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Accounting

Board of Studies
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)

PAPER 1

ACCOUNTING

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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PREFACE

The paper of Accounting concentrates on conceptual understanding of the crucial aspects of accounting and reporting of financial statements. Students are expected to acquire working knowledge in this paper. The importance of this subject is growing over the years due to various factors like liberalization, cross-border flow of capital, emergence of global corporations and movement towards better corporate governance practices. New Accounting Standards have been formulated keeping in mind this growing importance of Accounting in the corporate scenario. Accordingly, developing better understanding of the relevant accounting standards should be given proper emphasis while preparing for the examination.

The book is divided into fifteen chapters, each addressing to a special aspect of accounting. Chapter 1 deals with Accounting Standards. This chapter is divided into two units; first unit is based on the general knowledge of the national and international accounting standards and their issuing authorities whereas the second unit propagates the working knowledge of those accounting standards which are the part of course. Chapter 2 covers financial statements of companies and chapters 3 and 4 deal with profit and loss prior to incorporation and accounting for bonus issue. Chapters 5 and 6 lay emphasis on simple problems on amalgamation and reconstruction of companies. Chapters 7 and 8 cover average due date, account current and self balancing ledgers. Chapters 9 and 10 deal with preparation of financial statements of not-for-profit organizations and accounting from incomplete records whereas Chapter 11 to 13 are devoted to accounting for special transactions i.e. hire purchase and instalment sale, investment accounts and insurance claims for loss of stock and loss of profit. Chapter 14 discusses accounting of partnership firms and Chapter 15 explains basic concepts of accounting in computerized environment.

Learning objectives have been incorporated at the beginning of each chapter/unit to guide the students about the knowledge they should acquire after studying the chapters. Care has been taken to present the chapters in a logical sequence to facilitate easy understanding by the students. Small illustrations have been incorporated in each chapter/unit to explain the concepts/principles dealt with in the chapter/unit. Another helpful feature is the addition of self-examination questions which will help the students in preparing for the Examination.

SYLLABUS

PAPER 1: ACCOUNTING

(One paper – Three hours – 100 Marks)

Level of Knowledge : Working Knowledge

Objectives :

(a) To lay a foundation for the preparation and presentation of financial statements,

(b) To gain working knowledge of the principles and procedures of accounting and their application to different practical situations,

(c) To gain the ability to solve simple problems and cases relating to sole proprietorship, partnership and companies and

(d) To familiarize students with the fundamentals of computerized system of accounting.

Contents :

1. **A General Knowledge of the framing of the accounting standards, national and international accounting authorities, adoption of international financial reporting standards**

2. **Accounting Standards**

Working knowledge of:

AS	1	:	Disclosure of Accounting Policies
AS	2	:	Valuation of Inventories
AS	3	:	Cash Flow Statements
AS	6	:	Depreciation Accounting
AS	7	:	Construction Contracts (Revised 2002)
AS	9	:	Revenue Recognition
AS	10	:	Accounting for Fixed Assets
AS	13	:	Accounting for Investments
AS	14	:	Accounting for Amalgamations

3. **Company Accounts**

   (a) Preparation of financial statements – Profit and Loss Account, Balance Sheet and Cash Flow Statement

   (b) Profit (Loss) prior to incorporation

   (c) Alteration of share capital, Conversion of fully paid shares into stock and stock into shares, Accounting for bonus issue

   (d) Simple problems on Accounting for business acquisition, Amalgamation and reconstruction (excluding problems of amalgamation on inter-company holding)

4. **Average Due Date, Account Current, Self-Balancing Ledgers**

5. **Financial Statements of Not-for-Profit Organisations**

6. **Accounts from Incomplete Records**

7. **Accounting for Special Transactions**

   (a) Hire purchase and instalment sale transactions

   (b) Investment accounts

   (c) Insurance claims for loss of stock and loss of profit.

9. **Issues in Partnership Accounts**

   Final accounts of partnership firms – Admission, retirement and death of a partner including treatment of goodwill.

10. **Accounting in Computerised Environment**

   An overview of computerized accounting system–Salient features and significance, Concept of grouping of accounts, Codification of accounts, Maintaining the hierarchy of ledger, Accounting packages and consideration for their selection, Generating Accounting Reports.

Note : If either old Accounting Standards (ASs), Announcements and Limited Revisions to ASs are withdrawn or new ASs, Announcements and Limited Revisions to ASs are issued by the Institute of Chartered Accountants of India in place of existing ASs, Announcements and Limited Revisions to ASs, the syllabus will accordingly include/exclude such new developments in place of the existing ones with effect from the date to be notified by the Institute.

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CHAPTER 1

ACCOUNTING STANDARDS

UNIT 1: INTRODUCTION TO ACCOUNTING STANDARDS

Learning objectives

After studying this unit you will be able to:

- Understand the concept of Accounting Standards.
- Grasp the objectives, benefits and limitations of Accounting Standards.
- Learn the standards setting process.
- Familiarize with the overview of Accounting Standards in India.
- Recognize the international accounting standard authorities.
- Appreciate the adoption of International Financial Reporting Standards as global standards.

1.1 INTRODUCTION

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. Accounting Standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises.

Accounting Standards deal with the issues of

(i) recognition of events and transactions in the financial statements,

(ii) measurement of these transactions and events,

(iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and

(iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

Accounting Standards standardize diverse accounting policies with a view to eliminate, to the maximum possible extent,

(i) the non-comparability of financial statements and thereby improving the reliability of financial statements, and

(ii) to provide a set of standard accounting policies, valuation norms and disclosure requirements.

Before moving on to further discussion, let us examine a very simple case of a trader to see how many rational figures of profit accountants can be derived:

(i) On 01/04/05, a trader purchased 10 units of certain articles @ Rs. 50 per unit.

(ii) On 02/04/05, the trader purchased further 10 units of same article @ Rs. 70 per unit.

(iii) On 03/04/05, the trader sold 6 units of the article @ Rs. 65 per unit on credit

(iv) On 04/04/05, the trader sold 9 units of the article @ Rs. 65 per unit for cash

A few of the possible profit and stock figures are shown below:

(a) Profit Rs. 125 (FIFO and accrual basis); Value of stock = Rs. 350 (5 units)

(b) Profit Rs. 25 (LIFO and accrual basis); Value of stock = Rs. 250 (5 units)

(c) Profit Rs. 75 (Weighted average and accrual basis); Value of stock = Rs. 300 (5 units)

(d) Profit Rs. 135 (FIFO, and cash basis); Value of stock = Rs. 750 (11 units)

(e) Loss Rs. 45 (LIFO and cash basis); Value of stock = Rs. 570 (5 units)

(f) Profit Rs. 45 (Weighted average and cash basis); Value of stock = Rs. 660 (11 units)

If as many as six alternatives are possible in this simple case, the readers can well imagine the number of possible alternatives that may exist in real life and the extent of confusion that will ensue. The users of financial statements are sure to lose all faith in accounting data and hardly any commerce will be possible. It is however worth noting that standardisation cannot reduce the number of possible alternatives to one, because more than one method must be permitted to suit the needs of particular trades and it is impractical to think of separate standardisation for each kind of trade. For example, when one stores liquid in single container, the use of FIFO is not rational.

In the given case, standardisation (compliance with Accounting Standards) reduces the possible figures of profit and stock to two as explained below:

(a) AS 2, Valuation of Inventory does not permit LIFO;

(b) AS 9, Revenue Recognition, requires recognition of revenue for sale transactions when
   (i) the risks and rewards of ownership is transferred from the seller to buyer; and
   (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Thus, revenue should ordinarily be recognised on accrual basis. The two possible figures of profit and stock are as given below:

- Profit Rs.125 (FIFO and accrual basis); Value of stock = Rs.350 (5 units)
- Profit Rs.75 (Weighted average and accrual basis); Value of stock = Rs.300 (5 units)

The standard policies are intended to reflect a consensus on accounting policies to be used in different identified area, e.g. inventory valuation, capitalisation of costs, depreciations and amortisations and so on. Since it is not possible to prescribe a single set of policies in any area to be appropriate for all enterprises for all time, it is not enough to comply with the standards and state that they have been followed; one must also disclose the accounting policies actually used in preparation of financial statements. (See AS 1, Disclosure of Accounting Policies). For example, an enterprise should disclose which of the permitted cost formula (FIFO, Weighted Average etc.) has actually been used for ascertaining inventory costs.

In addition to improving credibility of accounting data, standardisation of accounting procedures improves comparability of financial statements, both intra-enterprise and inter-enterprise. Such comparisons are very effective and most widely used tools for assessment of enterprise performances by users of financial statements for taking economic decisions, e.g. whether or not to invest, whether or not to lend and so on. The intra-enterprise comparison involves comparison of financial statements of same enterprise over number of years. The intra-enterprise comparison is possible if the enterprise uses same accounting policies every year in drawing up its financial statements. For this reason, AS 1 requires disclosure of changes in accounting policies. The inter-enterprise comparison involves comparison of financial statements of different enterprises for same accounting period. This is possible only when comparable enterprises use same accounting policies in preparation of respective financial statements. The disclosure of accounting policies allows a user to make appropriate adjustments while comparing the financial statements.

A third advantage of standardisation is reduction of scope for creative accounting. The creative accounting refers to twisting of accounting policies to produce financial statements favourable to a particular interest group. For example, it is possible to overstate profits and assets by capitalising revenue expenditure or to understate them by writing off a capital expenditure against revenue of current accounting period. Such practices can be curbed only by framing rules for capitalisation, particularly for the borderline cases where it is possible to have divergent views. The accounting standards do just that. (See AS 10, AS 16 and AS 26 for instances)

In brief, the accounting standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements. Good financial reporting not only promotes healthy financial markets, it also helps to reduce the cost of capital because investors can have faith in financial reports and consequently perceive lesser risks.

1.2 EVOLUTION OF ACCOUNTING STANDARDS

Formal standard setting has a longer history in the United States than in any other country. As early as in 1932-34, the American Institute of Accountants (now known as American Institute of Certified Public Accountants), collaborated with the New York Stock Exchange in the formulation of five 'rules or principles' of accounting to narrow down the variations in accounting policies, recommend disclosures for significant items, and suggest improvement in disclosures required by accounting standards keeping in view the company law and other regulatory requirements. In 1959, the American Institute of Certified Public Accountants (AICPA) established the Accounting Principles Board (APB) with the objective of carrying on research so as to provide a solid conceptual base for its opinions. APB was replaced by Financial Accounting Standards Board (FASB) in 1973. Accounting Standards Committee (ASC) was set up in United Kingdom to lay down 'standards' which could produce greater uniformity in financial accounting practices.

Prior to 1970s, very few academicians paid much attention to the standard setting process in accounting. However, it became clear that standard setting was a fascinating process that had intertwined with the economic self-interests of the affected parties. Currently, standard setting boards or committees are active in number of countries including the United States, United Kingdom, Australia, Canada, India etc. In the same direction, the International Accounting Standards Committee (now known as IASB), the London based group responsible for developing International Accounting Standards, was set up in June 1973. The IASC comprises the professional accountancy bodies of over 75 countries (including the Institute of Chartered Accountants of India).

1.3 STANDARDS SETTING PROCESS

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board

(ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The composition of ASB includes, representatives of industries (namely, ASSOCHAM, CII, FICCI), regulators, academicians, government departments etc. Although ASB is a body constituted by the Council of the ICAI, it (ASB) is independent in the formulation of accounting standards and Council of the ICAI is not empowered to make any modifications in the draft accounting standards formulated by ASB without consulting with the ASB.

The standard-setting procedure of ASB can be briefly outlined as follows:

- Identification of broad areas by ASB for formulation of AS.
- Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.
- Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.
- Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.
- Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
- Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.
- Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.

  The accounting standard on the relevant subject is then issued by the ICAI.

1.4 BENEFITS AND LIMITATIONS

Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards the accountant has following benefits:

(i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.

(ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.

(iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

However, there are some limitations of setting of accounting standards:

(i) Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.

(ii) There may be a trend towards rigidity and away from flexibility in applying the accounting standards.

(ii) Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

1.5 HOW MANY ACCOUNTING STANDARDS?

The council of the Institute of Chartered Accountants of India has, so far, issued thirty two Accounting Standards. However, AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are 31 Accounting Standards at present. The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

1.6 ACCOUNTING STANDARD INTERPRETATIONS

The Accounting Standard Interpretations address questions that arise in course of application of a standard. These are therefore issued after issue of the relevant standard. Authority of an interpretation is same as that of the Accounting Standard to which it relates. So far, 30 interpretations have been issued.

A brief summary of these interpretations is given below. The readers may refer appropriate chapters for details.

No.	Related AS	Topic
1	16	Interpretation of the term 'substantial period'
2	2, 10	Treatment of machinery spares
3	22	Computation of deferred tax during tax holiday u/s 80-IA and 80-IB (Revised)
4	22	Computation of deferred tax in respect of losses under the head Capital Gains
5	22	Computation of deferred tax during tax holiday u/s 10A and 10B
6	22	Computation of current and deferred tax subject to MAT u/s 115JB
7	22	Disclosure of deferred tax assets/liabilities in balance sheet
8	21, 23, 27	Interpretation of the term 'near future'
9	22	Interpretation of the term 'virtual certainty'
10	16	Computation of exchange difference to be treated as borrowing cost
11	22	Computation of deferred tax in case of Amalgamations
12	20	Applicability of AS 20 to unlisted companies
13	18	Aggregation of related party disclosures
14	9	Manner of disclosure of excise duty
15	21	Notes to the Consolidated Financial Statements (CFS)
16	23	Treatment in CFS: Dividend proposed by an associate
17	23	Treatment in CFS: Changes in equity not included in P & L A/c
18	23	Consideration of potential equity to ascertain whether the investee is an associate
19	18	Interpretation of the term 'intermediary'
20	17	Disclosure of segment information in certain cases (Revised)
21	18	Non-executive directors; whether related parties
22	17	Interest expenses; whether to treat as segment expenses
23	18	Remuneration paid to key management personnel; whether related party transaction

24	21	Subsidiaries having two parents
25	21	Shares held as stock-in-trade
26	21	Consolidation of current and deferred tax
27	25	Applicability of AS 25
28	21, 27	Disclosure of post-acquisition reserves in Consolidated Financial Statements
29	7	Turnover in case of contractors
30	29	Applicability of AS 29 to onerous contracts

1.7 NEED FOR CONVERGENCE TOWARDS GLOBAL STANDARDS

The last decade has witnessed a sea change in the global economic scenario. The emergence of trans-national corporations in search of money, not only for fuelling growth, but to sustain on going activities has necessitated raising of capital from all parts of the world, cutting across frontiers. Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin. Therefore translation and re-instatements are of utmost importance in a world that is rapidly globalising in all ways. In themselves also, the accounting standards and principle need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organizations.

International analysts and investors would like to compare financial statements based on similar accounting standards, and this has led to the growing support for an internationally accepted set of accounting standards for cross-border filings. The harmonization of financial reporting around the world will help to raise confidence of investors generally in the information they are using to make their decisions and assess their risks. Also a strong need was felt by legislation to bring about uniformity, rationalization, comparability, transparency and adaptability in financial statements. Having a multiplicity of accounting standards around the world is against the public interest. If accounting for the same events and information produces different reported numbers, depending on the system of standards that are being used, then it is self-evident that accounting will be increasingly discredited in the eyes of those using the numbers. It creates confusion, encourages error and facilitates fraud. The cure for these ills is to have a single set of global standards, of the highest quality, set in the interest of public. Global Standards facilitate cross border flow of money, global listing in different bourses and comparability of financial statements.

The convergence of financial reporting and accounting standards is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital market stakeholders. It improves the ability of investors to compare investments on a global basis and thus lowers their risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements say reinstatement of financial statements. It has the potential to create a new standard of accountability and greater transparency, which are values of great significance to all market participants including regulators. It reduces operational challenges for accounting firms and focuses their value and expertise around an increasingly unified set of standards. It creates an unprecedented opportunity for standard setters and other stakeholders to improve the reporting model. For the companies with joint listings in both domestic and foreign country, the convergence is very much significant.

1.8 INTERNATIONAL ACCOUNTING STANDARD BOARD

With a view of achieving these objectives, the London based group namely the International Accounting Standards Committee (IASC), responsible for developing International Accounting Standards, was established in June, 1973. It is presently known as International Accounting Standards Board, The IASC comprises the professional accountancy bodies of over 75 countries (including the Institute of Chartered Accountants of India). Primarily, the IASC was established, in the public interest, to formulate and publish, International Accounting Standards to be followed in the presentation of audited financial statements. International Accounting Standards were issued to promote acceptance and observance of International Accounting Standards worldwide. The members of IASC have undertaken a responsibility to support the standards promulgated by IASC and to propagate those standards in their respective countries.

Between 1973 and 2001, the International Accounting Standards Committee (IASC) released International Accounting Standards. Between 1997 and 1999, the IASC restructured their organisation, which resulted in formation of International Accounting Standards Board (IASB). These changes came into effect on 1st April, 2001. Subsequently, IASB issued statements about current and future standards: IASB publishes its Standards in a series of pronouncements called **International Financial, Reporting Standards (IFRS).** However, IASB has not rejected the standards issued by the ISAC. Those pronouncements continue to be designated as “International Accounting Standards” (IAS). The IASB approved IASB Resolution on IASC Standards at their meeting in April, 2001, in which it confirmed the status of all IASC Standards and SIC Interpretations in effect as on 1st April, 2001.

1.9 INTERNATIONAL FINANCIAL REPORTING STANDARDS AS GLOBAL STANDARDS

The term IFRS comprises IFRS issued by IASB; IAS issued by International Accounting Standards Committee (IASC); and Interpretations issued by the Standard Interpretations Committee (SIC) and the International Financial reporting Interpretations Committee (IFRIC) of the IASB.

International Financial Reporting Standards (IFRSs) are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving toward adopting them to some extent. Large number of authorities requires public companies to use IFRS for stock-exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports. So over the next few years, thousands of companies will adopt the international standards. This requirement will affect about 7,000 enterprises, including their subsidiaries, equity investors and joint venture partners. The increased use of IFRS is not limited to public-company listing requirements or statutory reporting. Many lenders and regulatory and government bodies are looking to IFRS to fulfil local financial reporting obligations related to financing or licensing.

1.10 ADOPTION OF IFRS IN INDIA

Increasingly, Indian accountants and businessmen feel the need for convergence with IRFS. Capital markets provide an important explanation for this change. Some Indian companies are already listed on overseas stock exchanges and many more will list in the future. Internationally-acceptable accounting standards will then become the language of communication for Indian companies. Also, the recent stream of overseas acquisitions by Indian companies makes a compelling case for adoption of high quality standards to convince foreign enterprises about the financial standing as also the disclosure and governance standards of Indian acquirers. Convergence with IFRS would require several changes in Indian laws and decision processes.

In India, the Institute of Chartered Accountants of India (ICAI) is on the way towards convergence of its Standards with Global Standards. Divergences have been minimized to the maximum possible extent in the areas wherein full convergence is difficult. Recognizing the growing need of full convergence of Indian Accounting Standards with IFRSs, ICAI has constituted a Task Force to examine various issues involved. Full convergence would involve adoption of IFRSs in the same form as that issued by the IASB. While formulating the Accounting Standards, ICAI recognizes the legal and other conditions prevailing in India and makes deviations from the corresponding IFRSs Accounting Standards are issued by the Accounting Standards Board (ASB) of the ICAI.

To bring Indian standards at par with the IAS, some of the earlier Accounting Standards and Guidance notes have been revised or are under the process of revision. The Securities and Exchange Board of India (SEBI) has also set up a Standing Committee on Accounting Standards to monitor the existence of relevant Accounting Standards and their harmonization with corresponding International Accounting Standards. SEBI mandates the adherence to standards and enforces the same through the listing agreements between the companies and recognized Stock Exchanges.

Self- Examination Questions

I. Objective type Questions

Choose the most appropriate answer from the given options:

1. Accounting Standards cover the aspect of

   (a) Recognition of events and transactions in the financial transactions.

   (b) Measurement of events and transactions in the financial transactions.

   (c) Presentation and disclosure of events and transactions in the financial transactions.

   (d) All of the above.

2. Which of the following statement is not true?

   (a) Standards reduce to reasonable extent confusing variations in the accounting treatments.

   (b) Standards may call for disclosures beyond that required by law.

   (c) The application of accounting standards facilitate comparison of financial statements of companies though there legal systems, traditions and accounting policies adopted are different.

   (d) Accounting standards cannot override the statute.

3. Which of the following accounting standard has been withdrawn by ICAI?

   (a) AS 2 on Valuation of Inventories.

   (b) AS 8 on Accounting for Research and Development.

   (c) AS 13 on Accounting for Investments.

   (d) AS 10 on Accounting for Fixed Assets.

[**Answers** : **1** (d), **2** (c), **3** (b)]

II. Short Answer Questions

4. How does an accountant get benefited by preparing a financial statement on the basis of accounting standards?

5. Though setting of accounting standards is of great benefit still it faces some limitations. Explain.

III. Long Answer Questions

6. Why do we need the convergence of accounting standards towards global standards?

UNIT 2: OVERVIEW OF ACCOUNTING STANDARDS

Learning objectives

After studying this unit you will be able to:

- Comprehend the status and applicability of accounting standards.
- Know the scope of various accounting standards.
- Understand the provisions of the given Accounting Standards.
- Relate relevant Accounting Standards at various situations and apply them accordingly.
- Solve the practical problems based on application of Accounting Standards.

2.1 APPLICABILITY OF ACCOUNTING STANDARDS

It has already been mentioned in unit one of the chapter that the standards are developed by the Accounting Standards Board (ASB) of the institute and are issued under the authority of its Council. The institute not being a legislative body can enforce compliance with its standards only by its members. Also, the standards cannot override laws and local regulations. The accounting standards are nevertheless made mandatory from the dates specified in respective standards and are generally applicable to all enterprises, subject to certain exception as stated below. The implication of mandatory status of an accounting standard depends on whether the statute governing the enterprise concerned requires compliance with the standard.

In assessing whether an accounting standard is applicable, one must find correct answer to the following three questions.

(a) Does it apply to the enterprise concerned? If yes, the next question is:

(b) Does it apply to the financial statement concerned? If yes, the next question is:

(c) Does it apply to the financial item concerned?

The preface to the statements of accounting standards answers the above questions.

Enterprises to which the accounting standards apply

Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, whether or not profit oriented and even if established for charitable or religious purposes. Accounting Standards however, do not apply to enterprises solely carrying on the activities, which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the

Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise were considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those, which are not commercial, industrial or business in nature.

Implication of mandatory status

Where the statute governing the enterprise does not require compliance with the accounting standards, e.g. a partnership firm, the mandatory status of an accounting standard implies that, in discharging their attest functions, the members of the Institute are required to examine whether the financial statements are prepared in compliance with the applicable accounting standards. (See Scheme of Applicability) In the event of any deviation from the accounting standards, they have the duty to make adequate disclosures in their reports so that the users of financial statements may be aware of such deviations. It should nevertheless be noted that responsibility for the preparation of financial statements and for making adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.

Where the statute governing the enterprise requires compliance with the accounting standards, e.g. companies, mandatory status of an accounting standard implies that the duty of compliance is primarily on the enterprise presenting the financial statement.

Section 211(3A) of the Companies Act requires companies to present their profit and loss accounts and balance sheets in compliance with the accounting standards. (See Note 1) Also, the auditor is required by section 227(3)(d) to report whether, in his opinion, the profit and loss account and balance sheet of the company audited, comply with the accounting standards referred to in section 211(3C). Where the profit and loss account and balance sheet of a company do not comply with the accounting standards, the company is required by section 211(3B) to disclose the deviations from the accounting standards together with reasons for the deviations and financial effect if any arising due to such deviations.

In addition, listed companies are required to comply with the accounting standards issued by The Institute of Chartered Accountants of India, by clause 50 of listing agreement with the stock exchanges.

The above discussion shows that unlike other enterprises, duty to comply with the standards is also on the company, which is presenting the financial statements.

Note 1:

As per section 211(3C), the expression 'accounting standards', for the purpose of section 211(3A), means standards of accounting recommended by the Institute of Chartered Accountants of India, as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under subsection (1) of section 210A. It is also provided that, till the time the Central Government prescribes accounting standards, the accounting standards specified by the Institute of Chartered Accountants of India shall be deemed to be accounting standards for the purpose of section 211(3A). Till date, the Central Government has not prescribed any accounting standards. For the purpose of section 211(3A) and Section 227(3)(d), the institute has specified all mandatory accounting standards. In other words, companies are required to comply with all applicable mandatory standards issued by the Institute of Chartered Accountants of India.

Note 2

Enterprises in insurance business are required to comply with the accounting standards by the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000. The standards to be complied by these enterprises are those, made applicable to them.

Financial items to which the accounting standards apply

The Accounting Standards are intended to apply only to items, which are material. An item is considered material, if its omission or misstatement is likely to affect economic decision of the user. Materiality is not necessarily a function of size; it is the information content if the financial item which is important. A penalty of Rs. 50,000 paid for breach of law by a company can seem to be a relatively small amount for a company incurring crores of rupees in a year, yet is a material item because of the information it conveys. The materiality should therefore be judged on case-to-case basis. If an item is material, it should be shown separately instead of clubbing it with other items. For example it is not appropriate to club the penalties paid with legal charges.

Conflict between requirements of accounting standard and Court/Tribunal order

On 17 November 2004, the Council of the ICAI has announced that if an item in the financial statement of an enterprise is treated differently pursuant to an Order made by the Court/Tribunal, as compared to the treatment required by an Accounting Standard, following disclosures should be made in the financial statements of the year in which different treatment has been given:

A description of the accounting treatment made along with the reason that the same has been adopted because of the Court/Tribunal Order.

(a) Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the enterprise.

(b) The financial impact, if any, arising due to such a difference.

Accounting Standard and Income Tax Act

Accounting standards intend to reduce diversity in application of accounting principles. They improve comparability of financial statements and promote transparency and fairness in their presentation. Deductions and exemptions allowed in computation of taxable income on the other hand, is a matter fiscal policy of the government. Thus, an expense required to be charged against revenue by an accounting standard does not imply that the same is always deductible for income tax purposes. For example, depreciation on assets taken on finance lease is charged in the books of lessee as per AS 19 but depreciation for tax purpose is allowed to lessor, being legal owner of the asset, rather than to lessee. Likewise, recognition of revenue in the financial statements cannot be avoided simply because it is exempted under section 10 of Income Tax Act.

As already explained, the Guidance Note on Audit Under Section 44AB of Income Tax Act, requires all financial statements prepared under mercantile system of accounting to comply with all applicable mandatory accounting standards issued by the Institute. The financial statements prepared under cash basis of accounting however, need not adhere to the accounting standards issued by the Institute.

It follows from above, that a member of the Institute reporting for tax audit purposes, is under an obligation to see whether the audited financial statements, if prepared under mercantile system of accounting, comply with all applicable mandatory standards issued by the Institute. In case of any deviation, the member should consider making qualification/appropriate disclosure in his reports.

It should be noted that the Central Government has notified two accounting standards, viz. AS (IT) 1, Disclosure of Accounting Policies and AS (IT) 2, Disclosure of Prior Period and Extra Ordinary Items and Disclosure of Accounting Policies for the purpose of taxation. Section 145 of Income Tax Act requires all assesses keeping their books by the mercantile system of accounting to comply with these two standards. Also, requirements of AS (IT) 1 and AS (IT) 2 are practically same as the corresponding AS 1 and AS 5 issued by the institute. The mandatory compliance of AS (IT) 1 and AS (IT) 2 are nevertheless required for the limited purpose of income tax.

Mandatory accounting standards issued by the ICAI apply to all financial statements prepared under mercantile system irrespective of the requirements of Income Tax Act. The differences between requirements of Income Tax Act and those of accounting standards cause taxable profit to differ from the accounting profit before tax.

2.2 COMPLIANCE OF ACCOUNTING STANDARDS

For the purpose of compliance of the Accounting Standards, all enterprises in India are classified into three broad categories:

Level I Enterprise: Following enterprises are covered under this level:

- Enterprises, whose equity or debt securities are either listed or is in the process to be listed in India or outside India.
- Banks, Insurance Companies and Financial Institutions.
- All commercial, industrial and other reporting business enterprises, whose total turnover during the previous year is in excess of Rs.50 crores (as per the audited financial statement).
- All commercial, industrial and other reporting business enterprises, whose total borrowings including public deposits during the previous year are in excess of Rs.10 crores (as per the audited financial statement).
- Holding or subsidiary company of any of the above enterprises any time during the year.

Level II Enterprise: Following enterprises are covered under this level:

- All commercial, industrial and other reporting business enterprises, whose total turnover during the previous year exceeds Rs.40 lakhs but within the limit of Rs.50 crores (as per the audited financial statement).
- All commercial, industrial and other reporting business enterprises, whose total borrowings including public deposits during the previous year exceeds Rs.1 crore but within the limit of Rs.10 crores (as per the audited financial statement).
- Holding or subsidiary company of any of the above enterprises any time during the year.

Level III Enterprise: All the enterprises not covered in above two levels come under this level.

2.3 LIST OF ACCOUNTING STANDARDS

Following is the list of Accounting Standards with their respective date of applicability along with the scope.

AS No.	AS Title	Date	Scope
1	Disclosure of Accounting Policies	01/04/1993	All Level
2	Valuation of Inventories (Revised)	01/04/1999	All Level
3	Cash Flow Statement (Revised)	01/04/2001	Level I

4	Contingencies and Events Occurring		
	after the Balance Sheet Date	01/04/1998	All Level
5	Net Profit or Loss for the Period, Prior Period		
	Items and Changes in Accounting Policies (Revised)	01/04/1996	All Level
6	Depreciation Accounting (Revised)	01/04/1995	All Level
7	Construction Contracts (Revised)	01/04/2002	All Level
8	Research & Development	Now included	in AS – 26
9	Revenue Recognition	01/04/1993	All Level
10	Accounting for Fixed Assets	01/04/1993	All Level
11	The Effects of Changes in Foreign		
	Exchange Rates (Revised)	01/04/2004	All Level
12	Accounting for Government Grants	01/04/1994	All Level
13	Accounting for Investments	01/04/1995	All Level
14	Accounting for Amalgamations	01/04/1995	All Level
15	Employee Benefits	01/04/2006	All Level
16	Borrowing Costs	01/04/2000	All Level
17	Segment Reporting	01/04/2001	Level I
18	Related Party Disclosures	01/04/2001	Level I
19	Leases	01/04/2001	All Level
20	Earning Per Shares	01/04/2001	Level I
21	Consolidated Financial Statement	01/04/2001	Enterprises preparing CFS[*]
22	Accounting for Taxes on Income	01/04/2001	Listed Companies
		01/04/2002	Other Companies
		01/04/2006	All Enterprises

[*] CFS has been written for cash flow statement.

23	Accounting for Investment in Associates in Consolidated Financial Statement	01/04/2002	Enterprises preparing CFS
24	Discontinuing Operations	01/04/2004	Level I
25	Interim Financial Statement	01/04/2002	Level I
26	Intangible Assets	01/04/2003	All Level
27	Financial Reporting of Interests in Joint Ventures	01/04/2002	Enterprises preparing CFS
28	Impairment of Assets	01/04/2004	Level I
		01/04/2006	Level II
		01/04/2008	Level III
29	Provisions, Contingent Liabilities and		
	Contingent Assets	01/04/2004	All Level
30	Financial Instruments: Recognition and Measurement	01/04/2011	Level I
31	Financial Instruments: Presentation	01/04/2011	Level I
32	Financial Instruments: Disclosures	01/04/2011	Level I

Note: Accounting Standards 1, 2, 3, 6, 7, 9, 10, 13 and 14 are covered in the ATC (Gr-I) syllabus and have been discussed in detail in the coming paras.

