each at par the entire amount being payable with application.

The issue was fully subscribed. The company achieved the target of the buy-back. Later, the company issued one fully paid-up equity share of Rs. 10 by way of bonus share for every four equity shares held by the equity shareholders.

Show journal entries for all the transactions including cash transactions.

Solution.

In the Books of Ispat Ltd.

JOURNAL ENTRIES

(Rs in *lakhs)*

Date	*Particulars*	*Debit Rs.*	*Credit Rs.*
	Bank A/c Dr. To Investments A/c To Profit and Loss A/c (Sale of investments & Profit transfered)	150	 148 2
	Bank A/c Dr. To 14% Preference Share Application A/c (Application money received on 2,00,000 preference shares at Rs. 100 each)	200	 200
	14% Preference Share Application A/c Dr. To 14% Preference Share Capital A/c (Allotement of preference shares to all applicants	200	 200
	Equity Share Capital A/c Dr. Securities Premium A/c Dr. To Equity Shareholders A/c (Amount due to shareholders for buying back of 25% of equity share capital @ Rs. 15 each)	600 300	 900
	Equity Shareholders A/c Dr. To Bank A/c (Payment made against money due to equity shareholders)	900	 900
	General Reserve A/c Dr. To Capital Redemption Reserve A/c (Nominal value of shares bought back and not by fresh issue transferred.)	400	 400

	Capital Redemption Reserve A/c Dr.	400	
	Securities Premium A/c Dr.	50	
	To Bonus to Shareholders A/c		450
	(Issue of bonus shares of one for every four Equity shares)		
	Bonus to Shareholders A/c Dr.	450	
	To Equity Share Capital A/c		450
	(Convertion of bonus shares into equity shares)		

BALANCE SHEET As On 1-4-2009

(Rs in *lakhs)*

	Rs.		Rs.
SHARE CAPITAL		FIXED ASSETS	
2,00,000 14% Preference shares of Rs. 100 each	200	Machinery	3,600
Equity Shares :		Furniture	452
2,250 of Rs. 10 each	2,250	CURRENT ASSETS	
RESERVES & SURPLUS		Stock	1,200
General reserve	530	Debtors	520
Profit and Loss A/c	342	Cash at Bank	190
SECURED LOANS			
12% Debentures	1,500		
CURRENT LIABILITIES			
Sundry Creditors	750		
Sundry Provisions	390		
	5,962		5,962

Illustration 7.

K Ltd. furnishes you with the following Balance Sheet as at 31st March, 2009 :

(Rs. in Crores)

Sources of Funds		
Share capital :		
Authorised		100
Issued :		
12% redeemable preference shares of Rs. 100 each fully paid	75	
Equity shares of Rs. 10 each fully paid	25	100
Reserves and surplus		
Capital reserve	15	
Share Premium	25	
Revenue reserves	260	300
		400
Funds employed in :		
Fixed assets : cost	100	
Less: Provision for depreciation	100	nil
Investments at cost (Market value Rs. 400 Cr.)		100
Current assets	340	
Less : Current liabilities	40	300
		400

The company redeemed preference shares on 1st April 2009. It also bought back 50 lakh equity shares of Rs. 10 each at Rs. 50 share. The payments for the above were made out of the huge bank balances, which appeared as a part of Current assets.

You are asked to :

i. Pass journal entries to record the above

ii. Prepare balance sheet

iii. Value equity share on net asset basis.

Solution :

Part I - Journal entries in the books of K Ltd.

Rs. in crores

Particulars		Debit	Credit
a. Redemption of Preference Shares on 1st April 2009			
i. Due Entry			
12% Preference Share capital A/c	Dr.	75	
To Preference Share Holders A/c			75
ii. Payment Entry			
Preference Shareholders A/c	Dr.	75	
To Bank A/c			75
b. Shares bought back			
i. On buy back			
Shares bought back A/c	Dr.	25	
To Bank A/c			25
(50 lakhs shares × Rs. 50 per share)			
ii. On Cancellation			
Equity Share capital A/c (50 Lakhs × Rs. 10)	Dr.	5	
Security premium A/c (50 Lakhs × Rs. 40)	Dr.	20	
To Shares bought back A/c			25
iii. Transfer to Capital Redemption Reserve			
Revenue reserve A/c	Dr.	80	
To Capital Redemption Reserve A/c			80
(Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)			

Part-II : Balance Sheet of M/s. K Ltd. after reconstruction :

Balance Sheet of M/s. K Ltd. as at 1.4.2009 (Rs. in crores)

Liabilities		Rs.	Assets		Rs.
Share capital			Fixed assets		
Authorised		100	Cost :		
Issued, subscribed and paid up			Less : Provision for		
equity shares of 200 lakhs of			Depreciation	(100)	Nil
Rs. 10 each		20	Investment at Cost		
12% Redeemable preference			(Market Value of		
shares were redeemed at par.			Investments=Rs. 400 Crores)		100
Reserves and surplus			Current assets as on 31.3.2004	340	
Capital reserve	15		Less : Bank payment for		
Capital Redemption Reserve	80		redemption and buy back	(100)	240
Share Premium (25-20)	5				
Revenue reserve (260-80)	180	280			
Current liabilities		40			
		340			340

Part - III - Net Asset Value of Equity Shares

(Rs. in crores)

Particulars	Amount	Amount
a. i. Fixed assets	Nil	
ii. Investments (at market value)	4,00	
iii. Current assets	2,40	6,40
b. Less : Current liabilities		(40)
Net assets available for equity share holders		6,00
c. No. of equity shares outstanding		2
d. Value per equity share of Rs. 10 each = (600÷2)		Rs. 300

Illustration 8.

The following was the balance sheet of Diamond Ltd. as at 31st March, 2009.

Liabilities	Rs, in lakhs
10% Redeemable Preference Shares of Rs. 10 each, fully paid up	2,500
Equity Shares of Rs. 10 each fully paid up	8,000
Capital Redemption Reserve	1,000
Securities Premium	800
General Reserve	6,000
Profit and Loss Account	300
9% Debentures	5,000
Sundry creditors	2,300
Sundry Provisions	1,000
	26,900

Assets	Rs, in lakhs
Fixed assets	14,000
Investments	3,000
Cash at Bank	1,650
Other Current assets	8,250
	26,900

On 1st April, 2009 the company redeemed all of its preference shares at a premium of 10% and bought back 25% of its equity shares @ Rs. 20 per share. In order to make cash available, the company sold all the investments for Rs.3, 150 lakh and raised a bank loan amounting to Rs. 2,000 lakhs on the security of the company's plant.

Pass journal entries for all the above mentioned transactions including cash transactions and prepare the company's balance sheet immediately thereafter. The amount of securities premium has been utilized to the maximum extent allowed by law.

Solution :

Journal Entries

Particulars		***Debit Rs.***	***Credit Rs.***
1. Bank A/c	Dr.	3,150	
To Investment A/c			3,000
To Profit and Loss A/c			150
(Being sale of investments and profit thereon)			
2. Bank A/c	Dr.	2,000	
To Bank Loan A/c			2,000
(Being loan taken from bank)			
3. 10% Redeemable preference Share capital A/c	Dr.	2,500	
Premium on redemption of preference shareholder A/c	Dr.	200	
To Preference shareholder A/c			2,750
(Being redemption of preference shares)			
4 Preference shareholders A/c	Dr.	2,750	
To Bank A/c			2,750
(Being payment of amount due to preference shareholders)			
5. Securities premium A/c	Dr.	250	
To Premium on redemption of preference share A/c	Dr.		250
(Being use of securities premium to provide premium on redemption of preference shares)			
6. Equity Share capital A/c	Dr.	2,000	
Securities premium A/c [800 - 250]	Dr.	550	
General reserves A/c [(200×20) - 2000 - 550]	Dr.	1,450	
To Equity shareholders A/c			4,000
(being buy back of equity shares)			
Note : Balance of General Reserve [6000 - 1450] = Rs. 4550.			
7. General Reserves A/ c	Dr.	4,500	
To Capital redemption reserve A/c (2000 + 2500)			4,500
(Being creation of capital redemption reserve to the extent of the face value of preference share redeemed and equity shares bought back).			
Note: Balance in General reserve as on 01.04.03 (4550 - 4500) = Rs. 50.			

Particulars		Debit Rs.	Credit Rs.
8. Equity shareholders A/c	Dr.	4,000	
To Bank A/c			4,000
(Being payment of amount due to equity shareholders).			
Note : Cash at Bank [1650+3150+2000-2750-4000] = Rs.50			

Balance Sheet of Diamond Ltd., as on 01.04.09

Liabilities	Rs.	Assets	Rs.
Share capital		Fixed assets	
Issued, subscribed and paid up equity shares of Rs. 10 each	6,000	Current asset, Loans and Advances	14,000
Reserves and surplus			
Capital Redemption Reserve (1000 + 4500)	5,500	Cash at Bank	50
		Other Current assets	8,250
General Reserves	50		
Profit and Loss A/c (300+ 150)	450		
Secured Loans			
9% Debentures	5,000		
Bank Loan	2,000		
Current liabilities and Provisions			
Sundry creditors	2,300		
Provisions	1,000		
Total	22,300	Total	22,300

Illustration 9.

XYZ Ltd. has the following capital structure on of 31st March 2009.

	Particulars	Rs. in Crores
a.	Equity Share capital (Shares of Rs. 10 each)	300
b.	Reserves :	
	General reserve	270
	Security Premium	100
	Profit and Loss A/c	50
	Export Reserve (Statutory reserve)	80
c.	Loan Funds	800

The shareholders have on recommendation of Board of Directors approved vide special resolution at their meeting on 10th April 2009 a proposal to buy back maximum permissible equity shares considering the huge cash surplus following A/c of one of its divisions.

The market price was hovering in the range of Rs. 25/- and in order to induce existing shareholders to offer their shares for buy back, it was decided to offer a price of 20% above market.

Advice the company on maximum number of shares that can be bought back and record journal entries for the same assuming the buy back has been completed in full within the next 3 months.

If borrowed funds were Rs. 1200 Lakhs, and 1500 Lakhs respectively would your answer change?

Solution :

Maximum shares that can be bought back

	Situation I	***Situation II***	***Situation III***
a. Shares outstanding test (WN # 1)	7.5	7.5	7.5
b. Resources test (WN # 2)	6	6	6
c. Debt Equity ratio test (WN # 3)	10.67	4	—
d. Maximum number of shares for buy back - LEAST of the above	6	4	—

Particulars		Situation I		Situation I	
		Debit	Credit	Debit	Credit
a. Shares bought back A/c	Dr.	180		120	
To Bank A/c			180		120
[Being purchase of shares from public]					
b. Share capital A/c	Dr.	60		40	
Security premium A/c	Dr.	100		80	
General reserve A/c (*balancing figure*)	Dr.	20		—	
To Shares bought back A/c			180		120
[Being cancellation of shares bought on buy back]					
c. General reserves A/c					
To Capital redemption reserve A/c					
[Being transfer of reserves to capital redemption reserve to the extent capital is redeemed]					

Note : Under situation III, the company does not qualify the debt equity ratio test. Therefore the company cannot perform the buy back of shares (Under section 77A of the Companies Act, 1956)

WORKING NOTES :

WN # 1 : Shares outstanding test

Particulars	Amount
a. No. of shares outstanding	30 crores
b. 25% of shares outstanding	7.5 crores

WN # 2 : Resources test

(Rs. in Crores)

Particulars	Amount
a. Paid up capital	300
b. Free reserves	420
c. Shareholders fund (a+b)	720
d. 25% of shareholders fund	180
e. Buyback price per share	Rs. 30
f. Number of shares that can be bought back	6 Crores

WN # 3 : Debt Equity ratio test :

(Rs. in Crores)

Particulars	*Situation I*	*Situation II*	*Situation III*
a. Borrowed Funds	800	1.200	1.500
b. Minimum equity to be maintained after buy back in the ratio 2:1	400	600	750
c. Present equity	720	720	720
d. Maximum possible dilution in equity	320	120	—
e. Maximum shares that can be bought back @ Rs. 30/- per share	10.67	4	—

EXERCISE

1> State whether the following statements are 'True' or 'False':

(1) A buy-back may be affected only at part.

(2) No explanatory statement is required in a buy-back.

(3) A company can purchase own shares through its subsidiary.

(4) The total buy-back of shares In a financial year should not exceed 25% of total paid up equity capital in that year.

(5) Buy-back is permitted only in respect of fully paid up shares.

Ans: (1) *F* (2) *F* (3) *F* (4) *T* (5) *T*

Questions

(1) What do you mean by 'buy-back of shares'? State the conditions to be satisfied for buy back of shares.

(2) What are the specific cases where a share buy-back is prohibited under the Act? Are there any exceptions to it?

(3) What do you understand by an Escrow account in the case of a Share buy-back?

(4) Explain any three benefits a company achieves by a share buy-back plan.

(5) Detail SEBI guidelines in the case of a share buy-back.

(6) Briefly explain the accounting for share buy-back under various situations.

REDEEMABLE PREFERENCE SHARES

Introduction

Preference shares that can be redeemed by the company in accordance with the terms of issue are called Redeemable Preference shares. However the Articles of the company must have the provision in this regard.

The terms of issue generally stipulate the time of redemption and whether the redemption will be at par or premium.

Irredeemable preference shares, on the other hand, are those preference shares which can not be redeemed except the event of the company being wound up.

Prior to the amendment of the Companies Act, 1988, companies were permitted to issue both redeemable and irredeemable preference shares. For all practical purposes there is not much difference between the equity shares and irredeemable preference shares. But in terms of return, the equity shareholders enjoy a better return than the holders of irredeemable preference shares do. This was considered as an anomaly and the Companies (Amendment) Act, 1988, prohibited the issue of irredeemable preference shares in future and also provided for the redemption of such shares, which were issued prior to the Act of 1988.

Conditions for Issue and Redemption of Redeemable Preference Shares

The conditions are provided in Sec. 80 of the Act and are summarized below:

1. A company limited by shares can issue redeemable preference shares subject to the provisions of Sec. 80 of the Act. Such an issue must also be authorized by the Articles of the company.

2. With effect from 1st March 1997 a company cannot issue irredeemable preference shares or shares which can be redeemed beyond a period of 20 years (Amendment Act, 1996). [See 80-5 (A)]
3. A company is permitted to carry out redemption from only two sources. They are:

   (a) Profits of the company which would otherwise be available for dividend.

   (b) Proceeds of fresh issue of shares made for the purpose of redemption.

The section rules out any other source such as issue of debentures, borrowing from banks and other financial institutions for carrying out redemption.

4. Where shares are redeemed from out of profits otherwise available *for* dividend, a sum equal to the nominal value of the shares redeemed must be transferred to 'Capital Redemption Reserve Account'.
5. Only fully paid preference shares are to be redeemed. If partly paid shares are to be redeemed, call must be made first and then redemption must be carried out.
6. Redemption may be at par or at premium according to the terms of issue. If redemption is at premium, such premium must be met out of profits or the balance in 'security premium account'.
7. Capital Redemption Reserve Account is available only *for* the purpose of issue of bonus shares. This reserve must be kept intact unless otherwise sanctioned by the court.
8. Redemption of redeemable preference shares does not result in the reduction of authorized capital of the company. To the extent reduction has taken place, company can issue further shares, as if those shares had never been issued.
9. If new shares are issued *for* the purpose of redemption, it will not amount to increase in capital.
10. Subject to the provisions of this section, redemption must be carried out in accordance with the terms provided in the Articles of the company.

Redemption of Irredeemable Preference Shares

While sub-section 5A of Sec. 80 bars the issue of irredeemable preference shares after the commencement of the Amendment Act 1996, Sec. 80 (A) provides *for* the redemption of irredeemable preference shares and redeemable preference shares which are redeemable beyond ten years. The important points governing such redemption are:

1. Irredeemable preference shares issued, prior to the Amendment Act of 1988 are to be redeemed, within a period of 5 years *from* the date of the commencement of amendment. This in effect means, that all irredeemable preference shares, issued prior to the amendment, must have been redeemed by 14th June 1993.
2. Redeemable preference shares providing redemption beyond ten years and issued before the Amendment Act are required to be redeemed on the date on which they are due or within a period not exceeding ten years whichever is earlier.

Illustration 1.

A Ltd. made the following issue of redeemable preference shares prior to the Amendment Act of 1988. Determine the dates on which they are redeemable having regard to the provisions of Sec. 80 (A) of the Amendment Act of 1988.

1. Issue of 10,000 redeemable preference shares on 1st April 1985 redeemable after 15 years.
2. Issue of 5,000 redeemable preference shares on 1st April 1986 redeemable after 11 years.

Solution.

1. Normal date of redemption as per terms of issue:

   15 years *from* 1st Apri11985, that is 1st April 2000.

   Ten years *from* the commencement of the Amendment Act.

   Ten years *from* 14th June 1988, that is 14th June 1998.

   As per Sec 80(A) redemption must take place on 14th June 1998.

2. Normal date of Redemption. 11 years *from* 1st April 1986 that is 1st April 1997.

   10 years *from* the commencement of the Amendment Act, namely 14th June 1988 that is 14th June 1998.

   As 1st April 1997 is earlier than 14th June 1998 is, the shares are to be redeemed on 1st April 1997.

Where a company is not in a position to redeem the shares in the period mentioned in (2) and to pay the dividend thereon, it may with the consent of the Company Law Board, on a petition made by it, issue further redeemable preference shares (make a further issue) equal to the amount due including the dividend thereon in respect of the unredeemed preference shares. By the issue of such further shares the unredeemed preference shares are deemed to have been redeemed.

Sec. 80 (A) was intended to cover the period of transition and will have no significance after the companies fulfill the requirements stated therein.

CAPITAL REDEMPTION RESERVE

A> Transfer to capital redemption reserve account is allowed from these profits.

(i.e Profits otherwise available for dividend)

I. General reserve
2. Reserve fund
3. Dividend equalisation fund

4. Insurance fund
5. Workmen's compensation fund
6. Workmen's accident fund
7. Voluntary debenture redemption account
8. Voluntary debenture sinking fund
9. Profit and loss account.

B> Transfer to capital redemption reserve account is not allowed from these profits.

(i.e Profits otherwise not available for dividend)

1. Securities premium account
2. Forfeited shares account
3. Profit prior to incorporation
4. Capital reserve
5. Development rebate reserve

Proceeds of fresh issue.

The word 'proceeds' used in the present context implies the amount received *excluding the amount of share premium,* if shares are issued at premium; but the *net* amount received if shares are issued either at par or at discount.

Though there remains the controversy over the meaning of the term but a closer examination of the provisions and intentions of the company law reveals that, the word 'proceeds of shares' does not include the amount of premium if shares are issued at premium but stands for the actual amount received if shares are issued at par or at discount. This may be clearer from the following example:

A company is to redeem its preference shares of (say) Rs. 10,00,000. If the company decides to redeem these shares by making an equivalent issue of fresh shares at (say) 10% discount, the company, on the one hand, gets Rs. 9,00,000 in cash from the fresh issue and on the other hand pays Rs. 10,00,000 for redeeming shares. Though the liability side of the balance sheet apparently discloses that shares have been properly replaced because new shares of Rs. 10,00,000 will appear at face value, it does not amount to a replacement of assets utilized in the redemption of redeemable preference shares.

This is particularly significant, considering an extreme case, when by chance the company goes into liquidation immediately after the redemption of preference shares, and when the financial position of the company is as bad as not to be able to pay back its creditors in full. In such a case it does mean the repayment of capital in priority over the creditors to the extent of Rs. 1,00,000 which is the amount of discount. If 'proceeds' were interpreted as the amount actually received, preference shares would have been redeemed only to the extent of Rs. 9,00,000 which is properly replaced by a fresh issue.

However, if shares are issued at premium the total amount received including the amount of premium cannot be taken to purport ‘proceeds’ in the sense in which the Act has used this word. The amount of premium is to be deducted from the total proceeds for arriving at the ‘proceeds of a fresh issue’ for the purpose of this section. This is based on the following premises:

(i) The proceeds of premium, although represented by tangible assets, do not provide any protection to the third party as proceeds of premium may not be kept intact like proceeds of the share capital until the repayment of all creditors because the premium has been allowed to be used (not share capital) for the following four purposes under Sec. 78 (2) of the Companies Act, 1956:

a) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares;

b) in writing off the preliminary expenses of the company;

c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company, or

d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

The utilization of the premium for the above purposes distinguishes it from the proceeds of share capital which is made available only to creditors in the event of liquidation.

(ii) If proceeds of premium be allowed to be included in the total proceeds for the redemption purpose, the capital redeemed will be replaced partly by share capital and partly by security premium. If this interpretation of the proceeds is taken to be correct, the security available to the creditors may be reduced after some time by the amount of premium as the utilization of premium is open for specified purposes under the provisions of the Act itself.

(iii) Sec. 78(1) further states that security premium if used for any other purpose except for that stated in Sec. 78(2), will amount to reduction of share capital. This logically means that security premium account is not treated as paid up capital of the company only when it is used for the four purposes. *The protection provided by the security premium thus*, is *only incidental and uncertain*.

(iv) Besides, the above negative approach, the Act clearly states that it premium account is used for any purpose other than the four purposes stated in Sec. 78(2), it amounts to reduction of capital. Under such circumstances, if security premium is used for the redemption purpose which is outside the scope of the four purposes, it must amount to a reduction of capital.

Accounting Entries Necessary for Redemptions and issue of Bonus shares

Transaction	Journal Entry	
1.Due for redemption a> at a premium	Red. Pref. Share Capital A/c Premium on Redemption A/c To Red. Pref. Shareholders A/c	Dr. Dr.
b> at Par	Red. Pref. Share Capital A/c To Red. Pref. Shareholders A/c	Dr.
2.Sale of Investment, if any, for fund. P/L on Sale transferred to P/L A/c	Bank A/c To Investments A/c To Profit and Loss A/c (Sale of investments & Profit transferred)	Dr.
3.Fresh Issue for Fund, If any, a> at par	Bank A/c To Equity Share Capital A/c	Dr.
b> at a premium	Bank A/c To Equity Share Capital A/c To Securities Premium A/c	Dr.
c> at a discount	Bank A/c Discount on issue of shares To Equity Share Capital A/c	Dr. Dr.
4.Transfer of Premium on Redemption.	Securities Premium A/c, or Profit and Loss A/c To Premium on Redemption A/c	Dr. Dr.
5.Payment to Shareholders	Red. Pref. Shareholders A/c To Bank A/c	Dr.
6.Nominal value of shares Redeemed, not by fresh issue of shares.	General Reserve A/c Profit and Loss A/c To Capital Redemption Reserve A/c	Dr. Dr.

7.Issue of bonus shares a> At a premium b> At Par	Capital Redemption Reserve A/c Securities Premium A/c To Bonus to Shareholders A/c Capital Redemption Reserve A/c To Bonus to Shareholders A/c	Dr. Dr. Dr.
8.Conversion of bonus shares into equity shares	Bonus to Shareholders A/c To Equity Share Capital A/c	Dr.
9. Conversion of Red. Pref. Share into other shares	Red. Pref. Share Capital A/c To Pref. / Equity share capital A/c	Dr.

Illustration 1. Find out in each case what amount shall be transferred to capital redemption reserve account :

Redeemable preference shares redeemed	Fresh *issue of* share *capital*
a. Rs. 10,00,000 at par	Rs. 10,00,000 at par
b. Rs, 10,00,000 at 5% premium	Rs. 800,000 at par
c. Rs. 10,00,000 at par	Rs. 800,000 at 10% premium
d. Rs. 10,00,000 at par	Rs. 800,000 at 10% discount
e. Rs. 10,00,000 at 5% premium	Rs. 800,000 at 10% premium

Solution.

For (a)	Nil.
For (b), (c) and (e)	Rs 2,00,000
For (d)	Rs 2,80,000

Explantion:

Amount utilized from the existing sources towards the nominal value of the preference shares redeemed, should be transferred to Capital Redemption Reserve Account. So, in the above case, the difference of nominal value of shares redeemed and amount received from nominal value of fresh issue is the transferable amount.
In case of (a) the total requirement is met up by fresh issue.

In cases of (b), (c) and (e): Rs 10,00,000 – 8,00,000 (from nominal value of fresh issue) i.e. Rs 2,00,000

In case of (d) Rs 10,00,000 – 7,20,000 (from nominal value of fresh issue) i.e. Rs. 2,80,000.

Illustration 2. The balance sheet of Pixel Ltd. as on 31st March 2009 is given below:

Liabilities	*Rs./Lakh*	*Assets*	*Rs/Lakh*
Share Capital:			
10,00,000 Equity shares of Rs. 10 each	100	Fixed Assets	140
1,00,000 Redeemable Pref.		Investments	40
shares of Rs. 100 each	100	Stock	46
Less: Call-in-arrears on	(4)	Debtors	30
20,000 shares		Bank	30
Security premium account	15		
Reserve	30		
Profit and Loss account	15		
Creditors	30		
	286		286

On 1st April 2009, fixed assets costing Rs. 40 Lakh were sold for Rs.32 Lakh. On the same date it was decided to redeem the preference shares at a premium of 20% by issuing sufficient number of equity shares at a discount of 10% subject to leaving a balance of Rs. 10 Lakh in the reserve. All the payments were made except to a holder of 10000 shares who could not be traced. The company also made bonus issue to the existing equity shareholders in the ratio of 1: 10. You are required to pass the necessary journal entries and show the resulting balance sheet on 1st April 2009.

Solution

Workings

Requirement of Fund for Redemption

	No.	Rate	Rs / Lakh
Pref Shares	1,00,000	100	100
Calls in Arrear	20,000	100	20
Bal. to be redeemed	80,000		80
Prem on redemption		20%	16
Total Fund requirement			96

Rs. /Lakh

Sources	Nominal Value	Premium	Total
Requirement	80	16	96
Securities Prem. A/c		15	15
P/L A/c	6	1	7
General Reserve	20		20
Balance fund requirement (From fresh issue)	54		54
Discount (10%)	6		
New Issue	60		

Actual payment made = (80000-10000)*120 = Rs 84 Lakh

Transfer to Capital Redemption Reserve	Rs/Lakh	Rs/Lakh
From P/L A/c		
Balance	15	
Less: Loss on Sale of Assets	8	
Balance	7	
Less: Used for Premium on Redemption of Pref. Shares	1	6
From General Reserve		20
Total		26

In the books of Pixel Ltd.

Journal entries Dr Cr

Journal Entry		Rs/lakh	Rs/Lakh
Red. Pref. Share Capital A/c	Dr.	80	
Premium on Redemption A/c	Dr.	16	
To Red. Pref. Shareholders A/c			96
(Amount due on Redemption)			
Bank A/c	Dr.	32	
Profit and Loss A/c	Dr.	8	
To Fixed Assets A/c			40
(Sale of Fixed Assets, Loss transferred)			
Bank A/c	Dr.	54	
Discount on issue of Shares A/c	Dr.	6	
To Equity Share Capital A/c			60
(Issue of new shares)			

Securities Premium A/c Profit and Loss A/c To Premium on Redemption A/c (Transfer)	Dr. Dr.	15 1	16
Red. Pref. Shareholders A/c To Bank A/c (Payment to Pref. Shareholders)	Dr.	84	84
General Reserve A/c Profit and Loss A/c To Capital Redemption Reserve A/c (Transfer)	Dr. Dr.	20 6	26
Capital Redemption Reserve A/c To Bonus to Shareholders A/c (Bonus declared)	Dr.	16	16
Bonus to Shareholders A/c To Equity Share Capital A/c (Conversion of Bonus Shares to Equity Shares)	Dr.	16	16

Balance Sheet as on 1st April 2007

Liabilities	Rs./Lakh	Assets	Rs/Lakh
Share Capital:			
17,60,000 Equity shares of Rs 10 each	176	Fixed Assets	100
20,000 Redeemable Pref.		Investments	40
shares of Rs. 100 each	20	Stock	46
Less: Call-in-arrears	(4)	Debtors	30
Reserve	10	Bank	32
Cap. Redemption Reserve	10	Discount on	
Creditors	30	issue of shares	6
Red. Pref. Shareholders A/c	12		
	254		254

EXERCISE

1. State whether the following statements are true or false:
   a. Capital Redemption Reserve Account is created to meet legal requirements.
   b. Partly paid up preference shares can be redeemed.
   c. Capital redemption reserve account cannot be utilised for issuing fully paid bonus shares.

d. Premium payable on redemption of preference shares must be debited to security premium account only.

e. Capital redemption reserve account can be utilised in writing off preliminary expenses.

f. Redemption of preference shares cannot be made out of the fresh issue of debentures.

g. An amount equal to redemption of preference shares out of the profits must be transferred to General reserve.

Ans. (a) True; (b) False; (c) False; (d) False; (e) False; (f) True; (g) False;

2 Discuss the provisions of law with regard to redemption of Redeemable Preference Shares.

3. What do you mean by capital redemption reserve? How is it created? How is it utilised for issuing fully paid bonus shares?

PROBLEMS

1. A company wishes to redeem its preference shares amounting to Rs. 100,00,000 at a premium of 5% and for this purpose issues 500,000 equity shares of Rs. 10 each at a premium of 5%. The company has also a balance of Rs. 100,00,000 in General Reserve and Rs. 50.00,000 in profit and Loss Account. Give the journal entries to record the above transactions.

2. A company:

(1) Issues at par 40,000,000 Redeemable Preference Shares of Rs. 10 each, redeemable at premium of 10 per cent.

(2) Redeems 15,00,000 of the Redeemable Preference Shares out of the profits of the Company.

(3) Issues for cash 30,00,000 Equity Shares of Rs. 10 each at a premium of Re. 1 per share and out of the proceeds, redeems the balance of the Redeemable Preference shares.

Journalise these transactions.

3. X and Company issued 50,00,000 Equity Shares of Rs. 10 each and 3,00,000 Redeemable Preference Shares of Rs. 100 each, all shares being fully called and paid up. On 31st March 2006 Profit and Loss Account showed an undistributed profit of Rs. 50,00,000 and General Reserve Account stood at Rs. 120,00,000. On 2nd April, 1996 the directors decided to issue 1,50,000 10% Preference Shares of Rs. 100 each for cash and to redeem the existing Preference Shares at Rs. 105 utilising as much profits as would be required for the purpose.

Show the journal entries to record these transactions. Prepare also a summarised Balance Sheet showing the position of the Company on completion *of* the redemption. On 31st March, 2006 the cash balance amounted to Rs. 185,00,000 and Sundry Creditors stood at Rs. 87,00,000.

Ans. [Bank Balance Rs. 20,00,000 ; Amount transferred from Profit and Loss Account to Capital Redemption Reserve Account Rs. 45,00,000].

4. Pk Limited has issued Share Capital 60,000,000, 8% redeemable cumulative Preference Shares of Rs. 20 each and 400,000,000 Equity Shares o.f Rs. 10 each. The Preference Shares are redeemable at a premium of 5% on 1st April, 2007.

As at 31st March, 2007 the company's Balance Sheet was:

Liabilities	Rs'000	Assets	Rs'000
Issued Share Capital:		Plant and Machinery	25,00,000
60,000 10% Redeemable		Furniture & Fixtures	9,00,000
Cumulative Preference		Stock	15,00,000
Shares of Rs. 20 each,		Debtors	14,00,000
fully paid	12,00,000	Investments	3,50,000
4,00,000 Equity Shares of		Balance at Bank	3,50,000
Rs.10 each fully paid.	40,00,000		
Profit and Loss A/c	7,00,000		
Sundry Creditors	11,00,000		
	70,00,000		70,00,000

For redemption of Preference Shares it was decided:

(a) To sell the investments for Rs. 300,000,000.

(b) To finance part of the redemption from company funds subject to leaving a balance on Profit and Loss Account of Rs. 200,000,000.

(c) To issue sufficient equity shares of Rs. 10 each at a premium of Rs.2 per share to raise the balance of funds required.

The Preference Shares were redeemed on due date and Equity Shares were fully subscribed.

Prepare

(i) Journal entries to. record the above transactions.

(ii) A memorandum Balance Sheet as on completion of redemption.

Ans. [B/S Total (Rs'000) 65,90,000]

7.3. PROFIT PRIOR TO INCORPORATION

In many cases, a new company is formed exclusively to acquire an existing business unit and take it over as a going concern, from a date prior to its ***own incorporation***. In such cases, the business unit is purchased first, and the registration of the acquiring company takes place later. For example, AB Pvt. Ltd. is incorporated on 1st October, 2009 to take over the running business of Das Bros. from 1st January, 2009. The profit earned (or loss suffered) during the pre-incorporation period (in our example: 1st January to 30th September 2009) is called ***profit (loss) prior to incorporation***. Legally, this profit is not available for distribution as dividend, since a company cannot earn profit before it comes into existence. However, profit earned after incorporation is available for distribution as dividend. Profit earned before incorporation is a ***capital profit*** and profit earned after incorporation is a ***revenue profit***.

It is a common practice that the ***date of incorporation*** should be taken as the basis for calculation of pre-acquisition profit.

Methods of Computing Profit Prior to Incorporation

They are different methods of computing profit prior to incorporation. They are :

First Method

Step 1 Prepare a Profit and Loss Account for the pre-incorporation period.

Step 2 Prepare a Profit and Loss Account for post-incorporation period.

The entries are :

(i)	Land & Building Account	Dr.	At the value on the date of incorporation
	Plant & Machinery Account	Dr.	
	Sundry Debtors Account	Dr.	
	Stock Account	Dr.	
	Cash at Bank	Dr.	
	Cash in Hand	Dr.	
	To Liabilities Account		
	To Vendors Account		
(ii)	Vendors Account	Dr.	Purchase consideration
	To Equity Share Capital Account		

Second Method

Under this method profit is calculated as follows :

Step 1 Prepare a Trading Account for the entire period (pre- and post-incorporation periods combined).

Step 2 Allocate gross profit and expenses (indirect) between pre- and post-incorporation period on the basis of the following principles :

(i) Gross profit is allocated in the ***ratio of sales*** of each period.

(ii) Fixed portion of an expenses is allocated on ***the basis of time***.

(iii) Expenses related to sales, e.g., traveller's commission, discount allowed; on ***the basis of sales***.

(iv) Expenses related to time, e.g., rent, rates and taxes; insurance; depreciation, salaries of general staff, to that period's profit. Some example are :

(a) Preliminary expenses, director's fees, debenture interest, etc. are to be charged against post-incorporation profit.

(b) Partner's salaries, interest on partners' capital, etc are to be charged against the profit of pre-incorporation period.

Appointment Basis may be :

	Allocated on Basis of Time		Allocated in Ratio of Sales
1.	Rent, Rates and Taxes	1.	Gross Profit
2.	Depreciation	2.	Bad Debts
3.	Salaries of General Staff	3.	Discount Allowed
4.	Insurance	4.	Carriage Outwards
5.	Interest on Purchase Consideration	5.	Selling Expenses
6.	Audit Fees	6.	Commission on Sales
7.	General Expenses	7.	Advertisement Expenses
8.	Printing and Stationery	8.	Delivery Expenses
9.	Office Expenses	9.	Free Samples
10.	Fixed Expenses	10.	After-sales service cost
11.	Miscellaneous Expenses	11.	Salaries to Salesmen
12.	Fixed Distribution Expenses	12.	Sales Promotion Expenses
13.	Administrative Expenses	13.	Variable Distribution Expenses
14.	General Travelling Expenses		

Step 3 Net profit/loss of respective periods are calculated after deducting apportioned expenses and acquisition entries are passed at the ***end of the accounting year***.

<u>Accounting Treatment of Pre-incorporation Profit/Loss</u> :

Profit Prior to Incorporation

Any profit prior to incorporation may be :

(a) Credited to Capital Reserve Account

(b) Credited to Goodwill Account to reduce the amount of goodwill arising from acquisition of business.

(c) Utilised to write down the value of fixed assets acquired.

Loss Prior to Incorporation

Any loss prior to incorporation may be dealt with as follows :

(a) Debited to Goodwill Account

(b) Debited to Capital Reserve Account arising from acquisition of business.

(c) Debited to a Suspense Account, which can be written-off later as fictitious asset.

Accounting Treatment of Post-incorporation Profit/Loss

Any profit / loss after incorporation is transferred to Profit and Loss Appropriation Account. Post-incorporation profit can be distribution as dividend.

Illustration 1.

Hansa Ltd. was incorporated on 1st July, 2008 to acquire a running business with effect 1st April, 2008. The accounts for the year ended 31st March, 2009 disclosed the following :

(i) There was a gross profit of Rs. 30,00,000.

(ii) The sales for the year amounted to Rs. 1,20,00,000 of which Rs. 24,00,000 were for the first six months.

(ii) The expenses debited to the Profit and Loss Account included—directors' fees : Rs. 1,50,000; bad debts : Rs. 36,000; advertising : Rs. 1,20,000 (under a contract amounting to Rs. 10,000 per month); salaries and general expenses : Rs. 6,40,000; preliminary expenses written off Rs. 50,000; and donation to a political party given by the company Rs. 50,000.

Prepare a statement showing the amount of profit made before and after incorporation.

Solution : Hansa Ltd.

Statement showing Apportionment of Profit between Pre- and Post-incorporation Period

Particular	Notes	Basis	Total Rs.	Pre-incorporation 1.4.2008 to 30.6.2008 (3 months)	Post-incorporation 1.7.2008 to 31.3.2009 (9 months)
Gross Profit (A)	1	Sales (1:9)	30,00,000	3,00,000	27,00,000
Less : Expenses (B)					
Bad Debts		Sales (1:9)	36,000	3,600	32,400
Advertising		Direct	1,20,000	30,000	90,000
Salaries and General Expenses	2	Time (1:3)	6,40,000	1,60,000	4,80,000
Director's Fees	3	Direct	1,50,000	—	1,50,000
			9,40,000	1,93,600	7,52,400
Net Profit (A–B)			20,54,000	1,06,400	19,47,600
Less : Appropriations :					
Preliminary Expenses (Note 4)		50,000			
Donation (Note 4)		50,000	1,00,000	—	1,00,000
			19,54,000	1,06,400	18,47,600
				Capital Profit	Net Profit

Note : Capital profit is transferred to Capital Reserve Account and Net profit is transferred to Profit and Loss Appropriation Account.

Working Notes :

(1) Total sales for the year 2008-09 = Rs. 12,00,000. Sales for the first 6 months (1.4.2008 to 30.9.2008) = Rs. 24,00,000. Therefore, sales per month during first 6 months = Rs. 24,00,000 / 6 = Rs. 4,00,000.

In effect, sales of first three months (1.4.2008 to 30.6.2008) = Rs. 4,00,000×3 = Rs. 12,00,000. Sales of next nine months (1.7.2008 to 31.3.2009) = Rs. 1,20,00,000 — Rs. 12,00,000 = Rs. 1,08,00,000.

Ratio of Sales = 12,00,000 : 1,08,00,000 = 1 : 9. It is assumed that sales evenly occurred during first six months.

(2) These expenses generally accrue evenly throughout the year and are, therefore, divided on the ***time basis***, i.e. 3 : 9 or 1 : 3.

(3) Directors' fees are paid in case of company only. These must naturally be shown in the post-incorporation period.

(4) Preliminary expenses and donation are not charges against profit. These are treated as appropriations.

Illustration 2.

The promoters of proposed Horizon Ltd. purchased a running business on 1st January, 2009 from Mr. Ultra Modern. Horizon Ltd was incorporated on 1st May, 2009. The combined Profit and Loss Account of the company prior to and after the date of incorporation is as under :

Profit & Loss Account for the year ended on 31.12.2007

	Rs.		Rs.
To Rent, rates, insurance, electricity & salaries	1,20,000	By Gross profit	15,00,000
To Directors' sitting fees	36,000	By Discount received from creditors	60,000
To Preliminary expenses	49,000		
To Carriage outwards and selling expenses	55,000		
To Interest paid to Vendors	1,00,000		
To Profit	12,00,000		
	15,60,000		15,60,000

Following further information is available :

(1) Sales up to 30.4.2009 were Rs. 30,00,000 out of total sales of Rs. 1,50,00,000 of the year.

(2) Purchases up to 30.4.2009 were Rs. 30,00,000 out of total purchases of Rs. 90,00,000 of the year.

(3) Interest paid to Vendors on 1.11.2009 @ 12% p.a on Rs. 10,00,000 being purchase consideration.

From the above information, prepare Profit and Loss Account for the year ended 31st December, 2009, showing the profit earned prior to and after incorporation and also show the transfer of the same to the appropriate accounts.

Solution :

Horizon Ltd.

Dr. Profit and Loss Account for the year ended 31st December, 2009 Cr.

Particulars	Note	Total Rs.	Pre-incor-poration	Post-incor-poration	Particulars	Note	Total Rs.	Pre-incor-poration	Post-incor-poration
To Rent, Rates Insurance, Electricity & Salaries	2	1,20,000	40,000	80,000	By Gross Profit	1	15,00,000	3,00,000	12,00,000
To Directors' sitting fees	3	36,000	—	36,000	By Discount received	7	60,000	20,000	40,000
To Preliminary Expenses	4	49,000	—	49,000					
To Carriage Outward	5	55,000	11,000	44,000					
To Interest to Vendor	6	1,00,000	40,000	60,000					
To Net Profit —		12,00,000	—	—					
Transferred to :									
— Capital Reserve		—	2,29,000	—					
— P&L Appropriation		—	—	9,71,000					
		15,60,000	3,20,000	12,40,000			15,60,000	3,20,000	12,40,000

Working Notes :

(1) For 4 months to 30th April, sales amounted to Rs. 30,00,000 and for the remaining 8 months, sales were (Rs. 1,50,00,000 - Rs. 30,00,000) Rs. 1,20,00,000. Gross profit is apportioned in the ratio of 3 : 12 or 1 : 4 assuming the gross rate was uniform throughout the year). Therefore, the gross profit is apportioned as :

Pre : $\frac{15,00,000}{5} \times 1 = \text{Rs. } 3,00,000.$ Post : $\frac{15,00,000}{5} \times 4 = \text{Rs. } 12,00,000.$

(2) These expenses generally accrue evenly throughout the year and are therefore divided on the time basis, pre : post 4 months : 8 months or 1 : 2.

(3) Directors' sitting fees and preliminary expenses are generally found in case companies. These must naturally be shown in post- incorporation period.

(5) Carriage outward has been apportioned in the ratio of sales, i.e.

Pre : Rs. $\frac{55,000}{5} \times 1 = \text{Rs. } 11,000$ Post : Rs. $\frac{55,000}{5} \times 4 = \text{Rs. } 44,000$

(6) Interest accrues on the basis of time. Therefore it is divided on the time basis. Interest has been paid for a total of 10 months (January to October). 4 months related to pre-incorporation period and 6 months to post-incorporation period. Therefore, it is split as :

Pre : Rs. $\frac{1,00,000}{10} \times 4 = \text{Rs. } 40,000$ Post : Rs. $\frac{1,00,000}{10} \times 6 = \text{Rs. } 60,000$

(7) For 4 months to 30th April, purchases amounted to Rs. 3,00,000 and for the remaining 8 months, purchases were : (Rs. 90,00,000 – 30,00,000) = Rs. 60,00,000.

Discount received is apportioned in the ratio of 3 : 6 or 1 : 2. Therefore, discount received is apportioned as :

Pre : $\frac{60,000}{3} \times 1 = \text{Rs. } 20,000$ Post : $\frac{60,000}{3} \times 2 = \text{Rs. } 40,000$

Illustration 3.

From the following information, calculate the ratio of Sales in each case separately.

(a) (i) Date of acquisition — 1st April, 2008; date of incorporation — 1st July, 2008 and date of closing the books of accounts — 31st March, every year.

(ii) The sales for the year ending on 31st March, 2009 were Rs. 1,20,000 of which Rs. 24,000 were sold during the first six months of the accounting period.

(b) (i) The accounts were made up to 31st December, 2008. The company was incorporated on 1st May, 2008 to take over a business from the preceding 1st January.

(ii) Total sales for the year were Rs. 24,00,000. It is ascertained that the sales for November and December are one and half times the average of those for the year, while those for February and April are twice the average.

(c) (i) X Ltd. was incorporated on 1st July, 2008 to take the existing business of X from 1st April, 2008. Date of closing the books of account — 31st March, 2009.

(ii) Monthly sales in April 2008, January 2009 and March 2009 are double the average monthly sales for remaining months of the year, June & July half the average,

(d) (i) Z. Ltd. was incorporated on 1st August, 2008, to take over the running business of Kabir Bors. with effect from 1st April, 2008. The company received the certificate of commencement of business on 1st October, 2008.

(ii) Total sales for the year, which amounted to Rs. 64,00,000 arose evenly upon the date of certificate of commencement, whereafter they recorded an increase of 2/3rd during the remaining period.

Solution :

(a) Sales of first 6 months = Rs. 24,000. Average sale of first 6 months = Rs. 24,000/6 = Rs. 4,000 per month.

Pre-incorporation period consist of 3 months (i.e., April, May and June). The sales of those 3 months = Rs. 40,000×3 = Rs. 12,000. Sales of remaining 9 months = Rs. 1,20,000 — Rs. 12,000 = Rs. 1,08,000.

Therefore, the ratio of sales = Rs. 12,000 : Rs. 1,08,000 = 1 : 9.

(b) Let the average of monthly sales = x. The sales of different months can be shown as follows :

Month	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec
Sales	$1x$	$2x$	$1x$	$2x$	$1x$	$1x$	$1x$	$1x$	$1x$	$1x$	$1.5x$	$1.5x$

Date of incorporation

The ratio of Sales = $7x : 8x = 7 : 8$.

(c) Let the average montly sales be x. The sales of different months can be shown as follows :

Month	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March
Sales	$2x$	$1x$	$0.5x$	$0.5x$	$1x$	$1x$	$1x$	$1x$	$1x$	$1x$	$2x$	$2x$

Date of incorporation

The ratio of Sales = $3.5x : 10.5x = 1 : 3$.

(d) Let the average monthly sales = x. The sales of different months can be shown as follows :

Month	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March
Sales	$1x$	$1x$	$1x$	$1x$	$1x$	$1x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$

Date of incorporation Certificate of commencement

The ratio of Sales = $5x : 12x = 5 : 12$.

7.4. Debentures-Issue and Redemption

INTRODUCTION

Sec-2(12) of the Companies Act, 1956 defines debentures as 'debentures include debenture stock, bonds and any other securities of the company whether constituting a charge on the assets of the company or not'

A commercial definition of the debenture is an acknowledgement of a debt in writing, given under the seal of the company, containing a contract for the repayment of the principal sum at a specified date and for the payment of interest (usually half yearly) at a fixed rate until the principal sum is repaid. It may or may not give a charge on the assets of the company as a security for the loan.

A debenture like a share is also a movable property transferable in the manner provided in the Articles of the company.

Requirement

The long-term requirements of capital are raised by any company primarily through issue of shares and debentures. While the shareholders are essentially the owners of the enterprise, those who buy debentures are creditors for long-term funds and do not enjoy voting rights. In brief all securities other than shares issued by a company will come under the term debentures.

According to the guidelines issued by the Controller of Capital Issues, the objects of the issue can be among other things:

1> Setting up of new projects;

2> Expansion or diversification of existing projects;

3> Normal capital expenditure for modernization;

4> To augment long-term resources of the company for working capital requirements;

5> Merger / Amalgamation of companies in pursuance of schemes approved by banks, financial institutions and / or any legal authority;

Differences between Shares and Debentures

	SHARES	DEBENTURES
Definition	An instrument to acknowledge the ownership of the company	An instrument to acknowledge the creditors of the company
Status	A shareholder is the owner and a member of the company.	A debenture holder is not a member but a creditor.
Return	A shareholder may receive dividend only when a company makes a profit.	A debenture holder has a right to interest even if the company does not make profit.
Rate of return	Dividend rate can vary depending on the profit position.	Debenture carries a fixed rate of interest.
Accounting treatment	Dividend is given out of appropriable profit and not chargeable to Profit and Loss account.	Debenture interest is chargeable to Profit and Loss account.
Redemption	In the case of shares, the concept of redemption does not apply. However as per the recent change in the Companies Act, a company can buy back shares in accordance with the provisions in the Act.	Debentures are normally redeemable although a company can issue perpetual debentures
Voting rights	A shareholder has voting rights.	A debenture holder cannot have voting rights.
Status at the time of winding up	At the time of winding up share holders have the least priority regarding the return of amount due to them.	At the time of winding up debenture holders have a priority over the share holders regarding the return of amount due to them

Types of Debentures

Debentures can be classified according to permanence, security, priority, convertibility and records point of view.

(1) Permanence point of view.

(a) Redeemable debentures :

Debentures, which are redeemed or the payment of which is made after a specified time, are called as *Redeemable Debentures.*

These are redeemable-

i. At the expiry of a specified period either at par or at premium;

ii. By purchasing in the open market at any time at the price prevailing in the market; and

iii. By annual drawings.

(b) Irredeemable debentures.

When the issuing company does not fix any date by which they should be redeemed and the holders of such debentures cannot demand payment from the company so long as it is a going concern. Usually such debentures are repayable after a long period of time or on winding up of the company.

(2) Priority point of view.

a. First debentures:

Those debentures, which are repaid before other debentures are paid out, are called First debentures.

b. Second debentures:

Those debentures, which are paid after the payment towards the first debenture, are called Second debentures.

c. Convertible debentures:

Those debentures, which are given the option to convert the debentures fully or partly into equity shares after a specified time, are called Convertible debentures. If the debentures are fully converted, then it is called as 'Fully Convertible Debentures'. Those which are partly convertible are called 'Partly Convertible Debentures'. The non-convertible portion of the debenture is also called 'Khoka' in market circles.

Conversion may be at par or premium.

d. *Non-convertible debentures:*

The holders of which have no right to convert them into equity shares. These are called *Non-convertible debentures.*

(3) Security point of view.

(a) Naked debentures:

Those debentures which are not secured, is called, naked debentures. Companies having very good standing are able to issue debentures of this type. They are not very common.

(b) Mortgage debentures:

Debentures, which are secured either on a particular asset [called fixed charge] or on the general assets of the company [called floating charge], is called Mortgage debentures.

Accounting for Debentures.

There are three stages of accounting for debentures:

(i) When debentures are *issued;*

(ii) When *provision for its redemption* is made; and

(iii) When ultimately debentures are *redeemed.* A detailed study of each stage is made in the following pages.

1> ISSUE OF DEBENTURES

Important Provisions in the Companies Act on Issue of Debentures.

1. A company cannot issue any debentures carrying voting rights at any meeting of the company, whether generally or in respect of particular classes of business (See 117).
2. Whenever debentures are issued, to the public for subscription, it is mandatory to appoint one or more debenture trustees for such debentures. It is the general duty of the debenture trustees generally to protect the interests of debenture holders and to redress their grievances effectively. In particular, the debenture trustees must take the following steps:

   (a) To ensure that the assets of the company issuing debentures and each of guarantors are sufficient to discharge the principal amount at all times;

   (b) To satisfy himself that the prospectus or letter of offer does not contain any matter which is inconsistent with the terms of the debentures or with the trust deal;

   (c) To ensure that the company does not commit any breach of covenants and provisions of the trust deed;

   (d) To take such reasonable steps to remedy any breach of the covenants of trust deed or the terms of issue of debentures; and

   (e) To take steps to call a meeting of holders of debentures as and when the meeting is required to be held. (See 117(B))

3. When a company issues debentures it must create a 'Debenture Redemption Reserve' (DRR) for the redemption of such debentures. Such a reserve is created by crediting adequate amounts from out of the profits, until such debentures are redeemed. The company has to pay interest in accordance with the terms and conditions of their issue. (Sec. 117(C))

4. Perpetual debenture means debentures that cannot be redeemed. If perpetual secured debentures are issued, the implication is that the borrower can never repay the loan and free the property from the charge. However the Act specifically allows the issue of irredeemable debentures or issue of debentures for a very long period. Debentures can also be issued which are redeemable only on the happening of a contingency which is very

remote. Normally companies may issue very long term debentures such as debentures with maturity of 50 or even 100 years but uncommon to issue debentures which are irredeemable. (Sec. 120)

5. The company has a right to re-issue debentures except when there is a contrary provision in the Articles or a specific resolution has been passed that the debentures will not be re-issued. This will be done by re-issuing the same debentures or by issuing other debentures in their place. Upon such reissue the persons entitled to the debentures will have the same rights and priorities as if the debentures had never been redeemed. Thus, after the re-issue any previous charge on the assets in relation to such debentures, continues and there is no need to make a fresh charge. There is no restriction on the number of fresh debentures to be issued.(Sec. 121)

6. The power to issue debentures is to be exercised by the board at a meeting. It cannot be delegated to a committee or the resolution for the issue of debentures cannot be passed by circulation. (Sec 292 (1))

7. Technically a company can issue unsecured debentures. However, such debentures will be prepaid as public deposits and all the provisions relating to acceptance of public deposits will apply.

SEBI Regulations on Issue of Debentures

1. Credit rating. It is compulsory in the case of all issues of debenture. If a company has obtained more than one rating, all such ratings must be disclosed. If the issue exceeds Rs. 200 crores, rating must be obtained from two agencies.

2. Put and call options. If FCDs are to be converted before 18 months, they are considered as quasi-equity. If conversion is after 18 months but before 36 months, it is treated as deferred equity. In the case of deferred equity, the conversion will be optional in the hands of debenture holder. In the case of conversion beyond 36 months, it must be made optional with both put and call options.

3. Security for debentures. If secure debentures are issued, a company must obtain certificate from the bankers that the assets are free from encumbrances or no objection certificate from the bank / financial institution for creating a second charge or *pari passu* charge as per terms of offer of debentures. Normally security must be created within 6 months. If security is not created, within 12 months, a penal interest at 2% is payable to debenture holders. If the security is not created, within 18 months, a meeting of the debenture holders must be called with 21 days notice to explain the reasons for delay in creating the security and the expected date by which security will be created.

Trustees to debentures will supervise the creation of security. If security is not created, the debentures will be unsecured. As stated earlier in such a situation, the debentures will be treated as fixed deposits which makes it incumbent to satisfy the requirements of Sec. 58(A).

4. Debenture trustees. If the maturity of debentures is more than 18 months, the company has to appoint debenture trustees to safeguard the interests of the debenture holders. The

trustees should have requisite powers for protecting the interests of the debenture holders including their rights to nominate a director on the board in consultation with institutional debenture holders.

The debenture trustees must also ensure the compliance of the following:

(a) Lead financial institutions / investment institutions should monitor the progress in respect of debentures raised for project finance / modernization / expansion / diversification / normal capital expenditure.

(b) The lead bank must monitor debentures raised for working capital funds.

(c) Obtain a certificate from the company's auditors during the implementation period of the projects and in the case of debentures for working capital at the end of each accounting year.

(d) Debenture issues by companies belonging to the groups for financing replenishing of funds or acquiring shares in other companies should not be permitted.

(e) The trustees must supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption reserve.

Accounting Aspects of Issue

Accounting aspects of issue of debenture may be studied from three different sides.

(1) What would be the consideration?
   (a) Issued for cash
   (b) Issued for consideration other than cash
   (c) Issued as collateral security

(2) What would be the issue price?
   (a) Issued at par
   (b) Issued at premium
   (c) Issued at discount

(3) How the redemption be made.
   (a) Redeemed at par
   (b) Redeemed at premium
   (c) Redeemed at discount

Combining (2) and (3), the following are the options of issue.
   (a) Issued at par and redeemable at par
   (b) Issued at discount and redeemable at par
   (c) Issued at premium and redeemable at par

(*d*) Issued at premium and redeemable at premium

(*e*) Issued at par and redeemable at premium

(*f*) Issued at discount and redeemable at premium

The accounting entries for the above six combinations are given in the table below.

	Transaction	Account Debited	Account Credited
A.	Issued at par and redeemable at Par	1>Bank	1>Debentures
B.	Issued at discount and redeemable at par	1>Bank 2>Discount on issue of debentures	1>Debentures
C.	Issued at premium and redeemable at par	1>Bank	1>Debentures 2>Security Premium
D.	Issued at premium and redeemable at premium	1>Bank 2>Loss on issue of debenture	1>Debentures A/c 2>Security Premium 3>Prem. on redemption of debentures.
E.	Issued at par and redeemable at premium	1>Bank 2>Loss on issue of debentures	1>Debentures 2>Prem. on redemption of debentures
F.	Issued at discount and redeemable at premium	1>Bank 1>Loss on issue of Debentures **	1>Debentures 2>Prem. on redemption of debentures

** Loss on issue of debentures includes discount on issue and Premium on redemption.

Illustration 1.

Journalize the following transactions. Narration is not required:

Issue of 12% 1,00,000 debentures of Rs. 100 each

1> at par and redeemable at par.

2> at 10% discount and redeemable at par.

3> at 10% premium and redeemable at par.

4> at 10% premium and redeemable at a premium of 5%.

5> at par and redeemable at a premium of 5%.

6> at 10% discount and redeemable at a premium of 5%.

Solution.

Journal

	Particulars		Debits Rs.'000	Credits Rs.'000
1.	Bank Account	Dr.	10,000	
	To 12% Debentures Account			10,000
2.	Bank Account	Dr.	9,000	
	Discount on Issue of Debentures Account	Dr.	1,000	
	To 12% Debentures Account			10,000
3.	Bank Account	Dr.	11,000	
	To 12% Debentures Account			10,000
	To Securities Premium Account			1,000
4.	Bank Account	Dr	11,000	
	Loss on issue of debenture	Dr	500	
	To 12% Debentures Account			10,000
	To Securities Premium Account			1,000
	To Prem. on redemption of debentures			500
5.	Bank Account	Dr.	10,000	
	Loss on issue of Debentures Account	Dr.	500	
	To 12% Debentures Account			10,000
	To Prem. on redemption of Debentures			500
6.	Bank Account	Dr.	9,000	
	Loss on Issue of Debentures Account **	Dr.	1,500	
	To 12% Debentures Account			10,000
	To Prem. on redemption of Debentures			500

****** This amount includes Rs. 1,000 discount on issue of debentures and Rs. 500 premium on redemption.

Issue for Consideration other than Cash

In this case debentures are issued for consideration other than cash. Examples are allotment of debentures for assets purchased or technical services received. There is no receipt of cash in these transactions for the allotment of debentures. The following are the accounting entries:

Illustration 2.

(For consideration other than cash).

The XYZ Company Ltd. took over assets of Rs. 230 Lakh and liabilities of Rs. 30 Lakh of PQR Company Ltd. for the purchase consideration of Rs. 220 Lakh. The XYZ Company Ltd. paid the purchase consideration issuing debentures of Rs. 100 each at 10% premium. Give journal entries in the books of the XYZ Company Ltd.

Solution.

Journal of XYZ Company Ltd.

Dt	Particulars		Rs. / Lakh	Rs / Lakh
	Sundry Assets	Dr.	230	
	Goodwill	Dr.	20	
	To Liabilities			30
	To PQR Company			220
	(Being purchase of assets and liabilities of Company)			
	PQR Company	Dr.	220	
	To Debentures			200
	To Securities Premium			20
	(Being issue of debentures at 10% premium)			

Debentures issued as Collateral Security

(a) This is the third type of consideration for which company issues debentures. Issue of debentures as a collateral security means issue of debentures as a subsidiary or secondary security, that is, a security in addition to the prime security. Secondary security is to be realized only when the prime security fails to pay the amount of loan. Debentures issued as a collateral security can be dealt with in two ways in the books:

a> First Method

No entry is made in the books. On the liability side of the balance sheet below the item of loan a note that it has been secured by the issue of debentures is to be given. This is shown in the balance sheet as follows:

b> Second method

Sometimes issue of debentures as collateral security is recorded by making a journal entry as follows:

Debenture suspense account	Dr.	(This appears on the assets side)
To Debenture account		(This appears on the liabilities side)

When the loan is paid the above entry is cancelled by means of a reverse entry.

Discount on issue of Debenture

When debentures are issued at discount, it is prudent to write off the loss during the life of debentures.

REDEMPTION OF DEBENTURES

Meaning

Redemption of debentures is the process of discharging the liability on account of debentures in accordance with the terms of redemption stated in the debenture trust deed. Discharge of debenture liability is usually by paying cash to the debenture holders. But this can take other forms such as conversion or rollover. In the case of conversion debentures are converted into preference shares or equity shares. Rollover refers to the issue of new debentures, in exchange for the old ones. Both conversion and rollover are subject to detailed SEBI guidelines.
When a company issues debentures it must also plan the resources required for such redemption. This can be done by setting aside profits every year and investing them wisely in investments outside, so that there will be no liquidity problem at the time of redemption. Alternatively the company can take an insurance policy by paying regular premium, so that the policy matures coinciding with the time of redemption. With the amount received on the maturity of policy the company faces no problem in carrying out the redemption. These are the two ways in which a company can make provisioning for redemption of debentures. The question of provisioning was earlier left to the discretion of company and many companies did provisioning routinely, as a matter of financial prudence. Now under the SEBI guidelines, the matter is no more a matter of discretion or financial prudence. SEBI guidelines provide for compulsory provisioning and also restrictions on the payment of dividends till debentures are redeemed. We will first deal with SEBI guidelines before proceeding with the accounting aspects of creating sinking fund for redemption of debentures.

SEBI on Creation of Debenture Redemption Reserve ((DRR)

1. A company has to create DRR in case of issue of debentures with maturity of more than 18 months.
2. The issuer must create DRR in accordance with the provisions given below.
   a. If debentures are issued for project finance DRR can be created upto the date of commercial production.
   b. The DRR in respect of debentures issued for project finance may be created either in equal installments or higher amounts if profits so permit.
   c. In the case of PCDs, DRR must be created for the non-convertible portion of debenture issues on the same lines as applicable for fully non-convertible debenture issue.
   d. In respect of convertible issues by new companies, the creation of DRR must

commence from the year the company earns profits for the remaining life of debentures.

e. DRR shall be treated as part of general reserve for consideration of bonus issue proposals and for price fixation related to post-tax return.

f. Company must create DRR equivalent to 50% of the amount of debenture issue before debenture redemption commences. Only after the company has actually redeemed 10% of the debenture liability, drawal from DRR is permissible only after the company has actually redeemed 10% of the debenture liability.The requirement of creation of DRR is not applicable to issue of debt instruments by infrastructure companies.

Restrictions on Dividends

(a) In the case of new company, distribution of dividends shall require the approval of trustees to the issue of debentures and lead institution, if any.

(b) In the case of existing companies prior permission-of the lead institution for declaring dividend exceeding 20% or as per the loan covenants is necessary if the company does not comply with institutional condition regarding interest and debt coverage ratio.

(c) Dividends may be distributed out of profits of particular year only after transfer of requisite amount in DRR. If residual profits are inadequate to distribute reasonable dividends, company may distribute dividend out of general reserve.

As mentioned already the two modes of provisioning are (1) the sinking fund method, and (2) the insurance policy method.

It is always prudent for a company to save money for redeeming debentures on the due date. In the absence of such a provision it becomes difficult for the company to find lumpsum amount to repay the debt. This can be done by adopting any of the two methods explained below:

Sinking fund method

Under this method the amount is invested in first class securities with secured and fixed return. Accumulation of interest becomes compounded resulting to produce the amount required to redeem the debentures on the due date. This method of providing for funds is also called debenture redemption fund method. The sinking fund method for redeeming a loan is different from sinking fund method for replacing an asset in the following ways:

1. Sinking fund created for replacing an asset is in the nature of accumulated depreciation, while sinking fund created for repaying loan is in the nature of accumulated profits. It is for this reason that sinking fund's balance (after the redemption of loan) is transferred to general reserve, while that for an asset is transferred to asset account.

2. Annual installment set aside for the replacement of an asset is a charge and is debited to profit and loss account, while that for the redemption of a loan is an appropriation and is debited to profit and loss appropriation account.

Accounting entries for making the provision for the redemption of debentures are as follows:

First year

1. Profit and loss appropriation account Dr
   To Sinking fund account
   (Setting aside the required amount based on sinking fund table)
2. Sinking fund investment account Dr
   To Bank account
   (Investment of amount set aside)

Second and subsequent years

1. Bank Account Dr
   To Sinking fund interest account
   (Interest on sinking fund investment received.)
2. Sinking fund interest account Dr
   To Sinking fund account
   (Transfer of interest account to sinking fund.)
3. Profit and loss appropriation account Dr
   To Sinking fund account
   (Setting aside the required amount based on sinking fund table)
4. Sinking fund investment account Dr
   To Bank account
   (Investment of amount set aside and the amount of interest received.)

Last year:

1. Bank Account Dr
   To Sinking fund interest account
   (Interest on sinking fund investment received.)
2. Sinking fund interest account Dr
   To Sinking fund account
   (Transfer of interest account to sinking fund.)
3. Profit and loss appropriation account Dr
   To Sinking fund account
   (Setting aside the required amount based on sinking fund table)

At the time of sale of investments and redemption

1. Bank Account Dr
   To Sinking fund investment account
   (Amount received from sale of investment)

2. Sinking fund account Dr
   To Sinking fund investment account
   (Loss on sale)

3. Sinking fund investment account Dr
   To Sinking fund account
   (Profit on sale)

4. Sinking fund account Dr
   To General reserve
   (Transfer of balance of sinking fund account)

5. Debentures account Dr
   To Bank
   (Redemption of debentures)

It may be noted that in the final year the amount appropriated from the profits of the company and the amount received as interest on sinking fund investment are not invested, as the amount would be needed on the following day for the redemption of debenture.

Non cumulative sinking fund.

A non-cumulative sinking fund differs from the cumulative type of sinking fund only in one respect: in non-cumulative sinking fund, interest received on sinking fund investment is not re-invested, nor is it transferred to sinking fund. Interest on sinking fund investment is treated as a simple profit and is kept in the business without earmarking its use and the amount is transferred to profit and loss account. Nevertheless, a careful study of the two types of funds will reveal that there is no difference between the two methods. In a non-cumulative type of fund, the appropriation from the profits is more but the excess burden on the profits is corrected by the transfer of interest on the investment to profit and loss account. While in the case of a cumulative type of sinking fund method, the appropriation from the profit is less, but that amount is made up by crediting to sinking fund the amount of interest earned on investment.

Insurance policy method

Under this method, an insurance policy for the required amount is to be taken for the redemption of debentures at the end of a fixed period. Under this system, the premium is paid regularly in installments and the insurance company, in its turn, returns the total accumulated money at the expiry of the period. Money so received is used for redeeming debentures. This method differs from the sinking fund method only in respect of interest on investment. Unlike sinking fund method, the insurance company does not give any interest on the installments received. Entries in respect of insurance policy are as follows:

Each year

1. Profit and loss appropriation account Dr
   To Debenture redemption fund account
   (Appropriation of the amount of premium of the policy)
2. Debenture redemption policy account Dr
   To Bank account
   (Payment of premium on the policy)

Premium in the policy is always paid in advance so, it must be paid even in the last year.

At the time of realization of policy and redemption

1. Bank account Dr
   (amount of policy taken)
   To Debenture redemption policy account
   (Amount at which policy account stands)
   To Debenture redemption fund account
   (Difference in the two amounts.)
2. Debenture redemption fund account Dr
   To General Reserve
   (Transfer of Balance)

DIFFERENT METHODS OF REDEMPTION OF DEBENTURES

Though discharge of debenture liability is usually by paying cash to the debenture holders for which either of the two methods mentioned above be followed to meet the cash requirement at the time of redemption.

However, following are the other methods by which the liability on debentures may be extinguished.

Conversion

The conversion of debentures means the debentures are converted into preference shares or equity shares.

For the purpose of conversion debentures are to be classified as fully convertible debentures (FCDs), partly convertible debentures (PCDs), and non-convertible debentures (NCDs). A company cannot issue FCDs having a conversion period of more than 36 months, unless the conversion is made optional with a put and call option. If conversion takes place 18 months after the date of allotment but before 36 months, any conversion in part or whole of the debenture is optional in the hands of the debenture holder. If he does not exercise the option it will effectively become an NCD. FCDs with conversion period less than 12 months are treated as quasi-equity and are treated at par with equity.

FCDs are fully convertible into equity shares either at par or premium. The premium to be charged at conversion must be predetermined and announced in the prospectus. In the case of PCDs it comprises two parts, namely the convertible portion and the non-convertible portion.. It is only the convertible portion that would be converted into shares.

In the case of NCDs the liability will be discharged by payment of cash or rollover. A company can also convert NCDs at a later date into equity shares but it should be at the option of debenture holder.

Rollover

Rollover means the issue of new debentures in the place of old ones. Rollover must be with the written consent of the debenture holder. If he does not given written consent, his claim must be settled in cash. Also whenever the debenture liability is rolled over company must obtain fresh credit rating. Fresh trust must be executed at the time of rollover. Also fresh security must be created in respect of rolled over debentures. Subject to the conditions listed rollover can be done without change in the' interest rate if the non-convertible portion of PCDs / NCDs of a listed company exceeds Rs. 50 lakhs.

Sources of redemption

From the point of view of sources redemption may be carried out with the help of any of the following sources:

1. Out of capital,
2. Out of profits,
3. Conversion or rollover (already discussed), and
4. Out of provision in the nature of sinking fund.

We shall now consider each case.

Redemption out of capital

SEBI guidelines require the setting up of a 'Debenture Redemption Reserve when profits are available and the debentures are issued for a period beyond 18 months. If the debentures are for a period less than 18 months or profits are not available for capital redemption, debentures may be redeemed from out of capital. When redemption is carried from out of capital only entries are made for redemption and no entry will be made to transfer profits to 'Debenture Redemption Reserve.