2.4 OVERVIEW

2.4.1 Disclosure of Accounting Policies (AS 1)

Irrespective of extent of standardisation, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard. Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time. The accounting standards therefore permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

The purpose of Accounting Standard 1, Disclosure of Accounting Policies, is to promote better understanding of financial statements by requiring disclosure of significant accounting policies in orderly manner. As explained in the preceding paragraph, such disclosures facilitate more meaningful comparison between financial statements of different enterprises for same accounting periods. The standard also requires disclosure of changes in accounting policies such that the users can compare financial statements of same enterprise for different accounting periods.

Accounting Standard 1, Disclosure of Accounting Policies, was first issued November 1979. It came into effect in respect of accounting periods commencing on or after April 1, 1991. The standard applies to all enterprises.

Fundamental Accounting Assumptions (Paragraph 10)

The Accounting Standard 1 recognises three fundamental accounting assumptions. These are (a) Going Concern (b) Consistency and (c) Accrual. So long as these assumptions are followed in preparation of financial statements, no disclosure of such adherence is necessary. Any departure from any of these assumptions should however be disclosed.

Going Concern

The financial statements are normally prepared on the assumption that an enterprise will continue in operation in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations. Going concern assumption is not likely to be compatible with the intention or necessity to enter into a scheme of arrangement with the enterprise's creditors or to liquidate in near future.

Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities. If any financial statement is prepared on a different basis, e.g. when assets of an enterprise are stated at net realisable values in its financial statements, the basis used should be disclosed.

Consistency

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The consistency improves comparability of financial statements through time. An accounting policy can be changed if the change is required (i) by a statute (ii) by an accounting standard (iii) for more appropriate presentation of financial statements.

Accrual basis of accounting

Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid. Accrual basis ensures better matching between revenue and cost and profit/loss obtained on this basis reflects activities of the enterprise during an accounting period, rather than cash flows generated by it. While accrual basis is a more logical approach to profit determination than the cash basis of accounting, it exposes an enterprise to the risk of recognising an income before actual receipt. The accrual basis can therefore overstate the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital. For this reason, accounting standards require that no revenue should be recognised unless the amount of consideration and actual realisation of the consideration is reasonably certain. Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting as illustrated below. Section 209(3)(b) of the Companies Act makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated.

Selection of Accounting Policy (Paragraph 17)

Financial Statements are prepared to portray a true and fair view of the performance and state of affairs of an enterprise. In selecting a policy, alternative accounting policies should be evaluated in that light. In particular, major considerations that govern selection of a particular policy are:

Prudence

In view of uncertainty associated with future events, profits are not anticipated, but losses are provided for as a matter of conservatism. Provision should be created for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. The exercise of prudence in selection of accounting policies ensure that (i) profits are not overstated (ii) losses are not understated (iii) assets are not overstated and (iv) liabilities are not understated. The prudence however does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses.

Example

The most common example of exercise of prudence in selection of accounting policy is the policy of valuing inventory at lower of cost and net realisable value.

Suppose a trader has purchased 500 units of certain article @ Rs.10 per unit. He sold 400 articles @ Rs.15 per unit. If the net realisable value per unit of the unsold article is Rs.15, the trader shall value his stock at Rs.10 per unit and thus ignoring the profit Rs.500 that he may earn in next accounting period by selling 100 units of unsold articles. If the net realisable value per unit of the unsold article is Rs.8, the trader shall value his stock at Rs.8 per unit and thus recognising possible loss Rs.200 that he may incur in next accounting period by selling 100 units of unsold articles.

Profit of the trader if net realisable value of unsold article is Rs.15

= Sale – Cost of goods sold = (400 x Rs.15) – (500 x Rs.10 – 100 x Rs.10) = Rs.2,000

Profit of the trader if net realisable value of unsold article is Rs. 8

= Sale – Cost of goods sold = (400 x Rs.15) – (500 x Rs.10 – 100 x Rs.8) = Rs.1,800

Example

Exercise of prudence does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses. Suppose a company is facing a damage suit. No provision for damages should be recognised by a charge against profit, unless the probability of losing the suit is more than the probability of not losing it.

Substance over form

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

Materiality

Financial statements should disclose all 'material items, i.e. the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases quantitative limits of materiality is specified. A few of such cases are given below:

(a) In giving 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 purchases, stocks or turnover as the case may be, are shown as separate and distinct items with quantities thereof in the break-up. (Requirements as to Profit & Loss Account; Part II of Schedule VI of Companies Act).

(b) Any item under which the expenses exceed 1 per cent of total revenue of the company or Rs. 5,000, whichever is higher, are shown as a separate and distinct item against appropriate account head in the Profit & Loss Account and are not combined with any other item shown under 'Miscellaneous Expenses'. (Requirements as to Profit & Loss Account; Part II of Schedule VI of Companies Act).

Manner of disclosure

(c) All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed (Paragraph 24)

(d) The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place. (Paragraph 25)

Note:

Being a part of the financial statement, the opinion of auditors shall cover the disclosures of accounting policies. In view of paragraph 25, it is not appropriate to scatter the disclosures of accounting policies over the financial statement. For example, it is not correct to disclose depreciation policy as part of schedule of fixed assets and inventory policy as part of schedule of inventory.

Disclosure of Changes in Accounting Policies (Paragraph 26)

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 a later period should be disclosed. In the case of a change in accounting policies, which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

Examples

1 A simple disclosure that an accounting policy has been changed is not of much use for a reader of a financial statement. The effect of change should therefore be disclosed wherever ascertainable. Suppose a company has switched over to weighted average formula for ascertaining cost of inventory, from the earlier practice of using FIFO. If the closing inventory by FIFO is Rs.2 lakh and that by weighted average formula is Rs.1.8 lakh, the change in accounting policy pulls down profit and value of inventory by Rs.20,000. The company may disclose the change in accounting policy in the following manner:

'The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year the company has changed to weighted average formula, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy gas reduced profit and value of inventory by Rs. 20,000'.

2. A change in accounting policy is to be disclosed if the change is reasonably expected to have material effect in future accounting periods, even if the change has no material effect in the current accounting period.

The above requirement ensures that all important changes in accounting policies are actually disclosed. Suppose a company makes provision for warranty claims based on estimated costs of materials and labour. The company changed the policy in 2003-04 to include overheads in estimating costs for servicing warranty claims. If value of warranty sales in 2003-04 is not significant, the change in policy will not have any material effect on financial statements of 2003-04. Yet, the company must disclose the change in accounting policy in 2003-04 because the change can affect future accounting periods when value of warranty sales may rise to a significant level. If the disclosure is not made in 2003-04, then no disclosure in future years will be required. This is because an enterprise has to disclose changes in accounting policies in the year of change only.

Disclosure of deviations from fundamental accounting assumptions (Paragraph 27)

If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The deviation from the principle of consistency therefore means a change in accounting policy, the disclosure requirements for which are covered by paragraph 26.

2.4.2 Valuation of Inventory (AS 2)

The cost of closing inventory, e.g. cost of closing stock of raw materials, closing work-in-progress and closing finished stock, is a part of costs incurred in the current accounting period that is carried over to next accounting period. Likewise, the cost of opening inventory is a part of costs incurred in the previous accounting period that is brought forward to current accounting period. Since inventories are assets, and assets are resources expected to cause flow of future economic benefits to the enterprise, the costs to be included in inventory costs, are costs that are expected to generate future economic benefits to the enterprise. Such costs must be costs of acquisition and costs that change either (i) the location of the inventory, e.g. freight incurred to carry the materials to factory or (ii) conditions of the inventory, e.g. costs incurred to convert the materials into finished stock. The costs incurred to maintain the inventory, e.g. storage costs, do not generate any extra economic benefits for the enterprise and therefore should not be included in inventory costs.

The valuation of inventory is crucial because of its direct impact in measuring profit/loss for an accounting period. Higher the value of closing inventory lower is the cost of goods sold and hence larger is the profit. The principle of prudence demands that no profit should be anticipated while all foreseeable losses should be recognised. Thus, if net realisable value of inventory is less than inventory cost, inventory is valued at net realisable value to reduce the reported profit in anticipation of loss. On the other hand, if net realisable value of inventory is more than inventory cost, the anticipated profit is ignored and the inventory is valued at cost. In short, inventory is valued at lower of cost and net realisable value. The standard specifies

(i) what the cost of inventory should consist of and (ii) how the net realisable value is determined.

Failure of an item of inventory to recover its costs is unusual. If net realisable value of an item of inventory is less than its cost, the fall in profit in consequence of writing down of inventory to net realisable is an unusual loss and should be shown as a separate line item in the Profit & Loss A/c to help the users of financial statements to make a more informed analysis of the enterprise performance. (See AS 5, for details)

By their very nature, abnormal gains or losses are not expected to recur regularly. For a meaningful analysis of an enterprise's performance, the users of financial statements need to know the amount of such gains/losses included in current profit/loss. For this reason, instead of taking abnormal gains and losses in inventory costs, these are shown in the Profit & Loss A/c in such way that their impact on current profit/loss can be perceived. (See AS 5 for details)

Parts I and II of Schedule VI of Companies Act prescribes valuation and disclosure norms for inventory held by companies. The AS 2, Valuation of Inventories was first issued in June 1981 to supplement the legal requirements. It was revised and made mandatory for all enterprises in respect of accounting periods commencing on or after April 1, 1999.

Paragraph 3 of the standard defines inventories as assets held

(a) For sale in the ordinary course of business or

(b) In the process of production for such sale or

(c) In the form of materials or supplies to be consumed in the production process or in rendering of services.

As per paragraph 1, the following are excluded from the scope of AS 2.

Work in progress arising under construction contracts, i.e. cost of part construction, including directly related service contracts, being covered under AS 7, Accounting for Construction Contracts; Inventory held for use in construction, e.g. cement lying at the site shall however be covered by AS 2.

(a) Work in progress arising in the ordinary course of business of service providers i.e. cost of providing a part of service. For example, for a shipping company, fuel and stores not consumed at the end of accounting period is inventory but not costs for voyage-in-progress. Work-in-progress may arise for different other services e.g. software development, consultancy, medical services, merchant banking and so on.

(b) Shares, debentures and other financial instruments held as stock-in-trade. It should be noted that these are excluded from the scope of AS 13 as well. The current Indian practice is however to value them at lower of cost and fair value.

(c) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries, e.g. where sale is assured under a forward contract or a government guarantee or where a homogenous market exists and there is negligible risk of failure to sell.

Machinery spares (Accounting Standard Interpretation 2)

Machinery spares, which are not specific to a particular item of fixed asset but can be used generally for various items of fixed assets, should be treated as inventories for the purpose of AS 2. Such machinery spares should be charged to the statement of profit and loss as and when issued for consumption in the ordinary course of operations. Other types of machinery spares are treated as fixed assets (See AS 10, for details).

Containers and Empties

Containers and empties are not goods for sale in the ordinary course of business, nor are they goods in the production process nor they are materials or supplies for consumption in the production process or in rendering of services. The Expert Advisory Committee of ICAI has however expressed an opinion that containers and empties are items of inventory. It seems nevertheless that containers and empties having useful life more than one year should be regarded as depreciable assets, in accordance with AS 6.

Measurement of Inventories (Paragraph 5)

Inventories should be valued at lower of cost and net realisable value. As per paragraph 3, net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. The valuation of inventory at lower of cost and net realisable value is based on the view that no asset should be carried at a value which is in excess of the value realisable by its sale or use.

Example 1

Cost of a partly finished unit at the end of 2004-05 is Rs. 800. The unit can be finished next year by a further expenditure of Rs. 100. The finished unit can be sold Rs.250, subject to payment of 4% brokerage on selling price. The value of inventory is determined below:

	Rs.
Net selling price	250
Less: Estimated cost of completion	100
	150

Less: Brokerage (4% of 250)	10
Net Realisable Value	140
Cost of inventory	800
Value of inventory (Lower of cost and net realisable value)	140

Note:

Incremental cost Rs. 100 (cost to complete) is less than incremental revenue Rs. 240 (Rs. 250 – Rs. 10). The enterprise will therefore decide to finish the unit for sale at Rs. 250.

Example 2

In example 1, suppose cost to complete the unit is Rs. 245 instead of Rs. 100. The enterprise will be better off by not finishing the unit as shown below:

Incremental cost Rs. 245 (cost to complete) is more than incremental revenue Rs. 240 (Rs. 250 – Rs. 10). The enterprise will therefore prefer not to finish the unit.

Net Realisable Value = Nil

Cost = Rs. 800

Value of inventory (Lower of cost and net realisable value) = Nil

Costs of inventory (Paragraph 6)

Costs of inventories comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of purchase (Paragraph 7)

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities, e.g. CENVAT credit, State level Value Added Tax etc, freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Example 3

An enterprise ordered 13,000 Kg. of certain material at Rs. 90 per unit. The purchase price includes excise duty Rs. 5 per Kg., in respect of which full CENVAT credit is admissible. Freight incurred amounted to Rs. 80,600. Normal transit loss is 4%. The enterprise actually received 12,400 Kg and consumed 10,000 Kg.

Cost of inventory and allocation of material cost is shown below.

Normal cost per Kg.

	Rs.
Purchase price (13,000 Kg. x Rs. 90)	11,70,000
Less: CENVAT Credit (13,000 Kg. x Rs. 5)	65,000
	11,05,000
Add: Freight	80,600
A. Total material cost	11,85,600
B. Number units normally received = 96% of 13,000 Kg.	Kg. 12,480
C. Normal cost per Kg. (A/B)	95

Allocation of material cost

	Kg.	Rs./Kg.	Rs.
Materials consumed	10,000	95	9,50,000
Cost of inventory	2,400	95	2,28,000
Abnormal loss	80	95	7,600
Total material cost	12,480	95	11,85,600

Note: Abnormal losses are recognised as separate expense

Costs of Conversion

The costs of conversion include costs directly related to production, e.g. direct labour. They also include overheads, both fixed and variable. (Paragraph 8)

The fixed production overheads should be absorbed systematically to units of production over normal capacity. Normal capacity is the production the enterprise expects achieve on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates the normal capacity. (Paragraph 9)

The amount of fixed production overheads allocated to each unit of production should not be increased as a consequence of low production or idle plant. Unallocated overheads (i.e. under recovery) is recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities. (Paragraph 9)

The above two points imply:

Where actual production is less than or equal to normal capacity, fixed overheads are recovered on the basis of normal capacity.

Where actual production is more than normal capacity, fixed overheads are recovered on the basis of actual production.

Example 4

In example 3, suppose normal processing loss is 5% of input. During the accounting period, the enterprise has actually produced 9,600 units of finished product. 9,300 units were sold at Rs. 250 per unit. The labour and overhead costs amounted to Rs. 6,12,845 and Rs. 2,23,440 respectively. Overheads are recovered on the basis of output. Excise duty on final product is Rs. 28.50 per unit

Profit & Loss A/c and costs of finished inventory assuming (i) normal capacity is 9,400 units (ii) normal capacity is 9,800 units are shown below.

Case (i) (Actual production 9,600 units is more than normal capacity 9,400 units)

Normal recovery rate = Rs. 2,23,440 / 9,400 units = Rs. 23.77

Actual Overhead per unit = Rs. 2,23,440 / 9,600 units = Rs. 23.275

Recovery rate is decreased to actual Rs. 23.275 per unit due to high production.

Normal cost per unit of finished product

	Rs.
Materials consumed	9,50,000
Wages	6,12,845
Overheads (9,600 x Rs. 23.275)	2,23,440
Excise Duty (9,600 x Rs. 28.50)	2,73,600
A. Total cost	20,59,885
B. Normal output (95% of 10,000)	9,500 units
C. Normal cost per unit of finished product (A/B)	216.83

Allocation of total cost

	Units	Rs./Unit	Rs.
Cost of goods sold	9,300	216.83	20,16,519
Cost of finished inventory	300	216.83	65,049
	9,600	216.83	20,81,568

Less: Abnormal gain	100	216.83	21,683
Total cost	9,500	216.83	20,59,885

Statement of Profit & Loss

	Rs.	Rs.
Sales		23,25,000
Less: Cost of goods sold		20,16,519
		3,08,481
Abnormal Gain	21,683	
Less: Abnormal loss	7,600	14,083
Net profit		3,22,564

Case (ii) (Actual production 9,600 units is less than normal capacity 9,800 units)

Normal Overhead recovery rate = Rs. 2,23,440 / 9,800 units = Rs. 22.80

Actual overhead per unit = Rs. 2,23,440 / 9,600 units = Rs. 23.275

Recovery rate is not increased to actual Rs. 23.275 per unit due to low production.

Overhead recovered = 9,600 x Rs. 22.80 = Rs. 2,18,880

Under-recovery = Rs. 2,23,440 – Rs. 2,18,880 = Rs. 4,560

Under recovery per unit of normal output = Rs. 4,560 / 9,500 = Re. 0.48

Normal cost per unit of finished product

	Rs.
Materials consumed	9,50,000
Wages	6,12,845
Overheads (9,600 x Rs. 22.80)	2,18,880
Excise Duty (9,600 x Rs. 28.50)	2,73,600
A. Total cost	20,55,325
B. Normal output (95% of 10,000)	9,500 units
C. Normal cost per unit of finished product (A/B)	216.35

Allocation of total cost

	Units	Rs./Unit	Rs.
Cost of goods sold	9,300	216.35	20,12,055
Cost of finished inventory	300	216.35	64,905
	9,600	216.35	20,76,960
Less: Abnormal gain	100	216.35	21,635
	9,500	216.35	20,55,325
Add: Under-recovery			4,560
Total cost			20,59,885

Statement of Profit & Loss

	Rs.	Rs.
Sales		23,25,000
Less: Cost of goods sold		20,12,055
		3,12,945
Less: Under recovery		4,560
		3,08,385
Abnormal Gain	21,635	
Less: Abnormal loss	7,600	14,035
Net profit		3,22,420

Note 1

Excise duty on output is product cost rather than period cost. Hence taken in production cost and consequently in cost of inventory.

Note 2

Profit in case (ii) is reduced by Rs. 144 from that in case (i). This is because, the whole of under recovery is charged against profit for the year in case (ii) while a part of current year overhead Rs. 144 (300 units x Re. 0.48 per unit) gets carried over to next period as part of inventory cost in case (i).

Joint or By-Products (Paragraph 10)

In case of joint or by products, the costs incurred up to the stage of split off should be allocated on a rational and consistent basis. The basis of allocation may be sale value at split off point, for example. The value of by products, scrap and wastes are usually not material. Theses are therefore at net realisable value. The cost of main product is then joint cost minus net realisable value of by-products, scraps or wastes.

Other Costs

(a) These may be included in cost of inventory provided they are incurred to bring the inventory to their present location and condition. Cost of design, for example, for a custom made unit may be taken as part of inventory cost. (Paragraph 11)

(b) Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition. These costs are therefore not usually included in cost of inventory (Paragraph 12). Interests and other borrowing costs however are taken as part of inventory costs, where the inventory necessarily takes substantial period of time for getting ready for intended sale. Example of such inventory is wine. (See AS 16, Borrowing costs, for further details)

(c) The standard is silent on treatment of amortisation of intangibles for ascertaining inventory costs. It nevertheless appears that amortisation of intangibles related to production, e.g. patents right of production or copyright for a publisher should be taken as part of inventory costs.

(d) Exchange differences are not taken in inventory costs under Indian GAAP.

Exclusions from the cost of inventories (Paragraph 13)

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(a) Abnormal amounts of wasted materials, labour, or other production costs;

(b) Storage costs, unless the production process requires such storage;

(c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition;

(d) Selling and distribution costs.

Cost Formula (Paragraph 16)

Mostly inventories are purchased / made in different lots and unit cost of each lot frequently differs. In all such circumstances, determination of closing inventory cost requires identification of units in stock to have come from a particular lot. This specific identification is best wherever possible (Para 14). In all other cases, the cost of inventory should be determined by the First-In First-Out (FIFO), or Weighted Average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

Other techniques of cost measurement

(a) Instead of actual, the standard costs may be taken as cost of inventory provided standards fairly approximate the actual. Such standards (for finished or partly finished units) should be set in the light of normal levels of material consumption, labour efficiency and capacity utilisation. The standards so set should be regularly reviewed and if necessary, be revised to reflect current conditions. (Paragraph 18)

(b) In retail business, where a large number of rapidly changing items are traded, the actual costs of items may be difficult to determine. The units dealt by a retailer however, are usually sold for similar gross margins and a retail method to determine cost in such retail trades makes use of the fact. By this method, cost of inventory is determined by reducing sale value of unsold stock by appropriate average percentage of gross margin. (Paragraph 19)

Example 5

A trader purchased certain articles for Rs. 85,000. He sold some these articles for Rs. 1,05,000. The average percentage of gross margin is 25% on cost. Opening stock of inventory at cost was Rs. 15,000. Cost closing inventory is shown below.

	Rs.
Sale value of opening stock and purchase (Rs. 85,000 + Rs. 15,000) x 1.25	1,25,000
Sales	1,05,000
Sale value of unsold stock	20,000
Less: Gross Margin (Rs. 20,000 / 1.25) x 0.25	4,000
Cost of inventory	16,000

Estimates of Net Realisable Value

Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date. (Paragraph 22)

Comparison of Cost and Net Realisable Value

(a) The comparison between cost and net realisable value should be made on item-by-item basis. In some cases nevertheless, it may be appropriate to group similar or related items. (Paragraph 21)

Example 6

The cost, net realisable value and inventory value of two items that a company has in its inventory are given below:

	Cost	Net Realisable Value	Inventory Value
	Rs.	Rs.	Rs.
Item 1	50,000	45,000	45,000
Item 2	20,000	24,000	20,000
Total	70,000	69,000	65,000

Estimates of NRV should be based on evidence available at the time of estimation

As per paragraph 3, net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Paragraph 22 provides that estimates of net realisable value are to be based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

NRV of materials held for use or disposal

As per paragraph 24, materials and other supplies held for use in the production of inventories are not written down below cost if the selling price of finished product containing the material exceeds the cost of the finished product. The reason is, as long as these conditions hold the material realises more than its cost as shown below.

An enterprise may either (i) dispose off the material without incorporating it in finished product to realise its current price or (ii) Incorporate the material in finished product to realise the selling price less costs of making (Incremental Revenue)

An enterprise prefers to incorporate the material in finished product when:

Incremental Revenue by making > Current price of material

Or when: (Selling price of finished product – Cost to make) > Current price of material

Or when: (Selling price of finished product > (Current price of material + Cost to make)

Or when: (Selling price of finished product > Relevant cost of finished product

As long as selling price of finished product is more than relevant cost of finished product, the enterprise incorporates the material in finished product and realises incremental revenue rather than current price of material. Thus If selling price of finished product is more than relevant cost of finished product, the enterprise incorporates the material in finished product and NRV is incremental revenue.

(a) If selling price of finished product is less than relevant cost of finished product, the enterprise disposes of the material and NRV is current price of material

If current price of material is greater than material cost

Observe that the NRV is either current price of material or higher, i.e. incremental revenue. Thus, if current price of material is greater than material cost, NRV always exceeds the material cost. The inventories in all such cases are therefore valued at cost.

If current price of material is less than material cost

As before, the NRV is either current price of material or higher, i.e. incremental revenue. If current price of material is less than material cost, and NRV is current price of material (i.e. when enterprise prefers to dispose of the material at current price) the NRV is less than material cost. The inventory is therefore written down to NRV, i.e. current price [See Example 12(a) below].

For the reason stated above, paragraph 24 further provides that when there has been a decline in the price of materials and it is estimated that the cost of finished products will exceed net realisable value (i.e. when enterprise prefers to dispose of the material at current price) the materials are written down to net realisable value. In such circumstances, the replacement cost (i.e. current price of material) may be the best available measure of net realisable value.

If current price of material is less than material cost, and NRV is incremental revenue, (i.e. when enterprise prefers to make the product) the NRV is more than current price of material but may or may not exceed the material cost. If the incremental revenue exceeds material cost, the inventory is valued at cost [See Example 14(b) below]. If the incremental revenue is less than material cost, the inventory is valued at NRV, i.e. incremental revenue [See Example 12(c) below].

Example 7

Raw materials inventory of a company includes 1 Kg. of certain material purchased at Rs. 100 per Kg. The price of the material is on decline and replacement cost of the inventory at the year-end is Rs. 80 per Kg. It is possible to incorporate the material in a finished product. The conversion cost (wages and overheads) is Rs. 120.

Inventory values for expected selling prices of the finished product (a) Rs. 195 (b) Rs. 230 and (c) Rs. 210. are shown below.

In all cases, current price of material (Rs. 80) is less than material cost Rs. 100

Case (a): Selling price = Rs. 195

Incremental revenue = Rs. 195 – Rs. 120 = Rs. 75

Current price of material = Rs. 80

It is better to not to make the product.

Net realisable value = Rs. 80

Cost of material = Rs. 100

Value of inventory = Rs. 80

Case (b): Selling price = Rs. 230

Incremental revenue = Rs. 230 – Rs. 120 = Rs. 110

Current price of material = Rs. 80

It is better to make the product.

Net realisable value = Rs. 110

Cost of material = Rs. 100

Value of inventory = Rs. 100

Case (c): Selling price = Rs. 210

Incremental revenue = Rs. 210 – Rs. 120 = Rs. 90

Current price of material = Rs. 80

It is better to make the product.

Net realisable value = Rs. 90

Cost of material = Rs. 100

Value of inventory = Rs. 90

Review of net realisable value at each balance sheet date

If an item of inventory remains at more than one balance sheet dates, paragraph 25 requires reassessment of net realisable value of the item at each balance sheet date. The AS 2 is silent whether an item of inventory carried at net realisable value, can be written up on subsequent increase of net realisable value. The IAS 2, Inventory permits such write-ups.

Disclosures

Paragraph 26 requires financial statements to disclose:

The accounting policies adopted in measuring inventories, including the cost formula used; and

The total carrying amount of inventories and its classification appropriate to the enterprise.

Paragraph 27 requires disclosure of carrying amounts and changes in them during an accounting period for each class of inventory, e.g. raw materials, components, work-in-progress, finished stock, stores, spares and loose tools.

2.4.3 CASH FLOW STATEMENT (AS 3)

Traditional financial statements comprised of a balance sheet portraying at the end of accounting period, resources controlled by the reporting enterprise together with sources of funds used for their acquisition and a statement of income, showing income, expenses and profit earned or loss incurred by the reporting enterprise during the accounting period. It was however noticed that due to use of accrual basis of accounting, recognition of financial elements, e.g. assets, liabilities, income, expenses and equity, coincide with the events to which they relate rather than with cash receipts or payments. For this reason, traditional financial statements fail to inform the users the way the reporting enterprise has generated cash and the way these were utilised during the accounting period. To a person, less accustomed with accounting practices, it may sometimes appear perplexing to observe that despite earning large profit, an enterprise is left with very little cash to pay dividends. The need for inclusion of a summary of cash receipts and payments in the financial statements of the reporting enterprise was therefore recognised. The summary of cash receipts and payments during an accounting period is called the Cash Flow Statement.

A simple example is given below to illustrate the relation of cash flow with profitability of an enterprise.

Status of AS 3

In 1997, the Accounting Standard 3, Cash Flow Statement, replaced its predecessor, the recommendatory Accounting Standard 3, Changes in Financial Position, (Statement showing Changes in Financial Position is commonly known as Fund Flow Statement) issued in June 1981. The standard is mandatory for Level 1 enterprises in respect of accounting periods commencing on or after April 1, 2001. The Level II and Level III enterprises are encouraged but not required to apply the standard.

All listed companies in India are required by Clause 32 of the listing agreements with stock exchanges to prepare and present cash flow statements by indirect method in accordance with AS 3.

Meaning of the term cash for cash flow statements (Paragraph 5)

Cash for the purpose of cash flow statement consists of the following:

(a) Cash in hand and deposits repayable on demand with any bank or other financial institutions and

(b) Cash equivalents, which are short term, highly liquid investments that are readily convertible into known amounts of cash and are subject to insignificant risk or change in value. A short-term investment is one, which is due for maturity within three months from the date of acquisition. Investments in shares are not normally taken as cash equivalent, because of uncertainties associated with them as to realisable value.

Note : For the purpose of cash flow statement, 'cash' consists of at least three balance sheet items, viz. cash in hand; demand deposits with banks etc. and investments regarded as cash equivalents. For this reason, the paragraph 42 of the standard requires enterprises to give a break-up of opening and closing cash shown in their cash flow statements. This is presented as a note to cash flow statement.

Meaning of the term cash flow (Paragraph 5)

Cash flows are inflows (i.e. receipts) and outflows (i.e. payments) of cash and cash equivalents. Any transaction, which does not result in cash flow, should not be reported in the cash flow statement. Movements within cash or cash equivalents are not cash flows because they do not change cash as defined by AS 3, which is sum of cash, bank and cash equivalents. For example, acquisitions of cash equivalent investments or cash deposited into bank are not cash flows.

It is important to note that a change in cash does not necessarily imply cash flow. For example suppose an enterprise has a bank balance of USD 10,000, stated in books at Rs. 4,90,000 using the rate of exchange Rs. 49/USD prevailing on date of receipt of dollars. If the closing rate of exchange is Rs. 50/USD, the bank balance will be restated at Rs. 5,00,000 on the balance sheet date. The increase is however not a cash flow because neither there is any cash inflow nor there is any cash outflow.

Types of cash flow

Cash flows for an enterprise occur in various ways, e.g. through operating income or expenses, by borrowing or repayment of borrowing or by acquisition or disposal of fixed assets. The implication of each type of cash flow is clearly different. Cash received on disposal of a useful fixed asset is likely to have adverse effect on future performance of the enterprise and it is completely different from cash received through operating income or cash received through borrowing. It may also be noted that implications cash flow types are interrelated. For example, borrowed cash used for meeting operating expenses is not same as borrowed cash used for acquisition of useful fixed assets.

For the aforesaid reasons, the standard identifies three types of cash flows, i.e. investing cash flows, financing cash flows and operating cash flows. Separate presentation of each type of cash flow in the cash flow statement improves usefulness of cash flow information.

The investing cash flows are cash flows generated by investing activities. The investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The examples of investing cash flows include cash flow arising from investing activities include: (a) receipts from disposals of fixed assets; (b) loan given to / recovered from other entities (other than loans by financial enterprises) (c) payments to acquire fixed assets (d) Interests and dividends earned (other than interests and dividends earned by financial institutions).

The financing cash flows are cash flows generated by financing activities. Financing activities are activities that result in changes in the size and composition of the owners' capital (including preferences share capital in the case of company) and borrowings of the enterprise. Examples include issue of shares / debentures, redemption of debentures / preference shares, payment of dividends and payment of interests (other than interests paid by financial institutions).

The operating cash flows are cash flows generated by operating activities or by other activities that are not investing or financing activities. Operating activities are the principal revenue-producing activities of the enterprise. Examples include, cash purchase and sale of goods, collections from customers for goods, payment to suppliers of goods, payment of salaries, wages etc.