Illustration 3.

A company issued 100,000 15% debentures of Rs. 100 each at par redeemable at a premium of 15%. After 8 years the company served notice of redemption and redeemed all debentures as per the terms of issue. You are required to make entries at the time of issue and at the time of redemption.

Solution.

Journal

Date	Particulars		Dr *Rs'000.*	Cr *Rs'000.*
1st year	Bank account	Dr.	10,000	
	Loss on issue of debentures A/c	Dr.	1,500	
	To 15% Debentures A/c			10,000
	To Premium on redemption A/c			1,500
8th year end	15% Debentures account	Dr.	10,000	
	Premium on redemption A/c	Dr.	1,500	
	To Debenture Redemption A/c			11,500
	Debenture redemption account	Dr.	11,500	
	To Bank account			11,500

Redemption from out of Profits

Now it is mandatory to set up 'Debenture Redemption Reserve'. Earlier companies could redeem debentures from out of profits without a formal setting up of 'Debenture Redemption Reserve'. It was the directors who decided as to whether the redemption is from capital or profits.

After carrying out the entire redemption the amount to the credit of debenture redemption reserve will be transferred to general reserve account.

Illustration 4.

A Company issued 100,000 debentures of Rs. 100 each redeemable at the end of 10^{th} year, but reserves the right to redeem earlier from the end of 5th year. The company decides at the end of 5th year to redeem 20,000 debentures out of profits it has made.

Pass necessary journal entries relating to redemption.

Solution.

Date	Particulars		Dr Rs'000.	Cr Rs'000.
5th year end	Debentures A/c	Dr.	2,000	
	To Debenture redemption A/c			2,000
	Debenture redemption A/c	Dr.	2,000	
	To Bank account			2,000
	Profit/ loss appropriation A/c	Dr.	2,000	
	To Debenture redem. reserve A/c			2,000

Conversion or rollover

In the case of conversion debentures are converted into equity or preference shares. In the case of rollover old debentures or replaced by the issue of new debentures. The new shares may be issued at par or premium.

Additional accounting entries for conversion or rollover are as below:

Transaction	Debited	Credited
Conversion into shares at par	Deb.redemption/ Deb. Holders a/c	Equity/ Preference share capital
Conversion into shares at premium	do	1>Share capital 2>Security prem.
Rollover at par	do	New debentures
Rollover at premium	do	1>New debentures 2>Security prem.

Illustration 5.

On April 1, 2002 PT Ltd. issued 25,00,000 12% fully convertible debentures of Rs. 100 each at par. The debenture holders were given the call option to convert the debentures into Rs. 10 equity shares at a premium of Rs. 40 per share on or after July 1, 2006. On January 1 2007, debenture holders holding 10,00,000 debentures exercised their option. Pass the necessary journal entries.

Solution

Date	Particulars	Dr Rs/Lakh	Cr Rs/Lakh
1-1-02	Bank A/c Dr. To 12% Convertible debentures (Issue of 25,00.000 convertible debentures of Rs. 100 each)	2,500	 2,500
1-1-07	12% Convertible debentures A/c Dr. To Equity share capital A/c To Security Premium A/c (Conversion of 10.00,000 deb. each, into two eq. shares of Rs 10 at a premium of Rs. 40 each)	1,000	 200 800

Illustration 6.

Beta Ltd. had issued 11 % 5,00,000 debentures of Rs. 100 each redeemable on 31st March 2007 at a premium of 5%.

The company offered three options to debenture holders as under:

(i) 13% Preference shares of Rs. 10 each at Rs. 10.50

(ii) 14% debentures of Rs. 100 at par.

(iii) Redemption in cash.

The options were accepted as under.

Option (i) by holders of 1,00,000 debentures.

Option (ii) by holders of 1,00,000 debentures.

Option (iii) by holders of 3,00,000 debentures.

The company carried out the redemption. Pass the necessary journal entries.

Dt.	Particulars		Dr Rs/Lakh.	Cr Rs/Lakh.
	11% Debentures A/c Premium on redemption of debentures A/ c To Debenture Holder A/c	Dr. Dr.	500 25	 525
	Debenture holders account To 13% Preference share capital account To Securities premium account	Dr.	105	 100 5
	Debenture holders A/c To 14% Debenture A/c	Dr.	105	 105
	Debenture holders A/c To Bank A/c	Dr.	315	 315

When to be redeemed?

Time of redemption can be classified in the following three ways:

1. Redemption by annual drawings even before the maturity of debentures.
2. Purchases *of* debentures from the open market and canceling them immediately *or* later.
3. Redemption only on maturity.

Redemption by Annual Drawings

SEBI guidelines state that the issuing company shall redeem the debentures as per the offer document. A company at the time *of* issue may provide for staggered redemption. This can be done in two ways. The redemption may be certain amount *of* each debenture with a schedule so that redemption may be completed over a time frame. The other way is to select certain number of debentures every year and redeem them fully. The debentures to be redeemed are selected by drawing a lot annually. This method is known as 'Redemption by Annual Drawings'. Again whether the redemption is at par, premium *or* discount, depend on the terms *of* offer.

Nowadays it is also common for companies to have a call option which gives them the right to redeem the debentures at a pre-determined price. This gives them the right to cancel but not the obligation to cancel.

Purchase and Cancellation of Own Debentures,

Debentures may also be cancelled before the expiry of the period by purchasing them from the open market at market price, which may be at premium or discount to the book value. It is certainly advantageous to buy when they are selling in the market at a discount. Cancellation of debentures may be done immediately or later. In some cases such debentures may also be reissued. This method of redemption is known as 'purchase and cancellation of own debentures'.

For purchase and cancellation of own debentures, the company have to consider the following parameters.

(1) The company may cancel such debentures immediately or carry them as an investment and cancel at a later date.

(2) Where they are immediately cancelled, a debenture liability is extinguished to the extent of par value of the debentures cancelled. From the date of cancellation, interest is not payable on cancelled debentures.

Since the debenture liability cancelled is more than the amount paid for such debentures, profit on cancellation of debentures should be recorded. If there is a Sinking Fund, such profit is transferred to the Sinking Fund.

(3) When debentures are carried as an investment, debenture liability is shown as before and at the same time, 'Investment in own Debentures' or simply 'Own Debentures' appears on the assets side of the balance sheet, till they are cancelled.

(4) In the case of own debentures, interest on own debentures must be reckoned as income or set-off against the gross interest payable on the whole of debentures.

(5) If debentures are purchased between two interest dates, and not immediately after payment of interest, then the price paid for debentures depends on the quotation.

Accounting Entries

Transaction	***DR***	***CR***
(1) Purchase of own Debenture	Own Debentures	Bank
(2) Cancellation of own debentures	Debentures	Own Debentures
(3) Profit on cancellation	Debentures	Profit on Cancellation of Debentures / Sinking Fund
(4) Loss on cancellation	Sinking Fund / Loss on Cancellation	Own Debentures
(5) Reissue (or sale) of own debentures	Bank	Own debentures
(6) Profit on re-issue	Own Debentures	Profit and Loss A / c
(7) Loss on re-issue	Profit and Loss A / c	Own Debentures
(8) Interest on own debentures	Profit and Loss A / c	Sinking Fund

Illustration 7.

On 1st April, 2003 A Ltd. made an issue of 10,00,000 14% debentures of Rs. 100 each at Rs. 98 per debenture. According to the terms of issue, commencing from 2005, the company should redeem 10000 debentures either by purchasing them from the open market or by drawing lots at par at the company's option. Profit, if any, on redemption is to be transferred to capital reserve. The company's accounting year ends on 31st March. Interest is payable on 30th Sep and 31st March.

During 2003-04, the company wrote off 20% of debenture discount account.

During 2006-07, the company purchased and cancelled the debentures as given below:

(i) Rs. 200,00,000 at Rs. 95 per debenture on 30th September, and

(ii) Rs. 300,00,000 at Rs. 97 per debenture on 31st March.

Give the journal entries in the books of A Ltd. for both the years

Date	Particulars		Dr Rs / Lakh	Cr Rs / Lakh
1-4-03	Bank A / c	Dr	980	
	Dis. on issue of debentures A / c	Dr	20	
	To 14 % Debentures A / c			1000
30-9-03	Debentures interest A / c		70	
	To Bank A / c			70
31-3-04	Debentures interest A / c	Dr	70	
	To Bank A / c			70
31-3-04	Profit and loss A / c	Dr	144	
	To Debenture interest A / c			140
	To Dis. on issue of Debentures A / c			4
30-9-05	Debentures interest A / c	Dr	70	
	To Bank A / c			70
30-9-06	Own debentures A / c	Dr	190	
	To Bank A / c			190
30-9-06	14 % Debentures A / c	Dr	200	
	To Own debentures A / c			190
	Capital Reserve A / c			10
	Debentures interest A / c	Dr	56	
	To Bank A / c			56
31-3-07	Own debentures A / c	Dr	291	
	To Bank A / c			290
	14 % Debentures A / c	Dr	300	
	To Own debentures A / c			291
	Capital Reserve A / c			9
	Profit and loss A / c	Dr	126	
	To Debenture interest A / c			126

ISSUE OF DEBENTURES AT PAR

Illustration 8. *B* Ltd. issued Rs. 1,000 10% Debentures of Rs. 1000 each payable :

Rs. 200 on application; Rs. 400 on allotment; and the balance two months after allotment. The public applied for 1,400 debentures. Applications of 900 debentures were accepted in full; applicants for 200 debentures were allotted 100 debentures and the remaining applications were rejected. All money were duly received.

Required : Journalise the transactions.

Solution :

Journal of ***B*** Ltd.

Date	*Particulars*	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
	Bank A/c Dr.		2,80,000	
	To Debenture Application A/c			2,80,000
	(Being the Receipt of application money on 1,400 debentures)			
	Debentures Application A/c Dr.		2,80,000	
	To 10% Debentures A/c			2,00,000
	To Debentures Allotment			20,000
	To Bank A/c			60,000
	(Being the application money adjusted and surplus refunded)			
	Debentures Allotment A/c Dr.		4,00,000	
	To 10% Debentures A/c			4,00,000
	(Bening the Amount due on allotment on 10,000 debentures)			
	Bank A/c Dr.		3,80,000	
	To Debentures Allotment A/c			3,80,000
	(Being the Balance of the amount due on allotment received)			
	Debenture Call A/c Dr.		4,00,000	
	To 10% Debentures A/c			4,00,000
	(Being the Amount due on call)			
	Bank A/c Dr.		4,00,000	
	To Debenture Call A/c			4,00,000
	(Being the Amount due on call received)			

ISSUE OF DEBENTURES AT A PREMIUM

Illustration 9. *Z* Ltd. issued 2,500, 10% Debentures of Rs. 100 each a premium of 10% payable Rs. 20 on application, Rs. 50 on allotment (including premium) and the balance on first & final call. The public applied for 3,500 debentures. Applications for 2,250 debentures were accepted in full, application for 500 were allotted 250 debentures and remaining applications were rejected. All moneys were duly received.

Required : Journalise these transactions.

Solution :

Journal of ***Z*** Ltd.

Date	*Particulars*	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
	Bank A/c Dr. To Debenture Application A/c 70,000 (Being application money received on 3,500 debentures)		70,000	
	Debentures Application A/c Dr. To 10% Debentures A/c To Debentures Allotment A/c To Bank A/c (Being the application money adjusted and the surplus refunded)		70,000	 50,000 5,000 15,000
	Debenture Allotment A/c Dr. To 10% Debentures A/c To Securities Premium A/c (Being the Amount due on allotment @ Rs. 50 on 2,500 debentures)		1,25,000	 1,00,000 25,000
	Bank A/c Dr. To Debentures Allotment A/c (Being the Balance of the amount due on allotment received)		1,20,000	 1,20,000
	Debentures Call A/c Dr. To 10% Debentures A/c (Being the Amount due on Call @ Rs. 40 on 2,500 debentures)		1,00,000	 1,00,000
	Bank A/c Dr. To Debentures Call A/c (Being the Amount due on call received)		1,00,000	 1,00,000

ISSUE OF DEBENTURES AT A DISCOUNT

Illustration 10. *A* Ltd. issued 750, 12% Debentures of Rs. 1000 each at a discount of 10% payble Rs. 200 on application, Rs. 400 on allotment and Rs. 300 on first and final call. The public applied for 1,050 debentures. Application for 675 debentures were accepted in full, applicants for 150 debentures were allotted 75 debentures and the remaining applications were rejected. All moneys were duly received.

Required : Journalise these transactions.

Solution :

Journal of ***A*** Ltd.

Date	*Particulars*		*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
	Bank A/c	Dr.		2,10,000	
	To Debenture Application A/c				2,10,000
	(Being the Receip of application money on 1,050 debentures)				
	Debentures Application A/c	Dr.		2,10,000	
	To 12% Debentures A/c				1,50,000
	To Debentures Allotment A/c				15,000
	To Bank A/c				45,000
	(Being the application money adjusted and surplus refunded)				
	Debentures Allotement A/c	Dr.		3,00,000	
	Discount on issue of Debentures A/c	Dr.		75,000	
	To 12% Debentures A/c				3,75,000
	(Being the amount due on allotment @ Rs. 500 on 750 debentures)				
	Bank A/c	Dr.		2,85,000	
	To Debentures Allotment A/c				2,85,000
	(Being the Balance of the amount due on allotment received)				
	Debentures Call A/c	Dr.		2,25,000	
	To 12% Debentures A/c				2,25,000
	(Being the Amount due on debentures @ Rs. 300 on 750 debentures)				
	Bank A/c	Dr.		2,25,000	
	To Debenture Call A/c				2,25,000
	(Being the Amount due on call received)				

ISSUE OF DEBENTURES FOR CONSIDERATION OTHER THAN CASH

Illustration 11. *Z* Ltd. took over the assets of Rs. 6,00,000 and liabilities of Rs. 80,000 of *C* Ltd. for an agreed purchase consideration of Rs. 5,40,000 to be satisfied by the issue of 10% Debentures of Rs. 1,000 each.

Required : Show the necessary journal entries in the books of *Z* Ltd, assuming that—

Case (a) Such Debentures are issued at par;

Case (b) Such Debentures are issued at 20% premium; and

Case (c) Such Debentures are issued at 10% discount;

Solution :

In the Books of ***Z*** Ltd.

Journal

Particulars		*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
Entry in all cases				
Sundry Assets A/c	Dr.		6,00,000	
Goodwill A/c	Dr.		20,000	
To Sundry Liabilities A/c				80,000
To *C* Ltd.				5,40,000
(Being the purchase of assets and liabilities from *B* Ltd. as per agreement dated...)				
Case (a) If Debentures are issued at par				
C Ltd. Dr.			5,40,000	
To 15% Debentures A/c				5,40,000
(Being the issue of 5,400 debentures at par to *B* Ltd. as per Board's resolution dated....)				
Case (b) If Debentures are issued at 20% premium				
C Ltd.	Dr.		5,40,000	
To 10% Debentures A/c				4,50,000
To Securities Premium A/c				90,000
(Being the issue of 4,500 debentures at a premium of 20% to *B* Ltd. as per Board's resolution dated...)				
Case (c) If Debentures are issued at 10% discount				
C Ltd.	Dr.		5,40,000	
Discount on Issue of Debentures A/c	Dr.			60,000
To 10% Debentures A/c				6,00,000
(Being the issue of 6,000 debentures at a discount of 10% to *B* Ltd. as per Board's resolution dated...)				

Working Notes :

(i) The amount by which the purchase consideration exceeds the value of the net assets (i.e. the difference between the agreed value of the assets taken over and the agreed amount of liabilities taken over) has been debited to Goodwill Account.

(ii) *Calculation of No. of Debentures to be issued in each case.*

Particulars	*At 20% Premium*	*At 10% Discount*	*At Par*
A. Issue Price per Debenture (Rs.)	120	90	100
B. Purchase Consideration (Rs.)	5,40,000	5,40,000	5,40,000
C. No. of Debentures to be issued (B/A)	4,500	6,000	5,400

DEBENTURES ISSUED AS COLLATERAL SECURITY

Illustration 12. *C* Ltd. secured a loan of Rs. 8,00,000 from the Axis Bank by issuing 1,000, 12% Debentures of Rs. 1000 each as collateral security.

Required : How will you treat the issue of such debentures ?

Solution :

I. First Method

An Extract of Balance Sheet of ***C*** Ltd. as at...

Liabilities	*Rs.*	*Assets*	*Rs.*
Secured Loans :			
Loan from Canara Bank			
(Secured by the issue of 1,000, 12%			
Debentures of Rs. 1000 each as			
collateral security)	10,00,000		

II. Second Method

Journal of ***C*** Ltd.

Particulars	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
Debentures Suspense A/c Dr.		10,00,000	
To 12% Debentures A/c			10,00,000
(Being the issue of 1,000, 12% debentures of Rs. 1000 each as collateral security for a loan from a bank as per Board's resolution dated...)			

An Extract of Balance Sheet of ***C*** Ltd. as at...

Liabilities	*Rs.*	*Assets*	*Rs.*
Secured Loans :		Misecellaneous Expenditures :	
1,000, 12% Debentures of Rs. 1000 each (Issued as collateral security)	10,00,000	Debentures Suspense 10,00,000	
Loan from Axis Bank (Secured by the issue of 1,000, 12% debentures of Rs. 1000 each as collateral security)	10,00,000		

ISSUE OF DEBENTURES UNDER DIFFERENT TERMS OF REDEMPTION

Illustration 13. Given Journal entries in each of the following alternative cases assuming the face value of a debenture being Rs. 100.

(a) A debenture issued at Rs. 100 repayable at Rs. 100

(b) A debenture issued at Rs. 95 repayable at Rs. 100

(c) A debenture issued at Rs. 105 repayable at Rs. 100
(d) A debenture issued at Rs. 100 repayable at Rs. 105
(e) A debenture issued at rs. 95 repayable at Rs. 105
(f) A debenture issued at Rs. 90 repayable at Rs. 95

Solution :

Journal

Particulars		*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
(a) Bank A/c	Dr.		100	
To Debentures A/c				100
(Being the issue of debentures at par)				
(b) Bank A/c	Dr.		95	
Discount on Issue of Debentures A/c	Dr.		5	
To Debentures A/c				100
(Being the issue of debentures at 5% discount)				
(c) Bank A/c	Dr.		105	
To Debentures A/c				100
To Securities Premium A/c				5
(Being the issue of debentures at 5% premium)				
(d) Bank A/c	Dr.		100	
Loss on Issue of Debentures A/c	Dr.		5	
To Debentures A/c				100
To Premium on Redemption of Debentures A/c				5
(Being the issue of debenture at par but redeemable at 5% premium)				
(e) Bank A/c	Dr.		95	
Loss on Issue of Debentures A/c	Dr.		10	
To Debtures A/c				100
To Premium on Redemption of Debentures A/c				5
(Being the issue of debenture at 5% discount which are redeemable at 5% premium)				
(f) Bank A/c	Dr.		90	
Discount on Issue of Debentures A/c	Dr.		10	
To Debentures A/c				100
(Being the issue of debentures at 10% discount)				

TREATMENT OF DISCOUNT ON ISSUE OF DEBENTURES

Illustration 14. On 01.04.08, *P* Ltd. issued 1,000, 15% Debentures of Rs. 100 each at a discount of 10% redeemable at par.

Required : Show the 'Discount on Issue of Debentures A/c if (a) such debentures are redeemable after 4 years, and (b) such debentures are redeemable by equal annual drawings in 4 years. *A* Ltd. follows financial year as its accounting year.

Solution :

(a) *When such debentures are redeemable after 4 years :*

A. Total discount allowed (Rs. 1,00,000 × 10/100) = Rs. 10,000

B. Period for which debentures are held = 4 Years

C. Amount of discount to be written off to P & L A/c every year (A/B) = Rs. 2,500

Dr. Discount on Issue of Debentures Account *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
01.04.08	To 15% Debentures A/c	10,000	31.03.09	By P & L A/c	2,500
				By Balance c/d	7,500
		10,000			10,000
01.04.09	To Balance b/d	7,500	31.03.10	By P & L A/c	2,500
				By Balance c/d	5,000
		7,500			7,500
01.04.10	To Balance b/d	5,000	31.03.11	By P & L A/c	2,500
				By Balance c/d	2,500
		5,000			5,000
01.04.11	To Balance b/d	2,500	31.03.12	By P & L A/c	2,500
		2,500			2,500

(b) *When such debentures are redeemable by equal annual drawings in 4 years :*

Statement Showing the Debentures Discount to be Written Off Each Year

Year ended on *A*	*Face Value of Deb. used* *B*	*Period of Use* *C*	*Product* *D = B×C*	*Ratio* *E*	*Amount of Discount to be w/o* *10,000×E/10*
31.03.09	1,00,000	12 months	12,00,000	4	4,000
31.03.10	75,000	12 months	9,00,000	3	3,000
31.03.11	50,000	12 months	6,00,000	2	2,000
31.03.12	25,000	12 months	3,00,000	1	1,000

Dr. Discount on Issue of Debentures Account *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
01.04.08	To 15% Debentures A/c	10,000	31.03.09	By P & L A/c	4,000
				By Balance c/d	6,000
		10,000			10,000
01.04.09	To Balance b/d	6,000	31.03.10	By P & L A/c	3,000
				By Balance c/d	3,000
		6,000			6,000
01.04.10	To Balance b/d	3,000	31.03.11	By P & L A/c	2,000
				By Balance c/d	1,000
		3,000			3,000
01.04.11	To Balance b/d	1,000	31.03.12	By P & L A/c	1,000
		1,000			1,000

Illustration 15. *Y* Ltd. issued 500, 15% Debentures of Rs. 1000 each at 8% discount repayable asunder :

Year end	*Nominal Value of debentures to be redeemed*
2	Rs 50,000
3	Rs. 1,00,000
4	Rs. 1,50,000
5	Rs. 2,00,000

Required : Calculate the amount of discount to be written off each year assuming that the company closes its accounts on calender year basis.

Solution :

Statement Showing the Debenture Discount to be Written Off Each Year

Year *A*	*Face Value of Deb. (in lakhs)* *B*	*Period of Use (Month)* *C*	*Product* *D = B×C*	*Ratio* *E*	*Amount of Discount to be w/o* *Rs. 40,000×E/40*
1	5.00	12	60.00	10	10,000
2	5.00	12	60.00	10	10,600
3	4.50	12	54.00	9	9,000
4	3.50	12	42.00	7	7,000
5	2.00	12	24.00	4	4,000

TREATMENT OF LOSS ON ISSUE OF DEBENTURES

Illustration 16. On 01.01.2007 *E* Ltd. issued 500, 10% Debentures of Rs. 100 each, at a discount of 10% redeemable at a premium of 10%.

Required : Show the 'Loss on Issue of Debentures A/c', if (i) such debentures are redeemable after 4 years, and (ii) such debentures are redeemable by equal annual drawings in 4 years. *E* Ltd. follows calendar year as it accounting year.

Solution :

Loss on Issue at Discount = 10%; Loss on Redemption at premium = 10%

∴Total Loss = 20%

(a) *When such debentures are redeemable after 4 years* :

A. Total Loss (Rs. 50,000 × 20/100)	= Rs. 10,000
B. Period for which debentures are held	= 4 Years
C. Amount of discount to be written off to P & L A/c every year (A/B)	= Rs. 2,500

Dr. Loss on Issue of Debentures Account *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
01.01.07	To 10% Debentures A/c	5,000	31.12.07	By P & L A/c	2,500
	To Premium on redemption	5,000		By Balance c/d	7,500
		10,000			10,000
01.01.08	To Balance b/d	7,500	31.12.08	By P & L A/c	2,500
				By Balance c/d	5,000
		7,500			7,500
01.01.09	To Balance b/d	5,000	31.12.09	By P & L A/c	2,500
				By Balance c/d	2,500
		5,000			5,000
01.01.10	To Balance b/d	2,500	31.12.10	By P & L A/c	2,500
		2,500			2,500

(b) *When such debentures are redeemable by equal annual drawings in 4 years :*

Statement Showing the Debentures Discount to be Written Off Each Year

Year ended on A	*Face Value of Deb. used (in lakhs)* B	*Period of Use (Month)* C	*Product D = B×C* D	*Ratio* E	*Amount of Loss to be w/o 10,000×E/10*
31.12.07	50,000	12 months	6,00,000	4	4,000
31.12.08	37,500	12 months	4,50,000	3	3,000
31.12.09	25,000	12 months	3,00,000	2	2,000
31.12.10	12,500	12 months	1,50,000	1	1,000

Dr. Discount on Issue of Debentures Account *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
01.01.07	To 10% Debentures A/c	5,000	31.12.07	By P & L A/c	4,000
	To Premium on redemption	5,000		By Balance c/d	6,000
		10,000			10,000
01.01.08	To Balance b/d	6,000	31.12.08	By P & L A/c	3,000
				By Balance c/d	3,000
		6,000			6,000
01.01.09	To Balance b/d	3,000	31.12.09	By P & L A/c	2,000
				By Balance c/d	1,000
		3,000			3,000
01.01.10	To Balance b/d	1,000	31.12.10	By P & L A/c	1,000
		1,000			1,000

REDEMPTION OUT OF PROFIT

Illustration 17. Give the necessary journal entries both at the time of Issue and Redemption of Debentures in each of the following alternative cases :

(a) *P* Ltd. issued 1,000, 10% Debentures of Rs. 110 each at par and redeemeable at par at the end of 4 years.

(b) *S* Ltd. issued Rs. 1,00,000, 12% Debentures at a discount of 5% repayable at par at the end of 4 years.

(c) *Z* Ltd. issued 10% Debentures of the total face value of Rs. 1,00,000 at a premium of 5% to be redeemed at par at the end of 4 years.

(d) *K* Ltd. issued 1,000, 14% Debentures of Rs. 100 each at par but redeemable at 5% premium at the end of 4 years.

(e) *D* Ltd. issued Rs. 1,00,000, 18% Debentures at a discount of 5% but redeemable at a premium of 5% at the end of 4 years.

Solution :

Case (a) Journal of ***P*** Ltd.

Particulars	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
On Issue			
Bank A/c Dr.		1,00,000	
To 10% Debenture A/c			1,00,000
(Being the issue of Debentures at par)			
On Redemption			
Profit & Loss Application A/c Dr.		1,00,000	
To Debentures Redemption Reserve A/c			1,00,000
(Being the transfers of an amount equivalent to the nominal value of Debentures redeemed to Debenture Redemption Reserve A/c out of profits)			

10% Debentures A/c Dr.		1,00,000	
To Debentureholders' A/c			1,00,000
(Bening the the amount due on redemption)			
Debentureholders A/c Dr.		1,00,000	
To Bank A/c			1,00,000
(Being the payment made to Debentureholders)			

Case (b) Journal of ***S*** Ltd.

Particulars	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
On Issue			
Bank A/c Dr.		95,000	
Discount on issue of Debentures A/c Dr.		5,000	
To 12% Debentures A/c			1,00,000
(Being the issue of Debentures at 5% discount)			
On Redemption			
Profit & Loss Appropriation A/c Dr.		1,00,000	
To Debenture Redemption Reserve A/c			1,00,000
(Being the transfer of an amount equivalent to the nomial value of Debentures redeemed to Debenture Redemption Reserve A/c out of profits)			
12% Debentures A/c Dr.		1,00,000	
To Debentureholders' A/c			1,00,000
(Being the amount due on redemption)			
Debentureholders A/c Dr.		1,00,000	
To Bank A/c			1,00,000
(Being the payment made to Debentureholders)			

Case (c) Journal of ***Z*** Ltd.

Particulars	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
On Issue			
Bank A/c Dr.		1,05,000	
To 10% Debentures A/c			1,00,000
To Securities Premium A/c			5,000
(Being the issue of Debentures at 5% discount)			
On Redemption			
Profit & Loss Appropriation A/c Dr.		1,00,000	
To Debenture Redemption Reserve A/c			1,00,000
(Being the transfer of an amount equivalent to the nominal value of Debentures redeemed to Debenture Redemption Reserve A/c out of profits)			

10% Debentures A/c Dr.		1,00,000	
To Debenture holders A/c			1,00,000
(Being the amount due on redemption)			
Debentureholders A/c Dr.		1,00,000	
To Bank A/c			1,00,000
(Being the payment made to Debentureholders)			

Case (d) Journal of ***K*** Ltd.

Particulars	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
On Issue			
Bank A/c Dr.		1,00,000	
Loss on Issue of Debentures A/c Dr.		5,000	
To 14% Debentures A/c			1,00,000
To Premium on Redemption of Debentures A/c			5,000
(Being the issue of Debentures at par and redeemable at 5% premium)			
On Redemption			
Profit & Loss Appropriation A/c Dr.		1,00,000	
To Debenture Redemption Reserve A/c			1,00,000
(Being the transfer on an amount equivalent to the nominal value of Debentures redeemed to Debenture Redemption Reserve A/c out of profits)			
14% Debentures A/c Dr.		1,00,000	
Premium on Redemption of Debentures A/c Dr.		5,000	
To Debentureholder's A/c			1,05,000
(Being the amount due on redemption)			
Debentureholders' A/c Dr.		1,05,000	
To Bank A/c			1,05,000
(Being the payment made to Debentureholders)			

Case (e) Journal of ***D*** Ltd.

Particulars	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
On Issue			
Bank A/c Dr.		95,000	
Loss on Issue of Debentures A/c Dr.		10,000	
To 18% Debentures A/c			1,00,000
To Premium on Redemption of Debentures A/c			5,000
(Being the issue of Debentures at 5%discount & redeemable at 5% premium)			

On Redemption			
Profit & Loss Appropriation A/c Dr.		1,00,000	
To Debenture Redemption Reserve A/c			1,00,000
(Being the transfer of an amount equivalent to the nominal value of Debenures redeemed to Debenture Redemption Reserve A/c out of profits)			
18% Debentures A/c Dr.		1,00,000	
Premium on Redemption of Debentures A/c Dr.		5,000	
To Debentureholders' A/c			1,05,000
(Being the amount due on redemption)			
Debentureholders' A/c Dr.		1,05,000	
To Bank A/c			1,05,000
(Being the payment made to Debentureholders)			

Illustration 18. *D* Ltd. issued 200, 14% Debentures of Rs. 1,000 each on 1.1.2008 at a discount of 10% redeemable at a premium of 10% out of profits. Give journal entries both at the time of issue and redemption of Debentures if (a) the Debentures are redeemable in lump sum at the end of 4th year from the date of isue (b) the Debentures are redeemable in equal annual drawings in 4 years. [*Ignore the treatment of loss on issue of Debentures and interest. Assume the Calender year being the accounting year of D Ltd.*]

Solution :

(a) *If Debentures are redeemable in lump sum at the end of 4th year.*

Journal of ***X*** Ltd.

Date	*Particulars*	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
01.01.08	Bank A/c Dr.		1,80,000	
	Loss on issue of Debentures A/c Dr.		40,000	
	To 14% Debenture A/c			2,00,000
	To Premium on Redemption of Deb. A/c			20,000
	(Being the issue of debentures at 10% discount and redeemable at 10% premium)			
31.12.11	14% Debentures A/c Dr.		2,20,000	
	Premium on Redemption of Debenures A/c Dr.		20,000	
	To Debentureholders' A/c			2,20,000
	(Being the amount due on redemption)			
	Debentureholders' A/c Dr.		2,20,000	
	To Bank A/c			2,20,000
	(Being the amount paid to Debenture-holders)			
	Profit & Loss Appropriation A/c Dr.		2,00,000	
	To Debenture Redemption Reserve A/c			2,00,000
	(Being the transfer of profit to DDR)			

(b) *If Debentures are redeemable in 4 equal annual drawings :*

Journal of ***X*** Ltd.

Date	*Particulars*		*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
01.01.08	Bank A/c	Dr.		1,80,000	
	Loss on issue of Debentures A/c	Dr.		40,000	
	To 14% Debenture A/c				2,00,000
	To Premium on Redemption of Debentures A/c				20,000
	(Being the issue of debentures at 10% discount and redeemable at 10% premium)				
31.12.08	14% Debentures A/c	Dr.		50,000	
	Premium on Redemption of Debentures A/c	Dr.		5,000	
	To Debentureholders's A/c				55,000
	(Being the amount due on redemption)				
	Debenureholders' A/c	Dr.		55,000	
	To Bank A/c				55,000
	(Being the payment made)				
	Profit & Loss Appropriation A/c	Dr.		1,00,000	
	To Debenture Redemption Reserve A/c				1,00,000
	(Being the transfer of profit equal to 50% of the nominal value of debentures outstanding as per SEBI Guidelines)				
31.12.09	14% Debentures A/c	Dr.		50,000	
	Premium on Redemption of Debentures A/c	Dr.		5,000	
	To Debentureholder's A/c				55,000
	(Being the amount due on redemption)				
	Debentureholders' A/c	Dr.		55,000	
	To Bank A/c				55,000
	(Being the amount due on redemption)				
31.12.10	14% Debentures A/c	Dr.		50,000	
	Premium on Redemption of Debentures A/c	Dr.		5,000	
	To Debentureholders' A/c				55,000
	(Being the amount due on redemption)				
	Debentureholders' A/c	Dr.		55,000	
	To Bank A/c				55,000
	(Being the payment made)				
31.12.11	14% Debentures A/c	Dr.		50,000	
	Premium on Redemption of Debentures A/c	Dr.		5,000	
	To Debentureholders' A/c				55,000
	(Being the amount due on redemption)				

(*Contd.*)

	Debentureholders' A/c Dr.		55,000	
	To Bank A/c			55,000
	(Being the payment made)			
	Profit & Loss Appropriation A/c Dr.		1,00,000	
	To Debenture Redemption Reserve A/c			1,00,000
	(Being the transfer of profits to DRR so as to make its balance equal to nominal vlaue of debentures redeemed)			

SINKING FUND METHOD

Illustration 19. On 1st April 2004. H Ltd. issued 442, 10% Debentures of Rs. 1000 each at a discount of 10% redeemable at a premium of 5% after 4 years. It was decided to create a Sinking Fund for the purposes of accumulating sufficient funds to redeem the Debentures and to invest in some radily convertible securities yielding 10% interest p.a. Reference to the table shows that Re. 1.00 p.a. at 10% compound interest amounts to Rs. 4.641 in 4 years. Investments are to be made in the Bonds of Rs. 1000 each available at par.

On 31st March 2008, the investments realised Rs. 3,40,000 and debentures were redeemed. The bank balance as on that date was Rs. 50,000.

Required : Prepare Debenture Redemption Fund Account and Debenture Redemption Fund Investments Account for 4 years.

Solution :

DRF = Debenture Redemption Fund, DRFI = Debenture Redemption Fund Investment

Dr. Discount on Issue of Debentures Account *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
31.03.05	To Balance c/d	1,00,000	31.03.05	By P & L App. A/c	1,00,000
31.03.06	To Balance c/d	2,10,000	01.04.05	By Balance b/d	1,00,000
			31.03.06	By Interest on DRFI A/c	10,000
				By P & L App. A/c	1,00,000
		2,10,000			2,10,000
31.03.07	To Balance c/d	3,31,000	01.04.06	By Balance b/d	2,10,000
31.03.07				By Interest on DRFI A/c	21,000
				By P & L App. A/c	1,00,000
		3,31,000			3,31,000
31.03.08	To Loss on issue of Debentures (premium)	22,100	01.04.07	By Balance b/d	3,31,000
				By Interest on DRFI A/c	33,100
				By P & L App. A/c	91,000
	To Debenture Redemption Reserve A/c	4,52,000		By Debenture Red. Fund Investment A/c (profit)	19,000
		4,74,100			4,74,100

Dr. Debentures Redemption Fund Investment (DRFI) Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
31.03.05	To Bank A/c	1,00,000	31.03.02	By Balance c/d	1,00,000
01.04.05	To Balance b/d	1,00,000	31.03.06	By Balance c/d	2,10,000
31.03.06	To Bank A/c	1,10,000			
		2,10,000			2,10,000
01.04.06	To Balance b/d	2,10,000	31.03.07	By Balance c/d	3,31,000
31.03.07	To Bank A/c	1,21,000			
		3,31,000			3,31,000
01.04.07	To Balance b/d	3,31,000	31.03.08	By Bank A/c (Sales)	3,50,000
31.03.08	To Debenture Redemption Fund A/c (Profit)	9,000			
		3,50,000			3,50,000

Working Note :

(i) *Calculation of the amount of profit set aside*

		Rs.
a.	Face Value of Debentures	4,42,000
b.	Premium Premium Payable on Redemption	22,100
c.	Depreciable Cost (A + B)	4,64,100
d.	Value of annuity per Re 1	4,641
e.	Annual amount to be charged (C/D)	1,00,000

(ii) *Calculation of the amount of investments and interest*

Year *a*	*Opening Balance* *b*	*Interest* *c = b×10/100*	*Saving* *d*	*Investments* *e = c + d*	*Closing Balance* *f = b + e*
2004-05	—	—	1,00,000	1,00,000	1,00,000
2005-06	1,00,000	10,000	1,00,000	1,10,000	2,10,000
2006-07	2,10,000	21,000	1,00,000	1,21,000	3,31,000
2007-08	3,31,000	33,100	1,00,000	—	—

INSURANCE POLICY METHOD

Illustration 20. On 01.01.2005, Hello Ltd. issued 500, 15% Debentures of Rs. 300 each at a discount of 10%, redemable at a premium of 10% after 4 years. It was decided to take out an Insurance Policy to provide the necessary funds for the redemption of the debentures. The annual premium for the policy, payable on 1st January every year, was Rs. 40,000. The sum assured of the policy was Rs. 1,65,000.

Required : Give the necessary journal entries. *[Ignore Debenture Interest]*

Solution :

Journal

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
01.01.05	Bank A/c	Dr.		1,35,000	
	Discount on Issue of Debentures A/c	Dr.		15,000	
	Loss on Issue of Debentures A/c	Dr.		15,000	
	To 15% Debenture A/c				1,50,000
	To Premium on Redemption of Deb. A/c				15,000
	(Being the issue of debentures at a discount of 10% and redeemable at 10% premium)				
	Debentures Redemption Fund Policy A/c	Dr.		40,000	
	To Bank A/c				40,000
	(Being the payment of annual premium)				
Dec. 31	Profit & Loss Appropriation A/c	Dr.		40,000	
	To Debenture Redemption Fund A/c				40,000
	(Being the transfer to profit to DRF A/c)				
Dec. 31	Profit & Loss A/c	Dr.		3,750	
	To Discount on Issue of Debentures A/c				3,750
	(Being the discount on issue of debentures w/off)				
01.01.06	Debenture Redemption Fund Policy A/c	Dr.		40,000	
Jan. 1	To Bank A/c				40,000
	(Being the payment of annual premium)				
Dec. 31	Profit & Loss Appropriation A/c	Dr.		40,000	
	To Debenture Redemption Fund A/c				40,000
	(Being the transfer to profit to DRF A/c)				
Dec. 31	Profit & Loss A/c	Dr.		3,750	
	To Discount on Issue of Debentures A/c				3,750
	(Being the discount on issue of debentures w/off)				
01.01.07	Debenture Redemption Fund Policy A/c	Dr.		40,000	
	To Bank A/c				40,000
	(Being the payment of annual premium)				
Dec. 31	Profit & Loss Apprication A/c	Dr.		40,000	
	To Debenture Redemption Fund A/c				40,000
	(Being the transfer to profit to DRF A/c)				
Dec. 31	Profit & Loss A/c	Dr.		3,750	
	To Discount on Issue of Debentures A/c				3,750
	(Being the discount on issue of debentures w/off)				
01.01.08	Debenture Redemption Fund Policy A/c	Dr.		40,000	
	To Bank A/c				40,000
	(Being the payment of annual premium)				

(Contd.)

(*Contd.*)

Dec. 31	Profit & Loss Appropriation A/c Dr.		40,000	
	To Debenture Redemption Fund A/c			40,000
	(Being the transfer of profit to DRF A/c)			
	Profit & Loss A/c Dr.		3,750	
	To Discount on Issue of Debentures A/c		3,750	
	(Being the discount on issue of debentures w/off)			
	Bank A/c Dr.		1,65,000	
	To Debenture Redemption Fund Policy A/c		1,65,000	
	(Being the receipt of policy amount on maturity)			
	Debenture Redempion Fund Policy A/c Dr.		5,000	
	To Debenture Redemption Fund A/c			5,000
	(Being the transfer to profit on the policy to DRF A/c)			
	15% Debentures A/c Dr.		1,50,000	
	Premium on Redemption of Debenures A/c Dr.		15,000	
	To Debentureholders A/c			165,000
	(Being the amount due on redemption)			
	Debentureholders' A/c Dr.		1,65,000	
	To Bank A/c			165,000
	(Being the payment made to Debenureholders)			
	Debenture Redemption Fund A/c Dr.		15,000	
	To Loss on Issue of Debentures A/c			15,000
	(Being the loss on Issue of debentures written off against the balance in DRF A/c)			
	Debenture Redemption Fund A/c Dr.		1,50,000	
	To Debenture Redemption Reserve A/c			1,50,000
	(Being the transfer of nominal value of debentures redeemed to Debenture Redemption Reserve A/c)			

REDEMPTION BY CONVERSION

Illustration 21. On 1st January, 2008, CARGO Ltd. issued 2,000, 10% Debentures of Rs. 250 each at Rs. 225 each. Debenture-holders were given an option to get their debentures converted into equity shares of Rs. 50 each at a premium of Rs. 25 per share. On 31st December, 2008, one year's interest had accrued on these debentures which was not paid. A holder of 200 debentures informed that he wanted to exercise the option for conversion of debenures into equity shares. The company, therefore, accepted his request and redeemed these 200 debentures by issuing him equity shares. The interest, however, on these 200 debentures was paid to the debentureholder. Pass the necessary journal entries.

Solution :

Journal

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
01.01.08	Bank A/c	Dr.		4,50,000	
	Discount on Issue of Debentures A/c	Dr.		50,000	
	To 10% Debentures A/c				5,00,000
	(Being the Debentures issued at 10% discount)				
31.12.08	Interest on Debentures A/c	Dr.		50,000	
	To Outstanding Interest on debentures A/c				50,000
	(Being the Interest due on debentures)				
	10% Debenture A/c	Dr.		50,000	
	To Discount on issue of Debentures A/c				5,000
	To Debentureholders' A/c				45,000
	(Being the amount due to debenture-holders)				
	Debentureholders' A/c	Dr.			45,000
	To Equity Share Capital A/c				30,000
	To Securities Premium A/c				15,000
	(Being the issue of 600 Equity Shares of Rs. 50 each at a premium of 25%)				
	Outstanding Interest on Debentures A/c	Dr.		50,000	
	To Bank A/c				50,000
	(Being the Interest paid to the Debentures holders)				

Illustration 22. On 01.01.2007, Hudco Ltd. issued 1,000, 15% Convertible Debentures of Rs. 200 each at a discount of 5% redeemable at par after 4 years by coverting their holdings into equity shares of Rs. 100 each at a premium of 25%. As per terms of issue, the holders of these Debentures also have an option to convert their holdings as aforesaid at any time after 6 months but within 3 years. On 31.12.2007, a holder of 250 Debentures notified his intention to exercise the option.

Requirements : (a) Give Journal entries as on 01.01.2001, 31.12.2007 and on 31.12.2007 (ignoring interest), and (b) Prepare the Balance Sheet as on 31.12.2007 (showing related items only).

Solution :

Journal

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
01.01.07	Bank A/c	Dr.		1,90,000	
	Discount on Issue of Debentures A/c	Dr.		10,000	
	To 15% Debenture A/c				2,00,000
	(Being the issue of 1,000 debentures at a discount of 5%)				

(Contd.)

(*Contd.*)

31.12.07	15% Debentures A/c	Dr.		50,000	
	To Discount on Issue Debentures A/c				2,500
	To Equity Shares Capital A/c				38,000
	To Securities Premium A/c				9,500
	(Being the issue of 380 shares at 25% premium to a holder of 500 Debentures as per Board Resolution dated....)				
31.12.08	15% Debentures A/c	Dr.		1,50,000	
	To Equity Share Capital A/c				1,20,000
	To Secuirities Premium A/c				30,000
	(Being the issue of 1,200 share @ 25% premium to the holders of 1,500 Debentures as per Board's Resolution dated...)				

An Extract of Balance Sheet as at 31st December 2008

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital :		Miscellaneous Expenditure :	
Equity Shares of Rs. 100		Discount on Issue of Debentures	7,500
each fully paid up	38,000		
Reserves & Surplus :			
Securities Premium	9,500		
Securied Loans :			
750, 15% Debentures of			
Rs. 200 each	1,50,000		

Working Notes :

(i) It has been assumed that no portion of Discount on Issue of Debentures has yet been written off.

(ii) *Calculation of No. of Shares to be issued on 31.12.2008.*

a. Normal Value of Debentures to be converted (250 × 200)	Rs.	50,000
b. *Less* : Reversal of Discount @ 5%	Rs.	2,500
c. Amount actually received (a – b)	Rs.	47,500
d. Issued price of an Equity Share (Rs. 100 + 25%)	Rs.	125
e. No. of Shares to be issued (c/d)		380

New Shares have been issued exactly equal to be amount actually received (i.e., Net of discount) at the time of issue of Debentures, otherwise it would amount to an issue of shares at discount indirectly without complying with the provision of Sec. 79 of the Companies Act, 1956.

(iii) *Calculation of No. of Shares to be issued on 31.12.2010.*

a. Nominal Value of Debenturres to be converted	Rs.	1,50,000
b. Issue Price of an Equity Share (Rs. 100 + 25%)	Rs.	125
c. No. of Equity Shares to be issued (a/b)		1,200

Since the debentures are due for redemption and the conversion of debentures into shares is on the basis of terms and conditions mutually agreed upon at the time of issue for redemption, even the debentures originally issued at a discount can be converted into shares.

CUM INTEREST AND EX-INTEREST TRANSACTIONS

Illustration 23. On 01.01.2007 *S* Ltd. had 2,000, 12% Debentures of Rs. 100 each. On 01.05.2007 the company purchased 400 own Debentures at Rs. 97 cum-interest in the open market. Interest on debenture is payable on 30the June and 31st Dec. each year.

Required : Give the necessary journal entires assuming (a) that the own Debentures purchased were cancelled immediately and (b) the the own Debentures purchased were retained as investments till 31.12.2001 on which date they were cancelled.

Solution :

(a) *If own Debentures were cancelled immediately on date of purchase.*

Journal

Date	*Particulars*		*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
2007					
May 01	12% Debentures A/c	Dr.		40,000	
	Debentures Interest A/c	Dr.		1,600	
	To Bank A/c				38,800
	To Capital Reserve A/c				2,800
	(Being 400 debentures cancelled by purchase @ Rs. 97 cum-interest)				
June 30	Debentures Interest A/c	Dr.		9,600	
	To Bank A/c				9,600
	(Being the interest paid on Rs. 1,60,000 @ 12% p.a. for 6 months)				
Dec. 31	Debenture Interest A/c	Dr.		9,600	
	To Bank A/c				9,600
	(Being the interest paid on Rs. 1,60,000 @ 12% p.a. for 6 months)				
Dec. 31	Profit & Loss A/c	Dr.		20,800	
	To Debenture Interest A/c				20,800
	(Being the transfer of debenture interest to P & L A/c)				
Dec. 31	Profit & Loss Appropriation A/c	Dr.		37,200	
	To Debenture Redemption Reserve A/c				37,200
	(Being the transfer of an amount equivalent to the cash sum applied (towards principal) in redeeming the debentures to DRR out of profits)				

(b) *If own debentures were cancelled on 31.12.2001.*

Journal of ***X*** Ltd.

Date	*Particulars*	*L.F.*	*Dr. (Rs.)*	*Cr. (Rs.)*
May 01	Own Debentures A/c Dr.		37,200	
	Debentures Interest A/c			1,600
	To Bank A/c			38,800
	(Being the purchase of 400 debentures @ Rs. 97 cum-interest)			
June 30	Debentures Interest A/c Dr.		10,400	
	To Interest on Own Debentures A/c			800
	To Bank A/c			9,600
	(Being the Interest paid/credited on Rs. 1,60,000 debentures held by outsiders for 6 months & on Rs. 40,000 own debentures for 2 months)			
Dec. 31	Debenture Interest A/c Dr.		12,000	
	To Bank A/c			9,600
	To Interest on Own Debentures A/c			2,400
	(Being the interest paid/credited on Rs. 1,60,000 debentures held by outsiders and Rs. 40,000 own debentures for 6 months)			
Dec. 31	Profit & Loss A/c Dr.		24,000	
	To Debenture Interest A/c			24,000
	(Being the transfer of debenture interest to P & L A/c)			
Dec. 31	Interest on Own Debentures A/c Dr.		3,200	
	To Profit & Loss A/c			3,200
	(Being the transfer of interest on own debentures to P & L A/c)			
Dec. 31	12% Debentures A/c Dr.		40,000	
	To Own Debentures A/c			37,200
	To Capital Reserve A/c			2,800
	(Being the cancellation of 200 own debentures)			
Dec. 31	Profit & Loss Appropriation A/c Dr.		37,200	
	To Debenture Redemption Reserve A/c			37,200
	(Being the transfer of an amount equivalent to the cash sum applied in redeming the debentures)			

EXERCISE

1. State whether the following statements are true or false:
   - (a) After the redemption of all debentures, the balance in the sinking fund is transferred to General Reserve.
   - (b) Profit on sale of sinking fund investments is to credited to Debentures Account (c) Interest on debentures is payable only when a company makes profits.
   - (d) Interest on sinking fund investment is credited to Profit and Loss Account.
   - (e) Own Debentures Account will appear on the assets side of the Balance Sheet.
   - (f) If debentures are redeemed out of capital, entry for the transfer of profits to Debenture Redemption Reserve Account is not passed in the books.
   - (g) First debentures are those which are repaid before other debentures are paid out.
   - (h) Registered debentures are those which are transferable by mere delivery.
   - (i) A company cannot buy its own debentures.
   - (j) In case of debentures if the quotation is cum-interest it means that it is with interest and for recording purpose interest is added to the total price paid.

Ans. (a) True; (b) False; (c) False; (d) False; (e) True; (f) True; (g) True; (h) False; (I) False; (j) False.

2. Distinguish between:
   - (i) Debenture and Share.
   - (ii) Debenture and Debenture stock.
3. Give different considerations for which debentures may be issued.
4. Write notes on:
   - (i) Debentures Discount,
   - (ii) Interest on Debentures,
   - (iii) Own Debentures.
   - (iv) Ex-interest and Cum-interest.
5. What are the various methods of redemption of debentures?
6. What are the alternatives available for making the provision for redeeming debentures? Is it necessary to make such provision?

PROBLEMS

1. A limited company issued 100,00,000 Debenture Bonds of Rs. 100 each at a premium of 10 per cent repayable at par at the end of the 5th year. The Debenture Bonds were payable 25 per cent on application, 35 per cent on allotment (including the premium) and the balance on first and final call. All the moneys were received by the company in due course.

   Journalise the above transactions in the books of the company.

2. A limited company issued Rs. 100,000,000 debentures, which were issued as follows: Nominal Value (Rs.)

(1)	To sundry persons for cash at 90 per cent	500,00,000
(2)	To a creditor for Rs. 20,000 capital expenditure	
	In satisfaction of his claim.	250,00,000
(3)	To bankers as collateral security	250,00,000

The issue (1) and (2) are redeemable at the end of 6 years at premium of 10 %. How should the debentures be dealt with in preparing the Balance Sheet of the company?

3. On 1st June 2000 a company issued 500,00,000 11 % Debentures. Interest payable half yearly on 31st March and 30th September. The company has the power to purchase its Own Debentures in the open market which may be cancelled or kept or reissued at the company's option.

The company made the following purchases in the open market:

1st March, 2006-	100,00,000 debentures @ Rs. 99 ex-interest.
31st October, 2006-	Rs. 50,00,000 cum-interest.

The debentures purchased on 1st March, 2006 were cancelled on 30th June, 2006.

Journalise the above transactions and show the Balance Sheet as on 31st March, 2007 (relating to debentures)

4. On 1-4-2006 a company had a balance of Rs. 500,00,000 in its 10% Debentures A/c, Rs. 360,00,000 in Debenture Redemption Fund A/c and Rs. 360,00,000 in Deb. Red. Fund Investment A/c, represented by Govt. Securities at cost at Rs. 90. The Co. purchased from open market Rs. 100,00,000 Debenture @ Rs. 98 (Ex. Int) on 30-7-2006, and cancelled them. On the same date, the Co. sold investments of face value Rs. 100,00,000 at Rs. 95 (Ex. Int.).

Show the Debentures A/c, Deb. Red. Fund A/c, and Deb. Red Fund Investment A/ c for the year, 2006-07

5. Some years ago, a limited Co. has issued 9% Debentures redeemable at the company's option at 105% on any interest date (31st March and 30 th September) on giving three months' notice. The company had built up a Debenture Redemption Fund partly represented by investments.

On 31st March, 2006 Rs. 300,00,000 of the Debentures were outstanding, the Debenture Redemption Fund stood at Rs. 121,00,000 and the investments appeared in the books at cost Rs. 118,00,000.

On 31st December, 2006 the Directors of the company gave notice of their intention to repay the whole of the Debentures three months after date, at the same time offering holders the right to subscribe for new 9.5% debentures at the issue price of Rs. 98 up to the nominal amount of Rs. 200,00,000. The whole of these were taken up.

The balance of cash required to payoff the old Debentures was provided as to Rs. 95,00,000 by the sale of investments having a book value of Rs. 90,00,000 and as to the remainder out of current funds.

You are required to show the relevant ledger accounts in the books of Company making any transfers or adjustments you consider appropriate. Cash book entries and ledger entries relating to interest are not required to be shown.

Ans. [Amount transferred to General Reserve from Debenture Redemption Fund Nc Rs. 107,00,000].

STUDY NOTE – 8

PREPARATION OF FINAL ACCOUNTS UNDER COMPANIES ACT, 1956

This study note includes -

- Preparation of Final Accounts Under Companies Act, 1956

8.1. PREPARATION OF FINAL ACCOUNTS UNDER COMPANIES ACT, 1956

INTRODUCTION.

Preparation of company financial statements implies preparation of profit and loss account, balance sheet and notes to the accounts. Notes to the accounts includes relevant data-and information which is needed by the users but which cannot be presented in the financial statements. For example, they may contain additional information that is relevant to the needs of the users about items in the balance sheet and profit and loss account. They may include disclosures about risks and uncertainties affecting the enterprise and any resources and obligations not recognized in the balance sheet (such as mineral reserves). Information about geographical and industry segments and the effect on enterprise of changing prices may also be provided in the form of supplementary information. Notes also include significant accounting policies followed in the preparation of financial statements, physical data relating to production and sales, details regarding exports, foreign currency receipts, expenditure, etc.

Financial statements also show the results of the efforts, accountability and performance of the management for the resources entrusted to it by the shareholders. The shareholders who assess the stewardship or accountability of management may do so in order to take a decision about their rights. They can also change the management if they are not satisfied with their performance.

In addition to the shareholders there are several other interested parties like investors, creditors of both short and long-term, employees, researchers etc. for whom the information provided by the financial statements is valuable for a wide range of economic decisions.

Objectives of Financial Statements

The main objectives in preparing the financial statements are as follows:

1. To provide financial information that is useful in making rational investment, credit and similar decisions.
2. To provide financial information to enable users to predict cash flows to the business.
3. To provide financial information about business resources (assets), claims to these resources (liabilities and owner's equity) and changes in these resources and claims.

FINANCIAL STATEMENTS

REQUIREMENTS AND CONTENTS

Need for Regulation

Financial statements, the main link between the management and the interested parties will not help much, if they are not drawn up properly and do not disclose the required information.

Without a proper system and control, the managements may conceal more than reveal in attempting at window dressing to cover up their inefficiency. They would like to project a better image of the performance of the undertaking and its financial position than what it really is. Such manipulations are referred to sarcastically as 'Creative Accounting'. It may be worthwhile to recall the constitution of the now famous Cadbury Committee on Corporate Governance in U.K. The committee was set up due to the general lack of confidence in accounting and other statements published even by very prominent companies in U.K. which subsequently collapsed. The concern was not so much on account of the collapse of these companies but, more importantly, these companies were perceived as very stable and strong companies and did not give any prior indication of the true state of their financial affairs even before their sudden failure. If this can happen in a developed country one can easily imagine the scenario in a country like ours. It did happen in our country also. When some companies failed and the manipulations and frauds came to light, the audited accounts published immediately before such failures were seriously questioned.

Due to the fact stated above, systematic and attempts on the part of regulatory authorities is coming out with more standards and compelling more disclosures in order to ensure transparency in financial statements resulting to improvement of the quality of information to many users. Corporates are also required to publish financial statements at more frequent intervals. While Companies Act requires annual reports, Securities Exchange Board of India (SEBI) requires corporate to publish quarterly results, although unaudited.

Legal framework

(1) The board of directors must present at every annual general meeting the following:

(a) a balance sheet at the end of the financial year, and

(b) a profit and loss account for that period.

A financial year may be more or less than a calendar year but it should not exceed 15 months. With special permission from registrar it may extend to 18 months. Companies normally prepare their accounts for the financial year ending with 31st March every year (S. 210).

(2) The profit and loss account and the balance sheet are prepared with the help of books of account kept by the company. Such books are required to be kept on accrual basis and according to the double entry system of accounting. (S. 209)

(3) Every balance sheet of a company must give a true and fair view of the state of affairs of

the company and must conform to either the horizontal or vertical form specified in the part I of Schedule VI to the Act. It must also comply with the general instructions given at the end of the part I. Every profit and loss account must give a true and fair view of the profit and loss of the company for the financial year and must also comply with the requirements of part II of the Schedule VI.

Financial statements must be prepared in accordance with accounting standards. These standards are prepared by the Institute of Chartered Accountants of India (ICAI) and are prescribed by the Government in consultation with the National Advisory Committee on Accounting Standards constituted under S. 210 (A) of the Act. Until the standards are prescribed by the Central Government the accounting standards specified by ICAI are applicable. Where the companies do not comply with the accounting standards such companies must disclose the following:

(a) The deviation from the accounting standards;

(*b*) The reasons for such deviation; and

*(c) T*he financial effect, if any, arising due to such deviation (S. 211)

(4) As per standard ASI (‘Disclosure of accounting policies’) all significant accounting policies adopted in the preparation and presentation of financial statements must be given at one place and form part of financial statements. In the published accounts significant accounting policies constitute one of the schedules to the profit and loss account and the balance sheet. Some companies also give it under notes to accounts.

(5) A holding company must give a statement disclosing its interest in the subsidiaries besides enclosing the financial statements and the reports of board of directors of such subsidiaries. (S. 212)

(6) Every balance sheet and profit and loss account of a company must be authenticated by its manager or secretary and by not less than two directors one of whom must be managing director if there is one. (S. 215)

(7) The financial statements must be accompanied by the report of the statutory auditor to the shareholders. The audit report must also be accompanied by the annexure as required by the Manufacturing and Other Companies (Auditor’s Report) Order 1988 issued by the Central Government in terms of S. 227 (4A) of the companies Act, 1956. (S. 216)

(8) Every balance sheet laid by the company at the annual general meeting must be accompanied by a report of the board of directors. (S. 217). The contents of this report are given later.

(9) All the above documents are known as published accounts / annual accounts and must be sent to every shareholder / trustees of debenture holders at least 21 days before the date of AGM. (S. 219)

(10) In addition to the above requirements annual accounts of listed companies will also in-

clude certain other statements in accordance with the requirements of listing agreement.

With a view to increase transparency, ensure good corporate governance and provide protection to investors SEBI has directed stock exchanges to introduce additional clauses in the listing agreement, which make the following statements mandatory.

Cash flow statement

A report on Corporate Governance

Management discussion and analysis

(11) Enlightened companies also include in the annual accounts much more information like 'financial highlights' for 5 to 10 years, important ratios, social responsibility statements etc. These aspects will be discussed in the next chapter.

(l2) Annual accounts listed in stock exchanges outside the country must satisfy the requirements of those stock exchanges. For example those companies listed in U.S.A report income as per GAAP followed in USA.

Preparation of financial statements - Statutory and accounting standard requirements.

Under the heading Legal Framework we have seen that financial statements must be prepared in accordance with the provisions of company and also comply with the Accounting Standards. In the company law schedule VI deals with the preparation of both the balance sheet and profit and loss account. Besides, there are number of Sections which have bearing on the ration of financial statements like 198,205, 349, 350 to mention a few. These will be dealt with at the appropriate place. With respect to accounting standards all accounting standards specified by ICAI have to be complied till the Government prescribe the standards. It has been made mandatory for the directors to give a responsibility statement stating that applicable accounting standards have been followed. They must also state that accounts are prepared on going concern basis. We will discuss the relevant accounting standards on the preparation of statements at the appropriate place.

Meaning of 'True and fair view'.

True and fair does not mean conforming to the forms prescribed by the Act. True and fair view can be obtained only if annual accounts are prepared in a defined manner as laid down by various accounting standards and in conformity with the Generally Accepted Accounting Principles (GAAP). Although managers prepare the accounts to reflect a true and fair view according to their opinion, ultimately it must be to the satisfaction of the auditor, as he is the person concerned to give the certificate that the statements reflect a true and fair view of the state of affairs of the company. If he is not satisfied he would give only a qualified report.

The term 'true and fair' has not been defined in law nor is defined by any accounting standard. However, it may be presumed that the financial statements reflect a 'true and fair view' if the following requirements are met:

a) The statements are drawn in accordance with the requirements of Parts I and II of Schedule VI of the Companies Act.

b) Proper books of accounts are maintained on double entry principles and following accrual basis of accounting.

c) Accounts are drawn up conforming to GAAP and the requirements of accounting standards.

d) Financial statements reflect substance of transactions and events that took place during the year.

e) Accounts disclose all information as required by the statutory auditor although some information may not be strictly required by law.

Accrual Basis

It is mandatory under the Companies Act for all companies to maintain their accounts on accrual basis and according to double entry system of accounting. Accrual basis as distinguished from cash basis recognizes revenues in the period earned even if such revenues are not received in cash and similarly expenses are recognized in the period incurred in the process of generating revenues even if such expenses have not been paid. AS-1 on ‘Disclosure of Accounting Policies’ requires disclosure if fundamental accounting assumptions, viz., Going Concern, Consistency and Accrual are not followed. Implicit in this is that enterprises should follow these fundamental assumptions in the preparation of financial statements. In the previous para, the meaning of accrual is explained. The meaning of going concern is that the enterprise will continue operation for the foreseeable future. On that basis assets are valued. If there is a need or intention to liquidate the enterprise, the financial statements may have to be prepared on a different basis and, if so, the basis should be disclosed. Consistency lies in following consistently the same accounting policies from one period to another. However, accounting policies can be changed in exceptional circumstances such as legal compulsion or due to the requirement by an accounting standard.

(A) BALANCE SHEET

1. Balance sheet must be prepared in the prescribed form as set out in Part I of Schedule VI of the Companies’ Act, (Sec. 211). The Central Government may permit other forms either generally or in particular case. Under Schedule VI a company has the choice to choose either the horizontal form or vertical form. Almost all the companies prefer to report in vertical form as the horizontal form appears clumsy with all details stuffed under each heading. Both the forms have a column indicating the figures of the immediately preceding financial year in respect of each of the items shown in the balance sheet.

   This form does not apply to banking, insurance, and electricity companies which are governed by special statutes and the formats for financial statements are prescribed therein.

2. Companies while preparing the balance sheet must not only conform to the format but must also adhere to notes and general instructions given in the schedule. For instance the Department of Company Affairs (DCA) has stated that it would not be desirable to use

the general reserve for the purpose of redeeming the preference shares as long as there is a debit balance in the profit and loss account.

3. Vertical balance sheet which is very simple is supported by a number of schedules which give details under each of the items. The schedules giving such details, significant accounting policies and explanatory notes form an integral part of the balance sheet.

4. A footnote is added to the balance sheet to show separately contingent liabilities.

5. In addition to the balance sheet, companies are also required to give balance sheet abstract and company's general business profile in the prescribed format.

6. A skeleton summary of the horizontal balance sheet is given below followed by details to be given under each item. After that the two types of balance sheets, as prescribed in Part I of Schedule VI, are reproduced.

Horizontal Balance Sheet (in skeleton form)

Liabilities	Assets
(i) Share Capital	(I) Fixed Assets
(ii) Reserves and Surplus	(il) Investments
(iii) Secured Loans	(iii)Current Assets and Loans and Advances
(iv) Unsecured Loans	A. Current Assets
(v) Current Liabilities	B. Loans and Advances
and Provisions	
A. Current Liabilities	(iv) Miscellaneous Expenditure
B. Provisions	(v) Profit and Loss Account (debit balance)

Details in the Balance Sheet items

Share Capital

(i) Details of authorised, issued, subscribed and, called-up capital must be given separately with respect to preference and equity shares, the two types of shares, companies are permitted to issue.

(ii) From the called-up capital 'calls in arrears' must be deducted to arrive at paid-up capital. Calls in arrears must be separately shown for directors and others.

(iii) Forfeited shares balance, if any, after transferring profit on reissue to capital reserve, should be added to paid-up capital.

(iv) Shares allotted for consideration other than cash such as shares allotted to vendor companies in mergers and acquisitions in pursuance of takeover agreements must be disclosed by way of information under this head.

(v) Similarly particulars of bonus shares issued must be given. Sources from which bonus shares are issued, *e.g.*, capitalization of profits or reserves or from share premium account, must also be stated.

(vi) Terms and conditions of redemption/ conversion of preference shares along with the earliest date of redemption or conversion must be given. Particulars of any option on unissued share capital must be specified.

(vii) When a public issue is made, any money received will become part of share capital only after the allotment is made. Therefore, share application moneys and calls-in-advance must be shown separately. The ICAI has suggested that such amounts should be shown separately between 'share capital' and 'reserves and surplus'. However, excess application moneys received must be shown under current liabilities as these have to be repaid within a short period.

Reserves and Surplus

(i) Under this heading are shown the items reserves and surplus. Surplus refers to the credit balance in the profit and loss accounts after providing for appropriations such as dividends, reserves, etc. This item is available in future for distribution of dividends and any write-offs which the company may decide.

Reserves are of two types, namely capital and revenue reserves. Capital reserves are built up by appropriating capital profits such as profits on sale of assets, investments, on reissue of forfeited shares etc. These are not available for distribution as dividends. On the other hand revenue reserves are built up by appropriating revenue receipts or profits. These may again be classified into free reserves and specific reserves. Specific reserves are created for a specific purpose and the examples are dividend equalization reserve, debenture redemption reserve, etc. Some of the specific reserves such as investment allowance reserve, development allowance reserve, export incentive reserve may be called tax reserves as these are created under the Income Tax Act. They are also referred to as statutory reserves.

(ii) Details of reserves and surplus are to be shown under seven items provided under this heading. All additions and deductions since the last balance sheet must be shown under each of the specified heads.

(iii) A reserve is to be distinguished from reserve fund. The last item under this heading is 'Sinking Fund'. The word fund in relation to any reserve is specifically represented by earmarked investments.

(iv) If the profit and loss account is a credit balance it would be shown as surplus under this heading. On the other hand, if it is a debit balance the same should be deducted from the reserves. Although it is not specified, such deduction can only be from free reserves.

(v) In the case of the item 'Security Premium account' all details of utilization in the manner provided under Sec. 78 of the Companies Act must be shown in the year of utilization.

(vi) Debenture Redemption Reserve created as per SEBI guidelines is an example of specific revenue reserve.

Secured Loans

(i) Under this heading fully secured loan are shown. A fully secured loan is one where the market value of the security is more than the amount of loan. If the value of the security is less than the loan amount, the loan becomes partly secured. Unsecured part of such loan has to be shown under the next heading unsecured loans.

(ii) Interest accrued on loans should be included under the appropriate item under this head. If it relates to debentures then under debentures and similarly for other items.

(iii) If the loans are guaranteed by the directors or managers, details must be disclosed. If loans are from directors it should be shown separately.

(iv) Nature of security in each case is to be specified.

(v) Terms of redemption or conversion of debentures and earliest date of redemption to be stated.

(vi) If the assets are mortgaged in favour of a third party who had guaranteed the loan, such loan should also be classified as secured loan. The fact of mortgag ing the assets in favour of guarantor instead of the lender should be stated.

(vii) Future installments payable under hire-purchase agreements should be shownunder secured loans as a separate item.

(viii) Debentures guaranteed by Government are not a secured loan as no asset has been mortgaged against such a loan.

(ix) Application moneys received against a debenture issue pending allotment should be shown as short-term deposits.

Unsecured Loans

(i) These are loans for which no security has been provided for. In the case of partly secured loans that portion of the loan which is not covered by the secu rity win also appear under this heading. There are four items under this head, namely, (1) fixed deposits, (2) loans and advances, (3) short-term loans and advances, and (4) other loans and advances.

(ii) Short-term loans and advances are those which are due for payment within one year from the date of balance sheet. Normally such items are shown un der current liabilities. However, current liabilities are expected to be repaid from out of current assets. Because of this other condition probably these items are not shown under current liabilities.

Current Liabilities

(i) The ICAI 'Guidance note on terms used in Financial Statements' defines current liability as liability including loans, deposits, bank overdraft which falls due for payment in a

relatively short period, not more than twelve months. However, Schedule VI requires showing of short-term secured and unsecured loans under the appropriate heads and not under current liabilities. Again interest accrued and due with respect to secured and unsecured loans are also not shown under current liabilities but shown under the respective heads.