Identifying type of cash flows

Cash flow type depends on the business of the enterprise and other factors. For example, since principal business of financial enterprises consists of borrowing, lending and investing, loans given and interests earned are operating cash flows for financial enterprises and investing cash flows for other enterprises. A few typical cases are discussed below.

Loans/Advances given and Interests earned (See Paragraph 30)

(a) Loans and advances given and interests earned on them in the ordinary course of business are operating cash flows for financial enterprises.

(b) Loans and advances given and interests earned on them are investing cash flows for non-financial enterprises.

(c) Loans and advances given to subsidiaries and interests earned on them are investing cash flows for all enterprises.

(d) Loans and advances given to employees and interests earned on them are operating cash flows for all enterprises.

(e) Advance payments to suppliers and interests earned on them are operating cash flows for all enterprises.

(f) Interests earned from customers for late payments are operating cash flows for non-financial enterprises.

Loans/Advances taken and interests paid (See Paragraph 30)

(a) Loans and advances taken and interests paid on them in the ordinary course of business are operating cash flows for financial enterprises.

(b) Loans and advances taken and interests paid on them are financing cash flows for non-financial enterprises.

(c) Loans and advances taken from subsidiaries and interests paid on them are investing cash flows for all enterprises.

(d) Advance taken from customers and interests paid on them are operating cash flows for non-financial enterprises.

(e) Interests paid to suppliers for late payments are operating cash flows for all enterprises.

(f) Interests taken as part of inventory costs in accordance with AS 16 are operating cash flows.

Investments made and dividends earned (See Paragraph 30)

(a) Investments made and dividends earned on them in the ordinary course of business are operating cash flows for financial enterprises.

(b) Investments made and dividends earned on them are investing cash flows for non-financial enterprises.

(c) Investments in subsidiaries and dividends earned on them are investing cash flows for all enterprises.

Dividends Paid (See Paragraph 30)

Dividends paid are financing cash outflows for all enterprises.

Income Tax (See Paragraph 34)

(a) Tax paid on operating income is operating cash outflows for all enterprises

(b) Tax deducted at source against income are operating cash outflows if concerned incomes are operating incomes and investing cash outflows if the concerned incomes are investment incomes, e.g. interest earned.

(c) Tax deducted at source against expenses are operating cash inflows if concerned expenses are operating expenses and financing cash inflows if the concerned expenses are financing expenses, e.g. interests paid.

Insurance claims received

(a) Insurance claims received against loss of stock or loss of profits are extraordinary operating cash inflows for all enterprises.

(b) Insurance claims received against loss of fixed assets are extraordinary investing cash inflows for all enterprises.

Paragraph 28 of the standard requires separate disclosure of extraordinary cash flows, classifying them as cash flows from operating, investing or financing activities, as may be appropriate.

Profit or loss on disposal of fixed assets

Profit or loss on sale of fixed asset is not operating cash flow. The entire proceeds of such transactions should be taken as cash inflow from investing activity.

Fundamental techniques of cash flow preparation

A cash flow statement is a summary of cash receipts and payments of an enterprise during an accounting period. Any attempt to compile such a summary from cashbooks is impractical due to the large volume of transactions. Fortunately, it is possible to compile such a summary by comparing financial statements at the beginning and at the end of accounting period.

There are two methods, by which operating cash flows can be presented. By direct approach, the operating cash flows are presented under broad headings, e.g. cash received from customers and cash paid to suppliers and employees. By the indirect approach, operating cash flows are obtained by adjusting profits for changes in working capital and for non-cash charges, e.g. depreciation.

Reporting Cash Flows on Net Basis

Paragraph 21 forbids netting of receipts and payments from investing and financing activities. Thus, cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets. For example, if an enterprise pays Rs. 50,000 in acquisition of machinery and realises Rs. 10,000 on disposal of furniture, it is not right to show net cash outflow of Rs. 40,000. The exceptions to this rule are stated in paragraphs 22 and 24.

As per paragraph 22, cash flows from the following operating, investing or financing activities may be reported on a net basis.

(a) Cash receipts and payments on behalf of customers, e.g. cash received and paid by a bank against acceptances and repayment of demand deposits.

(b) Cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short, e.g. purchase and sale of investments by an investment company.

Paragraph 24 permits financial enterprises to report cash flows on a net basis in the following three circumstances.

(a) Cash flows on acceptance and repayment of fixed deposits

(b) Cash flows on placement and withdrawal deposits from other financial enterprises

(c) Cash flows on advances/loans given to customers and repayments received therefrom.

Non-Cash transactions (Paragraph 40)

Investing and financing transactions that do not require the use of cash or cash equivalents, e.g. issue of bonus shares, should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Business Purchase

The aggregate cash flows arising from acquisitions and disposals of business units should be presented separately and classified as cash flow from investing activities. (Paragraph 37)

(a) The cash flows from disposal and acquisition should not be netted off. (Paragraph 39)

(b) As per paragraph 38, an enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:

   (i) The total purchase or disposal consideration; and

   (ii) The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

Treatment of current assets and liabilities taken over on business purchase

Business purchase is not operating activity. Thus, while taking the differences between closing and opening current assets and liabilities for computation of operating cash flows, the closing balances should be reduced by the values of current assets and liabilities taken over. This ensures that the differences reflect the increases/decreases in current assets and liabilities due to operating activities only.

Exchange gains and losses

The foreign currency monetary assets (e.g. balance with bank, debtors etc.) and liabilities (e.g. creditors) are initially recognised by translating them into reporting currency by the rate of exchange transaction date. On the balance sheet date, these are restated using the rate of exchange on the balance sheet date. The difference in values is exchange gain/loss. The exchange gains and losses are recognised in the statement of profit and loss (See AS 11 for details).

The exchange gains/losses in respect of cash and cash equivalents in foreign currency (e.g. balance in foreign currency bank account) are recognised by the principle aforesaid, and these balances are restated in the balance sheet in reporting currency at rate of exchange on balance sheet date. The change in cash or cash equivalents due to exchange gains and losses are however not cash flows. This being so, the net increases/decreases in cash or cash equivalents in the cash flow statements are stated excusive of exchange gains and losses. The resultant difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement. (Paragraph 25)

Disclosures

Paragraph 45 requires an enterprise to disclose the amount of significant cash and cash equivalent balances held by it but not available for its use, together with a commentary by management. This may happen for example, in case of bank balances held in other countries subject to such exchange control or other regulations that the fund is practically of no use.

Paragraph 47 encourages disclosure of additional information, relevant for understanding the financial position and liquidity of the enterprise. Such information may include:

(a) The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and

(b) The aggregate amount of cash flows required for maintaining operating capacity, e.g. purchase of machinery to replace the old, separately from cash flows that represent increase in operating capacity, e.g. additional machinery purchased to increase production.

Note: For details regarding preparation of Cash Flow Statement and Problems based on practical application of AS 3, students are advised to refer unit 2 of Chapter 2.

2.4.4 Depreciation Accounting (AS 6)

Where an asset, e.g. machinery, generates revenue over more than one accounting period, the matching principle demands that the cost of the asset be recognised over same number of accounting periods. Also, the allocation, as far as possible should be in the proportion of revenue generated by the asset. Depreciation for an accounting period is the cost of assets allocated to that accounting period. However, the allocated historical cost of an asset may not always reflect the appropriate charge against revenue. This can happen for example, when the asset has a terminal value or when the asset is revalued. For this reason, depreciation for an accounting period is regarded as amount of depreciable value allocated to an accounting period. The depreciable value is historical cost ± Change in historical cost due to revaluation or otherwise – terminal value expected on disposal of the asset.

The depreciation is a non-cash charge, i.e. a charge of depreciation reduces profit available for distribution without reducing the available cash. The cash thus retained in the business is intended to be used for replacement of the depreciable asset. For this reason, section 205 of the Companies Act 1956, provides that companies can pay dividend only out of profit available after charging depreciation in accordance with subsection 2 of that section. For the purpose, Schedule XIV of the Companies Act prescribes certain rates of depreciation. These are minimum rates of depreciation a company must charge.

Accounting standard 6, sets the broad principles for computation of depreciation without prescribing any specific rate or method of depreciation. Enterprises other than companies to which the standard applies, must compute and charge depreciation in accordance with the standard. In case of companies, the depreciation charged should be higher of (i) depreciation under Companies Act (ii) depreciation as per AS 6.

AS 6 is mandatory in respect of accounting periods commencing on or after April 1, 1995. It applies to all enterprises.

Land has indefinite life and hence does not permit allocation of value over finite number of accounting periods. Hence, the standard does not apply to land, unless it has a limited useful life. The standard applies to all depreciable assets except the following to which special considerations apply:

(i) forests, plantations and similar regenerative natural resources

(ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources

(iii) expenditure on research and development

(iv) livestock

Accounting Standard 6 defines depreciation as a measure of the wearing out, consumption or other loss of value of depreciable asset arising from use, efflux of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is pre-determined.

"Depreciable assets" are assets which:

1. are expected to be used during more than one accounting period; and
2. have a limited useful life; and

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

"Useful life" is either

(a) the period over which a depreciable asset is expected be used by the enterprise; or

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

"Depreciable amount" of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less estimated residual value.

The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset. (Paragraph 20)

The useful life of a depreciable asset should be estimated after considering:

expected physical wear and tear

(i) obsolescence and

(ii) legal or other limits on the use of the asset. (Paragraph 22)

The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life. (Paragraph 23)

Example 1

A machine of cost 1,20,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. The estimate of remaining useful life after third year was reassessed at 5 years.

Depreciation per year charged for three years = Rs. 1,20,000 / 10 = Rs. 12,000

WDV of the machine at the end of third year = Rs. 1,20,000 – Rs. 12,000 × 3 = Rs. 84,000.

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 5 years

Depreciation for the fourth year onwards = Rs. 84,000 / 5 = Rs. 16,800.

Additions and Extensions (Paragraph 24)

(a) Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed off, depreciation should be provided independently on the basis of an estimate of its own useful life.

(b) Where an addition or extension becomes an integral part of an existing asset, it should be depreciated over the asset's remaining useful life. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset.

Example 2

The estimated working life of a machine is 6 years. The machine is used with an attachment having a useful life of 10 years. The cost of the machine and that of the attachment are Rs. 60,000 and Rs. 6,000 respectively. The terminal value is zero for both. Straight-line depreciation is in use.

Depreciation for the year

(a) if the attachment retains a separate identity and is capable of being used after the machine is disposed off = Rs. 60,000 / 6 + Rs. 6,000 / 10 = Rs. 10,600

(b) if the attachment becomes an integral part of the machine = Rs. 66,000 / 6 = Rs. 11,000

Change in depreciable amount

(a) The historical cost of a depreciable asset may change due to increase or decrease in long-term liability on account of exchange fluctuations (See note), price adjustments, changes in duties or other similar factors. In these cases, depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual life of the asset. (Paragraph 25)

(b) Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out. (Para 26)

The aforesaid two requirements ensure that no amortisation of depreciable amounts remain pending after the assets cease to be useful. Since an asset does not generate any revenue after its useful is over, any amortisation charged against revenue after such time, defeats the principle of matching revenue and costs.

Example 3

A machine of cost 1,20,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. At the end of third year, the machine was revalued upwards by Rs. 6,000 the remaining useful life was reassessed at 9 years.

Depreciation per year charged for three years = Rs. 1,20,000 / 10 = Rs. 12,000

WDV of the machine at the end of third year = Rs. 1,20,000 – Rs. 12,000 × 3 = Rs. 84,000.

Depreciable amount after revaluation = Rs. 84,000 + Rs. 6,000 = Rs. 90,000

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 9 years

Depreciation for the fourth year onwards = Rs. 90,000 / 9 = Rs. 10,000.

Change in method of charging depreciation (Paragraph 21)

The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use.

The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

Example 4

A company acquired a machine on 01/04/01 for Rs. 5,00,000. The company charged straight-line depreciation based on 10 year working life estimate and residual value Rs. 50,000 upto 2003-04. From 2004-05, the company decided to change to 20% reducing balance method of depreciation. Show adjustment required in books of the company.

Solution

Annual depreciation charged by the company upto 2003-04

= (Rs. 5,00,000 – Rs. 50,000)/10 = Rs. 45,000

WDV of machine at the end of 2003-04 = Rs. 5,00,000 – Rs. 45,000 × 3 = Rs. 3,65,000

WDV of machine at the end 2003-04 (by reducing balance method)

= Rs. 5,00,000 $(1 - 0.20)^3$ = Rs. 2,56,000

Depreciation to be charged in 2004-05

= (Rs. 3,65,000 – Rs. 2,56,000) + 20% of Rs. 2,56,000 = Rs. 1,60,200

Books of the company

	Rs. 000	Rs. 000
Depreciation	160.2	
To Machine		160.2
Profit & Loss A/c	160.2	
To Depreciation		160.2

Machine A/c

	Rs. 000		Rs. 000
To Balance b/d	365.0	By Depreciation	160.2
		By Balance c/d	204.8
	365.0		365.0

Disclosures

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

- ♦ The historical cost or other amount substituted for historical cost of each class of depreciable assets;
- ♦ Total depreciation for the period for each class of assets and the related accumulated depreciation.

(b) In addition to above, the following information should be disclosed in the financial statements along with the disclosure of other accounting policies:

- ♦ depreciation methods used; and
- ♦ depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

(c) If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

2.4.5 Construction Contracts (AS 7)

Accounting Standard 7 prescribes the principles of accounting for construction contracts in the financial statements of contractors. The focus of the standard is on principles of revenue recognition by the contractors. The standard was initially issued in December 1983 and had the title "Accounting for Construction Contracts". The standard was revised later and the revised standard applies to all enterprises in respect of construction contracts entered into during accounting periods commencing on or after April 1, 2003. The earlier standard applies to construction contracts entered into during accounting periods commencing on or before 31/03/03.

A construction contract is one, by which a contractor agrees to build some asset for his customer. The contractor's profit is the excess of contract price over construction costs. The contract price may or may not be fixed. In a fixed price contract, the price is agreed as fixed sum. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations. In a cost plus contract, the customer undertakes to reimburse specified costs together with a fee calculated as percentage on reimbursable costs. The fee is the contractor's margin of profit.

Percentage completion method

Construction contracts are mostly long term, i.e. they take more than one accounting year to complete. This means, the final outcome (profit/ loss) of a construction contract can be determined only after a number of years from the year of commencement of construction are over. It is nevertheless possible to recognise revenue annually in proportion of progress of work to be matched with corresponding construction costs incurred in that year. This method of accounting, called the percentage completion method, provides useful information on the extent of contract activity and performance during an accounting period.

The percentage completion method suffers from a serious drawback viz. anticipation of profit. Since the method recognises revenue pending final outcome of a contract is known, it is possible that an enterprise may distribute dividend based on reported profit of a year, while final result is loss. To avoid such possibilities, percentage completion method should be used with caution. The AS 7 prescribes that the percentage completion method should not be used unless it is possible to make a reasonable estimate of the final outcome of the contract. Also, paragraph 35 of the standard provides that whenever total contract cost is expected to exceed the total contract revenue, the loss should be recognised as an expense immediately.

As per paragraph 22, the outcome of fixed price contracts can be estimated reliably when all the following conditions are satisfied:

(i) total contract revenue can be measured reliably;

(ii) it is probable that the economic benefits associated with the contract will flow to the enterprise;

(iii) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and

(iv) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

As per paragraph 23, the outcome of a cost plus contract can be estimated reliably when all the following conditions are satisfied:

(i) it is probable that the economic benefits associated with the contract will flow to the enterprise; and

(ii) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

Example 1 (The percentage completion method)

X Ltd. commenced a construction contract on 01/04/05. The fixed contract price agreed was Rs. 2,00,000. The company incurred Rs. 81,000 in 2005-06 for 45% work and received Rs. 79,000 as progress payment from the customer. The cost incurred in 2006-07 was Rs. 89,000 to complete the rest of work.

Solution:

Profit & Loss A/c

Year		Rs. 000	Year		Rs. 000
2005-06	To Construction Costs (for 45% work)	81	2005-06	By Contract Price (45% of Contract Price)	90
	To Net profit (for 45% work)	9			
		90			90
2006-07	To Construction costs (for 55% work)	89	2006-07	By Contract Price (55% of Contract Price)	110
	To Net Profit (for 55% work)	21			
		110			110

Customer A/c

Year		Rs. 000	Year		Rs. 000
2005-06	To Contract Price	90	2005-06	By Bank	79
				By Balance c/d	11

		90			90
2006-07	To Balance b/d	11	2006-07		
	To Contract Price	110		By Bank	121
		121			121

The amount of contract revenue recognised in the statement of profit and loss as per the requirements of AS 7 should be considered as turnover according to Accounting Standards Interpretation (ASI) 29. This means, the revenue recognised by percentage completion method should not be described as work-in progress. It may also be noted that as per the scheme for applicability of accounting standards, enterprises having turnover exceeding Rs. 50 crores treated as level I enterprises. The implication of ASI 29 is, that the proportionate revenue recognised in the statement of profit and loss by a contractor, should be taken in computation of turnover for the purpose of the scheme. This is important because level I enterprises are required to comply with all applicable accounting standards in entirety.

The paragraph 31 provides that the percentage completion method should not be applied if the outcome of a construction contract cannot be estimated reliably. In such cases:

(a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

(b) contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should however be recognised as an expense immediately.

When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method. (Para 34)

Example 2

X Ltd. commenced a construction contract on 01/04/05. The contract price agreed was reimbursable cost plus 20%. The company incurred Rs. 1,00,000 in 2005-06, of which Rs. 90,000 is reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at Rs. 5,000. The other costs to complete the contract could not be estimated reliably.

The Profit & Loss A/c extract of X Ltd. for 2005-06 is shown below:

Profit & Loss A/c

	Rs. 000		Rs.000
To Construction Costs	100	By Contract Price	90

To Provision for loss	5	By Net loss	15
	105		105

Treatment of costs relating to future activity (Para 26)

Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. The contract costs that relate to future activity on the contract are however recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

Uncollectable Contract Revenue (Para 27)

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

Stage of Completion (Para 29)

The stage of completion of a contract may be determined in a variety of ways. Depending on the nature of the contract, the methods may include:

(a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

(b) surveys of work performed; or

(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

Example 3

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data.

	Rs. 000
Contract price (Fixed)	600
Cost incurred to date	390
Estimated cost to complete	260

Solution

	Rs. 000
A. Cost incurred to date	390
B. Estimate of cost to completion	260
C. Estimated total cost	650
D. Degree of completion (A/C)	60%
E. Revenue Recognized (60% of 600)	360
Total foreseeable loss (650 – 600)	50
Less: Loss for current year (E – A)	30
Expected loss to be recognised immediately	20

Profit & Loss A/c

	Rs.		Rs.
To Construction costs	390	By Contract Price	360
To Provision for loss	20	By Net Loss	50
	410		410

Combining and Segmenting Construction Contracts

A contractor may undertake a number of contracts. The percentage completion method may not however be appropriate in all cases. Each of the contracts should be tested on the basis of respective facts for electing the appropriate method of revenue recognition. The standard identifies certain cases where for the purposes of accounting, (i) More than one contract can be taken as one and (ii) a single contract can be taken as to comprise of more than one contract.

(a) When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

(i) separate proposals have been submitted for each asset;

(ii) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(iii) the costs and revenues of each asset can be identified.

(b) A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

(i) the group of contracts is negotiated as a single package;

(ii) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(iii) the contracts are performed concurrently or in a continuous sequence.

(c) A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. As per paragraph 9, the construction of the additional asset should be treated as a separate construction contract when:

(i) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(ii) the price of the asset is negotiated without regard to the original contract price.

Contract Revenue and costs

(a) As per paragraph 10, contract revenue should comprise:

(i) the initial amount of revenue agreed in the contract; and

(ii) variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.

(b) As per paragraph 15, contract costs should comprise:

(i) costs that relate directly to the specific contract;

(ii) costs that are attributable to contract activity in general and can be allocated to the contract; and

(iii) such other costs as are specifically chargeable to the customer under the terms of the contract.

Note:

1. Direct costs can be reduced by incidental income, e.g. sale of surplus material, not included in contract revenue. (Paragraph 16)

2. The allocation of indirect costs should be based on normal levels of construction activity. The allocable costs may include borrowing costs as per AS 16. (Paragraph 17)

Changes in Estimates (Para 37)

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate in accordance with AS 5. The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

Disclosure

(a) The paragraph 38 requires an enterprise to disclose:

(i) the amount of contract revenue recognised as revenue in the period;

(ii) the methods used to determine the contract revenue recognised in the period; and

(iii) the methods used to determine the stage of completion of contracts in progress.

(b) The paragraph 39 requires the following disclosures in respect of contracts in progress at the reporting date:

(c) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;

(i) the amount of advances received; and

(ii) the amount of retentions.

(d) The Paragraph 41 requires an enterprise to present:

(i) the gross amount due from customers for contract work as an asset; and

(ii) the gross amount due to customers for contract work as a liability.

2.4.6 Revenue Recognition (AS 9)

This statement was issued by ICAI in the year 1985 and in the initial years it was recommendatory for only level I enterprises and but was made mandatory for enterprise in India from April 01, 1993.

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:

i. Revenue arising from construction contracts;

ii. Revenue arising from hire-purchase, lease agreements;

iii. Revenue arising from government grants and other similar subsidies;

iv. Revenue of insurance companies arising from insurance contracts.

Examples of items not included within the definition of "revenue" for the purpose of this Statement are:

i. Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

ii. Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;

iii. Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

iv. Realised gains resulting from the discharge of an obligation at less than its carrying amount;

v Unrealised gains resulting from the restatement of the carrying amount of an obligation.

Sale of Goods

A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer.

At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit and loss and appropriately described.

Example 1

The stages of production and sale of a producer are as follows (all in Rupees):

Stage	Activity	Costs to date	Net Realisable Value
A	Raw Materials	10,000	8,000
B	WIP 1	12,000	13,000
C	WIP 2	15,000	19,000
D	Finished Product	17,000	30,000
E	For Sale	17,000	30,000
F	Sale Agreed	17,000	30,000
G	Delivered	18,000	30,000
H	Paid For	18,000	30,000

State and explain the stage at which you think revenue will be recognized and how much would be gross profit and net profit on a unit of this product?

Solution:

According to AS – 9, sales will be recognized only following two conditions are satisfied:

1. The sale value is fixed and determinable.
2. property of the goods are transferred to the customer.

Both these conditions are satisfied only at Stage F when sales are agreed upon at a price and goods allocated for delivery purpose.

Gross Profit will be determined at Stage E, when goods are ready for sale after all necessary process for production is over i.e. Rs. 13,000 (30,000 – 17,000).

Net Profit will be determined at Stage H, when goods are delivered and payment collected i.e. Rs. 12,000 (30,000 – 18,000).

Rendering of Services

Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

Proportionate completion method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract. Here performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act.

Completed service contract method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable

Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

Use by others of such enterprise resources gives rise to:

i. Interest: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognized on a time proportion basis taking into account the amount outstanding and the rate applicable.

ii. Royalties: charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement.

iii. Dividends: rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established.

Effect of Uncertainties on Revenue Recognition

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases:

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

Disclosure

An enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

Example 2

A public sector company is trading gold in India for its customers, after purchasing gold the price of gold is fixed within 120 days as per rules and regulations of Indian Bullion Market by the customer. At the close of year, price of some gold was not fixed on March 31, 2006. The details are given below:

Quantity of Gold	=	10,000 TT Bars
Gold Rate as on March 31, 2006	=	Rs. 275 per TT Bar
Gold Rate was fixed on June 26, 2006 before the finalization of accounts of company	=	Rs. 273 per TT Bar

Calculate the amount of sales regarding 10,000 TT Bars to be booked in the company's account for the year ended March 31, 2006.

Solution:

We need to refer to AS 5 along with AS 9 in this case, since gold is an item which has ready market hence they should be valued at the market price. So, as event occurring after the balance sheet date, the price of gold is fixed at Rs. 273 per TT Bar, gold will be valued at that rate.

2.4.7 Accounting for Fixed Assets (AS 10)

After introduction of AS – 16; 19 & 26, provisions relating to respective AS are held withdrawn and the rest is mandatory from the accounting year 1-4-2000.

This statement does not deal with accounting for the following items to which special considerations apply:

i. Forests, plantations and similar regenerative natural resources.

ii. Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

iii. Expenditure on real estate development and

iv. Livestock.

Identification of Fixed Assets

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.

Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

Components of Cost

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price.

The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement.

Self-constructed Fixed Assets

Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.

Example

ABC Ltd. is constructing a fixed asset. Following are the expenses incurred on the construction:

Materials	Rs. 10,00,000
Direct Expenses	Rs. 2,50,000
Total Direct Labour	Rs. 5,00,000
(1/10th of the total labour time was chargeable to the construction)	
Total office & administrative expenses	Rs. 8,00,000
(5% is chargeable to the construction)	
Depreciation on the assets used for the construction of this assets	Rs. 10,000

Calculate the cost of fixed assets.

Solution:

Calculation of the cost of construction of Assets

Particulars	Rs.
Direct Materials	1,000,000
Direct Labour	50,000
Direct Expenses	250,000
Office & Administrative Expenses	40,000
Depreciation	10,000
Cost of the Asset	1,350,000

Non-monetary Consideration

When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident.

When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

Improvements and Repairs

Any expenditure that increase the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.

The cost of an addition or extension to an existing asset, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately.

Amount Substituted for Historical Cost

The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation.

Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis.

It is not appropriate for the revaluation of a class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class.

An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve.

Retirements and Disposals

Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognised immediately in the profit and loss statement.

On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

Hire Purchases

In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which, if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

Joint Ownership

Where an enterprise owns fixed assets jointly with others, the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

Goodwill

Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

Patents

Patents are normally acquired in two ways: (i) by purchase, in which case patents are valued at the purchase cost including incidental expenses, stamp duty, etc. and (ii) by development within the enterprise, in which case identifiable costs incurred in developing the patents are capitalised. Patents are normally written off over their legal term of validity or over their working life, whichever is shorter.

Know How

Know-how in general is recorded in the books only when some consideration in money or money's worth has been paid for it. Know-how is generally of two types: Relating to manufacturing processes and Relating to plans, designs and drawings of buildings or plant and machinery.

Know-how related to plans, designs and drawings of buildings or plant and machinery is capitalised under the relevant asset heads. In such cases depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalised. Know-how related to manufacturing processes is usually expensed in the year in which it is incurred.

Disclosure

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

ii. Expenditure incurred on account of fixed assets in the course of construction or acquisition; and

iii. Revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

Example

On March 01, 2006, X Ltd. purchased Rs. 5 lakhs worth of land for a factory site. Company demolished an old building on the property and sold the material for Rs. 10,000. Company incurred additional cost and realized salvaged proceeds during the March 2006 as follows:

Legal fees for purchase contract and recording ownership	Rs. 25,000

Title guarantee insurance	Rs. 10,000
Cost for demolition of building	Rs. 30,000

In March 31, 2006 balance sheet, X Ltd. should report a balance in the land account.

Solution

Calculation of the cost for Purchase of Land

Particulars		*R*s.
Cost of Land		500,000
Legal Fees		25,000
Title Insurance		10,000
Cost of Demolition	50,000	
Less: Salvage value of Material	10,000	40,000
Cost of the Asset		575,000

2.4.8 Accounting for Investments (AS 13)

This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995.

This Statement does not deal with:

a. The bases for recognition of interest, dividends and rentals earned on investments which are covered by AS 9.

b. Operating or finance leases.

c. Investments of retirement benefit plans and life insurance enterprises and

d. Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

Market value is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

Forms of Investments

Investments are 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. Assets held as stock-in-trade are not 'investments'.

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings).

For some investments, an active market exists from which a market value can be established. For other investments, an active market does not exist and other means are used to determine fair value.

Classification of Investments

A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

A long term investment is an investment other than a current investment.

Cost of Investments

The cost of an investment includes acquisition charges such as brokerage, fees and duties.

If an investment is acquired, or partly acquired, by the issue of shares or other securities or another assets, the acquisition cost is the fair value of the securities issued or assets given up. The fair value may not necessarily be equal to the nominal or par value of the securities issued. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income.

If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

Carrying Amount of Investments

The carrying amount for current investments is the lower of cost and fair value. Valuation of current investments on overall basis is not considered appropriate. The more prudent and appropriate method is to carry investments individually at the lower of cost and fair value. Any reduction to fair value and any reversals of such reductions are included in the Profit & Loss Statement.

Long-term investments are usually carried at cost. Where there is a decline, other than temporary, in the carrying amounts of long term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

Investment Properties

An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

Disposal of Investments

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

Reclassification of Investments

Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

Disclosure

The following disclosures in financial statements in relation to investments are appropriate: -

a. The accounting policies for the determination of carrying amount of investments.

b. The amounts included in profit and loss statement for:

i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.

ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.

iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.

c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.

d. The aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments.

e. Other disclosures as specifically required by the relevant statute governing the enterprise.

2.4.9 Accounting for Amalgamations (AS 14)

This standard came into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature. It deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

This statement does not deal with cases of acquisitions. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.

Transferor company means the company which is amalgamated into another company.

Transferee company means the company into which a transferor company is amalgamated.

Types of Amalgamations

Amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. These are known as Amalgamation in nature of merger. Other is known as Amalgamation in nature of purchase.

Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.

i. All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

iii. The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

iv. The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

v No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified above.

Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamations the pooling of interests method and the purchase method.

Pooling of interests

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts.

If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5.

The Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [AS 4].

Example

A Ltd. take over B Ltd. on April 01, 2006 and discharges consideration for the business as follows:

(i) Issued 42,000 fully paid equity shares of Rs. 10 each at par to the equity shareholders of B Ltd.

(ii) Issued fully paid up 15% preference shares of Rs. 100 each to discharge the preference shareholders (Rs. 1,70,000) of B Ltd. at a premium of 10%.

(iii) It is agreed that the debentures of B Ltd. (Rs. 50,000) will be converted into equal number and amount of 13% debentures of A Ltd.

Solution:

Particulars	Rs.	Rs.
Equity Shares (42,000 x 10)		4,20,000
Preference Share Capital	1,70,000	
Add : Premium on Redemption	17,000	1,87,000
Purchase Consideration		6,07,000

Treatment of Reserves on Amalgamation

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

If the amalgamation is an ‘amalgamation in the nature of purchase’, the amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve.

In the case of an ‘amalgamation in the nature of purchase’, the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

Certain reserves may have been created by the transferor company pursuant to the requirements of certain acts, referred to hereinafter as ‘statutory reserves’. Such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., ‘Amalgamation Adjustment Account’) which is disclosed as a part of ‘miscellaneous expenditure’ or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

Treatment of Goodwill Arising on Amalgamation

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

Illustration:

The following are the balance sheets of A Ltd. and B Ltd. as on March 31, 2008:

Liabilities	A Ltd. (Rs.)	B Ltd. (Rs.)
Equity Shares, Rs. 10 each, fully paid up	7,20,000	3,00,000
14% Preference Share Capital, Rs. 100 each, fully paid up	1,50,000	1,70,000
Securities Premium	1,50,000	

Capital Reserve		13,000
General Reserve	80,000	45,000
Export Profit Reserve		20,000
Profit and Loss Account	75,000	40,000
Workmen Compensation Fund		9,000
13% Debentures, Rs. 100 each, fully paid up	1,00,000	50,000
Creditors	1,15,000	35,000
Provision for Taxation	15,000	10,000
	14,05,000	6,92,000
Assets		
Goodwill	2,00,000	60,000
Land and Buildings	2,50,000	
Plant and Machinery	3,25,000	2,70,000
Furniture and Fixtures	57,000	95,000
Stock	2,15,000	1,75,000
Debtors	72,000	30,000
Income Tax Refund Claim		6,000
Cash at Bank	2,16,000	50,000
Cash in Hand	70,000	
Preliminary Expenses		6,000
	14,05,000	6,92,000

A Ltd. take over B Ltd. on April 01, 2008 and discharges consideration for the business as follows:

a. Issued 42,000 fully paid equity shares of Rs. 10 each at par to the equity shareholders of B Ltd.

b. Issued fully paid up 15% preference shares of Rs. 100 each to discharge the preference shareholders of B Ltd. at a premium of 10%.

c. It is agreed that the debentures of B Ltd. will be converted into equal number and amount of 13% debentures of A Ltd.

d. The Statutory Reserve of B Ltd. is to be maintained for two more years.

e. Expenses of amalgamation amounting to Rs. 15,000 are borne by A Ltd.

Solution:

Since all the five conditions are satisfied, it is amalgamation in the nature of merger. Following are the journal entries in the books of A Ltd. and the calculation of the Purchase Consideration.

Particulars	Dr. (Rs.)	Cr. (Rs.)
Goodwill Account Dr.	60,000	
Plant & Machinery Account Dr.	270,000	
Furniture & Fixtures Account Dr.	95,000	
Stock Account Dr.	175,000	
Debtors Account Dr.	30,000	
IT Refund Account Dr.	6,000	
Bank Account Dr.	50,000	
Preliminary Expenses Account Dr.	6,000	
General Reserve Account Dr. (Balancing Figure)	52,000	
To Capital Reserve Account		13,000
To Export Profit Reserve Account		20,000
To Workmen Compensation Fund Account		9,000
To 13% Debentures Account		50,000
To Creditors Account		35,000
To Provision for Tax Account		10,000
To Business Purchase Account		607,000
Business Purchase Account Dr.	607,000	
To B Ltd. Liquidator Account		607,000
B Ltd. Liquidator Account Dr.	607,000	
To Equity Share Capital Account		420,000
To Preference Share Capital		187,000
13% Debentures Account Dr. (In B Ltd.)	50,000	
To 13% Debentures Account (In A Ltd.)		50,000
General Reserve Account Dr.	15,000	
To Bank Account		15,000

If we consider that the fifth point i.e. business of B Ltd. was not carried on by A Ltd. then it will be Amalgamation in the nature of Purchase and the journal entries in the books of A Ltd. will be as follow:

Particulars	Dr. (Rs.)	Cr. (Rs.)
Goodwill Account Dr. (Balancing Figure)	76,000	
Plant & Machinery Account Dr.	270,000	
Furniture & Fixtures Account Dr.	95,000	
Stock Account Dr.	175,000	
Debtors Account Dr.	30,000	
IT Refund Account Dr.	6,000	
Bank Account Dr.	50,000	
To 13% Debentures Account		50,000
To Creditors Account		35,000
To Provision for Tax Account		10,000
To Business Purchase Account		607,000
Business Purchase Account Dr.	607,000	
To B Ltd. Liquidator Account		607,000
B Ltd. Liquidator Account Dr.	607,000	
To Equity Share Capital Account		420,000
To Preference Share Capital		187,000
13% Debentures Account Dr. (In B Ltd.)	50,000	
To 13% Debentures Account (In A Ltd.)		50,000
Goodwill Account Dr.	15,000	
To Bank Account		15,000
Amalgamation Adjustment Account Dr.	20,000	
To Export Profit Reserve Account		20,000

Disclosure

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Names and general nature of business of the amalgamating companies;

b. Effective date of amalgamation for accounting purposes;

c. The method of accounting used to reflect the amalgamation; and

d. Particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;

b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Consideration for the amalgamation and a description of the consideration paid or contingently payable; and

b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

Miscellaneous Illustrations

Illustration 1

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2005-06, the Historical Cost and Net Realizable Value of the items of closing stock are determined as follows:

Items	Historical Cost	Net Realisable Value
	(Rs. in lakhs)	(Rs. in lakhs)
A	40	28
B	32	32
C	16	24

What will be the value of Closing Stock?

Solution

As per para 5 of AS 2 on Valuation of Inventories, inventories should be valued at the lower of cost and net realizable value. Inventories should be written down to net realizable value on an item-by-item basis in the given case.

Items	Historical Cost (Rs. in lakhs)	Net Realisable Value (Rs. in lakhs)	Valuation of closing stock (Rs. in lakhs)
A	40	28	28
B	32	32	32
C	16	24	16
	88	84	76

Hence, closing stock will be valued at Rs. 76 lakhs.

Illustration 2

During the current year 2005–2006, X Limited made the following expenditure relating to its plant building:

	Rs. In lakhs
Routine Repairs	4
Repairing	1
Partial replacement of roof tiles	0.5
Substantial improvements to the electrical wiring system which will increase efficiency	10

What amount should be capitalized?

Solution

As per para 12.1 of AS 10 on Accounting for Fixed Assets, expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity. Hence, in the given case, Repairs amounting Rs.5 lakhs and Partial replacement of roof tiles should be charged to profit and loss statement. Rs.10 lakhs incurred for substantial improvement to the electrical writing system which will increase efficiency should be capitalized.

Illustration 3

A plant was depreciated under two different methods as under:

Year	SLM (Rs. in lakhs)	W.D.V. (Rs. in lakhs)
1	7.80	21.38
2	7.80	15.80
3	7.80	11.68
4	7.80	8.64
	31.20	57.50
5	7.80	6.38

What should be the amount of resultant surplus/deficiency, if the company decides to switch over from W.D.V. method to SLM method for first four years? Also state, how will you treat the same in Accounts.

Solution

As per para 21 of AS 6 on Depreciation Accounting, when a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In the given case, there is a surplus of Rs. 26.30 lakhs on account of change in method of depreciation, which will be credited to Profit and Loss Account. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

Illustration 4

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2006.

	(Rs. in lakhs)
Total Contract Price	1,000
Work Certified	500
Work not Certified	105
Estimated further Cost to Completion	495
Progress Payment Received	400
To be Received	140

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS 7 (Revised) issued by your institute.

Solution

(a)	Amount of foreseeable loss	(Rs in lakhs)
	Total cost of construction (500 + 105 + 495)	1,100
	Less: Total contract price	1,000
	Total foreseeable loss to be recognized as expense	100

According to para 35 of AS 7 (Revised 2002), when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

(b)	Contract work-in-progress i.e. cost incurred to date are Rs. 605 lakhs	(Rs in lakhs)
	Work certified	500
	Work not certified	105
		605

This is 55% (605/1,100 × 100) of total costs of construction.

(c) Proportion of total contract value recognised as revenue as per para 21 of AS 7 (Revised).

55% of Rs. 1,000 lakhs = Rs. 550 lakhs

(d) Amount due from/to customers = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)

= [605 + Nil – 100 – (400 + 140)] Rs. in lakhs

= [605 – 100 – 540] Rs. in lakhs

Amount due to customers = Rs. 35 lakhs

The amount of Rs. 35 lakhs will be shown in the balance sheet as liability.

(e) The relevant disclosures under AS 7 (Revised) are given below:

	Rs. in lakhs
Contract revenue	550
Contract expenses	605
Recognised profits less recognized losses	(100)
Progress billings (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35

Illustration 5

In preparing the financial statements of R Ltd. for the year ended 31st March, 2006, you come across the following information. State with reasons, how you would deal with this in the financial statements:

An unquoted long term investment is carried in the books at a cost of Rs. 2 lakhs. The published accounts of the unlisted company received in May, 2006 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than Rs. 20,000.

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2006 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Para 17 of AS 13 ‘Accounting for Investments’ states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to Rs. 20,000 in the financial statements for the year ended 31st March, 2006.

Illustration 6

Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received Rs. 10 lakhs and Rs. 15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2005-06.

You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

Solution

As per para 13 of AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

(i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.

(ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.

Illustration 7

On 1st December, 2005, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for Rs. 85 lakhs. On 31st March, 2006 the company found that it had already spent Rs. 64,99,000 on the construction. Prudent estimate of additional cost for completion was Rs. 32,01,000. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2006 as per provisions of Accounting Standard 7 (Revised)?

Solution

(a)	Rs.
Cost incurred till 31st March, 2006	64,99,000
Prudent estimate of additional cost for completion	32,01,000
Total cost of construction	97,00,000
Less: Contract price	85,00,000
Total foreseeable loss	12,00,000

According to para 35 of AS 7 (Revised 2002), the amount of Rs. 12,00,000 is required to be recognized as an expense.

$$\text{Contract work in progress} = \frac{\text{Rs.}\,64{,}99{,}000\times 100}{97{,}00{,}000} = 67\%$$

Proportion of total contract value recognized as turnover as per para 21 of AS 7 (Revised) on Construction Contracts.

= 67% of Rs.85,00,000 = Rs.56,95,000.

Self- Examination Questions

I. Objective type Questions

Choose the most appropriate answer from the given options:

1. Which of the following does not form a part of contract costs as defined in AS 7 (Revised)?

   (a) Estimated warranty costs under the construction contract.

   (b) Comprehensive insurance policy premium for all open construction contracts.

   (c) Research and development costs incurred at the instance of the contractee and billed to his account.

   (d) General administration costs for which reimbursement is not specified in the contract.

2. Investments classified as long-term investments should be carried in the financial statements at

   (a) Cost.

   (b) Fair value.

   (c) Lower of cost or fair value.

   (d) Face value.

3. A change in accounting policy is justified

   (a) To comply with Accounting Standards.

   (b) To ensure more appropriate presentation of the financial statements.

   (c) To comply with the Law.

   (d) All of the above.

4. AS 10 requires that the financial statements should disclose

   (a) Gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements.

   (b) Expenditure incurred on account of fixed assets in the course of construction or acquisition.

   (c) Revalued amounts substituted for historical costs along with the method adopted to compute the revalued amounts.

   (d) All of the above.

5. Which one of the following best describes the reason for allocating a fixed asset's cost over its useful life?

   (a) To provide a better measure of the market value of the asset in the balance sheet.

   (b) To match the cost of the asset with the revenue it is used to produce.

   (c) To gradually bring the cost of the asset into income rather than to expense it all in the year of acquisition.

   (d) To reduce income to take advantage of tax benefits of owning fixed assets.

6. Internally generated goodwill is

   (a) Recorded at cost of generating goodwill.

   (b) Recorded at valuation done by experts.

   (c) (a) or (b) whichever is less.

   (d) Not recorded.

[**Answers** :. **1.** (d), **2.** (a), **3.** (d), **4.** (d), **5.** (b), **6.** (d).]

II. Short Answer Questions

7. Mention any five areas in which different accounting policies may be adopted by different enterprises.

8. What type of costs are excluded from the cost of inventory?

9. Write short note on Effect of Uncertainties on Revenue Recognition.

10. Explain provisions contained in the Accounting Standard in respect of Revaluation of fixed assets.

11. When can revenue be recognised in the case of transaction of sale of goods?

12. Write short note on valuation of fixed assets in special cases.

III. Long Answer Questions

13. Elucidate the classification of investments to determine the value of investments for the purpose of balance sheet.

IV. Practical Problems

14. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2006.

    A claim lodged with the Railways in March, 2003 for loss of goods of Rs.2,00,000 had been passed for payment in March, 2006 for Rs.1,50,000. No entry was passed in the books of the Company, when the claim was lodged.

15. Raw material was purchased at Rs.100 per kilo. Price of raw material is on the decline. The finished goods in which the raw material is incorporated is expected to be sold at below cost. 10,000 kgs. of raw material is on stock at the year end. Replacement cost is Rs. 80 per kg. State with reference to AS 2, how will you value the inventories ?

16. X Co. Ltd. charged depreciation on its asset on SLM basis. For the year ended 31.3.2006 it changed to WDV basis. The impact of the change when computed from the date of the asset coming to use amounts to Rs.20 lakhs being additional charge.

    Decide how it must be disclosed in Profit and loss account. Also, discuss, when such changes in method of depreciation can be adopted by an enterprise as per AS–6.

17. X Limited has recognized Rs.10 lakhs on accrual basis income from dividend on units of mutual funds of the face value of Rs.50 lakhs held by it as at the end of the financial year 31st March, 2006. The dividends on mutual funds were declared at the rate of 20% on 15th June, 2006. The dividend was proposed on 10th April, 2006 by the declaring company. Whether the treatment is as per the relevant Accounting Standard? You are asked to answer with reference to provisions of Accounting Standard.

CHAPTER 2

FINANCIAL STATEMENTS OF COMPANIES

UNIT – 1: PREPARATION OF FINANCIAL STATEMENTS

Learning Objectives

After studying this unit, you will be able to:

- Know how to maintain books of account of a company.
- Learn about statutory books of a company.
- Prepare and present the final account of a company in a proper format.
- Calculate managerial remuneration of managers in a company.
- Appreciate the term divisible profit.

1.1 MEANING OF COMPANY

The word 'company' derived from the Latin word '*com*' *i.e.* with or together and '*panis*' *i.e.* bread. Originally the word referred to an association of persons or merchant men discussing matters and taking food together. It denotes a group of persons and the effect of registration under the Companies Act is that such group becomes a corporate body having perpetual succession and a common seal. The term 'company' is defined in Section 2(10). The definition only says that a company means a company as defined in Section 3 of the Companies Act. Section 3 further explains the meaning of expression 'company', 'existing company', 'private company' and 'public company'. Apart from these categories, the different kinds of company are holding company, subsidiary company, foreign company and companies which are limited by guarantee and lastly an unlimited company. All these have already been discussed in the Common Proficiency Test Study Material. For their understanding, students can refer it.

1.2 MAINTENANCE OF BOOKS OF ACCOUNT

Section 209 of the Companies Act states that books of account shall be maintained at the company's registered office unless the Board of Directors decide to keep them at another place in India. It is a duty of the company to inform the Registrar of Companies within seven days of the decision in case the Board of Directors decides to maintain books at the place other than the registered office.

Where the company has a branch office, whether in or outside India the proper books of accounts relating to the transactions effected at the branch office are kept at that office and proper summarised returns made up to date at intervals of not more than three months are prepared and sent within reasonable time to head office.

Every company is required to keep proper books of account showing (i) all monies received and spent and the details thereof, (ii) sales and purchases of goods, and (iii) assets and liabilities. A company engaged in production, processing, manufacturing or mining activities has also to maintain, if required by the Central Government, cost accounting records *i.e.,* particulars relating to utilisation of material, labour and other items of costs.

Proper books of accounts shall not be deemed to be kept if there are not kept such books as are necessary to give a *true and fair view* of the state of affairs of the company or branch office, as the case may be, and to explain its transactions. Also if such books are not kept on *accrual basis* and according to system of double entry book keeping, proper books of accounts shall not be deemed to have been kept.

1.3 STATUTORY BOOKS

The following statutory books are required to be maintained by a company under different sections of the Companies Act :

- Register of Investments of the company not held in its own name (Section 49).
- Register of Mortgages and Charges (Section 143).
- Register of Members and Index (Sections 150 & 151).
- Register of Debenture-holders and Index (Section 152).
- Foreign Register of Members and of Debenture-holders and their duplicates (Sections 157 and 158).
- Minute Books (Section 193).
- Register of Contracts, Companies, and firms in which directors are interested (Section 301).
- Register of directors, managing director, manager and secretary (Section 303).
- Register of Directors' share-holding (Section 307).
- Register of investments in securities of any other body corporate, loans made, guarantees given or securities provided to any body corporate.

In addition, a company usually maintains a number of statistical books to keep a record of its transactions which have resulted either in the payment of money to it or constitute the basis on which certain payments have been made by it. Registers and documents relating to the issue of shares are :

(i) Share Application and Allotment Book ;

(ii) Share Call Book ; and

(iii) Certificate Book.

In respect of shares, the company, in addition to maintain Register of Members, which it has to maintain statutorily, it also maintains (*a*) Share Transfer Book ; and (*b*) Dividend Register.

1.4 ANNUAL RETURN

Under Section 149 of the Companies Act, every company having a share capital, shall within sixty days from the day of which each of the annual general meeting is held, prepare and file with the Registrar the annual return containing the particulars specified in Part I of Schedule V. The annual return shall be in the Form set out of Part II of Schedule V or near thereto as circumstances meet.

1.5 FINAL ACCOUNTS

Under Section 210 of the Companies Act, at the annual general meeting of a company, the Board of Directors of the company shall lay before the company:

(a) a balance sheet as at the end of the period;

(b) a profit & loss account for that period.

In case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting instead of profit and loss account.

Every balance-sheet of the company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and shall subject to the provisions of the section be in the Form set out in Part I of Schedule VI, or as near thereto as circumstances admit. Any insurance or banking company or any company engaged in generation or supply of electricity or any other class of company for which a Form of balance sheet has been prescribed under the Act governing such class of company need not follow such form (Section 211). Every Profit and Loss Account of a company shall also give a true and fair view of profit or loss of the company for the financial year and shall comply with the requirements of Part II of Schedule VI. Every insurance or banking company or any company engaged in the generation of electricity or any other class of company for which a Form of Profit and Loss Account has been specified under the Act governing such class of company need not follow the Form given in the Schedule VI to this Act.

While preparing the final accounts of a company the following should be kept in mind :

* Requirements of Schedule VI;

* Other statutory requirements;

* Accounting Standards issued by the Institute of Chartered Accountants of India on different accounting matters (AS-1 to AS-32);

* Statements and Guidance Notes issued by the Institute of Chartered Accountants of India;

which are necessary for understanding the accounting treatment / valuation / disclosure suggested by the ICAI]

Recently, the Companies (Amendment) Act, 1999 which shall be deemed to have come into force on 31st day of October, 1998, has made the compliance of accounting standards mandatory by adding Sub-sections 3A, 3B and 3C in Section 211.

These are :

‘(*3A*) Every profit and loss account and balance sheet of the company shall comply with the accounting standards.

(*3B*) Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely :

(a) the deviation from the accounting standards;

(b) the reasons for such deviation; and

(c) the financial effect, if any, arising due to such deviation.

(*3C*) For the purposes of this section, the expression “accounting standards” means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949, as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under Sub-section (*1*) of Section 210A :

Provided that the standard of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the Accounting Standards are prescribed by the Central Government under this sub-section’.

[Thus, until the National Advisory Committee on Accounting Standards is established, companies will be required to prepare their profit and loss account and balance sheet in respect of accounting years closing on or after October 31, 1998, in accordance with the Accounting Standards specified by the Institute {excluding recommendatory accounting standard(s)}- as notified by the ICAI in Journal of the ICAI, January 1999]

The balance sheet can be prepared either in Horizontal Form or in Vertical Form. However, there is no specified Form of Profit and Loss Account. Schedule VI - Part II gives only requirements as to Profit and Loss Account. Part III of Schedule VI gives interpretation. Students are advised to refer ' Part-1 Form of Balance Sheet' of Schedule VI from the latest Companies Act, for better understanding and presentation of Companies' Balance Sheet. While 'General Instructions for Preparation of Balance Sheet' and other relevant Forms given in Schedule VI and the requirements have been produced on the following pages.

NOTES

General instructions for preparation of balance sheet

(a) The information required to be given under any of the items or sub-items in this Form, if it cannot be conveniently included in the balance sheet itself, shall be furnished in a separate Schedule to be annexed to and to form part of the balance sheet. This is recommended when items are numerous.

(b) Naye Paise can also be given in addition to Rupees, if desired.

(c) 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.

(cc) The item “Share Premium Account” shall include details of its utilisation in the manner provided in section 78 in the year of utilisation.

(d) Short-term loans will include those which are due for not more than one year as at the date of the balance sheet.

(e) Depreciation written off or provided shall be allocated under the different assets heads and deducted in arriving at the value of fixed assets.

(f) Dividends declared by subsidiary companies after the date of the balance sheet should not be included unless they are in respect of period which closed on or before the date of the balance sheet.

(g) Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance sheet but shall be made in the Board’s report.

(h) The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserves, if any.

(i) As regards Loans and Advances, [the amount due from other companies under the same management within the meaning of sub-section (1B) of section 370 should also be given with the names of the companies] the maximum amount due from every one of these at any time during the year must be shown.

(j) Particulars of any redeemed debentures which the company has power to issue should be given.

(k) Where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated.

(l) 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 the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate; provided that in the case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner), shall be given in the statement.

(m) If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated.

(n) Except in the case of the first balance sheet 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 balance sheet shall be also given in the balance sheet. The requirement in this behalf shall, in the case of companies preparing quarterly or half-yearly accounts, etc., relate to the balance sheet for the corresponding date in the previous year.

(o) The amounts to be shown under Sundry Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances.

(p) Current accounts with directors, and manager, whether they are in credit, or debit, shall be shown separately.

B. Vertical Form

Name of the Company......

Balance Sheet as at......

		Schedule	*Figures as the end of*	*Figures as at the end of*
		No.	*current*	*previous*
			financial year	*financial*
year				
1	2	3	4	5

I. Sources of Funds

(1) Shareholders' funds :

(a) Capital

(b) Reserves 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

Less: 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 A — Horizontal Form 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 figures in the balance sheet may be rounded off to nearest '000' or '00' as may be convenient or may be expressed in terms of decimals of thousands.
4. A footnote to the balance sheet may be added to show separately contingent liabilities.

Amendments in Schedule VI to the Companies Act, 1956

Notification No. GSR 129(E), dated 22-2-1999, issued by the department of Company Affairs, Ministry of Law, Justice & Company Affairs

In exercise of the powers conferred by sub-section (1) of section 641 of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following further alterations in Schedule VI to the said Act, namely :-

In the said Schedule, in "Part I - Form of Balance Sheet", -

(1) in the first column relating to "Instructions in accordance with which Liabilities should be made out", after the first paragraph appearing against the sub-heading "current liabilities and provisions", occurring in the second column, the following paragraph shall be inserted, namely:—

"The name(s) of the small scale industrial undertaking(s) to whom the Company owe a sum exceeding Rs. 1 lakh which is outstanding for more than 30 days, are to be disclosed."

(2) in the second column, relating to "Liabilities", under the heading "current liabilities and provisions", after item (2), the following sub-items shall be inserted, namely:—

"(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) in the "Notes" embodying General Instructions for preparation of balance sheet, after item (*p*), the following shall be inserted, namely:-

(*q*) A small scale industrial undertaking has the same meaning as assigned to it under clause (*j*) of section 3 of the Industries (Development and Regulation) Act, 1951."

Proforma of Profit and Loss Account

Name of the Company......

Profit and Loss Account for the Year Ended......

	Schedule	*Figures as at*	*Figures as*
at			
	No.	*the end of*	*the end of*
		current	*previous*
		financial year	*financial*
year			
1	2	3	4
Income			
Sales			
Other Income			
Expenditure			
Purchases			

Manufacturing and other expenses

Depreciation

Interest and other Financial Charges

Profit for the financial year before tax

Provision for taxation

Profit for the financial year after tax

Balance of profit and

loss account brought forward

Proposed dividend

Transfers to reserves

Balance carried to Balance sheet

Notes:

1. Separate schedules should be annexed wherever required and would form a part of the Profit and Loss Account.

2. The figures in the profit and loss account may be rounded of to the nearest ‘000’ or ‘00’ as may be convenient or may be expressed in terms of decimals of thousands.

3. Footnotes may be appended to show the director’s fees, managers and auditors remuneration, contingent liabilities not provided for etc.

Part II

Requirements As To Profit And Loss Account

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-section (2) of section 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 section 294 of the Act.

(c) Commission paid to other selling agents.

(d) Brokerage and discount on sales, other than the usual trade discount.

(ii) (a) 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 the total value of the raw material consumed shall be shown as separate and distinct items with quantities thereof in the break-up.

(2) (a) The opening and closing stocks of goods produced, giving break-up in respect of each class of goods and indicating the quantities thereof.

(b) 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.

(c) In the case of companies rendering or supplying services, the gross income derived from services rendered or supplied.

(d) 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.

(e) 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 items 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 licences 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 of 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 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 section 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 of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.

(vii) The amount 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 at 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) Profit 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 or reserve acount.

(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 account are affected by any change in the basis of accounting.

4. The profit and loss account shall also contain or give 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:—

(i) managerial remuneration under section 198 of the Act paid (or payable) during the financial year to the directors (including managing directors), or manager, if any;

(ii) omitted.

(iii) omitted.

(iv) omitted.

(v) omitted.

(vi) other allowances and commission including guarantee commission (details to be given);

(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 computation of net profits in accordance with section 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 directors), 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 licence 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 (*c*), 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 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 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, know-how, professional 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 head, namely :

(i) export of goods calculated on F.O.B. basis;

(ii) royalty, know-how, professional and consultation fees;

(iii) interest and dividend;

(iv) other income, indicating the nature thereof.

5. The Central Government may direct that a company shall not be obligated to show the amount set aside to 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.

Part III

Interpretation

7. (1) For the purpose of Parts I and II of this Schedule, unless the context otherwise requires—

(a) the expression "provision" shall, subject to sub-clause (2) of this clause, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(b) the expression "reserve" shall not, subject as aforesaid, include 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;

(c) the expression “capital reserve” shall not include any amount regarded as free for distribution through the profit and loss account; and the expression “revenue reserve” shall mean any reserve other than a capital reserve;

and in this sub-clause the expression “liability” shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where—

(a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

(b) any amount retained by way of providing for any known liability;

is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision.

8. For the purposes aforesaid, the expression “quoted investment” means an investment as respects which there has been granted a quotation or permission to deal on a recognised stock exchange, and the expression “unquoted investment” shall be construed accordingly.

Part IV

By Notification No. GSR 388(E), dated May, 15, 1995, the Central Government has inserted Part IV in the Schedule VI to the Act. The summarised disclosure requirements of the said Part are as under :

(i) Registration Details.

(ii) Capital raised during the year of account.

(iii) Position of mobilisation and deployment of funds.

(iv) Performance of the company.

(v) Three principal products/services of the company (as per monetary terms) together with ITC codes of such products.

This amendment will take effect in respect of accounts closed on or after 16-5-95.

1.6 PRESENTATION OF FINAL ACCOUNTS IN A SUMMARY FORM

It is another form in which final statements of account of companies are drawn up, which has become quite popular in recent years. According to this form figures of income and expenditure, assets and liabilities grouped under main heads are shown in the profit and loss account and the balance sheet and their details and other information requiring disclosure are also disclosed in summarised form. In consequence, the profit and loss accounts and balance sheets are not loaded with details. They are simple and intelligible. However, those who want to see the full details may be frustrated with the abridged form of accounts.

The advantages of this form of presentation are as follows :

(a) the financial position of the company can be ascertained easily since it is not cluttered up by a mass of details.

(b) the shareholders and other interested parties do not lose interest in the statement, since it is not necessary for them to go through a long statement spared over several pages to find out the actual financial position.

(c) nevertheless any one interested in details may obtain detailed financial statement from the company.

Section 219(1) of the Companies Act, 1956 requires that a copy of every balance sheet (including the profit and loss account, the auditor's report, and every other document required by law to be annexed or attached, as the case may be, to the balance sheet) is to be laid before a company in general meeting. The balance sheet and profit and loss account can be prepared in abridged Form for use of the members and others who do not need full statements.

Such abridged accounts are to be prepared as per Form 23AB of Companies (Central Government's) General Rules and Forms, 1956. The statement shall be approved by the Board of Directors and signed on behalf of them. The Form is given on the following pages.

[Form No. 23-AB]

(See rule 7A)

Statement Containing Salient Feature of Balance-Sheet and Profit and Loss Account etc.,

As per section 219(1)(b)(iv)

Form of Abridged Balance-Sheet

Name of the company......

Abridged balance-sheet as at......

Particulars	*Figures as at the end of*	
	Current financial year	*Previous financial year*
1. Sources of funds		
(1) Shareholders funds		
(a) Capital		
(i) Equity		
(ii) Preference		
(b) Reserves and surplus		
(i) Capital reserve		
(ii) Revenue reserve		
(iii) Revaluation reserve		
(iv) Surplus in profit and loss account		
(v) Share Premium Reserve		
(vi) Investment Allowance Reserve		
(2) Loan funds		
(a) Debentures (The amount of convertible/ partly convertible debentures indicating the date of conversion)		

(b) Public deposits

(c) Secured loans (other than debentures)

(d) Unsecured loans

Total of (1) and (2) :

II. APPLICATION OF FUNDS

(1) Fixed assets

(a) Net block (Original cost less depreciation)

(b) Capital work in progress

(2) Investments

(a) Government securities

(b) Investment in subsidiary companies

(i) Quoted

(ii) Unquoted

(c) Others

(i) Quoted

(ii) Unquoted

(3) (i) Current assets, loans and advances

(a) Inventories

(b) Sundry debtors

(c) Cash and bank balances

(d) Other current assets

(e) Loans and advances

(i) To subsidiary companies

(ii) To others

Less :

(ii) Current liabilities and provisions

(a) Liabilities

(b) Provisions

Net current assets [(*i*) – (*ii*)]

(4). Miscellaneous expenditure to the extent not written off or adjusted

(5). Profit and Loss Account

Total of 1 to 5

Abridged Profit and Loss Account for the year ending......

Particulars	*Figures as at the end of*	
	Current year	*Previous year*
I. Income		
- Sales/services rendered (Details to be given		
- separately as per annexure)		
- Dividend		
- Interest		
- Other income (See Note 5)		
Total		
II. Expenditure		
Cost of goods consumed/sold		
(i) Opening Stock		
(ii) Purchases		
Less : Closing stock		
Manufacturing expenses		
Selling expenses		

	Particulars	Figures as at the end of	
		Current year	Previous year
I	Salaries, wages and other employee benefits		
	Managerial remuneration		
	Interest		
	Depreciation		
	Auditor's remuneration		
	Provisions for (i) doubtful debts; and		
	(ii) other contingencies (to be specified)		
	Any other expenses (See Note 5)		
	Total		
III.	Profit/loss before tax (I-II)		
IV.	Provision for taxation		
V.	Profit/loss after tax		
VI.	Proposed dividend :		
	Preference shares		
	Equity shares		
VII.	Transfer to reserves/surplus		

Note to the abridged balance-sheet and the abridged profit and loss account.

1. The amounts to be shown here should be the same as shown in the corresponding aggregated heads in the accounts as per Schedule VI or as near thereto as possible.
2. The total amount of contingent liabilities and that of capital commitments should be shown separately.
3. All notes forming part of the accounts as per Schedule VI to which specific attention has been drawn by the auditors or which form a subject-matter of a qualification by the auditor should be reproduced.

4. If fixed assets are revalued, the amount of revaluation should be shown separately for the first five years subsequent to the date of revaluation.

5. Any item which constitutes 20% or more the total income or expenditure (including Provisions) should be shown separately.

6. Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting, should be disclosed separately.

7. If no provision is made for depreciation, the fact that no provision has been made shall be stated along with the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act.

8. Market value of quoted investments (both of current year and also of previous year) should be mentioned.

9. Any note forming part of the accounts as per Schedule VI which is in the nature of any explanation regarding compliance with any law should reproduced.

10. Important ratio performance such as sales/total assets ratio, operating profit/capital employed ratio, return on net worth, profit/sales ratio.

11. Details of installed capacity and productivity of main items should be disclosed.

12. Notes in abridged balance sheet should be given the same number as in the main balance sheet.

The above stated salient features of balance-sheet and profit and loss account should be authenticated in the same manner as the main accounts are to be authenticated.