(ii) This heading provides for seven items. Acceptances are bills accepted by the enterprise and pending payment on the balance sheet date. The items sundry creditors include all liabilities arising out of the trading activities of the com pany and any other current liabilities fall under item (6) 'Other liabilities (if any).

(iii) The item 'Subsidiary Company' is to be used to reveal liabilities to a subsidiary for purchase of goods and services etc.

(iv) Advance payments include any payment received in advance against which goods are to be supplied or services are to be rendered in short run. Advances from customers, dealers etc. fall under this category.

(v) Unclaimed dividends. These are dividends in respect of which warrants have been issued to the shareholders but not yet encashed by the shareholders. These must be distinguished from unpaid dividends which mean dividends have been declared but not paid or the warrants and cheques in respect of that have not been issued. Both unclaimed dividends and unpaid dividends are to be shown as current liabilities.

(vi) Interest accrued on loans but not due should be shown under current liabilities. This happens when interest dates and balance sheet date do not coincide. For example if interest is payable on a loan on June 30, and December 31, and the balance sheet is prepared on March 31. Interest Payable from December 31, the last date of interest payment to March 31, the date of balance sheet represents interest accrued but not due. It becomes due only on the next interest date, viz. June 30.

Provisions

(i) Part III of Schedule VI defines a provision as any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. For example, a tax on current profits is a known liability but the amount cannot be determined exactly as the income tax officer may compute taxable income differently. Therefore, a provision is made for taxation. Part III also states that reserves do not include any such provisions. If the directors feel any such provision already made is in excess of the requirement such excess can be treated as reserve.

(ii) There are six items under this heading. While some provisions have been mentioned like provisions for taxation, proposed dividends, provision for contin gencies etc. there is a residuary item called "Other Provisions".

(iii) In the case of contingencies losses should be provided for if the two following conditions are satisfied:

(a) It is possible that future events will confirm, after taking into account any related recovery that an asset has been impaired or a liability has been incurred.

(b) A reasonable estimate of the resulting loss can be made.

All such amounts provided would appear under the heading provision for contingencies. Contingency is a condition or situation at the balance sheet date, the ultimate outcome of which resulting in gain or loss is known only on occurrence or non-occurrence of one or more uncertain future events. Disputed tax liabilities such as excise duty, sales tax, income tax are all example of contingencies. Where the amounts cannot be reasonably estimated, companies disclose them as contingent liabilities. Some of the contingencies can result in gains and such gains should not be recognized as per AS-4.

Contingent Liabilities

(1) According to Guidance note on Terms used in Financial Statements issued by ICAI, contingent liability means "an obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events". For example, there may be litigation against the company pending in a court, say, for breach of contract. It becomes a liability if the decision is against the company and the company is called upon to pay damages to the other party. On the other hand if the court holds that no breach has occurred there will be no liability, as the company need not pay any damages. Similarly a company may contest the assessments made by tax authorities in relation to excise duty, sales tax, income tax etc. In all such cases the amounts involved in the appeal are shown as contingent liabilities. However, the correct procedure would be to assess the legal proceedings and after obtaining the opinion of the lawyers make adequate provision if such opinion expresses that there is no strength in the appeal and the appeal is likely to be lost.

(2) Schedule VI classifies contingent liabilities under the following heads:

(i) Claims against the company not acknowledged as debts;

(ii) Uncalled liability on shares partly paid;

(iii) Arrears of fixed cumulative dividend;

(iv) Estimated amount of contracts remaining to be executed on capital account not provided for; and

(v) Other money for which the company is contingently liable. Under this head ing is to be shown the amount of any guarantees given by the company on behalf of directors or other officers of the company. Where practicable, the general nature and amount of each such contingent liability, if material, must also be specified.

With respect to contingencies, it is the accounting policy of many companies to provide for all known liabilities in the accounts, except liabilities of a contingent nature, which they disclose adequately at the foot of the balance sheet.

Fixed assets

(1) As per AS-10 'Accounting for Fixed Assets' a fixed asset is an "asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business." Even assets which are not legally owned but are held for the production of goods or services are shown under this heading. Examples are leasehold premises, and assets purchased under hire-purchase agreements. The latter are shown at cash price and the interest element is excluded from the value of assets.

   (1*a)* With AS 19 coming into force, assets leased will appear in the books of lessee and not lesser as the case before. Lessor will show in his books lease payments due under financial lease.

(2) Under this heading there are different categories starting with goodwill and ending with vehicles etc. Under each head the original cost, and additions thereto and deductions therefrom during the year and the total depreciation written off or provided to the end of the year are to be stated. It would be clumsy to show all the details in the balance sheet itself and therefore a separate schedule will provide such details.

(3) In ascertaining the cost of an asset all expenditure incurred in bringing it to present location and put it to working condition should be included. Thus costs of transportation, expenditure on trial runs should be capitalized. In the case of land and buildings amounts spent on registration, stamp duty paid, architects fees etc. are all capitalized.

(4) In the case of assets purchased with a liability in foreign currency outstanding, such liability may increase or decrease due to fluctuations in exchange rates. Such increase or decrease in liability is to be added or deducted from the assets concerned.

(5) Sometimes assets are written off due to a scheme of capital reduction or as a result of revaluation. In such cases every balance sheet (after the first balance sheet) subsequent to the reduction or revaluation must show the revised figures with the date of reduction in place of the original cost.

(6) Similarly, where sums have been added by writing up the assets, every balance sheet subsequent to such writing up must shown the increased figures with the date of the increase in place of the original cost. Each balance sheet for the first five years subsequent to the date of writing up must also show the amount of increase made.

(7) In every case where the original cost of the asset cannot be ascertained with out unreasonable expense or delay, the valuation shown by the books can be given. For this purpose, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off by way of depre ciation, and where such an asset is sold, the amount of sale proceeds shall be shown as a deduction.

Investments

(1) AS-13 defines investments as assets held by an enterprise for earning income by way of

dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Investments represent capital invested outside by an enterprise and they may be long-term or current investments. Current investments by its nature are readily realizable and are intended to be held for not more than one year. Investments other than current are considered to be long-term. This classification is very important as current investments are considered to be current in nature. Schedule VI does not require this classification. The schedule also leaves valuation to the company. A company can value the investments at cost or market value. The schedule was proposed to be amended in 1993 to make good the omissions but did not come through.

(2) The schedule requires investments to be shown under the following categories:

(i) Government or Trust securities;

(ii) Shares, debentures or bonds;

(iii) Immovable properties;

(iv) Capital of partnership firms.

(3) Shares, debentures and bonds held in subsidiary company must be separately shown.

(4) Company should disclose the nature of investment and the mode of valuation.

(5) The first two categories must be subdivided into quoted and unquoted and market value of quoted investments must be given.

(6) In the case of shares etc. details of fully-paid and partly-paid must be given.

(7) A statement of investments (whether shown under investment or under current assets as stock-in-trade) separately classifying trade investments and other investments should be annexed to the balance sheet, showing the names of body corporates in whose shares or debentures investments have been made and the nature and extent of investment so made in each such body corporate.

Trade investment means an investment by a company in shares or debentures of another company, not being its subsidiary, for the purpose of promoting trade or business of the first company. Trade investments are considered to be fixed assets.

(8) In the case of investments in partnership firms, the names of the firms, the names of all the partners, the total capital, and the shares of each partner must be given.

Current Assets and Loans and Advances

(1) This is a common heading to

(A) Current Assets, and

(B) Loans and Advances

(2) Cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business are defined as current assets (ICAI: Guidance Note on terms used in Financial Statements). Current assets are usually valued at lower of cost and net realizable value. However, the schedule does not specify the mode of valuation but requires disclosure of mode of valuation with respect to stores and spare parts, raw material, stocks, and work-in-progress. If in the opinion of the board of directors, any of the current assets does not have a value on realisation in the business at least equal to the amount at which it is stated, this fact must be disclosed.

(3) Sundry Debtors:

The following details must be shown:

a. Age-wise classification showing debts outstanding for a period of more than six months and other debts.

b. Classification based on security and recoverability: *(a)* Debtors considered good in respect of which the company is fully secured; *(b)* Debts considered good for which the company holds no security other than the debtor's personal security; *(e)* Debts considered doubtful or bad.

c. Related party debts and maximum outstanding: *(a)* Debts due by directors or other officers of the company or anyone of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated. *(b)* Debts due from other companies under the same management to be disclosed with the names of the companies. (c) The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note.

d. It is required to deduct provision for bad and doubtful debts from the sundry debtors. The provision should not exceed the amount considered doubtful or bad. Any surplus provision already created should be shown as 'Reserve for bad and doubtful debts' under the head 'Reserves and Surplus'.

(4) Bank balances

These are primarily classified into *(a)* balances with scheduled banks, and other banks. With respect to balances with scheduled banks details of current accounts, call accounts and deposit accounts should be given. With respect to other banks, the name of the banks together with nature of accounts should be given. If the directors or their relatives have interest in the non-scheduled bank wherein bank balances are maintained the same should be disclosed.

(5) Loans and advances

These are also broken into:

a. Advances and loan to subsidiaries;

b. Advances and loans to partnership firms in which the company or its subsidiary is a partner;

c. Bills of Exchange;

d. Advances recoverable in cash or kind or for value to be recovered, *i.e.*, rates, taxes, insurance etc.

e. Balance with customers, port trusts, etc. (where payable on demand).

f. Disclosure requirements of loans and advances are similar to that of sundry debtors.

Miscellaneous Expenditure

(1) The amounts are shown to the extent not written off or adjusted. The first item under this head is 'Preliminary Expenses'. These are also known as formation expenses and include legal costs in drafting the Memorandum and Articles, capital duty and other fees on registration, cost of printing memorandum, articles and the statutory books of the company and any other expenses associated with the formation of the company. These are normally written off against profits over a period of time. Until it is fully written off, the amount not written off appears under this head.

(2) Expenses associated with the issue of shares and debentures such as issue expenses, brokerage paid to brokers, underwriting commission paid to under-writers appears under this head. These can also be capitalized instead of showing as miscellaneous expenditure. When shares and debentures are issued at discount, the liability on account of share capital and debentures will appear at par value. However, cash received will be short of such liability and the difference being discount appears under this heading. Financial prudence requires such amount to be written off over a period.

(3) Interest paid out of capital during construction can either be capitalized or shown as miscellaneous expenditure. Most of the items coming under miscellaneous expenditure are deferred revenue expenses and must be written off over the period for which benefit is available. For example, debenture discount and issue expenses can be written off over the maximum period for which the debentures would be outstanding. The fact that the amount spent is large does not make expenditure deferred revenue expenditure. Such expenditure should benefit future period.

Profit and Loss Account

This represents accumulated losses. To the extent free reserves are available, such losses must be adjusted. When the reserves are not sufficient, the balance appears under this heading.

(Sec Sec. 211)

Schedule VI Part I

(Sec Sec. 211)

A— HORIZONTAL FORM OF BALANCE SHEET

Balance Sheet of ..... (Here enter the name of the company) as at .... (Here enter the date as at which the balance sheet is made out)

Figure for the previous year Rs.	Liabilities	Figure for the current the year Rs.	Figure for previous year Rs.	Assets	Figure for the current year Rs.
	Share Capital:			Fixed Assets:	

Authorized ... share of Rs. ... each.

Issued: (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class)... shares of Rs. ... each).

Subscribed: (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class... shares of Rs. ... each Rs. ... called up). Of the above shares... shares are allotted as fully paid-up pursuant to a contract without payments being received in cash. Of the above and the additions shares... shares are allotted as fully paid-up by way of bonus shares. (Specify the source from which bonus Shares are issued, *e.g.*, capitalization of profits or reserves or from share premium a/c). *Less:* Calls unpaid:

(i) By directors.

(ii) By others.

Add: Forfeited shares: (amount originally paid up) (Any capital profit on reissue of forfeited shares should be transferred to capital reserve).

Distinguishing as far as possible between expenditure upon:

(a) Goodwill

(b) Land

(c) Buildings

(d) leasehold

(e) Railway sidings,

(f) plant and machinery

(g) furniture and fittings

(h) development of prop

(I) patents, trade marks

(j) livestock,

(k) Vehicles, etc

Notes:

(1)Under each head the original cost and the additions thereto and deductions there from during the year, and the total depreciation written off or provided up to the end of the year are to be stated.

1. Terms of redemption or conversion (if any) of any redeemable preference capital are to be stated together with earliest date of redemption or conversion.
2 Particulars of any option on unissued share capitals are to be specified.
3. Particulars of the different classes of Preference shares are to be given.
4. In the case of subsidiary companies the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated.

   The Auditor is not required to certify the correctness of such shareholdings as certified by the management.

Reserves and Surplus:

1. Capital reserves
2. Capital redemption reserve
3. Share premium account (showing details of its utilisation in the manner provided in Sec. 78 in the year of utilisation).
4. Other reserves specifying the nature of each reserve and the amount in respect thereof. *Less:*Debit balance in profit and loss account (if any) (The debit balance in the profit and loss account shall be shown as a deduction from the uncommitted reserves, if any).
5. Surplus, *i.e.*, balance in profit and loss ount after providing for proposed allocations namely dividend bonus or reserves.
6. Proposed additions to Reserves
7. Sinking Funds.

Secured Loans:

1. Debentures.
2. Loans and advances from banks.
3. Loans and advances from subsidiaries
4. Other loans and advances

(2)Where the original cost aforesaid and additions and deductions thereto, relate to any fixed assets which has been acquired in a country outside India, and in consequence from a country outside India, and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment, towards the whole or a part of the cost of the asset or for the repayment of the whole or part of moneys borrowed by the Company from any person, directly or indiectly in any foreign currency specially for the purpose of acquiring the asset (being in either cases the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability is so increased or reduced during the year, shall be added to, or, as the case may be, deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed asset.*Explanation.* (1) In this paragraph unless the context otherwise requires, the expressions rate of exchange, foreign currency and Indian currency shall have the meanings respectively assigned to them under sub-section (1) of Section 43A of the Income- tax Act, 1961 and explanation 2 and explanation 3 of the said subsection shall, as far as may be, apply in relation to the same paragraph as they apply to the said sub-section (2) In every case where the original cost cannot be ascertained without unreasonable expense or delay, thevaluation shown by the books is to be given. For the purpose of this paragraph, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold the amount of sale proceeds, shall be shown as

Notes:

(1) Loans from directors and manager shouldbe shown separately.

(2) Interest accrued and due on secured loans should be included under the appropriate subheads under the head secured loans.

(3) The nature of security to be specified in each case.

(4) Where loans have been guaranteed by managers and/or directors,a mention thereof shall also be made and also the aggregate amount of such loans under each head.

(5) In case of debentures, terms of redemption or conversion (if any) are to be stated together with earliest date of redemption or conversion.

Unsecured Loans:

1.Fixed deposits.

2.Loans and advances from subsidiaries.

3. Short-term loans and advances:

(a) From Banks.

(b) From others.

(Short-term loans include those which are due

or repayment not later than one year as at the date of the balance sheet.]

4.Other loans and advances;:

(a) From banks.

(b) From others.

Notes:

(1) Loans from directors and manager should

be shown separately.

(2) Interest accrued and due on unsecured loans should be included under the appropriate subheads under the head Unsecured Loan.

(3) Where any sum have been written off on a reduction of capital or revaluation of assets, every balance sheet subsequent to such reduction or revaluation must show the reduced figures and the date of the reduction. For a period of Five years, the amount of the reduction made shall also be stated. Similarly, where sums have been added by writing up the asset, each subsequent balance sheet, should show the increased figures with the date of the increase. For a period of five years, the amount increase shall also be stated.

Investments:

Showing nature of investment and mode of valuation, for example, cost or market value, and distinguishing between.

1. investments in government or trustsecurities.
2. Investments in shares, debentures or bonds. (Showing separately shares, fully paid-up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies).
3. Immovable properties.
4. Investment in the capital of partnership firms.
5. Balance of unutilised monies raised by issue.

Note:

(1) Aggregate amount of company's quoted investments and also the market value thereof shall be shown.

(2) Aggregate amount of company's unquoted investments shall also be shown.

All unutilised monies out of the issue must be separately disclosed in the balance sheet of the company indicating the form in which such unutilised funds have been invested.

(3)Where loans have been guaranteed by manager, and / or directors, mentions thereof shall also be made together with the aggregate amount of such loans under each head. This does not apply to fixed deposits

Current Liabilities and Provision:

A. Current Liabilities

1.Acceptances.

2.Sundry creditors.

(i)Total outstanding dues of small scale industrial undertaking (s); and (ii)total outstanding dues of creditors other than small scale industrial undertaking (s).

3.Subsidiary companies.

4.Advance payments and unexpired discounts for the portion for which value has still to be given, e.g., in the case of the following companies; Newspaper, fire insurance. theatres, clubs, banking, steamship companies etc.

5. Unclaimed dividends

6. Other liabilities (if any)

7. Interest accrued but not due on loans. The name(s) of the small scale industrial unertakings(s) to whom the company owe a sum exceeding Rs.1 lakh which is outstanding for more that 30 days are to be disclosed.

B. Provisions

8. Provisions for taxation.

9. Proposed dividends.

10. For contingencies.

11. For provident fund scheme.

12. For insurance, pension and similar staff benefit schemes.

13. Other provisions.

A footnote to the balance sheet may be added to show separately:

Current Assets, Loans and Advances:
(A) Current Assets:

1. Interest accrued on investments.

2. Stores and spare parts.

3.Loose tools

4.Stock-in-trade.

5.Works-in-progress,

Notes:

(1) In respect of(2) and (4), mode ofvaluation of stock shall be stated and the amount in respect of raw materials shall alsobe stated separately wherepracticable. (2) Mode of valuation of works-in-progress shall be stated.

6.Sundry debtors:

(a) Debtors outstanding for a period

exceeding six months.

(b) Other debts

Less: Provision.

Nots:

In regard to sundry debtors particulars to be given separately of—

(a) debtors considered good and in respect of which the company is fully secured;

(b) debts considered good for which the company holds no security other than the debtors personal security; and (c) debts considered doubtful or bad. Debt due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated.

Debts due from other companies under the same management within the meaning of subsection (IB) of Sec. 370 to be disclosed with the name of the companies. The maximum

1. Claims against the company not acknow ledged as debts.
2. Uncalled liability on shares partly paid.
3. Arrears of fixed cumulative dividends. [The period for which the dividends are in arrear or if there is more than one class of shares, the dividends on each such class are in arrear shall be stated. The amount shall be stated before deductions of income tax, except that in the case of tax-free dividends the amount shall be shown free of income-tax and the fact that it is so shown shall be stated.]
4. Estimated amount of contracts remaining to be executed on capital account and not provided for.
5. Other moneys for which the company is contingently liable.

[The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and, where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified.]

amount due by directors or other officers of the company at any time during the year to be shown by way of a note. The provision to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such provision, if already created, should be shown at every closing under Reserves and Surplus (on the Liabilities side) under a separate subhead [Reserve for Doubtful or Bad Debts.]

7 A. Cash balance on hand.

7 B. Bank balances-

(a) With scheduled banks.

(b) With others.

Notes:

[In regard to bank balances particulars to be given separately-

(a) the balance lying with scheduled banks on current accounts, call accounts and deposit accounts;

(b) the names of the bankers other than scheduled banks and the balances lying with each such banker on current account, call account and deposit account and the maximum amount outstanding at any time during the year with each such banker; and

(c) the nature of the interest, if any, of any director or his relative in each of the banks (other than scheduled banks referred to in (b) above.)

(B)Loans and Advances:

(8) (a) Advances and loans to subsidiaries.

(b) Advances and loans to partnership firms in which the company or any of its subsidiaries is a partner

(9) Bill of exchange.

(10) Advances recoverable in cash or in kind or for value to be received, e.g., rates, taxes, insurance, etc.

(11) Balance with Customs, Port Trust, etc. (where payable on demand).

Notes:

The instructions regarding sundry debtors apply to Loans and Advances also.

Miscellaneous Expenditure:(to the extent not written off or adjusted):

(1) Preliminary expenses.

(2) Expenses including commission or brokerage on underwriting or subscription of shares or debentures.

(3) Discount allowed on the issue of shares or debentures.

(4) Interest paid out of capital during construction (also stating the rate of interest)

(5) Development expenditure not adjusted.

(6) Other sums (specifying nature).

Profit and Loss Account

[Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any.]

B. VERTICAL FORM

Name of the Company

Balance Sheet as at ....

1	2	*Schedule No.* 3	*Figures as at the end of current financial year* 4	*Figures as at the end of previous financial year* 5
I.Sources of Funds				
(1) Shareholders' funds:				
(a) Capital				
(b) Reserve and surplus				
(2)Loan funds:				
(a) Secured loans				
(b) Unsecured loans				
TOTAL				
II. Application of funds				
(1) Fixed assets:				
*(a)*Gross: block				
(b) Less: Depreciation				
(c) Net block				
(d) Capital work-in-progress				
(2)Investments				
(3)Current assets, loans and advances:				
(a) Inventories				
(b) Sundry debtors				
(c) Cash and bank balances				
(d) Other current assets				
(e) Loans and advances				
Current Liabilities and provisions:				
(a) Liabilities				
(b) Provisions				
Net current assets				
(4)***(a)***Miscellaneous expenditure to the extent not written off or adjusted				
(b) Profit and loss account				
TOTAL				

Notes:

(1) Details under each of the above items shall be given in separate schedules. The schedules shall incorporate all the information required to be given under Part 1A of the Schedule VI read with notes containing general instructions for preparation of Balance Sheet.

(2) The schedules, referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet.

(3) The fig in the balance sheet may be rounded off to the nearest '000 0r '00 as may be convenient or may be expressed in terms of decimals of thousand.

AMENDMENT IN SCHEDULE VI

As amended in May 15 1995, the central Government hereby makes the following amendments in the Schedule VI of the Companies Act 1956 which came into force from the date of publication of the notification.

Under this amendment, in the Schedule VI, the following shall be inserted.

Part IV

Balance Sheet Abstract And Company's General Business Profile.

I.	Registration Details				
	Registration No.			State Code	
	Balance Sheet				
	Date				
		Date	Month	Year	
II.	Capital Raised during the year (Amount in Rs thousand)				
		Public Issue			Rights Issue
		Bonus Issue			Private Placement
III.	Position of Mobilisation and Deployment of Funds (Amount in Rs Thousands)				
		Total Liabilities			Total Assets
	Sources of Funds	Paid up Capital			Reserves and Surplus
		Secured Loans			Unsecured Loans

	Application of Funds	Net Fixed Assets	Investments
		Net Current Assets	Misc. Expenditure
		Accumulated Losses	
IV	Performance of the Company (Amount in Rs Thousands)		
		Turnover	Total Expenditure
		Profit /loss Before Tax	Profit /loss After Tax
	+ -		+ -
	(Please tick appropriate box + for profit, - for Loss)		
		Earnings per Share in Rs	Dividend
V	Generic Names of Three Principal Products / Services of Company		
	(As per Monetary Terms)		
	Item Code No.		
	(ITC Code)		
	Product Description		
	Item Code No.		
	(ITC Code)		
	Product Description		

	Item Code No.																				
	(ITC Code)																				
	Product Description																				

Note: For ITC Code of Products one may refer to the publication Indian Trade classification based on harmonized commodity description and coding system by Ministry of Commerce, Directorate General of Commercial Intelligence & Statistics, Calcutta-700001.

State Codes

Code	***State Name***	***Code***	***State Name***
01	Andhra Pradesh	02	Assam
03	Bihar	04	Gujarat
05	Haryana	06	Himachal Pradesh
07	Jammu & Kashmir	08	Karnataka
09	Kerala	10	Madhya Pradesh
11	Maharashtra	12	Manipur
13	Meghalaya	14	Nagaland
15	Orissa	16	Punjab
17	Rajasthan	18	Tamil Nadu
20	Uttar Pradesh	21	West Bengal
22	Sikkim	23	Arunachal Pradesh
24	Goa	52	Andaman Islands
53	Chandigarh	54	Dadra Islands
55	Delhi	56	Daman & Diu
57	Lakshwadeep	58	Mizoram
59	Pondicherry		

(B) PROFIT AND LOSS ACCOUNT

(1) According to Sec. 211 of the Companies' Act every Profit and Loss Account of a company should give a 'true and fair' view of the net profit or net loss of the company. The meaning of 'true and fair' view has been explained while discussing the requirements of balance sheet.

(2) While Sec. 211 requires the preparation of balance sheet in the form given in Schedule VI, no form has been prescribed for the profit and loss account. It is left to the company to present the profit and loss account in a form which satisfies the requirements of Part II of Schedule VI, reporting requirements of AS-5 on 'Net Profit or Loss for the Period, Prior Period items, and changes in Accounting policies, and present a 'true and fair view' of the state of affairs of the company'.

(3) As in the case of balance sheet, profit and loss account may be prepared either in horizontal or vertical form. Almost all companies prepare the profit and loss account in vertical form as it is easy to understand by the users and the details can be shown in schedules so that the main account would be simple to follow. In the case of horizontal form which the students of accountancy popularly use, the account is divided into two sections-one called 'above the line' and the second called 'below the line'. In the first section are shown all revenues and expenses leading to the preparation of current year's profit. In the section below the line which is also called the profit and loss appropriation account are shown retained profits brought forward from earlier years, current profits brought down on the credit side and on the debit side all appropriation such as dividends proposed, transfers to reserves, sinking funds etc. together with the balance carried forward as retained earnings to the next year. Because of this it is also referred to as 'statement of retained earnings'. Adjustments relating to prior period are also shown below the line.

(4) Except in the case of the first profit and loss account, every other profit and loss account must show the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account.

(5) Part II of Schedule VI has laid down a number of requirements in the matter of the preparation of profit and loss account. Special mention must be made of item (2) of Part II of Schedule VI. It states that the profit and loss account must be so prepared as to closely disclose the results of the working of the company during the period covered by the account and must disclose every material feature, including credits or receipts and debits or expenses in respect of nonrecurring transactions or transactions of exceptional nature. This requirement and in general the reporting requirements of profit and loss account has been taken care of by AS-5. The summary requirements of AS-5 follow Part II of Schedule VI. A suggested vertical format of profit and loss account which takes care of the requirements of the Companies' Act as well as the requirements of AS-5 is given for the guidance of the student. However, there is no rigidity about the form and it should cater to the requirements of each company as well as the requirements of the Companies' Act and the accounting standard AS-5.

PART II SCHEDULE VI

REQUIREMENTS AS TO PROFIT AND LOSS ACCOUNT

1. The provision of this Part shall apply to the income and expenditure account referred to in sub-section (2) of Sec. 210 of the Act, in like manner as they apply to a profit and loss account, but subject to the modification of references as specified in that sub-section.

2. The profit and loss account

(a) Shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account; and

(b) Shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.

3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads; and in particular, shall disclose the following information in respect of the period covered by the account:

(i) (a) The turnover, that is, the aggregate amount for which sales are effected by the company, giving the amount of sales in respect of each class of goods dealt with by the company, and indicating the quantities of such sales for each class separately.

(b) Commission paid to sole selling agents within the meaning of Sec. 294 of the Act.

(c) Commission paid to other selling agents.

(d) Brokerage and discount on sales, other than the usual trade discount.

(ii) In the case of manufacturing companies,

(1) The value of the raw materials consumed, giving item-wise break-up and indicating the quantities thereof. In this break-up, as far as possible, all important basic raw materials shall be shown as separate items. The intermediates or components procured from other manufacturers may, if their list is too large to be included in the break-up, be grouped under suitable headings without mentioning the quantities, provided all those items which in value individually account for 10% or more of the total value of the raw material consumed shall be shown as separate and distinct items with quantities thereof in the break-up.

(2) The opening and closing stocks of goods produced, giving break-up in respect of each class of goods and indicating the quantities thereof.

a) In the case of trading companies, the purchases made and the opening and closing stocks, giving break-up in respect of each class of goods traded in by the company and indicating the quantities thereof.

b) In the case of companies rendering or supplying services the gross income derived from services rendered or supplied.

c) In the case of a company, which falls under more than one of the categories mentioned in *(a)*, *(b)* and *(c)* above, it shall be sufficient compliance with the requirements herein if the total amounts are shown in respect of the opening and closing stocks, purchases, sales and consumption of raw material with value and quantitative break-up and the gross income from services rendered is shown.

d) In the case of other companies, the gross income derived under, different heads.

Note 1: The quantities of raw materials, purchases, stocks and the turnover, shall be expressed in quantitative denominations in which these are normally purchased or sold in the market.

Note 2: For the purpose of items *(ii) (a)*, *(ii)(b)* and *(ii)(d)*, the item for which the company is holding separate industrial licences, shall be treated as separate classes of goods, but where a company has more than one industrial licence for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licenses shall be treated as one class. In the case of trading companies, the imported items shall be classified in accordance with the classification adopted by the Chief Controller Imports and Exports in granting the import licences.

Note 3: In giving the break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10% or more of the total value of the purchases, stocks, or turnover, as the case may be, are shown as separate and distinct items with quantities thereof in the break-up.

(iii) In the case of all concerns having works in progress, the amounts for which such works have been completed at the commencement and at the end of the accounting period.

(iv) The amount provided for depreciation, renewals or diminution in value of value of fixed assets.

If such provision is not made by means of a depreciation charge, the method adopted for making such provision.

If no provision is made for depreciation, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with Sec. 205(2) of the Act shall be disclosed by way of a note.

(v) The amount of interest on the company’s debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any, paid or payable to the managing director and the manager, if any.

(vi) The amount of charge for Indian income-tax and other Indian taxation on profits, including, where practicable with Indian income-tax, any taxation imposed elsewhere to the

extent to the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.

(vii) The amounts reserved for

(a) Repayment of share capital; and

(b) Repayment of loans.

(viii) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist as the date as. at which the balance sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(ix) (a) The aggregate, if material, of any amounts set aside to provisions made for meeting specific liabilities contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(x) Expenditure incurred on each of the following items, separately for each item:

(a) Consumption of stores and spare parts.

(b) Power and fuel.

(c) Rent.

(d) Repairs to buildings.

(e) Repairs to machinery.

(f) (1) Salaries, wages and bonus.

(2) Contribution to provident and other funds.

(3) Workmen and staff welfare expenses to the extent not adjusted from any previous provision or reserve.

Note 1: Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account.

(g) Insurance.

(h) Rates and taxes, excluding taxes on income.

(i) Miscellaneous expenses:

Provided that any item under which the expenses exceed 1 per cent of the total revenue of the company or Rs. 5,000, whichever is higher, shall be shown as a separate and distinct item against an appropriate account head in the Profit and Loss Account and shall not be combined with any other item to be shown under 'Miscellaneous expenses'.

*(xi) (*a) The amount of income from investments, distinguishing between trade investments and other investments.

(b) Other income by way of interest, specifying the nature of the income.

(c) The amount of income tax deducted if the gross income is stated under sub-paragraphs (a) and (b) above.

(xii) (a) Profits or losses on investments showing distinctly the extent of the profits or losses earned or incurred on account of membership of a partnership firm to the extent not adjusted from any previous provision or reserve.

Note: Information in respect of this item should also be given in the balance sheet under the relevant provision reserve account.

(b) Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount.

(c) Miscellaneous income.

(xiii) *(a)* Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(xiv) The aggregate amount of the dividends paid, and proposed, and stating whether such amounts are subject to deduction of income-tax or not.

(xv) Amount, if material by which any items shown in the profit and loss accounts are affected by any change in the basis of accounting.

4. The profit and loss account shall also contain or given by way of a note detailed information, showing separately the following payments provided or made during the financial year to the directors including managing directors or manager, if any, by the company, the subsidiaries of the company and any other person;

(1)Managerial remuneration under Sec. 198 of the Act paid or payable during the financial year to the directors (including managing directors, or manager, if any;

Clauses (ii) to *(vi)* relating to managing agents omitted by notification No. GSR 78 dated 4-1-1963.

(vii) any other perquisites or benefits in cash or in kind (stating approximate money value where practicable);

*(viii)*pensions, etc.,

(a) pensions,

(b) gratuities,

(c) payments from provident funds, in excess of own subscriptions and interest thereon,

(d) compensation for loss of office,

(e) consideration in connection with retirement from office.

4A. The profit and loss account shall contain or give by way of a note a statement showing the computations of net profits in accordance with Sec. 349 of the Act with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors including managing director, or manager (if any).

4B. The profit and loss account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, whether as fees, expenses or otherwise for services rendered

(a) as auditor;

(b) as adviser, or in any other capacity, in respect of

(i) taxation matters;

(ii) company law matters;

(iii) management services; and

(c) in any other manner.

4C. In the case of manufacturing companies, the profit and loss account shall also contain, by way of a note in respect of each class of goods manufactured, detailed quantitative information in regard to the following, namely:

(a) the licensed capacity (where license is in force);

(b) the installed capacity; and

(c) the actual production.

Note 1: The licensed capacity and installed capacity of the company as on the last date of the year to which the profit and loss account relates, shall be mentioned against items *(a)* and *(b)* above, respectively.

Note 2: Against item *(e)*, the actual production in respect of the finished products meant for sale shall be mentioned. In cases where semi-processed products are also sold by the company, separate details thereof shall be given.

Note 3: For the purposes of this paragraph, the items for which the company is holding separate industrial licenses shall be treated as separate classes of goods but where a company has more than one industrial license for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class.

4D. The profit and loss account shall also contain by way of a note the following information, namely:

(a) value of imports calculated on C.I.F. basis by the company during the financial year in respect of:

(i) Raw materials;

(ii) Components and spare parts;

(iii) Capital goods;

(b) expenditure in foreign currency during the financial year on account of royalty, known-how, professional and consultation fees, interest, and other matters;

(c) value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) the amount remitted during the year in foreign currencies on account of dividends with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and year to which the dividends related; .

(e) Earnings in foreign exchange classified under the following heads, namely:

(i) Export of goods calculated on F.O.B. basis;

(ii) Royalty, know-how, professional and consultation fees;

(iii) Interest and dividends;

(iv) Other income, indicating the nature thereof.

5. The Central Government may direct that a company shall not be obliged to show the amount set aside the provisions other than those relating to depreciation renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.

6. (1) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account.

(2) The requirement in sub-clause (1) shall, in the case of companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period which ended on the corresponding date of the previous year.

INCOME STATEMENT-REPORTING REQUIREMENTS

The Companies Act does not prescribe any format for the profit and loss account. It is left to the individual company to choose one, which is appropriate for its requirements. However, Part II of Schedule VI of Companies Act lays down certain requirements, which, every company should satisfy. In particular, every profit and loss statement should satisfy the following:

(a) Disclose clearly the results of the working of the company during the period covered by the account, and

(b) Must disclose every material feature including revenue and expenses in respect of non-recurring transactions or transactions of an exceptional nature.

Part II of Schedule VI is also very elaborate about the details to be given by profit and loss account which have been mentioned earlier and therefore are not repeated here.

Besides Companies Act, the profit and loss statement should also comply with the accounting standards on the subject. In our country AS-5 in particular has a bearing on the preparation and presentation of the items in the statement. In brief the requirements” of the standard are:

(1) Extraordinary Items. Profit and loss account should disclose net profit or loss separately for ordinary activities and extraordinary items. The nature and amount of each extraordinary activity should be disclosed separately, so that its impact on profit and loss can be perceived. However, these items although separately stated are part of the net profit or loss.

An item to be called an extraordinary item must satisfy both the features listed below:

(a) It should arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise, and

(b) The events are not expected to occur frequently or regularly. The standard gives the examples of attachment of property of an enterprise or an earthquake as extraordinary events. Some of the events mentioned in the annual reports as extraordinary are given below:

(i) Restructuring of business.

(ii) Sale of segments of business.

(iii) Write of goodwill arising out of purchase of business.

(iv) Compensation payments in accordance with non-competing agreements.

Ordinary activities. Profit or loss from some ordinary activities also warrant separate disclosure because of the size, nature or incidence of such activities. Examples of such activities are:

(i) The write down of inventories to net realizable value as well as the reversal of such write-downs;

(ii) Disposal of items of fixed assets;

(iii) Disposals of long-term investments;

(iv) Legislative changes having retrospective applications;

(v) Litigation settlements; and

(vi) Other reversals of provisions.

Prior Period items. These are items of income or expenses which arise in the current period as a result of errors or omissions in the presentation of financial statements of one or more prior periods. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight. The standard requires separate disclosure of prior period items ~n the profit and loss account. So the people can perceive the impact of such items on current profit.

It would be better to show prior period items after the determination of current profit or loss although such items are normally included in the determination of current profit or loss. Examples of prior period items are tax adjustments relating to previous years, adjustments due to over or understatement of inventories of earlier years etc.

Changes in Accounting Estimates. In the preparation of accounts many accounting estimates have *to* be made, such as bad debts, obsolescence of inventory, economic lives of the assets for determining depreciation etc. Such estimates may have to be revised subsequently because of the availability of more accurate information. The revision of the estimate, by its nature, does not bring the adjustment within the definition of an extraordinary item or a prior period item.

The effect of a change in the accounting estimate should be included in the determination of the net profit or loss in:

(a) the period of the change, if the change affects the period only; or

(b) the period of the change and future periods, if the change affects both.

A change in the estimate of the bad debts if immediately made affects the current period only, whereas a revision in the estimate of the economic life of an asset affects both the current year as well as the future periods.

The nature and amount of a change in an accounting estimate which has material effect in the current period, or is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Change in Accounting Policies. In order to ensure comparability of financial statements by users there should be consistency in the adoption of accounting policies. However, a change in the accounting policy should be made in the following cases:

(a) a different accounting policy is required by statute;

(b) to comply with an accounting standard;

(c) change would result in more appropriate presentation of the financial statements of the enterprise.

Any change in the accounting policy which has a material effect should be disclosed. The impact of and the adjustments resulting from such change, if material should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Format for Profit and Loss Account

In view of the above requirements of the accounting standards as well as the requirements of the Companies' Act the following summarized Profit and Loss Statement in vertical form is suggested for adoption. However, each item in the profit and loss account should be accompanied by supporting schedules which will give more details.

______ Limited

Profit and Loss Account

for the year ended _______

	Schedule year	*Current year*	*Previous year*
Income			
Sales	1	xxxx	xxxx
Other Income	2	xxxx	xxxx
Increase / Decrease in Work-in-progress			
/ Finished Stocks	3	xxxx	xxxx
Total		xxxx	xxxx
Expenditure			
Cost of Raw materials and Spares	4	xxxx	xxxx
Excise Duty		xxxx	xxxx
Employees' Remuneration & Benefits	5	xxxx	xxxx
Other Expenses	6	xxxx	xxxx
Interest	7	xxxx	xxxx
Depreciation	8	xxxx	xxxx
Total		xxxx	xxxx
Profit Before Taxation & Extraordinary Items		xxxx	xxxx
Extraordinary Item	9	xxxx	xxxx
Profit for the Current Year		xxxx	xxxx
Prior Period Adjustments	10	xxxx	xxxx
Profit before Taxation		xxxx	xxxx
Provision for Taxation		xxxx	xxxx
Profit After Tax		xxxx	xxxx
Balance B / F from the Previous Year		xxxx	xxxx
Total available for Appropriations		xxxx	xxxx
Appropriations		xxxx	xxxx
Proposed Dividend		xxxx	xxxx
Corporate Dividend on Taxes (CDT)*		xxxx	xxxx
Debenture Redemption Reserve		xxxx	xxxx
General Reserve		xxxx	xxxx
Any other Statutory Reserves			
Balance c / f *to* next year		xxxx	xxxx
Total of Appropriations & Balance c / f		xxxx	xxxx

Notes to the Format

(1) Profit and Loss Account schedules are numbered after the schedules of balance sheet, and therefore start with higher numbers.

(2) In some annual reports adjustments relating to work-in-progress and finished stocks are carried to materials consumed.

(3) Under other expenses there can be more classifications such as manufacturing expenses, administration expenses, selling and distribution expenses, etc.

(4) Each schedule gives more details as the income statement avoids showing such details. For example sales may give details of sales by product and / or territory.

(5) The schedule of other income will show such items as profit on sale of fixed assets or investments and such other items.

(6) It may be noted that both extraordinary items and prior period items form part of current profits but they are shown separately so that the users can understand the impact of such items on current profit.

(7) In the preparation of profit and loss account each enterprise has a choice in accounting policies with respect to revenue recognition; inventory valuation, depreciation, foreign currency translation, valuation of investments etc. As per AS-1 every enterprise has to disclose significant accounting policies, as part of Annual Accounts. Generally a schedule to the accounts discloses the selected accounting policies.

(8) The change in any accounting policy and its impact on current profit will be mentioned only in the notes to accounts and will not be shown in the income statement.

BOARD OF DIRECTORS' REPORT (S. 217)

Every balance sheet laid before a company in general meeting must be accompanied by a report of its board of directors. The report must include the following:

(a) The state of the company affairs.

(b) The amounts directors wish to transfer to reserves.

(c) The proposed dividend as recommended by the board.

(d) Financial performance of the company during the year under review, outlining material changes and commitments having an impact on the financial position.

(e) The conservation of energy, technology absorption, foreign exchange earnings and outgo in such manner as may be prescribed. This report is normally given as an annexure to the

directors' report. The annexure is in accordance with Companies (Disclosure of Particulars in the Report of Board of Directors) Rules, 1988. These rules were framed as a result of an amendment to Companies Act in 1988 and came in to effect from 1.4.1989.

* This tax has been withdrawn by the Finance Act, 2002.

(f) Particulars of employees whose annual emoluments exceed a specified sum. (With effect from 12.3.99 the amount prescribed is Rs. 6,00,000). The statement should also disclose the names of the directors to whom any such employees are related.

(g) Directors' Responsibility statement. As a result of the Companies (Amendment) 2000 the directors' report must include a directors' responsibility statement including therein.

(i) That in the preparation of annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(ii) That the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit or loss of the company for the period;

(iii) That the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(iv) That the directors had prepared the annual accounts on a going concern basis.

(h) Reasons for the failure, if any, to complete the buy back within the time specified.

(i) The board must give full information and explanations on every reservation, qualification or adverse remark contained in the auditors report.

NOTING POINTS AT THE TIME OF PREPARING FINAL STATEMENTS

(A) General Points

(1) Although there is no restriction, it is usually seen that a company does not split its income statement into three parts, *i.e.*, trading account, profit and loss account and profit and loss appropriation account. The company prepares the profit and loss account only.

(2) The profit and loss account is usually divided into two parts-the first part for calculating profit or loss of the company and the second (popularly known as 'below the line') for appropriating the profit.

(3) In the case of a company it is essential to show the figures of the previous year on both sides of account.

(4) It is neither essential nor useful to write 'To' on the debit side and 'By' on the credit side of the profit and loss account.

(B) Some Adjustments

(1) Calls in arrear. This item generally appears in the trial balance. It represents the amount not paid by the shareholders on the calls made on them by the company. This is shown in the balance sheet on the liability side by deducting the amount from the called-up amount. If this item appears in the adjustment then the trial balance shows paid-up capital (not called-up capital). The amount is first added to paid-up capital to make the paid-up capital as called-up capital and then deducted again.

(2) Unclaimed dividend. This always appears on the credit side of trial balance. This represents dividend not collected by the shareholders. It is shown on the liability side of the balance sheet under the heading 'current liabilities'.

(3) Interim dividend. This item always appears in the trial balance and it represents dividend paid by the company before the Annual General Meeting and mostly based on half-yearly accounts. This is an appropriation of profit and is shown on the debit side of appropriation section of profit and loss account. The appropriation section of the profit and loss account is usually called 'profit and loss appropriation account'. We shall hereinafter use this term.

(4) Final dividend. Like item (3) it is also shown on the debit side of profit and loss appropriation account.

(5) Proposed dividend. This item is generally given under adjustments. This is shown on the debit side of profit and loss appropriation account and on the liability side of balance sheet under the heading 'Provisions'.

(6) Dividends received. These are dividends received on investments made in shares of other companies, and represent income on investment.

(7) Interest received. This is income being interest on monies lent on bank deposits. As per S. 194A of the Income Tax Act, 1961, tax is to be deducted at source. Where interest is payable to a domestic company tax is to be deducted, if any.

Let X Ltd received a gross interest of Rs. 12,000 and actually received net Rs. 9,900 after deducting tax at source. Then the entry will be.

Bank	Dr.	9,900
Tax deducted at source	Dr.	2,100
To Interest received		12,000

(8) Interest paid on money borrowed for construction. This is a capital expenditure and is capitalized by adding to the cost of asset. So long as this item is not adjusted, it is shown in the balance sheet on the assets side under the heading 'miscellaneous expenditure'.

(9) Interest on debentures. The company disbursing interest on debentures has the responsi-

bility of deducting tax at source. If a company is paying Rs. 50,000 by way of debenture interest and deducted tax at 10 % then the entry on payment will be:

Interest on debentures	Dr.	50,000	
To Bank			45,000
To Income tax payable			5,000

At the time of depositing the tax deducted from the payment the entry will be:

Income tax payable	Dr	5,000	
To Bank			5,000

(10) Discount and cost of issue of debentures. This includes discount, commission and other expenses on the issue of debentures. This appears on the assets side of balance sheet under the heading 'miscellaneous expenditure.' This expense is written *off* as prudently as possible but in no case should it be allowed to stand in the books after the life of debentures. The amount written *off* is shown on the debit side of profit and loss account and the unwritten off portion is shown in the balance sheet under the heading 'Miscellaneous expenditure'.

(11) Forfeited shares account. This appears on the credit side of trial balance and is shown on the liability side of the balance sheet by adding to the paidup capital under the heading subscribed capital.

(12) Securities premium account. This is shown tm tire liability side of the balance sheet under the heading 'Reserves and surplus'.

(13) Tax adjustments. In relation to corporate taxation, the following items to be considered:

(a) Tax deducted at source.

(b) Advance payment of tax.

(c) Income-tax (corporate tax).

(d) Provision for taxation.

(e) Deferred tax.

How these are to be dealt with

(a) ***Tax deducted at*** source. As per Section 194 of the Income-tax Act, 1961, tax is to be deducted at source from interest on securities before they are paid.

Thus the item 'Tax deducted at source' will appear on the debit side of the trial balance. The amount so deducted can later be adjusted towards income tax payable after the assessment is over.

(b) ***Advance payment of tax.*** Under Section 207 of the Income-tax Act, 1961, an assessee is liable to pay advance tax when the income exceeds a certain limit and the limit is Rs. 2,500 for companies. When the tax is so paid the following entry is made:

Advance payment of tax A/c	Dr
To Bank account	

This amount also appears on the debit side of a trial balance and is in the nature of a prepaid item. Advance payment of tax can later be adjusted towards income-tax payable after the assessment is over.

(c) ***Income-tax***. Tax payable on the assessed income is debited to income tax account. As stated earlier a company adjusts any tax paid in advance or deducted at source towards tax due. For example, if the tax payable on assessed income is Rs. 2,00,000 and it has already paid in advance Rs. 140,000, the company now pays Rs. 60,000 only. The entry will be:

		Rs.	Rs.
Income-tax account	Dr.	2,00,000	
To Advance payment of tax			140,000
To Bank			60,000

If the assessment is not completed both 'advance payment of tax' and 'tax deducted at source' remain unadjusted and would appear in the balance sheet under the heading 'Current Assets, Loan and Advances: (B) Loan and Advances'.

(d) ***Provision for taxation***. Since it would take quite some time for the company to get its income assessed, it is usual to provide some amount for income-tax on profits at current rates of taxation. Such provision is debited to the profit and loss account above the line and credited to 'provision for taxation account' which appears in the balance sheet under the head 'Current Liabilities and Provisions-B Provisions'.

Just as provision is made this year, provision would have been made the previous year and such provision called 'old provision' would appear in the trial balance on the credit side. When such a provision exists income-tax paid must be debited to the provision account and not to the profit and loss account. If the old provision is in excess of the income-tax paid, such surplus provision should be shown on the credit side of the profit and loss account below the line. Likewise, if the old provision is not sufficient, further debit is made to the profit and loss account below the line. These adjustments are shown below the line so that the current profits may not be affected due to these items.

Illustration

The trial balance of Karur Ltd. as at 31st March 2007 shows the following items.

Items	*Debit (Rs)*	*Credit (Rs)*
Advance payment of income-tax	140000	
Provision for taxation for the year ended 31-3-2006		100000

The following further information is given:

(i) Advance payment of income tax includes Rs.1,20,000 for 2005-06.

(ii) Actual tax liability for 2005-06 amounts to Rs. 1,32,000. No effect for the same has so far been given in the accounts.

(iii) Provisions for income tax has to be made for 2006-07 for Rs.1,80,000.

You are required to pass the necessary journal entries and show the relevant accounts. Also show how these items will appear in the profit and loss account and balance sheet for the year 2007.

Solution.

Journal

Date	*Particulars*		*Debit Rupees*	*Credit Rupees*
31-3-07	Income-tax account	Dr.	1,32,000	
	To Advance payment of income-Tax			1,20,000
	To Tax payable account			12,000
	(Being the tax liability for 2005-06 and the tax Payable after adjusting advance payment of tax			
31-3-07	Provision for taxation (2005-06) a/c	Dr.	1,00,000	
	Profit and loss appropriation AI c	Dr.	32,000	
	To Income-tax account			1,32,000
	(Tax for 06-07 adjusted against the provision)			
31-3-07	Profit and loss account	Dr.	1,80,000	
	To provision for taxation account (06-07)			1,80,000

Ledger

Dr. Income-tax Account (2005-06) Cr

To Advance payment of income-tax a/c	1,40,000	By Provision for taxation a/c	1,20,000
To Liability for taxation a/c	12,000	By Profit and loss appropriation a/c (2006-07)	32000
	1,52,000		1,52,000

Profit and Loss Account For the year ended 31-3-07 (extracts)

	Rs.
Profit before taxation	xxxxx
Less: Provision for taxation	1,80,000
Profit after taxation for the year	xxxxx
Less: Appropriations	
Excess of income-tax over provision (2006-07)	32,000

Karur Ltd.

Balance sheet as at 31-3-07 (extracts)

Liabilities	*Rs*	Assets-	*Rs*
Current liabilities and provisions		- Current assets, loans and advances	
Current Liabilities		Advance payment of income-tax	1,20,000
Liability for taxation (2006-07)	12,000		
Provision for taxation (2006-07)	1,80,000		

DEFERRED TAXES

Taxable Income and Accounting Income

While preparing the profit and loss account, tax on profits is estimated and a provision is made for such tax. The current practice has been to make such a provision on the taxable income. AS 22 'Accounting for taxes on income' defines taxable income as the amount of income (loss) for a period determined in accordance with the tax laws based upon which income tax is payable (recoverable) is determined. Tax based on taxable income is known as the 'current tax'. The standard defines current tax 'as the amount of income tax determined to be payable (recoverable) in respect of taxable income (tax loss) for a period.

Accounting income is different from taxable income. The standard defines 'accounting income' as the net profit or loss for a period, as reported in the statement of profit and loss before deducting income tax or adding income tax saving. Tax can also be calculated on the accounting income. The difference between tax on accounting income and taxable income is called 'deferred tax'. Deferred tax is the effect of timing differences (see below). What should be charged to the profit and loss account is tax expenses (tax saving). This is the aggregate of current tax and deferred tax charged or credited to the profit and loss account. This is in accordance with the matching principle. Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effect of timing differences are included in the tax expenses in the profit and loss statement as deferred tax and in the balance sheet as deferred tax assets or liabilities.

Deferred tax assets and liabilities

A deferred tax asset comes into existence when accounting income is more than taxable income and this is due to a timing difference. For example in accounts certain provisions are made for anticipated losses. Tax authorities allow such loss to be deducted only when it crystallizes. The common example is provision for bad debts. In accounts provision is made for anticipated bad debts whereas tax authorities allow only actual bad debts.

Illustration For the year ended 31.03.2007 accounting income of Picaso Ltd. is Rs. 20 Lakh after a provision for bad debts to the extent of Rs. 5 Lakh. Tax authorities disallow this charge and this is the only timing difference. Discuss income tax treatment in the accounts for 2006-07, if the tax rate is 40%.

Solution

Taxable income would be Rs. 25 Lakh as the provision for bad debts has to be added back due to disallowance

Tax on accounting income 40% of Rs. 25 Lakh	= Rs. 10 Lakh
Tax on taxable income 40% on Rs. 20 Lakh	= Rs. 8 Lakh

Hence, tax expense is Rs 10 Lakh and current tax is Rs. 8 Lakh; deferred tax is the difference between the two, namely Rs. 2 Lakh. In this case it is a tax liability for future years & Journal entry is as below:

		Rs/Lakh	Rs/Lakh
Profit and loss A/c	Dr	8.00	
Deferred tax asset A/c	Dr	2.00	
To Provision for taxation A/c			10.00
(Adjustment for differed tax liability)			

A deferred tax liability comes into existence when taxable income is less than accounting income due to timing differences. There are many timing differences which, result in such a situation. These are discussed below. To give one example here, for tax purposes wdv depreciation may be followed whereas in accounting straight line method has been the policy of the enterprise.

Illustration 4. For the year ended 31.03.2007 accounting income of Picaso Ltd. is Rs. 20 Lakh A Ltd. However its taxable income was Rs. 15 Lakh only due to timing differences. Discuss income tax treatment in the accounts for 2006-07, if the tax rate is 40%.

Solution.

Tax on accounting income 40% of Rs. 20 Lakh	=	Rs. 8 lacs
Tax on taxable income 40% on Rs. 15 Lakh	=	Rs. 6 lacs

Hence, tax expense is 8 Lakh and current tax is Rs. 6 Lakh; deferred tax is the difference between the two, namely Rs. 2 Lakh. In this case it is a tax liability for future years and journal entry is as below:

		Rs/Lakh	Rs/Lakh
Profit and loss A/c	Dr	8.00	
To Current tax A/c			6.00
To Deferred tax liability			2.00

The differences between the two incomes is primarily due to:

(1) Permanent differences; and
(2) Accounting differences.

Permanent difference

Permanent differences are those differences that originate in the current period and do not reverse in subsequent periods. Export earnings are exempt from tax and the tax saving is permanent. In subsequent period these earnings are not taxed. Similarly to encourage certain industries tax holiday is given for a certain period. The tax saving is permanent and does not get reversed in subsequent periods. Like wise certain expenditures are allowed for tax purpose only subject to certain limits. The amount disallowed results in a permanent difference. Permanent differences do not result in deferred tax assets or deferred tax liabilities.

Timing differences

Timing differences are those that which originate in the current period and reverse in subsequent periods. The examples of timing differences are:

(1) ***Depreciation:*** Book and tax depreciation differ for the following reasons;

(a) Differences in depreciation rates

(b) Differences in depreciation / methods of depreciation

(c) Differences in method of calculation e.g. calculation of depreciation with reference to individual assets in the books but on block basis for tax purposes and calculation with reference to time in the books but on the basis of full or half depreciation under the block basis for tax purposes.

(d) Differences in decomposition of actual cost of assets. This can arise due to capitalized interest and foreign exchange fluctuation charges of the loans borrowed for creating such assets.

(2) ***Expenses***: Certain expenses are debited to profit and loss account but allowed for tax purposes when paid in subsequent years. Examples are taxes, duty, cess, fees etc (43B).

(3) ***Amortisation***: Certain expenses are debited fully in one year for tax purpose but in books they are amortised over a period. Examples of this nature are heavy advertisement to market a new product, and expenditure on research and development.

(4) ***Provisions***: Provisions for contingencies are debited in the books but allowed for tax purposes only when they crystallize.

(5) ***Spread of income***: Sometimes income is recognized in accounts over number of years in the accounts but the income is fully taxed in the year of receipt.

(6) Income credited to profit and loss account but taxed only in subsequent years.

Consideration of prudence

Deferred tax assets should be recognized and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognized only to the extent there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition should be disclosed.

Measurement

Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws. Deferred tax assets and liabilities should be measured using the tax rates and tax laws that have been enacted or subsequently enacted by the balance sheet date. When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using average rates.

Transitional provisions

On the first occasion that the taxes on income are accounted for in accordance with AS-22, the enterprise should recognize, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of the standard. For the purpose of determining accumulated deferred tax for the first time, the opening balances of assets and liabilities for accounting purposes and for tax purposes are compared and the differences if any are determined. The tax effects of these differences, if any, should be recognized as deferred tax assets or liabilities, if these differences are timing differences. When the deferred tax is brought into existence, the corresponding adjustment is made to revenue reserve, subject to the consideration of prudence in the case of deferred tax asset. The amount so credited / charged to the revenue reserves should be the same as that which should have resulted if this statement had been in effect from the beginning.

Reversal of Timing Differences

From the following illustrations reversal of timing difference can be explained.

Illustration 5. Sakura Ltd. closes its accounts on 31st March. On 18t April, 2004, it purchases a machine at a cost of Rs. 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight-line method is considered appropriate for accounting purposes. Profits before depreciation and taxes of the company are Rs. 2,00,000 in each year and the corporate tax rate is 40 per cent in each year. Give necessary adjustment entries for three years

Solution

The purchase of machine at a cost of Rs. 1,50,000 in 2004 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 purpose, the amount of the tax saving should also be spread over the same period as shown below:

Rs / Lakh

Year Ending	2004	2005	2006
Profit before depreciation and taxes	200	200	200
Less: Depreciation for accounting purposes	50	50	50
Profit before taxes	150	150	150
Less: Tax expense			
Current tax			
0.40 (200 - 150)	20		
0.40 (200)		80	80
Deferred tax			
Tax effect of timing differences			
Originating during the year 0.40 (150 - 50)	40		
Tax effect of timing differences		-20	-20
Reversing during the year 0.40 (0 - 50)			
Tax Expense	60	60	60
Profit after tax	90	90	90
Net timing differences	100	50	50
Deferred tax liability	40	20	20

In 2004, the amount of depreciation allowed for tax purposes exceeds the amount of depreciation charged for accounting purposes by Rs. 1,00,000 and, therefore, taxable income is lower than the accounting income.

This gives rise to a deferred tax liability of Rs. 40,000. In 2005 and 2006, accounting income is lower than taxable income because the amount of depreciation charged for accounting purposes exceeds the amount of depreciation allowed for tax purposes by Rs. 50,000 in each year.

Accordingly, deferred tax liability is reduced by Rs. 20,000 each in both the years.

Tax expense is based on the accounting income of each period.

Year wise Journal entries will be as below:

Year 2004			
Profit and Loss A/c	Dr.	20,000	
To Current tax A/c			20,000
(Amount of taxes payable for the year provided for)			
Profit and Loss A/c	Dr.	40,000	
To Deferred tax A/c			40,000
(Deferred tax liability created for originating timing difference of Rs. 1,00,000)			
Year 2005			
Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Amount of taxes payable for the year provided for)			
Deferred tax A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Deferred tax liability adjusted for reversing timing difference of Rs. 50,000)			
Year 2006			
Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Amount of taxes payable for the year provided for			
Deferred tax A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Deferred tax liability adjusted for reversing timing difference of Rs. 50,000)			

MANAGERIAL REMUNERATION

The Act not defined the word managerial personnel. Considering S. 197 A, S. 309 (3) and section I of Part II of Schedule XXIII, it appears that managerial personnel refer to managing / whole-time director and manager. From Sec-198 together with Ses- 309 it may conclude that directors also to be included under this category. Section 198 prescribes 11% as the overall limit for managerial personnel. The limit become 10%, if only whole-time / managing directors are considered.

Remuneration paid to managerial personnel, viz. part-time and whole time directors, managing director or manager, is subject to overall limits as well as separate limits for each category of managerial personnel. Under S. 197 A of the Act a company can have either managing director or manager and not both. (Amendment Act, 2000).

Overall Maximum

S.198 deals with overall maximum remuneration payable to managerial personnel. It also deals with the remuneration payable when profits are not adequate. As per this section the total managerial remuneration payable in a public limited company or a private limited company which is a subsidiary of a public company, to its directors and its manager in respect of any year should not exceed eleven percent of the profits of that company.

The profits must be calculated in accordance with the provisions in Sections 349 and 350 of the Act. This would be discussed later. Gross profit for the purpose of S. 198 excludes remuneration to directors as expenditure. The percentage specified is exclusive of any fees payable to directors under S.309 of the Act.

Within the maximum specifies above a company may pay monthly remuneration to its whole-time director or managing director or to its manager.

As per Schedule XIII of the companies act a company having profits in any financial year may pay remuneration by way of salary, dearness allowance, perquisites and other allowances. Such remuneration should not exceed 5% of the net profits of the company for single managerial personnel and 10% for all of them together.

Companies are not permitted to pay to any officer or employee remuneration free of tax or varying with any tax payable by him.

Remuneration when profits are inadequate

Schedule XIII provides for minimum remuneration if a company is making losses or the profits are inadequate. The remuneration to the managerial person may be by way of salary, dearness allowance, perquisites and any other allowances not exceeding a ceiling limit of Rs. 24,00,000 per annum or Rs. 2,00,000 per month.

The ceilings are exclusive of the following:

(a) Contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income Tax Act, 1961,

(b) Gratuity payable at a rate not exceeding half a month's salary for each completed year of service; and

(c) Encashment of leave at the end of tenure.

In addition to the above an expatriate managerial person (including a nonresident Indian) is eligible to children's education allowance, holiday passage for children studying outside India and leave travel concession.

Prior approval of Government

Section 269 now dispenses with the requirement of prior approval of Central Government (requirement of S.198) for appointment of managerial personnel so long as appointment and remuneration are in accordance with Schedule XIII. Only in cases where appointment and remuneration are not in accordance with Schedule XIII prior approval is required.

Remuneration to directors

Directors can be classified into two categories. They are executive and non-executive directors. Non-executive directors are those who are not employed full time and they attend only board meetings convened to discuss matters included in the agenda. They are paid fees to attend the board or committee meetings at the rates prescribed in the articles [sec 309 (2)]. Maximum siting fees is prescribed at Rs. 5000 per meeting, which can be increased with the prior approval of the central government. Executive directors are not entitled to sitting fees.

In addition to the sitting fees they can also be paid remuneration if articles permit. This may be monthly or by way of commission. For paying commission company should pass a special resolution.

The directors together can be paid up to 1% of the net profits, if the company has a managing director, whole-time director or manager. If the company has no managing director / whole-time director or manager, the remuneration should not exceed 3% of the net profits. Directors should not be paid tax-free remuneration or remuneration indexed to tax rates. (S. 200).

Remuneration to managing/whole-time director/manager

As stated earlier they are not entitled to sitting fees. Remuneration to them may be by way of salary, dearness allowance, perquisites, commission and other allowances. Remuneration to this category is restricted to 5% if there is only one person and if there is more than one 10% to all of them together. As in the case of directors profits must be computed in accordance with Sections 349 and 350.

If a person is employed by two companies, he can draw remuneration from both the companies but should not exceed the maximum admissible from any one of the companies of which he is a managerial person. As stated earlier a company can have either managing director or manager and not both. However while the company can have more than one managing director, it cannot have more than one manager.

Monetary Limits to Managerial Remuneration

In addition to the statutory limits discussed above, the Central Government has fixed administrative ceilings for the chief executive, viz., the managing director or the whole-time director or the manager. These ceilings were introduced in the year 1969 and revised thereafter from time to time. Now these ceilings go and the appointment and remuneration of the 'Managing Director' etc. is governed by Sec. 269 of the Act as well as Schedule XIII to the Act. Sec. 269 of the Act not only insists on the appointment of the Chief Executive in the case of big-size companies but also dispenses with the compulsory approval of such appointments by Central Government in certain cases.

Schedule XIII lays down the conditions of appointment in Part I and deals with remuneration payable by companies having profits and remuneration payable by companies having no profits or inadequate profits in Part II of the schedule. With the amendment of the schedule effective from 1-2-1994, a company with adequate profits has full freedom to work out a suitable remuneration package for its managerial personnel within the limits of 5% of the net profits if it has one and 10% of its net profits if it has more than one managerial personnel. The ceilings on remuneration and commission payable to managerial personnel (even if the company has adequate profits) that were in force prior to 1-2-1994 have now been withdrawn. Remuneration payable when profits are inadequate or there are no profits has already been dealt with.

Computation of profits for managerial remuneration

As mentioned earlier profits have to be computed in accordance with Sections 349 and 350 for the purpose of calculating limits for managerial remuneration. We will now discuss the provisions of the two sections before giving illustrations. S.349 allows certain credits while disallowing others and similarly allows certain expenses as admissible while disallowing others. These details are shown in the table below.

Credits allowed

1. Bounties and Subsidies received from any Government or any public authority constituted or authorised in this behalf by any Government. Government has also the Power to direct the company to exclude such sums.

2. Profit on sale of assets only to the extent of difference between the written down value and the original cost of the asset. (1)

Credits disallowed

1. Premium received on issue and sales of shares and debentures

2. Profit on reissue of forfeited shares

3. Profits of capital nature including profits from sale of undertaking or any of the undertakings of the company or any part thereof.

4. Profits from sale of any immovable property or fixed assets of a capital nature, unless the business consists of buying and selling such property and assets.

Admissible expenses

1. All the usual working charges.
2. Directors' remuneration
3. Bonus or commission paid or payable to any staff member, engineer, technician or person employed or engaged by the company whether on part-time or full time basis.
4. Taxes on excess or abnormal profits notified by the Government.
5. Any tax on business profits imposed for, special reasons or in special circumstances' and notified by Central Government in this behalf.
6. Debenture interest
7. Interest on mortgages and loans and advances secured by a fixed or floating charge on the assets of the company.
8. Interest on unsecured loans and advances.
9. Repairs to movable and immovable properties which are not capital in nature.
10. Contributions to charitable and other funds not relating to the business the welfare of its employees. Clause *(e)* of (Sec. 293(1).
11. Depreciation to the extent specified in Sec. 350(4)
12. Losses of previous years (computed as per this section) which have not been adjusted so far.
13. Any compensation or damages to be paid by virtue of any legal liability, including a liability arising from breach of contract.
14. Insurance premium paid with respect to liability mentioned in (13)
15. Bad debts written off during the year.

Inadmissible Expenses

1. Income tax and Super tax payable by the company and any other tax on income other than those mentioned in (4) and (5) of the previous section.
2. Any compensation damages or payments made voluntarily.
3. Loss of a capital nature including loss on the sale of undertaking or any of the undertakings or any part thereof. The loss should exclude the one mentioned in proviso to s 350. The proviso refers to terminal depreciation which has to be charged to profit and loss account in the year of sale.

Illustration. PT Ltd. has purchased an asset for Rs. 70,000 and its book value after writing of depreciation is Rs 40,000. How much credit should be taken U /8349 assuming it is sold for:

(I). Rs. 57,000 (II). Rs. 65,000 (III). Rs. 70,000 (IV). Rs. 80,000.

Solution.

I> Credit will be taken for Rs. 17,000 being the difference between Rs. 57,000 and Rs. 40,000.

(II) Credit will be for Rs. 25,000 (Rs. 65,000 - Rs. 40,000)

(III) Credit will be for Rs. 30,000 (Rs. 70,000 - Rs. 40,000)

(IV) Credit will be for Rs. 30,000 only as the excess of proceeds over the original cost of Rs. 70,000 has to be ignored.

Admissible depreciation for managerial remuneration (S.350)

Depreciation for the purpose of determining net profits as a base for calculating managerial remuneration should be in accordance with S.350 of the Act. As per this section the amount of depreciation to be deducted under clause S.349 (k) is the amount of depreciation on assets as shown by the books of the company at the end of financial year, calculated at the rates specified in Schedule XIV to the Act. Prior to the Amendment Act of 2000 depreciation was to be computed on written down values where as companies some times used to follow straight-line method. This required an adjustment in the calculation of net profits as per S.349. The adjustment was to add the depreciation provided in the books to net profits before taxation and deduct depreciation calculated as per S.350. The amended S.350 has substituted the words 'the amount of depreciation on assets' in the place of 'the amount calculated with reference to the written down value of assets'. Because of this, adjustment becomes superfluous unless the company has deviated from the schedule.

S.350 has also an important proviso. The proviso requires writing of capital losses if any asset is sold, discarded, demolished or destroyed before the provision of full depreciation on such asset. The excess of the written down value of such asset over its sale proceeds or its scrap value must be written off in the financial year in which it is sold, discarded or destroyed.

Format for calculating admissible profits

The following format will be helpful to the student for calculating profits to base calculations of managerial remuneration.

<u>Net profit after provision for taxation*</u>

Add: Directors' remuneration

Directors' sitting fees

Depreciation as per company books**

Loss on sale of investments

Capital losses on the sale of the Undertaking or part there of but it should not include terminal Depreciation U/S 350. Provision for taxation

All provisions including provision For bad debts

Any compensation or damages paid Voluntarily

Less: Depreciation as per S.350 of the Act

Profit on sale of investments

Capital loss on sale of investments

Profits of capital nature on the

Sale of undertaking or part of it.

Profit on sale of investments

Prior period adjustments

Bad debts written off

Any compensation or damages paid by Virtue of any legal liability

Net profit (adjusted) for managerial remuneration

*If net profit before provision for taxation is the starting point then provision for taxation should not be added.

** With the amendment of S.350 the depreciation charged in the books will be the same as depreciation U/S. 350. Therefore this adjustment becomes unnecessary. The adjustment is to be carried out only when depreciation as per books differ from the one under S.350.