AUDITOR'S REPORT AND COMMENTS IF ANY OF THE COMPTROLLER AND AUDITOR GENERAL OF INDIA UNDER SUB-SECTION (4) OF SECTION 619, IN RESPECT OF GOVERNMENT COMPANIES, AND COMPANIES UNDER SECTION 619B.

—Should be given in full

DIRECTORS'S REPORT

Should be given in full except the information under clause (*e*) of Sub-section (1) and Sub-section (2A) of Section 217.

(Signed by directors/secretary)

in the manner prescribed in section 215(1)

Recently the aforesaid form has been amended vide No. 3/12/89 - CL V dated 11-5-92 issued by the Ministry of Justice and Company Affairs, Department of Company Affairs. These amendments have been incorporated in the form itself. This amended form stands applicable for the Companies which have closed their accounts on or after 11-5-92.

Illustration 1

You are required to prepare vertical and horizontal financial statements from the following trial balance of Haria Chemicals Ltd. for the year ended 31st March, 2006.

Haria Chemicals Ltd.

Trial Balance as at 31st March, 2006

Particulars	*Rs.*	*Particulars*	*Rs.*
Stock	6,80,000	Equity Shares	
Furniture	2,00,000	Capital (Shares of Rs. 10 each)	25,00,000
Discount	40,000	11% Debentures	5,00,000
Loan to Directors	80,000	Bank loans	6,45,000
Advertisement	20,000	Bills payable	1,25,000
Bad debts	35,000	Creditors	1,56,000
Commission	1,20,000	Sales	42,68,000
Purchases	23,19,000	Rent received	46,000
Plant and Machinery	8,60,000	Transfer fees	10,000
Rentals	25,000	Profit & Loss	
Current account	45,000	account	1,39,000
Cash	8,000	Depreciation	
Interest on bank loans	1,16,000	provision :	
Preliminary expenses	10,000	Machinery	1,46,000
Fixtures	3,00,000		
Wages	9,00,000		
Consumables	84,000		
Freehold land	15,46,000		
Tools & Equipments	2,45,000		
Goodwill	2,65,000		
Debtors	2,87,000		
Bills receivable	1,53,000		
Dealer aids	21,000		
Transit insurance	30,000		

Trade expenses	72,000		
Distribution freight	54,000		
Debenture interest	20,000		
	85,35,000		85,35,000

Additional information : Closing stock on 31-3-2006: Rs. 8,23,000.

Solution

Horizontal Financial Statements

Haria Chemicals Ltd.

Profit and Loss Account for the year ended 31st March, 2006

Particulars	*Rs.*	*Particulars*	*Rs.*
To stock	6,80,000	By sales	42,68,000
To purchases	23,19,000	By rent received	46,000
To consumables	84,000	By transfer fees	10,000
To wages	9,00,000	By stock	8,23,000
To bad debts	35,000		
♦ To discount	40,000		
To rentals	25,000		
To commission	1,20,000		
To interest on bank loans	1,16,000		
To advertisement	20,000		
To dealers' aids	21,000		
To transit insurance	30,000		
To trade expenses	72,000		
To distribution freight	54,000		
To debenture interest	20,000		
To Net profit	6,11,000		
	51,47,000		51,47,000

Haria Chemicals Ltd.

Balance Sheet as at 31st March, 2006

Liabilities	*Rs.*	*Assets*	*Rs.*
Equity Share Capital	25,00,000	Fixed Assets :	
Reserves & Surplus		Goodwill	2,65,000
Profit & Loss Account	7,50,000	Freehold land	15,46,000
Secured Loans :		Furniture	2,00,000
11% Debentures	5,00,000	Fixtures	3,00,000
Bank loans	6,45,000	Plant & Machinery	
Unsecured Loans :		Less: Depreciation	7,14,000
Current liabilities &		Tools & Equipment	2,45,000
Provisions :		Current Assets,	
Bills payable	1,25,000	Loans & Advances :	
Creditors	1,56,000	(*a*) Current assets :	
		Stock	8,23,000
		Debtors	2,87,000
		Current account	45,000
		Cash	8,000
		(*b*) Loans & Advances :	
		Loan to directors	80,000
		Bills receivable	1,53,000
		Miscellaneous expenses :	
		Preliminary expenses	10,000
	46,76,000		46,76,000

Vertical Financial Statements

Haria chemicals Ltd.

Balance Sheet as at 31st March, 2006

	Schedule No.	*Figures as at the end of 31st March 2006*
(1)	(2)	(3)
I. Source of Funds		
(1) Shareholders' funds :		
(*a*) Capital	1	25,00,000
(*b*) Reserves and Surplus	2	7,50,000
(2) Loan funds :		
(a) Secured loans	3	11,45,000
(b) Unsecured loans		
Total		43,95,000
II. Application of Funds		
(1) Fixed Assets :		
(a) Gross block		34,16,000
(b) Less: Depreciation		1,46,000
(c) Net Block	4	32,70,000
(2) Investments		
(3) Current assets, loans and advances		
(a) Inventories		8,23,000
(b) Debtors		2,87,000
(c) Cash and bank balances	5	53,000
(d) Loans and advances	6	2,33,000
(e) Other assets		10,000

Less :		
Current liabilities and provisions		
(a) Current liabilities	7	2,81,000
(b) Provisions		
Net current assets	11,25,000	
Total		43,95,000

Note: Other assets represent preliminary expenses not written off Rs. 10,000.

Haria Chemicals Ltd.

Profit and Loss Account for the year ended 31st March, 2006

	Schedule No.	*Figures as at the end of 31st March 2006*	
♦ INCOME			
Sales		42,68,000	
Other income	8	56,000	
			43,24,000
Expenditure			
Purchases	9	21,76,000	
Manufacturing & other expenses	10	14,01,000	
Interest & other financial charges	11	1,36,000	
			37,13,000
Profit before tax			6,11,000
Provision for tax			—
Profit after tax			6,11,000
Balance of profit and loss account brought forward			1,39,000
Balance carried to balance sheet			7,50,000

SCHEDULE 1

Share capital	*Rs.*
Authorised :	
Equity share capital of Rs. 10 each	25,00,000
Issued and Subscribed :	
Equity share capital of Rs. 10 each	25,00,000

SCHEDULE 2

Reserves and Surplus	
Balance as per last balance sheet	1,39,000
Balance in profit and loss account	6,11,000
	7,50,000

SCHEDULE 3

Secured Loans	
11% Debentures	5,00,000
Bank loans	6,45,000
	11,45,000

SCHEDULE 4

Fixed Assets

	Gross block	Depreciation	Net Block
Goodwill	2,65,000		2,65,000
Freehold land	15,46,000		15,46,000
Furniture	2,00,000		2,00,000
Fixtures	3,00,000		3,00,000
♦ Plant & Machinery	8,60,000	1,46,000	7,14,000
Tools & Equipment	2,45,000		2,45,000
Total	34,16,000	1,46,000	32,70,000

SCHEDULE 5

Cash and Bank Balances	45,000
Current account balance	8,000
Cash	53,000

SCHEDULE 6

Loans and Advances	
Loan to directors	80,000
Bills receivable	1,53,000
	2,33,000

SCHEDULE 7

Current Liabilities	
Creditors	1,56,000
Bills payable	1,25,000
	2,81,000

SCHEDULE 8

Other Income	
Rent received	46,000
Transfer fees	10,000
	56,000

SCHEDULE 9

Purchases	
♦ Opening stock	6,80,000
Add: purchases	23,19,000
Less: Closing stock	8,23,000
	21,76,000

SCHEDULE 10

Manufacturing and Other Expenses	
Consumables	84,000
Wages	9,00,000
Bad debts	35,000
Discount	40,000
Rentals	25,000
Commission	1,20,000
Advertisement	20,000
Dealers’ aids	21,000

Transit insurance	30,000
Trade expenses	72,000
Distribution freight	54,000
	14,01,000

SCHEDULE 11

Interest and Other Financial Charges	
Interest on bank loans	1,16,000
Debenture interest	20,000
	1,36,000

1.7 MANAGERIAL REMUNERATION

Managerial remuneration is calculated as a percentage on profit. Managerial remuneration payable by a company is governed by various sections of the Companies Act, 1956 and also Schedule XIII of the Companies Act, 1956. The scope of the relevant sections are as below :

Section 198 prescribes the overall maximum managerial remuneration payable and also managerial remuneration in case of absence or inadequacy of profits.

Section 309 prescribes the remuneration payable to whole-time directors and part-time directors.

Section 310 states that if there is an increase in managerial remuneration within the scope of Schedule XIII and within the overall ceiling, permission of Central Government is not required for such increase. In other words sanction of Central Government will be required only if the increase in managerial remuneration has the effect of exceeding the overall ceiling as given in Section 198.

Section 349 lays down how the net profit of the company will be ascertained for the purpose of calculating managerial remuneration.

Section 387 deals with remuneration of manager. Remuneration to manager cannot exceed in the aggregate five per cent of the net profits. However, a manager is included within the scope of the term 'managerial person'.

Schedule XIII consists of three parts. Part I lays down conditions to be fulfilled for the appointment of a managing or wholetime director or a manager without the approval of the Central Government. Part II deals with remuneration payable to managerial person by companies having profits and also by companies having no profits or inadequate profits. Part III specifies the provisions applicable to earlier parts of the schedule.

It may be noted that the Central Government had amended Schedule XIII to the Companies Act, 1956 on 14th July, 1993 introducing sweeping changes in provisions governing managerial appointment and remuneration. As a result of such amendment, the ceiling on commission on net profit was withdrawn. With a view to give still greater freedom to companies in regard to managerial appointment and remuneration, Central Government have once again amended Schedule XIII to the Companies Act, 1956 effective from 1st February, 1994.

Managerial Remuneration : Maximum limits :

(A) For companies having profits:

(i)	Overall (excluding fees for attending meetings)	11% of net profit
(ii)	If there is one managerial person	5% of net profit
(iii)	If there are more than one managerial person	10% of net profit
(iv)	Remuneration of part-time directors :	
(a)	If there is no managing or whole-time director	3% of net profit
(b)	If there is a managing or whole-time director	1% of net profit

(B) For companies having no profits or inadequate profits :

In the event of absence or inadequacy of net profits in any financial year, managerial remuneration will have to be limited to amounts (varying from Rs. 40,000 per month to Rs. 87,500 per month, depending on the effective capital of the company) specified in Section II of Part II of Schedule XIII. Such remuneration may be paid as 'minimum remuneration' without the approval of the Central Government. However, approval of the Central Government will be required if such 'minimum remuneration' is sought to be exceeded. Loss making companies or companies with inadequate net profits have the freedom to work out suitable remuneration packages for their managerial personnel within the limits specified in Section II of Part II of Schedule XIII.

The remuneration of managerial person in case of absence or inadequacy of profits shall be calculated on the following scale [vide circular CL-V dated 2nd March, 2000, issued by Department of Company Affairs]

Where the effective capital of company is :	*Monthly remuneration payable shall not exceed :*
(i) Less than Rs. 1 crore	Rs. 75,000
(ii) Rs. 1 crore or more but less than Rs. 5 crores	Rs. 1,00,000
(iii) Rs. 5 crores or more but less than Rs. 25 crores	Rs. 1,25,000

(ix)	Rs. 25 crores or more but less than Rs.100 crores	Rs. 2,00,000

Subject to the provisions of Section I and II, a managerial person shall draw remuneration from one or both companies, provided that the total remuneration drawn from the companies does not exceed the higher maximum limit admissible from any one of the companies of which he is a managerial person

Explanation :

1. Managerial persons include managing or whole-time director and manager.

2. Effective capital means the aggregate of the paid-up share capital (excluding share application money or advances against shares), amount, if any, for the time being standing to the credit of share premium account, reserves and surplus (excluding revaluation reserves), long-term loans and deposits repayable after one year (excluding working capital loans, overdrafts, interest due on loans unless funded, bank guarantee etc. and other short-term arrangements) as reduced by the aggregate of any investments (except in the case of investment by an investment company), accumulated losses and preliminary expenses not written off.

Ascertainment of profit for managerial remuneration

As we have seen above that in case of a company having profits, managerial remuneration is calculated as a percentage on net profit. Such net profit is to be arrived in accordance with the provisions of Section 349 of the Companies Act, 1956.

The following credits or incomes in addition to the gross profit should be taken into account:

Bounties and subsidies received from any Government, or any public authority constituted or authorised in this behalf, by the Government unless and except in so far as the Central Government otherwise directs.

The following "incomes" or credits should not be taken into account :

(a) premium on shares or debentures issued or sold by the company;

(b) profit on sale by the company of forfeited shares;

(c) profits of a capital nature including profit from the sale of the undertaking or any of the undertakings of the company, or any part thereof; and

(d) profits from the sale of any immovable property of fixed assets of capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling such property or assets.

But where the amount for which any fixed asset is sold exceeds its written down value (calculated according to Section 350) credit should be given for such of the excess as is not higher than the difference between the original cost of that fixed asset and its written down value: Suppose a machine purchased for Rs. 30,000, written down to Rs. 18,000 by writing off depreciation, is sold for Rs. 35,000. The managerial personnel are entitled to remuneration on profit including Rs. 12,000 *i.e.,* excluding the profit over and above the original cost of Rs. 5,000.

From the incomes of the company, the following have to be deducted :

(a) all the usual working charges;

(b) bonus or commission paid or payable to any member of the company's staff or any engineer, technician or person employed or engaged by the company whether on a wholetime or on a part-time basis;

(c) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profit;

(d) any tax on business profit imposed for special reasons or in special circumstances notified by the Central Government in this behalf;

(e) interest on debentures issued by the company;

(f) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets.

(g) interest on unsecured loans and advances;

(h) expenses on repairs, whether to immovable property or to movable property, provided the repairs are not of a capital nature;

(i) outgoings, inclusive of contributions made under clause (of sub-section) of Section 293. This relates to donations to charitable funds;

(j) depreciation calculated according to Section 350. Under Section 350 the depreciation (for the purpose of calculating remuneration to managerial personnel) is to be calculated according to the rates specified in Schedule XIV. Depreciation includes only normal depreciation including extra and multiple shift allowance but excluding any special, initial or other depreciation or any development rebate.

If an asset is sold, discarded, demolished or destroyed before it is completely written off, the excess of the written down value over its sale proceeds or its scrap value has to be written off in the financial year in which the assets is sold, discarded, demolished or destroyed;

(k) the excess of expenditure over income which arises in computing the net profit in accordance with this section in any year (after the commencement of the Act) in so far as its excess has not been deducted in any subsequent year preceding the year in respect of which the net profit have to be ascertained;

(l) any compensation or damage to be paid in by virtue of any legal liability including a liability arising from a breach of contract;

(m) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in (m); and

(n) debts considered bad and written off or adjusted during the year of account.

Profit on which remuneration has to be allowed should be ascertained without deducting the following :

(a) income-tax and super tax payable by the company under the Income-tax Act or any other tax on the income of the company not covered by (d) and (e) above;

(b) any compensation, damages or payment made voluntarily, that is to say, otherwise than by virtue of a liability such as is referred to in (m) above; and

(c) loss of a capital nature including loss or sale of the undertaking or any of the undertakings of the company or of any part thereof not including in any excess of written down value over its sale proceeds of scrap value of any asset sold. The excess has to be written off to the Profit and Loss A/c.

It should be noted that the Profit and Loss Account should have a statement attached showing how profit has been ascertained for the purpose of remuneration due to directors, managing director or manager as per the requirements of paras 4 and 4A of Part II, Schedule VI.

Illustration 2

The following is the Profit & Loss A/c of Mudra Ltd., the year ended 31st March, 2006

		Rs.				*Rs.*
To	Administrative, Selling and		By	Balance b/d		5,72,350
	distribution expenses	8,22,542	“	Balance from Trading A/c		40,25,365
”	Donation to charitable funds	25,500	“	Subsidies received from Govt.		2,32,560
”	Directors fees	66,750	“	Interest on Investments		15,643
”	Interest on debentures	31,240	“	Transfer fees		722
”	Compensation for breach of		“	Profit on sale of		
	contract	42,530		Machinery:		
”	Managerial remuneration	2,85,350		Amount realised	55,000	
”	Depreciation on fixed assets	5,22,543		Written down value	30,000	25,000
”	Provision for Taxation	12,42,500				
”	General Reserve	4,00,000				
”	Investment Revaluation Reserve	12,500				
”	Balance c/d	14,20,185				
		48,71,640				48,71,640

Additional Information:

(1) Original Cost of the machinery sold was Rs. 40,000

(2) Depreciation on fixed assets as per Schedule XIV of the Companies Act, 1956 was Rs.5,75,345.

You are required to comment on the managerial remuneration in the following situations:

(a) there is only one whole time director;

(b) there are two whole time directors;

(c) there are two whole time directors, a part time director and a manager.

Solution :

Calculation of net profit u/s 349 of the Companies Act, 1956

	Rs.	Rs.
Balance from Trading A/c		40,25,365
Add : Subsidies received from Government	2,32,560	
Interest on investment	15,643	
Transfer fees	722	
Profit on sale of machinery (40,000 – 30,000)	10,000	2,58,925
		42,84,290
Less : Administrative, selling and distribution expenses	8,22,542	
Donation to charitable funds	25,500	
Director's fees	66,750	
Interest on debentures	31,240	
Compensation for breach of contract	42,530	
Depreciation on fixed assets as per Schedule XIV	5,75,345	15,63,907
Profit u/s 349		27,20,383

Situation:

(a) When there is only one whole time director:

Managerial remuneration = 5% of Rs. 27,20,383 = Rs. 1,36,019

(b) When there are two whole time directors :

Managerial remuneration =10% of Rs. 27,20,383 = Rs. 2,72,038

(c) When there are two whole time directors, a part time director and a manager:

Managerial remuneration = 11% of Rs. 27,20,383 = Rs. 2,99,242

Comment : In situations (*a*) and (*b*) since managerial remuneration as per Profit and Loss account Rs. 2,85,350 exceeds the maximum amount payable, the company should obtain permission under Section 309(3) for such excess payment.

Illustration 3

The following extract of Balance sheet of X Ltd. was obtained:

Balance sheet (Extract) as on 31st march, 2006

Liabilities	*Rs.*
Authorised capital:	
20,000, 14% preference shares of Rs. 100	20,00,000
2,00,000 Equity shares of Rs. 100 each	2,00,00,000
	2,20,00,000
Issued and subscribed capital:	
15,000, 14% preference shares of Rs. 100 each fully paid	15,00,000
1,20,000 Equity shares of Rs. 100 each, Rs. 80 paid-up	96,00,000
Share suspense account	20,00,000
Reserves and surplus	
Capital reserves (60% is revaluation reserve)	2,50,000
Securities premium	50,000
Secured loans:	
15% Debentures	65,00,000
Unsecured loans:	
Public deposits	3,70,000
Cash credit loan from SBI	4,65,000
Current Liabilities:	
Sundry creditors	3,45,000
Assets:	
Investment in shares, debentures, etc.	75,00,000
Profit and Loss account	15,25,000
Preliminary expenses not written off	55,000

Share suspense account represents application money received on shares, the allotment of which is not yet made.

X Ltd. has been sustaining loss for the last few years. X Ltd. has only one whole-time director. Find out how much remuneration X Ltd. can pay to its managerial person as per the provisions of Part II of Schedule XIII. Would your answer differ if X Ltd. is an investment company?

Solution :

Computation of effective capital :

	Where X Ltd. is a non-investment company	*Where X Ltd. is an investment company*
	Rs.	*Rs.*
Paid-up share capital —		
15,000, 14% Preference shares	15,00,000	15,00,000
1,20,000 Equity shares	96,00,000	96,00,000
Capital reserves	1,00,000	1,00,000
Securities premium	50,000	50,000
15% Debentures	65,00,000	65,00,000
Public Deposits	3,70,000	3,70,000
(A)	1,81,20,000	1,81,20,000
Investments	75,00,000	—
Profit and Loss account (Dr. balance)	15,25,000	15,25,000
Preliminary expenses not written off	55,000	55,000
(B)	90,80,000	15,80,000
Effective capital (A–B)	90,40,000	1,65,40,000
Monthly remuneration shall not exceed	75,000	1,00,000

1.8 DIVISIBLE PROFIT

One of the important functions of company accounting is to determine the amount of profits which is available for distribution. This is necessary since the amount of profits disclosed by the Profit & Loss Account, in every case, is not available for distribution.

The availability of profits for distribution depends on a number of factors, *e.g.*, their composition, the amount of provisions and appropriations that must be made out of them in priority, etc.

Dividends cannot be declared except out of profits - Declaration of a dividend presupposes that there is a trading profit or a surplus available for distribution, arrived at after providing for depreciation on assets, not only for the year in which the profits were earned but also for any arrears of depreciation of the past years, calculated in the manner prescribed by sub-section (2) of Section 205 (*see* below). The balance of undistributed profits of the past years, provided the same has been arrived at in a like manner, is also available for distribution. Any money provided by the Central or State Government for any payment of dividend in pursuance of a guarantee given by the Government also is available for distribution as a dividend.

Capital cannot be returned to the shareholders by way of dividend — Under the Companies Act it is not obligatory for a company to maintain its capital intact. But the Act has prescribed the procedure for reduction of capital. It must be followed in every case if the paid-up capital is to be reduced. Therefore, no part of the capital can be paid unless there is profit. But interest may be paid under Section 208.

Provision for Depreciation — Section 205(2) provides that depreciation must be provided either —

(*a*) to the extent specified in Section 350.

(*b*) equal to an amount arrived at by dividing 95% of the cost of the asset by the number of years at the end of which the asset would cease to be serviceable; or

(*c*) on any other basis approved by the Central Government by which 95% of the cost of each depreciable assets will be written off on the expiry of its serviceable life; or

(*d*) As regards any other depreciable asset for which no rate of depreciation has been laid down by the Companies Act, 1956 or any rules made thereunder, on such basis as may be approved by the Central Government by any general order published in the Official Gazette or by any special order in any particular case.

Section 350 provides that depreciation should be written off at the rates specified for different assets in Schedule XIV to the Companies Act, 1956. Provision is required only for the normal depreciation (including extra and multiple shift allowance) and not for any initial depreciation or any development rebate. Further, when the assets are sold, discarded, demolished or destroyed in any financial year, the excess of the written down value over its sale proceeds as scrap, if any should be written off in the same financial year.

Section 350 contemplates that depreciation on assets shall be computed with reference to the written down value of the assets as shown by the books of the company at the end of the financial year. The Amendment Act, 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".

Thus any other method of depreciation is also allowed. Earlier only written down value of method could be used for the purpose of calculation of depreciation under this section.

It should be noted that depreciation has to be written off or provided for if dividends are to be declared; a company need not provide for depreciation if it does not want to declare dividends. In such a case, the fact that depreciation has not been provided for or written off, together with the quantum of arrears of depreciation [computed as per Section 205(2)], must be stated in the Profit and Loss Account.

If provision for depreciation is not made by means of a depreciation charge but by some other method, the method adopted should be disclosed.

N.B. For purpose of ascertaining profit on which remuneration is to be paid to managerial personnel, depreciation according to Section 350 is to be considered.

Loss suffered in the past may not be made good - Where a company has incurred any loss in any previous financial year or years, Sub-section (2) of Section 205 prescribes that it must set off either the loss or an amount which is equal to the amount provided for as depreciation in that year or those years whichever is less, against the profit of the company for the year, out of which the dividend is proposed to be declared or paid. Thus, the losses suffered in the past or at least amount of depreciation on assets comprised therein, must first be made good out of the profits of a year before any part thereof is distributed as a dividend. This is illustrated below :

		Year ended 31st December			
		(in Rs. lakhs)			
		2003	*2004*	*2005*	*Total*
1.	Depreciation as provided in the books	3	2	8	13
2.	Depreciation chargeable under section 205	13	10	8	31
3.	Profit before charging depreciation	–15	–7	37	15
4.	Profit after charging depreciation as in (1)	–18	–9	29	2
5.	Profit after charging depreciation as in (2)	–28	–17	29	-16

The amount available for dividend in 2005 is Rs. 6,00,000 as shown below :

A.	Past Losses [4]	27
B.	Depreciation previously provided [1]	5

C. Depreciation in arrear [2–1]

	2003	10	
	2004	8	
	2005	Nil	18
Profit for 2005 (as per books)			29
Less: Arrears of Depreciation not provided for as per (C) above, which must be now provided			18
			11
Less: Amount of depreciation provided (B) or the loss (A), whichever is less			5
Distributable Profit			6

This amount of Rs. 6,00,000 may also be arrived at as follows :

Profit for 2005 (before charging depreciation)	37
Less: Total depreciation for 3 years u/s 205	31
Distributable Profit	6

However, one should note that before the amendment of the Companies Act in 1960 the legal position was according to the decisions in various cases in England. Therefore, it was not necessary to provide for depreciation on fixed assets or past losses for declaring a dividend (*Ammonia Soda Co.* v. *Chamberlain and Stapley* v. *Read Bros Ltd.*). It is still not necessary to provide arrears of depreciation and losses relating to the financial year falling before 28th December 1961.

Distribution of Capital Profit - Any capital profit or any appreciation in the value of fixed asset in the case of a company may be distributed as dividend provided (*i*) the revaluation of all the assets discloses a surplus; (*ii*) the profit has been realised in cash; (*iii*) and the article of the company permit such a distribution, (*Lubbok* v. *British Bank of South America and Foster* v. *The New Trinidod Lake Asphalte Co. Ltd.*).

Writing off losses against capital profits - It is permissible for a company to revalue its assets but the revaluation must be in a *bona fide* manner. Depending upon the results disclosed by such a revaluation, with the approval of the shareholders, the assets, which may have been over depreciated in the past may be written up and the surplus, if any, resulting therefrom utilised for writing down value of other assets, so that the value of each asset is brought closer to its current value (*Ammonia Soda Co.* v. *Chamberlain*).

Where any expenditure of a capital nature has been charged to revenue the company can subsequently reimburse an equal amount of revenue, out of capital. Similarly, when losses on capital account have been charged off to revenue and later the value of the capital assets appreciates, the amount so realised would be a revenue profit (*Mills* v. *Northern Railway of Buenos Aires Co.*).

Transfer to Reserves : The Board of Directors, unless prohibited by the Articles, can appropriate a part of the profits to the credit of a reserve or reserves. Appropriation of a part of profit is sometimes made under law. For example, under the Banking Regulation Act, 20% of the profit of a banking company must first be transferred to the General Reserve before any dividend can be distributed. Similarly, when profit of a licence under the Electricity Supply Act, 1984 exceeds the amount of reasonable return, a part (about 1/3 of the excess) has to be transferred to the Tariffs and Dividend Control Reserve. Transfer of a part of profit to a reserve is also necessary where the company has undertaken, at the time of raising of loan, that before any part of its profit is distributed, a specified percentage of the profit every year shall be credited to a reserve for the repayment of the loan and until the time for repayment arrives, the amount shall remain invested in a specified manner. Apart from appropriations aforementioned, it may also be necessary to provide for losses and arrears of depreciation and to exclude capital profit, as mentioned earlier, to arrive at the amount of divisible profit.

The changes made in the company law (effective 1st February, 1975) now authorises Government to compel companies to transfer a part of their after tax profits to reserve. The Government has promulgated the following rules in this regard:

(1) No dividend shall be declared or paid by the company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Sub-section (2) of Section 205 of the Act, except after the transfer to the reserve of the company of a percentage of its profit for that year as specified below :

(*i*) Where the proposed dividend exceeds 10 per cent but does not exceed 12.5 per cent of the paid-up capital, the amount not be transferred to the reserve shall not be less than 2.5 per cent of the current profits;

(*ii*) Where the proposed dividend exceeds 12.5 per cent but does not exceed 15 per cent of the paid up capital, the amount to be transferred to the reserve shall not be less than 5 per cent of the current profits;

(*iii*) Where the proposed dividend exceeds 15 per cent, but does not exceed 20 per cent of the paid up capital, the amount to be transferred to the reserves shall not be less than 7.5 per cent of the current profit; and (*iv*) Where the dividend proposed exceeds 20 per cent of the paid-up capital the amount to be transferred to reserve shall not be less than 10 per cent of the current profits.

(2) Nothing in rule (1) shall be deemed to prohibit the voluntary transfer by a company of a percentage higher than 10 per cent of its profit to its reserves for any financial year, so however that :

(*i*) Where a dividend is declared:

(*a*) a minimum distribution sufficient for the maintenance of dividends to shareholders at a rate equal to the average of the rates at which dividends declared by it over the three years immediately preceding the financial year; or

(*b*) in a case where bonus shares have been issued in the financial year in which the dividend is declared or in the three years immediately preceding the financial year, a minimum distribution sufficient for the maintenance of dividend to shareholders at an amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial year is ensured; Provided that in a case where the net profits after tax are lower by 20% or more than the average net profit after tax of the two financial years immediately preceding, it shall not be necessary to ensure such minimum distribution.

(*ii*) Where no dividend is declared, the amount proposed to be transferred to its reserves from the current profit shall be lower than the average amount of the dividends to the shareholders declared by it over the three years immediately preceding the financial year.

Declaration of dividend out of reserves : Government have promulgated rules regarding utilisation of reserves for payment of dividend. In the event of inadequacy or absence of profit in any year, dividend may be declared by a company for that year out of the accumulated profit earned by it in previous years and transferred by it to the reserves, subject to the condition that:

(*i*) the rate of the dividend declared shall not exceed the average of the rates at which dividend was declared by it in five years immediately preceding that year or ten per cent of its paid-up capital, whichever is less;

(*ii*) the total amount to be drawn from the accumulated profits earned in previous years and transferred to the reserves shall not exceed an amount equal to one-tenth of the sum of its paid up capital and free reserves and the amount so drawn shall first be utilised to set off the losses incurred in the financial year before any dividend in respect of preference or equity shares is declared; and (*iii*) the balance of reserves after such drawal shall not fall below fifteen per cent of its paid up share capital.

Interest on Capital : As has been pointed out above, dividends cannot be paid except out of profits or, in other words, dividends cannot be paid out of capital. In certain cases, however, the Central Government has the power to permit payment of interest to shareholders even when there is no profit. A company which has to wait rather a long period before it can commence production because construction of works may take long may find the shareholders restive if nothing is given to them by way of yield. Moreover, if construction is carried on by borrowed funds interest will have to be paid; hence there is some theoretical justification for payment of interest to the shareholders. Section 208 governs payment of interest in such cases. The company is allowed to pay interest on such shares as are issued for the purpose of defraying the expenses of the construction of any works of building or providing any plant which cannot be made profitable for a lengthy period, subject to the following conditions:

(*a*) The payment is authorised by Articles or by a special resolution.

(*b*) Prior sanction of the Central Government is obtained.

(*c*) Interest is paid only for such period as may be determined by the Central Government.

But the period cannot extend beyond the close of the half year next after the half year in which the works, buildings, etc., have been actually completed. For example, if the construction is over on 10th October, 2005, interest cannot be paid after 30th June 2006.

(*d*) The rate of interest does not exceed four per cent *per annum* or such other rates as the Central Government may, by notification in the Official Gazette, direct.

The Central Government can order an enquiry at the company’s cost before according its sanction, the company can treat the interest so paid as part of the cost of construction.

Profit and Loss (Appropriation) Account: The provisions contained in Part II of Schedule VI of the Companies Act require that the undermentioned appropriations made out of profit should be disclosed in the Profit and Loss Account of the year:

(*a*) Amounts provided for:

(i) repayment of share capital; and

(ii) repayment of loans [clause (*vii*)].

(*b*) (*i*) The aggregate, if material, of any amount 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 at the date as at which the balance sheet is made up.

(*ii*) The aggregate, if material, of the amounts withdrawn from such reserves [clause (viii)].

(c) (i) The aggregate, if material, of the amount set aside to provisions made for meeting specific liabilities, contigencies or commitments.

(ii) The aggregate, if material, of the amounts withdrawn from such provisions as no longer required [clause (*ix*)].

(*d*) the aggregate amount of dividend paid and proposed and stating whether such amounts are subjects to deduction of income-tax or not [clause (XIV)]

It is evident therefore that it is necessary to disclose in the Profit & Loss Account amount withdrawn from reserves, excess provisions written back and appropriation proposed by the directors out of profits.

One should note that provisions for income-tax relating to the current year is no longer treated as an appropriation of profits - at one time it was.

With a view to distinguish the appropriation of profits from expenses chargeable against profits, the Research Department of the Institute has made the following recommendations:

"The Profit & Loss Account should be prepared in two parts:

(*i*) The Profit and Loss Account, proper, include all income and expenditure properly attributable to the year's working and show the figure of profit or loss for the year; and

(*ii*) The second part of the account should include all appropriations for dividends, transfers to and from reserves."

When appropriations are shown in a separate section in the Profit & Loss account, an imaginary line is supposed to separate them from income and expenses of the year. The account, therefore, refers to amount being shown above or below the 'line' depending on whether the amount is chargeable in the Profit and Loss section or the Appropriation section.

It is pertinent to mention here that clause (3) of Part II of Schedule VI states that the Profit & Loss account shall set out items relating to income and expenditure of the company, arranged under the most convenient heads in respect of the period covered by the account. It would, therefore appear that when an addition to or a deduction from a reserve has no impact on the profit and loss of the period of account, such an addition or deduction need not be passed through the Profit & Loss Account.

Capital reserve : It is the reserve which does not include any amount regarded as free for distribution through the Profit and Loss account. Share Premium and Capital Redemption Reserve Account should not be credited to capital reserve; these accounts have to be kept separate. Only profits or a surplus of a capital nature can be credited to such a reserve. The following are instances of profit or surpluses which can be so created:

1. Profit prior to incorporation.
2. Capital profit on sale of fixed assets when these are not available for distribution as dividends in the circumstances mentioned below :
   (*i*) where the profit on sale of a fixed asset has not been realised; or

   (*ii*) where the profit on sale of fixed assets though realised is likely to be wiped out by the deficiency on revaluation of other assets; or

   (*iii*) where the Articles of Association do not permit distribution of such profit as a dividend.
3. The excess of the value of net assets over the price paid for the acquisition of a business.
4. Profit on re-issue of forfeited shares. (Premiums received on issue of shares according to the provisions contained under Section 78 are to be credited to Shares Premium Account.)
5. The credit balance in the Capital Reduction Account, where there has been a reduction of capital with the consent of the Court.
6. Premiums received on issue of debentures or profits on redemption of debentures where the distribution of such profits is not permitted by the Articles.

Dividends : A dividend is a distribution of divisible profit of a company among the members according to the number of shares held by each of them in the capital of the company and the rights attaching thereto. Such a distribution may or may not entail a release of assets; it would be where a distribution involves payment of cash. But when profits are capitalised and the amount distributed is applied towards payment of bonus shares, issued free to the share holders, no part of the assets of the company can be said to have been released since, in such a case, profits are only capitalised, thereby increasing the paid up capital of the company. The company does not give up any asset.

A dividend is declared in the annual general meeting on the basis of the recommendation of the Board of Directors. Though the shareholders may declare a dividend smaller than recommended by the Board, they cannot declare a larger dividend or any dividend when none has been recommended (Clause 85 of Table A of Schedule I of the Companies Act). The Board of Directors may, from time to time, pay to the members an interim dividend at a rate which may appear to be justified by the amounts of profit earned by the company (Clause 86 of table A of Schedule I to the Companies Act). The interim dividend is not adjusted when the final dividend is declared (that is the final dividend is in addition to the interim dividend) unless the resolution declaring the dividend states otherwise.

It is thus apparent that the Board of Directors determines the amount of profit which is to be distributed as a dividend as well as the time at which the distribution shall be made.

Interim Dividend : The Companies (Amendment) Act, 2000 has inserted new sub-section (14 A) in Section 2 of the Companies Act which includes 'interim dividend' in the definition of the term 'dividend'.

Dividend on preference shares : Holders of preference shares are entitled to receive a dividend at a fixed rate before any dividend is declared on equity shares. But such a right can be exercised subject to there being profits and the Directors recommending payment of the dividend. In the case of cumulative preference shares the holders are entitled to receive all the dividends which are in arrear before any dividend is paid on equity shares. For instance, suppose a company has not paid a dividend say, for five years and in the sixth year it earns a handsome profit. If Directors decide to declare a dividend on equity shares, it would be necessary to make a provision first for the payment of one year’s dividend to holders of preference shares, if they are non-cumulative. If on the other hand, the right is cumulative, a provision for payment of dividends due to the preference shares for all the six years shall first have to be made before any dividend is declared on equity shares.

In respect of preference shares issued before 1st April, 1960, the dividend payable is to be increased by 30% if the dividend payable was stipulated to be tax free and by 11% in the other case [Preference Shares (Regulation & Dividend) Act, 1960].

Dividend on partly paid shares : In the case of partly paid-up shares, the dividend is payable either on the nominal, called up or the paid-up amount of shares, depending on the provision in this regard that there may be in the Articles. In the absence of any such provision, Table A would be applicable. In such a case the amount of dividend payable will be calculated on the amount paid up on shares, and while doing so, the dates on which the amounts were paid must be taken into account. Calls paid in advance do not rank for payment of dividend. Instead, interest may be paid on such calls; the rate of interest is 6% p.a. according to Table A; Articles of a company may prescribe a different rate. A company may if so authorised by its Article, pay a dividend in proportion to the amount paid on each share, where a larger amount is paid on some share than on other (Section 93). But where the Articles are silent and Table A has been excluded, the amount of dividend payment will have to be calculated on nominal amount of shares. It should, however, be noted that according the Clause 88 of Table A, dividends are to be declared and paid according to the amounts paid or credited as paid on the shares in respect whereof the dividend, is paid but, if and so long as nothing is paid upon any of the shares in the company, dividends may be declared and paid according to the nominal amounts of the shares.

In the case of fresh issue of capital, the holders thereof, unless precluded by the terms of issue, are entitled to receive dividend *pari passu* with the shares already issued.

Payment : All dividends must be paid in cash [Section 205(3)]; dividend warrants, made payable at a bank are treated as cash. Dividend must be paid within 30 days of declaration. The following provisions of law [after the introduction of the Companies (Amendment) Act, 1999 and Companies (Amendment) Act, 2000] should be noted :

(*i*) Where a dividend has been declared by a company but has not been paid, or claimed, within thirty days from the date of the declaration, to any shareholder entitled to the payment of the dividend, the company shall within seven days from the date of expiry of the said period of thirty days, transfer the total amount of dividend which remains unpaid or unclaimed within the said period of thirty days to a special account to be opened by the company in that behalf in any sheduled bank to be called "Unpaid Dividend Account of _ _ _ _ _ Company Limited/Company (Private) Limited.

(*ii*) Any money transferred to the unpaid dividend account of a company in pursuance of this section which remains unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred by the company to the Fund established under Sub-section (*1*) of Section 205C.".

(*iii*) In Section 205 of the Principal Act after sub-section (1), the following sub-sections have been inserted by the Companies Amendment Act, 2000 namely :

(1A) The Board of Directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited in a separate bank account within five days from the date of declaration of such dividend.

(1B) The amount of dividend including interim dividend so deposited under sub-section (1A) shall be used for payment of interim dividend

(1C) The provisions contained in sections 205, 205A, 205C, 206, 206A and 207 shall, as for as may be, also apply to any interim dividend.

(*iv*) Section 55A (inserted by Companies Amendment Act, 2000) grants power to Securities and Exchange Board of India in respect of the listed companies for the matters relating to issue and transfer of securities and non-payment of dividend.

(*v*) Substitution of new section for 207. – For section 207 of the principal Act, the following section shall be substituted, namely :

Penalty for failure to distribute dividends within thirty days. – Where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof has not been posted, within thirty days from the date of declaration, to any shareholder entitled to the payment of the dividend, every director of the company shall, if he is knowingly a party to the default, be punishable with simple imprisonment for a term which may extend to three years and shall also be liable to a fine of one thousand rupees for every day during which such default continues and the company shall be liable to pay simple interest at the rate of eighteen per cent per annum during the period for which such default continues :

Provided that no offence shall be deemed to have been committed within the meaning of the foregoing provisions in the following cases, namely :

(a) where the dividend could not be paid by reason of the operation of any law;

(b) where a shareholder has give directions to the company regarding the payment of the dividend and those directions cannot be complied with;

(c) where there is a dispute regarding the right to receive the dividend;

(d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or

(e) where, for any other reason, the failure to pay the dividend or to post the warrant within the period aforesaid was not due to any default on the part of the company.

Under Section 205C (*1*), the Central Government shall establish a fund to be called the Investor Education and Protection Fund (hereafter in this section referred to as the "Fund").

There shall be credited to the Fund the following amounts, namely :

(*a*) amounts in the paid dividend account of companies;

(*b*) the application moneys received by companies for allotment of any securities and due for refund;

(*c*) matured deposits with companies;

(*d*) matured debentures with companies;

(*e*) the interest accrued on the amount referred to in clauses (*a*) to (*d*);

(*f*) grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purpose of the Fund; and

(*g*) the interest or other income received out of the investments made from the Fund:

Provided that no such amounts referred to in clauses (*a*) to (*d*) shall from part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

Explanation : For the removal of doubts, it is hereby declared that no claims shall lie against the Fund or the company in respect of individual amounts which were unclaimed and unpaid for a period of seven years from the dates that they first became due for payment and no payment shall be made in respect of any such claims.

The Fund shall be utilised for promotion of investor awareness and protection of the interests of investors in accordance with such rules as may be prescribed.

Corporate Dividend Tax: The Finance Act, 1997, has introduced Chapter XIID (Sections 115O and 115 Q) on "Special Provisions Relating to Tax on Distributed profits of Domestic Companies" [Hereinafter referred to as 'CDT' (Corporate Dividend Tax)]. The ICAI has issued Guidance Note on Accounting for Corporate Dividend Tax.

The salient features of CDT are as below:

(i) CDT is in addition to the income-tax chargeable in respect of the total income of a domestic company.

(ii) CDT is chargeable on any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of June 1997.

(iii) The dividends chargeable to CDT may be out of the current profits or accumulated profits.

(iv) The rate of CDT is ten per cent.

(v) CDT shall be payable even if no income-tax is payable by the domestic company on its total income.

(vi) CDT is payable to the credit of the Central Government within 14 days of

(a) declaration of any dividend,

(b) distribution of any dividend, or

(c) payment of any dividend.

whichever is the earliest.

(vii) CDT paid shall be treated as the final payment of tax on the dividends and no further credit therefor shall be claimed by the company or by any person in respect of the tax so paid.

(viii) The expression 'dividend' shall have the same meaning as is given to 'dividend' in clause (22) of Section 2 but shall not include sub-clause(e) thereof.

Accounting for CDT: According to generally accepted accounting principles, the provision for dividend is recognised in the financial statements of the year to which the dividend relates. In view of this, CDT on dividend, being directly linked to the amount of the dividend concerned, should also be reflected in the accounts of the same financial year even though the actual tax liability in respect thereof may arise in a different year.

Disclosure and Presentation of CDT in Financial Statements: It is noted that clause 3(vi) of Part II of Schedule VI to the Companies Act, 1956, requires the disclosure of "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 of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation." It is also noted that Part II of Schedule VI only lays down the information to be disclosed in the profit and loss account. However, as a matter of convention and to improve readability, the information in the profit and loss account is generally shown in two parts, viz., the first part contains the information which is required to arrive at the figure of the current year's profit-often referred to as 'above the line', and the second part which discloses, inter alia, information involving the appropriations of the current year's profits - often referred to as 'below the line'.

Since dividends are disclosed 'below the line', a question arises with regard to disclosure and presentation of CDT, as to whether the said tax should also be disclosed `below the line' or should be disclosed along with the normal income-tax provision for the year `above the line'.

The liability in respect of CDT arises only if the profits are distributed as dividends whereas the normal income-tax liability arises on the earning of the taxable profits. Since the CDT liability relates to distribution of profits as dividends which are disclosed `below the line', it is appropriate that the liability in respect of CDT should also be disclosed `below the line' as a separate item. It is felt that such a disclosure would give a proper picture regarding payments involved with reference to dividends.

CDT liability should be recognised in the accounts of the same financial year in which the dividend concerned is recognised.

CDT liability should be disclosed separately in the profit and loss account, 'below the line', as follows:

Dividend	xxxxx	
Corporate Dividend Tax thereon	xxxxx	xxxxx

Provision for Corporate Dividend Tax should be disclosed separately under the head 'Provisions' in the balance sheet.

The accounting treatment for corporate dividend tax in the financial statements of a company can be explained with the help of following example:

X Co. Ltd. proposed dividend amounting to Rs. 500 lacs for the year ended 31st March, 2006. The corporate dividend tax liability of Rs. 50 lacs arises as per sections 115 O and 115 Q of the Income-tax Act. In this case, the charge for CDT should be disclosed separately in the Profit and Loss Account, below the line as given below:

Profit and Loss Account
for the year ended 31st March, 2006

	Rs. (lacs)	Rs. (lacs)
Proposed Dividend	500	
Corporate Dividend Tax	50	550

The provision for corporate dividend tax should be disclosed separately under, the head 'current liabilities and provisions'. The relevant extracts of the Balance Sheet of X Co. Ltd. can be shown as follows:

Balance Sheet as on 31st March, 2006

Current liabilities and provisions:	
Proposed Dividend	500
Corporate Dividend Tax	50

Illustration 4

The following are the balances from the Ledger of Mount View Hotel Ltd., on 31st March 2006:

	Rs.
Share Capital - Credit Balance on 1st January, 2006	56,685
Preliminary Expenses	7,500
Freehold Premises	46,800
Furniture and Fittings	8,934
Glass and China	1,101
Linen	840
Cutlery and Plate	390
Rates, Taxes and Insurance	1,713
Salaries	2,400
Wages	4,305
Stocks on 31st March, 2005 :	
Wines, Rs. 1,239 ; Spirits, Rs. 378 ; Beer, Rs. 165 ;	1,782
Minerals, Rs. 147 ; Cigars and Cigarettes, Rs. 114	261
Sundry Provisions and Stores, Rs. 183; Coal, Rs. 150	333
Purchases :	
Meat, Rs. 3,627 ; Fish and Poultry Rs. 3,960	7,587
Sundry Provisions and Stores, Rs. 5,220	5,220

Wines Rs. 1,881 ; Spirits Rs. 2,190 ; Beer Rs. 1,152	5,223
Minerals, Rs. 1,050 : Cigars and Cigarettes, Rs. 240	1,290
Laundry	951
Coal and Gas	2,160
Electric Light	1,128
General Expenses	1,710
Sales —	
Wines, Rs. 3,870 ; Spirits, Rs. 4,335 ; Beer, Rs. 1,863	10,068
Minerals, Rs. 2,160 ; Cigars and Cigarettes, Rs. 390	2,550
Meals	23,829
Rooms	9,375
Fires in Bedrooms	582
Washing Charges	219
Repairs, Renewals, and Depreciation -	
Premises, Rs. 348 ; Furniture and Fittings, Rs. 660	1,008
Glass and China, Rs. 609 ; Linen, Rs. 390	999
Cutlery and Plate	207
Cash Book - Debit Balances:	Rs.
In Bank	2,148
On hand	219
Visitors Accounts unpaid	489
Sundry Creditors	3,390

Stocks on 31st March, 2006 were valued as follows -

Wines, Rs. 1,197; Spirits, Rs. 333 ; Beer, Rs. 174 ;
Minerals, Rs. 357 ; Cigars and Cigarettes, Rs. 69 ;
Sundry Provisions and Stores, Rs. 141 ; Coal, Rs. 99

The Manager is entitled to a commission of 5% of the net profits *after* charging his commission. The authorised share capital is 10,000 shares of Rs. 10 each of which 5,700 shares were issued, the whole of the amount being called up. The final call on 210 shares @ Rs. 1.50 per share was unpaid ; the directors forfeited these shares at their meeting held on 15th March, 2006.

The tax liability is estimated at Rs. 4,300 and the directors propose to declare a dividend at the rate of 6 per cent. Prepare the Final Accounts for presentation to the shareholders.

Solution :

Profit and Loss Account of Mount-View Hotel Ltd.,

for the year ended 31st March, 2006

		Rs.		*Rs.*
To	Opening Stocks -		By Sales -	
	Wines, Spirit and Beer	1,782	Wines, Spirits, Beer	10,068
	Minerals, Cigars and Cigarettes	261	Minerals,Cigars and	
	Sundry Provision & Stores and		Cigarettes	2,550
	Coal	333	By Meals	23,829
To	Purchases :		By Rooms	9,375
	Meat, Fish and Poultry	7,587	By Fires in Bed Rooms	582
	Sundry Provisions & Stores	5,220	By Washing Charges	219
	Wines, Spirits, Beer	5,223	By Closing Stocks :	
	Minerals, Cigars & Cigarettes	1,290	Wines, Spirit & Beer	1,704
To	Wages	4,305	Minerals, Cigars & Cigarettes	426
To	Coal and Gas	2,160	Sundry Provisions &	
To	Rates, Taxes and Insurances	1,713	Stores and Coal	240
To	Salaries	2,400		
To	Laundry	951		
To	Electricity Light	1,128		
To	General Expenses	1,710		
To	Repairs, Renewals and			
	Depreciation :			
	Premises	348		
	Furniture & Fittings	660		
	Glass and China	609		
	Linene	390		
	Cutlery & Plate	207		
To	Commission to Manager			
	Outstanding (on Rs. 10,206 @ 5%)	510		
To	Provision for Taxation	4,300		
To	Net Profit Transferred to			

	Profit & Loss Appropriation			
	Account	5,906		
		48,993		48,993
To	Proposed Dividend	3,294	By Net Profit for the current year	5,906
To	Corporate Dividend Tax (3,294 × .10)	329.4		
To	Balance c/d	2282.6		
		5,906		5,906

Balance Sheet of Mount-View Hotel Ltd., as on 31st March, 2006

Liabilities	*Rs.*	*Assets*	*Rs.*	*Rs.*
Share Capital :		*Fixed Assets :*		
Authorised Freehold Premises	47,148			
10,000 Shares of Rs. 10 each	1,00,000	*Less :* Depreciation	348	46,800
Issued & Subscribed :				
5,490 Equity Shares of Rs. 10		Furniture & FIttings	9,594	
each fully paid up	54,900	*Less :* Depreciation	600	8,934
Forfeited Shares	1,785			
Reserves and Surplus :		*Current Assets, Loans and Advances :*		
Profit & Loss Account	2282.6	(A) Current Assets :		
Current Liabilities and Provisions		Linen	1,230	
(A) Current Liabilities :		*Less :* Depreciation	390	840
Sundry Creditors	3,390			
Manager's Commission		Cutlery & Plate	597	
Outstanding	510	*Less :* Depreciation	207	390
(B) Provisions :				
Provision for Taxation	4,300	Glass & China	1,710	
Proposed Dividend	3,294	*Less :* Depreciation	609	1,101
Corporate Dividend Tax	329.4	Stock of :		
		Wines, Spirits & Beer	1,704	
		Minerals, Cigars & Cigarettes	426	
		Sundry Provisions & Stores		
		and Coal	240	
		Debtors	489	
		Cash in hand	219	
		Cash at Bank	2,148	

	(B)	Loans & Advances :	Nil
		Miscellaneous Expenditure :	
		Preliminary Expenses	7,500
70,791			70,791

Illustration 5

The following balances have been extracted from the books of DOW Books Limited as on 31st March, 2006.

Dr.			Cr.
	Rs.		*Rs.*
Cash in hand	3,800	Share Capital	90,000
Cash at Bank	12,600	9% Debentures	30,000
Bills Receivable	4,000	Sundry Creditors	29,000
Investment	1,000	Profit and Loss A/c	2,000
Security Deposit	400	Secured Loan from bank	
Advances	8,500	against stock	50,000
Debtors	75,000	Gross Profit	1,75,000
Land and Buildings	1,05,000	Share Suspense	3,000
Furniture	4,500	Liabilities for expenses	12,000
Motor Car	25,000	Sale of Furniture	300
Closing Stock	95,000	Bills Payable	3,100
Establishment expenses	35,200	Miscellaneous Receipts	425
Repairs and renewals	2,600		
Motor Car Expenses	4,200		
Travelling and Conveyance	1,600		
Printing and Stationery	900		
Telephone	1,200		
Debenture Interest	2,025		
Commission on sales	3,200		
Advertisement	3,500		
Managing Director’s remuneration	3,600		
Directors fees	2,000		
	3,94,825		3,94,825

The following further particulars are available :

(1) Amount of share capital has been arrived at as follows -

9,200 equity shares of Rs. 10 each, fully called up	92,000
Less : Calls-in-arrear @ Rs. 2 on 1,000 shares	2,000
	90,000

(2) The Profit and Loss Account balance has been arrived at after charging Rs. 5,000 on account of short provision of taxation for the earlier year.

(3) A Bank advice, for debit of Rs. 710 on account of interest on loan upto 31st March 2006, was received on 5th April, 2006 the loan having been taken on 1st March, 2006.

(4) The Bank statement shows a wrong credit of Rs. 3,000 on 16th March 2006, the same being detected and adjusted by the Bank on 30th April 2006.

(5) The 1,000 shares, on which calls were forfeited by the Board, and Share Suspense represents the amount received on their reissue, as fully paid, by Board's resolution.

(6) Sale of furniture represents disposals, during the year, of a few old items of furniture having a written-down value of Rs. 400 on 30th September 2006, against their original cost of Rs. 800.

(7) Cost of land Rs. 30,000 is included in the amount of land and buildings.

(8) Sundry debtors, which are all unsecured and considered goods, include Rs. 10,000 due for more than six months.

(9) Advertisement charges include materials of Rs. 1,500.

(10) Advances include Rs. 3,000 paid for a new telephone installed during the year under the OYT Scheme, of which an amount of Rs. 150 has been set off against the current year's bills.

(11) Amounts of Rs. 2,000 and Rs. 1,200 debited to purchases and wages respectively, were for making new furniture during the year.

(12) Investment represents purchase of 200 equity shares of Rs. 10 each, Rs. 5 per share called and paid up.

(13) Charge depreciation on the closing written down amount of -

Buildings	@ 2.5%
Furniture	@ 10%
Motor Car	@ 20%

(14) Original costs of fixed assets were -

	Rs.
Buildings	1,00,000
Furniture	9,000
Motor Car	35,000

(15) The Managing Director is entitled to 5% of the annual net profits as his remuneration, subject to a minimum of Rs. 300 per month. The net profits, for this purpose, are to be taken without charging income-tax and his remuneration itself.

(16) Bills discounted not matured Rs. 1,500.

(17) Provision for income-tax is to be made, for the year, of Rs. 65,000.

(18) The following appropriations have been proposed by the Board of Directors out of the profit for the year -

(a) Transfer of Rs. 20,000 to General Reserve.

(b) Dividend of 12% on the paid-up capital.

(19) Debentures were issued two years back, and are not secured.

You are required to prepare the Profit and Loss Account for the year ended 31st March, 2006 and the Balance as on that date. Ignore previous year's figures.

Solution :

DOW Books Ltd.

Profit and Loss Account for the Year ended 31st March, 2006

		Rs.	*Rs.*		*Rs.*
To	Establishment Expenses		35,200	By Gross Profit	1,75,000
To	Repairs, Renewals		2,600	By Cost of furniture, (expenses	
To	Motor Car Expenses		4,200	to be capitalised)	3,200
To	Travelling & Conveyance		1,600	By Miscellaneous Receipts	425
To	Loss on sale of furniture		100		
To	Printing & Stationery		900		
To	Telephone		1,350		

To	Debenture Interest		2,700		
To	Bank Interest		710		
To	Commission on Sales		3,200		
To	Advertisement		2,000		
To	Directors’ Fees		2,000		
To	Depreciation :				
	Furniture	730			
	Buildings	1,875			
	Motor Car	5,000	7,605		
To	Managing Director’s				
	Remuneration		5,723		
To	Provision for Income Tax		65,000		
*To	Short Provision for Income				
	tax in the previous year		5,000		
To	Net Profit c/d		38,737		
			1,78,625		1,78,625
			Rs.		*Rs.*
To	Transfer to General Reserve			By Net Profit for the year b/d	38,737
	(Proposed)		20,000	By Balance from previous year	7,000
To	Proposed Dividend		11,040		
To	Corporate Dividend Tax (11,040 × .10)		1104		
To	Balance c/d		13,593		
			45,737		45,737

*The excess tax liability is to be considered as change in accounting estimate and the effect of such change should be included in the determination of net profit or loss of the affected period, in accordance with para 23 of AS 5 (Revised).

Note on Remuneration to Managing Director:	*Rs.*
Profit as disclosed	43,737

Add :Provision for Taxation		65,000
Managing Director's Remuneration		5,723
Profit before calculating the Remuneration		1,14,460
Remuneration @ 5%	5,723	

Balance Sheet of DOW Books Ltd., as at 31st March, 2006

Liabilities and Capital	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Share Capital		?	Fixed Assets :		
Authorised		?	Land at cost		30,000
Issued			Building : Cost	1,00,000	
Subscribed and Paid up :			Depreciation		
9,200 Equity Shares of Rs. 10			provided	26,875	73,125
each fully paid		92,000			
Reserve and Surplus			Furniture : Cost	9,000	
Capital Reserve		1,000	*Less :* Disposed of		
Profit & Loss Account Balance		13,593	(cost)	800	
General Reserve (Proposed				8,200	
Transfer)		20,000	Addition during the		
Secured Loans			year	3,200	
Loan from bank (secured				11,400	
against stock) :	50,000				
Interest due	710	50,710	Depreciation provided	4,830	6,570
			Motor Car		
Unsecured Loans			Cost	35,000	
9% Debentures		30,000	Depreciation provided	15,000	20,000
Current Liabilities and Provisions :					
A. *Current Liabilities*					
Bills Payable		3,100	*Investments :*		
Sundry Creditors for goods			Partly paid shares		1,000
and expenses		43,123	*Current Assets, Loans and*		
Interest accrued on Debentures		675	*Advances*		
B. *Provisions :*			*Current Assets :*		
Provision for Taxation		65,000	Stock in Trade (at cost)	95,000	

Proposed Dividend	11,040	(Book Debts all un-		
Corporate Dividend Tax	11,04	secured but considered good) More than		
		6 months 10,000		
		Others 65,000	75,000	
		Cash in hand	3,800	
		Cash at Bank (Bank assumed to be Scheduled)	12,600	1,86,400
		B. *Advances :*		
		Bills Receivable	4,000	
		Deposits		8,350
		Advertisement		
		Material on hand	1,500	
		Security Deposit	400	14,250
	3,31,345			3,31,345

Note : There is contingent liability for calls that may be made on partly paid shares, Rs. 1,000 and for Bills under discount, Rs. 1,500.

Working Notes :

(*i*) Rs. 710, interest due to Bank, may also be adjusted against the bank balance, specially when the Bank is entitled to debit to company's accounts under the Loan Agreement.

(*ii*) The wrong credit given by the Bank, subsequently adjusted, is only an item for the Bank Reconciliation Statement.

(*iii*) The Share Suspense Account has a balance of Rs. 1,000 after adjustment of the amount in arrear. It has to be credited to Capital Reserve.

(*iv*) Rs. 150 out of OYT deposit has to be treated as telephone charges.

(*v*) Previous year's figures have not been given since these are not available. Stastical information required to be disclosed under Schedule VI has also not been given for the same reason.

Illustration 6

You are required to prepare a Profit and Loss Account and Balance Sheet from the following Trial Balance extracted from the books of the International Hotels Ltd., on 31st March, 2006-

	Dr.	*Cr.*
	Rs.	*Rs.*
Authorised Capital-divided into 5,000 6% Preference Shares		
of Rs. 100 each and 10,000 equity Shares of Rs. 100 each		15,00,000
Subscribed Capital -		
5,000 6% Preference Shares of Rs. 100 each		5,00,000
Equity Capital		8,05,000
Purchases - Wines, Cigarettes, Cigars, etc.	45,800	
- Foodstuffs	36,200	
Wages and Salaries	28,300	
Rent, Rates and Taxes	8,900	
Laundry	750	
Sales - Wines, Cigarettes, Cigars, etc.		68,400
- Food		57,600
Coal and Firewood	3,290	
Carriage and Cooliage	810	
Sundry Expenses	5,840	
Advertising		8,360
Repairs	4,250	
Rent of Rooms		48,000
Billiard		5,700
Miscellaneous Receipts		2,800
Discount received		3,300
Transfer fees		700
Freehold Land and Building	8,50,000	
Furniture and Fittings	86,300	
Stock on hand, 1st April, 2005		
Wines, Cigarettes. Cigars,etc.	12,800	

Foodstuffs	5,260	
Cash in hand	2,200	
Cash with Bankers	76,380	
Preliminary and formation expenses	8,000	
2,000 Debentures of Rs. 100 each (6%)		2,00,000
Profit and Loss Account		41,500
Sundry Creditors		42,000
Sundry Debtors	19,260	
Investments	2,72,300	
Goodwill at cost	5,00,000	
General Reserve		2,00,000
	19,75,000	19,75,000

Wages and Salaries Outstanding	1,280
Stock on 31st March, 2006	
Wines Cigarettes and Cigars, etc.	22,500
Foodstuffs	16,400

Depreciation :

Furniture and Fittings @ 5% p.a. : Land and Building @ 2% p.a.

The Equity capital on 1st April, 2005 stood at Rs. 7,20,000, that is 6,000 shares fully paid and 2,000 shares Rs. 60 paid. The directors made a call of Rs. 40 per share on 1st October 2005. A shareholder could not pay the call on 100 shares and his shares were then forfeited and reissued @ Rs. 90 per share as fully paid. The Directors propose a dividend of 8% on equity shares, transferring any amount that may be required from General Reserve. Ignore Taxation.