Illustration. XYZ Limited made a net profit of Rs. 25,000 lakh after adjusting the following items.

Particulars	Rs/Lakh
(a) Provision for taxation	10,000
(b) Capital profit on sale of part of the Undertaking	200
(c) Depreciation as per books	600
(d) Managerial remuneration	55
(e) Provision for diminution in the value of investments	15
(f) Profit on sale of investments	30
(g) Provision for wealth tax	20

Particulars	Rs / Lakh
(h) Directors' fees	15
(i) Profit on sale of assets U / S 349	40
(j) Loss on sale *of* assets U / S 349	35
(k) Prior period adjustments (credit)	15
(l) Provision for bad debts	100
(m) Ex-gratia payment to an employee	5

You are given the following additional information:

(1) Depreciation as per S.350 Rs.500 lakhs

(2) Bad debts actually written off Rs.60 lakhs

You are required to calculate net profits U / S 198 and 309 (5) *of* the Companies Act 1956.

Solution.

Particulars	Rs / Lakh	Rs / Lakh
Net profit after Prov. for Taxation		25,000
Add, Provision for taxation	10,000	
Directors' fees	15	
Depreciation as per books	600	
Managerial remuneration	55	
Provision for diminution in the value of investments	15	
Provision for bad debts	100	
Provision for wealth tax	20	
Ex-gratia payment to an employee	5	10,810
Total		35,810
Less Depreciation as per Sec. 350	500	
Profit on sale of investments	30	
Prior period adjustments (credit)	15	
Capital profit on sale of part of the Undertaking	200	
Bad debt written off	60	805
Net Profit as per section 198 and 309(5) Of the Act		35,005

Illustration. From the following particulars *of* Prakash Limited, you are required to calculate the managerial remuneration in the following situations.

(i) There is only one whole time director.

(ii) There are two whole time directors,

(iii) There are two whole time directors, a part time director and Manager.

Net profit before provision for income-tax and managerial remuneration, but after depreciation and provision for repairs	8,70,410
Depreciation provided in the books	3,10,000
Provision for repairs *of* machinery during the year	25,000
Depreciation allowable under Schedule XIV	2,60,000
Actual expenditure incurred on repairs during the year	15,000

Solution.

Sections 198 and 309 *of* the Companies Act, 1956 prescribe the maximum percentage *of* profit that can be paid as managerial remuneration. For this purpose, profit is to be calculated in the manner as specified in Section 349.

Calculation of net profit u/s 349 of the Companies Act, 1956

	Rs.	Rs.
Net Profit before provision for income-tax and Managerial remuneration, but after depreciation and provision for repairs	8,70,410	
Add back: Depreciation provided in the books	3,10,000	
Provision for repairs *of* machinery	25,000	
	3,35,000	12,05,410
Less: Depreciation allowable under Schedule XIV	2,60,000	
Actual expenditure incurred on repairs	15,000	2,75,000
Profit under section 349		9,30,410

Calculation of managerial remuneration

(i) There is only one whole time director

Managerial remuneration	=	5 % of Rs. 9,30,410
	=	Rs. 46,520.50

(ii) There are two whole time directors

Managerial remuneration	=	10% of Rs. 9,30,410
	=	Rs. 93,041

(ii) There are two whole time directors, a part time director and a manager

Managerial remuneration	=	11% of Rs. 9,30,410
	=	Rs. 1,02,345.10

DIVISIBLE PROFITS AND DIVIDENDS

Divisible Profits

Divisible profits means Profits available to shareholders for dividend. For this purpose profits must be computed in accordance with recognized accounting principles and the accounting standards applicable to the country. In ascertaining profits all expenses incurred to earn the revenues must be deducted from such revenues. Besides the company must also provide for past losses, depreciation on fixed assets, tax liability on profits, and fall in the value of current assets. A company normally does not distribute all the profits made as dividend. Transfers are made to reserves for enabling growth and also provide for contingencies.

Sources for payment of dividend

S. 205 deals with the sources for payment of dividend and other conditions. The sources for payment of dividend are:

(i) Dividend out of current year's profits: Dividend out of current year's profits can be declared only after providing for depreciation in accordance with the provisions of S. 205(2). Depreciation aspect will be discussed separately.

(ii) Dividend out of previous year or years profits: Dividend from out of previous year or year's profits which falls or fall after the commencement of the Companies (Amendment) Act, 1960. Again depreciation should have been provided out of the profits of that financial year or from out of the profits of any other previous year or years.

(iii) Dividend out of aggregate profits: Dividend can be declared out of the aggregate of profits mentioned in *(i)* and *(ii)* above.

(iv) Dividend out of State subsidies: Dividend can be declared out of money provided by the

Central Government or a State Government for the payment of dividend in accordance with guarantees given.

Capital profits

Besides the above sources mentioned in S. 205(1) profits made on sale of assets can also be used for the payment of dividend but the following three conditions are to be satisfied:

(1) The profits must have been realised and not the result of revaluation.

(2) Articles of the company should permit for such distribution.

(3) Surplus must remain after the revaluation of all assets and liabilities.

Transfers from Reserves

We have seen earlier that companies make transfer to reserves as a matter of financial prudence. Now it is also mandatory to transfer profits to reserves if the dividend paid exceeds 10%. (See below). If the profits of previous years are not transferred to. reserves but remain as balance in the profit and loss account such profits can be used for payment of dividend. However if they are held in the form of reserves there are restrictions on the use of such reserves for the payment of dividend. This will be discussed separately. But the point to note here is that revenue reserves can also be used for payment of dividend.

Transfers from capital reserves are not permitted

Reserves built up with capital profits cannot be used for the payment of dividend. Examples of capital profits are:

(i) Securities premium account.

(ii) Profit on re-issue of forfeited shares.

(iii) Capital redemption reserve.

(iv) Profits made prior to incorporation.

(v) Profit on revaluation of assets.

(vi) Profit on sale of fixed assets if all the conditions mentioned earlier (under the heading 'Capital Profits') are not satisfied.

Such reserves can be used for certain specified purposes like issue of bonus shares, writing off fictitious assets, writing off losses on revaluation of assets and paying premium on the redemption of debentures.

Provision for capital losses

The provision to S. 350 and also to S. 205 *(2)(d)* requires the provision of capital losses before determining the profits. As per this proviso if an asset is sold, discarded, demolished or destroyed the difference between the excess of the written down value of such an asset over its sale proceeds or scrap value should be written off in the financial year in which such an asset is sold etc.

Certain stipulations for the declaration of dividend

There are certain conditions mentioned in various sections that will have to be satisfied before dividend is declared. They are discussed below:

(I) A Company, which fails to redeem the irredeemable preference shares in accordance with the provisions of S. BOA, cannot declare dividend so long as such failure continues. S. 205 (2B).

(II) *Transfer of profits* to *reserves.* S. 205(2A) requires the transfer of profits to reserves before declaring dividend. If the percentage of dividend proposed exceeds 10%, the percentage of profits to be transferred to reserves is shown below. The percentage of transfer depends on the rate of proposed dividend.

	Proposed dividend	*Percentage of profits to* be *transferred to reserves*
(a)	Exceeding 10% but not more than	
	12.5% of the paid up capital	2.5%
(b)	Exceeding 12.5% but not more than	
	15% of paid up capital	5%
(c)	Exceeding 15% but not more than	
	20% of paid up capital	7.5%
(d)	Exceeding 20% of the paid up capital	10%

Transfer of higher percentage of profits to reserves:

A Company can transfer more than 10% of its profits to reserves. In such an event a minimum dividend has to be declared as stated below.

a. Minimum dividend rate should be equal to average rate of dividend declared in preceding three years.

b. Where bonus shares have been issued in the preceding three years, the distribution of dividend, a minimum distribution of dividend equal to the average amount (quantum and not the rate) of the dividend declared for the three years is ensured.

c. However, the minimum distribution in the above two cases need not be ensured if net profits after tax have fallen by at least 20% of the net profits of the average net profits after tax of the two preceding financial years.

d. Where no dividend is declared the amount proposed to be transferred to its reserves from the current profits must be less than the average amount of dividends declared to the shareholders over the three preceding financial years.

DECLARATION OF DIVIDEND FROM OUT OF ACCUMULATED RESERVES

It has been the practice of most of the companies to create a 'Dividend Equalization Reserve' by setting apart a portion of the profits during years of heavy profits and utilize them during difficult years with a view to maintain a uniform and steady rate of dividend.

Companies were also free to draw accumulated profits from other revenue reserves for declaring dividends as and when required.

After the Companies (Amendment) Act, 1974, there are now restrictions on the utilization of such reserves. According to Section 205-A (3) a company can declare dividend from out of profits transferred to reserves, only according to the rules made by the Central Government in this behalf. For this purpose the Central Government has framed the rules known as Companies (Declaration of dividend out of reserves) Rules, 1975 and according to rule 2 of these rules, the following conditions are to be satisfied:

(a) The rate of dividend must be 10% or the average of the rates of the five preceding years, whichever is less.

(b) The amount drawn from such reserves should not exceed an amount equal to one-tenth of the sum of its paid-up capital and free reserves. The amount so drawn must first be utilized to set off the losses incurred in the financial year and only the balance can be utilized for the declaration of dividend.

(c) The balance of reserves after such draw shall not fall below 15% of its paid up share capital.

Illustration

Due to inadequacy of profit during the year, the company proposes to declare dividend out of general reserves. From the following particulars you are to ascertain the amount that can be drawn applying the Companies (Declaration of dividend out of Reserves) Rules, 1975.

	Rs / Lakh
8.75 Lakh 8% Preference shares of Rs. 100	
each fully paid	875
350 Lakh equity shares of Rs. 10 each fully paid	3500
General Reserves	1050
Capital reserves on revaluation of assets	175
Share Premium	175
(vi) Profit and loss A/c (Cr)	31.50
(vii) Net Profit for the year	178.50

Average rate of dividend during the last five years is 15%.

Solution.

(1) First condition:

Since 10% is lower than the average rate only 10% dividend can be declared.

For 10 % Dividend transfer from Reserves required is

		Rs/lakh
10 % on 3500		350.00
Profit available Rs (31.50+178.50) Lakh =	Rs 210.00 Lakh	
Less Dividend on preference Shares	Rs 70.00 Lakh	
		140.00
Balance to be drawn from reserve		210.00
		======

(2) Second Condition:

Maximum amount that can be drawn should not exceed 10% of paid-up capital plus free reserves:

i.e., 1/l0th of Rs. (3500+875+1050) = Rs. 542.50 Lakh.

(3) Third condition:

Balance of Reserves should not fall below 15 % of its paid up share capital.

Let Dividend = "D"

Free Reserve = "FR"; and

Paid up Capital = "C"

Then to satisfy the above condition

FR – D = 15 % of C; or D = FR – 15 % of C

Here FR = 1050: C = 4375

Hence, D = 1050- 15 % of 4375

or D = 1050-656.25

or D = Rs 393.75 Lakh

Since Rs 210 Lakh is less than the amount available as per conditions 2 and 3 10 % dividend can be paid.

DEPRECIATION FOR THE PURPOSE OF DETERMINING DIVISIBLE PROFITS

Profits must be derived after providing for depreciation in accordance with S. 205(2) and past losses for calculating the sources for dividend.

Three related aspects are to be looked into in dealing with depreciation like below:

A> Provision of depreciation in accordance with S. 205(2).

B> Arrears of depreciation relating to previous years

C> Losses relating to previous years.

(A) Depreciation under S. 205(2)

This section provides for the calculation of depreciation in anyone of the following three ways.

1. Depreciation according to S. 350: Under this section depreciation on assets is to be calculated at the rates specified in Schedule XIV to the Act. The Schedule provides rates separately for different categories of assets. Again rates are given on a straight-line basis and written down value basis. Depreciation rates are also different when the units work on single shift, double shift and triple shift. If during the year there is any addition or deletion to assets depreciation must be calculated on pro rata basis. In the case of items whose cost does not exceed Rs. 5,000, hundred percent depreciation can be provided.

The proviso to this section requires writing off of capital losses when assets are sold, discarded, demolished or destroyed.

Prior to the year 1988 this section required provision of depreciation as per income tax rules. In that year Schedule XIV was introduced de linking provision of depreciation from the Income Tax Act. Till the Companies (Amendment) Act, 2000 this section required calculation of depreciation on the written down value of assets. Therefore when companies provided depreciation on straight-line basis adjustment became necessary to compute profits for managerial remuneration. Depreciation on straight-line basis was added to net profits and depreciation on written down value basis was deducted to arrive at profits for purpose of managerial remuneration. The amendment in 2000 has replaced the words “the amount calculated with reference to the written down value of the assets” with “the amount of depreciation on assets.” Therefore if the schedule is followed adjustment becomes unnecessary.

2. In respect of each item of depreciable asset 95% of the original cost may be written off over the estimated life of the asset.

3. Any other basis approved by the Central Government that has the effect of writing off by way of depreciation 95% of the original cost to the company of each such depreciable asset on the expiry of the specified period.

4. If the schedule has not provided the rate for any asset, depreciation may be provided on such basis as may be approved by the Central Government by any general order published in the gazette or by any special order in the particular case. The proviso to S. 350 mentioned under (1) above also applies to (2) and (3) above.

(B) Arrears of depreciation

For arrears of depreciation the following three rules is to be noted:

1. In respect of the *current* financial year the prescribed depreciation must be provided;
2. In respect of financial years falling before 28th December, 1960 the arrears of depreciation are not required to be made good for declaring dividend out of the profit of such previous years;
3. In respect of financial year falling after 28th December, 1960, the arrears of depreciation computed in the prescribed manner must be made good before declaring dividend out of the profit of those financial years.

(C) Past losses

If a company incurs a loss in any financial year falling *after* 28th December, 1960 then:

(i) the amount of loss, or

(ii) an amount which is equal to the amount provided for depreciation for that year or those years., whichever is less, must be set off against:

(a) the profits of the company, after providing for the prescribed depreciation for the year for which dividend is proposed to be declared; or

(b) the profits of the company for any *previous* financial year or years arrived at after providing for the prescribed depreciation; or

(c) the aggregate of *(a)* and *(b)* together.

Other provisions relating to divisible profits

Any dividend payable in cash may be paid by cheque or warrant sent through the post directed to the registered address of the shareholder entitled to the payment of the dividend, or in the case of joint shareholders, to the registered address of that one of the joint shareholders which is first named on the register of members, or to such person and to such address as the shareholder or joint shareholders may in writing direct.

Types of dividends

Dividends may be classified as preference and equity dividends according to the shares on which dividends are declared. Equity dividends may be classified as interim and final from the point of view of time of declaration and authority declaring them. They are also classified as cash and scrip dividends. We will now consider each of these.

1. Interim dividend.

A dividend paid during a financial year between two Annual General Meetings (AGMs) or that is paid on shares before the time of declaring the final dividend is called an interim dividend. Regulation 86A of Table A provides that the board may from time to time pay to the members such dividend as appears to it to be justified by the profits of the company. This dividend is based on the unaudited financial results of less than a year. Directors must make sure that profits are available and must adopt a very conservative basis, as there is possibility of the company incurring losses after the declaration of interim dividend. Earlier directors could retrace and cancel the interim dividend. The Companies (Amendment) Act, 2000 has introduced number of changes with respect to interim dividend and they are mentioned below:

(a) For the first time the Act mentions about interim dividend. UnderS.2 (14A) the term dividend includes interim dividend.

(b) S. 205(l A) gives the power to the board to declare interimdividend but requires the dividend including interim dividend to be deposited in a separate bank account with in five days from the date of declaration of such dividend.

(c) S. 205(1B) states that the amount of dividend including interim dividend so deposited shall be used for payment of interim dividend. There seems to be drafting defect in this sub-section. The payment must be applicable to final as well as interim dividend. Otherwise final dividend cannot be paid.

(d) S. 205(1C) states that provisions contained in Sections 205, 205A, 205C, 206,206A and 207 shall, as far as may be also apply to interim dividend.

Because of sub-section IC of Section 205, the payment of interim dividend is brought on par with final dividend. Interim dividend can be paid only after providing for depreciation, losses of previous years and transfers to reserves etc. There is no need to transfer to reserves if dividend declared is 1O% or less. In view of the changed provisions directors should be very careful in declaring interim dividend.

Final dividend

Final dividend is declared by the shareholders at the Annual General meeting. Table A states that the company may declare dividends in general meeting but no dividend shall exceed the amount recommended by the board. The board transfers profits to statutory reserve depending on the rate of dividend recommended. It may also transfer to other reserves such as dividend equalization reserve or reserves for any contingencies. The board may also carry forward part of the profits in profit and loss account without any transfer to reserve. When a final dividend is declared, interim dividend is not adjusted unless the resolution mentions it specifically. Both interim and final dividends must be paid within 30 days from the date of declaration (S. 205A).

Scrip dividend

Before the passing of Companies (Amendment) Act, 1960 many companies used to pay dividend by distributing shares or debentures of other companies. The dividend so paid was called scrip-dividend. Often a shareholder was put to a loss because the dividend in the form of shares or debentures of other companies was worthless as directors would use such investments which they found were not good. In order to avoid such unhealthy practice, the payment of scrip dividend had been stopped after 1960.

Preference share dividend

Preference share dividend is always paid prior to any payment of dividend to equity shareholders. But preference shareholders can claim dividend only out of profits and unlike interest on debentures, it cannot be paid when there is no profit. Preference share dividend, unless stated non-cumulative, is always cumulative and if for reasons of inadequate profits it has not been paid for some years, the whole of the dividend (including the arrears of past years) is to be paid first to preference shareholders before declaring any dividend to equity shareholders. It may be noted that preference shareholders cannot force the company to pay all dividends (including arrears); what they can do is to force the company to pay them before any payment is made to equity shareholders. Thus, if equity shareholders are not paid any / dividend, preference shareholders also cannot make any claim. So long as dividend on preference share capital remains unpaid, it appears as a *contingent liability* outside the balance sheet.

Unpaid Dividend Account

Under S. 205A the limit for claiming or paying interim or final dividend has been reduced from 42 to 30 days. If it is not so paid the company must within seven days from the date of the said period of 30 days, transfer the unpaid amount of dividend to a special account to be opened with a scheduled bank to be called 'Unpaid Dividend Account of ……………company limited/company (private limited)'.

Under S. 205B, a person entitled to the unpaid dividend can apply to central government for an order of payment of the dividend so claimed. If the central government is satisfied on the basis of a certificate given by the company or otherwise, may order such payment. However this claim has to be made within seven years from the date of transfer to the unpaid dividend account. After the transfer of seven-year period the amount standing to the credit of

unpaid dividend account will be transferred to a fund set up under S. 205C called 'Investor Education and Protection Fund.' The fund is utilized for promotion of investor awareness and protection of the interests of investors in accordance with such rules as may be prescribed.

Payment of Interest out of Capital

The dividends can be paid from out of profits only. However in some cases the projects will have long gestation periods and it will take long time to earn profits. The Companies Act permits payment of interest in such cases. Such payment is subject to the following conditions.

(i) Shares must have been issued to raise money for meeting expenditure on the construction of any work or building or the provision of any plant, which cannot be made for a lengthy period.

(ii) The interest paid on such capital is capitalized as part of the cost of the work or building or plant.

(iii) Such payment must be authorised by the articles of company.

(iv) Such payment should be made only after obtaining the permission of central government.

(v) The payment may be made only for the period specified by the government. Such payment in any case cannot be made beyond the half-year next after the half-year during which the work or building has been completed or the plant has been provided.

(vi) The rate of interest is 4% or such other higher rate as notified in the gazette.

(vii) The payment shall not operate as a reduction of the amount of paid up shares in respect of which such amount is paid.

(viii) The amount of such interest not written off will appear in the balance sheet under the heading 'Miscellaneous Expenditure'.

BONUS SHARES

Bonus shares are issued by a company when it wants to pay dividend by issuing shares. Bonus shares are declared when company has sufficient profits to declare dividend but either does not possess cash to pay it or does not want to part with it in order to implement some capital expenditure plans. Thus bonus shares result in the capitalization of profit of the company.

Advantages of the issue of Bonus shares:

The Bonus issue can be discussed from:

(1) the viewpoint of the company and

(2) the viewpoint of shareholders.

(1) From the viewpoint of the company:

(a) Since there is no cash outgoing, liquidity of the company is not impaired.

(b) The capital as per balance sheet will be more realistic than it would be otherwise.

(c) Profits remaining the same, the company cannot declare high dividends on expanded capital. By not declaring high dividends, it can avoid the tall claims of the employees and regulation by Government, and

(d) Capitalization of reserves increases substantially the creditworthiness of the company.

(2) From the viewpoint of shareholders

(a) The shareholders can dispose of these shares and realise cash. Sometimes they can be sold even at a premium, as only successful companies can issue bonus shares.

(b) The shareholders can receive dividend on the increased shareholding, and

(c) As it is very difficult to buy shares of successful companies from the market, the issue of bonus shares will enable the shareholder to increase his holding. In due course he will also have capital appreciation and increased dividend.

Guidelines for Bonus issue

The following are the Guidelines issued by SEBI for issue of Bonus shares by a listed company:

(i) Issue of bonus shares after any public/rights issue is subject to the condition that no bonus issue shall be made which will dilute the value or rights of the holders of debentures, convertible fully or partly.

In other words, no company shall, pending conversion of FCDs/PCDs, issue any shares by way of bonus unless similar benefit is extended to the holders of such FCDs/PCDs, through reservation of shares in proportion to such convertible part of FCDs or PCDs. The shares so reserved may be issued at the time of conversion(s) of such debentures on the same terms on which the bonus issues were made.

(ii) The bonus issue is made out of free reserves built out of the genuine profits or share premium collected in cash only.

(iii) Reserves created by revaluation of fixed assets are not capitalized.

(iv) The declaration of bonus issue, in lieu of dividend, is not made.

(v) The bonus issue is not made unless the partly-paid shares, if any existing, are made fully paid-up.

(vi) The company

1. has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption thereof, and

2. has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

(vii) A company which announces its bonus issue after the approval of the Board of Directors must implement the proposals within a period of six months from the date of such approval and shall not have the option of changing the decision.

(viii) There should be a provision in the Articles of Association of the company for capitalization of reserves, etc. and if not, the company shall pass a Resolution at its General Body Meeting making provisions in the Articles of Association for capitalization.

(ix) Consequent to the issue of bonus shares if the subscribed and paid-up capital exceeds the authorised shares capital, a resolution shall be passed by the company at its General Body Meeting for increasing the authorised capital.

Changes in the Guidelines

In keeping with pace of liberalization and reforms in the primary market, SEBI has modified the previous guidelines with effect from 13 April 1994. The new guidelines give a lot of freedom in the matter of bonus, compared to the restrictions in force earlier. Previously the bonus issue was subject to following three restrictions:

(1) *Residual Reserve Test.* The residual reserves after the bonus issue should be at least 40% of the increased paid-up capital.

(2) *Minimum Dividend Test.* Thirty per cent of the average profits before tax of the company for the previous three years should yield a rate of dividend on the expanded capital base of the company at 10 per cent.

(3) *Ratio Restriction.* At anyone time the amount capitalized should not exceed the paid-up capital. In other words, bonus issue can be made only in the ratio of 1: 1. This restriction was relaxed even during the CCI regime.

The guidelines now in force have done away with the earlier restrictions mentioned above. The SEBI only desires that the Board of Companies wishing to make bonus issues to take due consideration of relevant financial factors while deciding on bonus issues and observe the guidelines it has framed.

Accounting treatment.

Case 1. Capitalization by making partly paid-up shares fully paid-up.

Journal entries:

1.	Profit and loss appropriation account	Dr
	or any other reserve account	
	To Bonus to shareholders account	
	(Declaration of Bonus Dividend)	
2.	Share Call Account	Dr
	To Share capital account (making of call)	
3.	Bonus to shareholders account	Dr
	To Share call account	

(Application of bonus dividend towards the call of share)

Illustration

A company had issued 20,000 shares of Rs. 10 each, Rs. 8 called up. The directors of the company now wish to apply the profits earned during the year for making the partly paid-up shares fully paid-up. Give journal entries for carrying out their wishes.

Solution.

Journal Entries

Particulars		Dr (Rs.)	Cr(Rs)
Profit and loss appropriation account	Dr.	40,000	
To Bonus to shareholders account			40,000
Share final call account	Dr.	40,000	
To Share capital account			40,000
Bonus to shareholders account	Dr.	40,000	
To Share final call account			40,000

Case 2. Capitalization by issuing fully paid-up bonus shares.

Accounting entries will be as follows:

1. *Profit and loss appropriation account* *Dr*
or share premium account or any
other reserve account
(for declaring bonus)
To Bonus to shareholders account

2. *Bonus to shareholders account* *Dr*
(for issuing bonus shares)
To Share capital account.

Illustration A company had an issued share capital of Rs. 20,00,000 in Rs. 10 equity shares. It had share premium of Rs. 1,50,000, capital redemption reserve account of Rs. 75,000, and undistributed profit of Rs. 8,80,000. It was decided that fully paid-up bonus shares of Rs. 10 each be issued at the rate of one share for every four existing shares and that this resolution be carried out by using the minimum amount of undistributed profits. You are required to give journal entries.

Solution.

Journal Entries

Particulars		Dr (Rs.)	Cr (Rs)
Profit and loss appropriation account	Dr.	2,75,000	
Security premium account	Dr.	1,50,000	
Capital redemption reserve account	Dr.	75,000	
To Bonus to shareholders account			5,00,000
Bonus to shareholders account	Dr.	5,00,000	
To Equity share capital account			5,00,000

Security premium account and capital redemption reserve account are available only for fully paid-up bonus shares.

Illustration The following is the trial balance of PK Ltd. as on 31st March 2007:

Debit	*Rs.*	*Credit*	*Rs.*
Advance tax for 2006-07	2,50,000	Shares forfeiture a/c	6,000
Interim dividend	50,000	Preference share	
Capital redemption a/c	2,20,000	capital	2,00,000
Discount on debenture a/c	6,000	Equity share capital	5,00,000
Share reissue a/c	2,000	General reserve	2,00,000
Fixed assets	10,00,000	Securities Premium a/c	20,000
Investments	3,00,000	Profit & loss a/c	1,50,000
Current assets	1,60,000	Operating profit for	
		2006-07 (before tax)	6,02,000
		13% debentures	1,00,000
		Current liabilities	2,10,000
	19,88,000		19,88,000

The following additional information is provided to you.

(i) On 31st March, 2007, the issued share capital consists of 50,000 equity shares of Rs. 10 each fully paid up. Share reissue account represents discount allowed at the time of reissue of 1,000 forfeited equity shares which were earlier forfeited for the non-payment of the final call.

(ii) Subsequent to the above, the preference share capital was redeemed out of profits otherwise available for dividend; the directors deciding to pay a premium of 10% to the preference shareholders. The company also issued bonus shares to equity shareholders in the ratio of 2: 5 out of capital redemption reserve account. Both the redemption of preference shares and the issue of bonus shares have not been recorded in the books except that the amount paid to the preference shareholders has been debited to the capital redemption account.

(iii) Provision for tax is required at 50%.

(iv) The Board of directors has proposed a final dividend of 20% on equity shares after appropriating profits as per law.

(v) The Board of directors has decided to record the upward revaluation of fixed assets by 25%.

(vi) Rs. 2,000, out of discount on debentures account, is yet to be written off against the profit for the current year.

Your are required to prepare the profit and loss account of the company for the year ended 31st March, 2007 and its balance sheet as on that date after incorporating the above.

Solution.

Books of PK Ltd.

Profit and Loss A/C for the year ended March 31, 2007

Dr. Cr.

	Rs.		Rs.
To Discount on Debentures *AI* c	2,000	*By* Operating Profit	6,02,000
To Provision for Tax	3,00,000		
To Net Profit *cld*	3,00,000		
	6,02,000		6,02,000

Profit and Loss Appropriation A/c

for the year ended 31st *March,* 2007

	Rs.		Rs.
To General Reserve	30,000	*By* Balance b/d	1,50,000
To Interim Dividend	50,000	*By* Net Profit b/d	3,00,000
To Proposed Dividend	1,40,000		
To Balance c / d	2,30,000		
	4,50,000		4,50,000

Balance Sheet as on 31st March, 2007

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	12,50,000
Equity Shares of Rs. 10 each			
fully paid	7,00,000	Investments	3,00,000
(Of the above 20,000 shares		Current Assets, Loans	
have been allotted as fully paid up by way of bonus shares using capital Redemption Reserve as source)		and Advances: Current Assets	1,60,000
		Advance Tax for2006-07	2,50,000
Reserves and Surplus:		Miscellaneous Expenditure:	
Fixed Assets Revaluation A/c	2,50,000	Discount on Debentures	4,000
Capital Reserve	4,000		
General Reserve	30,000		
Profit and Loss *AI* c	2,30,000		
Secured Loans:			
13% Debentures	1,00,000		
Current Liabilities and *Provisions:*			
Current Liabilities	2,10,000		
Provision for Tax	3,00,000		
Proposed Dividend	1,40,000		
	19,64,000		19,64,000

Notes:

1. Since all the shares are fully paid, the Share Forfeiture Account and Share Reissue Account should be cancelled out. The difference of Rs. 4,000 (6,000-2,000) is shown as Capital Reserve i.e. profit on reissue of forfeited shares.

2. Since Preference Share Capital has already been redeemed @ 10% premium, it need not appear in the Balance Sheet. An amount of Rs. 2,00,000 should be transferred from the General Reserve to Capital Redemption Reserve A/c which has been used to issue bonus shares of Rs. 2,00,000.

   The share premium will be used to write-off premium paid on redemption of Preference Share Capital.

3. Since the company had proposed dividends@ 20%, it must transfer 10% of current year profit to general reserve as per Companies (Transfer of Profit to Reserve) Rules, 1975.

4. Fixed Assets Revaluation Reserve Account must appear separately in the balance sheet.

Illustration The Excell Manufacturing Co. Ltd was registered with an authorised capital of Rs. 10,00,000 divided into shares of Rs. 10 each, of which 40,000 shares had been issued and fully paid.

You are required to prepare Trading and Profit & Loss Account for the year ended 31st March, 2005 and Balance Sheet as on that date after taking into consideration the following adjustments:

(i) On 31st March, 2005 outstanding Manufacturing Wages and outstanding Office Salaries stood at Rs. 1,890 and Rs. 1,200 respectively. On the same date Stock was valued at Rs. 1,24,840 and Loose Tools at Rs. 10,000.

(ii) Provide for interest on Bank Loan for 6 months.

(iii) Depreciation on plant and machinery is to be provided@ 15% while on Office Furniture it is to be @ *10%*.

(iv) Write off one-third of balance of Preliminary Expenses.

(v) Make a Provision for Income Tax @ *50%*.

(vi) The directors recommended a maiden (first) dividend @ 15% for the year ending 31st March 2005 after a transfer of 5% of net profits to General Reserve.

The following is the Trial Balance extracted on 31st March, 2005:

	Debit (Rs)	Credit(Rs)
Opening Stock	1,86,420	
Purchases and Sales	7,18,210	11,69,900
Returns	12,680	9,850
Manufacturing Wages	1,09,740	
Sundry Manufacturing Expenses	19,240	
Carriage Inwards	4,910	
18% Bank Loan (Secured)		50,000
Interest on Bank Loan	4,500	
Office Salaries and Expenses	17,870	
Auditors' Fees	8,600	
Directors' Remuneration	26,250	
Preliminary Expenses	6,000	
Freehold Premises	1,64,210	
Plant and Machinery	1,28,400	
Furniture	5,000	
Loose Tools	12,500	
Debtors and Creditors	1,05,400	62,220
Cash in Hand	19,530	
Cash at Bank	96,860	
Advance payment of tax	84,290	
P&L *A/c* on 1st April, 2004		38,640
Share Capital		4,00,000
	17,30,610	17,30,610

Solution.

The Excell Manufacturing Co. Ltd

Trading and Profit & Loss Account for the year ended 31st March 2005

Dr *Particulars*		*Amount* *Rs.*	*Particulars*		Cr *Amount* *Rs.*
To Opening Stock		*186,420*	*By* Sales	*1,169,900*	
To Purchase	*718,210*		*Less:* Ret.	12,680	1,157,220
Less: Returns	9,850	*708,360*			
To Wages *AI* c	109,740		*By* Closing stock		*124,840*
Add: Outstanding	1,890	111,630			
To Sundry Mfg. Expenses		19,240			
To Carriage Inwards		4,910			
To *Gross* Profit *cld*		*251,500*			
		1,282,060			*1,282,060*
To Interest on Bank Loan	4,500		*By Gross* Profit b / d		*251,500*
Add: Outstanding	*4,500*	9,000			
To Office Salaries & Expenses	17,870				
Add: Outstanding	1,200	19,070			
To Auditors' Fees		8,600			
To Directors' Remuneration		26,250			
To Depreciations:					
Loose Tools	2,500				
Plant & Mach.	19,260				
Furniture	500	22,260			
To Preliminary Expenses		2,000			
To Provision for tax		82,160			
To Net Profit		82,160			
		251,500			251,500

Profit & Loss App. A/c

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*
To Dividends (15%)	60,000	By P & L *AI* c (1-4-04)	38,640
To General Reserves		By Profit for the year	82,160
(5% of *NIP)*	4,108		
To Balance C/F	56,692		
	1,20,800		1,20,800

The Excell Manufacturing Co. Ltd

Balance Sheet as ***on*** 31-3-2005

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*	*Amount Rs.*
Share Capital	4,00,000	Plant & Machinery	1,28,400	
General Reserve	4,108	-Dep.	19,260	1,09,140
P & L *A/*c	56,692	Freehold Premises		1,64,210
18% Bank Loan (Secured)	50,000	Furniture	5,000	
Proposed Dividends	60,000	-Dep.	500	4,500
Outstanding Expenses:		Loose Tools	12,500	
Interest on Bank Loan	4,500	-Dep.	2,500	10,000
Mfg. Wages	1,890	Debtors		1,05,400
Office Salaries	1,200	Cash in Hand		19,530
Creditors	62,220	Cash at Bank		96,860
Provision for Taxation	82,160	Stocks		1,24,840
		Advance Tax.		84,290
		Preliminary Exp.		4,000
	7,22,770			7,22,770

EXERCISE

1. State whether the following statements are true or false:

(a) Shareholders can increase the rate of dividend recommended by the Board of Directors, if they think it too low

(b) Advance payment of tax should be shown on the assets side of the balance sheet.

(c) No dividend is payable on calls in advance.

(d) Requirements given in Part II of Schedule VI apply to the balance sheet.

(e) Ordinarily capital profits are not .available for the distribution of dividend. Managerial remuneration is calculated after milking a provision for taxation.

(g) Fees payable to the directors for attending the meetings of the Board are excluded for calculating the managerial remuneration.

Ans. [(a) F ; *(b)* T ; *(c)* T ; *(d)* F ; *(e)* T ; (f) F ; (g) T ;

2. How will you deal with the following matters when preparing the annual accounts of a company in accordance with the .requirements of Schedule VI to the Companies Act, 1956 as amended up to date:

(a) Bonus shares issued.

(b) Balance of forfeited shares account after the reissue of forfeited shares.

(c) Application money received on shares pending allotment.

(d) Share Premium Account.

(e) Redeemable. Mortgage debentures issued by the company.

(j) Arrears of fixed cumulative dividends.

(g) Amount written off Plant and Machinery on reduction of share capital seven years previously.

(h) Arrears of depreciation.

(i) Payment to auditors.

(o) Expenditure relating to a previous year.

(k) Selling commission paid and payable.

(l) Income Tax.

3. Indicate the correct answers:

(a) Fictitious assets are shown on the assets side of the Balance Sheet of a company under the heading: .

(i) Fixed assets;

(ii) Current assets;

(iii) Miscellaneous expenditure (to the extent not written off).

(b) Assets in the Balance Sheet of a limited company are arranged in the order of:

(i) Permanence;

(ii) Liquidity.

(c) Calls in arrear is shown on the liabilities side of the Balance Sheet:

(i) Under the head Current Liabilities;

(ii) By deducting the amount from the called up capital;

(iii) Under the head current assets.

(d) Goodwill in case of a joint stock company is shown on the assets side under the heading of:

(i) Fixed assets;

(ii) Investments;

(iii) Current assets;

(iv) Miscellaneous expenditure (to the extent not written off).

Ans. *[(a)* (iii) ; *(b)* (i) ; *(c) (ii)* ; (d) (i) ;

4. How do you calculate profits for the purpose of the calculation of the managerial remuneration? What are the maximum rates of remuneration allowable under the Companies Act to (i) Directors. *(ii)* Managing Director and (iii) Manager? Is there any provision for the payment of the minimum managerial remuneration?

5. Peacock Ltd. employs a manager* and three whole-time directors. It pays 5% commission to the manager and 2% to each whole-time director. The commission payable to the manager is calculated on the profit left after charging his commission and commissions of whole time directors, and commissions payable to whole-time directors are calculated on profits left after charging the commissions as per the Companies Act after taking into consideration the following information.

Dr Cr

	Rs		Rs
To Administrative and selling expenses	70,400	By Gross profit	3,00,000
To Staff salaries and bonus	30,000	Subsidy from the	
To Development rebate reserve	8,000	State Government	40,000
To Income tax	6,000	Profit on sale	
To Tax on abnormal profits	1,000	of plant Cost	
To Managerial remuneration	15,000	C.P Rs 1,20,000	
		S.P Rs1,40,000	30,000
To Depreciation provision	50,000		
To Profit available for appropriation	1,89,600		
	3,70,000		3,70,000

Note: Administration and selling expenses included the cost of construction of a new show-room Rs. 10,000; staff salaries and bonus included bonus paid to staff on account of last year services Rs. 2,300-bonus estimated for this year Rs. 2,400 has not been brought into account. Depreciation as per Sec. 350 works out to Rs. 48,500.

(Ans: Total Commission payable Rs 20,810. Manager will get Rs 9,459; Three whole time directors will get Rs 11,351)

6. A company carried forward a balance of Rs. 30,000 in the profit and loss account from the year ended 31st March, 2005. During the year 2006 it made a further profit of Rs. 3,00,000. It was decided that following decisions be carried out

(a) Provision for taxation Rs. 1,50,000,

(b) Dividend equalization account Rs. 20,000,

(cl Dividend on 8% preference shares of Rs. 2,00,000,

(d) Dividend at 15% on 30,000 equity shares of Rs. 10 each fully paid,

(e) General reserve Rs. 35,000,

(f) Corporate dividend tax@ 12% on the dividend.

You are required to give profit and loss appropriation account and give journal entries for payment of dividend.

(Profit carried forward to next year Rs 56,680)

7. A limited company was registered with an authorised capital of Rs. 30,000 Lakh in equity shares of Rs. 10 each. The following is the list of balances extracted from its books on 31-3-2006 :

	Rs.in '000
Purchases	9,25,000
General Expenses	84,175
Wages	4,24,325
Stock on 1-4-2005	3,75,000
Manufacturing Expenses	65,575
Goodwill	1,00,000
Salaries	70,000
Cash in hand	28,750
Bad Debts	10,550
Cash at Bank	1,99,500
Director's Fees	31,125
Subscribed and fully paid Capital	20,00,000
Debentures Interest paid	45,000
Preliminary Expenses	25,000
Profit and Loss Account (Cr)	72,500
Calls in Arrear	37,500
Plant and Machinery	15,00,000
6% Debentures	15,00,000
Premises	16,50,000
Sundry Creditors	2,90,000
Interim Dividend paid	1,87.500
Bills Payable	1,67,500
Furniture and Fixtures	35,000
Sales	20,75,000
Sundry Debtors	4,36,000
General Reserve	1,25,000

Prepare Trading and Profit and Loss Account for the year ended 31st March, 1996 and the Balance Sheet as at that date, after making the following adjustments:

Depreciate Plant and Machinery by 10%. Provide half year's interest on debentures. Also write off Rs. 25,00,000 from preliminary expenses and make the provision for bad and doubtful debts Rs. 42,50,000 on sundry debtors. Stock on 31st March, 2006 was Rs. 455,000,000.

Ans. [Gross Profit (Rs.'000) 7,40,100 ; Net Profit (Rs'000). 2,97,500 ; Surplus carried to B / S (Rs'000). 1,82,500 ; B / S Total (Rs.'000) 42,72,500].

8. Muskat Ltd. was incorporated on 1st July 2006 to take over as from 1st January in the same year the existing business of M / S Muskat & Co. a partnership firm. Under the takeover agreement all profits made from 1st January are to 'belong to the company. The purchase consideration was Rs. 10,000 Lakh. The vendors were allotted 50 Lakh shares of Rs. 100 each at the premium of Rs. 10 per share in part satisfaction of the purchase price and the balance was paid on 1st October 2006 together with an interest at 10 per cent per annum.

The following balances appear in the company's ledger as at 31st March, 2007.

	Rs'000.		Rs.'000
Share Capital 65 Lakh Shares		Cash in hand	3,500
of Rs. 100 each fully paid		Balance with Banks	59,000
(including vendor's shares)	6,50,000	Preliminary Expenses	8,500
Share Premium Account	65,000	Rates and Taxes	9,000
Bank Overdraft (secured by		Buildillgs at cost	2,60,000
hypothecation of stocks)	1,50,000	Furniture & Fixtures at cost	22,000
Fixed Deposits from outsiders	22,500	Transport Vehicles at cost	45,000
Sundry Creditors'	65,000	Salaries and Wages	55,000
Freehold Land at cost.	1,00,000	Rent received	16,000
Stock in Trade as on 1st April		Audit Fees	5,000
2006 at the lower of cost		Miscellaneous Expenses	17,000
and market values	5,20,000	Purchases	7,60,000
Book Debts (Rs. 1440 Lakh	1,44,000	Repairs to Buildings	4,500
unsecured but considered		Directors' Fees	3,500
good, Rs. 100 Lakh doubtful)	1,54,000	Sales	10,80,000

The stock as on 31st March 2007, at the lower of cost and market value, amounted to Rs.5060 Lakh. Bad debts amounting to Rs. 15 Lakh out of which Rs. 7.5 Lakh related to the book debts taken over by the company, have to be written off, and a provision of Rs. 60 Lakh has to be made for doubtful debts as on 31st March.

Depreciation has to be written off, Buildings at 7.5%, Furniture and fixture at 10% and Transport vehicles at 15%. Vehicles include one Tempo (second hand) Purchased on 1-10-2006 at Rs. 150 Lakh. The business is seasonal to some extent, the sales in the second half of the year being twice the sales in the first half of the year, but sales during the two seasons are spread evenly. Preliminary expenses are to be wholly written off.

Prepare the Profit and Loss Account of the Company for the year ended 31st March 2007 and the Balance Sheet as at that date in accordance with the requirements of the Companies Act, 1956.

Note. (1) Previous year's figures are not required.

(2) Ignore taxation.

Ans. [Gross Profit Rs. 3060 Lakh; Profit prior to incorporation Rs. 250.75 Lakh; Profit after incorporation Rs. 1371 Lakh ; B/S Total Rs. 11146.75 Lakh].

9. A company with an issued and subscribed capital of Rs. 10,00.000 in 1,00.000 shares face value Rs. 10 each of which Rs. 8 per share is paid up, has accumulated a Reserve of Rs. 3.00,000. Out of this Reserve Rs. 2.00,000 is intended to be utilised in declaring a bonus at the rate of 25% on the paid up capital so that the shares may become fully paid.

Show the necessary journal entries

10. The Balance Sheet of Cosmos Ltd. on 31st March. 1995 was as follows:

Liabilities	Rs.	Assets	Rs
4,000 Equity Shares of Rs.100		Sundry Assets	10,00,000
each, Rs. 80 paid	3,20,000		
Security Premium Account	60,000		
Capital Redemption Reserve A/C	70,000		
General Reserve	1,00,000		
Profit and Loss Account	3,00,000		
Sundry Creditors	1,50,000		
	10,00,000		10,00,000

The directors recommended the following with a view to capitalising whole of Security Premium Account, General Reserve and Rs 50,000 of Profit and Loss Account:

(a) The existing shares to be made fully paid without the shareholders having to pay anything.

(b) Each shareholders to be given fully paid bonus shares at a premium of 25% for the remaining amount in proportion to his holding.

Assuming that the scheme is accepted and that all formalities are gone through, give journal entries and also show in what proportion bonus shares will be distributed among shareholders.

Ans. [1,600 bonus shares arc. issued for 4.000 shares, *i.e.*, 2 bonus shares for every 5 shares held are issued].

STUDY NOTE - 9

ACCOUNTING IN SERVICE ORGANISATION

This study note includes

- Accounts for Miscellaneous Services
- Computer Software Accounting
- Accounts of Insurance Companies
- Accounts of Banking Companies
- Accounts of Electric Supply Companies.

9.1. ACCOUNTS FOR MISCELLANEOUS SERVICE

1. In addition to usual final accounts, contractors prepare different Contract Accounts to find out cost of each contract, work-in-progress and profit to be considered in case of each contract.

(1) Accounting Procedure

Contract Accounts for different work site are maintained in the Contract Ledger. Materials sent to the work site, wages to labourers engaged in that work site and any special plant purchased for that particular work site are debited to the specific Contract Account identified by number or name. Materials may be sent to site by suppliers, or from the main stores or supplied by the Contractee. The overheads are charged to different Contract Accounts on the basis of some estimate. When the same plant is used at different worksites appropriate depreciation on the basis of the period for which it is used in a particular worksite is debited to that Contract Account.

(II) 1. Contract Account should get the credit. On the other hand, if materials are sold out from a worksite, in addition to the credit to that Contract Account, profit or loss on sale of materials is to be transferred from that Contract Account, as this profit or loss should be shared by all contracts i.e., the amount is adjusted with Profit and Loss Account. Similarly, for accidental loss the Contract Account is credited as against Loss by Accident Account, which is cleared by transfer to Profit and Loss Account to the extent not covered by Insurance Claim.

2. At the end of the year the special plant, if any, is carried down at the estimated value, so that difference between charging price and the price atwhich it is carried down remains charged in that particular account. Similarly, the materials remaining at site are carried down. In addition to these, work certified and the work completed but not certified are carried down. In the alternative, all these may be transferred to Work-in-Progress Account. Some accountants, however, prefer to carry down materials and plant at site in the Contract Account itself and to transfer work certified and work not certified to Work-in Progress Account. If Contract Account is given a break before considering certified or uncertified work, upto date cost of contract comes out.

3. Contractee usually makes payment upto a percentage of the work certified. The percentage of certified work retained is know as retention of security 10% is usual security. If 2% earnest money was paid at the time of tender, 8% is deducted from Running Bills. In addition to 10% 2% 1. T. is also deducted.

4. The amount received is credited to the Contractee's Account. The amount certified, as already noted, may be carried down in the Contract Account or may be transferred to Work-in-Progress Account. In the alternative, contractee may be debited as against Contract Account or Work-in-Progress Account with the certified work. When the contractee is debited with certified work from the time to time the balance in the acccount represent total retention amount. On the other hand, if the contractee is not so debited, then the credit in his account represents advance payment to be adjusted by debit with contract value against the Contract Account on completion of the work.

5. For valuation of uncertified work the materials used, wages and proportionate overheads for the work completed but not yet certified are considered.

5.1 Profit on Uncompleted Contract

When the contract is not yet complete it is not proper to consider profit therein as earned profit, as nobody knows as to what will happen ultimately. It should be appreciated that the payments are in the nature of advance payments, and hence the contract is for the entire work and not for the part as such. However, if no profit is taken into consideration when the contract is for a lengthened period there is no profit for a number of years, and there is a huge profit in the year of completion. To aviod this, an amount of profit estimated on a very conservative basis to have been earned in the current year is credited to P. & L. Account, the balance being carried forward or credited to WIP Account. No profit is considered if less than one-third is complete. But loss is always taken into consideration.

5.II The estimate of profit in the current year may be either on (a) retrospective basis or on (b) prospective basis. The systems may be compared with the systems of valuation ~f liabilities under Life Insurance Policies. In any case the Contract Account may be balanced off after the items discussed above have been considered, the balance (say, Accounting Profit) being carried down. If there is loss at this stage, it is written off to Profit and Loss Account.

5.III. Under retrospective method the accounting profit as disclosed above is the basis of determination of profit in the current year. The percentage of payment is applied to the accounting profit to convert it to cash or realised basis, as the profit is deemed to have been earned on the work certified. Usually one-third (when half or more than one-third) or two-thirds (when more than half is complete) thereof is considered as profit to be credited to the Profit and Loss Account. Sometimes, an approximate reasonable ratio having regard to the extent of completion (certified value compared to contract value, or sometime, time spent compared to total time) is taken instead of the above one-third or two-thirds basis. The difference between accounting profit and profit credited to Profit and Loss Account is either carried down to Contract Account or is credited to WIP Account. This method is most commonly used.

5.IV. Prospective method is applied when the work is going to be completed shortly. if the Contract Account is balanced without considering certified work or uncertified work, the balance indicates cost incurred upto-date for certified and uncertified work. An estimate for further expenditure on materials, wages etc. for completion of the contract is made. The amount of opening balances at site and the estimated sale or balance at site on completion must be considered for finding out estimated further cost for completion of the work. Net cost already incurred plus estimated future net cost will a mount to estimated total cost for completion of the work. Sometimes a contingency provision is made to have estimated total cost ultimately. The contingency provision may be in terms of a percentage on the estimated total cost or on the estimated ultimate total cost.

6 The excess of the contract value over the estimated ultimate total cost is the estimated total profit on the contract. A reasonable proportion thereof (according to the extent of as discussed under prospective system above) is considered to be profit earned uptodate. If some profits have already been credited to Profit and Loss Account in earlier years, the excess of estimated uptodate profit over the profits already considered is credited to ProfIt and Loss Account in the current year. Sometimes, to be more conservative, the uptodate estimated profit is converted to realised profit on the basis of percentage of payment.

(Ill) W. I. P. and Completion of Contract

1.. In valuation of Work-in Progress the certified work, uncertified work, materials and plants at site are added and provision for unrealised profit is deducted. The valuation may be available from the Contract Account itself, from Work-in-Progress Account or from both these accounts according to the nature of entries passed for considering the balances etc. In the alternative, uptodate net cost may be found as discussed under prospective system, and the profit considered in accounts is added up with net cost together with balances at site to get the value of Work-in-Progress. If receipts are lying as advances in Contractee's Account the balance in Contractee's Account is deducted from the Work-in-Progress Account. However, if the contractee's balance is in excess of the value of Work-in-Progress, the accounts are shown on both the sides. At the beginning of the next year Work-in-Progress Account is closed by transfer to particular Contract Account from both sides separately.

In the year of completion the accounting profit (or loss) as disclosed by the Contract Account is transferred to Profit and Loss Account without any further calculation either by retrospective or by Prospective methods. The Contract Account is closed by credit to Contract Account and debit to Contractee's Account either with full value of contract or with certified value of contract in that year according to the system followed so far.

Problem :

The following are the particulars of a contract up to 31st December, 1975

	Rs.
Contract Value	8,00,000
Machinery installed at site	50,000
Material sent to site	1.60,000
Labour at site	1,30,000
Direct expenses	6,000
Overhead charges allocated	5,000
Materials returned from site	2,000
Work certified	5,00,000
Cash received	4,50,000
Cost of work not certified yet	20,000
Materials on hand as at 31-12-1975	4,000
Wages accrued due on 31-12-1975	3,000
Value of machinery as at 31-12-1975	38000

General Plant costing Rs. 1,00,000 was used for three months. Depreciation @ 20% p.a. is to be provided. Materials costing Rs. 2000 were so1d out for Rs. 3,000. In addition, scraps were sold for Rs. 1,000. Materials costing Rs. 8,000 were lost in an accident.

It was decided that 1/3 of the profit should be regarded as a provision against contingencies, and that such provision should be increase to the credit of Profit and Loss Account only such portion of the 2/3 profit as the cash received bore to the work certified.

Prepare the Contract Account and Contractee's Account for the year and show the amount taken to the credit of the Profit arid Loss Account, and also how it will appear in Balance Sheet.

Contract No Account

	Rs.		Rs.
To Materials	1,60,000	By Cash—Materials sold	3,000
To Wages	1,33,000	By Cash—Sale of scraps	1,000
To Direct Expenses	6,000	By Loss in Accident	8,000
To Overheads	5,000	By Materials—Return	2,000
To Special Plant	50,000	By Work-in-.Progress'	
To Depreciation on General Plant		Plant at site	38,000
(for 3 Months)	5,000	Materials at site	4,000
To Profit and Loss Account—		By Balance c/d—	
profit on sale of materials	1,000	cost to date	3,04,000
	3,60,000		3,60,000
To Balance b/'d- -		By Work-in-Progress'	
cost to date	3,04,000	Certified Work	5,00,000
		Uncertified Work	20,000
To Profit and Loss Account'	1,29,600		
To Work-in-Progress			
(provision)	86,400		
	5,20,000		5,20,000

Notes:

I Profit credited:

(a) Profit as per Contract Account : Rs. 2,16,000= Rs. 5,20,000—Rs. 3,04,000

(b) 1/3 provision i.e., 1/3 x 2,16,000=Rs. 72,000/-

(c) 2/3 x 2,16,000=R.s. 1,44,000/- Cash received Rs. 4,50,000 out of Rs. 5,00,000 i.e., 90%. So, provision is to be increased by 10% of Rs. 1,44,000= Rs. 14400/-

(d) Total provision is : Rs. 72,000+Rs. 14,400:-=Rs. 86,400.

(e) Profit to be credited : Rs. 2,16,000—86,400=Rs. 1,29,600.

The profit is same as: 2/3 x 90% of 2,16,000 =1,29,600.

2 Some accountants prefer to transfer only work certified and work uncertified to the Work-in-Progress Account.

Work-in-Progress Account

Particulars	Rs.	Particulars	Rs.
To Contract No ...A/c:		By Contract No. A/c	
Plant at site	38,000	(provision)	86,400
Materials at site	4,000	By Balance c/d	4,75,600
Certified Work	5,00,000		
Uncertified work	20,000		
	5,62,000		5,62,000

The Contractee's Accounts will be as below

Contractee's Account

Particulars	Rs.	Particulars	Rs.
To Balance c/d	4,50,000	By Bank (total)	4,50,000
		Contractee's Account	
To Contract No.	5,00,000	By Bank (tota1~	4,50,000
		By Balance c/d	
		(or, Security Dep.)	50,000
	5,00,000		5,00,000

Obviously, Contract Account in the second case is credited with certified work as against Contractees Account, and not as against Work-in-Progress Account.

in the alternative, Work-in-Progress Account may be dispensed with and the balances may be carried down in Contract Account itself.

Contract Account No

Particulars	Rs.	Particulars	Rs
To Materials	1,60,000	By Cash—materials sold	3,000
To Wages	1,33,000	By Cash—scrap	1,000
To Direct Expenses	6,000	By Materials Returned	2,000
To Overheads	5,000	By Loss in Accident	8,000
To Special Plant	50,000	By Balance c/d:	
To Depreciation	5,000	Plant at site	38,000
To Profit on Sale of Materials	1,000	Materials at site	4,000
		Cost 10 date	3,04,000
	3,60,000		3,60,000

Particulars	Rs.	Particulars	Rs.
To Balance b/d :		By Balance c/d'	
Plant at site	38,000	Certified Work	5,00,000
Materials at site	4,000	Uncertified Work	20,000
Cost to date	3,04,000	Plant at site	38,000
To Profit and Loss A/c	1,29,600	Materials at site	4,000
To Balance c(d'	86,400		
	5,62,000		5,62,000

The Balance Sheet will include:

Assets	Rs	Rs.
Work-in-Progress	4,75,600	
Less Contractee's Account –	4,50,000	25,600
Note WIP Rs.	5,62,000—Rs.86400 =	Rs 4,75,600

Problem

The Contract Ledger of Company showed the following expenditure in connection with a contract for the erection of a factory:

	Rs.
Special Plant	1,00,000
Materials	1,50,000
Wages	3,00,000
Overhead Charges	60,000

The contract price was Rs. 12,00,000. It was estimated that it would take one more year for the completion of the contract. The work certified was Rs. 8,00,000 and eighty per cent of the certified work was received in cash. At the end of the year materials lying on site were valued at Rs. 20,000 Depreciate the plant by 10 per cent. 6% of wages and 5% of materials may be taken to have been incurred for the portion of work completed but not yet certified. Overheads are charged as a percentage of direct wages. After making the necessary adjustments show how the Contract Account will appear and what profit should be credited to Profit and Loss Account. Neglect depreciation of Plant for use on uncertified portion.

Valuation of Uncertified Work:

		Rs.
Materials	5% of Rs. 1,50,000	7,500
Wages	6% of Rs. 3,00,000	18,000
Overheads	20% of Rs. 18,000	3,600
		29,100

Contract Account

Particulars	Rs.	Particulars	Rs
To Special Plant	1,00,000	By Work-in-Progress A/c:	
To Materials	1,50,000	Certified Work	8,00,000
To Wages	3,00,000	Uncertified Work	29,100
To Overheads	60,000	Plant	90,000
To Balance c/d	329100	Materials	20,000
	9,39,100		9,39,100
To Profit and Loss A/c	175520	By Balance b/d	3,29,100
To Work-in-Progress A/c	153580		
	329,100		329,100

Notes

‘Other alternative systems as discussed in Problem may also be followed.

Profit credited:

(a) Profit as per account Rs. 3,29,100.

(b) Realised Profit 80% of Rs. 3.29,100=Rs. 2,63,280.

(c) Rs. 8,00,000 has been certified out of a contract of Rs. 12,00,000 i.e..2/3 So profit to be credited— Rs. 2,63,280x2/3 =Rs. 1,75,520.

Problem

Y.Ltd undertook a contract No. 80 for Rs. 7,50,000. The contract account showed the following particulars

1973

Materials Rs. 30,000, Wages Rs. 25,000, Overheads Rs. 10,000, Plant Rs. 1,00,000 and Materials at site at close Rs. 3,000.

1974:

Materials Rs. 1,00,000, Wages Rs. 60,000, Overheads Rs. 15,000, Materials returned Rs. 8,000. The Plant at its depreciated value was transferred to contract No. 88. Uncertified work Rs. 15,000.

1975

Materials Rs. 1,60,000, Wages Rs. 1,00,000, Overheads Rs. 28,000 and Materials sold Rs. 4,000,

The amount of work certified at the end of the first year was Rs. 1,00,000. The work certified upto the end of the second year was Rs. 4,00,000 and the work certified in the third year was Rs. 3,50,000. 80 per cent of the certified work was received in cash.

Profit to be taken credit for are one-third and one-half on cash basis in each of the two years respectively. Depreciate plant by 10 per cent on balance at the beginning ui each year.

Prepare accounts in respect of the contract at the end of each year.

Contract No. 80

Particulars	Rs.	Particulars	Rs
1973		1973	
To Materials	30,000	By Work-in-Progress Ac	
To Wages	25,000	Materials	3,000
To overheads	10,000	Plant	90,000
To Plant	1,00.000	Certified Work	1,00,000
To Balance c/d	28,000		
	1,93,000		1,93,000

Particulars	Rs.	Particulars	Rs.
1973		1973	
To Profit and Loss Account[1]	7,467	By Balance b/d	
To Work-in-Progress Account	20,533		28,000
	28,000		28,000

Particulars	Rs	Particulars	Rs.
1974		1974	
To Work-in-Progress—Opening		By Work-in-Progress—Opening	
balance transferred		provision transferred	20,533
Materials	3,000	By Materials—returned	8,000
Plant	90,000	By Contract No. 88—Plant	
('certified Work)	1,00,000	transferred	
To Materials	1,00,000	By Work-in-Progress c/d :	81000
To Wages	60.000	Uncertified Work	
To Overheads	15,000	Certified Work	15,000
To Balance c/d	1,56 533		4,00,000
	5,24,533		5,24,533
To Profit and Loss A/c[1]	62,613	By Balance b/d	1,56,533
To Work-in-Progress	93,920		
	1,56,533		1,56,533

Particulars	Rs.	Particulars	Rs.
1975		1975	
To Work-in-Progress:		By Work-in-Progress	93920
Uncertified Work	15,000	By Bank—sale of materials	4000
Certified Work	4,00.000	BY Contractee's Account	7,50,000
To Materials	1,60,000		
To Wages	1,00,000		
To Overheads	28,000		
To Profit and Loss Account	1,44,920		
	8,47,920		8,47,920

Notes

Profit credited in 1973 and 1974

	1973	1974
	Rs.	Rs.
Accounting Profit	28,000	1,56,533
Cash Profit—on 80% basis	22,400	1,25,226
Proportionate profit to be credited		
1/3x 22,400 1/3 x 1,25,226	=7,467	= 62,613

In absence of specific direction, no profit in 1973 would have been considered as extent of completion was less than one-third.

- In 1975 the entire work was certified and hence no provision is necessary.

Work-in-Progress Account

Particulars	Rs.	Particulars	Rs.
1973		1973	
To Contract Account No. 80		By Contract no.80 -Provision	20,533
Materials	3,000	By Balance c/d	1, 72,467
Plant	90,000		
Certified Work	1,00,000		
	1,93,000		1,93,000

1974—Jan. 1

Particulars	Rs.	Particulars	Rs.
To Balance b/d	1,72,467	1974—Jan-1	
To Contract No. 80—transfer	20,533	By Contract No. 80 (details)	1,93,000
Dec. 31		Dec. 31	
To Contract No.80:		By Contract No. 80—Provision	93,920
Uncertified Work	15,000	By Balance c/d	3.21,080
Certified Work	4,00,000		
	6,08,000		6,08,000

Particulars	Rs.	Particulars	Rs.
1975—Jan. 1		1975 Jan.1	
To Balance b/d	3,21,080	By Contract No.80 (details	4,15,000
To Contract No. 80—transfer.			
To balance c/d	93,920		
	4,15,000		4,15,000

Contractee's Account

Particulars	Rs.	Particulars	Rs.
1973		1973	
To Balance c/d	80,000	By Bank (80% of Rs.1,00,000)[4]	80,000
1974		1974	
To Balance c/d	3,20,000	By Balance b/d	80,000
		By Bank	
		80% of (4,00,000—1.00,000)'	2,40,000
	3,20,000		3,20,000
1975		1975	
To Contract Account	7,50,000	By Balance b/d	3,20,000
		By Bank	4,30,000
	7,50,000		7,50,000

Only certified work and uncertified work may be transferred to Work-in Progress Account. It is assumed that full payment has been made in 1975, Each year credit may also be given for full amount, 20% being transferred to Security Deposit. Last year there would be Rs. 1,00,000 refund of Security Deposit.

Problem

A firm of contractors obtained a contract to build a house for Rs. 6,00 000. The work commenced on 1st April, 1975 and the following expenditure was incurred during the year ended 31st March, 1976

Plant and tools Rs. 20,000 ; Stores and materials Rs. 90,000 Wages Rs. 80,000 ; Sundry expenses Rs. 7,000 and establishment charges Rs. 18,000

Some of the materials were found to be in excess and was sold ultimately for Rs. 17,000 while their cost price was Rs. 14,000. A portion of the Plant was scrapped and sold as scrap for Rs. 3,000

The value of the Plant and tools on site on 31st March, 1975 was Rs. 8,000 and the value of stores and materials on site was Rs. 5,000.

Cash received from the contractee was 80% of the work certified and it amounted to Rs.3,20,000 upto 31st March, 1976. The value of work done but not certified was Rs. 30,000,

The firm wanted to take into account part-profit for the work done on the basis of an estimate as to what further expenses would be incurred in completing the work such that the profit to he taken into account would be proportional to such estimated profit for the work certified as the work certified bears to the whole work.

The estimate was as follow~

(a) That the contract would he completed by 31st December, 1976.

(b) The wages on the contract for the next nine months would amount to Rs. 80,000.

(c) That the cost of stores and materials required in addition to those on site on 31st March, 1976 would be Rs. 90,000 and that further contract expenses would amount to Rs. 9,000.

(d) That a further Rs. 35,000 would have to be spent for installing Plant and tools and the scrap value of these on 31st December, 1976 would be Rs. 8,800.

(e) That the establishment charges would cost the same per month as in the year ended 31st March, 1976.

(f) 2% on ultimate total cast is to be taken as Contingency Provision.

Prepare Contract, Stores and Materials and Plant Accounts for the year ended 31st March, 1976 and show Pro-forma calculation for the profit that should be credited to Profit and Loss Account of the firm for the year ended 31st March, 1976.

Pro-forma Contract Account

Particulars		Rs.	Particulars	Rs.
To Cost incurred upto 1-4-75 (as per Contract A/c)		1,75,000	By Contract Price	6,00,000
To Estimated Cost of Materials:				
At Site	5,000			
Add	90,000	95,000		
To Estimated Wages		80,000		
To Estimated Expenses		9,000		
To Plant:				
At Site	8,000			
Installation	35,000			
	43,000			
Less Scrap	8,800	34,200		
To Establishment Charges:				
	1,500x9	13,500		
		4,06,700		
To Contingency Provision'		8,300		
		4,15,000		
To Estimated Profit on completion		1,85,000		
		6,00,000		6,00,000

Generally, the above profit is also converted to realised profit. Here, however, that is not, intended.

Provision for unrealised profit :	Accounting Profit	2,55,000
	Less Profit to be credited	1,23,333
		1,31,667

Contingency Provision: 2/98 x 4,06,700 = 8,300

Problem

After making provision of one-third of profit received draw out Contract Accounts No. 63 and No. 64, Profit and Loss Account and Balance Sheet from the following Trial Balance as on 3 1.12.75 and information

Particulars	Dr. Rs.	Cr. Rs.
Contractees' Account		3,00,000
Buildings	1,00,000	
Creditors		62,000
Bank	35,000	
Capital Amount		3,00,000
Materials	1,00,000	
Wages	70,000	
Expenses	37,000	
Plant	2,50,000	
Work-in-Progress (1-1-75)	70,000	
	6,62,000	6,62,000

Contract No. 63 which was in progress on 1-1-75 was completed during the year and contract No. 64 was started. There was a provision of Rs. 30,000 for unrealised profit against Contract No. 63 and Work-in-Progress balance is given above after deduction of the provision.

Rs. 20,000 materials and Rs. 10,000 wages were paid for Contract No. 63. Rs. 60,000 materials were sent to Contract No. 64 site, but Rs. 3,000 was lost there by accident. Rs. 60,000 wages were paid and Rs. 50,000 plant was used in Contract No. 64 all through, hut Plant costing Rs. 2,()O,UO() was used upto September in contract No. 64 and then it was returned to stores. Rs. 4,000 materials were at site of Contract No. 64. Provide 1O% depreciation on the plant for the entire year.

Contract Account No. 63

To Work-in-Progress	1,00,000	By Work-in-Progress'	30,000
To Materials	20,000	By Sundry Debtors~	1,50,000
To Wages	10,000		
To Expenses	5,000		
To Profit and Loss Account	45,000		
	1,80,000		1,80,000

Contract Account No. 64

Particulars	Rs.	Particulars	Rs.
To Materials	60,000	By Loss by Accident	3,000
To Wages	60,000	By Work-in Progress	
To Expenses	30,000	Plant	45,000
To Special Plant	50,000	Materials	4,000
To Dep. on General Plant'	15,000	Uncertified Work	15,000
To Balance c/d	52,000	Certified Work[2]	2,00.000
	2,67,000		2,67,000
To Profit and Loss Account[4]	31,200	By Balance b/d	52,000
To Work-in-Progress	20,800		
	52,000		52,000

Profit and Loss Account for the year ended 31st December. 1975

Particulars	Rs.	Particulars	Rs.
To Depreciation' on Plant		By Profit from Contract A/c	
(unabsorbed)	5,000	Contract No. 63	45,000
To Depreciation on building	2,000	Contract No. 64	31,200
To Loss by Accident	3,000		
To Expenses (37,000—35.000)	2,000		
To Capital Account	64,200		
	76,200		76,200

Notes:

1 Net balance of Rs. 70,000 is after deduction of Rs. 30.000 provision. Hence gross value Rs. 100000 together with the provision Rs. 30,000 is transferred to Contract Account.

2 The plant specifically installed is carried down in the contract site Work-in-Progress) after charging depreciation. For General Plant depreciation for 9 months is Charged to Contract No. 64 balance being written off to Profit and Loss Account. of 1,50.000) is received n account of Contract No. 64. Hence certified value is Rs. 1,80,000x 100/20 =Rs. 2,00,000. So, 2/3rd of profit is to be considered. '

Profit to be credited to Profit & Loss Account:

Accounting Profit: Rs. 52,000

Realized Profit: 90% of Rs 52,000 = Rs. 46,800

Reasonable. proportion such profit = Rs. 46,800 x 2 / 3 = 31,200

Contractees' Account

Particulars	Rs.	Particulars	Rs.
To Sundry Debtors~ —		By Balance c / d	3,00,000
of Rs. 1,50.000)	1,20,000		
To Balance c / d	1,80,000		
	3,00,000		3,00,000
T o Balance b / d	70,000	By Contract No. 63—transfer[1]	1,00.000
To Contract No. 63—transfer[1]	30,000	By Contract No. 64—Provision for	
To Contract No. 64:		Unrealized Profit	20,800
Plant	45,000	By Balance c / d	2,43,200
Materials	4,000		
Certified Work	15,000		
Uncertified Work	2,00,000		
	3,64,000		3,64,000

Balance Sheet as at 31st December, 1975

Liabilities		Rs.	Assets		Rs.
Capital Account	3,00,000		Buildings	1,00,000	
Add Profit	64,200		*Less* Depreciation	2.000	98,000
		3,64,200	Plant	2,00,000	
Sundry Creditors		62,000	Less Depreciation	20,000	1,80,000
			Sundry Debtors'		30,000
			Stock of Materials'		20,000
			Work-in-Progress'		
			Contract No. 64	2,43,200	
			Less		
			Contractee's A / c	1,80,000	63,200
			Bank		35,000
		4,26,200			4,26,200

Notes:

~ Debtors' balance: Rs. 1,50,000—1,20,000=Rs. 30,000.

'Assuming that there is no handling loss etc., closing stock will be Rs. (1,00,000—20,000—60,000)=Rs. 20000.

WIP = Rs. 2,64,000— Rs. 20,800 = Rs. 2,43,200

Problem

From the following expenses incurred during January, 1976 on Contract No. 78 show the day to day account for the Contract 7~ in Contract Ledger:

January 2	Wages	4,000
3	Materials	10,000
14	Wages	15,000
15	Plant	20,000
26	Direct Expenses	4,000
27	Wages	8,000
	Direct Expenses	3,000

On 1-1-76 Rs. 80,000 was carried forward being Rs. 30,000 Materials, Wages Rs. 20,000, Rs. 7,000 Direct Expenses, Rs. 3,000 Indirect Expenses and Plant Rs. 20,000. Certificates for completion were received on 10- 1-76 for Rs. 30,000 and on 17.1.76 for Rs. 35,000. As on 1.1.76 total of work certified amounts to Rs_1 1,00,000.

Balance Sheet as at 31st December, 1975

Particulars	Rs	Particulars		Rs.
Capital	5,000	Furniture		4,000
Add Profit	24,700	Less Depreciation	400	3,600
	29,700	Library	5,000	
Less Drawings	10,000	Less Depreciation	500	4,500
	19,700	Work-in-Progress		2,800
Provision for Unrealised Profit	12,800	Clients' Disbursements '		2,150
Clients' Deposit	5,950	Clients' Control Account		10,000
Liabilities for Expenses	600	Bank (Office)		8,050
		Bank (Clients)		5,950
		Cash		2,000
	39,050			39,050

Farm Accounting

(Including Agriculture, Horticulture, Dairy and Poultry)

1. Farming activities may constitute in agriculture, horticulture, dairy, poultry, pisiculture and the like or may combine two or more lines. Raising of fruits and flowers as also rearing of sheep and sericulture etc. may also be included in "farming" in the widest sense of the term. Nurseries for growing and selling of seedlings and plants are also within the purview of the term "farming".

2. In our country we have rarely well-organized farming activities, and as such we have rare use of proper system of accounting in farming. Where there are large scale and organised farms the benefits of Double Entry accounting system may be enjoyed by them. Apart from giving true cost and profit on each line of proper accounting will ensure better control by management.

(A) Agriculture, Horticulture' & Nurseries

3. For agriculture detailed accounts should be kept for different crops, as, rice, wheat, jute etc. Moreover, if the same crop is produced in different fields, accounts for each field should also be maintained. The Field Account should be debited with cost of seeds, seedlings, manures and expenses for tilling. Wages for different activities, rent, canal dues or expenses for irrigation and depreciation on agricultural equipments, livestock etc. should also be considered. The Crops Account and Hays Account are debited as against Field Accounts with. cost of production. The cost being common cost the transfer to Hays Account and Crops Account is to be made on the basis of some estimated value of hays. The hays used for feeding the livestock, seeds used for growing seedlings and the cost of food supplied from farm produces to the workers and proprietor do not involve apparent monetary transactions but these "imputed" transactions should be brought into accounts on the basis of estimated values. The Crops and Hays Account are credited on sales, consumption or on use in further production.

4. For growing of vegetables, accounts for different vegetables as cabbage, potato, tomato etc., should be maintained in the lines as above.

(B) Dairy & Poultry

For rearing of sheep and other live-stock, accounts must be maintained for each type of livestock separately. The cost of Tearing is matched by sale common costs on reasonable basis. The cost of rearing is matched by sale proceeds of the live stock or other products there from. However, in small firms having different types of activities, sometimes account for each type is avoided for the trouble of allocation, and the Farm Account is made up for all items. When accounts for different lives-stocks are being maintained separately,

There should also be a column for numbers.

In case of birth of calves etc., Calves Accounts -estimated Cost as against Cows or Buffaloes Account. It should be noted that the number of calves will be debited in the number column of Calves Account, but there will be no corresponding credit in the number column of Cows Account. On growing up, the calves are retransferred to Cows Account, Bull Account or Bullocks Account. If no transfer is made at all, the position will be automatically adjusted in the Final Accounts as values of the claves shall be considered in closing stock with those of cows and buffaloes.

In case of deaths the account is credited with number and sales of the carcasses and the loss is automatically adjusted, as in closing stock only the value of remaining heads is considered.

For different types of farming activities Cash Book, Purchase Book and Sales Book should be maintained in columnar fashion with suitable heads. As for example, Sales Book should have columns for Cattle, Milk, Cream, Butter, Ghee, Poultry, Vegetables, Rice, Wheat, Fruits etc

In preparation of final accounts, opening and closings stocks of live stock, crops in hand and hays and straw, growing corps, manures, should be considered. Depreciation, maintenance etc. should also be considered. In Final Accounts of Companies shows the special items in the Profit & Loss Account and Balance Sheet.

Builders and House Owners

1. There may be some organization specialization in construction of buildings for selling out. Contractors undertake to construct house etc. for others. But these types of organizations acquire a plot of land, develop it, divide it smaller plots. construct house or flat according to their plans having regard to the needs of the prospective buyers. When the house constructed it is Sold out as such, in such cases until all the houses have been disposed of (Sold or finally retained for own residence) profit or loss can be found out by taking valuation of houses not yet disposed of.

2. It will be better to have detailed and separate accounts of each unit Otherwise, all the houses (usually being small in one area may he considered as one unit. The cost of. land required or passages. parks etc. will increase the Cost of houses, but if no account for each house is maintained. the cost of land left vacant for these purposes will automatically increase the cost of the entire estate. If a house is retained for the proprietor, its value should also be considered in determining the true profit.

3. When a person or a concern has a number of houses for letting out, detailed accounts for each tenant has to be maintained. But the number of tenants may be very large because there may be many tenants particularly business area) in the same house. The best way to keep accounts of tenants is to maintain Rental Ledger in which against each property (entered with number and address~ the names of tenants with their particulars are entered. The balance is brought forward first and then the rent for the month is booked and then-is the total of debit. The date and number of receipts together with Cash Book folio are entered in the credit side. Any rebate or allowance for repairs carried out or adjustments against advances are also entered in the credit side. there is a column for "total of credits" and the amount therein is deducted from the total of debits" column, balance being carried forward to the next month. House meant for sale may also be let out temporarily. Final Accounts of House Builders considered in Problem 18 of Final Accounts of Companies)

Problem

A Civil Engineer decided to build four house on a piece of freehold land which he purchased for Rs. 60,000. He engaged a foremen at a wage of Rs. 300 per month, plus 20 per cent of any profit realized on the sale of the houses after deducting his commission. For that purpose, the land was to be valued at Rs. 20,000 after developments for each of the four plots. The essential figures were as follows

	Rs.
Development Expenses	10,000
Wages paid, including that of foreman	40,000
Cost of Materials, Timber, Fittings, etc.	50,000
Net cost of Scaffolding and Plant	2,000
Charges for Electricity, Water, etc.	1,000
Insurance, Advertising etc.	2,000
Bank Charges	1,000
Sundry Expenses	800
Law Charges	600

Three of the houses were sold at Rs. 50,000 each the fourth as retained by the owner and was valued at Rs.55,000 and treated as sale at that price.

You are required to prepare an account showing the actual profit or loss to the owner.

Buildings Construction and Sale Account

Particulars	Rs.	Particulars	Rs.
To Cost of Land	60,000	By Stock A/C	1,50,000
To Development Expenses	10,000	By Capital Account—house retained	55,000
To Wages (incl. Foreman)	40,000		
To Cost of Materials	50,000		
To Cost scaffolding etc	2,000		
To Electricity	1,000		
To Insurance, Advrt..	2,000		
To Bank Charges & Interest	1,000		
To Sundry Exp.	800		
To Law Charges	600		
To Balance c/d	37,600		
	2,05,000		2,05,000

To Commission[1]	4,600	By Balance b/d	37,600
To Capita! Account —			
Net Profit	33,000		
	37,600		37,600

Note:

	Rs.	Rs.
Commission		
Profit as above		37,600
Agreed cost of land : 20,000 x 4	80,000	
Less Cost of land and development		
charged in the above account : (60,000 +10,000)	70,000	10,000
Charged Profit for Commission		27,600

Garage and Motor Car Dealers

1. The Garage Companies may provide for garaging of cars, sale of accessories, petrol and even sale of cars and motor cycles in addition to repairs and servicing Job The Accounting will depend upon the size and exact nature of the concern In general, columnar Sales Day Book is suitable for recording sale of car, motor cycle. accessories. Lubricants, petrol, repairs and servicing, hire charges garage charges and the like. When the petrol pump is attached with the garage. it accounts should be separately maintained. The Purchases Book and Cash Book may also be main tained in analytical form. The Garages Accounts for different sections should also be made separately.

2. Transfer are required from one department to another department for goods and spars used and also for benefits enjoyed by employees and proprietor. Old cars purchased may be overhauled with the help of Repairs Section and then sold. The cost of such cars should be increased by credit to Repairs Section.

3.. It will be better to have separate ledger for each ship and all expenses and incomes in connection therewith are to he considered in that ledger. Moreover, the expenses and incomes against each voyage should be recorded in the Voyage Account.

ENTERTAINMENT

Cinema, Theatre, Jatra and Circus

1. These organizations have substantial similarity in respect of incomes viz., sale of tickets, programmes, advertisement and the like. These can better be recorded in Cash Book with these columns. The daily sales of tickets is recorded in the Daily Return of Tickets sold and this must be in agreement with the Register of Stamps of Amusement Taxes.

2. The Distributors have the above incomes as against which Amusement Tax is a direct charge. Hire charges of films, advertisement, wages for different groups of staff are to be considered along with rent or depreciation of the buildings, furni ture, Projectors and other equipments Accounts for each book should be drawn by he Distributors. For Producers the income are sale and hire of films as against which fees of artists, expenses of outdoor shooting, charges of studios, remunera tion of Cameramen, Music Directors, Directors etc. are charged. Working Account of each feature should be separate1y drawn out by Producers.

3. In Theatres also similar accounts are maintained. Salaries of Orchestra, cost of dresses, remuneration of artists, rents etc. are considered as running expenses and are recorded preferably in columnar form of Cash Book. The cost of scenery, equipment etc. is capitalized and depreciation is charged along with depreciation on Furniture and Fixture. The accounts of Jatra Party may also be maintained in the same way but usually collections are on contract basis rather than on the basis of sales of tickets. -

4. In Circus, accounts for collection and expenses may be maintained in the same way as above. Special care should be given to Live Stock Account and preferably different Live Stock Accounts for different animals should be maintained. Working Account should be drawn for each establishment usually running over a few months; as generally they are of mobile type.

Hotels, Restaurants and Caterers

1. The accounting scheme of the organization will, of course, depend upon its size and exact nature and requirements, but the principle of accounting remains same as in all cases. There may be provision for saving of refreshment only, or for serving of launches and dinners usually with provisions of refreshments; there may be arrangement of bar, and lodging may also be provided. Some may have special section for catering at different places on the occasion of marriage and the like. At any rate, purchases of various types of items should be separately recorded and similarly accounts for sales of various types of items must be separately maintained to disclose the correct position and for helping in proper control.

2. Purchases and expenses may better be recorded through Analytical Purchase book and Cash Book. The purchase Day Book and payments side of Cash Book will be provided with columns for: Wines and Minerals; Groceries and Provisions; Cigarettes and Cigars; Cutlery, Glass and Plates; Bedding and

3. Linens ; Furniture and Fixtures; Establishment; and the like. There v~ ill be a Ledger Column also in Cash Book to show disbursement on behalf of visitors.

4. The Receipt side of Cash Book and Sales Book may have analysis columns as : Dinner and Launches, Breakfast, Bar, Cigarettes and Cigars, etc. in Cash Book there will be further columns for Visitors' Ledger and Personal Ledger.

5. The Sales Book is better maintained together with the account of each visitor (when lodging is provided) in the form of what is known as Window Ledger or Visitors' Ledger. Account for each day is maintained for each visitor together with details of charges (same as are shown in bills submitted to them ultimately) and the Room No. is indicated against each visitor. The vertical total shows the Debit Total for each visitor, and credits are shown below. The horizontal totals indicate totals of different types of charges during the whole day. The daily total may be posted in ledger or may be carried forward to next day and added up with next day total and carried forward and so on, ultimately being posted to ledger (it required) say, at the end of the month. When there are many rooms and guests, a number of pages has to be used every day. A pro-forma Visitors Ledger (Window Ledger

6. The items may be repeated by the side of Daily Total column to avoid confusion as there may be many columns for visitors in every page. The B.F. and C. F. columns ma also be avoided and Daily Totals may be posted in the General Ledger.

7. Stock Ledger must be maintained in details to have thorough control purchases, usage and sales of different items, and periodical stock must be carried out.

8. At the time of preparation of Final Accounts adjustment entries must be passed for meals, accommodation etc. of the staff and proprietor by crediting these items as against Salaries and Wages or Drawings, as the case may be. It will be better to draw out Working Accounts for different sections as Bar, Accommodation,Restaurant, Supply of Launches and Dinners. The rates and taxes and building repairs, depreciation on beddings together with attendant's wages and proportionate establishment charges are charged against Accommodation account whereas collections for accommodation arc credited to this accounts.

9. Cost of meat, eggs. fish and poultry. stores, groceries and provisions are apportioned in between Restaurant Section and Launches and Dinners. Depreciation on glass and china. cutlery and plates, table linens etc. should be similarly apportioned. Separate accounts may also be necessary for Billiard Room, Banquet Halls, Garage. Laundry and the like.

Plantation

(Tea, coffee, Rubber etc.)

1. In many plantation concerns there are distinct agricultural aspect and also industrial aspect and hence accounts should be made with an eye to that. Clearing expenses of areas where plantations have been abandoned should be capita used. Expenses of cultivation etc. in areas not bearing are similarly capitalized. When cultivation expenses of "not bearing" area are not available, total cultivation expenses should be distributed on acreage

basis. Wages Accounts should be separately maintained for Planting, Cutting, and Processing. Proper control should be exercised on the employment and payment of outdoor work. The Hospital and Medical Expenses thereon will be ultimately booked to Labour Expenses together with Recruitment and Passage Expenses. Cultivation Account and Processing Account may be Separately prepared.

2. The Garden Returns certified by the Manager are incorporated in Head Office Books. The sales are as per returns from the Brokers. Provision for necessary commission on sales as also on crops, if required, should be made.

3. The Final Accounts should better be drawn out in sections so that the cost of leaves plucked before processing may also be known. It may be pointed out in this connection that closing stock is not valued on the normal basis of "lesser of cost or market price", but on the basis of the "price since realised" inasmuch as the crop of the season is normally sold out at the time of finalisation of accounts. 6O~ of the income of tea companies is deemed to be agricultural income, and hence provision for Income-Tax is to be made on the basis of 4O% of profit only. Natural Accounting year should better be followed to coincide with the crop-season.

Doctors, Druggists and Nursing Homes

1. Practicing Doctors, whether G. P. (General Practitioners) or specialists, maintain diary, and all details, charges, special points are noted there. From these the Incomes are grouped and recorded in daily Cash Book having columns for visits, consultation fees, prescription served etc. Ii a number of specialists carry on in partnership further columns may be necessary for charge for pathological examinations, surgical operations, X'Ray and other plates, special therapy etc. (For accounts of a Polyclinic see Problem 16, p. 1154)

2. The expenses are also grouped in Cash Book as medical and surgical equipments and plants, special and general furniture and fixture, medicines and drugs, bandaging materials etc. and other expenses. Patients' Ledger may have to be maintained. In case of Dentists, purchases of dentures (i.e. artificial teeth etc.) and connected materials are to be recorded in separate columns.

3. in case of dispensing Chemists and druggists, sales book and purchases Book are to be ruled with columns for: Prescriptions served, drugs, patent medicines, baby foods, bandaging materials and the like.

4. In case of Nursing Homes accounts for the cabin and bed rents, expenses, and collections from patients should be maintained separately from those. for charges for attendance by Doctors and Surgeons, supply of drugs and medicines etc. Similarly, accounts for food and diet should be separately maintained. Columnar Purchases Book, Charges Book and Cash Book may be maintained for each bed.

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9.2. COMPUTER SOFTWARE ACCOUNTING

Introduction

Software is the general term describing programmes of instructions, languages and routines or procedures that make it possible for an individual to use the computer. It is any prepared set of instructions that controls the operations of the computer for computation and processing. More specifically, the term software applies to those programmes that are built within the computer. These programmes forming the software are supplied by the manufacturers and are usually named as *packages*. The hardware, the electronic, electrical, magnetic and mechanical components or devices that make the computer and software taken together form a computer *system*. It must be remembered that even a very powerful computer is useless junk without a strong support from its software.

In case computer software is acquired for sale in the ordinary course of business, it is treated as inventory and AS-2, Valuation of Inventories, is applicable which has been discussed in Section I of the book. If it is meant for internal use, AS-26 is applicable.

Computer software for internal use can be either:

(i) acquired, or

(ii) internally generated.

SOFTWARE ACQUIRED FOR INTERNAL USE

The cost of a software acquired for internal use should be recognized as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of the Accounting Standard-26* of the Institute of Chartered Accountants of India which are given below:

"19. The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the following definition and criteria:

(a) Definition of an intangible asset

An *intangible asset* is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

An *asset* is a resource:

(a) Controlled by an enterprise as a result of past events: and *from* which future economic benefits are expected to flow to the enterprise.

Non-monetary assets are assets other than monetary assets. *Monetary* assets are money held and assets to be received in fixed or determinable amounts of money.

(b) Recognition criteria set out in this Statement.

"20. An intangible asset should be recognized if, and only if:

(a) It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) The cost of the asset can be measured reliably.

*AS-26 applies in case of 10 enterprises whose securities are listed on an Indian recognized stock exchange and *(ii)* other business enterprises having annual sales exceeding Rs. 50 crores. AS-26 is mandatory for accounting periods beginning on or after 1-4-2003.

21. An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

22. An enterprise uses judgment to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition giving greater weight to external evidence.

23. An intangible asset should be measured initially at cost. In the determination of cost, matters stated in following paragraphs of Accounting Standard-26 are to be considered:

24. If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

25. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

26. If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value. or the fair value of the securities issued whichever is more clearly evident.

INTERNALLY GENERATED COMPUTER SOFTWARE

Internally generated computer software for internal use is developed or modified internally by the enterprise solely to meet the needs of the enterprise and at no stage it is planned to sell it.

The stages of development of internally generated software may be categorized into the following two phases:

a. Preliminary project stage. i*.e.*, the research phase.

b. Development stage.

a. Preliminary project stage, ***i.e.,*** the research phase

At the preliminary project stage the internally generated software should not be recognized as an asset. Expenditure incurred in the preliminary project stage should be recognized as an expense when it is incurred. The reason for such a treatment is that at this stage of the software project an enterprise cannot demonstrate that an asset exists from which future economic benefits are probable.

When a computer software project is in the preliminary project stage enterprises are likely to:

a. Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new Accounts system or make efforts toward correcting existing problems in an operating Accounts system.

b. Determine the performance requirements as well as the systems requirements for the computer software project it has proposed to undertake.

c. Explore alternative means e.g. should an entity make or buy the software. Should the software run on a mainframe or a client server system?

d. Determine that the technology needed to achieve the same.

e. Study the requirement of a consultant to assist in the development and/or installation of the software.

b. Development stage

Internally generated software arising at the development stage should be recognized as an asset if, and only if, an enterprise can find out all of the following:

(b) The intention of the enterprise to complete the internally generated software and use it to perform the functions needed. For example, the intention to complete the internally generated software can be demonstrated if the enterprise commits to the funding of the software project;

(a) The technical feasibility of installing the internally generated software.

(c) The ability of the enterprise to use the software;

(d) The probable usefulness of and economic benefits from the software.

(e) The availability of adequate technical, financial and other resources to com plete the development and to use the software; and

(f) The capacity to measure the expenditure attributable to the software during its development.

Examples of development activities in respect of internally generated software include:

Detailed programme design of for the software considering product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.

Codification of requirements. The coding of computer software may begin prior to, concurrent with, or subsequent to the completion of the detailed programme design.

At the end of these stages of the development activity, the enterprise has a working 'model, which is an operative version of the computer software capable of performing all the major planned functions, and is ready for initial testing ("beta" versions).

Testing which is the process of performing the steps necessary to determine whether the developed software meets the targeted performance requirements.

At the end of the testing process, the enterprise has a master version of the internal use of software, which is a completed version together with the related user documentation and the training materials.

Cost of internally generated software

The cost of internally generated software is the sum of the expenditure incurred from the time when the software first met the recognition criteria for an intangible asset as stated in paragraphs 20 and 21 of AS-26 given earlier. An expenditure which did not meet the recognition criteria as aforesaid and expensed in an earlier financial statements should not be reinstated if the recognition criteria are met later.

The cost of internally generated software comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis to create the software for its intended use. The cost includes:

(a) Expenditure on materials and services used or consumed in developing the software;

(b) The salaries wages and other employment related costs of personnel directly engaged in developing the software;

(c) Any expenditure that is directly attributable to generating software;

(d) Overheads related to developing the software and that can be allocated on a reasonable and consistent basis to the software (for example. an allocation of the depreciation of fixed assets, insurance premium and rent). Allocation of overheads is made on the normal acceptable basis.

The following are not components of the cost of internally generated software:

1. Selling, administration and other general overhead expenditure unless this expenditure can be directly attributable to the development of the software;

2. Clearly identified inefficiencies and initial operating losses incurred before software achieves the planned performance; and

3. Expenditure on training of the staff to use the internally generated software.

Subsequent expenditure

Considerable cost may have to incur in modifying existing software systems. Subsequent expenditure on software after its purchase or its completion should be recognized as an expense when it is incurred unless:

(a) It is probable that the expenditure will enable the software to generate future economic benefits in excess of its originally assessed standards of performance; and

(b) The expenditure can be measured and attributed to the software reliably. If these conditions are met, the subsequent expenditure should be added to the carrying amount of the software. Costs incurred in order to restore or maintain the future economic benefits that an enterprise can expect from the originally assessed standard of performance of existing software systems is recognized as an expense when, and only when, the restoration or maintenance work is carried out.

Period of Amortization

The depreciable amount of a software should be allocated on a systematic basis over the best estimate of its useful life. The amortization should commence when the software is available for use.

As per AS-26, there is a presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. However, due to phenomenal changes in technology, computer software is susceptible to technological obsolescence. Therefore, it is better to consider the useful life of the software much shorter, say 3 to 5 years.

Method of Amortization

The amortization method used should reflect the pattern in which the software's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used.

The amortization charge for each period should be recognized as expenditure unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortization of software used in a production process is included in the carrying amount of inventories.

Disclosure

The financial statements should disclose the following for computer software, distinguishing between internally generated software and acquired software:

(a) The useful lives or the amortization rates used;

(b) The amortization methods used;

(c) The gross carrying amount and the accumulated amortization at the beginning and end of the period;

(d) A reconciliation of the carrying amount at the beginning and end of the period showing:

(i) additions;

(ii) retirements and disposals;

(iii) impairment losses;

(iv) amortisation recognised during the period; and

(v) other changes in the carrying amount during the period.

Case Study- XXX limited

The company is organized into two main business segments:

- Learning Solutions Business comprising of provision of education and training to individuals, government and corporate clients primarily in the field of information technology.

- Software Solutions Business comprising of software services, systems integration and product distribution.

segment Information for the year ended 31st March 2007

Primary Segment Information-Business Segment

	Learning Solutions	Software Solutions	(Million Rs) Total
Revenue External Sales	25,641	19,356	44,997
Results Segmental Results	5,009	2,851	7,860
Unallocated Corporate expenses			(3,252)

Statement on Significant Accounting Policies.

The financial statements are prepared on an accrual basis and under historical cost convention. The significant accounting policies adopted by the company regarding Fixed Assets, Depreciation and Research and Development are detailed below:

Fixed Assets and Depreciation

Fixed Assets are stated at acquisition cost.

Depreciation is charged on a pro-rata basis on the straight-line method. over the estimated useful lives of the assets determined as follows:

Leasehold Improvements	3 years or lease period whichever is lower
Courseware products developed and capitalised	1-3 years
Desktops / low configuration workstations, related accessories and software	2-3 years
File servers, high ended workstations / servers, networking equipment, related accessories and software	4-5 years
Library books	3 years
Assets under employee benefits scheme	3 years
All other assets	Rates prescribed under schedule XIV to Companies Act, 1956.

Further, computer systems and software forming part of plant and machinery are technically evaluated each year for their useful economic life and the unamortised depreciable amount of the asset is charged to profit and loss account as depreciation over their revised remaining useful life.

Research & Development

Equipment purchased by the Company for research and development purposes are capitalized in the year of acquisition and included in Fixed Assets. All revenue expenses incurred for research and development activities are charged to the profit and loss account for the year.

Expenditure incurred on Research & Development

	2007	2006
Capital purchases	726,630	20,256,233
Revenue expenditure	19,145,152	96,699,335

EXERCISE

1. State whether the following statements are true or false:

(1) AS-26 applies when computer software is acquired for sale in the ordinary course of Business.

(2) Coding is part of preliminary stage.

(3) Costs incurred in salaries / wages in internally generated software are included in the cost computation.

Ans: (1) F (2) F (3) F

2. Choose the correct answer

(1) The amortization of amount of software commences from the date when it is

(a) available for use (h) put to use (c) developed upto 75%

(2) There is a rebuttable assumption that the useful life of an intangible asset like Computer Software will not exceed

(a) 5 years (b) 10 years (c) 15 years

Ans: (1) a (2) b

Questions

(1) Discuss the position of AS-26 on the treatment of Software acquired for internal use.

(2) Explain the treatment of internally generated software (a) in the preliminary stage and (b) in the development stage as per AS-26.

(3) Explain the amortization requirements w.r.t. period and method in respect of computer software as per AS-26.

Problems

1. An enterprise is developing as software internally. In the year 2006, expenditure incurred was Rs. 25 lacs, of which Rs. 24 lacs was incurred before 1st December 2006. The enterprise was able to demonstrate on 1 st December 2006 that the software development met the criteria for being recognized an intangible asset. The recoverable amount of the know-how embodied in the development (including future cash outflows to complete the process before it is available for use) is estimated to be Rs 20 lacs. How will you treat it in Financial Accounts and disclose it in the Balance Sheet of the company?

2. A computer software is appearing in Balance Sheet of A Ltd. on 1.04.05 at Rs. 8 lakhs. It was acquired for Rs. 20 lakhs on 1.4.2002, available for use from then. It follows a policy of amortizing the item over 5 years straight line. The period as per AS-26 is 8 years. How much amount should be amortised over the next two years?

9.3. INSURANCE COMPANY ACCOUNTS

INTRODUCTION

Several people exposed to a particular type of risk contribute small amounts called premiums to an insurance fund from which the unfortunates who actually suffer the risk are compensated. Insurance business is essentially a way of averaging the risks.

A policy is a contract entered into between the insurance companies called the 'insurer' and the person insuring his risk called the 'insured'.

Policy specifies all the conditions subject to which the policy is issued. These conditions bind both the parties.

The policy is in the form of a document which the insurance company issues after receiving the premium.

Thus Insurance is essentially a method of averaging risks.

Types of Policies

Depending on the type of risk, there are several types of insurance policies.

Risks of fire are covered by fire policies.

Marine risks of goods, vessels and freights of goods are covered by marine insurance policies.

Losses of theft are covered by Burglary insurance.

There are miscellaneous policies to insure accidents, fidelity of employees, loss of profits in the event of fire and accidents and deaths to employees at work spots.

Life insurance takes primarily two forms. In the case of endowment policy, the insured obtains a specified sum in the event of the insured obtaining a specified age or to the family in case the insured dies before attaining specified age. They may be again with or without profit policies. Whereas in the case of whole life policies the family of the insured (to be exact the nominee mentioned in the policy) receives a specified sum on the death of insured.

The premiums would be less in the case of whole life policies compared to endowment policies for the insured of the same age.

Principles of Insurance

There are several principles governing insurance business, the important of which are discussed below.

Principle of indemnity. Insurance is a contract of indemnity. The insurer is called indemnifier and the insured is the indemnified. In a contract of indemnity, only those who suffer loss are compensated to the extent of actual loss suffered by them. One cannot make profit by insuring his risks.

Insurable interest. All and sundry cannot enter into contracts of insurance. For example, *A* cannot insure the life of B who is a total stranger. But if *B.* happens to be his wife or his debtor or business manager, *A* has insurable interest and therefore he can insure the life of B. For every type of policy insurable interest is insisted upon. In the absence of such interest the contract will amount to a wagering contract.

Principle of ***uberrimae fidei.*** Under ordinary law of contract there is no positive duty to tell the whole truth in relation to the subject-matter of the contract. There is only the negative obligation to tell nothing but the truth. In a contract of insurance, however there is an implied condition that each party must disclose every material fact known to him. This is because all contracts of insurance are contracts *of uberrima fidei, i.e.,* contracts of utmost good faith. This is because the assessment of the risk and the determination of the premium by the insurer depends on the full and frank disclosure of all material facts in the proposal form.

Distinction between Life and Non-life Insurance

There are certain basic differences between life policies and other types of policies. These are listed below:

(1) Human life cannot be valued exactly. Therefore each insured is permitted to insure his life for a specified sum, depending on his capacity to pay premiums. This is also one form of investment and the policy amount depends on his investment decision. In the event of the policy maturing the insurer must pay the policy amount as actual loss cannot be determined. This is not the case with other policies. Other policies are contracts of indemnity. Therefore not withstanding the amount for which the policy is taken, the insurer would pay (reimburse) only the actual loss suffered or the liability incurred.

(2) Life insurance contracts are long-term contracts. Once a policy is taken premiums have to be paid for number of years till maturity and the policy amount is paid on maturity. Of course, a life policy can be surrendered after certain number of years and the insured is paid a proportion of the premiums paid known as surrender value. In the case of other policies they are for a short period of one year although the policy can be renewed year after year.

(3) Life insurance is known also by another term ‘assurance’ since the insured gets an assured sum. Other policies are known as insurance.

(4) The determination of profit is by different methods for life and general insurance business. In the case of life business periodically actuaries estimate the liability under existing policies. On that basis a valuation balance sheet is prepared to determine the profit. In the case of general insurance business a portion of the premium is carried forward as a provision for unexpired liability and the balance net of claims and expenses is taken as profit (or loss).

(II) IMPORTANT PROVISIONS OF THE INSURANCE ACT, 1938

The Insurance Act, 1938 and the rules framed thereunder have an important bearing on the preparation of accounts by insurance companies. Some of the provisions have become irrelevant after the nationalization of general insurance. Some provisions have been amended by IRDA Act, 1999 and these have been separately listed.

(1) *Forms for final accounts [So* 11 (1*)]*. Every insurer should prepare the balance sheet in accordance with the regulations contained in Part I of the First Schedule and in form (A) set forth in Part II of that Schedule. The balance sheet provides three columns, namely life and annuity business, other classes of business and total. Profit and loss account and the appropriation account are to be prepared in form Band C respectively given in Part II of the same schedule. Revenue accounts are to be prepared in accordance with the forms given in the Third Schedule in respect of each class of insurance business. These forms are given in relevant sections.

(2) *Audit.* The Act provides that the company carrying on general insurance business be audited as per the requirements of the Companies act, 1956.

(3) *Register of policies (S.* 14). Every insurer must maintain a register of record of policies showing in respect of every policy, the names and addresses of policyholders, the date when the policy was effected and record of any transfer, assignment or nomination of which the insurer has notice.

(4) *Register of claims.* The insurer must also maintain a register of claims, giving the details of claim made such as date of the claim, the name and address of the claimant and the date on which the claim was discharged. If the claim was rejected, the date of rejection and the reasons therefore. Apart from these there are other statutory records to be maintained and they are listed in a separate Section.

(5) *Approved investments (S. 27B).* A company carrying on general insurance business must invest its funds only in approved securities listed in this section.

(6) *Payment of commission* to *authorized agents (S.40).* The Act prohibits payment of commission to any person other than authorized agent for soliciting or procuring business, subject to a maximum of 15% of the premium.

(7) *Limits on expenditure [So* 40 *A* (3)]. Expenditure by way of commission must lie within the limits of 5 to 15% subject to the review by GIC.

(8) `Sec. 40C of the Insurance Act, 1938 prescribes the limitation on expenses of management in general insurance business. Rule 17E of the Insurance Rules, 1939 provides for the computation of the limit on expenses of management. A certificate signed by the chairman and two directors must state that all expenses of management have been fully debited to the revenue account.

(9) Section 64VA of the Insurance Act, 1938 requires every insurer to maintain an excess of the value of its assets over the amount of its liabilities at all times. The excess is known as solvency margin.

Amendments made by Insurance Regulatory and Development Authority Act, 1999 (IRDA Act, 1999)

This Act was passed with the following objectives;

(1) To protect the interests of policyholders ;

(2) To regulate and promote the orderly growth of insurance business;

(3) To further amend the Insurance. Act and other related Acts; and

(4) To end the monopoly of Life Insurance Corporation of India and the General Insurance Corporation and its subsidiaries in the matter of life and general insurance business respectively. It must be noted here that the Government monopoly has already ended and the insurance sector has opened up to private sector. The first license to a private sector company was granted on 23rd October, 2000. There are a number of companies in the area of both life and general insurance. As the minimum capital of Rs. 100 crores is required, many of them are joint ventures with a foreign insurer as one of the partners.

We will now list the important amendments made to the earlier Act by the IRDA Act, 1999.

(1) It is mandatory for every Insurer on or after the commencement of this Act, to prepare a balance sheet, a profit and loss account, a separate receipts and payments account, a revenue account in respect of insurance business transacted by him and in respect of his shareholders funds. The accounts are to be prepared for every financial year instead of the calendar year. The accounting year has already been changed to financial year when insurance companies prepared the accounts for 15 months ending with the financial year 1988-89, in response to Government directive. The directive might have become necessary because of the change in the previous year effected by Income Tax Act. The Act was amended requiring previous year to be the financial year.

(2) Every insurer must keep separate accounts relating to funds of shareholders and policyholders.

(3) Insurers are prohibited from investing either directly or indirectly their funds outside India.

(4) The Regulatory Authority has the power to direct the insurers to invest funds in infra structure and social sectors subject to certain conditions. The authority in general has the power to direct the time, manner and other conditions of investment with a view to protect the interests of policyholders.

(5) The amendment raises commission on fire and marine policies from the previous 10% to 15%.

(6) There is a necessity for insurers to keep a required solvency margin. The margin refers to the excess of assets over liabilities. If an insurer does not maintain such a margin, he has to

submit a financial plan indicating a plan to correct the deficiency. If these requirements are not met to the satisfaction of the Authority, the insurer may be deemed to be insolvent and the company may be wound up by the court.

(7) Every insurer must submit to the Authority a prescribed return certified by an actuary in the case of life business and certified by an auditor in the case of general insurance business to show that the required solvency margin has been maintained.

(8) Every insurer carrying on general insurance business is required to create a 'Catastrophe Reserve' to meet the future potential liability against the insurance policies in. force. This reserve is not created for any specific or known purpose. Creation of this reserve should be in accordance with the regulations issued by the Authority. So far the Authority has not issued any regulation in this regard.

(III) BOOKS REQUIRED TO BE MAINTAINED BY INSURANCE COMPANIES

Under the Insurance Act, 1938 it is obligatory on the part of all insurance companies including the general insurance companies to maintain the following books which may be called 'statutory books'.

1. The registrar of policies. This book contains the following particulars in respect of each policy issued:

   (a) The name and address of the policyholder-,

   (b) The date when the policy was effected-, and

   (c) A record of any assignment of the policy-.

2. The register of claims. This book should contain the following particulars in respect of each claim :

   (a) The date of claim-,

   (b) The name and address of the claimant-,

   (c) The date on which the claim was discharged-, and

   (d) In the case of a claim which is rejected, the date of rejection and the ground for rejection.

3. The register of licensed insurance agents. This book should contain the following particulars in respect of each agent:

   (a) Name and address of every insurance agent appointed-,

   (b) The date of appointment, and

   (c) The date on which appointment ceased, if any.

In addition to the statutory books mentioned above, insurance companies also maintain the following subsidiary books for recording the transactions:

(i) Proposal register

(ii) New premium cash book

(iii) Renewal premium cash book

(iv) Agency and branch cash book

(v) Petty cash book

(vi) Claims cash book

(vii) General cash book

(viii) Agency credit journal

(ix) Agency debit journal

(x) Lapsed and cancelled policies book

(xi) Chief journal

(xii) Commission book

(xiii) Agency ledger

(xiv) Policy loan ledger

(xv) General loan ledger

(xvi) Investment ledger

IV) EXPLANATION OF SPECIAL TERMS PECULIAR TO INSURANCE BUSINESS

Nature of business of an insurance company is different from that of a manufacturing, a trading or a banking company. Because of this, types and sources of expenses and incomes of such a company are different from those usually found in other business concerns. In order to explain these incomes and expenses some new terms are used. It is thus necessary for a student to understand these terms first.

Claims. The business of an insurance company is to cover the risk of the insured for a consideration called premium. If the risk falls on the insured then he makes a claim on the insurance company. This is the first item which appears on the debit side of revenue account. Claim is shown after deducting the Re-insurance claim and also after adjusting it in the light of information given in the problem. It may be noted that it is not the actual amount paid but the actual loss borne which is important for revenue account. In order to calculate the loss on account of claim the claim outstanding at the end is added and claim outstanding in the beginning is deducted. It should be noted that in keeping with the convention of conservatism, the claim intimated is taken at par with the claim intimated and accepted but not paid. Thus while calculating the claim outstanding at the end the claim intimated as well as the claim intimated and accepted both are considered. The adjustment entry required for this will be as follows:

Debit Claims account

Credit Claims intimated and accepted but not paid account

Credit Claims intimated but not accepted and paid account

At the commencement of the next period a reverse entry is passed, so that when these claims intimated are paid, they may not influence the claims account of next year. However, if company rejects any claim, such amount should be transferred to the insurance fund account and not to the claims account.

Illustration . From the following, you are required to calculate the loss on account of claim to be shown in the revenue account for the year ending 31st December, 1990 :

Claims:

Intimated in	***Admitted in***	***Paid in***	Rs.
1989	1989	1990	15,000
1990	1990	1991	10,000
1988	1989	1989	5,000
1988	1989	1990	12,000
1990	1991	1991	8,000
1990	1990	1990	1,02,000

Claim .on account of Re-insurance was Rs. 25,000.

Solution

	Rs
Total claim paid in 1990 : Rs. (1,02,000 + 12,000 + 15,000)	1,29,000
Less Outstanding in the beginning, *i.e.*, intimated in 1989 or earlier whether accepted in 1989 accepted in 1990 (Rs. 15,000+ Rs. 12,000)	27,000
	1,02,000
Add Outstanding at the end, i.e., intimated in 1990 whether accepted in 1990 or in 1991Rs (10,000 + 8,000)	18,000
	1,20,000
Less Re-insurance claim	25,000
Claims to be shown in revenue account	95,000

Notes;

1. It may be seen that the column for 'admitted in' is useless for calculating loss on account of claim. This is a mere information.

2. No.3 item 'intimated in 1988, admitted in 1989, paid in 1989 Rs. 5,000 is useless as the amount paid in 1989 is not included in the amount paid in 1990.

   Claims must include all expenses directly incurred in relation to assessment of claims. For examples expenses like survey fees, fees of Police Reports, Legal fees, Court expenses and other similar charges should be included under the head claims. However, it should not include any establishment or administrative expenses except in so far as they relate to any employee, exclusively employed or surveyor assessment of losses [Note *(a)* to the revenues account] When the account is furnished under the Provision of Sec. 11 of the Insurance Act, 1938, separate figures for claims paid to claimants in India and claimants paid outside India should be given [Note *(d)* to the revenue account].

Bonus in reduction of premium:

In all the cases of general insurance the policy is always taken for one year and it is to be renewed after the expiry of the policy. Whether the policy is renewed with the same company, or a fresh policy is taken with some other company, it is a standing practice that the company usually grants a reduction in premium at the prescribed rate if the insured has not made any claim. This rate of reduction increases every year for usually three years if the insured does not make any claim continuously year after year. For example, the General Insurance Companies in India allow the following rates of reduction for a motor cycle: 1st year 15%; 2nd year 25%; 3rd year 30%. This reduction is called bonus in reduction of premium. In fact this transaction should be divided into two parts-first, the total premium (without any reduction) should be assumed to be received and then reduction granted should be assumed to be paid separately. Thus total premium (without reduction) should be treated as income and bonus which is subtracted should be treated as an expense. Thus-

If net premium received is	126
Bonus in reduction of premium is	14

The revenue account on the credit side will show Rs. 140 (Rs. 126 + Rs. 14) as income and on the debit side Rs. 14 as an expense. The journal entry is :

Bonus in reduction of premium account Dr

To Premium account

Reversionary Bonus.

In the case of life policies with profits, policyholders are given the right to participate in the profits of the business. After nationalization, policyholders are given 95% of profits of L.I.C. by way of bonus. Bonus can be paid in cash, adjusted against the future premiums due from the policyholders or it can be paid on the maturity of the policy, together with the policy amount. Bonus paid in the end along with the policy amount is called reversionary bonus.

Re-insurance.

Sometimes the insurer considers a particular risk too much for his capacity and may re-insure a part of the risk with some other insurer. Such an arrangement between two insurers is referred to as reinsurance. In such a case the first insurer cannot retain all the premium on the policy for himself. Depending on the share of risk undertaken by the second insurer, proportionate premium must be ceded by the first insurer. Likewise if such a policy matures, the claim will have to be shared by both the insurers in the agreed ratio. These adjustments will have to be shown in the accounts of both the insurers. In the accounts of the first insurer amount of claim recovered from the second insurer has to be deducted from the total claim payable by him. Similarly, the premium ceded to the second insurer has to be deducted from the total premium received. In the accounts of the second insurer, claims paid include claims paid on account of Re-insurance and premiums received include premium received on re-insurance business.

Commission on re-insurance ceded /accepted.

The business of the company is fetched through its agents who are paid commission according to the amount of business they are getting for the company. When company gets re-insurance business it has to pay commission to some other company. This commission is called 'commission on re-insurance accepted' and is shown as an expense in the revenue account. When a company passes on a part of business to some other company then this company (which gives business) gets commission from the company to whom such business is given. This commission is called 'commission on re-insurance ceded' and is a gain to the company surrendering the business. It appears on the credit side of revenue account.

Reserve for unexpired risk.

This is applicable in General Insurance business only. This is in the nature of provision for claims that may arise in respect of policies which are subsisting on the date of balance sheet. Since premium has already been received in respect of such policies, provision must be made for the claims that may arise out of such policies. Insurance business is peculiar in that the premium is received in advance but the risk can arise on any day. In general insurance the policy is issued for a year which means the risk is covered for a year. Chances of the risk covered occurring do not come down proportionately with the passage of time. For example, if on the balance sheet date the unexpired period of a particular policy is one month (eleven months having expired) we cannot say that the risk on the policy is reduced to 1/ 12th of the total risk. Even on the last day of the policy company's risk is as high as it was on the day the policy was issued. Therefore, insurance companies must provide for the risks associated with all such policies for which the premia has been received and the policies are still in force. Thus a large portion of the premia collected must be kept in reserve for unexpired risk. Keeping in view the nature of the business, the Executive Committee of the General Insurance Council (which has been set up under the Insurance Act to supervise general insurance companies) has laid down that in the case of marine insurance the provision for unexpired risk should be 100% of the net premium and in the case of other businesses (like accident, fire, theft, etc.) the provision should be 50% of the net premium. The provision made on the balance sheet date will be shown on the debit side of the revenue account instead of subtracting from premia. The balance of provision also appears in the balance sheet on the liabilities side under the heading 'balance of funds and accounts'. This provision will be transferred to the credit side of next year's revenue account. Thus in the revenue account the balance of the previous year appears on the credit side and the balance provided for the current year appears on the debit side.

llustration. Indian Insurance Co. Ltd. furnishes you with the following information:

(i) On 31.12.1996 it had reserve for unexpired risks to the tune of Rs. 40 crores. It comprised of Rs. 15 crores in respect of marine insurance business; Rs. 20 crores in respect of fire insurance business and Rs. 5 crores in respect of miscellaneous insurance business.

(ii) It is the practice of Indian Insurance Co. Ltd. to create reserves at 100% of net premium income in respect of marine insurance policies and at 50% of net premium income in respect of fire and miscellaneous income policies.

During 1997, the following business was conducted:

		Rs. in crore	
	Marine	*Fire*	*Miscell neous*
Premium collected from:			
(a) Insured in respect of policies issued	18	43	12
(b) Other insurance companies in respect of risks undertaken	7	5	4
Premia paid / payable to other insurance companies on business ceded	6.7	4.3	7

(a) Pass journal entries relating to "Unexpired risks reserve".

Solution.

Journal of Indian Insurance Co. Ltd.

		(Rupees in crore)	
		Dr. *Rs.*	*Cr.* *Rs.*
1997 Dec. 31	Marine Revenue A / c Dr. To Unexpired Risks Reserve A / c (Reserve for unexpired risk equal to 100% of net premium earned during the year)	18.30	18.30
	Fire Revenue A / c Dr. To Unexpired Risks Reserve A / c (Reserve for unexpired risk equal to 50% of the net premium earned during the year)	21.85	21.85
	Miscellaneous Revenue A / c Dr. To Unexpired Reserve A / c (Rreserve for unexpired risk equal to 50% of the net premium earned during the year)	4.5	4.5

Additional reserve for unexpired risk.

In a particular year the management may feel that the percentage of premia recommended by the General Insurance Council is not sufficient to meet the unexpired risks. In such a situation they may provide additional reserve. Such additional reserve will also be debited to the revenue account. The balance will be shown in the balance sheet as in the case of normal reserve, and will be transferred to the credit of next year's revenue account. If in the problem given, there is no instruction regarding additional reserve it means no such reserve is required. As the provision of additional reserve is the discretionary right of the management it is not correct to carry forward such reserve even though there is no instruction about it in the problem.

(V) ACCOUNTS OF LIFE INSURANCE BUSINESS

Nationalization of Life Insurance Business. In 1956 life insurance business was nationalized by transferring all such business to the Life Insurance Corporation established for the purpose. The main objects of nationalization were:

(1) To ensure absolute security to the policy holder in the matter of life insurance protection.

(2) To spread insurance much more widely and in particular to the rural areas, and

(3) As a further step in the direction of more effective mobilization of public savings.

Some of the important provisions of *the* Act which are worth noting are stated below:

(1) Section 30. The Corporation has the exclusive privilege of carrying on life in surance business in India.

(2) Section 37. All the contracts for assurance executed by the Corporation are guar anteed as to payment in cash by the Central Government.

(3) Section 6. Functions of the Corporation.

(a) The general duty of the Corporation is to carryon life insurance business whether in or outside India and to develop the life insurance business to the best advantage of the community.

(b) In addition the Corporation has the power:

(i) To carry on capital redemption business, annuity certain business or re-insur ance business,

(ii) To invest the funds of the Corporation,

(iii) To acquire, hold and dispose of any property for the purpose of its business, and

(iv) To advance or lend money upon the security of any movable or immovable property or otherwise.

(4) Sections 14, 18 and 20. The central office is located at Mumbai and has zonal offices at Mumbai, Kolkata, Delhi, Kanpur and Chennai. In each zone there are divisional offices and branches.

The general superintendence and direction of the Corporation affairs is carried on by an executive committee consisting of not more than 5 members. The investment committee advises the Corporation in matters relating to investment of funds. This committee can have a maximum of 7 members of which 3 must be members of the Corporation.

As per Section 4 the Corporation consists of not more than 15 members appointed by the Central Government and one of them nominated will act as the Chairman. Under Section 20 the Corporation can have one or more managing directors. They are whole time officers exercising such powers and performing such duties as may be entrusted to them by the executive committee or the corporation.

(5) Section 24. The Corporation has its own fund and all the receipts are credited to such fund and all payments are made there from.

(6) Section 25. The accounts of the Corporation are to be audited by duly qualified auditors. The auditors are required to submit their report to the Corporation and also forward a copy of their report to the Central Government. Auditors are appointed by the Corporation with the previous approval of the Central Government.

(7) Section 26. There must be an actuarial valuation at least once in every two years and the Corporation must submit the report to the Central Government.

(8) Section 27. At the end of each financial year the Corporation is required to prepare and submit a report to the Central Government giving an account of its activities during the previous financial year and also an account of the planned activities for the next financial year.

(9) Section 28. Ninety-five percent (or a higher percentage approved by the Central Government) from actuarial valuation made under Section 26 shall be allocated to or reserved for the policyholders of the Corporation and the remainder either paid to the Central Government or utilized for such purposes and in such manner as the Government may determine.

(10) Section 28A. In the case of profits arising from business other than life, such profits after making provision for reserves and other matters are to be paid to the Central Government.

(11) Section 29. The Central Government has to place before Parliament a copy of the Auditors, Report (Sec. 25), a copy of the actuaries report (Sec. 26) and a copy of the Report of the Corporation (Sec. 27).

Types of Policies.

As stated earlier, under a contract of life insurance an insurance company guarantees to pay a fixed sum of money to the insured on his attaining a certain age or to his nominees or legal heirs on his death. The contract in its written form is called a policy and broadly there are two types of policies. They are (1) whole life policy, and (2) Endowment policy. Under whole life policy the insured does not get the amount during his life time. The amount is paid only to his nominees or heirs on his death. In the case of Endowment policy the amount is paid to the insured on his attainment of a specified age or if he dies before, the amount is paid to his nominees or heirs. As explained later life insurance company ascertains the profits once in two years. 95% of such profits are distributed to policyholders as bonus. Such bonus is to be credited only to ‘with profit policies’. The holders of ‘without profit policies’ have no right to the bonus. Naturally the premium is comparatively less in the case of ‘without profit policies’ than in the case of ‘with profit policies’. In recent years the reversionary bonus has been around Rs. 20 per thousand sum assured per annum on Endowment policies and Rs. 25 per thousand sum assured per annum on whole life policies.

Annuity Business.

Life insurance companies also do annuity business. Annuity refers to fixed annual payment made by the insurance company to the insured on his attaining a specified age. The insured deposits lump sum amount by way of consideration for the annuity granted. This is a method under which the person purchasing the annuity receives back his money with interest. Annuity paid represents an expenditure of the life insurance business and the consideration received for annuities is an item of income.

Surrender Value.

In the case of life policy, the policy normally has value only when it matures. But to facilitate the promotion of business, insurance companies assign value to the policy on the basis of the premiums paid. Insurance companies will be prepared to pay such value on the surrender of the policy by a needy policy holder desiring to realize the policy. Therefore the value is referred to as 'surrender value'. Surrender value is usually nil until at least two annual premiums are paid. Amount paid as surrender value is an expenditure and is similar to claims paid.

Paid-up Policy.

A policy holder, who has difficulty in paying the premium, may be allowed an option to get the policy paid-up. In such a case, the policyholder is relieved from the obligation of paying off the rest of premium, but he will not get the full value of policy which is calculated as follows:

$$\text{Paid-up Value} = \text{Sum assured} \times \frac{\text{No. of premiums paid}}{\text{Total number of premiums payable}}$$

The amount paid on maturity in respect of paid-up policies is included in the amount of claims.

Life Insurance Fund.

This represents the excess of revenue receipts over revenue expenditure relating to life business. The fund is available to meet the aggregate liability on all policies outstanding. Revenue account is prepared every year to ascertain the balance of life insurance fund at the end of the year. In the preparation of revenue account, the opening balance of the life insurance fund is the starting point. Other items of revenue income are credited to the fund and revenue items of expense are debited. The resulting figure is the closing balance of the revenue fund.

Valuation Balance Sheet.

The balance in the life assurance fund cannot be taken as the profit made by the life insurance business. For the purpose of ascertaining the profit, the insurance company should calculate its net liability on all outstanding policies. This calculation is done by experts called actuaries and is a highly complicated mathematical process. Prior to nationalization insurance companies were having this computation once in three years. Since nationalization L.I.C. is having such valuation once every two years. For calculating net liability, the actuaries calculate the present value of future liability on all the policies in force as well as present value of future premium to be received on policies in force. The excess of the present value of future liability over the present value on future premium is called the net liability.

It is by comparing the life insurance fund and net liability in respect of policies, that profit in respect of life insurance business can be ascertained. If the life insurance fund is more than the net liability, the difference represents the profit. On the other hand, the excess of net liability over the life assurance fund represents the loss for the inter-valuation period.

According to Section 28 of the Life Insurance Corporation Act, 1956, 95%

of the profit of life business must be distributed to the policyholders by way of "Bonus" on with-profit policies and the remaining 5% has to be utilized for such purposes as the Government may determine. The profit or loss of life insurance business is ascertained by preparing a statement called 'Valuation Balance Sheet' which is reproduced below.

Valuation Balance Sheet

as on..............................

To Net liability as per actuary's valuation To Surplus (Net Profit)		By Life Assurance Fund as per Balance Sheet By Deficiency (Net loss)

Illustration . The life insurance fund of Prakash Life Insurance Co. Ltd. was Rs. 34,00,000 on 31st March, 2007. Its actuarial valuation on 31st March, 2007 disclosed a net liability of Rs. 28,80,000. An interim bonus of Rs. 40,000 was paid to the policyholders during the previous two years. It is now proposed to carry forward Rs. 1,10,000 and to divide the balance between the policyholders and the shareholders. Show *(a)* the valuation balance sheet, *(b)* the net profit for the two-year period, and (c) the distribution of the profits.

Solution.

In the Books of Prakash Life Insurance Co. Ltd.

Valuation Balance Sheet ***as on 31st March,*** 2007

	Rs		Rs
To Net liability	2,880,000	By Life Assurance Fund	3,400,000
To Net Profit	520,000		
	3,400,000		3,400,000

Net profit for the two-year period

Profit as per Valuation Balance Sheet	5,20,000
Add: Interim Bonus paid during the previous two years	40,000
Net Profit	5,60,000

Distribution of the profits

Net Profit	5,60,000
Less: Amount proposed to be carried forward	1,10,000

Balance	4,50,000
Share of policyholders (95% of Rs. 4,50,000)	4,27,500
Less: Interim bonus paid	40,000
Amount due to policyholders	3,87,500
Share of Shareholders (5% of Rs. 4,50,000)	22,500

Preparation of Final Accounts.

Although the Life Insurance Corporation had been set up under the Life Insurance Corporation Act, 1956, the preparation of final accounts is made in accordance with the provisions of the Insurance Act, 1938. The accounts are prepared in the form prescribed by the Insurance Act, 1938. The accounts of life insurance business are prepared for the calendar year. As stated earlier, the profit of life insurance business is ascertained only once in every two years although the revenue account and balance sheet are prepared for every year.

Revenue Account.

The revenue account has to be prepared in form 'D' of the schedule to the Insurance Act, 1938. The object of preparing the revenue account is to find out the life insurance fund and it does not disclose the profit. The fund is carried forward to the next year and appears as first item on the credit side of the revenue account of that year. The revenue account is prepared on mercantilistic basis and therefore such items as premium paid in advance, outstanding premium (accrued), outstanding claims, etc., will have to be adjusted in the usual manner.

The Revenue account is prepared in the following form ;

FORM D

Form of Revenue Account applicable

Revenue Account of..............

In-respect of-..........

	Business within India	*Business out of India*	*Total*
	Rs. P.	Rs. P.	*Rs. P.*
Claims under Policies (including provision for claims due or intimated) *less* Re-insurances			
By Death			
By Maturity			
Annuities, *less* Re-insurances			
Surrenders (including Surrenders of Bonus), *less* Re-insurances			
Bonues in Cash, *less* Re-insurances			
Bonuses in reduction of Premiums, *less* Re insurances			
Expenses of Management			
1. *(a)* Commission to Insurance Agents *(less* that on Re-insurances)			
(b) Allowances and Commission [other than commission included in sub-item *(a)* preceding]			
2. Salaries, etc. (Other than to agents and those contained in item No.1)			
3. Traveling expenses			
4. Directors' fees			

		Business within India Rs. P.	*Business out of India* Rs. P.	*Total* *Rs. P.*
5.	Auditors' fees			
6.	Medical fees			
7.	Law charges			
8.	Advertisements			
9.	Printing and Stationery			
10.	Other expenses of management (accounts to be specified)			
11.	Rents for offices belonging to and occupied by the insurer			
	Rents of other offices occupied by the insurer			
12.	Bad debts			
13.	United Kingdom, Indian Dominion and Foreign Taxes			
14.	Other Expenditure (to be specified)			
	Profit transferred to Profit and Loss Account			
	Balance of Fund at the end of the year as shown in the Balance Sheet			
	Total			

D. (The Third Schedule)

to Life Insurance Business

For the Year Ended .... 20...

Business.

	Business within India Rs. P.	*Business out of India* Rs. P.	*Total* *Rs. P.*
Balance of Fund at the beginning of the year			
Premiums, *less* Re-insurances -			
(i) First year premiums, where the maximum			
premiums-paying period *(g)*-			
Two years			
Three years			
Four years			
Five years			
Six years			
Seven years			
Eight years			
Nine years			
Ten years			
Eleven years			
Twelve years or over (including			
throughout life)			
*(ii)*Renewal premiums			
(iii) Single premiums			
Consideration for Annuities granted,			
less re-insurance (c)			
Interest, Dividends and Rents			
Less Income-tax thereon *(d)*			
Registration Fees			

	Business within India Rs. P.	*Business out of India* Rs. P.	*Total* *Rs. P.*
Other Income (to be specified) *(e)*			
Loss transferred to Profit & Loss Account			
Transferred from Appropriation Account ..”			
Rs.			

NOTES

(a) These columns apply only to business the premiums in respect of which are ordinarily paid outside India. If any question arises whether any premiums are ordinarily paid outside India, the Controller shall decide the question and his decision shall be final.

(b) If any sum has been deducted from this item and entered on the assets side of the balance sheet, the amount so deducted must be shown separately. Under this item the salary paid to the managing agent or managing director shall be shown separately from the total amount paid as salaries to the remaining staff.

(c) All single premiums for annuities, whether immediate or deferred, must be included under this heading

(d) Indian, United Kingdom, Foreign and Dominion income tax on Interest, Dividends and Rents must be shown under this heading, less any rebates of in come-tax recovered from the revenue authorities in respect of expenses of man agement. The separate heading on the other side of the accounts is for United Kingdom, Indian, Foreign and Dominion taxes, other than those shown under this item.

(e) Under the head “Other Income”, if any, realized from the staff must be shown separately. All the amounts received by the insurer directly or indirectly whether from his head office or from any other source outside India shall also be shown separately in the revenue account except such sums as properly appertain tot he capital account.

(f) In the case of an insurer having his principal place of business outside the States, the expenses of management for out of India and total business need not be split up into the several sub-heads, if they are not so split up in his own country.

(g) Where the maximum premium-paying period includes a fraction of a year, such fraction shall be ignored for the purposes of this revenue account.

Balance sheet. The form of balance sheet is given in First Schedule Part II to the Insurance Act, 1938 and the form is reproduced on pages V.2.16.-2.77. This is common to Life and General Insurances under the old Act

FORM A

Balance Sheet of

	Life and Annuity Business (1)	*Other Classes of Business (2)*	*Total*
Liabilities	*Rs. P.*	*Rs. P.*	*Rs. P.*
Shareholders' capital (each class to be stated separately)			
Authorized :			
...............shares of Rs. ....each Rs.			
Subscribed:			
................shares of Rs.........each Rs.			
Called-up:			
.............shares of Rs............each Rs.			
Less Unpaid calls			
Reserve or Contingency Accounts *(a)*:			
Investment Reserve Account			
Profit and Loss Appropriation Account Balance			
Balances of Funds and Accounts:			
Life Insurance Fund-			
(i) Business in India			
(ii) Business outside India			
Fire Insurance Business Account			
Marine Insurance Business Account			
Miscellaneous Insurance Business Account			
Other accounts, if any (to be specified) *(i)*			
Pension or Superannuation Account *(b)*			
Debenture stock per cent			
Loans and advances *(c)*			
Bills payable *(c)*			
Estimated liability in respect of outstanding claims, whether due or intimated *(d)*			
Annuities due and unpaid *(d)*			
Outstanding dividends			
Amounts due to other persons or bodies carrying on insurance business *(c)*			
Sundry creditors (including outstanding and accruing expenses and taxes) *(c)*			
Other sums owing by the Insurer (particulars to be given) *(c)*			

Contingent liabilities (to be specified) (c)

FORM A. *(The First Schedule)*

Balance Sheet of......

	Life and Annuity Business (1)	*Other Classes of Business (2)*	*Total*
Assets	*Rs. P.*	*Rs. P.*	*Rs. P.*
Loans:			
On Mortgages of property within the States			
On Mortgages of property outside the States....			
On Security of municipal and other public rates			
On Stocks and shares			
On Insurer's Policies within their surrender value			
On personal security			
To Subsidiary Companies (other than Reversionary) (*f*)			
Reversions and Life Interests purchased			
Loans on Reversions and Life Interests			
Debentures and Debenture Stocks of Subsidiary Reversionary Companies (*f*]			
Ordinary Stocks and Shares of Subsidiary Reversionary Comapnies (*f*]			
Loans to Subsidiary Reversionary Companies [*f*]			
Investments:			
Deposit with the Reserve Bank of India (securities to be specified)			
Indian Government Securities			
State Government Securities			
British, British Colonial and British Dominion Government Securities			
Foreign Government Securities			
Indian Municipal Securities			
British and Colonial Securities			
Foreign Securities			
Bonds, Debentures, Stocks and other			
Securities whereon Interest is guaranteed by the Indian Government or a State Government			
Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by the			
Carried Over Rs			

	Life and Annuity Business (1)	*Other classes of Business* (2)	*Total*
	Rs. P.	Rs. P.	Rs. P.
Brought forward			
Preference or guaranteed Shares of any railway in India			
Preference or guaranteed Shares of any railway out of India			
Railway Ordinary Stocks (i) in India, (i out of India			
Other Debentures and Debenture Stock of Companies incorporated (i) in India, (i!) out of India			
Other guaranteed and Preference Stocks and shares of companies incorporated (i) in India, (ii) out of India			
Other Ordinary Stocks and Shares of companies incorporated (i) in India, (ii) out of India			
Holdings in Subsidiary Companies If)			
House property (i) in India, *(*ii) out of India			
Freehold and Leasehold ground rent and rent charges			
Agents' Balances			
Outstanding Premiums *(g) (d)*			
Interest, Dividends and Rents outstanding *(d)*			
Interest, Dividends and Rents accruing but not due			
Amounts due from other Persons or Bodies carrying on Insurance Business *(h)*			
Sundry Debtors (I)			
Bills Receivable			
Cash:			
At Bankers on Deposit Account			
At Bankers on Current Account and in hand			
At Call on Short Notice 0)			
Other Accounts (to be specified) (k)			

Liabilities will appear in the left hand side and Assets will appear on the right hand side of Balance Sheet.

* Assets and Liabilities, Shareholders' Capital and Reserves, not allocated to any class of business specified in column (1) must be shown in column (2).

NOTES

(a) The Reserves or Contingency Accounts must be separately stated.

(b) If the insurer has not full and unrestricted control of the assets constituting the Pension or Superannuation Accounts, Either those accounts and the assets and liabilities relating thereto must be omitted from the balance sheet or the assets of which the insurer has not such control must be clearly indicated on the face of the balance sheet.

(c) If the insurer has deposited security as cover in respect of any of these items, the amount and nature of the securities so deposited must be clearly indicated on the face of the balance sheet.

(d) These items are or have been included in the corresponding items in the Revenue or Profit and Loss Account. Outstanding and accruing interest, dividends and rents must be shown after deduction of income tax or the income tax must be provided for amongst the liabilities on the other side of the balance sheet.

(e) Such items as amount of liability in respect of bills discounted, uncalled capital of subsidiary companies, uncalled capital of other investments, etc., must either be shown in their several categories under the heading "Contingent Liabilities" or the appropriate items on the assets side must be set out in such details as will clearly indicate the amount of the uncalled capital.

(*f*) As respects life and annuity business full particulars of holdings in and loans to subsidiary companies must be stated, giving the name of each company, the number and description of each class of shares held, the amounts paid up thereon, and the value at which the holdings in each company stand in the balance sheet.

(g) Either this item must be shown net or the commission must be provided for amongst the liabilities on the other side of the balance sheet.

(h) The aggregate amount owing by a subsidiary company or subsidiary companies is to be shown separately from all other assets and the aggregate amount owing to a subsidiary company or subsidiary companies is to be shown separately from all other liabilities.

(i) Amounts due from directors and officers must be shown separately.

(j) No amounts must be entered under this heading unless fully secured. If not fully secured, the amounts must be included under the heading "Sundry Debtors".

(k) Under this heading must be included such items as the following, which must be shown under separate headings suitably described: Office furniture, goodwill, preliminary for-

mation and organization expenses, development expenditure account, discount on debentures issued, other expenditure carried for ward to be written off in future years, balance, being loss on Profit and Loss Appropriation Accounts, etc. The amounts included in the balance sheet must not be in excess of cost.

(*l*] Under the head "Other accounts, if any (to be specified)" on the left-hand side, fines realized from the staff and their contribution towards the provident fund, if any, should be shown under separate sub-heads.

(m) Where the insurer is required to maintain a separate account in respect of any sub-class of miscellaneous insurance business this heading is to be split up accordingly.

Illustration 5 (Life Assurance Fund). The revenue account of a life insurance company shows the life assurance fund on 31st March, 2002 at Rs. 62,21,310 before taking into account the following items:

(*i*) Claims covered under re-insurance Rs. 12,000.

(*ii*) Bonus utilized in reduction of life insurance premium Rs. 4,500.

(*iii*) Interest accrued on securities Rs. 8,260.

(iv) Outstanding premium Rs. 5,410.

(*v*) Claims intimated but not admitted Rs. 26,500.

What is the life assurance fund after taking into account the above omissions?

Statement showing Life Assurance Fund

Solution.

		Rs	Rs
Balance of Fund as on 31st March, 2002			62,21,310
Add: Bonus utilized in reduction on premium		4,500	
Interest on securities		8,260	
Premium outstanding		5,410	
		=====	18,170
			======
			62,39,480
Less: Claim outstanding	26,500		
Less: Covered under Re-insurance	12,000	14,500	
Bonus in reduction of premium		4,500	19,000
Balance of (correct) Life Assurance Fund			62,20,480

Ilustration. The following trial balance was extracted from the books of the New India Life Assurance Company Ltd. as on 31-03-2006.

Particulars	Dr (Rs)	Cr (Rs)
Paid-up Capital:		
10,000 shares of Rs. 10 each		100,000
Life fund balance as on 1-4-2001		2,972,300
Dividends Paid	15,000	
Bonus in reduction of premium	31,500	
Premium *less* re-assurance premium		161,500
(Commission thereon Rs. 5,000)		
Claims paid	197,000	
Outstanding claims (1-4-2001)		7,000
Commission	9,300	
Management expenses	32,300	
Mortgages in India	492,200	
Interest, dividend and rents		112,700
Agents' balances	9,300	
Freehold premises	40,000	
Investments	2,305,000	
Loans on Policies	173,600	
Cash on deposit	27,000	
Cash on current account	7,300	
Surrenders	7,000	
Medical Stores	7,000	
Consideration for annuities granted	10,000	
Annuity		10,000
	33,63,500	33,63,500

Prepare the revenue account for the year ended 31-3-2006 and a balance sheet of the company as at that date after taking the following into consideration:

	Rs
(a) Claims outstanding	10,000
(b) Further bonus in reduction of premium	5,000
(c) Premium outstanding	5,000
(d) Claims covered under re-insurance	80,000
(e) Management expenses due	30,000

Solution.

New India Life Assurance Co. Ltd.
Revenue Account
for the year ended 31st

	Rs	Rs		Rs	Rs
To Claims less re-assurances			By Life assurance fund at the		
Claims paid	197,000		at the beginning of the year		2,972,300
Add: Claims outstanding			By Premium less re-insurance	161500	
at the end of the year	10,000		*Add:* Accrued Premium	5000	
Less: Claims outstanding			*Add:* Bonus in reduction		
at the beginning of the year	7,000		of premium	5000	171,500
Less: Claims covered			By Consideration for		
under re-insurance	80,000	120,000	annuities granted		10,000
To Surrenders paid		7,000	By Commission on		
To Annuities paid and due		10,000	re-insurance ceded		5,000
Bonus paid in cash		-	By Interest, dividends and		
To Bonus in reduction of			interests received on		
premium (31,500 + 5,000		36,500	investments		112,700
To Expenses of					
management paid	32,300		By Fines for getting lapsed		
Add: Outstanding	30,000	62,300	policies revised		-
To Commission paid		9,300	By Other items, if any		-
To Income-tax on profits		-			
To Dividends paid					
to shareholders		15,000			
To Other items,if any,me					
dical fees		7,000			
To Life assurancefund at the					
close of the yeartransferred					
To Balance sheet		3,004,400			
		3,271,500			3,271,500

Vl) ACCOUNTS OF GENERAL INSURANCE BUSINESS

Just as Form D is prescribed for revenue account of life insurance business, Form F is the relevant format for preparing the revenue account of general insurance business. However the same form is used to prepare the revenue account separately in respect of fire insurance, marine insurance and miscellaneous insurance.