Solution :

Profit and Loss Account of International Hotels Ltd.

for the year ended 31st March, 2006

		Rs.	Rs.		Rs.
To	Stock on 1st April, 2005			By Sales,	
	Wines, Cigarettes, Cigars etc.		12,800	Wines, Cigaretters, Cigars etc.	68,400

Foodstuffs		5,260	By Food	57,600
To Purchases -			By Rent of Rooms	48,000
Wines, Cigarettes etc.		45,800	By Billiards	5,700
Foodstuffs		36,200	By Miscellaneous Receipts	2,800
To Wages and Salaries	28,300		By Discount Received	3,300
Add: Wages and			By Transfer fees	700
Salaries Outstanding	1,280	29,580	By Stock on 31st March, 2006 :	
To Rent, Rates and Taxes		8,900	Wines Cigarettes Cigars, etc.	22,500
To Laundry		750	By Foodstuffs	16,400
To Coal and Firewood		3,290		
To Carriage and Cooliage		810		
To Sundry Expenses		5,840		
To Advertising		8,360		
To Repairs		4,250		
To Interest on Debentures		12,000		
To Depreciation on Furniture				
and Fittings @ 5%		4,315		
Land and Buildings @ 2%		17,000		
To Net Profit c/d		30,245		
		2,25,400		2,25,400
To Preference Dividend Payable		30,000	By Net Profit b/d	41,500
To Proposed Equity Dividend		64,000	By Net Profit for the year	30,245
			By General Reserve	22,255
		94,000		94,000

Balance Sheet of International Hotels Ltd. as on 31st March, 2006

Liabilities		*Rs.*	*Assets*		*Rs.*
Share Capital :			*Fixed Assets*		
Authorised :			Goodwill (Cost)	5,00,000	
5,000 6% Preference shares	5,00,000		Freehold land &		
of Rs. 100 each			Buildings*	8,50,000	

10,000 Equity shares of	10,00,000		*Less* : Depreciation	17,000	8,33,000
Rs. 100 each	15,00,000				

* The amount in respect of Land has to be shown separately.

Liabilities		*Rs.*	*Assets*		*Rs.*
Issued and Subscribed :			Furniture and Fittings	86,300	
5,000 6% Preference Shares			*Less* : Depreciation	4,315	81,985
of Rs. 100 each		5,00,000	*Investments :*		2,72,300
8,000 Equity Shares of Rs. 100 each		8,00,000	*Current Assets, Loans and Advances :*		
Reserves and Surplus :					
Capital Reserve*[*]	5,000		*(A) Current Assets :*		
General Reserve	2,00,000		Stock :		
Less : Amount used to			Wines, Cigarettes &		
pay dividend	22,255	1,77,745	Cigars, etc.		22,500
			Foodstuffs		16,400
Secured loans :			Sundry Debtors		19,260
6% Debentures		2,00,000	Cash in hand		2,200
Outstanding Interest on above		12,000	Cash with Bankers		76,380
Current Liabilities and Provisions :			*(B)Loans and Advances :*		Nil
(A) Current Liabilities :			*Miscellaneous Expenditure :*		
Sundry Creditors		42,000	Preliminary Expenses		8,000
Wages and Salaries Outstanding		1,280			
(B) Provisions :					
Proposed Dividend (pref. and equity)		94,000			
		18,32,025			18,32,025

[*] Profit on forfeited shares reissued

Illustration 7

From the following particulars furnished by Pioneer Ltd., prepare the Balance Sheet as at 31st March, 2006 as required by Part I, Schedule VI of the Companies Act. Give notes at the foot of the Balance Sheet as may be found necessary -

	Debit		*Credit*
	Rs.		Rs.
Equity Capital (Face value of Rs. 100)			10,00,000
Calls in Arrears		1,000	
Land		2,00,000	
Building		3,50,000	
Plant and Machinery		5,25,000	
Furniture		50,000	
General Reserve			2,10,000
Loan from State Financial Corporation			1,50,000
Stock :			
Finished Goods	2,00,000		
Raw Materials	50,000	2,50,000	
Provision for Taxation			68,000
Sundry Debtors		2,00,000	
Advances		42,700	
Proposed Dividend			60,000
Profit and Loss Account			1,00,000
Cash Balance		30,000	
Cash at Bank		2,47,000	
Preliminary Expenses		13,300	
Loans (Unsecured)			1,21,000
Sundry Creditors (For Goods and Expenses)		———	2,00,000
		19,09,000	19,09,000

The following additional information is also provided :

(1) Miscellaneous expenses included Rs. 5,000 audit fees and Rs. 700 for out of pocket expenses paid to the auditors.

(2) 2,000 equity shares were issued for consideration other than cash.

(3) Debtors of Rs. 52,000 are due for more than six months.

(4) The cost of assets:

Building	Rs.4,00,000
Plant and Machinery	Rs.7,00,000
Furniture	Rs.62,500

(5) The balance of Rs. 1,50,000 in the loan account with State Finance Corporation is inclusive of Rs. 7,500 for interest accrued but not due. The loan is secured by hypothecation of the Plant and Machinery.

(6) Balance at Bank includes Rs. 2,000 with Perfect Bank Ltd., which is not a Scheduled Bank.

(7) Bills receivable for Rs. 2,75,000 maturing on 30th June, 2006 have been discounted.

(8) The company had contract for the erection of machinery at Rs. 1,50,000 which is still incomplete.

Solution :

Pioneer Ltd.

Balance Sheet as on 31st March, 2006

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Share Capital			*Fixed Assets*		
Authorised			Land	2,00,000	
.... Equity shares of			Building: Cost	4,00,000	
Rs. ... each			*Less:* Depreciation	50,000	3,50,000
Issued & subscribed:			Plant & Machinery		
10,000 Equity			Cost	7,00,000	
Shares of Rs. 100			*Less:* Depreciation	1,75,000	5,25,000

each fully called up	10,00,000				
(Of the above 2,000			Furniture: Cost	62,500	
Equity Shares of			*Less:* Depreciation	12,500	50,000
Rs. 100 each have been			*Investment*		
issued for consideration			*Current Assets, Loans & Advances*		
other than cash)			*A.Current Assets*		
Less: calls in arrears	1,000	9,99,000	Stock in trade		
Reserves & Surplus			Finished goods	2,00,000	
General Reserve		2,10,000	Raw Material	50,000	2,50,000
Profit & Loss Account		1,00,000	(*a*) Debts outstanding		
Secured Loans			for a period		
Loan from State			exceeding six		
Financial Corporation		1,42,500	months	52,000	
(Secured by hypothecation of			(*b*) Other Debts		
Plant and Machinery)			*Less* Provision	1,48,000	2,00,000
Unsecured Loan			Cash in hand		30,000
Unsecured Loans		1,21,000	Cash at Bank		
			(*a*) *with Scheduled*		
Current Liabilities &			*Banks*	2,45,000	
Provisions			(*b*) *with others*		
			Perfect Bank Ltd.	2,000	2,47,000
A. Current Liabilities					
Sundry Creditors		2,00,000	*B. Loans & Advances*		
Interest accrued but			Advances		42,700
not due on loans (SFC)		7,500	*Misc. Expenses*		
B. Provisions			(to the extent		
Provision for taxation		68,000	not written off)		
Proposed Dividend		60,000	Preliminary Expenses		13,300
		19,08,000			9,08,000

Notes:

(*a*) Estimated amount of contract remaining to be executed on capital account and not provided for Rs. 1,50,000.*

(*b*) Bills receivable discounted maturing on 31st June, 2006 amount to Rs. 2,75,000.

* It has been assumed that the company had given this contract for purchase of machinery.

Illustration 8

Fruit Juice Ltd., Mumbai has factories at Ratnagiri (alphonso mango pulp) and Nagpur (Orange juice).

During the year ended 31st March, 2006, the following location wise revenue statements were furnished by the two factories (from which the total column has been compiled):

	Ratnagiri	Nagpur	Total
	Rs.	Rs.	Rs.
Opening stock :			
Work in process	24,000	12,000	36,000
Finished goods	8,000	2,000	10,000
	32,000	14,000	46,000
Raw material consumption	25,00,000	10,00,000	35,00,000
Employee cost	5,00,000	6,00,000	11,00,000
Power and Fuel	1,00,000	50,000	1,50,000
Consumable stores	15,000	7,000	22,000
Rates and taxes	14,000	9,000	23,000
Repairs to factory :			
Building	4,000	5,000	9,000
Machinery	80,000	50,000	1,30,000
Other assets	3,000	1,000	4,000
Other expenses	65,000	55,000	1,20,000
Depreciation	1,00,000	90,000	1,90,000
	34,13,000	18,81,000	52,94,000
Less : Closing stock			
Work in process	28,000	13,000	41,000
Finished goods	5,000	8,000	13,000
	33,000	21,000	54,000
Cost of goods transferred to marketing division	33,80,000	18,60,000	52,40,000

The marketing division furnishes you with the following information of its productwise revenue statement for the year ended 31st March, 2006 (from which the total column has been compiled):

	Mango pulp	Orange juice	Total
Opening stock :	12,000	5,000	17,000
Receipt during the year out of :			
Last year's despatch from factory	10,000	5,000	15,000
Current year's despatch from factory	33,65,000	18,50,000	52,30,000
	33,75,000	18,55,000	52,30,000
Transport "in" cost from factory	50,000	60,000	1,10,000
	34,37,000	19,20,000	53,57,000
Less : Closing stock	7,000	10,000	17,000
	34,30,000	19,10,000	53,40,000
Sales commission	5,00,000	2,50,000	7,50,000
Sales tax	4,00,000	1,25,000	5,25,000
Profit	6,70,000	2,15,000	8,85,000
Sales	50,00,000	25,00,000	75,00,000

You are asked to prepare sectional and consolidated revenue statement for the year ended 31st March, 2006 for consideration of the board of directors and presentation to the members of Fruit Juice Ltd. Also work out the percentage of net profit to sales.

Show your working, if any.

Solution

Revenue Statement of Fruit Juice Ltd. (Sectional and Consolidated)
for the year ended 31st March, 2006

	Mango Pulp	Orange Juice	Total
	Rs. '000	Rs. '000	Rs. '000
Sales	5,000	2,500	7,500
Add : Excess of closing inventory over opening inventory *(Working note 1)*	1	17	18
Gross revenue	5,001	2,517	7,518
Less : Manufacturing and other expenses *(Working note 2)*	4,231	2,212	6,443
Profit before depreciation	770	305	1,075
Less : Depreciation	100	90	190
Net Profit	670	215	885

	Mango Pulp	Orange Juice	Total
Percentage of net profit to sales	13.4%	8.6%	11.8%

Working Notes :

(1) *Excess of closing inventory over opening inventory*

(a)	Mango Pulp	Orange Juice	Total
	Rs. '000	*Rs. '000*	*Rs. '000*
Opening Stock			
Finished goods :			
At factory	8	2	10
In transit (received during the year by marketing division)	10	5	15
With marketing division	12	5	17
	30	12	42
Work in process	24	12	36
Total	54	24	78

(b)	*Mango Pulp*	*Orange Juice*	*Total*
	Rs. '000	*Rs. '000*	*Rs. '000*
Closing Stock			
Finished goods :			
At factory	5	8	13
In transit*	15	10	25
With marketing division	7	10	17
	27	28	55
Work in process	28	13	41
	55	41	96
(c) Closing Stock	55	41	96
Less : Opening stock	54	24	78
Excess of closing stock over opening stock	1	17	18

*Goods sent by factory	3,380	1,860	5,240
Less : Received by marketing division	3,365	1,850	5,215
Finished goods in transit	15	10	25

(2) *Manufacturing and other costs*

	Mango Pulp	*Orange Juice*	*Total*
	Rs. '000	*Rs. '000*	*Rs. '000*
Manufacturing costs:			
Raw Material consumption	2,500	1,000	3,500

Employee cost		500	600	1,100
Power and fuel		100	50	150
Consumable stores		15	7	22
Rates and taxes		14	9	23
Repairs :	Building	4	5	9
	Machinery	80	50	130
	Other assets	3	1	4
Other costs :				
	Transport	50	60	110
	Sales commission	500	250	750
	Sales tax	400	125	525
	Other expenses	65	55	120
		4,231	2,212	6,443

Self-Examination Questions

I. Objective Type Questions

Choose the appropriate answer from the given options

1. Dividends are usually paid on:

   (a) Paid-up Capital

   (b) Authorised Capital.

   (c) Called-up Capital

2. Amount set aside to meet losses due to bad debts is a:

   (a) Reserve

   (b) Provision

   (c) Liability.

3. Securities Premium Account is shown on the liabilities side in the Balance Sheet under the heading:

   (a) Reserves and Surplus.

   (b) Current Liabilities and Provisions.

   (c) Share Capital.

4. If the proposed dividend is 20% the percentage of profits to be transferred to reserve is:

(a) 2.5%

(b) 5%

(c) 7.5%

5. Indicate the item that appears in the Profit and Loss Account below the line:

(a) Proposed Dividend.

(b) Provision for Taxation

(c) Contribution to Provident Fund.

6. Rate of corporate dividend tax is:

(a) 10%

(b) 8%

(c) Nil.

[**Ans. 1.** (a); **2.** (b); **3.** (a); **4.** (c); **5.** (a); **6.** (a)].

II. Short Answer Type Questions

7. Who is responsible for maintenance of books of account? Briefly explain the provisions of company law regarding maintenance of proper books of account.

8. What do you mean by divisible profit? When can dividend be paid out of capital profits?

III. Long Answer Type Questions

9. What are the various heads under which profits are usually appropriated by companies and for what reasons?

IV. Practical Problems

10. The engineer of sugar mill is entitled to a commission of 5% of the net profit of the mill; the chemist of the mill is also entitled to a commission of 4% of the net profit which in each case is to be calculated after charging the commission payable to the other person but before charging one's own commission. What is the amount payable to each if the net profit of the mill before the two commission is Rs. 5,00,000?

11. The following is the draft Profit & Loss Account of the Paper Company of India Ltd. for the year ending 31st March, 2006 :

	Rs.			Rs.
To Administrative, Selling		By Balance b/d		3,12,632
To Finance Expenses	5,73,804	By Balance from Trading		
To National Defence Fund	18,800	Account		38,35,414
To Directors' Fees	23,484	By Interest on Investments		10,964
To Interest on Debentures	2,824	By Transfer fee		37
To Managing Director's				
Remuneration	1,40,000	By Profit on sale of plant:	Rs.	
To Depreciation on fixed assets	4,69,713	By Amount realised	40,000	
To Provision for taxation	11,40,000	*Less* Book value		
To General Reserve	5,00,000	(Cost Rs. 35,000)	31,000	9,000
To Debentures Sinking Fund	4,800			
To Investment Revaluation Reserve	9,800			
To Balance c/d	12,84,822			
	41,68,047			41,68,047

As an auditor you are required to comment on the managerial remuneration.

12. Bee Ltd. had the following Balance on 31-03-2006:

	Rs.
6% Preference Shares of Rs. 25 each fully paid	2,00,000
Equity Shares of Rs. 100 each fully paid	10,00,000
Share Premium Account	2,00,000
Capital Redemption Reserve Account	1,00,000
General Reserve	3,00,000
Profit and Loss Account	80,000

On the date, Land and Building which stood at Rs. 5,00,000 in the books were revalued at Rs. 8,00,000. It was decided to

(i) consolidate the preference shares into shares of Rs. 100 each;

(ii) subdivide the equity shares of Re. 1 each;

(iii) adopt the revaluation of Land and Building; and

(iv) issue fully paid up bonus shares to equity shareholders equal to 50% of the present Equity Share Capital, revenue reserve and profit being used only if necessary for the purpose.

Give journal entries to record the above and state the reserve and profits that remain.

UNIT – 2 : CASH FLOW STATEMENTS

Learning Objectives

After studying this unit, you will be able to:

- Define cash low statement as per AS 3
- Differentiate operating, investing and financing activities
- Learn the various elements of cash and cash equivalents
- Prepare cash flow statement both by direct method and indirect method.

2.1 INTRODUCTION

Accounting Standard 3, Cash Flow Statements, was issued in March, 2004. This revised Accounting Standard super seeded the Accounting Standard (AS 3) on changes in Financial Position, issued in June 1981.

Cash flow statement provides information about the changes in cash and cash equivalents of an enterprise. Cash flow statement is based on cash concept of profit. Cash flow statement seems to be useful because it identifies cash generated from trading operations, the operating cash surplus which can be applied for investment in fixed assets. In fact a portion of cash from operations is used to pay dividend and tax and the other portion is ploughed back. What can be ploughed back is directly identifiable from cash flow statement. In projected form, this statement is a very useful tool of planning.

Cash flow statements are prepared to explain the cash movements between two points of time.

Sources of Cash:

1. Issue of shares and debentures and raising long-term loan.
2. Sale of investments and other fixed assets.
3. Cash from operations.
4. Decrease in Cash.

Applications of Cash:

1. Redemption of preference shares and debentures and repayment of long-term loan.

2. Purchase of investments and other fixed assets.
3. Payment of tax.
4. Payment of dividend.
5. Increase in cash.

Increase in cash or decrease in cash is put in the applications and the sources respectively just to balance the cash flow statement. At this juncture students may note that in cash flow statement changes in all balance sheet items are to be taken into consideration separately for explaining movement of cash.

2.2 ELEMENTS OF CASH FUND

As per AS 3, issued by the Council of the ICAI, 'Cash Funds' include:

(i) Cash in hand,

(ii) Demand deposits with banks, and

(iii) Cash equivalents.

Cash equivalents which are considered as part of funds for calculation of cash flows are defined as '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". Basic objective of acquisition of cash equivalents is to deploy, for a short period, idle cash required to meet short-term cash-commitments. Securities with short maturity period of, say, three months or less from the date of acquisition qualify as a cash equivalent. Examples are: acquisition of preference shares, shortly before their specified redemption date, bank deposits with short maturity period, etc. Thus, cash flow statement deals with flow of cash funds but does not consider the movements among cash, bank balance payable on demand and investment of excess cash in cash equivalents. Examples are cash withdrawn from current account, cash deposited in bank for 60 days, etc.

2.3 CLASSIFICATION OF CASH FLOW ACTIVITIES

Transactions, which increase cash, are classified as cash inflow and transactions which decrease cash are classified as cash outflow. Thus, cash flow statement provides explanation for changes in cash position of the business entity. Accounting Standard issued by the Institute of Chartered Accountants of India require that the cash flow statement should report cash flows during the period classified by operating, investing and financing activities:

2.3.1 Operating Activities: These are the principal revenue producing activities of the enterprise. Net impact of operating activities on flow of cash is reported as 'Cash flows from operating activities' or 'cash from operation'.

The amount of cash flows from operating activities is a key indicator of the extent to which the operations of the enterprises have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans, and make new investments without recourse to external sources of financing. It provides useful information about internal financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

2.3.2 Investing activities: These are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which the expenditures have been made for resources intended to generate future incomes and cash flows.

2.3.3 Financing activities: These are the activities that result in changes in the size and composition of the owner's capital (including preference share capital) and borrowings of the enterprise. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise.

2.4 CALCULATION OF CASH FLOWS FROM OPERATING ACTIVITIES

Cash flows from operating activities result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flow from operations include cash receipts from the sale of goods and the rendering of services; cash receipt from fees, commission and other revenue; cash payments to suppliers for goods; cash payments to employees and so on. An enterprise can determine cash flows from operating activities using either:

The direct method, whereby major classes of gross cash receipts and gross cash payments are considered; or the indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing activities.

2.4.1 Direct Method: Under the direct method, information about gross receipts and gross cash payments may be obtained from the accounting records to ascertain cash flows from operating activities. For example, information about cash received from debtors, payment to creditors, cash expenses etc., may be obtained by an analysis of cash book. In actual practice, the relevant information is obtained by adjusting sales, cost of sales and other items in the profit and loss accounts for:

Changes during the period in inventories and operating receivables and payables;

Other non-cash items such as depreciation on fixed assets, goodwill written off, preliminary expenses written off, loss or gain on sale of fixed assets etc.; and

Other items for which the cash effects are investing or financing cash flows. Examples are interest received and paid, dividend received and paid etc., which are related to financing or investing activities and are shown separately in the cash flow statement.

This procedure of computation of cash flows from operating activities is also known as income statement method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. However, indirect method of determining the cash from operating activities is more popular in actual practice.

2.4.2 Indirect Method: Under the indirect method, the net cash from operating activities is determined by adjusting net profit or loss instead of individual items appearing in the profit and loss account. Net profit or loss is also adjusted for the effect of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation; and

(c) all other items for which the cash effects are financing or investing cash flows.

The indirect method is also known as 'reconciliation method'. It is worth noting that both direct and indirect methods adjust current assets and current liabilities related to operating activities to determine cash from operating activities. But direct method adjust individual items of profit and loss account and indirect method adjusts overall net profit (or loss) to determine cash from operation. Therefore, indirect method fails to provide break-up of cash from operations.

Proforma of 'Cash Flow From Operating Activities' by indirect method:

			Rs.
Net Profit for the year			-
Add:	Non-Cash Expenses:	-	
	Depreciation	-	
	Share Discount Written off	-	
	Loss on Sale of Assets	-	
	Provision for taxation, etc.	-	

Less: Non-Cash Incomes:		
Profit on Sale of Assets	-	
Net Profit after Adjustment for Non-Cash Items	————	(-)

Cash from operation = Net Profit (after adjustment for Non-cash Items)

- Increase in Current Assets

+ Decrease in Current Asset

+ Increase in Current Liabilities

- Decrease in Current Liability

2.5 CALCULATION OF CASH FLOWS FROM INVESTING ACTIVITIES

These activities are related to the acquisition and disposal of long-term assets, non-operating current assets and investments which results in outflow of cash. Disposal of the aforesaid assets results in inflow of cash. Thus, inflows and outflows related to acquisition and disposal of assets, other than those related to operating activities, are shown under this category

2.6 CALCULATION OF CASH FLOWS FROM FINANCING ACTIVITIES

These activities are basically related to the changes in capital and borrowing of the enterprise which affect flow of cash. Redemption of shares and repayment of borrowings results in outflow of cash. Thus inflows and outflows related to the amount of capital and borrowings of the enterprise are shown under this head.

Students are advised to refer full text of revised Accounting Standard on Cash Flow Statements (AS 3) for the better understanding of the chapter.

Illustration 1

The following summary cash account has been extracted from the company's accounting records:

Summary Cash Account

	(Rs. '000)
Balance at I.1.2006	35
Receipts from customers	2,783

Issue of shares		300
Sale of fixed assets		128
		3,246
Payments to suppliers	2,047	
Payments for fixed assets	230	
Payments for overheads	115	
Wages and salaries	69	
Taxation	243	
Dividends	80	
Repayments of bank loan	250	(3,034)
Balance at 31.12.2006		212

Prepare Cash Flow Statement of this company Hills Ltd. for the year ended 31st December 2006 in accordance with AS-3 (Revised).

The company does not have any cash equivalents.

Solution

Hills Ltd.
Cash Flow Statement for the year ended 31st December 2006
(Using the direct method)

		(Rs. '000)
Cash flows from operating activities		
Cash receipts from customers	2,783	
Cash payments to suppliers	(2,047)	
Cash paid to employees	(69)	
Other cash payments (for overheads)	(115)	
Cash generated from operations	552	
Income taxes paid	(243)	
Net cash from operating activities		309
Cash flows from investing activities		
Payments for purchase of fixed assets	(230)	
Proceeds from sale of fixed assets	128	
Net cash used in investing activities		(102)
Cash flows from financing activities		
Proceeds from issuance of share capital	300	

Bank loan repaid	(250)	
Dividend paid	(80)	
Net cash used in financing activities		(30)
Net increase in cash and cash equivalents		177
Cash and cash equivalents at beginning of period		35
Cash and cash equivalents at end of period		212

The solution given in above illustration has been prepared using simply the summarised cash account. To team the technique of preparing Cash Flow Statement from comparative balance sheets and profit and loss account, the above illustration has been expanded by giving following further detailed information extracted from the records of Hills Ltd.

Illustration 2

The following data were provided by the accounting records of Ryan Ltd. at year-end, March 31, 2006:

Income Statement

		Rs.
Sales		6,98,000
Cost of Goods Sold		(5,20,000)
Gross Margin		1,78,000
Operating Expenses		
(including Depreciation Expense of Rs. 37,000)		(1,47,000)
		31,000
Other Income (Expenses)		
Interest Expense paid	(23,000)	
Interest Income received	6,000	
Gain on Sale of Investments	12,000	
Loss on Sale of Plant	(3,000)	
		(8,000)
		23,000
Income tax		(7,000)
		16,000

Comparative Balance Sheets

	31st March 2006	Rs. 31st March 2005
Assets	7,15,000	5,05,000
Plant Assets	(1,03,000)	(68,000)
Less: Accumulated Depreciation	6,12,000	4,37,000
Investments (Long term)	1,15,000	1,27,000
Current Assets:	1,44,000	1,10,000
Inventory	47,000	55,000
Accounts Receivable	46,000	15,000
Cash	1,000	5,000
Prepaid Expenses	9,65,000	7,49,000
Liabilities		
Share Capital	4,65,000	3,15,000
Reserves and Surplus	1,40,000	1,32,000
Bonds	2,95,000	2,45,000
Current Liabilities:		
Accounts Payable	50,000	43,000
Accrued Liabilities	12,000	9,000
income Taxes Payable	3,000	5,000
	9,65,000	7,49,000

Analysis of selected accounts and transactions during 2005-2006

1. Purchased investments for Rs. 78,000
2. Sold investments for Rs. 1,02,000.

   These investments cost Rs. 90,000
3. Purchased plant assets for Rs. 1,20,000
4. Sold plant assets that cost Rs. 10,000 with accumulated depreciation of Rs. 2,000 for Rs. 5,000.
5. Issued Rs. 1,00,000 of bonds at face value in an exchange for plant assets on 31st March, 2006

6. Repaid Rs. 50,000 of bonds at face value at maturity.

7. Issued 15,000 shares of Rs. 10 each.

8. Paid cash dividends Rs. 8,000.

Prepare Cash Flow Statement as per AS-3 (Revised), using indirect method.

Solution

Ryan Ltd.

Cash Flow Statement

for the year ending 31st March, 2006

	Rs.	*Rs.*
Cash flows from operating activities		
Net profit before taxation	23,000	
Adjustments for:		
Depreciation	37,000	
Gain on sale of investments	(12,000)	
Loss on sale of plant assets	3,000	
Interest expense	23,000	
Interest income	(6,000)	
Operating profit before working capital changes	68,000	
Decrease in accounts receivable	8,000	
Increase in inventory	(34,000)	
Decrease in prepaid expenses	4,000	
Increase in accounts payable	7,000	
Increase in accrued liabilities	3,000	
Cash generated from operations	56,000	
Income taxes paid*	(9,000)	
Net cash from operating activities		47,000
Cash flows from investing activities		
Purchase of plant assets	(1,20,000)	
Sale of plant assets	5,000	
Purchase of investments	(78,000)	
Sale of investments	1,02,000	

Interest received	6,000	
Net cash used in investing activities		(85,000)
Cash flows from financing activities		
Proceeds from issuance of share capital	1,50,000	
Repayment of bonds	(50,000*)*	
Interest paid	(23,000)	
Dividends paid	(8,000)	
Net cash from financing activities		69,000
Net increase in cash (and cash equivalents)		31,000
Cash (and cash equivalents) at beginning of period		15,000
Cash (and cash equivalents) at end of period		46,000

***Working Note:**

	Rs.
Income taxes paid:	
Income tax expense for the year	7,000
Add: Income tax liability at the beginning of the year	5,000
	12,000
Less: Income tax liability at the end of the year	3,000
	9,000

Illustration 3

The balance sheets of Sun Ltd. for the years ended 31st March 2006 and 2005 were summarised thus:

	2006	*2005*
	Rs.	Rs.
Equity Share Capital	60,000	50,000
Reserves:		
Profit and Loss Account	5,000	4,000
Current Liabilities:		
Creditors	4,000	2,500

Taxation	1,500	1,000
Proposed dividends	2,000	1,000
	72,500	58,500
Fixed Assets (at w.d.v.)		
Premises	10,000	10,000
Fixtures	17,000	11,000
Vehicles	12,500	8,000
Short-term investments	2,000	1,000
Current Assets		
Stock	17,000	14,000
Debtors	8,000	6,000
Bank and Cash	6,000	8,500
	72,500	58,500

and the profit and loss account for the year ended 31st March, 2006 disclosed

	Rs.
Profit before tax	4,500
Taxation	(1,500)
Profit after tax	3,000
Proposed dividends	(2,000)
Retained profit	1,000

Further information is available:

	Vehicles	*Fixtures*
	Rs.	*Rs.*
Depreciation for year	1,000	2,500
Disposals:		
Proceeds on disposal	—	1,700
Written down value	—	(1,000)
Profit on disposal		700

Prepare a Cash Flow Statement for the year ended 31st March, 2006.

Solution

Sun Ltd.

Cash Flow Statement

for the year ended 31st March, 2006

	Rs.	*Rs.*
Cash flows from operating activities		
Net Profit before taxation	4,500	
Adjustments for:		
Depreciation	3,500	
Profit on sale of vehicles	(700)	
Operating profit before working capital changes	7,300	
increase in sundry debtors	(2,000)	
Increase in inventories	(3,000)	
Increase in sundry creditors	1,500	
Cash generated from operations	3,800	
Income taxes paid	(1,000)	
Net cash from operating activities		2,800
Cash flows from investing activities		
Sale of vehicles	1,700	
Purchase of vehicles	(8,000)	
Purchase of fixtures	(7,000)	
Net cash used in investing activities		(13,300)
Cash flows from financing activities		
Issue of shares for cash	10,000	
Dividends paid	(1,000)	
Net cash from financing activities		9,000
Net decrease in cash and cash equivalents		1,500
Cash and cash equivalents at beginning of period (See Note 1)		9,500
Cash and cash equivalents at end of period (See Note 1)		8,000

Note to the Cash Flow Statement

Cash and Cash Equivalents

	31.3.2006	*31.3.2005*
Bank and Cash	6,000	8,500
Short-term investments	2,000	1,000
Cash and cash equivalents	8,000	9,500

Working Notes:

			Rs.
1.	Income taxes paid		
	Income tax expense for the year	1,500	
	Add: Income tax liability at the beginning of the year	1,000	
			2,500
	Less: Income tax liability at the end of the year		1,500
			1,000
2.	Dividend paid		
	Proposed dividend for the year	2,000	
	Add: Amount payable at the beginning of the year		1,000
			3,000
	Less: Amount payable at the end of the year		2,000
			1,000

3. Fixed assets acquisitions

	Fixtures	*Vehicles*
	Rs.	*Rs.*
W.D.V. at 31.3.2006	17,000	12,500
Add back:		
Depreciation for the year	1,000	2,500
Disposals	—	1,000
	18,000	16,000
Less: W.D.V. at 31.12.2005	11,000	8,000
Acquisitions during 2005-2006	7,000	8,000

Illustration 4

Ms. Joyti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year 2005 :

	(Rs. in Lakhs)
Net Profit	25,000
Dividend (including dividend tax) paid	8,535
Provision for Income tax	5,000
Income tax paid during the year	4,248
Loss on sale of assets (net)	40
Book value of the assets sold	185
Depreciation charged to Profit & Loss Account	20,000
Amortisation of Capital grant	6
Profit on sale of Investments	100
Carrying amount of Investment sold	27,765
Interest income on investments	2,506
Increase expenses	10,000
Interest paid during the year	10,520
Increase in Working Capital (excluding Cash & Bank Balance)	56,075
Purchase of fixed assets	14,560
Investment in joint venture	3,850
Expenditure on construction work in progress	34,740
Proceeds from calls in arrear	2
Receipt of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceeds from short-term borrowings	20,575
Opening cash and Bank balance	5,003
Closing cash and Bank balance	6,988

Required :

Prepare the Cash Flow Statement for the year 2005 in accordance with AS 3, Cash Flow Statements issued by the Institute of Chartered Accountants of India. (make necessary assumptions).