Form F

Form of Revenue Account Applicable to Fire Insurance Business

Marine Insurance Business*, Miscellaneous Insurance Business

Revenue Account of…….. ....***for the year ended..20 i***n respect of ……….Business

	Rs		Rs
Claims under policies, *less* re-insurances *(a) (d)*:		Balance of account at beginning of the year:	
Paid during the year		Reserve for unexpired risks	
Total estimated liability in respect of outstanding claims at the end of the year whether due or intimated		Additional reserve (if any)	
Less-Outstanding at end of previous year *(b)*		*Premiums *less* re-insurance *(d)*	
*Commission		Interest, dividends and rents	
Commission on direct business		*Less-Income* tax thereon	
Commission on Re-insurance accepted		Commission on re-insurance ceded	
*Expenses of management (e)		*Other income (to be specified) *(a)*	
Bad debts		Loss transferred to Profit and Loss A/c	
United Kingdom, Indian Dominion and Foreign Taxes		Transferred from Appropriation A/ c	
Other expenditure (to be specified)			
Profit transferred to Profit and Loss A/c			
Balance of account at the end of the year as shown in the balance sheet			
Reserve for unexpired risks, being per cent of premium income of year			
Additional reserve (if any)			

NOTES

a) This item must include all expenses directly incurred in relation to assessment of claims of the nature of survey fees, fees for police reports, legal fees, court expenses and other similar charges, but should not include any establishment or administration expenses except in so far as they relate to any employee on surveyor assessment of losses.

(b) If in any year the claims actually paid and those still unpaid at the end of that year in respect of the previous year's Revenue Account as provision for out standing claims, then the amount of such excess must be shown in the Revenue Account.

(c) If any sum has been deducted from this item and entered on the assets side of the balance sheet, the amount so deducted must be shown separately.

(d) Where the account is furnished under provisions of Sec. 11 of the Insurance Act, 1938, separate figures for claims paid to claimants in India and claim ants outside India must be given.

* Where the account is furnished under the provisions of clause *(b)* of sub-section (2) of Section 16 of the Insurance Act, 1938 by an insurer to whom that Section applies separate figures for business within India and business out of India must be given against the items marked with an asterisk. Against all other items the total amount for the business as a whole may be given.

(e) All the amounts received by the insurer directly or indirectly whether from his head office or from any other source outside India shall also be shown separately in the revenue account except such sums as properly appertain to the capital account.

Form B

Form of Profit and Loss Account

Profit and Loss Account of .... *for the year ended 20...*

	Rs.		Rs.
Indian (Central) taxes on the Insurer's Profit (not applicable to any particular fund or account)		Interest, dividends and rent (not applicable to any particular fund or account)	
Expenses of management (not applicable to any particular fund or account)'		*Less:* Income Tax thereon	
Loss on realization of Investments (not charged to reserves or any particular fund or account)		Profit on realization of investment (not credited to reserves or any particular fund or account)	
Depreciation of investment (not charged to reserves or any particular fund or account)		Appreciation of investments (not credited to reserves or any particular fund or account)	
Loss transferred from revenue accounts (details to be given)		Profit transferred from revenue accounts (details to be given)	
Other expenditure (to be specified)		Transfer fees	'
Balance for the year carried to appropriation account		Other income (to be specified)	
		Balance being loss for the year carried to appropriation account	-
.			

1. If any sum has been deducted from this item and entered on the assets side of the balance sheet, the amount must be shown separately.

Form C

Form of Profit and Loss Appropriation Account

Profit and Loss Appropriation Account of .... *for the year ended 20...*

	Rs		Rs
Balance being loss brought forward from last year		Balance brought forward from last year	
Balance being loss for the year brought from profit and loss account (as in Form B)		*Less:* Dividends since paid in respect of last year (to be specified and if "free of tax" to be so stated)	
Dividends paid during the year on account of the current year (to be specified and if free of tax to be stated)		Balance of the year brought from profit and loss account (as in Form B)	
Transfers to any particular funds or accounts (details to be given)		Balance being loss at end of the year as shown in the balance sheet	
Balance at end of the year as shown in the balance sheet			

As mentioned already Balance Sheet form is common to both life and general business. In the case of life there are no forms corresponding to Form B and Form C.

Illustration.

From the following balances of All Care General Insurance Co. Ltd. as on 31st March, 2006, prepare—

(*i*) Fire Revenue Account;

(ii) Marine Revenue Account; and

(*iii*) Profit and Loss Account:

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
Survey expenses (fire)	10,000	Commission earned on	
Additional reserve opening (fire)	50,000	re-insurance ceded (marine)	60,000
Commission paid (marine)	1,08,000	Commission earned on	
Commission paid (fire)	90,000	re-insurance ceded (fire)	30,000
Claims paid and outstanding		Management expenses (fire)	1,45,000
(marine)	3,80,000	Management expenses (marine)	4,00,000
Claims paid and outstanding (fire)	1,80,000	Marine premium	
Fire fund-opening	2,50,000	Less: Re-insurances	10,80,000
Marine fund-opening	8,20,000	Fire premium	
Bad debts recovered	1,200	Less: Re-insurance	6,00,000
Share transfer fee	800	Profit on sale of land	60,000
Directors' fees	5,000	Miscellaneous receipts	5,000
Auditors' fees	1,200	Differences in exchange (Cr.)	300
Bad debts (marine)	12,000	Interest, dividends, etc. received	14,000
Bad debts (fire)	5,000	Depreciation	35,000

In addition to usual reserves, additional reserve in case of fire insurance is to be increased by 5% of net premium.

Solution.

All Care General Insurance Co. Ltd.
Revenue Account (Fire Business)
for the year ended on 31st March, 2006

Dr Cr

Particulars		Rs.	Particulars		Rs.
Claims less re-insurance paid		190,000	Balance of Account as on 1.4.90:		
Commission		90,000	Fire Fund	250,000	
Expenses on Management		145,000	Add: Reserve	50,000	300,000
Bad debts		5,000	Premium less re-insurance		600,000
Profit transferred to Profit & Loss Account		120,000	Commission on re-Insurance ceded		30,000
Balance of Account as on 31-3-1991:					
Reserve for Unexpired Risks-					
50% of net premium	300,000				
Additional Reserve	80,000	380,000			
		930,000			930,000

All Care General Insurance Co. Ltd.
Revenue Account (Marine Business)
for the year ended on 31st March, 2006

Particulars	*Rs.*	*Particulars*	*Rs.*
Claims *less* re-insurance paid	3,80,000	Balance of Account as on 1.4.90:	
Commission	1,08,000	Marine Fund	8,20,000
Expenses of Management	4,00,000	Premium *less* re-insurance	10,80,000
Bad Debts	12,000	Commission on reinsurance ceded	60,000
Balance of Account as on 31.3.91			
Reserve for Unexpired Risks-100% of Net Premium	10,80,000	Loss transferred to Profit & Loss Account	20,000
	19,80,000		19,80,000

Particulars		*Rs.*	*Particulars*	*Rs.*
Expenses of Management:			Interest, Dividends and	
			Rents, etc., rceived	14,000
Auditors' fees	1,200			
Directors' fees	5,000	6,200	Profit on Sale of land	60,000
Depreciation		35,000	Profit transferred from Fire	
Loss transferred from			Revenue *AI* c	1,20,000
Marine Revenue A/c		20,000	Transfer fees	800
Balance for the year carried to			Bad Debts recovered	1,200
Appropriation A/c		1,40,100	Misc. Receipts	5,000
			Difference in exchange	300
		2,01,300		2,01,300

EXERCISE

1 State whether the following statements are 'True' or 'False':

(1) All insurance contracts are contracts of indemnity.

(2) A life insurance business is said to have earned profits only if its life assurance fund exceeds its net liability on all outstanding policies.

(3) For Life business premium income is to be recognised on receipt basis.

(4) Bonus payable on maturity is called reversionary bonus.

(5) Insurance company final accounts must also include a cash-flow statement.

(6) The balance sheet of life insurance business is called 'Valuation Balance Sheet'.

[Ans. (1) F (2) T (3) F (4) T (5) T (6) F

2. Fill in the blanks:

(1) The concept of surrender value is peculiar to ....

(2) Profit on life business is ascertained by the preparation of ....

(3) Valuation Balance Sheet is prepared once in every years …………..

(4) The shortage of premium received in relation to claims experience in the part is called……………… account.

(5) When an insurance company finds the risk heavy, part of the risk is insured with another insurance company. Such a procedure is known as ....

(6) IRDA requires a minimum capital of Rs. ….… crore for a company to start insurance business.

[Ans: (1) Life Insurance; (2) Valuation Balance Sheet; (3) Two; (4) Premium deficiency; (5) re-insurance; (6) 100;

3. Indicate the correct answers:

(1) A general insurance business carrying on more than one type of insurance business prepares

(a) A separate revenue account for each type of business.

(b) A separate profit and loss account for each type of business.

(c) A separate revenue account and combined profit and loss account.

(d) A separate revenue account and profit and loss account for each type of business.

(2) Survey expenses for marine insurance claims must be

(a) Added to claims

(b) Added to law charges

(c) Added to management expenses

(d) Shown as a separate item

(4) During a year a general insurance company has the following details:

	Rs in Lakh
Premiums received	500
Premiums on re-insurance accepted	100
Premiums on re-insurance ceded	200

The amount to be credited as premium to revenue account should be

(a) Rs. 500 lakh

(b) Rs. 600 lakh

(c) Rs. 700 lakh

(d) Rs.400 lakh

[Ans. (1) c (2) a (3) c (4) d

PROBLEM

1. The Life Assurance Fund of SK Life Insurance Company Limited shows a balance of Rs. 76,87,500 on 31-03-2006. It was later observed that the following had not been taken into account:

(a) Dividend from investments Rs. 3,50,000

(b) Income-tax on the above Rs. 32,000

(c) Bonus in reduction of premium Rs. 4,85,000

(d) Claims covered under re-insurance Rs. 3,25,000

(e) Claims intimated but not yet admitted by the company Rs. 8,07,000.

Ascertain the balance of Life Assurance Fund in the light of the above particulars.

(Adjusted Life Assurance Fund Rs. 75,23,500)

2. From the following balances as at 31st March, 2006 in the books oft he Mega Life Assurance Company Limited, prepare the revenue account and the balance sheet:

	Rs
Life Assurance fund as on	
1st April, 2005	3,000,000
Annuities paid	20,000
Surrenders	69,000
Reserve fund	665,000
Deposit with Reserve Bank	
of India	300,000
Government Securities:	
Indian Government securities	3,250,000
Foreign Government securities	187,000
Loans on company's policies	670,000
Leasehold ground rent	58,000
Due from re-insurers	39,000
Due to re-insurers	49,000
Agents' balances	20,000
Interest outstanding	15,000
Sundry creditors	4,000
Premium *less* re-insurance	700,000
Bonus to policyholders	30,000
Commission	60,000
Claims less re-insurances— on death	400,000
Claims less re-insurances— on Maturity	500,000
Consideration for annuities granted	40,000
Securities on which interest is guaranteed	
Life Assurance fund as on	
by the Government	1,350,000
Share Capital	5,000,000

Mortgage in India	1,636,000
Cash in Current Account	30,000
Cash in deposit a/c with bank	16,000
Cash in hand	105,000
State Government securities	888,000
Furniture	40,000
Outstanding premium	68,000
Salaries	50,000
Directors' fees	6,000
Auditors fees	8,000
Law charges	2,000
Rent paid	4,000
Other expenses of management	1,500
Interest and rent less taxes Rs 60,000	300,000
Interest accrued but not due	30,000

[Ans: Balance of life Assurance fund at the end of the year Rs 28,89,500; Balance sheet totalRs 86,07,500]

3. The life assurance fund of Suraksha Life Assurance Company Limited showed a balance of Rs. 50,25,000 at the end of. March 2007. The dividend payable to shareholders for the year amounted to Rs. 75,000. The actuary's valuation placed the 'net liability at Rs. 45,50,000. An interim bonus of Rs. 1,00,000 has been paid to the policyholders.

   Prepare a statement showing the amount now available as bonus to policyholders.

   (Surplus available to policyholders Rs. 4,75,000)

4. From the figures set out below, prepare the balance sheet of a Life Insurance Company as on 31st March 2006 in form (as far as circumstances permit) prescribed by Insurance Act, 1938 as governed by Life Insurance Corporation Act, 1956.

   The company's deposit with Controller General in 3.5 % G.P. Notes are of the face value of Rs. 10,00,000 and it also holds the following investments, besides loans of Rs. 3,00,000 on the security of the company's policies.

   4% Port Trust bonds of the face value of Rs. 12,00,000.

   5.5% War Bonds of the face value of Rs. 25,00,000.

Agents collection of premia during the current year amounted to Rs. 20,00,000 out of which after deducting Rs. 2,00,000 for commission due to them, they remitted to the company in the year ended 31.3.2006 Rs. 14,00,000 and the balance after 1-4-2006.

Other assets and liabilities were: Furniture Rs. 80,000, cash in hand Rs. 20,000, cash at bank Rs. 1,00,000. Outstanding premium Rs. 4,00,000. Interest accrued Rs. 1,00,000 out of which Rs. 30,000 was due. Share capital consists of 4,000 shares of Rs. 1,000 each, Rs. 500 paid-up. Commission due but not paid Rs. 2,00,000. Estimated liability regarding claims unpaid Rs. 6,00,000. The balance consists of Life Insurance Fund 75% and investments reserve fund 25%.

(Balance sheet total Rs. 61,00,000; Life Insurance fund Rs. 24,75,000)

5. The following balances appeared in the books of the Hindustan Fire and General Insurance Company Limited on 31st March, 2007 :

Re-insurance premiums paid	50,000	Commission	1,52,000
Reserves for unexpired risk		Claims paid	2,21,000
as on 1-4-2006	8,24,800	Loss on exchange	9,000
Expenses of Management	1,25,600	Claims outstanding	
Premium received	7,89,000	1-4-2006	2,81,000

You are required to prepare revenue account for the year ended 31st March, 2007, after taking the following information into consideration: (i) Provide for unexpired risks at 50% of the premiums; (ii) Create additional reserve of Rs. 75,000; [iii) Premiums outstanding at the end of the year were Rs. 1,50,000; (iv) On 31st March, 2007, the claims outstanding were Rs. 3,37,000.

(Profit Rs. 6,39,700; Balance of fund Rs. 5,19,500)

6. From the following balances of Prudential General Insurance Co., prepare-(I) Fire revenue account: (il) Marine revenue account; and (iil) Profit and loss account for the year ending on 31 st March 2006 :

		Rs
(i)	Claims paid and outstanding (Fire)	3.60,000
(ii)	Claims paid and outstanding (Marine)	7,60,000
(iii)	Additional reserve on 1.4.2005 (Fire)	1,00,000
(iv)	Sundry expenses (Fire)	20,000
(v)	Bad debts (Fire)	10,000
(vi)	Bad debts (Marine)	24,000
(vii)	Auditors' fees	2,400
(viii)	Directors' fees	10,000
(ix)	Share transfer fees	1,600
(x)	Bad debts recovered	2,400
(xi)	Fire fund on 1.4.2005	5,00,000
(xii)	Marine fund on 1.4.2005	16,40,000
(xiii)	Commission earned on re-insurance ceded (Fire)	20,000
(xiv)	Commission earned on re-insurance ceded (Marine)	40,000
(xv)	Depreciation	70,000
(xvi)	Interest, Dividends, etc., received	28,000
(xvii)	Difference in exchange (Cr.)	600
(xviii)	Miscellaneous receipts	10,000
(xix)	Profit on sale of land	1,20,000
(xx)	Fire insurance premium less re-insurance	12,00,000
(xxi)	Marine prc::mium re-insurance	21,60,000
(xxii)	Management Expenses (Fire)	2,90,000
(xxiii)	Management Expenses (Marine)	8,00,000

Additional reserve in case of fire insurance is to be raised by 5% of net premiums in addition to usual reserves. Re-insurance premium received amounted to Rs. 3,00,000 for the business and Rs. 6,40,000 for marine business. Management expenses are exclusive of commission. The net income of fire business in 2004-05 was Rs. 10,00,000.

[Fire Rs. *3,00,000; Marine Loss 52,000;* Net *Profit* 3,28,2001

7. The following figures have been extracted from the books of National Insurance Co. Ltd. in respect of their marine business for 2006-07:

	(Rs. In lakh)
Direct premium income received	50.00
Reserve for unexpired risks as on 1-4-2006	60.00
Claims outstanding as on 1-4-2006 (net)	20.00
Bad debts	10.00
Income from investments and dividends (gross)	10.00
Rent received from properties	5.00
Investments in Government securities as on 1-4-2006	100.00
Investments in shares as on 1-4-2006	20.00
Commission paid on direct business	5.00
Expenses of management	5.00
Income-tax deducted at source	3.00
Profit and loss account (Cr.) balance on 1-4-2006	10.00
Other expenses	1.25
Re-insurance premium receipts	5.00
Outstanding claims as on 31-03-2007 (net)	30.00
Direct claims paid (gross)	25.00
Re-insurance claims paid	4.00

Prepare revenue account, profit and loss account and the profit and loss appropriation account for the year, after taking into account the following further information:

(a) All direct risks are re-insured for 20% of the risk.

(b) Claim a commission of 25% on re-insurance ceded.

(c) Provide 25% commission on re-insurance accepted.

(d) Market value of investments as on 31-03-2007 is as under:

(i)	Government securities	Rs 105 Lakh
(ii)	Shares	Rs 18 Lakh

Adjust separately for each of these two categories of investment.

(e) Provide 65% for income-tax

[Balance in revenue account Rs. 18 lakh, Net profit Rs. 10.35 lakh,
Balance in the appropriation account Rs. 20.35 Lakhl

[Hints. (1) From the direct claims paid, deduct 20% covered by re-insurance.

(2) From the premium received, deduct 20% passed onto the re-insurers.

(3) Provision for income-tax

	(Rs. in lakh)
Income as per revenue account	18.00
Add: Tax deducted at source (income is not grossed up)	3.00
	21.00
Provision at 65%	13.65
Less; Tax already deducted at source	3.00
Net Provision required	10.65

8. From the following details, prepare the Revenue Account, Profit and Loss Account and the Balance Sheet *of* Moonshine Insurance *Co.* Ltd., carrying on marine insurance business, for the 15 months ended 31 st March. *2002* :

	Rs
Share Capital	15,00,000
Balance of Marine Fund as on 1 st January, 2001	7,60,000
Unclaimed dividends	2,400
Profit and Loss Account (Cr.)	2,40,000
Sundry Creditors	12,600
Agent's Balance (Dr.)	1,46,400
Interest accrued but not due	8,200
Due to Re-insurers	60,000
Furniture and Fixtures (cost Rs. 12,600)	8,400
Stock of Stationery	2,500
Expenses of Management	2,20,000
Foreign Taxes and Insurance	12,300
Outstanding Premium	21,200
Donations Paid	8,600

	Rs.
Advance Income-Tax Payments	62,000
Sundry Debtors	9,200
Government of India Securities	9,20,000
Debentures of Public Bodies	1,80,000
Shares in Limited Companies	3,60,000
Claims less re-insurance	10,60,000
Premium less re-insurance	12,40,000
Commission paid	62,400
Interest and Dividends	2,40,000
Transfer fees Received	600
Cash and Bank Balances	94,400

Outstanding claims on 31st March 2006 were Rs 1,40,000. Depreciation on furniture *to be provided @ 20 % p.a*

(B/ S total Rs. 29,55,000)

9.4. ACCOUNTING OF BANKING COMPANIES

A bank is a commercial institution, licensed to accept deposits and acts as a safe custodian of the spendable funds of its customers. Banks are concerned mainly with the functions of banking, i.e., receiving, collecting, transferring, buying, lending, investing, dealing, exchanging and servicing (safe deposit, custodianship, agency , trusteeship) money and claims to money both domestically and internationally. The principal activities of a bank are operating current accounts, receiving deposits, taking in and paying out notes and coins, and making loans.

Banking activities undertaken by banks include personal banking (non-business customers), commercial Banking (small and medium-sized business customers) and corporate banking (large international and multinational corporations).

According to Charles J. Woelfel:

A complete banking service would comprehend a variety of functions, including any of the following:

(1) Receive demand deposits and pay customers' cheques drawn against them, and operate automated teller machines (ATM);

(2) Receive time and savings deposits, issue negotiable orders of withdrawal, and pay interest thereon, as well as provide automatic transfer service (A TS) for funds from serving accounts to cover cheques;

(3) Discount notes, acceptances and bills of exchange;

(4) Supply credit to business firms with or without security, issue letters of credit and accept bills drawn thereunder;

(5) Transfer money at home and abroad;

(6) Make collections and facilitate exchanges;

(7) Issue drafts, cashier's cheques, money orders, and certify cheques;

(8) Furnish safe deposit vault service;

(9) Provide custodianship for securities and other valuables;

(10) Provide personal loans, credit and services to individuals, and lend or discount customer installment receivables of vendors;

(11) Act in a fiduciary capacity for individuals, as well as establish common trust funds;

(12) Provide corporate trust services (stock transfer agent, registrar, paying agent, escrow agent, and indenture trustee);

(13) Act as factors and engage in equipment leasing;'

(14) Deal in Government securities and underwrite general obligations of state and municipal securities;

15) Invest in government and other debt securities;

(16) Act as fiscal agent or depository for the Central Government, states and subdivisions of states;

(17) Provide miscellaneous services such as place orders in securities for customers; act as insurance agent of incidental to banking transactions; serve as finder to bring buyers and sellers together; act as travel agent and issue letters of credit and traveler's cheques; provide club accounts and other special purpose accounts; act as agent for accepting service of legal process of incidental I normal banking or fiduciary transactions of the bank; act as pay role issuer; establish charitable foundations, invest in small business investment corporations and bank service corporations; deal in foreign exchange; buy and sell gold bullion under license from the Treasury Department, and foreign coin; provide domestic and international correspondent banking services, etc.

In India, banking activities are governed by The Banking Regulation Act, 1949. As per the provisional Section 5(b) of the said Act, "banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, drafts, order or otherwise.

Section 5(c) defines "Banking Companies" as any company which transacts the business of banking in India. However, any company which is engaged in the manufacture of goods or carries on any trade and which accept deposits of money from the public merely for the purpose of financing its business as such manufacturer m trader shall not be deemed to transact the business of banking within the meaning of this clause.

Business of Banking Companies

As per the provision of Section 6 of the Banking Regulation Act, 1949, a banking company may engage in any one or more of the following forms of business, in addition to the business of banking. These are:

(a) The borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hoondees, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments, and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveler's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes: the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise, the providing of safe deposit vaults; the collecting and transmitting of money and securities;

(b) Acting as agents for any Government or local authority or any other person or persons; the carrying on of agency business of any description, including the clearing and forwarding of goods, giving of receipts and discharges, and otherwise acting as an attorney on behalf of customers; but excluding the business of a managing agent or secretary and treasurer of a company;

(c) Contracting for public and private loans and negotiating and issuing the same;

(d) The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock, debentures, or debenture stock of any company, corporation or association, and the lending of money for the purpose of any such issue;

(e) Carrying on and transacting every kind of guarantee and indemnity business;

(f) Managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

(g) Acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(h) Undertaking and executing trusts;

(i) Undertaking the administration of estates as executor, trustee or otherwise;

(j) Establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependants or connections of such persons; granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing money for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

(k) The acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company;

(l) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account, or otherwise dealing with all or any part of the property and rights of the company;

(m) Acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this sub-section;

(n) Doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

(o) Any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

Restriction on Business of Banking Company

Section 8 of the Banking Regulation Act, 1949, imposes certain restrictions on the business of a banking company. These are as follows:

(i) No banking company shall directly or indirectly deal in the buying, selling or bartering of goods, except in connection with the realisation of security given to or held by it;

(ii) No banking company can engage in any trade, or buy, sell or barter goods for others otherwise than in connection with bills of exchange, received for collection or negotiation or with such of its business or is referred to in clause (i) of sub-section (1) of section 6.

Some Important Provisions of the Banking Regulation Act, 1949 Disposal of Non-Banking Assets (Section 9)

Notwithstanding anything contained in Section 6, no banking company shall hold any immovable property howsoever acquired, except such as is required for its own use, for any period exceeding seven years from the acquisition thereof or from the commencement of this Act, whichever is later or any extension of such period as in s section provided; and such property shall be disposed of within such period or extended period, as the case may be:

Provided that the banking company may, within the period of seven years as aforesaid; deal or trade in any such property for the purpose of facilitating the disposal thereof. Provided further that the Reserve Bank may in any particular case extend the aforesaid period of seven years by such period not exceeding five years, where it is satisfied that such extension would be in the interest of the depositors of the banking company.

Restrictions as to Payment of Dividend (Section 15)

No banking company shall pay any dividend on its shares until all its capitalized expenses (including preliminary expenses, organization expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written-off.

However; it banking company may pay dividends on its shares without writing-off:

(i) The depreciation; if any, in the value of its investments in approved securities in any case where such depreciation has hot actually been capitalized or otherwise accounted for as a loss;

(ii) The depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;

(iii) The bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.

Statutory Reserve (Section 17)

Every banking company incorporated in India shall create a reserve fund and transfer to it at least 20% of its annual profit as disclosed in the Profit and Loss Account prepared under Section 29 and before any dividend is declared.

Where a banking company appropriates any sum or sums from the reserve fund or the Share Premium Account, it shall report the fact to the Reserve Bank, explaining the circumstances relating to such appropriations within 21 days from the date of such appropriation.

Cash Reserve (Section 18)

Every banking company, not being a scheduled bank, has to maintain a cash reserve (CRR) of at least a percentage of the total of its demand and time liabilities in India, as on last Friday of the second preceding fortnight, as specified by R.B.I. time to time.

Cash reserve can be maintained with itself or by way of a balance in the Current Account with the Reserve Bank or by way of net balance in current accounts or in one or more of the aforesaid ways.

Restrictions on Loans and Advances (Section 20)

No banking company shall

(a) grant any loans or advances on the security of its own shares, or

(b) enter into any commitment for granting any loan or advance to or on behalf of

   (i) Any of its directors,

   (ii) Any firm, in which any of its directors is interested as partner, manager, employee or guarantor, or

   (iii) Any company (not being a subsidiary of the banking company or a company registered under Section 25 of the Companies Act, 1956 (1 of 1956) or a Government company) of which (or the subsidiary of holding company of which) any of the directors of the banking company is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or

   (iv) Any individual, in respect of whom any of its directors is a partner or guarantor now-a-days, the daily transactions of a bank are numerous. All these transactions are to be recorded immediately to reflect the exact position of each customer's account. Therefore, a bank has to adopt specialised system of book-keeping, which will ensure immediate entry of numerous transactions and keep an internal check on the books of account. To achieve these objectives, banks generally maintain a large number of subsidiary and memorandum books in addition to Principal Books of Account. These are as below:

Subsidiary Books

These include the following:

(i) Personal Ledger The bank maintains separate ledgers for different types of accounts, such as,

  (a) Current Accounts Ledger,

  (b) Savings Bank Accounts Ledger,

  (c) Fixed Deposit Accounts Ledger,

  (d) Recurring Deposit Accounts Ledger, etc.

Entries are made in these ledgers directly from the vouchers.

(ii) Investments Ledger Accounts of all investments are kept in this ledger.

(iii) Loan Ledger Accounts of all the parties to whom loans have been granted are kept in this ledger.

(iv) Bills Discounted and Purchased Ledger Accounts of all the parties whose bills have been dis. counted and purchased are kept in this ledger.

Memorandum Books

In addition to the subsidiary books, a bank maintains various other books to facilitate its works, which do not form a part of double entry system. Some of these are:

(i) Receiving Cashier's Counter Cash Book

(ii) Paying Cashier's Counter Cash Book

(iii) Cash Balance Book.

Principal Books of Account

Cash Book and General Ledger are the principal Books of Account of any bank. Cash Book records all cash transactions and General Ledger contains Control Account of all subsidiary ledgers and different Assets am Liabilities Account. In the general ledger, accounts are arranged in such a manner that a Balance Sheet can be easily prepared.

Final Accounts

According to Section 29 of the Banking Regulation Act, 1949, every banking company is required to prepare with reference to that year a Balance Sheet and a Profit and Loss Account as on the last working day of the year in the 'Form A' and 'Form B' respectively set out in the 'Third Schedule' or as near thereto as circumstances admit.

Balance Sheet

With effect from 19th March, 1992, the Balance Sheet of a bank is to be prepared as per the new form. In the new form, assets and liabilities are shown vertically along with the figures of year. In the top section capital and liabilities" are shown and in the bottom section, assets are shown.

THE THIRD SCHEDULE

(See Section 29)

Form 'A'

FORM OF BALANCE SHEET

Balance Sheet of …..

Balance Sheet as on 31st March…..

('000 omitted)

	Schedule No.	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
Capital and liabilities			
Capital	1		
Reserves & Surplus	2		
Deposits	3		
Borrowings	4		
Other Liabilities and Provisions	5		
Total			
Assets			
Cash and balances with RBI	6		
Balances with banks and money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total			
Contingent liabilities	12		
Bills for collection			

FORM B

FORM OF PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH

	Schedule No.	Year ended 31.3 (Current Year)	Year ended 31.3 (Previous Year)
I. Income			
Interest earned	13		
Other Income	14		
Total			
II.Expenditure			
Interest Expended	15		
Operating Expenses	16		
Provision and contingencies			
Total			
III. Profit /Loss			
Net Profit/(Loss) for the year			
Profit/(Loss) brought forward			
Total			
Transfer to statutory reserve			
Transfer to other reserve			
Proposed Dividend			
Balance carried forward to Balance sheet			
Total			

Note: 1.The total income includes income of foreign branches at Rs______

2.The total expenditure includes expenditure of foreign branches at Rs___

3.Surplus / Deficit of foreign branches Rs______

SCHEDULES

Details of all schedules are in below:

A> Capital and Liabilities

1. **Capital**
2. **Reserve and Surplus**: It includes Capital Reserve, Security Premium, Revenue and other Reserve and Profit and Loss Account balance.
3. **Deposits**: It includes Demand deposits, Savings bank deposits and term deposits.
4. **Borrowings:** It includes Borrowings from Reserve Bank of India, other banks, institutions and agencies.
5. **Other Liabilities and Provisions**: It includes Bills payable, inter-office adjustments (net), interest accrued, provision for bad debts, provision for taxation.

B> Assets

6. **Cash and Balances with Reserve Bank of India**: Cash in hand (including foreign currency notes); and balances with Reserve Bank of India are shown under this item.
7. **Balances with Banks and Money at Call and Short Notice**: Balances with banks; money at call and short notice are shown under this item. Money at call is refundable at 24 hour's notice and money at short notice is refundable at 7day's notice.
8. **Investments:** Investment in Government securities, other approved securities, shares, debentures and bonds, subsidiaries, gold etc., are shown under this item.
9. **Advances**: Bills purchased and discounted, cash credit, overdrafts and loans payable on demand; and term loans are shown under this item.
10. **Fixed Assets**: Premises, other fixed assets (including furniture and fixtures) are shown under this item.
11. **Other Assets**: Inter- office adjustments, interest accrued, tax paid in advance, stationery and stamps, non-banking assets acquired in satisfaction of claims are shown under this item.
12. **Contingent Liabilities**: It is shown by way of a footnote. It represents liabilities not provided in the Balance Sheet.

Profit and Loss Account

Profit and Loss Account of a banking company is also prepared in vertical form. 'Form B' of the Third Schedule of the Banking Regulation Act, 1949 is to be used for preparing Profit and Loss Account. It is divided into four sections:

I. Income;

II. Expenditure;

III. Profit/Loss; and

IV. Appropriations.

C> Income:

The schedules of Income are:

13. **Interest Earned**. It includes interest/discount on advances/bills, income on investments, interest on balances with RBI etc. It should be noted that according to the new form, bad debts and provision for bad debts, other provisions are not to be deducted from the interest earned. For greater transparency in accounts, these items are shown as separate items in the Profit and Loss Account.

14. **Other income**. It includes commission, exchange and brokerage, profit on sale of investments, profit on revaluation of investments, profit on sale of land, building and other assets, profit on exchange transaction, and income earned by way of dividends from subsidiaries, etc.

***D*> Expenditure**

15. **Interest expended**. Interest paid on deposits, interest on RBI borrowings; interest on inter-bank borrowings, etc., are shown under this item.

16. **Operating expenses**. Salaries and wages of staff; rent, rates and taxes; printing and stationery; advertisement; depreciation on banks' properties; director's fees; auditor's fees; law charges; postage; repairs; insurance; etc., are shown under this item.

Third item of this section is provisions and contingencies. Provision for bad debts, provision for taxation and other provisions are shown under this item.

III. Profit/Loss

In this section, profit/loss for the current year (difference between income and expenditure explained above) and brought forward profit/loss are shown.

IV. Appropriations

In this section, amount transferred to statutory reserve as per Section 17; amount transferred to other reserve; proposed dividend, etc., are shown. The balance is transferred to the Balance Sheet.

FORM OF SCHEDULES

SCHEDULE 1 - CAPITAL

	As on 31.3. (Current Year)	As on 31.3 (Previous Year)
For Nationalised Banks		
Capital (Fully owned by Central Government)		
For Banks Incorporated Outside India		
Capital		
(The amount brought in by banks by way of start-up capital as prescribed by RBI		
should be shown under this head)		
Amount of deposit kept with the RBI under Section 11(2) of Banking Regulation Act, 1949		
Total		
For Other Banks		
Authorised Capital		
.... shares of Rs .... each		
Issued Capital		
.... shares of Rs .... each		
Subscribed Capital		
.... shares ofRs .... each		
Cafled-up Capital		
.... shares of Rs .... each		
Less: Calls unpaid		
Add: Forfeited shares		

SCHEDULE 2 - RESERVES AND SURPLUS

	(Curr. Year)	(Prev. Year)
I. Statutory Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
II. Capital Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
III. Shares Premium		
Opening Balance		
Additions during the year		
Deductions during the year		
IV. Revenue and other Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
V. Balance in Profit and Loss Account		
Total (I + II + III + IV + V)		

SCHEDULE 3 - DEPOSITS

	As on 31.3. (Curr. Year)	As on 31.3 (Prev Year)
I. Demand Deposits		
(i) From banks		
(ii) From otners		
II. Savings Bank Deposits		
III. Term Deposits		
(i) From banks		
(ii) From others		
Total (I + II + III)		
(i) Deposits of branches in India		
(ii) Deposits of branches outside India		
Total		

SCHEDULE 4 - BORROWINGS

	As on 31.3. (Curr. Year)	As on (Curr. (Prev. Year)
I. Borrowings in India		
(i) Reserve Bank of India		
(ii) Other Banks		
(iii) Other Institution and agencies		
II. Borrowings Outside India		
Total (I + II)		
Secured borrowings included in I and II above. Rs…..		

SCHEDULE 5 - OTHER LIABILITIES AND PROVISIONS

	As on 31.3 (Curr. Year)	As on 31.3 (Prev. Year)
Bills Payable		
Inter -Office adjustments(net)		
Interest accrued		
Others(Including Provisions)		
Total		

SCHEDULE 6 - CASH AND BALANCES WITH RESERVE BANK OF INDIA

	As on 31.3. (Curr. Year)	As on 31.3 (Prev. Year)
Cash in hand (including foreign currency notes)		
Balances with RBI		
(i) in Current Account		
(ii) in Other Accounts		
Total (I + II)		

SCHEDULE 7 - BALANCES WITH BANKS & MONEY AT CALL & SHORT NOTICE

	As on 31.3. (Curr. Year)	As on 31.3 (Prev. Year)
I. In India		
(i) Balances with banks		
(a) In Current Accounts		
(b) In Other Deposit Accounts		
(ii) Money at call and short notice		
(a) With banks		
(b) With other institutions		
Total		

	As on 31.3. (Curr. Year)	As on 31.3 (Prev. Year)
II. Outside India		
(i) in Current Accounts		
(ii) in Other Deposit Accounts		
(iii) Money at call and short notice		
Total		
Grand Total (I + II)		

SCHEDULE 8 - INVESTMENTS

	As on 31.3. (Curr. Year)	As on 31.3 {Prev. Year)
Investments in India in		
(i) Government securities		
(ii) Other approved securities		
(iii) Shares		
(iv) Debentures and Bonds		
(v) Subsidiaries and/or joint ventures		
(vi) Others (to be specified)		
Total		
Investments outside India in		
(i) Government securities (including local authorities)		
(ii) Subsidiaries and/or joint ventures abroad		
(iii) Other investments (to be specified)		
Total		
Grand Total (I + II)		

SCHEDULE 9 - ADVANCES

	As on 31.3. (Curr. Year)	As on 31.3 (Prev. Year)
(i) Bills purchased and discounted (ii) Cash credits, overdrafts and loans repayable on demand (iii) Term loans		
Total		
(i) Secured by tangible assets (ii) Covered by Bank/Government guarantees (iii) Unsecured		
Total		
I. Advances in India (i) Priority Sectors (ii) Public Sector (iii) Banks (iv) Others		
Total		
II. Advances outside India (i) Due from banks (ii) Due from others (a) Bills purchased and discounted (b) Syndicated loans (c) Others		
Total		
Grand Total (I + II)		

SCHEDULE 10 - FIXED ASSETS

	As on 31.3. (Curr. Year)	As on 31.3 (Prev. Year)
Premises		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
Other Fixed Assets (including furniture and fixtures)		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
Total (I + II)		

SCHEDULE 11 - OTHER ASSETS

	As on 31.3. (Curr. Year)	As on 31.3 (Prev. Year)
I. Inter-office adjustments (net)		
II. Interest accrued		
III. Tax paid in advance / tax deducted at source		
IV. Stationery and stamps		
V. Non-banking assets acquired in satisfaction of claims		
VI. Others		
Total		

SCHEDULE 12 - CONTINGENT LIABILITIES

	As on 31.3. (Curr. Year)	As on 31.3 (Prev. Year)
I. Claims against the bank not acknowledged as debts.		
II. Liability for partly paid investments		
III. Liability on account of outstanding forward exchange contracts		
IV. Guarantees given on behalf of constitutents		
(a) In India		
(b) Outside India		
V. Acceptances, endorsements and, other obligations		
VI. Other items for which the bank is contingently liable		
Total		

SCHEDULE 13 -INTEREST EARNED

	As on 31.3. (Curr. Year)	As on 31.3 (Prev. Year)
I. Interest discount on advances I bills		
II. Income on investments		
III. Interest on balances with Reserve Bank of India and other inter-bank funds		
IV. Others		
Total		

SCHEDULE 14 - OTHER INCOME

	Year ended 31.3. Current Year	Year ended 31.3. Previous Year
I. Commission, exchange and brokerage		
II. Profit on sale of investments		
Less: Loss on sale of investments		
III. Profit on revaluation of investments		
Less: Loss on revaluation of investments		
IV. Profit on sale of land, buildings and other assets		
Less: Loss on sale of land, buildings and other assets		
V. Profit on exchange transactions		
Less: Loss on exchange transactions		
VI. Income earned by way of dividends etc., from subsidiaries / companies and/or joint ventures abroad / in India		
VII Miscellaneous Income		
Total		

SCHEDULE 15 - INTEREST EXPENDED

	Year ended 31.3. ... (Current Year)	Year ended 31.3. ... (Previous Year)
I. Interest on deposits		
II. Interest on Reserve Bank of India I inter-bank borrowings		
III. Others		
Total		

SCHEDULE 16 - OPERATING EXPENSES

	Year ended 31.3. (Current Year)	Year ended 31.3. (Previous Year)
I. Payments to and provisions for employees		
II. Rent, taxes and lighting		
III. Printing and stationery		
IV. Advertisement and publicity		
V. Depreciation on bank's property		
VI. Directors' fees, allowances and expenses		
VII. Auditors' fees and expenses (including branch auditors' fees and expenses)		
VIII. Law charges		
IX. Postages, telegrams, telephones, etc.		
X. Repairs and maintenance		
XI Insurance		
Total		

@ In case there is any unadjusted balance of loss, the same may be shown under this item with appropriate foot-note.

Disclosure of Accounting Policies

In order that the financial position of banks represent a true and fair view, the Reserve Bank of India has directed the banks to disclose the accounting policies regarding the key areas of operations along with the notes of account in their financial statements for the accounting year ending 31.3.1991 and onwards, on a regular basis. The accounting policies disclosed may contain the following aspects subject to modification by individual banks:

(1) General

The accompanying financial statements have been prepared on the historical cost and conform to the statutory provisions and practices prevailing in the country.

(2) Transactions involving Foreign Exchange

(a) Monetary assets and liabilities have been translated at the exchange rates, prevailing at the close of the year. Non-monetary assets have been carried in the books at the historical cost.

(b) Income and expenditure items in respect of Indian branches have been translated at the exchange rates, ruling on the date of the transaction and in respect of overseas branches at the exchange rates prevailing at the close of the year.

(c) Profit or loss on pending forward contracts have been accounted for.

(3) Investments

(a) Investments in Governments and other approved securities in India are valued at the lower of cost or market value.

(b) Investments in subsidiary companies and associate companies (i.e., companies in which the bank holds at least 25 per cent of the share capital) have been accounted for on the historical cost basis.

(c) All other investments are valued at the lower of cost or market value.

(4) Advances

(a) Provisions for doubtful advances have been made to the satisfaction of the auditors:

(i) In respect of identified advances, based on a periodic review of advances and after taking into account the portion of advance guaranteed by the Deposit Insurance and Credit Guarantee Corporation, the Export Credit and Guarantee Corporation and similar statutory bodies.

(ii) In respect of general advances, as a percentage of total advances taking into account the guidelines issued by the Government of India and the Reserve Bank of India.

(b) Provisions in respect of doubtful advances have been deducted from the advances to the extent necessary and the excess have been included under "Other Liabilities and Provisions".

(c) Provisions have been made on a gross basis. Tax relief, which will be available when the advance is written-off, will be accounted for in the year of write-off. Fixed Assets

(5) Fixed Assets

(a) Premises and other fixed assets have been accounted for at their historical cost. Premises which have been revalued are accounted for at the value determined on the basis of such revaluation made by the professional values, profit arising on revaluation has been credited to Capital Reserve.

(b) Depreciation has been provided for on the straight line/diminishing balance method.

(c) In respect of revalued assets, depreciation is provided for on the revalued figures and an amount equal to the additional depreciation consequent of revaluation is transferred annually from the Capital Reserve to the General Reserve/Profit and Loss Account.

(6) Staff Benefits

Provisions for gratuity/pension benefits to staff have been made on an accrual/casual basis. Separate funds for gratuity/pension have been created.

(7) Net Profit

(a) The net profit disclosed in the Profit and Loss Account is after:

(i) Provisions for taxes on income, in accordance with the statutory requirements.

(ii) Provisions for doubtful advances.

(iii) Adjustments to the value of "current investments" in Government and other approved securities in India, valued at lower of cost or market value.

(iv) Transfers to contingency funds.

(v) Other usual or necessary provisions.

(b) Contingency funds have been grouped in the Balance Sheet under the head "Other Liabilities and Provisions".

Some Special Transactions

Interest on Doubtful Debts

When a debt is found to be doubtful at the end of the accounting year, a question may arise whether the interest on that should be credited to Interest Account or not. There is no doubt that interest has accrued; but it is equally clear that the realisation of this interest is doubtful.

Therefore, as a prudent accounting policy, such interest should be transferred to *Interest Suspense Account* by means of the following entry:

Loan Account Dr

To Interest Suspense Account

In the Balance Sheet, it should be shown on the liability side.

Next year, if a part of interest is realised and the balance becomes bad, the following entry should be passed

Interest Suspense Account	Dr. [Total interest}
To Interest Account	[Interest realised}
To Loan Account	[Interest unrealized}

It should be noted that if a debtor becomes insolvent, the bank should not take interest into account after the date of insolvency.

Illustration 1

While closing the books of AB Bank Ltd. on 31st March, 2007, you find in the loan ledger an unsecured balance of Rs 1 lakh in the account of Mr. X, whose financial condition is reported to you as bad and doubtful. Interest accrued on that account is Rs 10,000. On 1st July, 2007 the bank accepted a dividend of Re 75 paise in rupee in full settlement of amount due upto 31st March, 2007. You are required to pass necessary Journal Entries and prepare necessary Ledger Account.

Date	Particulars		Rs	Rs
2007 March 31	X Loan A/c	Dr.	10,000	
	To Interest Suspense A/c (Being accrued interest on doubtful debts)			10,000
July 1	Interest Suspense A/c	Dr.	10,000	
	To Interest A/c			7,500
	To X Loan A/c			2,500
	(Being the transfer of interest realised to Interest Account & the balance transf. to Loan Account)			
	Bank Ale	Dr.	82,500	
	Bad Debts A/c	Dr.	25,000	
	To X Loan A/c			1,07,500
	(Being the final dividend received from the estate of Mr. X@ 75 paise in a rupee)			

Rebate on Bills Discounted

When a bank discounts a bill, Bills Discounted and Purchased Account is debited with the full value of the bill and Current Account (customer's) is credited with the net proceeds and Interest and Discount Account is credited with the amount of total discount of the bill. Discount represents the interest on bill value for the unexpired period of the bill (difference between the date of maturity and date of discounting). It sometimes happen that on the closing day of the accounting year, the bill in question has not matured. At the time of preparing Final Accounts, the interest relating to next accounting period must be carried forward by means of the following entry :

Interest and Discount Account Dr.

To Rebate on Bills Discounted Account

It appears in the Balance Sheet under Capital and Liabilities'. At the commencement of the next accounting year, it is transferred to Interest and Discount Account by means of a reverse entry.

Illustration 2

On 1st February, 2007 a bill of Rs 3 lakh is discounted @ 12% p.a. The due date of the bill is 30th April, 2007. Pass necessary Journal Entries in the books of the bank assuming that the bill is collected on due date. Account year closing on 31st March, 2007.

Solution

In the books of Bank

Journal

Date	Particulars		Rs	Rs
2007	Bills Discounted and Purchased A/c	Dr.	3,00,000	
Feb. 1	To Current A/c			2,91,000
	To Interest and Discount A/c (Note 1)			9,000
	Discounting of a bill accepted			
	by.. and due on ...... @ 12% p.a.)			
	At maturity on 30th April, 2007,			
	the bank will collect the full amount			
	of the bill and the entry will be:			
	Cash A/c	Dr.	3,00,000	
	To Bills Discounted and Purchased A/c			3,00,000
	(The bill collected at maturity)			
	Actually 2 months' interest is the			
	income of 2006-07 and 1 month's			
	interest is related to 2007-08			
	Therefore, on 31st March 2007,			
	the adjusting entry will be :			
	Interest and Discount A/c	Dr.	3,000	
	To Rebate on Bills Discounted A/c (Note 2)			3,000
	(The proportionate discount not earned			
	in 2006-07 carried forward through Rebate			
	on Bills Discounted Account)			

Working Notes: (1) Discount for 3 months = Rs 3,00,000 x 12/100 x 3/12 = Rs 9,000. (2) Rebate on Bills Discounted = Rs 9,000/3 x 1 = Rs 3,000.

Illustration

Calculate rebate on bills discounted as on 31st March, 2007.

Date of Bill	Amount (Rs)	Period	Rate of Discount
15.1.2007	25,000	5 Months	8%
10.2.2007	15,000	4 Months	7%
25.2.2007	20,000	4 Months	7%
20.3.2007	30000	3 Months	9%

Solution

Calculation of Rebate on Bills Discounted

Date of Bill	Period	Due date (after days of grace)	Days beyond 31.3.07	Amount of the Bill	Rate of Dicount	Amount Dicount
15.1.2007	5 Months	18.6.2007	79	25,000	8%	432.88
10.2.2007	4 Months	13.6.2007	74	15,000	7%	212.88
25.2.2007	4 Months	28.6.2007	89	20,000	7%	341.37
20.3.2007	3 Months	23.6.2007	84	30,000	9%	621.37
				1,608.50		

Working Notes :

(1) Calculation of Days beyond 31.3.1995:

April		May		June	=	Total
30	+	31	+	18	=	79
30	+	31	+	13	=	74
30	+	31	+	28	=	89
30	+	31	+	23	=	84

(2) Journal Entry:

Interest and Discount A/c	Dr.	1,608.50	
To Rebate on Bills Discounted A/c			1,608.50

Illustration

Following is the Trial Balance of XYZ Bank Ltd. as on 31.03.2007

Particular	Dr.(Rs'000)	Cr. (Rs'000)
Share Capital		300,000
Cash in hand and with RBI	46,350	
Investments in Gov!. of India Bonds	194,370	
Olher Investments	155,630	
Gold Bullion	15,130	
Interest accrued on Investments	24,620	
Security Deposits of Employees		15,000
Savings Account Balance		7,420
Current Ledger Control Account		97,000
fixed Deposits		23,050
Security Premium Account		90,000
Slatutory Reserve		140,000
Siwer Bullion	2,000	
Constituents' Liability for acceptance and endorsements	56,500	
Buildings	65,000	
furniture	5,000	
Borrowings from Banks		77,230
Money at Call and Short Notice	26,000	
Advances	200,000	

Particular	Dr.(Rs'000)	Cr. (Rs'000)
Profit and Loss Account Balance		6,500
Bills Discounted and Purchased	12,500	
Bills for Collection		43,500
Acceptances and Endorsements		56,500
Interests	7,950	72,000
Commission and Brokerage		25,300
Discounts		42,000
Bills Receivable being bills for collection	43,500	
Audit fees	5,000	
Loss on sale of Furniture	1,000	
Directors' fees	1,200	
Salaries	21,200	
Postage	50	
Rents		600
Profit on Bullion		1,200
Managing Director's Remuneration	12,000	
Miscellaneous income		2,700
Loss on sale of investments	30,000	
Deposit with other Banks	75,000	
Branch Adjustments	20,000	
Depreciation Reserve on Building		20,000
Total	1,020,000	1,020,000

You are required to prepare a Profit and Loss Account for the year ended on 31st March, 2007 and also the Balance sheet after considering the following:

(i) Provide rebate on bills discounted: Rs 5,000,000.

(ii) A scrutiny of the Current Account Ledger reveals that there are accounts overdrawn to the extent of Rs 25,000,000 and the total of the credit balances is Rs 1,22,000,000.

(iii) Claims by employees for bonus amounting to Rs 15,000,000 is pending award of arbitration.

(iv) Depreciation on building for the year amounts to Rs 5,000,000.

(v) Out of profit for the year, 20 per cent thereof were transferred to statutory reserve, and the Directors proposed a dividend of 8 per cent, subject to deduc tion of tax.

Solution

XYZ Bank Ltd

Balance Sheet as at 31st March, 1995

	Schedule No.	As on 31.3.1995 (Current Year)	As on 31.3.1994 (Previous Year)
Capital and liabilities			
Capital	1	3,00,000	
Reserves & Surplus	2	2,67,900	
Deposits	3	1,52,470	
Borrowings	4	77,230	
Other Liabilities and Provisions	5	44,000	
Total		8,41,600	
Assets			
Cash and balances with RBI	6	46,350	

	Schedule No	As on 31.3.1995 (Current Year)	As on 31.3.1994 (PreviousYear)
Balances with banks and money			
at call and short notice	7	1,01,000	
Investments	8	3,65,130	
Advances	9	2,37,500	
Fixed Assets	10	45,000	
Other Assets	11	46,620	
Total		8,41,600	
Contingent liabilities	12	71,500	
Bills for collection		43,500	

XYZ Bank Ltd.

Profit & Loss Account for the year ended 31st March, 1995

	Schedule No.	Yr. ended 31.3.07 (Current Year) Rs' 000	Yr. ended 31.3.06 (Previous Year) Rs' 000
I. Income			
Interest earned	13	1,09,000	
Other Income	14	(1,200)	
Total		1,07,800	
II. Expenditure			
Interest Expended	15	7,950	
Operating Expenses	16	44,450	
Provision and contingencies			
Total		52,400	

Schedule No	As on 31.3.2007 (Current Year) Rs' 000	As on 31.3.2007 (PreviousYear) Rs' 000
III. Profit /Loss		
Net Profit/(Loss) for the year	55,400	
Profit/(Loss) brought forward	-	
Total	55,400	
Transfer to statutory reserve	11,080	
Transfer to other reserve	-	
Proposed Dividend	24,000	
Balance carried forward to		
Balance sheet	20,320	
Total	55,400	

SCHEDULE 1 - CAPITAL

	As on 31.3. 07 (Curr.Year) Rs'000	As on 31.3.06 (Prev.Year) Rs'000
Authorised Capital		
.... shares of Rs .... each		
Issued Capital		
.... shares of Rs .... each		
Subscribed Capital		
.... shares ofRs .... each		
Cafled-up Capital		
.... shares of Rs .... each	3,00,000	-
Less: Calls unpaid	-	-
Add: Forfeited shares	-	-
	3,00,000	-

SCHEDULE 2 - RESERVES AND SURPLUS

	As on 31.3. 07 (Curr.Year) Rs'000	As on 31.3.06 (Prev.Year) Rs'000
Statutory Reserves		
Opening Balance	1,40,000	
Additions during the year	11,080	
Deductions during the year		
Total	1,51,080	
Capital Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
Security Premium		
Opening Balance	90,000	
Additions during the year		
Deductions during the year		
Total	90,000	
Revenue and other Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
Balance in Profit and Loss Account		
Total (I + II + III + IV + V)	2,41,080	

SCHEDULE 3 - DEPOSITS

	As on 31.3. 07 (Curr. Year) Rs'000	As on 31.3.06 (Prev. Year) Rs'000
I. Demand Deposits		
(i) From banks	1,22,000	
(ii) From otners		
II. Savings Bank Deposits	7,420	
III. Term Deposits		
(i) From banks	23,050	
(ii) From others		
Total (I + II + III)	1,52,470	
(i) Deposits of branches in India	1,52,470	
(ii) Deposits of branches outside India		
Total	1,52,470	

SCHEDULE 4 - BORROWINGS

	As on 31.3. 07 (Curr. Year) Rs'000	As on 31.3.06 (Prev. Year) Rs'000
Borrowings in India		
(i) Reserve Bank of India		
(ii) Other Banks	77,230	
(iii) Other Institution and agencies		
Borrowings Outside India		
Total (I + II)	77,230	
Secured borrowings included in I and II above. Rs...	77,230	

SCHEDULE 5 - OTHER LIABILITIES AND PROVISIONS

		As on 31.3. 07 (Curr.Year) Rs'000	As on 31.3.06 (Prev.Year) Rs'000
Bills Payable			
Inter -Office adjustments(net)			
Interest accrued			
Others(Including Provisiona)			
Proposed Dividend	24,000		
Provision for Rebate	5,000		
Security Deposit of Employees	15,000	44,000	
Total		44,000	

SCHEDULE 6 - CASH AND BALANCES WITH RESERVE BANK OF INDIA

	As on 31.3. 07 (Curr.Year) Rs'000	As on 31.3.06 (Prev.Year) Rs'000
Cash in hand (including foreign currency notes)	45,350	
Balances with RBI		
(i) in Current Account		
(ii) in Other Accounts		
Total (I + II)	45,350	

SCHEDULE 7 - BALANCES WITH BANKS & MONEY AT CALL & SHORT NOTICE

	As on 31.3. 07 (Curr.Year)	As on 31.3.06 (Prev.Year)
In India		
(i) Balances with banks		
(a) in Current Accounts	75,000	
(b) in Other Deposit Accounts		
(ii) Money at call and short notice		
(a) With banks	26,000	
(b) With other institutions		
Total	1,01,000	
Outside India		
(i) in Current Accounts		
(ii) in Other Deposit Accounts		
(iii) Money at call and short notice		
Total		
Grand Total (I + II)	1,01,000	

SCHEDULE 8 - INVESTMENTS

	As on 31.3. 07 (Curr.Year) Rs'000	As on 31.3.06 (Prev.Year) Rs'000
Investments in India in		
(i) Government securities	1,94,370	
(ii) Other approved securities		
(iii) Shares		
(iv) Debentures and Bonds	1,55,630	
(v) Subsidiaries and/or joint ventures		
(vi) Others (to be specified) - Gold	15,130	
Total	3,65,130	
Investments outside India in		
(i) Government securities (including local authorities)		
(ii) Subsidiaries and/or joint ventures abroad		
(iii) Other investments (to be specified)		
Total	-	
Grand Total (I + II)	3,65,130	

SCHEDULE 9 - ADVANCES

	As on 31.3. 07 (Curr. Year)	As on 31.3.06 (Prev. Year)
(i) Bills purchased and discounted	12,500	
(ii) Cash credits, overdrafts and loans repayable on demand	2,25,000	
(iii) Term loans		
Total	2,37,500	

SCHEDULE 10 - FIXED ASSETS

	As on 31.3. 07 (Curr.Year) Rs'000	As on 31.3.06 (Prev.Year) Rs'000
Premises		
At cost as on 31st March of the preceding year	65,000	
Additions during the year		
Deductions during the year		
Depreciation to date	25,000	
	40,000	
Other Axed Assets (including furniture and fixtures)		
At cost as on 31st March of the preceding year	5,000	
Additions during the year		
Deductions during the year		
Depreciation to date		
Total (I + II)	45,000	

SCHEDULE 11 - OTHER ASSETS

	As on 31.3.07 (Curr. Year)	As on 31.3.07 (Prev. Year)
I. Inter-office adjustments (net)	20,000	
II. Interest accrued on Investments	24,620	
III Tax paid in advance / tax deducted at source		
IV Stationery and stamps		
V. Non-banking assets acquired in satisfaction of claims		
VI Others (Silver)	2,000	
Total	46,620	

SCHEDULE 12 - CONTINGENT LIABILITIES

	As on 31.3.07 (Curr. Year)	As on 31.3.07 {Prev. Year)
I. Claims against the bank not acknowledged as debts.	15,000*	
II Liability for partly paid investments		
III Liability on account of outstanding forward exchange contracts		
IV Guarantees given on behalf of constitutents		
(a) In India		
(b) Outside India		
V Acceptances, endorsements and, other obligations		
VI Other items for which the bank is contingently liable	56,500	
Total	**71,500**	

*** Claim for bonus by employee subject to Arbitration Award.**

SCHEDULE 13 -INTEREST EARNED

			Year ended 31.3.07 (Curr.Year) Rs'000	Year ended 31.3. 06 (Prev.Year) Rs'000
I	Interest & discount on advances/ bills	1,14,500		
	Less, Cl.Bal.on rebate of Bills discounted	5,000	1,09,500	
II	Income on investments			
III	Interest on balances with Reserve Bank of India and other inter-bank funds			
IV	Others			
	Total		**1,09,500**	

SCHEDULE 14 - OTHER INCOME

	Year ended 31.3.07 (Curr.Year) Rs'000	Year ended 31.3. 06 (Prev.Year) Rs'000
I. Commission, exchange and brokerage	25,300	
II. Rent	600	
III. Profit on sale of investments	1,200	
Less: Loss on sale of investments	(30,000)	
IV. **Less: Loss on sale of Furniture**	(1,000)	
V. Miscellaneous Income	2,700	
Total	(1,200)	

SCHEDULE 15 - INTEREST EXPENDED

	Year ended 31.3.07 (Curr.Year) Rs'000	Year ended 31.3. 06 (Prev.Year) Rs'000
I. Interest on deposits	7,950	
II. Interest on Reserve Bank of India I inter-bank borrowings		
III. Others		
Total	**7,950**	

SCHEDULE 16 - OPERATING EXPENSES

	Year ended 31.3.07 (Curr.Year) Rs'000	Year ended 31.3. 06 (Prev.Year) Rs'000
Payments to and provisions for employees	33,200	
Depreciation on bank's property	5,000	
Directors' fees, allowances and expenses	1,200	
Auditors' fees and expenses	5,000	
Postages, telegrams, telephones, etc.	50	
Total	44,450	

EXERCISE

1. State whether the following statements are 'TRUE' or 'FALSE':

(1) Subscribed capital of a banking company should not exceed half of the authorized capital and the paid-up capital should not exceed half of the subscribed capital.

(2) 'Rebate on bills discounted' is a liability and is, therefore, shown under the heading 'Other liabilities' by banks.

(3) A banking company should transfer 25% of its profits to a statutory reserve only till such reserve together with share premium account balance equals the paid-up capital.

(4) A banking company cannot pay dividend on its shares until it writes off all capitalized expenses such an preliminary expenses, brokerage and commission on issue of shares, etc.

(5) A banking company cannot grant any loans or advances on the security of its own shares.

(6) In a bank's balance sheet gold is shown under 'Other assets' whereas silver is shown under 'Investments'.

[Ans. (1) T, (2) F (3) F, (4) T, (5) T, (6) F]

2. Indicate the correct answer:

1. Banks show the provision for income-tax under the head

(a) Contingency accounts

(b) Contingent liabilities

(c) Other liabilities and provisions

(d) Borrowings

2. The heading other assets does not include

(a) Silver

(b) Interest accrued

(c) Inter-office adjustment (Dr.)

(d) Gold

3. A non-banking asset is

(a) An item of office equipment

(b) Any asset acquired from the debtors in satisfaction of claim

(c) Money at call and short notice

(d) Furniture and fixtures

4. A non-performing asset is

(a) Money at cal1 and short notice

(b) An asset that ceases to generate income

(c) Cash balance in till

(d) Cash balance with RBI

[Ans. 1 (c), 2 (d), 3 *(b), 4 (b),]*

3. In the banking company balance sheet what are the heading for following items:

1. Unclaimed dividend
2. Endorsements
3. Rebate on bills discounted
4. Government of India bonds

5. Demand drafts
6. Building acquired in satisfaction of a claim
7. Interest accrued but not due on investments

[Ans.

1. Other liabilities
2. Contingent liabilities
3. Other liabilities
4. Investments
5. Bills payable
6. Other Assets
7. Other Assets

Questions

1. Explain the fol1owing terms:
   (a) Rebate on bills discounted;
   (b) Money at call and short notice;
   (c) Cash credit;
   (d) Documentary bills purchased.
   (e) Letter of credit;
   (f) Liability of Customers for Acceptances and Endorsements.

2. What are the functions of a General Ledger? What accounts are usually maintained in it and from what subsidiary books are they derived?

Problems

1. In the books of a bank there was an amount of Rs. 25,00,000 due from a customer as on 31 st March 2005. The loan was unsecured and the position of the customer financially was not satisfactory. Interest accrued for the year was Rs. 9,000.

The customer was declared insolvent on 5th May 2005, and the bank was able to collect a dividend of 75 paise per every rupee.

How this transaction will be dealt with under alternative accounting policies. Give the journal entries and ledger accounts.

2. On 31st March Peoples' Bank Ltd. had a balance of Rs. 9 crores in "Rebate on bills discounted" account. During the year ended 31st March, 2006 the bank discounted bills of exchange of Rs. 4,000 crores charging interest at 18% per annum, the average period of discount being 73 days. Of these bills of exchange Rs. 600 crores were due for realisation from the acceptors/ customers after 31st March 2006, the average period outstanding after 31st March, 2006 being 36.5 days.

Pass journal entries and show the ledger accounts pertaining to:

(i) Discounting of bills of exchange, and

(ii) Rebate on bills discounted.

(Rebate on bills discounted at the end of the year Rs. 10.8 *crores.*

Discount to *be taken* to *Profit and Loss Account Rs.* 142.2 *crores)*

3. From the following information prepare the Profit and Loss A/c of Sonal Bank Ltd. for the year ended 31st March 2006:

	Rs
Interest on Loan	25,90,000
Interest on Fixed Deposits	27,50,000
Rebate on Bills discounted	4,90,000
Commission	82,000
Establishment Charges	5,40,000
Discount on Bills Discounted (net)	14,60,000
Interest on Cash Credits	22,30,000
Interest on Current Account	4,20,000
Rent and Rates	1,80,000
Interest on overdraft	15,40,000
Directors' Fees	30,000
Auditors' Fees	12,000
Interest on Saving Bank Deposits	6,80,000
Postage and Telegram	14,000
Printing and Stationery	29,000
Sundry Charges	17,000

Bad debts to be written off amounted to Rs. 4,00,000. Provision for taxation may be made at 55% of net profit.

[Profit before Provision for tax Rs. 36,70,000;

Provision for tax Rs. 18,53,350; Net Profit Rs. 18,16,650]

4. From the following details, prepare the profit and loss account of Triveni Bank Ltd. for the year ended 31st March, 2007 :

	Rs
Interest paid on deposits, borrowings, etc	79,26,660
Interest and discount	183,74,725
Rentals received	78,000
Net profit on sale of investments	2,27,000
Salaries, allowances, bonus and provident fund	97,79,925
(Including remuneration of the Chairman	
and Managing Director)	
Commission, brokerage and exchange	42,00,000
Law charges	72,000
Rates and taxes	46,300
Postage and telegrams	3,26,070
Audit fees	60,000
Directors fees	36,000
Printing and stationery	2,92,000
Depreciation on Bank's property	8,20,000
Miscellaneous receipts	40,006
Miscellaneous expenditure	1,65,406
Repairs to pr'Jperty	32,400
Telephones and stamps	4,83,200
Advertisement	2,76,000

Insurance and lighting	3,45,000
Bad debts written off	72,700
Unexpired discount (1st April, 2006)	5,70,000
Provision for bad debts (1st April, 2006)	16,10,000
Provision for taxation (1st April, 2006)	24,00,000

Other Informations:

1> During the year Income Tax proceedings of the previous years were concluded and the liability on this account worked out to Rs. 22,40,000.

2> The Bank has made an evaluation at the end of the year regarding the status of its advances and finds the following:

(a) Unsecured advances to the extent of Rs. 60,000 would be fully irrecoverable.

(b) Recovery of unsecured loan is doubtfull to the extent of 40 % of Rs 40,00,000

(c) Cash credit accounts to the extent of Rs. 25,00,000 have been left without the margin due to fall in the value of securities and the accounts to the extent of 10% are likely to become bad.

3> It is the Bank's policy to provide fully against the contingency of bad debts.

4> Provision for taxation be at 55%.

5> Unexpired discount and interest on bills discounted as on 31st March, 2007 was Rs. 7,25,000.

[Ans. *Net Profit Rs.* 9,38,981 ; *Bad Debts Provision Rs. 19,82,700;Provision for Taxation Rs. 9,52,089*]

5. The following is the Trial Balance of Bindas Bank Ltd. as at 31st March *2006:*

Debits	*Rs.*	*Credits*	*Rs.*
Loans, cash credits and		Subscribed Capital:	
overdrafts	4,28,000	15,000 shares of	
		Rs. 50 each	
Bank Premises	75,000	Rs. 25 fully paid	3,75,000
Development Loan (Reserve		Reserve Fund	3,70,000
Fund Investment)	3,70,000	Savings Deposits	1,94,000
Indian Govt. Securities	2,30,000	Demand Deposits	2,50,000
Interest paid	20,000	Term Deposits	3,50,000
Salaries	32,000	Profit and Loss AI c	
General expenses	31,000	Balance as on 1.4.2005	29,000
Rent, Rates and taxes	*4,000*	Interest and discount	1.80,000
Directors fees	*3,000*	Brokerage, commission	
		and exchange	42,000
Money at call and short			
notice	1,20,000		
Income tax paid	13,000		
Bills discounted	70,000		
Interim dividend			
(Paid up to 30th Sept. *2005)*	30,000		
Shares in other companies	75,000		
Cash in hand	89,000		
Cash with RBI	1,00,000		
Balance with other banks	1,00,000		
	17,90,000		17,90,000

Prepare profit and loss account for the year ending 31st March *2006* and a Balance sheet as on that date after taking into account the following information:

1. Interest accrued on investments Rs. 10,000.
2. Rebate on bills discounted Rs. *2,000.*
3. Interim dividend was declared @ 12%.
4. Rs. 15,000 was added to the premises during the year. Depreciation at 5% on opening balance is to be provided.
5. Endorsements on behalf of the customers were Rs. 1,15,000.
6. The provision for taxation at 1.4.2005 was Rs. 12,000. Same is to be maintained at Rs. 31,000.
7. Authorised capital was 30,00,000 shares of Rs. 50 each:

[Net profit Rs. 1,05,000; Balance Sheet Total Rs. 16,64,000]

9.5. ACCOUNTS OF ELECTRIC SUPPLY COMPANIES

The Double Account System

The Double Account System is a method of presenting annual financial statements of public utility concerns (formed by Special Acts of Parliament) like tramways, railways, gas, water and electricity companies. It is a special method of presenting the Final Accounts rather than a special system of keeping accounts. Here, all accounts are also kept under the normal double entry system. The main objective of this system is to disclose how much capital has been raised and how such capital has been utilized in the acquisition of fixed assets. To achieve this, the Balance Sheet is prepared in two parts, the first being a statement of Receipts and Expenditure on Capital Account and the second, the General Balance Sheet.

Features of the Double Account System

a. The conventional Balance Sheet is divided into two parts: (a) Receipts and Expenditure on Capital Account; and (b) General Balance Sheet.

b. Financial statements are prepared in greater detail, accompanied by a number of statistical data and statements.

c. Along with share capital and debentures, premium (or discount) on issue of shares and debentures are permanently retained in the books as capital items.

d. Long-term loans and debentures are treated as part of the capital acquired and are shown in the Receipts and Expenditure on Capital Account.

e. Revenue Account is prepared in place of Profit and Loss Account. Likewise, Profit and Loss Appropriation Account is named as Net Revenue Account.

f. Interest on loans and debentures are shown as appropriations in the Net Revenue Account.

g. Cost of replacement of an asset not involving any increase in capacity is charged to Revenue Account.

h. The fixed assets are shown at original cost in the Receipts and Expenditure on Capital Account. Depreciation is not shown as a deduction from the original cost of the assets but as an accumulated fund in the General Balance Sheet (Liabilities side).

i. Preliminary expenses on formation are treated as capital expenditure and shown in the Receipts am Expenditure on Capital Account.

j. Capital Account appearing on the assets side of the General Balance Sheet represents the total expenditure to date on assets which mayor may not be in existence on the date of the Final Accounts.

k. General Reserve, Sinking Fund, Investment Fluctuation Fund, etc., are shown on the liabilities side of the General Balance Sheet.

Difference between the Single Account System and the Double Account System

1. Under the Single Account System, a single Balance Sheet is prepared to show the financial position on the last day of the accounting period in the form of a statement of assets and liabilities. But under the Double Account System, the Balance Sheet is split into two parts, (i) Receipts and Expenditure on Capital Account, and (ii) General Balance Sheet.
2. Under the Single Account System, the main purpose of preparing a Balance Sheet is to give a true and fair view of the state of affairs of the Company, whereas under the Double Account System, the main purpose of preparing two Balance Sheets is to show how the amount of capital has been received and how the same has been used for acquiring fixed assets.
3. The Single Account System, shows existing fixed assets are shown in the Balance Sheet after deduction of depreciation. The Double Account System shows fixed assets are shown in the Capital Account at original cost (some of the assets may or may not be in existence on the date of the account). However, accumulated depreciation is shown on the liabilities side of the General Balance Sheet.
4. The Single Account System shows the income statement under Profit and Loss Account but under the Double Account System, it is prepared as:
   (i) Revenue Account; and
   (ii) Net Revenue Account.
5. Under the Single Account System, interest on debentures, loans, etc., are shown in the Profit and Loss Account as a charge against profit. But under the Double Account System, these items are shown in the Net Revenue Account as an appropriation.

Advantages of the Double Account System

The main advantages of the Double Account System are as under:

(a) Financial statements are prepared in a prescribed from which ensures that the business renders most efficient service to the public at a moderate cost, and at the same time a reasonable return is earned on capital employed.

(b) The presentation of financial statements is easily understood by different claimants of capital as to how the amounts provided by them have been utilized by the business. The Receipts and Expenditure on Capital Account presents the position regarding the sources of capital as also its utilization in the form of assets and liabilities.

(c) Since the depreciation fund is compulsorily created, assets can be replaced without any strain on working capital or cash resources.

(d) Revenue Account shows clearly the periodical results of the actual operating activities of the concern and the net revenue account shows all the items which are extraneous to the actual working of the business.

(e) The prescribed form used for preparing financial statements by the different concerns rendering similar services is standardized, which helps in compiling the statistical returns in an easy manner.

Disadvantages of the Double Account System

The main disadvantages of the Double Account System are as under:

(a) The Revenue Account fails to disclose properly the trading results of the business concern since it does not include interest paid or received. Also, since renewals are charged to revenue, it may lead to a distorted picture of the profits earned, or losses incurred, of any year.

(b) As the assets are shown at their historical costs in the Receipts and Expenditure on Capital Account and their respective depreciations on the liabilities side of the General Balance Sheet, the Balance Sheet is unable to portray the financial position of the company.

(c) The Receipts and Expenditure on Capital Account does not represent the true position a s some assets are continued to be shown at cost price even after their estimated economic lives.

(d) Some preliminary expenses like cost of special acts or cost of putting for Ward new bills are not permanently capitalized.

(e) The system has some difficulty in drawing a proper distinction between capital and revenue expenditure.

(f) The expenses on repairs and renewals in different years and charging them to the Revenue Account in which they are incurred, leads to a distorted picture of the profits earned or losses incurred, since there incurs no expense in some years and heavy expenses in others.

(g) There is a possibility of overlooking the amount of provision for depreciation in case of the assets which are so much in use.

(h) Infact, concerns maintaining accounts under the Double Account System are also to prepare accounts under the Double Entry System for reasons more than one.

(i) The different statistical returns annexed to the financial statements are not easily understood by the general public.

(j) When an asset requires replacement, it is not always possible to calculate the amount to be charged to revenue.

Final Accounts under the Double Account System

The final accounts under the Double Account System normally consist of:

[a] Revenue Account

[b] Net Revenue Account

[c] Capital Account (Receipts and Expenditure on Capital Account) and

[d] General Balance Sheet

Revenue Account

This account is similar to the Profit and Loss Account of a trading or manufacturing concern. It is debited with various items of expenses and credited with various items of incomes.

Depreciation on fixed assets is charged debiting the Revenue Account and crediting the Depreciation Fund Account. Generally, expenses are shown 'tI1he following broad headings:

(I) Generation, (B) Distribution, (C) Public Lamps, (0) Rent, Rates and Taxes, (E) Management Expenses, [f] Law Charges, (G) Depreciation, (H) Special Charges.

Similarly, incomes are grouped as: (1) Sale of energy for lighting, (2) Sale of energy for power, (3) Sale of energy under special contracts, (4) Public lightings, (5) Rental of meters, (6) Rent receivable, and (7) Transfer fees etc.

Statutory form of Revenue Account under Indian Electricity Act, 1910 is given below:

Revenue Account for the year ended... ...

Particulars	Rs	Particulars	Rs
A. Generation			
		By Sale of energy for lighting	
To Fuel		By Sale of energy for power	
To Oil wastage, water		By Sale of energy under special contracts	
To Salary of engineers		By Public lighting	
To Wages and gratuities		By Rental of meters	
		By Rent receivables	
B. Distribution		By Transfer fees	
To Salary of engineer		By Other items	
To Wages and gratuities		By Miscellaneous receipts	
To Repair and maintenance		By Sale as ashes	
		By Reconnection and disconnection fees	
C. Public Lamps			
To Attendance and repairs			
To Renewals			
D. Rent, rates and taxes			
To Rents payable			
To Rates and taxes			
E. Management Expenses			
To Director's remuneration			
To Management			
To General establishment			
To Auditor of the company			
F. Law Charges			
To Law charges			
G. Depreciation			
To Lease			
To Buildings			
To Plant			
To Mains			
To Meters, etc.			
H. Special Charges			
To Bad Debts			
To Balance carried to Net Revenue Account			

Net Revenue Account

This is similar to the Profit and Loss Appropriation Account of a trading or manufacturing concern except the treatment of interest on debentures and loans. In the Net Revenue Account, it is treated as appropriation of profits. However, in ordinary cases, such interest is treated as a charge against profits and shown in the Profit and Loss Account. The balance of the Net Revenue Account is shown in the General Balance Sheet.

The Statutory form of Net Revenue Account under the Indian Electricity Act, 1910 is given below:

Net Revenue Account for the year ended ... ...

Particulars	Rs	Particulars	Rs
To Balance from last year's Account To Interest on loans To Contingency reserve To Interest on debentures To Dividends To Balance carried to General Balance Sheet		By Balance from last year's Account By Balance brought from Revenue Account By Interest on Bank Account By Balance carried to General Balance Sheet	

Capital Account (Receipts and Expenditure on Capital Account)

The main purpose of this account is to show total amount of capital raised and its application for acquisition of fixed assets for carrying on the business.

As per the statutory forms (prescribed by the Indian Electricity Act, 1910) there are three columns on each side: (i) one showing balance at the end of the previous year; (ii) disclosing the amount received / spent during the year; and (iii) balance at the end of the year.

Important Points:

(i) Preliminary expenses on formation are treated as capital expenditure.

(ii) Premium received on issue of shares and debentures are shown on the Receipts side.

(iii) Discount on issue of shares or debentures are not shown separately. It is deducted from the proceeds of shares or debentures. Only net proceeds are shown in the Capital Account

(iv) Total expenditure is shown in the assets side of the General Balance Sheet and Total Receipts is shown in the liabilities side of the General Balance Sheet.

Statutory from of Capital Account under The Indian Electricity Act, is given below:

Receipts and Expenditure on Capital Account for the year ended ...

Expenditure	Expen. up to end of previous year Rs	Expen. during the year year Rs	Total. Exp Rs	Receipts	Receipts up to end of previous year Rs	Receipts during the year year Rs	Total Receipts Rs
To Preliminary Expenses							
To Land							
To Building							
To Plant							
To Mains							
To Transformers, motors, etc.							
To Meters							
To General stores							
To Special items							
Total Expenditure							
To Balance of Capital Account carried to General Balance Sheet							
By Ordinary shares							
By Preference shares							
By Debentures							
By Loans							
By Calls-in-advance							
By Other receipts							
By Balance of Capital Account carried to General Balance sheet							

General Balance Sheet

In the General Balance Sheet, all the remaining assets and liabilities, like current assets, current liabilities, reserves, etc., are shown along with the total of receipts (on the liability side) and the total expenditure (on the asset side). The Statutory forms of General Balance Sheet under Indian Electricity Act, 1910 is given below:

General Balance Sheet as on ... ...

Liabilities	Rs	Assets	Rs
Capital Account Sundry Creditors for Capital Expenditure Sundry Creditors on open Account Net Revenue Account Reserve Fund Depreciation Fund Special Items		Capital Account Stores in hand Sundry Debtors Preliminary expenses By Securities Special items Cash at bank Cash in hand	

Illustration

From the following particulars, draw up: (a) Balance Sheet as on 31st March 2006 on the Single Account System; and (b) The Capital Account and General Balance Sheet as at the same date on the Double Account System :

(i) Authorized Capital: 20,000 share of Rs. 10 each

(ii) Issued Capital: 10,000 shares of Rs 10 each fully paid (including 1,200 shares is sued during the year).

(iii) 12% Debentures Rs 50,000; Trade Creditors Rs 12,500; Trade Debtors Rs 20,500; Reserve Fund Rs 25,000; Cash at Bank Rs 7,500; Stock-in-trade Rs 22,000; Cash in hand Rs 125.

(iv) Reserve Fund Investment at cost Rs 25,000 (market value: Rs 27,500).

(v) Fixed assets - expenditure on 1st April 2005: Machinery Rs 50,000; Building Rs 72,500; Land Rs 15,000; Additions during the year: Machinery Rs 17,500.

(vi) Depreciation Fund: Machinery Rs 22,500 and Building Rs 10,000;

(vii) Profit and Loss Account Rs 10,125.

Solution

In the Books of …..

Balance Sheet as on 31st March 2006

Liabilities	Rs	Assets		Rs
Share Capital		Fixed Assets		
Authorised Capital:	2,00,000	Land		15,000
20,000 Equity Shares of Rs 10 each		Building	72,500	
Issued and Subscribed:		Less Accumulated Depreciation	10,000	62,500
10,000 Equity Sh. of Rs 10 each fully paid-up	100,000	Machinery	50,000	
Reserve and Surplus		Addition	17,500	
Reserve Fund	25,000		67,500	
Profit and Loss Account	10,125	Less Accumulated Depreciation	22,500	45,000
Secured Loans		Investments Reserve fund Investments;		
12% Debentures	50,000	(M.V. Rs 27,000)		25,000
Unsecured Loans	Nil	Current Assets, Loans and Advances		
Current Liabilities and Provisions		Stock in Trade		22,000
Trade Creditors	12,500	Trade Debtors		20,500
		Cash at Bank		7,500
		Cash in hand		125
		Miscellaneous Expenditure		Nil
	197,625			197,625

Receipts and Expenditure on Capita1 Account

for the year ended 31st March 2006

Expenditure	Expenditure up to 1.4.2005 Rs	Expenditure during the year Rs	Total Experiditure Rs	Receipts	Receipts up to 1.4.2005 Rs	Receipts during the year Rs	Total receipts Rs
To Land	15,000	-	15,000	By Equity Shares	88,000	12,000	100,000
To Building	72,500	-	72,500	By 12% Debentures	50,000	-	50,000
To Machinery	50,000	17,500	67,500	Total Receipts	138,000	12,000	150,000
				By Balance on Capital *A/c*			5,000
Total Expenditure	137,500	17,500	155,000				155,000

General Balance Sheet as on 31st March 2006

Liabilities	Rs	Assets	Rs
Capital Account		Capital Account	
Amount received	150,000	Amount expended on works	155,000
Sundry creditors (Trade)	12,500	Stock-in-Trade	22,000
Net Revenue Account: Balance	10,125	Sundry Debtors (Trade)	20,500
Reserve Fund Account: Balance	25,000		25,000
Depreciation Fund Account		Cash at bank	7,500
- For Machinery	22,500	Cash in hand	125
- For Building	10,000		
	230,125		230,125

Illustration

From the following balances as on 31 st March, 2006 prepare the Revenue Account, Net Revenue Account, Capital Account and General Balance Sheet of a Power Co.:

Particulars	Rs/Lakh	Particulars	Rs/Lakh
Balance as on 1st April 2005 :		Expenses of Management	14,400
land	1,80,000	Cost of Distribution	6,000
Machinery	7,20,000	Depreciation	24,000
Mains	2,40,000	Sale of current	1,56,000
Expenditure during the year:		Meter rent	6,000
land	6,000	Interest on Debentures	12,000
Machinery	6,000	Interim Dividend	24,000
Mains	61,200	Net Revenue Account as on 1.4.2005	34,200
Share capital - ordinary shares	6,58,800	Depreciation Fund	3,00,000
Debenturs	2,40,000	Sundry Debtors -	
Sundry Creditors	1,200	for energy supplied	48,000
Cost of generation	42,000	others	600
Rent rates and taxes	6,000	Cash balance	6,000

Solution

In the Books Power Co.

Revenue Account

For the year ended 31st March, 2006

Particulars	Rs/Lakh	Particulars	Rs/Lakh
To Cost of Generation	42,000	By Sale of current	1,56,000
To Cost of Distribution	6,000	By Meter rent	6,000
To Rent, rates and taxes	6,000		
To Management Expenses	14,400		
To Depreciation	24,000		
To Net Revenue Account (Transferred)	69,600		
	1,62,000		1,62,000

Net Revenue Account

For the year ended 31st March, 2006

Particulars	Rs/Lakh	Particulars	Rs/Lakh
To Interest on Debentures	12,000	By Balance b/d	34,200
To Interim Dividend	*24,000*	By Revenue A/c	69,600
To Balance *c/d*	67,800		
	1,03,800		1,03,800

Receipts and Expenditure on Capital Account

For the year ended 31st March, 2006

Expenditure	Expenditure up to 1.4.2005 Rs/Lakh	Expenditure during the year Rs/Lakh	Total Experiditure Rs/Lakh	Receipts	Receipts up to 1.4.2005 Rs/Lakh	Receipts during the year Rs/Lakh	Total receipts Rs/Lakh
To Land	180,000	6,000	186,000	By Equity Shares	658,800	-	658,800
To Mains	240,000	61,200	301,200	By Debentures	240,000	-	240,000
To Machinery	720,000	6,000	726,000	Total Receipts	898,800	-	898,800
				By Balance on Capital *A/c*	*241,200*	-	314,400
Total Expenditure	1,140,000	73,200	1,213,200		1,140,000		1,213,200

General Balance Sheet as on 31st March, 2006

Liabilities	Rs/Lakh	Assets		Rs/Lakh
Capital Account		Capital Account		
Amount received	898,800	Amount expended on works		1,213,200
Sundry creditors	1,200	Sundry Debtors		
Net Revenue Account: Balance	67,800	For Current supplied	48,000	
		Others	600	48,600
Depreciation Fund Account	300,000	Cash Balance		6,000
	1,267,800			1,267,800

Treatment of Replacement of an Asset

Under the Single Account System when an asset is replaced, the Cash Account is debited and the Asset Account is credited, and the difference is transferred to the Profit and Loss Account (being profit or loss on sale of asset), The Asset Account is reduced by its written down value. Similarly, when an asset is purchased, the Asset Account is debited and the Cash or Bank Account is credited and the Asset Account is increased by that amount.

However, under the Double Account System when an asset is replaced, the original cost of the asset is not disturbed, instead it continues to appear in the Capital Account at the old figure.

Under this system, the cost of replacement is treated in the books of accounts as under:

(i) When no Extension or Improvement is involved

In this case, the entire amount of cost of replacement is treated as revenue expenditure and is debited to Revenue Account.

(ii) When Extension or Improvement is involved

In this case, an amount equal to the present cost of replacement of the old asset is treated as revenue expenditure and is charged to the Revenue Account. However, this chargeable amount is reduced by

(a) sale proceeds of scrap of the old asset, and

(b) value of materials of old asset used in rebuilding the new asset.

The total cost of replacement plus the value of materials of old asset used in rebuilding the new asset ***minus*** the present cost of replacement of the old asset to be Capitalised. Accounting Entries are:

1> Cash Expenses

New Asset A/C	Dr	Amount to be capitalized Less value of Old material
Replacement A/C	Dr	Balancing Figures
To Bank		Actual Expenses

2> Use of old material

New Asset A/C Dr

To Bank

3> Sale of old material

Bank A/C Dr

To Replacement A/C

4> Closing of Replacement A/C

Revenue A/C Dr

To Replacement /C

Illustration

The BESC Limited decided to replace one of its old plants by an improved plant. This plant was built in 1946 for Rs 67,50,000. To 'build a new plant of the same size and capacity it would now cost Rs 1,00,00,000. The cost of the new plant with larger capacity was Rs 2,12,50,000 and in addition, materials of the old plant valued at Rs 6,87,500 were used in the construction of the new plant. The balance of the old plant was sold for Rs 3,75,000.

You are required to calculate the amount to be charged to Revenue Account and the amount to be capitalized. Also show the Plant Account and the Replacement Account.

Solution

Amount chargeable to Revenue Account		Rs
Estimated current cost of replacing old plant		10,000,000
Less: Sale proceeds of old plant	375,000	
Value of materials used in new plant	687,500	1,062,500
		8,937,500

Amount to be Capitalized		Rs
Cost of building new plant (cash)	21,250,000	
Add: Value of materials uSE:d from old plant	687,500	21,937,500
Less: Estimated current cost of replacing old plant		10,000,000
		11,937,500

Dr. Plant Account Cr.

Particulars	Rs	Particulars	Rs
To Balance *bid*	67,50,000	By Balance *c/d*	1,86,87,500
To Bank A/c (Rs 1,19,37,500 – Rs 6,87,500)	1,12,50,000		
To Replacement *A/c*	6,87,500		
	1,86,87,500		1,86,87,500

Dr. Replacement Account Cr.

Particulars	Rs	Particulars	Rs
To Bank *A/c* (current cost of replacement)	1,00,00,000	By Bank *A/c* (sale proceeds)	3,75,000
		By Plant *A/c* (materials used)	6,87,500
		By Revenue *A/c* (transfer)	89,37,500
	1,00,00,000		1,00,00,000

Illustration

Ratnakar Electricity Supply Company Ltd. (which adopts the Double Account Systems) rebuilt and re-equipped a power station and the connecting lines during the year 1994. For this purpose they purchased materials worth Rs 10,85,000 and used stores worth Rs 4,90,000 from their existing stocks. The cost of labour came to Rs 5,22,000. The estimated supervision overheads attributed to this project were Rs 13,000. The station was erected in 1977 at a cost of Rs 5,00,000 and the index of costs in this line stood in 1994 @ 385, taking 1977 as the base year. Discarded materials from the old station fetched Rs 12,000.

Calculate the amount to be capitalized and the amount to be charged on Revenue Account.

Solution

Amount to be Capitalized		
	Rs	Rs
Cost of building new plant:		
- Material purchased	10,85,000	
:- Materials taken from existing stock	4,90,000	
- Labour	5,22,000	
- Overhead	13,000	21,10,000
Less: Estimated current cost of replacing old		19,25,000
(Rs *5,00,000/100* x 385)		
Total		1,85,000

Amount chargeable to Revenue Account	Rs
Estimated current cost of replacing old plant	
(Rs *5,00,000/100* x 385)	19,25,000
Less: Sale of scrap	12,000
Total	19,13,000
Note: Index of base year is always taken as 100.	

Final Accounts Under the Electricity Supply Act, 1948I

At present in India the electricity supply companies have to prepare their Final Accounts as per the provision of Electricity Supply Act, 1948 and it should be presented in accordance with the forms prescribed in the Anrexure IV and V of the Indian Electricity Rules, 1956 (framed under the Electricity Supply Act, 1948). *Earlier fonm prescribed by the Indian Electricity Act, 1910 under the Double Account System is obsolete now*.

Annexure IV of the Indian Electricity Rules, 1956 deals with (a) *Technical* particulars and (b) *Financial* particulars respectively. But Annexure V deals with the forms of accounts.

New Forms under Electricity Supply Rules, 1956:

No. I Statement of Share and Loan Capital

No. II Statement of Capital Expenditure.

No. III Statement of Operating Revenue

No. IV Statement of Operating Expenses

No. XI Statement of Net Revenue and Appropriation Account No. XII General Balance Sheet

As per the new rules, in addition to the above statements certain other statements are also to be inc1uded in the published account. These statements are:

No. V Statement of Provision for Depreciation

No. VI Statement of Contingency Reserve

No. VII Statement of Development Reserve Account

No. VIII Statement of Tariffs and Dividends Control Reserve Account

No. IX Statement of Consumers' Rebate Reserve Account

No. X Statement of Special Appropriations permitted by State Government.

IMPORTANT PROVISIONS FOR PREPARATION OF FINAL ACCOUNTS

Some important provisions under the Act are:

1> Depreciation of Fixed Assets:

There are two methods of depreciation under this Act. Viz.

a> Compound Interest Method: In this method an amount should be set aside per annum throughout the prescribed life of the respective asset with a rate of 4 % p.a so that the said set aside amount would be equal to 90 % of the original cost of the assets.

b> Straight Line Method: In this method,the depreciation is calculated by dividing the 90 % of the original cost of the asset by the period as prescribed un respect if individual asset.

It is important to note that no depreciation is allowed in respect of an asset whose W.D.V become 10 % or less of its original cost.

2> Contingencies Reserve

Every electricity supply company is required to maintain a Contingencies Reserve. A sum equal to not less than 1/4% or not more than 1/2% of the original cost of fixed assets must be transferred from the Revenue Account to the Contingencies Reserve. The maximum amount in this account must not exceed 5% of the original cost of the fixed assets. The amount of Contingencies Reserve must be invested in trust securities.

With the prior approval of the State Government, the Contingencies Reserve can be utilised for the following purposes:

a. For meeting expenses or loss of profit due to accident, strikes or circumstances beyond the control of the management;

b. For meeting expenses on replacement or removal of plant or works other than expenses required for normal maintenance or renewals;

c. For paying compensation under any law for the time being in force and for which no other provision has been made.

3> Development Reserve

An amount equal to income tax saved on account of Development Rebate allowed under Income Tax Act, 1961 has to be transferred to the Development Reserve Account.

If, in any accounting year, the clear profit without considering special appropriations *plus* balance in the credit of Tariffs and Dividend Control Reserve is less than the required amount of Development Reserve, the shortfall may not be made good. In case of sale of the undertaking, this reserve should be handed over to the buyer.

4> General Reserve

Section 67 of the Act provides for the creation of the General Reserve by making appropriation from the Revenue Account after charging interest and depreciation. The amount of contribution shall be calculated @ 1/2% of the original cost of the fixed assets until the total of such reserve comes to 8% of the original cost of the fixed assets.

5> Tariffs and Dividend Control Reserve

It is created out of the disposable surplus of the electricity company. This reserve can be utilised whenever the clear profit is less than the reasonable return. At the time of sale of the undertaking, this reserve should be handed over to the buyer.

6> Appropriation of Profits

The Act provides that an electricity company can not charge any rates as they like. They are entitled to charge such rates which give them a reasonable return. They must so adjust the rate that the amount of clear profit in any year does not exceed the reasonable return by more than 20%.

Calculation of Clear Profit

The Clear profit is the difference between the total income and total expenditure *plus* specific appropriations. The Clear profit is calculated as follows:

(A) Income from

(i) Gross receipts from sale of energy, less discount

(ii) Rental of meters and other apparatus hired to customers

(iii) Sale and repair of lamps and apparatus

(iv) Rent, less outgoings not otherwise provided for

(v) Transfer fees

(vi) Interest on investments, fixed and calls deposits and bank balances

(vii) Other taxable general receipts

Total Income

(B) Expenditure

(i) Cost of generation and purchase of energy

(ii) Cost of distribution and sale of energy

(iii) Rent, rates and taxes (other than taxes on income and profits)

(iv) Interest on loan advanced by the Board

(v) Interest on loan taken from organisations or institutions approved by the State Gover ment

(vi) Interest on debentures issued by the licencee

(vii) Interest on security deposits

(viii) Legal charges

(ix) Bad debts

(x) Auditor's fees

(xi) Management expenses

(xii) Depreciation (as per Schedule Seventh)

(xiii) Other admissible expenses

(xiv) Contribution to Provident Fund; gratuity, staff pension and apprentice and other training schemes

(xv) Bonus paid to the employees of the Undertaking. In case of dispute, in accordance with the decision of the tribunal. In any other case, with the approval of the State Government.

Total Expenditure

Balance (A - B) C/F

Balance B/F

Less: Specific Appropriations:

(i) Past losses (i.e., excess of expenditure over income)

(ii) All taxes on income and profits

(iii) Amount written-off in respect of fictitious and intangible assets

(iv) Contribution to Contingency Reserve

(v) Contribution towards arrears depreciation (if any)

(vi) Contribution to Development Reserve

(vii) Other appropriation (special) permitted by the State Government

Clear Profit

Reasonable Return

It means the sum of the following items:

(i) An amount calculated at (bank rate + 2%) on Capital Base as defined below.

(ii) Income from investments (except income from Contingency Reserve Investment).

(iii) An amount equal to 1/2% on loans advanced by the State Electricity Board.

(iv) An amount equal to 1/2% on the amounts borrowed from organisations or institutions approved by the State Government.

(v) An amount equal to 1/2% on the amount raised through issue of debentures.

(vi) An amount equal to 1/2% on the balance of Development Reserve.

(vii) Any other amount as may be pennitted by the Central Government.

Capital Base

Capital Base means:

(i) Original cost of fixed assets available for useLess: Contribution, if any, made by the customers for construction of service lines

(ii) the cost of intangible assets

(iii) the amount of investments made compulsorily on account of contingencies reserve

(iv) the original cost of work-in-progress

(v) working capital which is equal to the sum of:

  (a) 1/12 of the sum of stores, materials and supplies including fuel on hand at the end of each month of the accounting year

  (b) 1/12 of the sum of cash and bank balance and call and short term deposit at the end of each month of accounting year but does not exceed in aggregate an amount equal to 1/4 of the expenditure .

Deduct

(i) Accumulated depreciation on tangible assets and amounts written-off intangible assets.

(ii) Loan advanced by Electricity Board. .

(iii) Security deposits of customers held in cash.

(iv) Debentures issued by the undertaking.

(v) Amount standing to the credit of Tariffs and Dividend Control Reserve.

(vi) Loan taken from organisations or institutions approved by the State Government.

(vii) Balance of Development Reserve.

(viii) Amount carried forward for distribution to consumers

Illustration 16

From the following information and details relating to the year ended 31 st March, 2005 and bearing in mind the provisions of the Electricity (Supply) Act, 1948, indicate the disposal of profits of Electricity Company:

Particulars	Rs	Particulars	Rs
Net profit before charging debenture interest	35,00,100	Security deposits of Customers	4,64,000
Fixed Assets	4,20,00,000	Customers Contribution to Main lines	3,20,000
Depreciation written-off on fixed assets	98,00,000	Preliminary expenses	1,40,000
Loan from Electricity Board	1,20,00,000	Average of current assets excluding customers'	
6% Investments of the Reserve fund (F.v. Rs 90,00,000)	90,00,000	balances of Rs 6,20,000	23,70,000
6% Investments of the Contingencies Reserve	76,00,000	Development Reserve	4,40,000
Tariffs and Dividends Control Reserve	8,40,000	10% Debenture interest paid in the year	7,50,000

The Reserve Bank of India rate of the relevant date was 8%.

Solution

Calculation of Capital Base

Particulars	Rs	Rs
(i) Original cost of fIxed assets	4,20,00,000	
Less: Amount contributed by the customers' for main lines	3,20 000	4,16,80,000
(ii) Preliminary expenses		1,40,000
(iii) Investment against contingency reserve		76,00,000
(iv) Average of current assets (excluding customers' balance Rs 6,20,000)		23,70,000
		5,17,90,000
Deduct		
(i) Depreciation written-off on Fixed assets	98,00,000	
(ii) Loan from SEB	1,20,00,000	
(iii) 10% Debentures (Note 1)	75,00,000	
(iv) Security deposits of customers	4,84,000	
(v) Balance of Tariff and Dividend Control Reserve	8,40,000	
(vi) Balance of Development Reserve	4,40,000	3,10,64,000
Total		2,07,26,000

Reasonable Return

	Rs
(i) Yield at standard rate, i.e., 8% + 2% on capital base	20,72,600
(ii) Income from Reserve Fund Investments	
(6% of Rs 90,00,000)	5,40,000
(iii) 1/2% on Loans from SEB	60,000
(iv) 1/2% on Debentures	37,500
(v) 1/2% on Development Reserve	2,200
	27,12,300
Final Distribution	
(i) Refunded to customers	12,600
(ii) Transferred to Tariff and Dividend Control Reserve	12,600
(iii) At the disposal of the Co. (Rs 27,12,300 + 12,600)	27,24,900
	27,50,100

Disposal of Surplus

	Rs
Profit before debenture interest	35,00,100
Less: Debenture interest	7,50,000
	27,50,100
Less: Reasonable return	27,12,300
Surplus	37 800
Allocation of Surplus	
(i) 1/3 (being less than 5% of Reasonable return at the disposal of the company)	12,600
(ii) Of the bal., 1/2 to Tariff and Dividend Control Reserve	12,600
(iii) 1/2 to be credited to Customers Rebate Reserve	12,600
	37,800

Working: (I) Face value of Debentures Rs 7,50,000/10 x 100 = Rs 75,00,000.

EXERCISE

1. Indicate whether the following statements are 'True' or 'False' :

   1. The capital account shows the sources of capital and the manner in which it is utilised.
   2. Depreciation under double account system is not credited to the assets, but is shown as an accumulated fund in the general balance sheet.
   3. Contingency reserve is to be invested in Trust Securities.
   4. The accounts of the electricity companies must be prepared in accordance with the requirements of Schedule VI to the Companies Act, 1956.
   5. Under double account system depreciation is credited to the asset account concerned.

   [Ans. (1) T (2) T (3) T (4) F (5) F.]

2. How would you deal with the following things under the Double Account System:

   (a) Depreciation on fixed assets;

   (b) Repairs and renewals; and

   (c) Expenditure on the construction of new works in place of old works?

3. The phrase "Double Account" must not be confused with the phrase "Double Entry". Double Entry is applied to the Double Account System in the same way as to the Single Account System. Elucidate the above statement and mention the distinctive features of the Double Account System.

4. Explain the following terms/expressions found in the Accounts of Electricity Companies in India:

   (a) Clear profit;

(b) Tariff and Dividend Control Reserve;

(c) Contingency Reserve; and,

(d) Development Reserve.

5. Describe the distinguishing characteristics of the Final Accounts of Electricity Companies under Electricity (Supply) Act, 1948.

6. The following balance appeared in the books of Mauna Power Ltd. as on 31 st March, 2005

Particulars	Dr. (Rs)	Cr. (Rs)
Equity shares		3,00,000
Debentures		1,00,000
Land on 31 st March 2004	75,000	
Land purchased during the year	30,000	
Mains incl. cost of laying to 31.03.2004	80,000	
Mains expended during the year	38,000	
Machinery on 31.03.2004	2,75,000	
Machinery purchased during the year	33,000	
Sundry creditors		500
Depreciation Fund Account		1,25,000
Sundry debtors for current supplied	20,000	
Other Book debts	250	
Stores on hand	3,000	
Cash in hand	2,000	
Cost of generation of electricity	15,000	
Cost of distribution	4,500	
Sale of current		75,000
Meter rent		2,500
Rent, rates and taxes	6,000	
Establishment expenses	10,500	
Interest on Debentures	5,000	
Interim Dividend	10,000	
Depreciation	10,000	
Net Revenue Account bal. on 31.03.2004		14,250
	6,17,250	6,17,250

From the above balances prepare (i) Capital Account, (ii) Revenue Account, (iii) Net Revenue Account, and (iv) General Balance Sheet.

(Balance of Revenue Account Rs 31,500;Balance of Net Revenue Account Rs 30,750; Balance on Capital Account Rs 1,31,000; Total of General Balance sheet Rs 5,56,250)

7. The Bombay Corporation decides to replace Transformer with a modern one with a large capacity. The cost of installation in 1990 was Rs. 24lakhs, the components of materials, labour and overheads being in the ratio of 5 : 3 : 2. It is ascertained that the costs of materials and labour have gone up by 40% and 80%, respectively. The proportion of overheads to total cost is expected to remain the same as before.

The cost of the new mains as per improved design is Rs. 60 lakhs and in addition material recovered from the old mains of a value of Rs. 2,40,000 has been used in the construction of the new mains. The old main was scrapped and sold for Rs. 7,50,000.

You are asked to make the allocation between capital and revenue and pass necessary entries under double account system.

[Capital Rs. 25,20,000: *Revenue (Net) Rs. 27,30,000]*

8. The following balances were extracted from the books of an Electric Supply company. as on March 31, 2005. Prepare revenue, net revenue and appropriation accounts and balance sheet in the form prescribed under the Electricity Act.

	Rs.		Rs.
Power purchased	2,83,397	Bills payable	896
Distribution expenses	46,658	Sundry creditors (consumers)	2,636
Rates and taxes	15	Sundry creditors (others)	119
General establishment charges	30,407	Consumers' security deposit	1,87,566
Management expenses	17,730	Depreciation reserve balance	1,28,785
Sale of electricity	4,19,434	Contingency reserve balance	
Meter rent, reconnection fee, etc.	27,546	on 1st January	6,902
Depreciation	18,758	Services advance	7,957
Income-tax	18,244	Unpaid wages	18
Repairs and maintenance		- Income-tax reserve	18,244
of building	526	Interest payable	11,905
Contribution towards		Stores in hand	48,852
contingency reserve	3,143	Sundry debtors for supply of	
Interest paid and accrued	6,089	electricity	39,219
Plant and machinery	4,59,968	Advances to staff	10,045
Public lighting	81,665	Cash at bank	7,334
General equipment	15,367	Cash in hand	1,492
Capital paid-up	3,55,000		

(Revenue Rs. 43,400; Net Revenue Rs. 43,400; Total of general balance sheet Rs. 7,63,942; Difference in T.B. Rs. 15,615)

STUDY NOTE - 10

ACCOUNTING AND INTERPRETATION OF FINANCIAL STATEMENTS

This Study Note includes

- Ratio Analysis

RATIO ANALYSIS

1. What is Ratio?

In mathematics ratio is defined as a medium of explaining the interrelation between two numerals or variables. Ratio is computed by dividing one numeral by the other. By means of ratio generally the times by which one numeral is greater than the other or the proportion of one in relaticn to the other is expressed. If of the total population of 2,000 of a village 1,200 are male and 800 are teniale the ratio of male and female population in the village can be expressed as 1.200: 800 or 12 : 8 or 1.5: 1. This ratio signifies that the male population is one and half times more than the female population of the village. Ratios are often meaningfully used in solving different mathematical problems. In this context it is relevant to note that through ratio only the arithmetical or quantitative relation can be judged.

2. What is Accounting Ratio?

The arithmetical method of ascertaining the interrelation between any two numeric data expressed in accounting statements is known as Accounting Ratio. The definition implies that in uase of an accouruing ratio both the components in the form of numerals or variables used in compuung a ratio are taken from tb financial statements prepared in financial accounting. For examle it can be stated that if in a concern the Sales of a particular year is Rs. 2.00.000 and the Net Profit is Rs. 40,000 Sales Ratio becomes 1:5 or $^{1/5}$ indicates that the Net Prtit of the concern for that year is one-fifth portion of its Sales or for Sales of Rs. 5 Net Profit is Rs. 1. In this case Sales and Net Profit both these variable are taken out of the *Profit* and Loss Account prepared in financial accounting. For this reason this ratio is stated as Accounting Ratio.In the opinion of J. Batty, accounting ratio "is used to describe significant relationships which exist between figures shown on a Balance Sheet, in a Profit and Loss Account in a Budgetary Control System or in any other part of the accounting organization".

3. Meaning of Analysis Through Accounting Ratios

Different statements prepared in financial accounting are known as financial statements. For ascertaining the utility and significance of various financial information expressed in these statements and in some cases for increasing their effectiveness an in-depth analysis of such financial statements is required. In execution of managerial functions like planning, decision making, controlling, etc. management needs a steady supply of only that financial information which is duly processed and analysed. As a supplier of such information the financial analysts or the management accountants make a solicitous and in-depth analysis of financial data expressed in financial statements. In making analysis of *finan*al statements the financial analysts use two specific tools. They are: (i) preparation of Fund Flow and Cash Flow Statements and (ii) ratio analysis.

Accounting Ratio analysis stands for computation of various ratios on the basis of different information expressed in financial statements and establishment of inter. relationship between the components of each ratio. Such analysis through ratios is a much effective device having a very wide use since a long past. It is a very popular means of communicating processed information in a nut and shell form to the management as per its requirement.

The ratios computed in the process of analysis through ratios may be expressed in four types. They are Ss follows:

(a) In multiples: In this case a quotient is obtained by dividing one figure by the other. It is known as 'times'. Here one figure is expressed in terms of 'times' of '.he other. Stock Turnover Ratio is an example of ratio expressed in terms of 'tinies. If Stock Turnover Ratio is 3 times? Indicates that the Net Sale or Cost of Goods Sold is 3 times of Average Stock or Inventory.

(b) In time element: In this case the relationship between numerical figures is expressed in time element measured either in terms of months or in terms of days. If Debtors Turnover Ratio is expressed as 2 months it indicates that a credit period of two months is received from the debtors.

(c) In proportion: Ratios can also be expressed in the form of proportion between the two figures. Current Ratio expressed in the form of 2: 1 implies that for every current liability of Re. I current asset is Rs. 2.

(d) In percentage: Here one figure is expressed as a percentage of the other by dividing the former by the latter and then multiplying the quotient by 100. For example, Net Profit is often expressed as a percentage of Sales. If this ratio is 10% it means that for Sales of Ra. 100 Net Profit is Rs. 10.

The financial analyst fixes up various means of expressing ratios on the bas:s of requirement and purpose of the desired information. It is to be stated here that ratio analysis only sets up arithmetical relationship between the variables used and makes them more meaningful. The main significance of such analysis is that, where one the components used in a ratio does not carry any definite meaning its relationship with the other component may add a new meaning to both of them. For this reason ratio analysts technique is considered as devIce to check up the financial health of an organisauon and to diagnose its financial disease, if any.

4. Steps in Ratio Analysis

The following steps are followed in analysis through accounting ratios:

(i) Collection of information: In the first step of ratio analysis raw data is collected from the financial statements for computing different ratios.

(ii) Computation of ratios: In the second step necessary ratios are computed between the figures having cause and effect interrelutionship. Such ratios may be expressed in terms of times, multiples, proportion or percentage depending on the specific requirement.

(iii) Making comparison: The ratios computed are compared with the ratios of the past year or years of the same concern or with the standard ratios of the industry to which the concern belongs.

(iv) Arriving at decisions on comments: In the next step the significance of these ratios must be conceived on the basis of comparative interrelationship among them in such a manner so that adequate comments can be made for helping the users of accounting information to arrive at their decisions.

(v) Preparing report: In the final step necessary reports are to be prepared for communicating analysed information and the relevant comments to the management.

5. Importance or Utility or Advantages of Ratio Analysis : Ratio analysis attempts to establish the significance of one numerical figure on the basis of its relationship with another numerical figure. No doubt, in the present day financial analysis ratio analysis is a very important tool. A rough sketch of the financial health, profitability, capital structure, solvency, weaknesses, etc. of an organisation can be drawn through such analysis. Whether an organisation is financially sound or not, how much shock absorbing capacity it has, whether its prospect is good or bleak that can be adjudged with the help of ratio analysis.

Sometimes the tool of' ratio analysis is compared with the blood pressure, pulse or temperature of a human being. As a medical expert diagnose the disease and comes to a conclusion as to the health of an individual with the help of such symptoms, similarly a financial analyst makes a critical assessment of an organisation's financial health with the help of different ratios. He also suggests for the measures needed to overcome the weakness, if any detected through such analysis. The importance and utility of ratio analysis as a tool of financial management may be discussed under the following heads:

(i) Expression in a simplified and condensed form: The detailed information expressed in financial statements can be presented through ratio analysis in a simple, easily understandabh~ and brief form. Such simple presentation helps even the non-accounting persons to understand various information easily and quickly.

(ii) Analysis of financial position: The financial position of an organisation can be judged through ratio analysis. What is the financial position of the concern and what are the reasons responsible for that can be analysed with the help of ratios. The financial analyst does not only identifies the weak points of the financial position, he also gives advice on the remedial measures.

(iii) Measurement of overall efficiency: Ratio analysis is often used as an index of measuring efficiency. Ratios can be used not only for measuring individual and departmental efficiency: efficiency in managerial performance can also be determined through ratios. For this reason the system of ratio analysis is often used as a controlling instrument in the hands of management.

(iv) Inter-firm and inter-department comparison: With the help of ratio analysis the financial position, capital structure, profitability, solvency, efficiency, etc. of an organisation can be compared with the same of the other firms belonging to the same industry and also with the overall industry standard. Besides, this tool can also be utilised for effecting comparison among different departments of the same firm in relation to the targets set, works performed and relative efficiency. Such inter-firm and inter. departmental comparisons are helpful to evaluate the real financial condition of any organisation.

(v) Measurement of solvency: An idea about the short-run and long-run loan repayment capacity or solvency of a concern can be made by computing different ratios for this purpose and making an in.depth analysis of the same. The present solvency position of a firm can be assessed by means of drawing a comparison of the current ratios with the ratios of earlier years. Such measurement of solvency does not only help management in its decision making process, it also helps the investors and creditors to take their investment decisions.

(vi) Measurement of profitability: Ascertainment of the profitability trend of a firm is another benefit of ratio analysis. Computation of certain ratios like Gross Profit Ratio, Net Profit Ratio. Operating Profit Ratio, Return on Capital Employed, etc. helps measuring a firm's current year's profitability. Similarly comparison of the current year's ratios with those of the earlier years helps projecting the profitability trend of the firm. Comparison of the profitability ratios of one firm with the same of its counterparts belonging to the same industry gives a clearer picture of the profit earning capacity.

(vii) Help in planning and forecasting: Trends of different strategic ratios help management in planning and forecasting. By using different ratios computed on the basis of information published in financial statements of past years, forecasting of saes, different revenue expenses, capital expenditure, etc. is made and budgets are prepared. Information revealed by past ratios is also used in the formulation of future financial policies.

(viii) Help in decision making: Organisational and departmental efficiency are evaluated through ratio analysis. The assessment of work performed and measurement of the efficacy in the use of resources make the trends indicated by such analysis dependable. For this reason management often takes many vital decisions on the basis of computed ratios.

(ix) Help in taking corrective measures: The financial analysts and management accountant-identify the areas of weakness and inefficiencies on the basis of the trend indicated by ratios and suggest remedial measures to overcome them. This helps the management to control financial affairs and take corrective actions to rectify the wrong decisions.

(x) Help in controlling : Analytical data available through ratio analysis helps controlling the trading and non-trading activities of the firm and the related costs. The trend of different expense ratios makes management aware of the necessity of controlling-different costs and identifies the specific areas of control.

(xi) Help in communication: Probably ratio analysis is one of the popular most' techniques of conmunicating accounting information in brief. It is possible to communicate flamboyant and composite data in a nut and shell and simple form through ratios. For this reason at present ratio analysis is accepted as a common medium of effecting interdepartmental and inter.firm communication. The managers of different levels communicate information within themselves through ratios.

(xii) Useful to the outsiders: Ratio analysis is indeed an well-accepted and widely used tool of supplying necessarY information to the management. In addition it is also considered as an important technique even to the outside parties associated with any business or non-business institution. The outsiders like potential investors, banks and other financial agencies, creditors, government, income-tax authority and othro's depend a lot on the analysed information available through ratio analysis for setting up business relation, maintaining the link with the firm, taking important decisions on different issues, etc. Even at present the researchers on accounting and management fields take the help of ratio analysis for the purpose of evaluation of performance, measurement of' trends and projection of future potentials.

From the foregoing discussion it is apparent that ratios have wide use not only in making financial analysis but also for different other porposes. In fact the utility or effectiveness of ratio analysis is dependent to a great extent on the purpose of use and the analytical aptitude of the analyst. At present the use of ratios is common almost in all managerial activities. J. Batty has rightly s'ated that ratios can help in executing the basic functions of management like forecasting, planning, co~ordination. control and communication.[2]

6. Limitations of Ratio Analysis

It can be undoubtedly said that ratio analysis is one of the widely used and popular financial techniques of the modern times. But in many cases its effective application largely depends on the expertise and analytical skill of the interpreter. It is not possible to obtain the expected utility from ratio analysis unless the ratios are properly used and interpreted. So despite having immense benefits ratio analysis technique is not an unmixed blessings. The arguments put forward by the critics against the technique of ratio analysis are as follows:

(1) Completely based on comparison: It is not possible to analyse any particular matter with the help of a single ratio. Such analysis is possible by making comparison of at least two or more ratios. Whether a particular trend indicated by any ratio is good or bad, favourable or unfav.oirable that can only be judged through comparative analysis. Comparison is only one of the techniques of making analysis, but in case of *ratio* analysis it is the sole technique. For this reason u is said that ratio analysis is only a partial analytical process, not a complete one.

(ii) Difficult to fix up definite standards: The real significance of a particular ratio can be understood by curiiparing it with any ideal or standard norm of that ratio. But the standard already fixed on for a ratio may change over time. Moreover, standard ratios of the industry to which the firm belongs may be fixed up on different basis and may vary widely with the computed ratios of the firm. Standards may also differ according to the nature of the situations. So fixing up acceptable standards for all the ratios is not doubt an uphill task.

(iii) Dependence on financial statements: Ratios are always based on information disclosed in basic financial statements like the Profit and Loss Account and the Balance Sheet. Financial statements have their own limitations. So ratios computed on the basis of information disclosed in those financial statements cannot also be free from such limitations. For getting rid of these limitations before computing ratios some adjustments are required to be ma-dc in the information disclosed in financial statements. In reality it is not done and so ratios always suffer from the limitations of the financial statements.

(iv) Problem of inter-firm comparison: In case there is significant variations in accounting policies adopted by different firms belonging to the same industry the inter-firm comparison through ratio analysis does not become effective. For example it can be said that if the policies relating to inventory valuation, depreciation, treatment of contingent liabilities, etc. of two firms under the same industry are different the trend indicated by an inter.firm comparison through ratios does not carry any effective meaning.

(v) Personal influence: The utility of ratio analysis depends a lot on the skill and judgement of the interpreter. If the personal sense of judgement and analytical power of different interpreters vary a particular ratio may indicate different trends. So presence of personal aptitude reduces the effectiveness of ratio analysis. Moreover, the interpreters may exert undue influence on their analysis with unfair motives.

(vi) Only quantitative analysis: Ratios are often called quantitative tools because their computations are based on only quantitative or numerical figures. The qualitative aspects of the concerned numerals are totally ignored in the process of ratio analysis. Ignoring qualitative aspect may mislead the users of ratios. For example, a high current ratio indicates a satisfactory loan repayment capacity of a firm. But if its current assets consist of a large quantity of obsolete stock or its debtors are slow paying the satisfactory trend of loan repayment capacity as indicated by the current ratio may prove to be only a paper jugglery.

(vii) Ratios indicate trend, do not prove: A common criticism against the ratio analysis technique is that it only indicates trend but does not prove anything. By comparing the computed ratios with the ideal or standard ratios, last year's ratios and similar ratios of other firms belonging to the same industry the inference that is arrived at by the interpreter is nothing but a trend on any particular event. Whether the trend of the item of consideration is favourable or unfavourable, satisfactory or unsatisfactory a general notion as to that can be inferred upon through ratio analysis. Whether the item is really favourable or unfavourable, satisfactory or unsatisfactory that can never be authenticated or proved through such analysis. The considerations that are needed for coming to such a conclusive decision are not taken care of in ratio analysis. Two reasons work behind this proposition that ratios indicate, they do not prove. The first one is that ratios do not measure numeral or quantities they express the numerical or quantitative relation in a brief manner. If the ratio of current assets and current liabilities is 2 : I the amount of current assets and current liabilities may be Rs. 20,000 and Rs. 10,000 respectively or they may also be Rs. 2,00,000 and Rs. 1,00,000 respectively. The second reason is that for arriving at a conclusive decision through any technique the same must have the basic feature of assessing the qualitative aspect along with the aspect of quantity.

(viii) Inclusion of window dressing: The term 'window dressing' stands for showing the numerical fiL'ures more than what they are in reality in financial statements with a fraudulent intention and by means of manipulation. If an effort is made to exaggerate the values of incomes, expenses, asset.s and liabilities in the financial statements for the-purpose of concealing the true and fair financial position of the firm, ratios computed also reflect the same and do not speak of the real financial scenario. It indicates that there is every possibility of ratios being biased and influenced by the window dressing process. Such window dressing may also be made for showing the ratios higher than what they are in reality with unfair intention. For example, stock turnover ratio may be exaggerated by deferring the purchase of inventory or showing the inventory less than the actual value for showing better managerial efficiency.

(ix) Linkage among different contradictory figures: In case of mixed ratios one component is taken from the Profit and Loss Account and another from the Balance Sheet. Again an average of two figures shown in two Balance Sheets may also be taken as one of the components of a particular ratio. The numeral shown in the Profit and Loss Account exhibits the outcome of some events occurred during a particular span of time (generally in one year). On the other hand the numeral shown in the Balance Sheet indicates the position of that item on a particular point of time (i.e. on a specific date). Again the average of two numerals shown in two different Balance Sheets expresses the average of the positions as on two separate dates. So such mixed ratios draw up the relationship between the figures having contradictory status and are not truly comparable.

(x) Problem of use: Computation of a single ratio is in no case sufficient to analyse any matter. For this purpose a series of ratios need to be calculated. There are also no hard and fast guideline for using specific ratios for specific purpose. Selection in most of the cases rests on the choice of the analyst. Often different analysts use different sets of ratios to analyse the same matter. Again using of the same ratios for different purposes create confusions. That is why it is said that the use of ratios is problematic in many cases.

(xi) Not effective without cause and effect relationship : The relationship between those numerals having cause and effect mutual relations between them can only be expressed through ratios. Numerals without having any cause and effect relationship are not the subject matter of ratio analysis. For example, there is no cause and effect relation between the purchase figure and the provision for taxation. So it is impossible to draw up any relationship between these two variaHes through ratio analysis.

(xii) Lack of depth: Ratio analysis is a primary tool used in financial statement analysis. It is only used to develop a general notion about the relationship between the related variables or to analyse the trend of the said relation. As this technique does not assess the qualitative aspect of the concerned variables it is not possible to make an in-depth assessment through it. The relationships indicated by ratio analysis need to be further analysed in-depth through other techniques for making the information more useful.

(xiii) Ignoring the effect of inflation: The increase in general price level in the market due to inflationary trend makes the ratio.based comparison futile. The return on fixed assets purchased many years back obviously becomes more than the return on recently purchased fixed assets. Apparently looking this difference indicates higher efficiency in the use of old fixed assets, but in reality that is not the case. The rise in market price due to inflationary trend may be responsible for such variation, As the effect of change in market price is ignored ratio analysis on the basis of past data often creates confusions in the minds of the users and misleads them.

7.Classification of Accounting Ratios

1. On the basis importance: a)Primary Ratio, b) Secondary Ratios, 1.b.i) Support ing Ratios, ii) General ExplanatoryRatios, iii) Specific Explanatory Ratios.

2. On the basis of users: a) Ratios useful to Management, b)Ratios useful to Shareholders,c)Ratios useful 2 Creditors.

3. On the basis of Sources or financial statements:a) Balance Sheet Ratios, b) Rev enue Statement or Profit & Loss Account Ratios, c) Mixed or Combined Ratios.

4. On the basis of functions or purposes:a) Profitability Ratio, b) Liquidity or Sol vency Ratios, c) Financial Stability Ratios, d) Management Effeciency Ratios, e) Activity or General Effiency Ratios, f) Capital Structure Ratios .4.b.i) Short-term Liquidity or Solvency Ratios ii) Long-term Solvency or Liquidity Ratios. 4.e.i) Turn over Ratios. 4.f.i) Other Ratios, ii) Leverage Ratios.

Accounting ratios can be classified from five viewpoints. Such classification of accounting ratios is discussed below:

I. Classification on the basis of importance: From the viewprirtt of importance accounting ratios are two types. A. Primary Ratio and B. Secondary Ratios.

A. Primary Ratio: The ratio that explains the relation between the capital employed and operating profit of a firm is known as primary ratio. So.

Primary Ratio = Operating Profit / Capital Employed

As this ratio is computed with the basic parameter of success or failure of the operating activities of a firm it is called primary ratio.

B. Secondary Ratios: Barring primary ratio other ratios which are related to tb measurement of success or failure of the operating activities (if a firm are kno'.vn as secondary ratios. These ratios are computed with the help of secondary or supporting parameters and are used to confirm the trend indicated by the primary ratio. This is the reason for identifying these ratio as secondary ratios. Secondary rat ios are again divided into the following three categories

(i) Supporting Ratios: Secondary ratios used to analyse the profitability position of' a firm are known as supporting ratios. Such supporting ratios are computed as follows:

(a) Operating Profit / Total Sales

(b) Total Sales / Capital Employed

(ii) General Explanatory Ratios: Ratios which explain the relationship between any two general or common factors of success or failure f the operating activities of the firm are identified as general explanatory ratios. The following are the examples of general explanatory ratios:

(a) Various Costs / Net Sales

(b) Net Sales / Current Assets

(c) Net Sales / Fixed Assets

(iii) Specific Explanatory Ratios: Ratios which explain the relationship between any two special factors related to success or failure of operating performance of the firm are known as specific explanatory ratios. Some of the specific explanatory ratios are mentioned below:

(a) Various specific costs / Net Sales

(b) Stock Turnover = Cost of Goods Sold / Average Stock

(c) Debtors Turnover = Credit Sales / Average Debtors

(d) Creditors Turnover = Credit Purchase / Average Creditors

II. Classification on the basis of users: From the viewpoint of users ratios may be divided into three catagories. Such divisions are as follows:

A. Ratios useful to management: The tool of ratio analysis has the main aim of providing useful information to the management in a nut and shell form. Most of the ratios generally computed are useful to the management. Some important examples of ratios having practical use in managerial functions are as follows:

(i) Operating ratio, (ii) operating profit ratio, (iii) all ratios related to solvency and liquidity, (iv) all efficiency measuring ratios, (v) profitability ratios other than operating profit ratio, (vi) all ratios related to the capital structure analysis.

The above-mentioned ratios will be discussed in later stage of this chapter.

B. Ratios useful to shareholders: Being owners the shareholders of the company are often interested to know th-~ financial stability and profit earning capacity of the firm. For getting such information they depend on the following ratios:

(i) all profitability measuring ratios, (ii) all ratios related to the evaluation of financial strength or stability, (iii) rate of return per share, (iv) leverage ratios.

These ratios will also be discussed in the following part of this chapter.

C. Ratios useful to creditors: The creditors or suppliers of raw materials and other components get interested to know the safety of their investment and the scope of getting timely interest and repayment of the investment. For this purpose they take the help of the following ratios

(i) all ratios indicating short-term and long.term solvency or debt repayment capacity.

(ii) all ratios related to financial stability, and

(iii) capital structure ratios.

These ratios will also be discussed in detail in the following part of this chapter.

III. Classification on the basis of sources or financial statements: Classification of ratios on the the basis of sources from where the components of ratios are taken i.e the financial statements, is probably the most important classification. From the viewpoint of sources i.e. the financial statements ratios are classified into three categories i.e. A. Balance Sheet Ratios, B. Profit and Loss Account or Revenue Statement Ratios and C. Mixed or Composite Ratios.

A. Balance Sheet Ratios: Ratios, both the components of which are taken from the information disclosed in the Balance Sheet, are identified as Balance Sheet Ratios. Such ratios are computed to analyse the relationship among the different numerical information expressed in a Balance Sheet. The following Balance Sheet Ratios are commonly used for financial statement analysis

(i) Current Ratio

(ii) Liquid or Quick or Acid Test Ratio

(iii) Absolute Liquid Ratio (also known as Cash Position Ratio)

(iv) Defensive Interval Ratio

(v) Proprietary or Net Worth Ratio

(vi) Assets—Proprietorship Ratio

(vii) Fixed Assets—Proprietorship Ratio

(viii) Net Assets—Proprietorship Ratio

(ix) Debt—Equity Ratio

(x) Net Worth to Debt Ratio

(xi) Capital Gearing Ratio

(xii) Fixed Assets to Current Assets Ratio

(xiii) Debt Ratio

lxiv) Equity Capital Ratio

(xv) Preference Capital Ratio

(xvi) Debenture Capital Ratio.

B. Profit and Loss Account or Revenue Statement Ratios: If both the components of a particular ratio are taken from the information disclosed in the Profit and Loss Account or the revenue statement the same is called Profit and Loss Account or Revenue Statement Ratio. The relationship that exists within the re~.enue and cost related items shown in the Profit and Loss Account is explained through Revenue Statement Ratios. The important Profit and Loss Account or Revenue Statement Ratios are stated below:

(i) Gross Profit or Gross Margin Ratio

(ii) Net Profit or Net Margm Ratio

(iii) Operating Ratio

(iv) Expense Ratio or Specific Expense Ratio

(v) Materials Consumed Ratio

(vi) Manufacturing Expense Ratio or Conversion Cost Ratio

(vii) Operating Profit Ratio -

(viii) Interest Coverage Ratio

(ix) Debt Servhe Rato:

(x) Tax Provision Ratio

(xi) Preference Dividend Coverage Ratio

(xii) Equity Dividend Coverage Ratio

(xiii) Dividend Payout Ratio

(xiv) Financial Leverace Ratio

(xv) Operating Leverage Ratio

C. Mixed or Composite Ratios: If in computation of any ratio one of the variables is taken from the inforotation disclosed in the Profit and Loss Account and the other variable from the Balance Sheet, the said ratio is identified as Mixed or Composite Ratio. Mixed or Composite ratios consist of components taken by mixing up both the important financial statements. The cause and effect relationship that exists among the items shown in the Profit and Loss Account and in[4] the Balance Sheet can be explained through such mixed or combined ratios.

The commonly used Mixed or Composite Ratios are stated below:

(i) Return on Capital Employed

(ii) Return on Proprietors' Fund or Equity

(iii) Return on Equity Shareholders' Fund

(iv) Return on Total Assets

(v) Return on Investment (ROl) -

(vi) Stock Turnover

(vii) Debtors or Receivables Turnover

(viii) Creditors or Payables Turnover

(ix) Fixed Assets Turnover

(x) Current Assets Turnover

(xi) Working Capital Turnover

(xii) Capital Turnover

(xiii) Proprietors' Fund Turnover

(xiv) Dividend Yield Ratio

(xv) Price Earning Ratio

(xvi) Earning per Share

(xvii) Earning Yield Ratio

IV. Classification on the basis of function or purpose: The technique of analysis through accounting ratios may be used by the financial analyst for variety of purposes. From the view-point of purposes of goals served ratios are dwided into six categories. Along with classification of ratios on the basis of sources such purpose-wise classifications of ratios have also gained gocd importance in the present accounting and management world. Use or purpose based classifications of ratios are discussed in the following lines:

A. Profitability Ratios: Almost all the parties related to a firm like shareholders or owners, management. Creditors, employees, government and others are interested to know its profit earning capacity Decisions taken by the users and their future relationship with the firm are often guided by this information. For this purpose a financial analyst tries to measure the profitability position of the tirm by selecting a few ratios. Ratios computed for the purpose of assessing the profitability position ot a firm are as follows -

(a) Gross Profit or Gross Margin Ratio

(b) Operating Ratio

(c) Operdting Profit Ratio

(d) Net Profit or Net Margin Ratio

(e) Return on Capital Employed

(f) Return on Proprietors' Fund or Net Worth

(g) Return on Total Assets

(h) Capital Turnover

(i) Earning per Share

(j) Price Earning Ratio.

B. Liquidity or Solvency Ratios: Creditors, probable investors. Debenture holders and other outside parties get interested to know the fete of their investments in the firm. For this purpose thev try to assess the loan repayment capacity of the firm with the help of ratio analysis. For effecting efficient debt management financial managers may also be interested to assess the loan repayment capacity of the firm -hrough ratio analysis. So ratios may be used for measuring the debt payment capacity of firm. Liquidity or solvency position ol a firm may be analysed on the basis of time frame i.e. short-term liquidity or solvency and long-term liquidity or solvency. -

(i) Short-term Liquidity or Solvency Ratios: These ratios are used to judge the capacity of the firm of repaying the debt of short-term creditors and trade payables. Short-term solvency ratios are often identified by the term 'liquidity ratios'.

The following ratios are usually computed to measure the short-term solvency or liquidity position of a firm:

(a) Current Ratio

(b) Liquid or Quiick or Acid Test Ratio

(c) Absolute Liquid Ratio

(d) Debtors' Turnover or Velocity

(e) Creditors' Turnover or Velocity

(f) Stock or Inventory Turnover or Velocity.

(ii) Long-term Liquidity or Solvency Ratios: These ratios are computed to assess the capacity of the firm to pay off the claims of debentureholders, preference shareholders and other long-term creditors. The following ratios are generally used for this purpose :

(a) Debt Equity Ratio

(b) Debt to Total Capital Ratio

(c) Proprietory Ratio

(d) Current Assets—Proprietorship Ratio

(e) Interest Coverage Ratio

C. Financial Stability Ratios: The shareholders and management of the concern may often feel interested to know whether the financial position of the firm is stable enough or not. A firm with financial stability has all the potentials of future growth. In this context financial stability means the strength to absorb all sorts of financial shocks. Usually short-term and long-term solvency ratios along with some other ratios are used for measuring the financial stability of a firm. The important ratios used for this purpose are:

(i) Debt Equity Ratio

(ii) Proprietary Ratio

(iii) Current Ratio

(iv) Liquid or Quick or Acid Test Ratio

(v) Capital Gearing Ratio

(v) Fixed Assets Proprietorship Ratio

(vi) Net Worth to Net Sales Ratio.

D. Managerial Efficiency Ratios: Ratios are also used to measure manageriali efficiency. The management niav be willing to make a self-appraisal of past performance. The owners or share-holders may also want to assess the efficiency of the agency on which they have entrusted the responsibility of running the concern. As managers are directlv related to all activities of a firrn many parameters must be tested for measuring its efficiency.

Ratios which are computed for measuring managerial efficiency are stated below:

(i) Short-term Solvency Ratios: (a) Current Ratio, (b) Liquid or Quick or Acid Test Ratio.

(ii) Long.term Solvency Ratios: (a) Debt-Equity Ratio. (b) Proprietary Ratio.

(iii) All Activity or Efficiency Ratios: as discussed in sub-paragraph E below:

(iv) Profitability Ratios: (a) Gross Profit Ratio, (b) Net Profit Ratio, (c) Operating Ratio. (d)Operating Profit Ratio. (e) Return on Capital Employed.

E. Activity or General Efficiency Ratios: Another purpose of ratio analysis technique is to measure the activity or general efficiency of the firm. Here not only managerial efficiency is measured, rather an effort is made to highlight the general efficiency of overall business activities. Such analysis is made by computing the turnover or velocity of the items directly related to operating activities in relation to the sales achieved by the firm. For this reason the ratios used for measuring activity or general efficiency are also called turnover ratios. Usually the following ratios are used for this purpose:

(i) Inventory Turnover or- Velocity

(ii) Fixed Assets Turnover

(iii) Total Assets Turnover

(iv) Debtors Turnover or Velocity

(v) Creditors Turnover or Velocity

(vi) Working Capital Turnover

(vii) Capital Employed Turnover

F. Capital Structure Ratios: The technique of ratio analysis may also be used to analyse the relationship between the financial stability of the firm and the composition of its capital structure. These ratios are known as capital structure ratios and they are also useful to measure the financial risk and operating risk involved in the activities of the firm. Capital structure ratios are of two types—(i) Leverage Ratios and (ii) Other Ratios.

(i) Leverage Ratios: (a) Financial Leverage Ratio, (b) Operating Leverage Ratio

(ii) Other Ratios: (a) Capital Gearing Ratio, (b) Debt Equity Ratio, (c) Fixed Assets to Net Worth Ratio, (d) Long-term Capital Employed to Long-term Liabilities Ratio, (e) Current Assets Proprietors Fund Ratio.

Discussion on Different Important Ratios

Of the different viewpoints f classifying accounting ratios the viewpoint of sources may probably be the most popular type of classification. For this reason important accounting ratios i-ire discussed below grouping them on the basis of sources of components or financial statements The purpose and interpretations of the selected ratios have als - been discussed.

I. BALANCE SHEET RATIOS.

A (a) Name of the Ratio : Current Ratio

(b) Formula: Current Assets / Current Liabilities

Current Assets = Closing stock + Debtors + Bills Receivable +Prepaid Expenses+Ad vances Given + Cash at Bank

Current Liabilities =Creditors + Bills Payable + Outstanding Expenses + Tax Liability + Bank Overdraft (short-term) Proposed Dividend

(c) Ideal Norm : 2 : 1 (Per one rupee current liabilities current assets of rupees two)

(d Purpose or Use: It is used for measuring short-term liquidity or solvency. Whether the current assets of the firm are sufficient to meet its current liabilities that is assessed through the current ratio.

(e) Significance and Interpretation:

(i) A comparatively higher current ratio indicates a good liquidity and satisfactory debt repayment capacity of the firm. It is also an indicator of safety of investment made by creditors.

(ii) A low current ratio than the standard indicates a bad liquidity, over-trading, less working capital and unsatisfactory debt repayment capacity of the firm. The investment of creditors in a firm having a low current ratio may not be too safe.

(iii) Current ratio expressed in terms of percentage is known as working capital ratio. This ratio also indicates the margin of safety or margin of caution of the creditors.

(iv) A high current ratio always indicates a sound debt repayment capacity and a l o w current ratio interprets this position in an adverse manner—this proposi tion may not be universally true in all cases. If the current assets do not have a good quality, like they consist of more obsolete stock, slow paying debtors, etc. the good liquidity position as indicated by a high current ratio may not be so good in reality. On the other hand if the current assets consist. of high quality stock and well-paying debtors even a current ratio lower than the standard may speak of the sound solvency of the firm.

(v) In measuring the short-term liquidity or solvency current ratio should not be aken as the sole parameter. Other liquidity ratios are also to be calculated for this purpose.

(vi) If there is a recession in a particular industry, all the firms belonging to tha industry may have large unsold inventory and long outstanding debtors. Thes would increase current assets and result in a high current ratio. But in this case the trend indicated by the high current ratio may not stand favourable for the firms.

B. (a) Name of the Ratio: Liquid or Quick or Acid Test Ratio

(b) Formula: Quick or Liquid Assets / Quick or Liquid Liabtltties

Quick or Liquid Assets = Current Assets - (Stock and Stores + Prepaid Expenses)

Quick or Liquid Liabilities =Current Liabilities - Bank Overdraft (short-term and not payable on demand)

(c) Ideal Norm: 1: 1 (Per rupee one of quick liabilities quick assets of the amount.)

(d) Purpose or Use : It is used for measuring short-term liquidity or solvency. Quick ratio is useful to verify the trend indeicated by the current ratio. Just as gold is tested through acid solution the trend indicated by the current ratio is verified through the quick or liquid' ratio. For this reason liquid ratio is also called acid test ratio.

(e) Significance and Interpretation:

(i) A high quick ratio along with a high current ratio indicates a good short-term solvency or debt repayment capacity of the firm.

(ii) Even if the current ratio is high, a low quick ratio does not indicate a good debt repayment capacity of the firm.

(iii) The authenticity of decision taken on the basis of current ratio can be verified through quick ratio.

(iv) A high quick ratio ensures the safety of the investment of creditors.

(v) The quick ratio is considered to be a better test of liquidity than the current ratio. But quick ratio itself may not be taken as a conclusive test of liquidity. If the quick or liquid assets consist of slow paying or defaulting debtors the good liquidity position as indicated by a high quick ratio may not be so good in practice. Again if the inventories which are not included in quick assets are not so illiquid and have very good turnover the firm may enjoy a better liquidity position than what is indicated by a low quick ratio.

(vi) For verifying the trend indicated by the current ratio and supported by the quick ratio it is required to adopt a more rigorous test of liquidity through the Absolute Liquid Ratio.

C. (a) Name of the Ratio: Absolute Liquid / Quick Ratio

(b) Formula: (Cash + Marketable Securities) / Quick or Liquid Liabilities

or

(Liquid or Quick Assets — Debtors) / Quick or Liquid Liabilities

(c) Ideal Norm: 0.5: 1 (Per 50 paise current assets current liabilities of rupee one)

(d) Purpose or Use: It is used to verify the short-term liquidity position of the firm as indicated by the current ratio and supported by the quick ratio. It is in fact used to measure the cash position of the firm.

(e) Significance and Interpretation:

(1) It is only a supporting ratio used simultaneously with the current ratio and th quick ratio. It is never used as a single test.

(ii) A high airrent ratio and a satisfactory quick ratio, if supported by a high absolute liquid ratio (either equal to idea! norm or more than that), exhibit very good short-term solvency of the firm.

(iii) Even if the current ratio and the quick ratio are satisfactory a low absoli liquid ratio indicates that the debt repayment capacity of the firm is not sound.

iv) A very high absolute liquid ratio (even more han the ideal norm) indictes unnecessary holding of cash and other assets equivalent to cash. Such a high cash position is an indicator of holding unproductive assets.

(v) A too high absolute liquid ratio speaks of satisfactory short-term solvency but such position is against the good profitability of the concern.

(vi) This ratio being an indicator of capital position is also known as cash position ratio.

D. (a) Name of the Ratios: Defensive Interval Ratio

(b) Formula: Total Defensive or Liquid Assets / Projected Daily Cash Requirement

or

Cash + Bank + Marketable Short - term Securities + Debtors / Projected Daily Cash Requirement

or

Current Assets — (Stock + Pr. paid Expenses) / Projected Daily Cash Require ment

(c) Ideal Norm: Absent

(d) Purpose or Use: It is used to measure the capacity of the firm to meet its day to day requirement of liquidity to meet the cash expenses.

(e) Significance and Interpretation:

i) Defensive interval ratio is not a measurement of short-term debt repayment capacity of the firm, rather it is an yardstick of measuring the firm's ability *to* pay off its immediate cash needs without resorting to sales realised or other sources.

(ii) The higher the defensive interval ratio the higher is the firm's ability to meet its lath. cash expenses.

(iii) The lower the defensive interval ratio the unsatisfa$_0$torv is the firm's ability to meet daily cash needs.

(iv) This ratio does not take into consideration the current liabilities of the firm. it implies whether the firm's cash position is sound enough to pay off its current liabilities that is not tested through this ratio.

E. (a) Name of the Ratio: Proprietary Ratio or Net Worth Ratio

(b) Formula: Proprietors' or Shareholders' Fund / Total Assets excluding Fictitious Assets

Proprietors' or Share-holders' Fund = Equity Share Capital Preference Share Capital + Reserve and Surplus — Fictitious Assets

(c) Ideal Norm :1 : 3 *(33$^{1/3}$ %* of total assets collected through proprietary capital:

(d) Purpose or Use :It is used in the analysis of long-term solvency and financial stability of tie firm. The proportion of total assets of a firm collected through proprietors fund can be understood from this ratio.

(e) Significance and Interpretation:

(i) A high proprietary ratio indicates more use of proprietors funds in acquiring total assets of the firm. This situation shows a favourable long-term solvency and a satisfactory financial stability of the firm. So a high proprietary ratio is favourable to the long-term creditors and investors.

(ii) A proprietory ratio below the ideal norm indicates less use of proprietors' fund and more use of debt funds in financing the assets structure of the firm. This situation speaks of the high risk, poor solvency and unstable financial position of the firm and so obviously discourages the long-term creditors and investors.

(iii) The trend indicated b the proprietary ratio is verified through the debt equity ratio.

(iv) If the proprietary ratio is too high it indicates unwillingness of the firm to use more debt capital. A firm's intention to use less debt capital reveals that it has adopted a more conservative financial policy. This situation is against high profitability.

F. (a) Name of the Ratio: Assets-Proprietorship Ratio

(b) Formula: This ratio can be computed in any of the following three ways:

(i) Total Assets-Proprietorship Ratio = Total Assets less Fictitious Assets / Proprietors' or Shareholders' Fund

(ii) Fixed Assets-Proprietorship Ratio = Fixed Assets / Proprietors or Shareholders Fund

(iii) Current Assets-Proprietorship Ratio = Current Assets / Proprietors or Shareholders Fund

(c) Ideal Norm: Absent (generally maximum 2/3 portion of fixed assets are financed by proprietors' fund)

(d) Purpose or Use: These ratios are used to evaluate the long-term solvency and financial stability of the firm. The role of proprietary capital in acquisition of total assets, fixed assets and current assets can be analysed through this ratio.

(e) Significance and Interpretation:

(i) A high assets-proprietorship ratio is an indicator of using more equity capital hare debt capital in financing the assets. It focuses on the satisfactory financial base capable of repaying the debts and a stable financial position.

(ii) A low assets-proprietorship ratio reveals that the firm is dependent mostly on debt capital so far financing of assets is concerned. Such higher dependence on debt, does- not ensure a good safety of inventors' fund.

(iii) If fixed assets-proprietorship ratio is higher than the current assets -proprietorship ratio it is apparent that the higher proportion of fixed assets has been financed by proprietors' fund. More investment of proprietors' fund in fixed assets ensures safety of outsiders' fund and indicates stable financial policy of the firm.

(iv) If the current assets-proprietorship ratio is more thin the fixed assets- proprietorship ratio it is implied that the greater proportion of proprietary capital has been invested in working capital tItan fixed assets Such a situation a situation indicates poor solvency and unstable financial position of the firm.

G. (a) Name of the Ratio: Debt-Equity Ratio

(b) Formula: This ratio can be computed following any of the following two furrirula:

i) External Debt or Fund / Proprietors' Fund or Owners' Equity

External Debt = Long-term Debt + Short-term Debt

ii) Long-term External Debt / Proprietors' Fund or Owners' Equity

From the above two formulas of debt equity ratio it is apparent that in the first case total debt (i.e. both long-term and short-term debt) and in the second case only long-term debt is taken as the numerator. The second formula is conventional while the first one has the recent origin. In the solution of the practical problems of this chapter the first formula, which is the modern one, has been used.

(c) Ideal Norm:

(i) 1: 1 (per rupee one debt same amount of equity) [applicable if total debt is taken as the numerator]

(ii) 2: 1 (Debt double than the amount of equity) applicable if only long-term debt is taken as the numerator)

(d) Purpose or Use:It is used for variety of purposes and is treated as a very important constituent of ratio analysis technique. It is mainly used to make a thorough analysis of long-term solvency, capital structure and risk, financial stability and managerial efficiency. The extent of owners' investment in relation to the use of debt capital is revealed by this ratio. It is also used to measure the risk involved in capital structure.

(e) Significance and interpretation:

(i) A too high debt equity ratio reveals more investment of loan capital than equity capital in meeting the requirement of finance of the firm. This situation is highly risky because of a higher claim of the outsiders to the firm. Moreover, the greater the loan, the higher is the fixed interest burden which the firm must pay even if it earns insufficient profit. It is true that debt capital is more risky, but at the Fame time it is considered cheaper than the equity capital. So more use of debt than equity undoubtedly increases the profitability of the firm. It is apparent that the higher the debt equity ratio, the more is the risk and so also the profitability. A high debt equity ratio is always favourable to the shareholders.

(ii) A comparatively, low debt-equity ratio than the :deal norm indicates more use of equity capital than debt capital. The .lower the debt, the lower arc the interest and repayment. burden of the firm. So firm having a low debt bears a low financial risk. But the use of costly equity capital than comparatively cheaper debt capital reduces the profitability of the firm. From the viewpoint oh' the creditors and outside investors a low debt situation is always favourable because it ensures more safety of outsiders fund. On the other hand as a low debt situation reduces profitability the owners or shareholders do not like it.

(iii)Due to the reverse effects of debt and equity all the firms using debt capital try. to maintain a perfect balance between debt and equity. From the viewpoint oft risk and profitability neither too much debt nor too much equity is desirable to a firm For this reason it is always prudent for a firm to try to maintain a debt equity ratio nearer to the ideal norm of 1: 1 or 2: 1.

(iv)A very low debt equity ratio indicates a sound long-term solvency, low risk, conservative capital structure, low profitability and inefficient managerial efficiency. Such a situation reveals that the management has failed to take advantage of debt capital. A debt equity ratio equal or near to equal to the ideal norm indicates a medium loan repayment capacity and a moderate risk, balanced capital structure, upto the mark profitability and efficient management quality. A very high debt equity ratio reveals unsatisfactory loan repayment capacity, too high risk, too flexible capital structure and immatured expertise of management.

H.(a) Name of the Ratio: Capital Gearing Ratio

(b) Formula: This ratio may be computed in any of the following two ways:

(Debentures + Preference Capital + Other Long Term Loans) / (Equity Capital + Free Reserves - Losses)

Or

Intcrest bearing funds / Non-interest bearing funds

(c) Ideal Norm:It depends on the nature of the firm. Generally the fixed interest and dividend bearing capital of rupee one against the equity shareholders' fund of rupees two is taken as the standard ratio.

(d) Purpose or Use : It is used to measure the capital structure policy, extent of risk taken and financial stability of the company. It has the basic objectives of setting up the relationship between stable and non-risky equity capital and risks' and aggressive other capital.

(e) Significance and Interpretation:

(i) The tern: gear' is generally used to control the speed of a motor fitted car. The word 'speed' has a close relationship with the term 'risk'. In accounting ratio the term 'gear' is used to measure the financial risk involved in the capital structure of a company. In case of a motor car using high gear means increasing the speed and using low gear means bringing down the speed. Similarly a highly geared company (a company having a high capital gearing ratio) runs with more risk and a lowly geared company (a company having a low capital gearing ratio) bears a low risk, it means that a high gear Is rum'- risky and vice versa.

(ii) The state of high gearing is favourable for taking advantage of trading on equity'. In inflationary situation high gearing is effective because at this time the increased income helps to bear the fixed interest burden.

(iii) In a deflationary market situation low gearing is more effective because the low income earned during deflationary. period is not sufficient to bear huge interest burden.

(iv) The management must try to draw up a perfect balance in the use of risky capital and non-risky capital. A balanced capital structure is reflected upon a moderate capital gearing ratio. it is that situation which is neither too risky nor too conservative.

(v) In highly geared companies the return of equity shareholders becomes high in the years of high profit but it becomes low in the year of low profit. In a year of high profit it is possible for the company to declare a high rate of dividend even after paying off high cost of debt. On the other hand in a year of low profit the major portion of profit earned is used up in meeting interest burden and only a small portion is left for equity shareholders.

I. (a) Name of the Ratio: Fixed Assets-Current Assets Ratio

(b) Formula: Fixed Assets / Current Assets

(c) Ideal Norm: Absent

(d) Purpose or Use: It is used to measure the long-term solvency and financial stability of the firm. It explains the relationship between fixed assets and current assets.

(e) Significance and Interpretation:

(i) If this ratio is high that indicates more investment in fixed assets than current assets. It reveals a stable financial position of the firm. But current assets are more productive than fixed assets and therefore, yield more profit. So a high fixed assets—current assets ratio is against the profitability of the firm.

(ii) If this ratio is low that indicates higher investment in current assets than fixed assets. It reveals more profitability and at the same time unstable financial position of the firm. From the viewpoint of long-term solvency a low fixed assets-current assets ratio is also not a welcoming feature.

II.(a) Name of the Ratio: Fixed Asset-Net Worth Ratio

(b) Formula: Net Fixed Assets less Depreciation / Net Worth

Net Worth =Proprietors' fund = Equity Capital — Preference Capital Reserves and Surplus — Fictitious Assets

(e) Ideal Norm : Absent (In some cases .50 and in some other cases .60 is taken as the accept able standard)

(d) Uses : This ratio is used to evaluate the long term solvency and financial stability of the firm. It has the aim to express the proportion of proprietors' fund or net worth invested in fixed assets.

(e) Significance and Interpretation:

(i) A fixed assets to net worth ratio of more than one reveals that in financing fixed assets along with equity shareholders' fund debt capital has also been. used. 0n the other hand if this ratio is less than one it explains that fixed have been financed entirely by net worth and a portion of net worth was also used to finance current assets.

(ii) A high fixed assets to net worth ratio speaks of the stable financial position and weak long-term solvency of the firm because it indicates more reliance on debt capital in financing fixed assets

(iii) A low fixed assets to net worth ratio indicates unstable financial position and ratio of long-term debt because in this case net worth is used more in financing fixed assets

(iv) Generally, the fund of the owners should be sufficient not only to finance the fixed assets requirement but also to provide for a part of the current assets.f the entire owners' funds are utilized to acquire fixed assets, the firm will have no permanent funds for financing its working capital. So it is desirable for a firm to maintain this ratio at a level of less than A i.e. within the rant 50 to 60 percent.

II. REVENUE STATEMENT RATIOS

A.(a) Name of the Ratio: Gross Profit or Gross Margin Ratio

(b) Formula: = (Gross Profit x 100) / Net Profit

(c) Ideal Norm: Absent. Generally a gross profit ratio in the range of 25% to 30% is taken as acceptable norm)

(d) Purpose and Use:It is used to measure profitability and managerial efficiency. The relation between sales and gross earning is explained through this ratio. It shows the profit earned (as a percentage of sales) after matching direct expenses.

(e) Significance and Interpretation:

(i) A higher:- gross profit ratio indicates more profitability and managerial efficiency. If the gross profit is higher the gross profit ratio also becomes higher. A higher gross profit ratio is favourable for earning sufficient net profit after meeting indirect costs or incidental expenses.

(ii) A lower gross profit rat i reveals the weak profitability and managerial inefficiency, A firm with a very low gross profit ratio finds itself in an awkward financial condition.

(iii) A negative gross profit ratio indicates that direct costs are more than the turnover and the firm is not in a position to meet any indirect cost.

(iv) The gross profit ratio reveals the efficiency in the operating activities of the firm but in order to verify the profitability and efficiency in a comprehensive way instead of 'only direct costs all costs should be taken into considerable: For this reason for assessing the profitability and managerial efficiency of a firm along with the gross profit ratio the net profit ratio is also to be computed.

(v) it is always better to analyse and study the gross profit ratio as a time series. The gross profit ratio of a single year may not truly reveal the operating efficiency of the firm. But if it is studied as a time series, the analyst can come to know the increasing or decreasing trend of the sales. profit relationship and develop an idea of the efficiency level of the firm.

B.(a) Name of the Ratio: Net Profit or Net Margin Ratio

(b) Formula: (Net Profit x 100) / Net Sales)

(c) Ideal Norm: Absent

(d) Purpose and Use: It is used to measure the overall profitability and the efficiency of the management in generating additional revenue over and above the total operating costs. It does not make any difference between operating and non operating expenses and shows the relation between net profit and net sales.

(e) Significance and Interpretation:

(i) The net profit ratio shows the net contributions made by sales of rupee 1 to the owners' fund.

(ii) A higher net profit ratio indicates better overall profitability and managerial efficiency. It expresses how much the total revenue earned is more than the total expenses incurred.

(iii) A low net profit ratio reveals that the net earning is insufficient and the profitability and managerial efficiency are not up to the mark.

(iv) If a firm has a low net profit ratio in spite of having a high gross profit ratio, it seems that it has excessive indirect expenses on which it has not been able to enforce control.

C.(a) Name of the Ratio: Operating Ratio

(b) Formula: (Cost of Goods Sold + Operating Expenses) / Net Sales x 100

Cost of Goods Sold = (Sales — Gross Profit)

or

(Opening Stock + Purchase — Closing Stock)

Operating Expenses = Administrative Expenses + Financial Expenses and Selling Ex penses

(c) Ideal Norm: Absent (Generally the range of 70% to 80% is accepted as the standard ratio)

(d) Purpose and Use: It is used to analyse profitability and managerial efficiency. It explains the proportion of operating expenses in sales of rupee 1.

(e) Significance and Interpretation:

(i) A low operating ratio indicates that the firm has more surplus in its hand alter meeting operating costs. This surplus -an be used for payment of tax, payment of dividend, transfer to reserve, etc.

(ii) A low operating ratio is, therefore, an indicator of high profitability and good. efficiency.

(iii) A very high operating ratio reveals poor surplus available to the firm after meeting operating costs. It is not favourable to the concern because of a lower profitability and poor efficiency of controlling costs.

(iv) Operating ratio must be used with caution because if may be affected by many uncontrollable factors beyond the firm's control.

D. (a) Name of the Ratio: Expense Ratio or Specific Expense Ratio

(b) Formula: (Particular Expenses x 100) / Net Sales

Example:

(i) Factory Expenses Ratio = (Factory Expenses x 100) / Net Sales

(ii) Administrative Expenses Ratio = (Administrative Expenses x 100) / Net Sales

(iii) Selling Expenses Ratio = (Selling Expenses x 100) / Net Sales

(iv) Financial Expenses Ratio = (Financial Expenses x 100) / Net Sales

(c) Ideal Norm: Absent (varies from industry to industry)

(d) Purpose and Use: These ratios are used to evaluate profitability and managerial effi ciency. The relationship between any particular expense and net sales is expressed by expense ratio.

(e) Significance and Interpretation:

(i) From the expense or specific expense ratios it is possible for an analyst to understand in a better way the behaviour and variability of different expense items for a given change in the sales.

(ii) The lower be these ratios, the higher is the profitability and the better is the managerial efficiency.

(iii) The higher expense ratios are not favourable for the firm because they indicate lower profitability and poor expertise of controlling costs.

(iv) In case of any fixed expense a decrease in sales results in an increased expense ratio. But such increase in expense ratio does not reveal lower profitability and poor efficiency.

E. (a) Name of the Ratio: Material Consumed Ratio

(b) Formula: (Cost of Materials Consumed x 100) / Cost of Production

(c) Ideal Norm: Absent (varies from industry to industry)

(d) Purpose and Use: It is used to analyse the managerial ~kill in carrying out production and in increasing the profitability of the firm. It explains the proportion of material cost of the total cost of production.

(e) Significance and Interpretation:

(i) A higher material consumed ratio comparison to the standard acceptable in the industry indicates that a greater proportion of total cost is spent for material. It is the indicator of managerial inefficiency and a possible lower profitability.

(ii) If this ratio is lower than the industry standard it indicates that material cost as a part of total cost is lower and the wages and overhead cost are higher. From the viewpoint of managerial skill and profitability it. is always desirable not to have a very high material consumed ratio.

F. (a) Name of the Ratio: Manufacturing Expenses Ratio or Conversion Cost Ratio

(b) Formula: (Manufacturing Cost — Cost of Materials Consumed) x 100 / Net Sales

(c) Ideal Norm: Absent

(d) Purpose and Use: It is used to analyse the profitability and managerial efficiency. The relation between the cost of converting raw materials into finished goods and the net sales is explained by this ratio.

(e) Significance and Interpretation:

(i) If this ratio is high, it indicates excessive conversion Cost, low profitability and poor managerial efficiency.

(ii) If this ratio is low, it indicates comparatively lower cost of conversion of raw materials, higher profitability and better managerial expertise.

(iii) Conversion cost ratio reveals a more meaningful interpretation if studied along with other expense and profitability ratios.

G. (a) Name of the Ratio: Operating Profit Ratio

(b) Formula: (Operating Profit x 100) / Net Sales

Operating Profit = Net Sales — (Cost of goods sold + Office and administrative expenses + Selling and distribution expenses)

or

Net Profit + Non operating Expenses — Non-operating Income or

or

Gross Profit — Operating Expenses excluding cost of goods sold.

(c) Ideal Norm: Absent (It varies from firm to firm. Generally an operating profit in the range of 20% to 25%. is the acceptable standard in manufacturing firms.)

(d) Significance and Interpretation:

(i) A high operating profit ratio is the indicator of good profitability and efficient managerial ability.

(ii) A low operating profit ratio (less than the industry standard) shows an alarming situation of the firm because in such a case both the profitability and managerial ability of the firm are below the expected level.

(iii) A low operating profit ratio along with a high net profit ratio reveal more dependence of the firm on non-operating income. It is not a healthy sign of the firms' business policy.

(iv) If this ratio is used along with other profitability ratios it provides a more meaningful interpretation of a firm's profitability and managerial efficiency.

(v) It is relevant to mention in this context that the operating profit ratio and the operating ratio are complementary to each other. If a firm's operating ratio is 80% its operating profit ratio will be (100 — 80)% or 20%.

H. (a) Name of the Ratio: Interest Coverage Ratio

(b) Formula: (Net Profit before Interest and Tax or EBIT) / Fixed Interest charges

(c) Ideal Norm: Absent (depends on the norm followed in the industry)

(d) Purpose and Use: It is used for measuring long-term solvency and the effect of fixed interest charges on profit earned. It explains the relation between earning before interest and tax and the interest paid on debt capital. From the lenders' viewpoint it is used to measure the safety of return on investment.

(e) Significance and Interpretation:

(i) The earning before interest and tax and the operating profit are same. So the interest coverage ratio measures as to how many times the interest burden of the firm is covered by the operating profit of the firm.

(ii) A higher interest coverage ratio indicates better debt servicing capacity. It is beneficial from the viewpoints of both the firm and the lenders. From the viewpoint of the firm it is beneficial because it indicates more shock absorbing capacity in case of lower profit and the reduced risk of default in interest payment. From the lenders' viewpoint it is welcome because it indicates steady return on investment.

(iii) A low interest coverage ratio reveals that the lenders have a low safety of return on their investment, it is also unfavourable to the firm because in such case the firm's profitability in relation to its interest payment commitment is low and it is not in a position to take recourse to further debt financing in case of any need.

I. (a) Name of the Ratio: Debt Service Coverage Ratio

(b) Formula: (Profit after Tax + Interest + Depreciation) /(Interest +Instalment of Loan Due for Repayment)

(c) Ideal Norm: Absent

(d Purpose and Use:It is used to measure the safety of the lenders' money invested in the firm and return on the same. It explains the firms ability to serve the debt timely.

(e) Significance and Interpretation:

(i) A higher debt service ratio is favourable both to the firm and the lenders. From the firm's viewpoint it indicates the sound capacity to repay interest as well as installment due in time. It also shows that the firm has the ability to serve more debt. On the other hand from the lenders' viewpoint it indicates a high safety and minimum risk of getting interest and principal repayment.

(ii) A low debt service ratio indicates that the firm is not in a satisfactory position to repay the interest and principal to the lenders. It goes against the firm's goodwill and refrains it from taking further loan. A low debt service ratio is also not a welcoming feature to the lenders because it indicates more risk in getting interest and principal in time.

J. (a) Name of the Ratio: Preference Dividend Coverage Ratio

(b) Formula: (Net Profit after Interest and Tax or PAT) / Preference Dividend

[Note: As the preference dividend is payable only out of profit after tax, the preference dividend coverage ratio is based on PAT]

(c) Ideal Norm: Absent

(d) Purpose and Use: It is used to measure the effect of preference dividend paid on profit and to analyse the long-term financial stability of the firm. It explains how many times the preference dividend liability of the firm is covered by the net profit after tax.

(e) Significance and Interpretation:

(i) The higher the preference dividend coverage ratio the more is the scope of higher dividend for the equity shareholders because equity dividend is paid from the surplus profit remaining after paying preference dividend. If this ratio is high that also indicates more surety for the preference shareholders in getting dividend.

(ii) A low preference dividend coverage reveals that the preference shareholders' claim of dividend is not much secured. So it is against the interest of the preference shareholders. A low preference dividend coverage indicates a low return for equity shareholders too.

K. (a) Name of the Ratio: Equity Dividend Coverage Ratio

(b) Formula: (Net Profit after Interest, Tax and Preference Dividend) / Equity Dividend

(c) Ideal Norm: Absent

(d) Purpose and Use: It is used to measure the probability of paying equity dividend.

(e) Significance and Interpretation:

(i) The higher the equity dividend coverage ratio the more is the security of the equity shareholders to get dividend. It also indicates good financial stability of the firm because the firm is in a position to pay equity dividend after meeting all fixed burdens and tax liability.

(ii) A low equity- dividend coverage ratio is against the interest of the equity shareholders as it reduces the security of getting dividend by them. This situation does not indicate sound financial base of the firm.

L. (a) Name of the Ratio: Dividend Payout Ratio

(b) Formula: Dividend per Share / Earning per Share

or

Cash Equity Dividend Paid / Profit available for Equity Shareholders

(c) Ideal Norm: Absent

(d) Purpose and Use:It is used to assess the scope of dividend of the equity shareholders and the extent of self financing made by the company.

(e) Significance and Interpretation:

(i) A high dividend payout ratio indicates that the greater portion of profit available to the equity shareholders has been distributed while a smaller portion has been retained. The shareholders like to get more cash dividend, so a high dividend payout ratio is favourable to them.

(ii) A low dividend payout ratio reveals that the smaller portion of profit due to the equity shareholders has been paid in cash, while the greater portion has been retained. The shareholders, keen to get cash dividend, do not like this position.

(iii) From the viewpoint of the financial health of the company a high dividend payout ratio is never desirable because in such case retention of profit becomes less. A low dividend payout ratio that indicates less distribution and more retention is helpful for the sustained growth of the company.

M.(a) Name of the Ratio: Financial Leverage Ratio

(b) Formula : Profit before Interest and Tax (PBIT) / Profit before Tax (PBT)

(c) Ideal Norm: Absent

(d) Purpose and Use: It is used in the analysis of capital structure and financial risk in volved in the same. It explains how does the fixed interest bearing loan capital affect the operating profit of the firm. To be precise it tells about the extent of change in profit before tax (PBT) as a result of a change in profit before interest and tax (PBIT).

(e) Significance and Interpretation:

(i) The financial risk of a firm depends on the use of debt capital in its capital structure. Debt capital is less costly than equity capital. So its use increases the return of the equity shareholders. So long as the profit that can be earned by using debt capital is more than the cost of the debt (i.e. the interest payable thereon) the use of more debt capital proves to be beneficial to the equity shareholders. This technique of magnifying equity shareholders' earning by employing more debt capital is known as trading on equity. So a positive or favourable financial ratio is known as trading on equity. The use of debt capital increases profit and at the same time risk too. The extent of risk involved in the use of debt is measured by the financial leverage ratio.

(ii) There is no difference between the profit before interest and tax (PBIT) and the profit before tax (PBT) of a firm that does not employ debt capital. As such a firm does not have any financial risk no question of financial leverage arises in this case. Financial leverage ratio can only be computed for the firms having debt capital in their capital structure. As PBIT is always more than the PBT financial leverage ratio becomes more than 1.

(iii) If this ratio is marginally more than 1, that is nearer to 1, it indicates moderate use of debt capital, low financial risk and good financial judgement.

(iv) If this ratio is far more than 1 it indicates high debt burden, too much risk and aggressive financial policy.

[More discussion on Financial Leverage Ratio may be found in Chapter 12, Article No. 12.8]

N. (a) Name of the Ratio: Operating Leverage Ratio

(b) Formula: Contribution / Profit before Interest and Tax (PBIT) or Operating Profit

Contribution = (Sales — Variable Cost)

(c) Ideal Norm: Absent

(d) Purpose and Use: It is used to analyse the effect of fixed cost on the operating profit of the firm. It is used as an yardstick of measuring the operating risk of a firm.

(e) Significance and Interpretation:

(i) If in the total operating cost of a firm fixed cost is more than the variable cost the operating leverage ratio becomes high. A high operating leverage ratio indicates a higher rate of increase in profit as a result of an increase in sales. In a firm having a high operating leverage ratio a small decrease in sales results in a significant fall in profit. It means that in such a firm change in sales has a more sensitive and rapid effect on profit. It is no doubt a situation of high operating risk.

(ii) If the operating leverage ratio is too low, i.e. a situation where variable cost is far more than the fixed cost, change in sales does not have so sensitive and wide impact on the profit of the firm. it indicates a lower operating risk of the firm.

(iii) A moderate operating leverage ratio indicates neither too much fixed cost nor excessive current cost. It is a balanced risk position which is favourable to the firm both from the viewpoints of profitability and risk.

III. MIXED OR COMBINED RATIOS

A. (a) Name of the Ratio: Return on Capital Employed

(b) Formula : (Net Profit after Tax but before Interest x 100) / Net Capital Employed

Net Capital Employed = (Equity Share Capital + Preference Share Capital + Reserves and Surplus) — Fictitious Assets

or

Fixed Assets + Current Assets — Current Liabili ties

or

Fixed Assets + Net Working Capital

This ratio can also be calculated on Gross Capital Employed. In this case the formula will be:

(Net Profit after Tax but before Interest x 100) / Gross Capital Employed

Gross Capital Employed = (Equity Share Capital + Preference Share Capital + Reserves and Surplus + Long term Loan + Current Liabilities) — Fictitious Assets

or

Fixed Assets + Current Assets

(c) Ideal Norm: Absent (ideal norm depends on the industrial standard)

(d) Purpose and Use: It is used to analyse the profitability of the firm from the point of view of funds employed and to evaluate the efficiency of the management. This ratio explains the relationship between the operating profit i.e. net profit before interest and tax and the net or gross capital employed in the firm.

(e) Significance and Interpretation:

(i) This ratio is a real test of the profitability and managerial efficiency. The higher the return on capital employed the higher is the profitability and the sound is the managerial ability. From the viewpoint of shareholders and the management a high return on capital employed is always favourable.

(ii) A low return on capital employed in comparison to the industry standard reveals that the firm has not been able to earn a reasonable profit. It also explains that the managerial skill is not sound enough to increase the profitability. A low return on capital employed is against the interest of the shareholders and management.

(iii) If the cost of long-term borrowing is lower than the return on capital employed, return to shareholders would increase.

(iv) A high return on capital employed achieved for a few consecutive years indicates that the firm has a stable financial position and has good future prospect.

B. (a) Name of the Ratio: Return on Proprietors' Funds or Equity

(b) Formula: (Net Profit before Interest and Tax x 100) / Proprietors Funds or Equity

Note: [In fact it is nothing but Return on Net Capital Employed]

(c) Ideal Norm: Absent (depends on the standard followed in the industry)

(d) Purpose and Use: Similar as stated in Article No. HI.A.(d) above.

C. (a) Name of the Ratio: Return on Equity Shareholders' Equity-

(b) Formula: (Net Income after Interest and Tax x 100) / (Equity Share Capital + Reserves & Surplus - Fictitious Assets)

(c) Ideal Norm: Absent (depends on the standard followed in the industry)

(d) Purpose and Use: It is used to measure profitability from equity shareholders' view and the efficiency of management in the utilisation of equity capital employed in the business. This ratio explains the return available to the equity shareholders as a percentage of their claim to the firm.

(e) Significance and Interpretation: Similar as stated in ArticleIII.A.(e) above.

D. (a) Name of the Ratio: Return on Total Assets

(b) Formula: (Net Profit after Tax but before Interest x 100) / Total Assets

Note: [Net operating profit after tax but before interest is nothing but operating profit]

This ratio may also be calculated taking Net Profit after Tax and Interest as the numerator.

(c) Ideal Norm: Absent (the average standard followed in the industry is taken as accept able norm)

(d) Purpose and Use: It is used to measure the profitability of the firm in terms of assets employed in the firm. It is also an yardstick of measuring managerial efficiency in relation to the utilisation of assets.

(e) Significance and Interpretation:

(i) It is a measure to evaluate the performance and profitability of the firm. It relates the profits to the size of the firm which is measured in terms of the assets under the firm's possession.

(ii) A high return on total assets is an indicator of high profitability and a good overall efficiency. Reversely a low return on total assets indicates low profitability on assets employed and it speaks of poor managerial efficiency.

(iii) If the total assets of a firm increase without any corresponding increase in its operating profit, the return on total assets will come down. It reveals that the increase in investment has not resulted in the welfare of the owners.

E. (a) Name of the Ratio: Return on Investment (ROl)

(b) Formula: (Net Profit before Interest and Tax x 100) / Gross Long-term capital or Net Capital Employed

Gross Long-term Capital = Equity Capital + Net Preference Capital + Reserves + Debentures and other Long-term Debt.

Net Capital Employed = As stated in III.A.(b) above.

Note : [Return on Investment and Return on Capital Employed are almost same. Return on Capital Employed may be calculated on gross capital employed or net capital employed

whereas Return on Investment may be calculated on Gross Lon-.term Capital (excluding current assets) or on Net Capital Employed.]

(c) Ideal Norm: Absent (the average rate of return prevailing in the industry may be taken as the standard rate.)

(d) Purpose and Use: Same as stated in III.A.(d)

(e) Significance and Interpretation: Similar as stated in III.A.(e)

Note: [All the ratios discussed in Article Nos. III.A. to III.E are profitability ratios based on assets or investment. All these ratios may not he calculated for financial analysis at the same time because of their overlapping nature. The selection and use of these ratios depend on the discretion of the financial analyst.]

F. (a) Name of the Ratio: Stock or Inventory Turnover or Velocity

(b) Formula:

(i) If expressed in times = Cost of Goods Sold or Net Sales / Average Stock

(ii) If expressed in months = (Average Stock x 12) / Cost of Goods Sold or Net Sales

(iii) If expressed in number of days = (Average Stock x 365) / Cost of Goods Sold or Net Sales

Average Stock = (Opening Stock + Closing Stock) / 2

[If it is not possible to ascertain the Cost of Goods Sold, the net sales may be used for the computation of this ratio.]

(c) Ideal Standard: Absent (the average stock turnover followed in the industry may be taken as the ideal norm.)

(d) Purpose and Use: It is used in measuring the short term solvency and overall activity of the firm. The efficiency in inventory management can also be assessed on the basis of this ratio. It explains the relationship between the cost of goods sold and the average inventory.

(e) Significance and Interpretation:

(i) It shows the rapidity with which the inventory transforms into receivables through sales.

(ii) A high inventory turnover ratio implies low inventory level and quick conversion of inventory into sales. It is the sign of efficient inventory management.

(iii) A low inventory turnover ratio indicates maintenance of a high level of inventory and slow rotation of inventory in the operating cycle process. It is suggestive of poor inventory management.

(iv) A too low inventor': turnover (even much lower than the industry standard) implies holding of excessive inventory. Holding of unnecessary inventory indicates unproductive blocking of funds which increases cost and reduces profit.

(v) If the inventory turnover is too high it is an indication of holding a very low level of inventory. Holding of a very low level of inventory bears the risk of frequent shortage of stock which may adversely affect the production process.

(vi) It is always desirable for a firm to maintain a balanced level of inventory. So a firm must fix up an optimum inventory turnover level and try to maintain that.

[Important Point to Note : The Inventory Turnover Ratio may be used to find out the number of days of inventory holding as follows:

Number of days of Inventory Holding = 365 (No. of days in a year) / (Inventory Turnover Ratio)

G. (a) Name of the Ratio: Debtors or Receivables Turnover

(b) Formula:

(i) If expressed in times = Credit Sales / Average Debtors or Average Receivables

(ii) If expressed in months = (Average Debtors or Average Receivables x 12) / Credit Sales

(iii) If expressed in number of days=(Average Debtors or Average Receivables x 365) / Credit Sales

Average Debtors = (Opening Debtors + Closing Debtors) / 2

Average Receivables = (Opening Receivables + Closing Receivables)/ 2
Here, Receivables stand for the summation of Debtors and Bills Receivable.

(c) Ideal Standard:Absent (the average followed in the industry is taken as the ideal norm.)

(d) Purpose and Use: It is used to measure the short-term solvency and overall activity of the firm. It measures the debt collection period and reveals whether the debtors are slow paying or quick paying.

(e) Significance and Interpretation:

(i) A high debtors turnover in comparison to the industry standard indicates quick collection from debtors i.e. short credit period, quick recycling of working capital and efficiency in debt management.

(ii) A low debtors turnover reveals slow realisation from debtors i.e. long credit period, slow recycling of working capital and inefficiency in receivables management.

(iii) If the debtors turnover is expressed in months or days it reveals the average collection period. If the collection period is long, the quality of debtors is poor and the requirement of working capital is more. On the other hand if the collection period is near to the standard debtors are good-paying and the requirement of working capital seems to be reasonable.

(iv) A very high debtors turnover or a too short collection period, however does not indicate efficient receivables management. It is indicative of a restricted debt collection policy of the management. Such a policy may be helpful to reduce the chances of bad debt hut it also reduces the sales and profitability.

(iv) A very low creditors turnover or a too long credit payment period is also not good from the firm's viewpoint because in such case the tendency of credit purchase increases, scope of getting cash discount diminishes and the overall cost of production increases. (v) A very low debtors turnover or a too long collection period, in an opposite way, indicates a very liberal and inefficient receivables management. The very slow realisation of debts compels the firm to arrange for more working capital, to. bear more bad debt losses and to earn a lower profit.

H. (a) Name of the Ratio: Creditors or Payables Turnover

(b) Formula:

(i) If expressed in times = Credit Purchases / Average Creditors or Average Payables

(ii) If expressed in months = (Average Creditors or Average Payables x 12) / Credit Purchase

(iii) If expressed in number of days =(Average Creditors or Average Payables x365) /Credit Purchase

Average Creditors = (Opening Creditors + Closing Creditors)/2

I. (a) Name of the Ratio: Fixed Assets Turnover

(b) Formula: Cost of Goods Sold or Net Sales / Net Fixed Assets

Note: [If it is not possible to ascertain the cost of goods sold this ratio may be computed on the basis of net sales.)

(c) Ideal Norm: Absent (depends on the average ratio accepted in the industry)

(d) Purpose and Use: It. is used to measure the managerial efficiency with which the firm has utilised its investment in fixed assets and its overall activity. It indicates the generation of sales for per rupee invested in fixed asset.

(e) Significance and Interpretation:

(i) A high fixed assets turnover ratio is an indicator of efficient utilisation of fixed assets in generating sales. It reveals that use of less fixed assets made possible higher generation of sales.

(ii) A low fixed assets turnover ratio indicates inefficient managerial ability in utilisation of fixed assets because it reveals that use of more fixed assets resulted in lower generation of sales.

(iii) If the major portion of a firm's fixed assets have been depreciated its fixed assets turnover ratio may be more than another firm which has recently purchased huge fixed assets. In such case it cannot be said that the former's managerial efficiency is more than the latter. So a careful consideration is necessary for measuring efficiency by using the fixed assets turnover ratio.

(iv) The comparison of a firm's fixed assets turnover ratio with that of th~ past years and with the industry standard may be a helpful tool to evaluate the activity level.

J. (a) Name of the Ratio: Current Assets Turnover

(b) Formula: Cost of Goods Sold or Net Sales / Total Current Assets

Note: [If the cost of goods sold cannot be ascertained this ratio may be computed on the basis of net sales.]

(c) Ideal Norm: Absent (The average followed in the industry is taken as the acceptable standard.)

(d) Purpose and Use: It is used to measure the managerial efficiency and overall activity level of the firm. It explains the generation of sales for each rupee of investment in current assets.

(e) Significance and Interpretation:

(i) If this ratio is high it indicates an efficient utilisation of current assets in generating sales. It reveals that use of less fixed assets has generated more sales.

(ii) If this ratio is low it is indicative of inefficiency in working capital management. It reveals that use of more current assets resulted in lower generation of sales.

(iii) A too high or too low current assets turnover is not a welcoming feature of a firm's management. If this ratio is nearer to the average or standard followed in the industry it is considered as an indicator of an efficient activity level of the firm.

K. (a) Name of the Ratio: Working Capital Turnover It has been already discussed in detail in earlier study note .

L. (a) Name of the Ratio: Capital Turnover

(b) Formula: Cost of Goods Sold or Net Sales / Net Capital Employed

Note: [If the cost of goods sold cannot be ascertained the net sales may be accepted as the numerator.]

(c) Ideal Norm: Absent (varies from industry to industry)

(d) Purpose and Use: It is used to analyse the efficiency in use of capital and overall managerial efficiency. It explains the sales achieved for per rupee net capital employed.

(e) Significance and Interpretation:

(i) A high capital turnover indicates an efficient management of the capital employed in the firm. It reveals that lower employment of capital has resulted in higher achievement of sales. This situation is helpful for increased profitability. It is an indicator of future growth potentiality.

(ii) If this ratio is low it expresses the inefficient management of capital. In such a situation more use of capital results in a comparatively lower generation of sales. A continuously falling capital turnover ratio is an indicator of deteriorating business growth.

M (a) Name of the Ratio: Price Earning Ratio

(b) Formula: Market Price per Share / Earnings per Share

(c) Ideal Norm: Absent (depends on the industry standard)

(d) Purpose and Use: It is used to analyse the activity, managerial efficiency, profitability and return on owners' investment. It is also used to ascertain the true value of each equity share. It indicates investors' expectation about the firm's performance.

(e) Significance and Interpretation:

(i) A high price earning ratio indicates either a fall in earning per share or an increase in market price per share. A high price earning ratio resulting from increased market price per share is beneficial to the shareholders. It indicates high managerial efficiency, high profitability and good market reputation.

(ii) A low price earning ratio not caused by an increased earning indicates reduced market price per share. It also reveals a low level of managerial efficiency and profitability. It is against the interest of the shareholders.

(iii) If the low price earning ratio is caused by an increased earning per share it does not indicate an unfavourable situation for the shareholders.

N. (a) Name of the Ratio: Dividend Yield Ratio

(b) Formula: (Dividend per Share x 100) / Market Value per Share

(c) Ideal Norm: Absent (depends on the industry standard)

(d) Purpose and Use: It is used to measure profitability and to assess the extent of protection of equity shareholders' interest.

(e) Significance and Interpretation:

(i) It makes an analysis of the return on equity shares not on the basis of the face value of the shares but on their market value. So it reflects on the true rate of return available to the equity shareholders.

(ii) The higher the dividend yield ratio the more is the return for equity shareholders. It indicates the high rate of profit earned by the company.

(iii) If this ratio is low it indicates a low return on equity share capital and a low profitability.

(iv) If the market price of the equity shares is too high the dividend yield ratio may be considerably low. In such case, of course, the return of the equity shareholders may not be too low. So a low dividend yield ratio in a situation of very high market price of equity share is not against the interest of the equity shareholders.

O. (a) Name of the Ratio: Earning Yield Ratio

(b) Formula: Earning per Share / Market Price per Share

(c) Ideal Norm: Absent (depends on the industry standard)

(d) Purpose and Use: Same as stated in III.M.(d) above.

(e) Significance and Interpretation: Same as stated in III.M.(e) above.

A Comprehensive Guideline for Calculating Different Accounting Ratios			
Name of Ratio	Formula	Unit of Expression	Ideal Standard (in Indian Prespective)
BALANCE SHEET RATIO			
1. Current Ratio	Current Assets / Current Liabilities	Times	2: 1
2.Acid Test / Quick Ratio	Current Assets — (Stock & Stores and Prepaid Expenses) / Current Liabilities - Bank O / D	Times	1:1
3. Absolute Liquidity Ratio	(Cash + Marketable Securities) / Quick Liabilities	Times	5:1
4.Stock to Working Ratio	(Closing Stock x 100) / Working Capital	%	75 to l00%
5.Net Working Capital Ratio	Net Working Capital / Net Assets	Times	—-
6.(a) Proprietary / Net Worth Ratio	Proprietors' or Shareholders' Fund / Total Assets Less Fictitious Assets [Proprietors' or Shareholders' Funds = Equity Share Capital + Preference ShareCapital +Reserves & Surplus - FictitiousAssets]	Times	1:3
(b) Fixed Assets to Proprietorship / Net Worth Ratio Ratio	Fixed Assets / Proprietors' Fund or Net Worth [Proprietors' Fund=Net Worth]	Times	—-
7(a) Debt-Equity Ratio	(a) External Equities / Internal Equities (b)Outsiders' Funds / Proprietors' Funds	Times	—-

Name of Ratio	Formula	Unit of Expression	Ideal Standard (in Indian Prespective)
(b) Net Worth Debt Ratio	Net Worth / Debt	Times	—-
8(a) Capital Gearing Ratio	(Equity Capital + Reserves & Surplus) / (Preference Share Cap. + Total Long-term Debts) (fixed interest bearing)	Times	—-
9. Fixed Assets to Current Assets Ratio	Fixed Assets / Current Assets	Times	—-
10. Fixed Assets to Net WorthRatio	Net Fixed Assets (after depreciation) / Net Worth	Times	—-
11 Debt Ratio	Total Liabilities / Total Assets	Times	—-
12. Equity Capital Ratio	(Equity Capital+Reserves & Surplus- Fictitious Assets) / (Net Worth+ Debentures)	Times	—-
13. Preference Capital Ratio	Preference Share Capital / (Net Worth+ Debentures)	Times	—-
14.Debenture Capital Ratio	Debentures / (Net Worth+ Debentures)	Times	—-
15.Solvency Ratio	Total Liabilities / Total Assets	Times	—-
16. Fixed Assets Ratio	Net Fixede Assets / (Total Long-term Funds)	Times	—-
REVENUE STATEMENT RATIOS			
1.Gross Profit / Gross Margin / Profit Margin Ratio	(Gross Profit X 100) / Net Sales	%	25%-30%
2. Net Profit / Gross Margin Ratio	(Net Profit X 100) / Net Sales	%	—

Name of Ratio	Formula	Unit of Expression	Ideal Standard (in Indian Prespective)
3. Operating Ratio	(Cost of Goods Sold+ Operating Expenses) X 100 / Net Sales	%	75%-80%
4. Expense Ratio	(Particular Expense X 100) / Net Sales	%	—
5. Material Consumed Ratio	(Material Consumed X 100) / Cost of Production	%	—
6. Manufacturing ExpenseRatio or Conversion Cost Ratio	(Manufacturing Cost X 100) / Net Sales	%	—
7. Tax Provision Ratio	(Provsion for Tax X 100) / Net Profit	%	—
8.Interest Coverage Ratio	Earnings before Interest & Tax (EBIT) / Fixed Interest Charges	Times	—
9. Preference Dividend Coverage Ratio	Net Profit after Tax and Interest / Preference Dividend	Times	—
10. Equity Shareholders' Coverage Ratio	(Net Profit after Interest Tax and Preference Dividend) / Equity Dividend	Times	—
11. Dividend Payout Ratio	Dividend per Share / Earning per share	Times	—
12. Operating Profit Ratio	(Operating Profit X 100) / Net Sales	%	—
COMPOSITE OR MIXED RATIOS			
1. Return on Capital	(Net Operating Profit after Tax but before Interest X 100) / Net Capital Employed	%	—

Name of Ratio	Formula	Unit of Expression	Ideal Standard (in Indian Prespective)
2.Return on Proprietor'Fund	(Net Operating Profit after Tax and Interest X 100) / Proprietors' Funds	%	—
3.Return on Equity Shareholders' Equity	(Net Income after Tax- Preference Dividend X 100) / (Equity Share Capital+ Reserves-Fictitious Assets)	%	—
4. Return on Total Assets	(Net Operating Profit after Tax but before Interest X 100) / Total Assets	%	—
5. Return on Investment	(Net Profit before Tax and Interest) x 100 / Total Long-term Fund Employed	%	—
6.Fixed Assets Turnover Ratio	Sales or Cost of Goods Sold / Net Fixed Assets	Times	—
7.Current Assets Turnover Ratio	Sales or Cost of Goods Sold / Current Assets	Times	—
8.Working Capital Turnover Ratio	Sales or Cost of Goods Sold / Net Working Capital	Times	—
9.Capital Turnover Ratio	Sales or Cost of Goods Sold / Net Capital Employed	Times	—
10.Proprietors' FundTurnover Ratio	Sales or Cost of Goods Sold / Proprietors' or Shareholders' Fund	Times	—
11. Dividend Yield Ratio	(Dividend per Share X 100) / Market Price per Share	%	—
12. Price Earning Ratio	Market Price per Share / Earning per Share	Times	—
13. Earning per Equity Share	(Net Profit after Interest, Tax and preference dividend) / No. of Equity Sares	Rs	—
14. Earning Yield Ratio	(Earning per Share X100) / Market Price per Share	%	—

Name of Ratio	Formula	Unit of Expression	Ideal Standard (in Indian Prespective)
LEVERAGE RATIOS			
1. Financial Leverage	Earning before Interest & Tax (EBIT) / Earning before Interest and Tax- Interest and Preference Dividend	Times	—
2. Operating Leverage	Contribution / Earning before Interest & Tax (EBIT)	Times	—
3. Combined Leverage	Contribution / Earning before Tax	Times	—

<u>Illustration.</u>

Debtors' velocity = 3 months

Creditors' velocity = 3 months

Stock velocity = 2 months

Fixed Assets—Turnover Ratio = 2.5 times

Capital—Turnover Ratio = 1.5 times

Gross Profit Margin = 25%

Gross Profit for the year amounts to Rs. 1,15,000. Reserve and Surplus amounts to Rs. 40,000. Liquid Assets are Rs. 1,10,000. Closing Stock of the year is Rs. 15,000 more than the Opening Stock. Bills Receivable and Bills Payable at the end of the year amount to Rs. 10,000 and Rs. 8,000 respectively. There is no long-term loan or bank overdraft.

From the above information you are required to find out: (a) Sales, (b) Purchase, (c) Sundry Creditors, (d) Sundry Debtors, (e) Closing Stock, (1) Fixed Assets, (g) Share Capital and (h) Bank Balance.

<u>Solution</u>

(a) Sales:

Gross Profit / Turnover = 25%,
1,15,000 / Turnover = 25 / 100
or 25 Turnover = 1,15,000 X 100, or Turnover = (1,15,000 x 100) / 25 = Rs. 4,60,000

(b) Purchase:

Purchase Cost of Goods Sold + Closing stock — Opening Stock

or Purchase (Sales — Gross Profit) + Opening Stock + 15,000 — Opening Stock

or Purchase = (4,60,000 — 1,15,000) + 15,000

or Purchase = 3,45,000 + 15,000, or Purchase = Rs. 3,60,000

(c) Sundry Creditors:

Creditors' Velocity = Average Payables x 12 / Sundry Creditors:

= Average Payables x 12 / 3,60,000 = 3

or Average Payables = 30,000 X 3 = Rs. 90,000

[It is assumed that all purchases are on credit basis and average payables are equal to closing payables.]

Closing Payables = Closing Sundry Creditors + Closing Bills Payable

or Closing Sundry Creditors = Closing Payables — Closing Bills Payable

or Closing Sundry Creditors = 90,000 — 8,000 = Rs. 82,000

(d) Sundry Debtors:

Debtors Velocity = $\frac{\text{Average Receivables}}{\text{Credit Sales}}$ x12, or 3 = $\frac{\text{Average Receivables}}{4,60,000}$ x 12

Or Average Receivables = (3 x 4,60,000) / 12 = Rs. 1,15,000

[It is assumed that all sales are on credit basis and average receivables are equal to closing receivables.]

Closing Stock Receivables = Closing Sundry Debtors + Bills Receivables

Or Closing Sundry Debtors = Closing Receivables – Bills Receivables

Or Closing Sundry Debtors = Rs. (1,15,000 – 10,000)= Rs. 1,05,000

(e) Closing Stock

Stock Velocity = (Average Stock X 12) / Cost of Goods Sold

Or 2 = Average Stock x 12 / Sales – Gross Profit

2 = Average Stock x 12 / 460000-115000

or 12 Average Stock = 345000 x 2

or Average Stock = $\frac{345000}{12}$ x 2 = Rs. 57500

Average Stock = $\frac{\text{Op. Stock + Cl. Stock}}{2}$

Or 57,500 = $\frac{\text{Op. Stock + (Op. Stock + 15000)}}{2}$

or 2 Op. Stock + 15,000 = 57,500 X 2, or 2 Op. stock = 1,15,000 — 15,000

or Opening Stock = $\frac{1,00,000}{2}$ = Rs. 50,000

Closing Stock = Rs. (50,000 + 15,000) = Rs. 65,000

(f) Fixed Assets:

Fixed Asset = Cost of Goods Sold / Fixed Assets or Sales – Gross Profit / Fixed Assets Turnover Ratio

or 2.5 Fixed Assets = 4,60,000 — 1,15,000, or Fixed Assets = 345000 / 2.5 = Rs. 138000

(g) Proprietary Fund:

Capital Turnover Ratio = Cost of Goods Sold / Capital Employed

or 1.5 = 3,45,000 / Capital Employed

or Capital Employed = (Rs. 3,45,000 / 1.5)= Rs. 2,30,000

Proprietary Fund is also Rs. 2,30,000 as there is no outside loan.

So Share Capital = Proprietary Fund — Reserves and Surplus

= Rs. (2.30,000 — 40,000) = Rs. 190,000

(h) Bank:

(Share Capital + Reserves and Surplus + Sundry Creditors + Bills Payable) —Fixed Assets + Stock + Debtors + Bills Receivable)

= Rs. (1,90,000 + 40,000+ 82,000 + 8,000) — Rs. (1,38,000 + 65,000 + 1,05,000 + 10,000)

Rs. 3,20,000 — Rs. 3,18,000 = Rs. 2,000

<u>Illustration</u>

Sales / Net Worth	5 times	Sales to Inventory	16 times
Annual Sales	Rs. 25,00,000	Debtor Velocity	10 times
Net worth / Current Liability	4 times	Reserve & Surplus	Rs.1,25,000
Total debts Proprietorship Ratio	60%	Fictitious Assets	Rs.25,000
Fixed Assets to Net worth	80%	80% of Sales were on credit	
Current Ratio	3 : 1		

Solution

Working Notes :

(a) Sales :

Sales / Net Worth =5

25,00,000 / Net Worth = 5

Or 5 Net Worth = 25,00,000 or Net Worth = $\frac{25,00,000}{5}$ = Rs. 5,00,000

(b) Current Liabilities

Net Woth / Current Liab.=4
or 5,00,000 / Current Liab. =4

Or 4 Current Liab = 5,00,000, or Current Liab = 5,00,000 / 4= Rs. 1,25,000

(c) Long term Debts or Liability :

Total debts / Proprietorship = 60 / 100 Proprietorship = Net Worth
So Total Debts / 5,00,000 = 60 / 100 or 100 x Total Debt = 60 x 5,00,000

or Total Debts = 60 x 5,00,000 / 100 = Rs. 3,00,000

Long-term Debts = Total Debts — Current Liabilities

= Rs. (3,00,000 — 1,25,000) = Rs. l,75,000

(d) Fixed Assets:

Fixed Assets / Net Worth = 80 / 100

Fixed Assets / 5,00,000 = 80 / 100

or 100 Fixed Assets = 80 x 5,00,000

or Fixed Assets =80 x 5,00,000 / 100 = Rs. 4,00,000

(e) Current Assets:

Current Assets / Current Liab. = 3

Current Assets = 1,25,000 x 3

Inventories or Current Assets = Rs. 3,75,000

(f) Inventory or Stock:

Sales / Average Inventory = 16,

or 16 Average Inventory= 25,00,000,

or Average Inventory = 2500000 / 16 = Rs. 1,56,250

[As it is not possible to find out cost of goods sold, in calculation of stock, sales figure has been taken. In absence of any information on opening or closing stock average inventory is assumed as closing inventory.]

Liabilities	Rs.	Assets	Rs.
Share Capital [W Note (i)]	3,75,000	Fixed Assets [W. Note]	4,00,000
Reserve and Surplus	1,25,000	Current Assets	
Long-term Liabilities [W'. Note (c)]	1,75,000	Stock (W. Note)	1,56,250
Current. Liabilities [W Note (1,))	1,25,000	Bank / Cash	2,00,000
		Miscellaneous Expenditure	18,750
		Fictitious Assets	25,000
	8,000,00		8,00,000

Illustration. . With the help of the following information, complete the Balance Sheet of *XYZ* Ltd.:

Equity	Rs. 100,000
The relevant ratios of the firm are as follows:	
Current debt to total debt	.40
Total debt to owners' equity	.60
Fixed assets to owners' equity	.60
Total assets turnover	2 times
Inventory turnover	8 times

Solution

Working Notes:

(a) Total Debt:

Total Debt to Owners' Equity =Total Debt / Owners Equity

.60 = Total Debt / 1,00,000

or Total Debt = 1,00,000 x .60 = Rs. 60,000

(b) Current Debt:

Current Debt to Total Debt = Current Debt / Total Debt

.40 = Current Debt / 60,000

or Current Debt = 60,000 x .40) = Rs. 24,000

(c) Long-term Debt

Long-term Debt = Total Debt — Current Debt

or Long-term Debt = Rs.60,000 —Rs. 24,000 = Rs. 36,000

(d) Fixed Assets

Fixed Assets to Owners' Equity = Fixed Assets / Owners' Equity' or .60 = Rs.1,00,000

or Fixed Assets = .60 x 1,00,000 = Rs, 60,000

(e) Total Assets :

Total Assets Equity + Long term Debt + Current Debt

or Total Assets = 1,00,000 + 36,000 + 24,000 = Rs. 1,60,000

(f) Turnover or Sales

Total Assets Turnover = Sales or Turnover / Total Assets

or 2 = Sales / 1,60,000

or Sales 1,60,000 x 2 = Rs, 3,20.000

[As it is not possible to ascertain the cost of goods of' sold it is assumed that total assets turnover and inventory turnover were calculated on the basis of sales instead of cost of goods sold.]

(g) Inventory or Stock:

Inventory Turnover = Sales / Average Inventory
8 = 3,20,000 / Average Inventory

or 8 Average Inventory = 3,20,000,

or Average Inventory =3,20,000 / 8 = Rs. 40,000

[It is assumed that average inventory is equal to closing inventory]

(h) Liquid Assets:

Liquid Assets = Total Assets — (Fixed Assets + Inventory)

or Liquid Assets = 1,60,000 — (60,000 + 40,000) = 1,60,000 — 1,00,000 = Rs. 60,000

Liabilities	Rs.	Assets	Rs.
Equity	1,00,000	Fixed Assets	60,000
Long term debt	36,000	Current Assets	
Current debt	24,000	Inventory	40,000
		Liquid assets	60,000
	1,60,000		1,60,000

EXERCISE

1. State importance of Ratio Accounting
2. How Investor will be benefited by Ratio Accounting?

Prob. 1.

From the following financial statements of Samrat Co. Ltd, for the year ended 30 June, 2000 calculate the following ratios:

(a) Current Ratio, (b) Liquid or Quick Ratio, (c) Absolute Liquidity Ratio, (d) Operating Ratio, (e) Stock Turnover Ratio, (f) Working Capital Turnover Ratio, (g) Turnover to Fixed Assets Ratio, (h) Return on Proprietors' Fund, (i) Return on Total Resolures, (j) Re turn on Capital Employed, (k) Debtors' Velocity (in days), (l) AverageCollection Period (in days), (m) Creditors' Velocity (in days), (n) Average Debt Payment period (in days).

Dr. Profit & Loss A/c for the year ended on 30 June, 2000 Cr.

	Rs.		Rs.
To Op. Stock	200000	By Sales	3600000
To Purchases (credit)	2000000	By Closing Stock	400000
To Gross profit c/d	1800000		
	4000000		4000000
To Office & Administration Exp.	600000	By Gross Profit b/d.	1800000
To Selling & Distribution Expenses	300000	By Profit on Sale of Assets	60000
To Other Financial Expenses	100000		
To Net Profit	860000		
	1860000		1860000

Balance Sheet as at 30 June, 2000

Liabilities	Rs.	Assets	Rs.
110000 Equity Shares of Rs. 10 each	1100000	Land & Buildings	900000
		Plant & Machinery	500000
General Reserve	250000	Stock	400000
Profit & Loss A/c	350000	Sundry Debtors	380000
Sundry Creditor	560000	Bills Receivable	20000
Bills Payable	40000	Cash & Bank	200000
Bank Overdraft	200000	Misc. Expenses	100000
	2500000		2500000

Prob 2.

Citra Ltd. presents the following financial statements :

Profit & Loss statement for the year ended on 31 December, 199

Particulars	Rs.	Rs.	Rs.
Net Sales			350000
Cost of Goods Sold :			
Stock of Finished Goods (1.1.99)		40000	
Add: Cost of Goods Produced :			
Stock of Raw Material (1.1.99)	20000		
Material Purchased	105000		
	125000		
Less: Stock of Raw Material (31.12.99)	25000		
Raw Materials Consumed	100000		
Direct Wages	90000		
Factory Overhead	70000		
		260000	
		300000	
Less: Stock of Finished Goods (31.12.99)		50000	
Cost of Goods Sold		250000	
Gross Profit Margin		100000	
Less: Administration and Selling Overhead		28000	
Net Operating Profit		72000	
Less : Interest Charges		6000	
		66000	
Less : Income Tax		28000	
Net Earnings		38000	

Balance Sheet as at 31 December, 1999

Liabilities	Rs.	Assets	Rs.
Equity Share Capital of Rs. 10 each	250000	Plant 390000	
Share Premium	10000	Less: Depreciation 150000	
			240000
Retained Earnings	45000	Stock of Raw Materials	25000
10% Debentures	60000	Stock of Finished Goods	50000
Accounts Payables (last year Rs.		Accounts Receivables (last	
80000) (inclusive of Creditors and		year Rs. 95000)	
(inclusive of Bills Payable)	45000	Debtors and Bills	
		Receivable	75000
Tax Payable	15000	Cash and Bank	20000
		Prepaid Expenses	10000
		Preliminary Expenses	5000
	425000		425000

You have been asked by the board of directors of the company to compute the following : (a)Current Ratio,(b) Quick Ratio, (c) Stock to Working Capital Ratio, (d) Debt Equity Ratio, (e) Net Worth Ratio, (f) Net Margin Ratio, (g) Operating Ratio, (h) Selling and Administration Expense Ratio, (i) Material Consumed Ratio, (j) Convension Cost Ratio, (k) Interest Coverage Ratio, (l) Return on Net Employed, (m) Return on Total Assets, (n) Stock Turnover Ratio, (o) Receivables Turnover Ratio, (p) Payables Turnover Ratio, (q) Fixed Assets Turnover Ratio, (r) Earnings per Share.

Prob. 3.

From the following Profit & Loss Account and Balance Sheet of Nancy Ltd. Calculate (a) Return pm Gross Capital Employed, (b) Return on Net Capital Employed, (c) Earning per Equity Share, (d) Price Earning Ratio, (e) Average Debt Collection Period (in days), (f) Average Payment period (in days).

Profit & Loss statement for the year ended on 30 September, 1999

	Rs.		Rs.
To Opening Stock	90000	By Sales (10% cash)	780000
To Purchases (80% Credit)	510000	By Closing Stock	120000
To Wages	42000		
To Gross Profit c/d	258000		
	900000		900000
To Office and Administration Exp.	90000	By Gross Profit b/d	258000
To Selling and Distribution Exp.	10000	By Profit on Sale of Furniture	6000
To Interest on Debentures	6000	By Interest on Govt. Bonds	10000
To Interest on Bank Overdraft	4000		
To Depreciation	9000		
To Loss on Sale of Asset	5000		
To Provision for Taxation	60000		
To Net Profit	90000		
	274000		274000

Balance Sheet as at 30 September, 1999

Liabilities	Rs.	Assets	Rs.
Equity Share Capital of Rs. 10 each	600000	Land and Building	200000
15% Preference Share Capital	100000	Plant and Machinery	350000
General Reserve	50000	Furniture	40000
Share Premium	10000	Investment in Govt. Bond	50000
Profit & Loss A/c	20000	Stock	200000
12% Debentures	50000	Stock of Finished Goods	50000
Sundry Creditors (last year Rs.120000)	140000	Debtors (last year Rs.140000)	100000
Bank Draft	30000	Preliminary Expenses	10000
	1000000		1000000

Market price of each equity share of the company on 30 September, 1999 was Rs. 24.

Prob. 4.

Following is the Balance Sheet of Sun Ltd.

Balance Sheet as at 30 June, 2000

Liabilities	Rs.	Assets	Rs.
Equity Share Capital	50000	Land and Building	100000
10% Preference Share	50000	Plant and Machinery	60000
8% Debentures	20000	Furniture	15000
General Reserve	75000	Stock	25000
Profit & Loss A/c	10000	Debtors	30000
12% Public Debt	10000	Bills Receivable	15000
Creditors	30000	Cash in hand	1000
Outstanding Liabilities	3500	Cash at Bank	5000
Bank Draft	20000	Preliminary Expenses	20000
Provision for Taxation	10000	Underwriting Commission	
			12500
Proposed Dividend	5000		
	283500		283500

During the year provision for taxation was Rs. 10000. Dividend was proposed at Rs. 5000. Profit and Loss Account balance carried forward from the last year Rs. 7500.

On 1.7.1999 the company had : Stock Rs. 30000, Debtors Rs. 40000, Creditor Rs. 50000, Bills Receivable Rs. 25000. Sales and purchases during the year were Rs. 450000 and R s. 340000 respectively. 90% of sales and 80% of purchases were on credit. The company's rate of gross profit is 8%.

You are required to compute (a) Short-term Solvency Ratios (b) Ling-term Solvency Ratios.

Prob. 5.

The following information is given about a limited Company :

Profit after tax (50%) Rs.1200000.

Market price of equity share Rs. 60.

Depreciation Rs.160000.

Equity Capital of Rs. 10 Shares Rs. 1600000

12% Preference Shares Capital Rs. 800000

Equity dividend paid at 20%

You are required to calculate : (a) Dividend Yield on Equity Shares, (b) Cover for Preference and Equity Dividend , (c) Earning per Share, (d) Price Earning Ratio.

Prob. 6.

Concept India Ltd. Supplies the following information relating to the financial year ended on 30 June, 2000 and requests you to find out: (a) Sales, (b) Purchases, (c) Sundry Creditors, (d) Sundry Debtors and (e) Closing Stock.

Stock Velocity : 4 months

Payables' Velocity : 3 months

Receivables Velocity : 2 months

Gross Profit Ratio : 20%

Gross Profit for the year was Rs 560000. Closing Stock of the year was Rs. 16000 higher than the Opening Stock. Bills receivable and Bills Payable amounted to Rs. 40000 and Rs. 23000 on the closing date of the financial year. 25% of Purchases and 10% of Sales were on cash basis.

Prob. 7.

From the following information relating to Moon Ltd. Prepare a Balance Sheet as on 31.12.99.

(i)	Current Ratio	2.5
(ii)	Liquid Ratio	1.5
(iii)	Net Working Capital	Rs. 300000
(iv)	Cost of Sales / Closing Stock	8 times
(v)	G.P. Ratio	25%
(vi)	Average Debt Collection Period	1.5 months
(vii)	Reserves & Surplus / Share Capital	0.50
(viii)	Fixed Assets / Shareholders' Net Worth	0.75

Prob. 8.

With the help of the following ratios and further information given below, prepare the Trading Account, Profit and Loss Account of Siddharth Ltd. for the year ended on 30 September, 1999 and a Balance Sheet of the company as on that date :

Gross Profit	25%	Current Ratio	2.5
Net Profit	15%	Total Debt / Equity	0.44

Debtors Turnover	12	Salaries as % of Sales	5%
Inventory Turnover	6	Inventory (Average)	Rs. 600000
Fixed Assets to Net Worth	0.8	Fixed Assets	Rs. 1600000
Capital to Reserve	3	Fixed Assets to Current Assets	1.25

Opening inventory was Rs. 50000 less than the Closing inventory.

Prob. 9.

You have been asked by the management of a company to project a Trading and Profit and Loss Account and the Balance Sheet on the basis of the following estimated figures and ratios, for the next financial year ending on 31 March, 2000.

Ratio of Gross Profit	20%
Stock Turnover Ratio	5 times
Average Debt Collection Period	3 months
Creditors' Velocity	3 months
Current Ratio	2
Proprietory Ratio (Fixed Assets to Capital Employed)	75%
Capital Gearing Ratio	30%
(Preference Shares and Debentures to Equity Shareholders' Fund)	
Net Profit to Issued Equity Capital	10%
General Reserve and Profit and Loss to Issued Equity Capital	25%
Preference Share Capital to Debentures	2
Cost of Sales consists of 50% for materials	
Gross Profit	Rs. 625000

Prob. 10.

You have given the following figures worked out from the Profit and Loss Account and the Balance Sheet of Zed Ltd. relating to the year 1999. Prepare the Profit and Loss Account and Balance Sheet of the company.

Fixed Assets (after writing off 30%)	Rs. 1050000
Fixed Assets Turnover Ratio	2
Finished Goods Turnover Ratio	6
Rate of Gross Profit to Sales	25%

Operating Net Profit (before interest) to Sales	8%
Fixed Charges Cover (Debenture interest 7 %)	8
Debt Collection Period	$1^{1/2}$ months
Materials Consumed to Sales	30%
Wages and Other Direct Expenses to Sales	45%
Stock of Raw Materials (in terms of number of months' consumption)	3
Current Ratio	2.4
Quick Ratio	1.0
Profit & Loss A/c Balance to Capital	0.21
Profit & Loss A/c Balance on 1.1.1999	Rs. 16000
Non-operating Income (dividend)	Rs. 8000
Non-operating Expenses (Loss on sale of Plant)	Rs. 10000

No Provision was made for tax.

Prob. 11.

You are given the following figures worked out from the Profit and Loss Account and Balance Sheet of *Zed* Ltd. relating to the year 1999. prepare the Profit and Loss Account and Balance Sheet of the company.

Fixed Assets (after writing off *30%)*	Rs.10.50,000
Fixed Assets Turnover Ratio	2
Finished Goods Turnover Ratio	*6*
Rate of Gross Profit to Sales	25%
Operating Net Profit (before interest) to Sales	SO
Fixed Charges Cover (Debenture interest 7%)	8
Debt Collection Period	1 ½ months
Material Consumed to Sales :	30%