Solution

Star Oils Limited
Cash Flow Statement
for the year ended 31st December, 2005

		(Rs. in lakhs)
Cash flows from operating activities		
Net profit before taxation (25,000 + 5,000)	30,000	
Adjustments for :		
Depreciation	20,000	
Loss on sale of assets (Net)	40	
Amortisation of capital grant	(6)	
Profit on sale of investments	(100)	
Interest income on investments	(2,506)	
Interest expenses	10,000	
Operating profit before working capital changes	57,428	
Changes in working capital (Excluding cash and bank balance)	(56,075)	
Cash generated from operations	1,353	
Income taxes paid	(4,248)	
Net cash used in operating activities		(2,895)
Cash flows from investing activities		
Sale of assets	145	
Sale of investments (27,765 + 100)	27,865	
Interest income on investments	2,506	
Purchase of fixed assets	(14,560)	
Investment in joint venture	(3,850)	
Expenditure on construction work-in progress	(34,740)	
Net cash used in investing activities		(22,634)
Cash flows from financing activities		
Proceeds from calls in arrear	2	
Receipts of grant for capital projects	12	
Proceeds from long-term borrowings	25,980	
Proceed from short-term borrowings	20,575	

Interest paid	(10,520)	
Dividend (including dividend tax) paid	(8,535)	
		27,514
Net increase in cash and cash equivalents		1,985
Cash and cash equivalents at the beginning of the period		5,003
Cash and cash equivalents at the end of the period		6,988

Working note :

Book value of the assets sold	185
Less : Loss on sale of assets	40
Proceeds on sale	145

Assumption :

Interest income on investments Rs. 2,506 has been received during the year.

Illustration 5

From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2006 in accordance with AS 3 (Revised) using the direct method. The company does not have any cash equivalents.

Summary Cash Account for the year ended 31.3.2006

	Rs. '000		**Rs. '000**
Balance on 1.4.2005	50	Payment to Suppliers	2,000
Issue of Equity Shares	300	Purchase of Fixed Assets	200
Receipts from Customers	2,800	Overhead expense	200
Sale of Fixed Assets	100	Wages and Salaries	100
		Taxation	250
		Dividend	50
		Repayment of Bank Loan	300
		Balance on 31.3.2006	150
	3,250		3,250

Solution

X Ltd.

Cash Flow Statement for the year ended 31st March, 2006

(Using direct method)

	Rs. '000	*Rs.'000*
Cash flows from operating activities		
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash from operating activities		250
Cash flows from investing activities		
Payments for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash		100
Cash at beginning of the period		50
Cash at end of the period		150

Illustration 6

Given below is Profit and Loss Account of ABC Ltd. and relevant Balance Sheet information:

Profit and Loss Account of ABC Ltd.
for the year ended 31st December, 2006

	Rs. in lakhs
Revenue:	
Sales	4,150

Interest and dividend	100
Stock adjustment	20
Total (A)	4,270
Expenditure:	
Purchases	2,400
Wages and salaries	800
Other expenses	200
Interest	60
Depreciation	100
Total (B)	3,560
Profit before tax (A – B)	710
Tax provision	200
Profit after tax	510
Balance of Profit and Loss account brought forward	50
Profit available for distribution (C)	560
Appropriations:	
Transfer to general reserve	200
Proposed dividend	300
Distribution tax	30
Total (D)	530
Balance (C – D)	30

Relevant Balance Sheet information	*31.12.2006*	*31.12.2005*
	Rs. in lakhs	*Rs. in lakhs*
Debtors	400	250
Inventories	200	180
Creditors	250	230
Outstanding wages	50	40
Outstanding expenses	20	10
Advance tax	195	180
Tax provision	200	180
Assessed tax liability		

Compute cash flow from operating activities using both direct and indirect method.

Solution

By direct method

Computation of Cash Flow from Operating Activities

	Rs.	*Rs.*
Cash Receipts:		
Cash sales and collection from debtors		
Sales + Opening debtors – Closing debtors (A)	4,150 + 250 – 400	4,000
Cash payments:		
Cash purchases & payment to creditors		
Purchases + Opening creditors – Closing creditors	2,400 + 230 – 250	2,380
Wages and salaries paid	800 + 40 – 50	790
Cash expenses	200 + 10 – 20	190
Taxes paid – Advance tax		195
(B)		3,555
Cash flow from operating activities (A – B)		445

By indirect method

Profit before tax			710
Add: Non-cash items : Depreciation			100
Add: Interest : Financing cash outflow			60
Less: Interest and Dividend : Investment cash inflow			(100)
Less: Tax paid			(195)
Working capital adjustments			
Debtors	250–400	(–150)	
Inventories	180–200	(–20)	
Creditors	250–230	20	

Outstanding wages	50–40	10	
Outstanding expenses	20–10	10	(130)
Cash flow from operating activities			445

Self-Examination Questions

I. Objective Type Questions

Pick-up the correct answer from the given choices

1. Yash Ltd. wants to prepare its cash flow statement. It sold equipment of book value of Rs. 60,000 at a gain of Rs. 8,000. The amount to be reported in its cash flow statement under operating activities is

   (a) Nil

   (b) (8,000)

   (c) 8,000

2. Cash flows arising from interest paid in the case of a financial enterprise is a cash flow from

   (a) Financing activity

   (b) Investing activity

   (c) Operating activity

3. In the cash flow statement, 'cash and cash equivalents' include

   (a) Bank and Cash

   (b) Short-term investments

   (c) Both (a) and (b)

4. As per AS 3 on Cash Flow Statements, cash received by a manufacturing company from sale of shares of ABC Company Ltd. should be classified as

   (a) Operating activity.

   (b) Financing activity.

   (c) Investing activity.

5. While preparing cash flow statement, conversion of debt to equity

   (a) Should be shown as a financing activity.

(b) Should be shown as an investing activity.

c) Should not be shown as it is a non-cash transaction.

[**Answer : 1.** (a), **2.** (c), **3.** (c), **4.** (c), **5.** (c)]

II. Short Answer Type Questions

6. What additional information can the users obtain from Cash Flow Statements?

7. Discuss briefly the cash flow classification which essential to provide cash flow information to the users of accounts.

8. Give two examples of cash flow from operating and investing activities of a manufacturing concern.

III. Long Answer Type Questions

9. What is the significance of cash flow statement? Explain various elements of cash and cash equivalents.

10. describe direct and indirect methods of preparing cash flow statements with the help of the example.

IV. Practical Problems

11. From the following details relating to the Accounts of Grow More Ltd. prepare Cash Flow Statement:

Liabilities	*31.03.2006 (Rs.)*	*31.03.2005 (Rs.)*
Share Capital	10,00,000	8,00,000
Reserve	2,00,000	1,50,000
Profit and Loss Account	1,00,000	60,000
Debentures	2,00,000	–
Provision for taxation	1,00,000	70,000
Proposed dividend	2,00,000	1,00,000
Sundry Creditors	7,00,000	8,20,000
	25,00,000	20,00,000
Assets		
Plant and Machinery	7,00,000	5,00,000
Land and Building	6,00,000	4,00,000
Investments	1,00,000	–
Sundry Debtors	5,00,000	7,00,000

Stock	4,00,000	2,00,000
Cash on hand/Bank	2,00,000	2,00,000
	25,00,000	20,00,000

(i) Depreciation @ 25% was charged on the opening value of Plant and Machinery.

(ii) During the year one old machine costing 50,000 (WDV 20,000) was sold for Rs. 35,000.

(iii) Rs. 50,000 was paid towards Income tax during the year.

(iv) Building under construction was not subject to any depreciation.

Prepare Cash flow Statement.

12. From the following Balance Sheet and information, prepare Cash Flow Statement of Ryan Ltd. for the year ended 31st March, 2006:

Balance Sheet

	31st March, 2006	*31st March, 2005*
	Rs.	*Rs.*
Liabilities		
Equity Share Capital	6,00,000	5,00,000
10% Redeemable Preference Capital	–	2,00,000
Capital Redemption Reserve	1,00,000	–
Capital Reserve	1,00,000	–
General Reserve	1,00,000	2,50,000
Profit and Loss Account	70,000	50,000
9% Debentures	2,00,000	–
Sundry Creditors	95,000	80,000
Bills Payable	20,000	30,000
Liabilities for Expenses	30,000	20,000
Provision for Taxation	95,000	60,000
Proposed Dividend	90,000	60,000
	15,00,000	12,50,000

	31st March, 2006	*31st March, 2005*
	Rs.	*Rs.*
Assets		
Land and Building	1,50,000	2,00,000
Plant and Machinery	7,65,000	5,00,000
Investments	50,000	80,000
Inventory	95,000	90,000
Bills Receivable	65,000	70,000
Sundry Debtors	1,75,000	1,30,000
Cash and Bank	65,000	90,000
Preliminary Expenses	10,000	25,000
Voluntary Separation Payments	1,25,000	65,000
	15,00,000	12,50,000

Additional Information:

(i) A piece of land has been sold out for Rs. 1,50,000 (Cost – Rs. 1,20,000) and the balance land was revalued. Capital Reserve consisted of profit on sale and profit on revaluation.

(ii) On 1st April, 2005 a plant was sold for Rs. 90,000 (Original Cost – Rs. 70,000 and W.D.V. – Rs. 50,000) and Debentures worth Rs. 1 lakh was issued at par as part consideration for plant of Rs. 4.5 lakhs acquired.

(iii) Part of the investments (Cost – Rs. 50,000) was sold for Rs. 70,000.

(iv) Pre-acquisition dividend received Rs. 5,000 was adjusted against cost of investment.

(v) Directors have proposed 15% dividend for the current year.

(vi) Voluntary separation cost of Rs. 50,000 was adjusted against General Reserve.

(vii) Income-tax liability for the current year was estimated at Rs. 1,35,000.

(viii) Depreciation @ 15% has been written off from Plant account but no depreciation has been charged on Land and Building.

CHAPTER 3

PROFITS OR LOSS PRIOR TO INCORPORATION

Learning Objectives

After studying this chapter, you will be able to:

- Account for pre-incorporation profit.
- Learn various methods for computing profit or loss prior to incorporation.

1. INTRODUCTION

When a running business is taken over by the promoters of a company, from a date before the company which is to manage and own is registered, the amount of profit or loss of such a business for the period prior to the date the company came into existence is referred to as pre-incorporation profits or losses. Such profits or losses, though belonging to the company or payable by it, are of capital nature; it is necessary to disclose them separately as trading profits or losses. The general practice in this regard is that if there is a loss, it is either written off by debit to the Profit and Loss Account or to a special account described as "Loss Prior to Incorporation" and show as an "asset" in the Balance Sheet: ,in the alternative, it is debited to the Goodwill Account. On the other hand, if a profit has been earned by business prior to the same being taken over and the same is not fully absorbed by any interest payable for the period, it is credited to Capital Reserve Account or to the Goodwill Account, if any goodwill has been adjusted as an asset. The profit will not be available for distribution as a dividend among the members of the company.

2. METHODS OF COMPUTING PROFIT OR LOSS PRIOR TO INCORPORATION

The determination of such profit or loss would be a simple matter if it is possible to close the books and take the stock held by the business before the company came into existence. In such a case, the trial balance will be abstracted from the books and the profit or loss computed: Thereafter, the books will be either closed off or the balance allowed continuing undistributed; only the amount of profit or loss so determined being adjusted in the manner described above. When this is not possible, one or the other of the following methods will have to be followed for the purpose.

(1) The simplest, though not always the most expedient method is to close off old books and open new books with the assets and liabilities as they existed at the date of incorporation. In this way, automatically the result to that date will be adjusted, the

difference between the values of assets and liabilities acquired and the purchase consideration being accounted for either as goodwill or as reserve. The accounts, therefore, would relate exclusively to the post-incorporation period and any adjustment for the pre-incorporation period, whether an adjustment of profit or loss, would not be required.

(2) Since the decision to take over a business is usually reached long after the date from which it is agreed to be taken over it is normally not possible to follow any of the method aforementioned. The only alternative left, in the circumstances, is to split up the profit of the year of the transfer of the business to the company between 'pre' and 'post' incorporation periods. This is done either on the time basis or on the turnover basis or by a method which combines the two.

The amount of gross profit of a business is not dependent on time. It is, therefore, more appropriate to distribute it on the basis of turnover. Similarly, the expenses incurred in earning the gross profit, not having any direct relationship thereto, should be distributed on a basis considered appropriate, having regard to the circumstances of each case. Common charges which are fixed *e.g.*, insurance, salaries, depreciation etc., are allocated on time basis, while those which are fluctuating *e.g.,* bad debts, discount and carriage outwards are allocated according to turnover unless, in the light of available information time at which these were incurred or in consideration of the relationship that these bear to the profit of the two periods. For example, interest payable on the credit balance of vendors is charged against the profit of the period before the business was taken over on the consideration that it is in respect of that period before the business was taken over on the consideration that it is in respect of that period that the profit accrued to the company, though the purchase consideration had not been discharged. But if the purchase consideration is not paid on taking over the business, the interest for the subsequent period is charged to the post-incorporation period. Again, preliminary expenses on the formation of the company though incurred in point of time, before the company was incorporated are charged against the profit of the period subsequent to incorporation.

	Rs.
Suppose Sales in Pre-incorporation Period	6,000
Sales in Post-incorporation Period	19,000
	25,000

The company deals in one type of product. The unit cost of sales was reduced by 10% in post incorporation period as compared to the pre-incorporation period in the year. In this case the cost of sales will be divided between the two periods in the ratio of 6,000: 17,100 *i.e.,* 19,000–1,900.

Illustration 1

Bidyut Limited was incorporated on 1st July, 2007 to acquire from Bijli as and from 1st January, the individual business carried on by him. The purchase price of the fixed assets and goodwill was agreed to be the sum equal to 80% of the profits made each year on ascertainment of the sum due.

The following Trial Balance as on 31st Dec., 2007 is presented to you to enable you to prepare a Balance Sheet as at that date. Also prepare a statement of appropriation of profit writing off one-third of the preliminary expenses.

	Dr.	*Cr.*
	Rs.	*Rs.*
Share Capital - 1,500 equity shares of Rs. 100 each, Rs. 80 paid up		1,20,000
Sundry Debtors	82,000	
Stock on 31st Dec., 2007	67,000	
Cash at bank and on hand	24,000	
Directors' fee	3,000	
Preliminary expenses	24,000	
Sundry Creditors		32,000
Net Profit for the year after providing for all expenses under agreement entered into with Bijli		48,000
	2,00,000	2,00,000

Solution

Balance Sheet of M/s Bidyut Ltd. as on 31st Dec., 2007

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital		*Fixed Assets*	
Issued & Subscribed		Goodwill & Fixed Assets	38,400*
Capital 1,500 Equity		*Investments*	Nil
Shares of Rs. 100 each,		*Current Assets*	
Rs. 80 paid up	1,20,000	Stock	67,000
Reserves & Surplus		Debtors	82,000
Capital Reserve	24,000	Bank	24,000
(Pre-incorporation profit)		*Misc. Expenses &*	
Profit & Loss A/c	13,000	*Losses not written off*	
Secured Loans	Nil	Preliminary expenses	16,000
Unsecured Loans	Nil		

Current Liabilities & Provisions		
Trade Creditors	32,000	
Due to Bijli	38,400	
	2,27,400	2,27,400

*In *Travancore Sugars and Chemicals Ltd.* v. *CIT* (62 CIT 566), the Supreme Court has held that such payment is a revenue expenditure and deductible from the profits of the company, for tax purposes.

Statement of Appropriation of Profit

	Rs.	*Pre-incorporation* *Rs.*	*Post-incorporation* *Rs.*
Net Profit for the Year		24,000	24,000
Less: Directors' fee	3,000		
Preliminary Exps.	8,000		11,000
		24,000	13,000
Amount Payable to Bijli:			
Profit for the year			48,000
80% due as cost of goodwill, assets, etc.		38,400	

Illustation 2

Inder and Vishnu, working in partnership registered a joint stock company under the name of Fellow Travellers Ltd. on May 31, 2005 to take over their existing business. It was agreed that they would take over the assets of the partnership for a sum of Rs. 3,00,000 as from January 1st, 2007 and that until the amount was discharged they would pay interest on the amount at the rate of 6% per annum. The amount was paid on June 30, 2007. To discharge the purchase consideration, the company issued 20,000 equity shares of Rs. 10 each at a premium of Re. 1 each and allotted 7% Debentures of the face value of Rs. 1,50,000 to the vendors at par.

The Profit and Loss Account of the "Fellow Travellers Ltd." for the year ended 31st December, 2007 was as follows :

	Rs.		*Rs.*
Purchase, including stock	1,40,000	Sales:	
Freight and carriage	5,000	1st January to 31st May 2005	60,000
Gross Profit c/d	60,000	1st June to 31st Dec., 2005	1,20,000
		Stock in hand	25,000
	2,05,000		2,05,000
Salaries and Wages	10,000	Gross profit b/d	60,000
Debenture Interest	5,250		

Depreciation	1,000	
Interest on Purchase Consideration (up to 30-6-2007)	9,000	
Selling Commission	9,000	
Directors' Fees	600	
Preliminary Expenses	900	
Provision for taxes	6,000	
Dividend on equity shares @ 5%	5,000	
Balance c/d	13,250	——
	60,000	60,000

Prepare statement apportioning the balance between the 'post' and 'pre-incorporation' periods and also show how these figures would appear in the Balance Sheet of the company.

Solution:

Fellow Travellers Ltd.

Statement showing apportionment of profit between periods prior to and since incorporation

		Ratio	Pre-*incorporation*	Post-*incorporation*
Gross profit allocated on the basis of sale		1:2	20,000	40,000
Administrative Expenses allocated				
On time basis:				
(*i*) Salaries and wages	10,000			
(*ii*) Depreciation	1,000	5:7	4,583	6,417
Selling Commission on the basis of sales		1:2	3,000	6,000
Interest on Purchase Consideration (Time basis)		5:1	7,500	1,500
Expenses applicable wholly to the Post-incorporation period:				
Debenture Interest	5,250			
Director's Fees	600			
Appropriations:				5,850
Preliminary Expenses w/o	900			

Provision for Tax	6,000		
Dividend on equity share	5,000		11,900
Balance c/d to Balance Sheet		4,917	8,333
		20,000	40,000

Fellow Travellers Ltd.

Extract From the Balance Sheet as on 31st Dec., 2007

	Rs.
Share Capital:	
20,000 equity shares of Rs. 10 each fully paid	2,00,000
Reserve and Surplus:	
Profit Prior to Incorporation	4,917
Securities Premium Account	20,000
Profit and Loss Account	8,333
7% Debentures	1,50,000
Provision for Taxes	6,000
Total	3,89,250

Illustration 3

The partners of Maitri Agencies decided to convert the partnership into a private limited company called MA (P) Ltd. with effect from 1st January, 2007. The consideration was agreed at Rs. 1,17,00,000 based on the firm's Balance Sheet as at 31st December, 2006. However, due to some procedural difficulties, the company could be incorporated only on 1st April, 2007. Meanwhile the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% per annum. The same books of account were continued by the company which closed its account for the first time on 31st March, 2008 and prepared the following summarized profit and loss account.

		Rs.
Sales		2,34,00,000
Cost of goods sold:	1,63,80,000	
Salaries	11,70,000	
Depreciation	1,80,000	
Advertisement	7,02,000	
Discounts	11,70,000	
Managing Director's remuneration	90,000	
Miscellaneous office expenses	1,20,000	

Office-cum-show room rent	7,20,000	
Interest	9,51,000	2,14,83,000
Profit		19,17,000

The company's only borrowing was a loan of Rs. 50,00,000 at 12% p.a. to pay the purchase consideration due to the firm and for working capital requirements.

The company was able to double the average monthly sales of the firm, from 1st April, 2007 but the salaries trebled from that date. It had to occupy additional space from 1st July, 2007 for which rent was Rs. 30,000 per month.

Prepare a profit and loss account in a columnar form apportioning cost and revenue between pre-incorporation and post-incorporation periods. Also, suggest how the pre-incorporation profits are to be dealt with.

Solution **MA (P.) Ltd.**

Profit & Loss A/c for 15 months ended 31st March, 2007

		Pre-inc.	*Post-inc.*			*Pre-inc.*	*Post-inc.*
		Rs.	*Rs.*			*Rs.*	*Rs.*
To	Cost of goods sold	18,20,000	1,45,60,000	By	Sales	26,00,000	2,08,00,000
"	Salaries	90,000	10,80,000	"	Loss	19,000	
"	Depreciation	36,000	1,44,000				
"	Advertisement	78,000	6,24,000				
"	Discounts	1,30,000	10,40,000				
"	M.D.'s remuneration	—	90,000				
"	Misc. Office Expenses	24,000	96,000				
"	Rent	90,000	6,30,000				
"	Interest	3,51,000	6,00,000				
"	Net Profit	—	19,36,000				
		26,19,000	2,08,00,000			26,19,000	2,08,00,000

Working Notes:

(1) Calculation of ratio of sales:

Let the average sales per month in pre-incorporation period be x. Then the average sales in post-inc. period are 2x. Thus total sales are (3 × *x*) + (12 × 2*x*) or 27*x*. Ratio of sales will be 3*x* : 24*x* or 1:8.

Time ratio is 3 months : 12 months or 1:4

(2) Expenses apportioned on turnover ratio basis are cost of goods sold, advertisement, discounts.

(3) Expenses apportioned o n time ratio basis are Depreciation, and misc. office expenses.

(4) Ratio for apportionment of Salaries:

If pre-incorporation monthly average is x, for 3 months 3x.

Average for balance 12 months 3x, for 12 months 36x.

Hence ratio for division, 1:12.

(5) Apportionment of Rent:

	Rs.
Total Rent	7,20,000
Additional rent for 9 months (From 1st July to 31st March, 2007)	2,70,000
Rent for old premises for 15 months or Rs. 30,000 p.m.	4,50,000

	Pre-inc.	Post-inc.
Old Premises	90,000	3,60,000
Addl.:”	—	2,70,000
	90,000	6,30,000

Note on treatment

Since the profits prior to incorporation are in the negative, they would:

(*a*) Either be considered as a reduction from any capital reserve accruing in relation to the transaction, or

(*b*) Be treated as goodwill.

Illustration 4

ABC Ltd. was incorporated on 1.5.2006 to take over the business of DEF and Co. from 1.1.2006. The Profit and Loss Account as given by ABC Ltd. for the year ending 31.12.2005 is as under:

Profit and Loss Account

		Rs.			*Rs.*
To	Rent and Taxes	90,000	By	Gross Profit	10,64,000
To	Salaries including manager’s salary of Rs. 85,000	3,31,000	By	Interest on Investments	36,000
To	Carriage Outwards	14,000			

		Rs.			Rs.
To	Printing and Stationery	18,000			
To	Interest on Debentures	25,000			
To	Sales Commission	30,800			
To	Bad Debts (related to sales)	91,000			
To	Underwriting Commission	26,000			
To	Preliminary Expenses	28,000			
To	Audit Fees	45,000			
To	Loss on Sale of Investments	11,200			
To	Net Profit	3,90,000			
		11,00,000			11,00,000

Prepare a Statement showing allocation of pre-incorporation and post-incorporation profits after considering the following information:

(i) G.P. ratio was constant throughout the year.

(ii) Sales for January and October were 1½ times the average monthly sales while sales for December were twice the average monthly sales.

(iii) Bad Debts are shown after adjusting a recovery of Rs. 7,000 of Bad Debt for a sale made in July, 2003.

(iv) Manager's salary was increased by Rs. 2,000 p.m. from 1.5.2006.

(v) All investments were sold in April, 2006.

Solution

Pre-incorporation period is for four months, from 1st January, 2006 to 30th April, 2006. 8 months' period (from 1st May, 2006 to 31st December, 2006) is post-incorporation period.

Profit and Loss Account for the year ended 31st December, 2006

		Pre-Inc	Post –Inc			Pre-Inc	Post inc
		Rs.	*Rs.*			*Rs.*	*Rs.*
To	Rent and Taxes	30,000	60,000	By	Gross Profit	3,42,000	7,22,000
To	Salaries			By	Interest on Investments		
	Manager's Salary	23,000	62,000			36,000	–
	Other Salaries	82,000	1,64,000	By	Bad Debts Recovery	7,000	–
To	Printing and Stationery	6,000	12,000				
To	Audit fees	15,000	30,000				

To	Carriage Outwards	4,500	9,500		
To	Sales Commission	9,900	20,900		
To	Bad Debts (91,000 + 7,000)	31,500	66,500		
To	Interest on Debentures	–	25,000		
To	Underwriting Commission	–	26,000		
To	Preliminary Expenses	–	28,000		
To	Loss on sale of investments	11,200	–		
To	Net Profit	1,71,900*	2,18,100	______	______
		3,85,000	7,22,000	3,85,000	7,22,000

*Pre-incorporation profit is a capital profit and will be transferred to Capital Reserve.

Working Notes

(i) Calculation of ratio of Sales

Let average monthly sales be *x*.

Thus Sales from January to April are 4½ *x* and sales from May to December are 9½ *x*.

Sales are in the ratio of 9/2*x* : 19/2*x* or 9 : 19.

(ii) Gross profit, carriage outwards, sales commission and bad debts written off have been allocated in pre and post incorporation periods in the ratio of Sales i.e. 9 : 19.

(iii) Rent, salaries, printing and stationery, audit fees are allocated on time basis.

(iv) Interest on debentures, underwriting commission and preliminary expenses are allocated in post incorporation period.

(v) Interest on investments, loss on sale of investments and bad debt recovery are allocated in pre-incorporation period.

Self-Examination Questions

I. Objective type questions

Choose the most appropriate answer from the questions:

1. Profit prior to incorporation is transferred to

(a) General reserve.

(b) Capital reserve.

(c) Profit and loss account.

(d) None of the above.

2. The profit earned by the company from the date of purchase to the date of incorporation is

(a) Pre- incorporation profit.

(b) Post- incorporation profit.

(c) Notional profit.

(d) Estimated profit.

[**Answer** : **1.** (b), **2.** (a)]

II. Short answer type questions

3. Write a short note on Profit or loss prior to pre-incorporation.

III. Long answer type questions

4. Explain various methods of computing profit or loss prior to pre-incorporation in detail.

IV. Practical problems

5. Flat Private Ltd. Was incorporated on 1st July, 2005 to take over the running business of Mr. Round with effect from 1st April, 2005. The following Profit and Loss Account for the year ended 31st March, 2006 was drawn up:

		Rs.			*Rs.*
To	Commission	2,625	By	Gross Profit	98,000
"	Advertisement	5,250	"	Bad Debt Realised	500
"	Managing director's Remuneration	9,000			
"	Depreciation	2,800			
"	Salaries	18,000			
"	Insurance	600			
"	Preliminary Expenses	700			
"	Rent & Taxes	3,000			
"	Discount	350			
"	Bad Debts	1,250			
"	Net Profit	54,925			
		98,500			98,500

The following details are available:

(i) The average monthly turnover from July 2005 onwards was double than that of the previous months.

(ii) Rent for the first 3 months was paid @ Rs.200 p.m. and thereafter at a rate increased by Rs.50 p.m.

(iii) Advertisement expenses were directly proportionate to the sales.

You are required to find out the profit prior to incorporation and state the treatment thereof in the books of the company.

6. B. Ltd. Was incorporated on 30th June, 2005 to take over the business of T. Ltd. As from 1st January, 2005. The financial accounts of the business for the year ended 31st December, 2005 disclosed the following information:

			Rs.	*Rs.*
Sales -	January to June		1,20,000	
	July to December		1,80,000	
				3,00,000
Less:	Purchases	- January to June	75,000	
		- July to December	1,20,000	
	Gross Profit			1,05,000
Less:	Salaries		15,000	
	Selling Expenses		3,000	
	Depreciation		1,500	
	Director's Remuneration		750	
	Debenture Interest		90	
	Administration Expenses (Rent, Rates etc.)		4,500	
				24,840
				80,160

You are required to prepare a statement apportioning the balance of profit between the periods prior to and since incorporation and show the profit and loss appropriation account for the year ended 31st December, 2005.

CHAPTER 4

ACCOUNTING FOR BONUS ISSUE

Learning Objectives

After studying this chapter, you will be able to

- Understand the provisions relating to issue of bonus shares.
- Account for bonus shares.

1. INTRODUCTION

The Companies Act does not contain any specific provision regarding capitalisation of profits and consequently issue of bonus shares. However, the Companies Act permits that the share premium amount can be used by the company in paying up unissued shares of the company to be issued to its members as fully paid bonus shares. Also the company can utilise the amount of the capital redemption reserve in paying up unissued shares of the company to be issued to its members as fully paid bonus shares. The SEBI (Disclosure and Investor Protection) Guidelines, 2000 which came into force w.e.f. 27th day of January, 2000 require that the company while issuing bonus shares shall ensure the following :

(a) No company shall, pending conversion of FCDs/PCDs/ issue any by way of bonus unless similar benefit is extended to the holders of such FCDs/ through reservation of shares in proportion to such convertible part of FCDs or PCDs

(b) The shares so reserved may be issued at the time of conversion(s) debentures on the same terms on which the bonus issues were made.

The bonus issue shall be made out of free reserves built of the profits or share premium collected in cash only.

Reserves created by revaluation of fixed assets are not capitalised.

The declaration of bonus issue, in lieu of dividend, is not made.

The bonus issue is not made unless the partly-paid shares, if any, are made fully paid-up.

The company—

(a) has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption and

(b) has sufficient reason to believe that it has not defaulted in respect of payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

A company which announces its bonus issue after the approval of the Board of directors must implement the proposal within a period of six months from the date of such approval and shall not have the option of changing the decision.

(i) The articles of association of the company shall contain a provision for capitalisation of reserves; etc.

(ii) If there is no such provision in the articles the company shall pass a resolution at its general body meeting making provisions in the articles of association for capitalisation.

Consequent to the issue of bonus shares, if the subscribed and paid up capital exceed the authorised share capital a resolution shall be passed by the company at its general body meeting for increasing the authorised capital.

2. JOURNAL ENTRIES

(1) Upon the sanction of an issue of bonus shares —

(a) Debit Profit & Loss Account (or reserve)

(b) Credit Bonus to Shareholders Account.

(2) Upon issue of share —

(a) Debit Bonus to Shareholders Account

(b) Credit Share Capital Account.

If partly paid shares are to be made fully paid by way of bonus, entry No. (2) will be split into two entries :

(a) Debit Call Account and Credit Share Capital Account, and

(b) Debit Bonus to Shareholders Account and Credit Call Account.

Illustration

Following is the extract of the Balance Sheet of Solid Ltd. as at 31st March, 2008:

		Rs.
Authorised capital :		
10,000	12% Preference shares of Rs. 10 each	1,00,000
1,00,000	Equity shares of Rs. 10 each	10,00,000
		11,00,000

Issued and Subscribed capital:	
8,000 12% Preference shares of Rs. 10 each fully paid	80,000
90,000 Equity shares of Rs. 10 each, Rs. 8 paid up	7,20,000
Reserves and Surplus :	
General reserve	1,20,000
Capital reserve	75,000
Securities premium	25,000
Profit and Loss Account	2,00,000
Secured Loan :	
12% Partly Convertible Debentures @ Rs. 100 each	5,00,000

On 1st April, 2008 the Company has made final call @ Rs. 2 each on 90,000 equity shares. The call money was received by 20th April, 2008. Thereafter the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held. Share premium of Rs. 25,000 includes a premium of Rs. 5,000 for shares issued to vendors pursuant to a scheme of amalgamation. Capital reserves include Rs. 40,000, being profit on sale of plant and machinery. 20% of 12% debentures are convertible into equity shares of Rs. 10 each fully paid on 1st July, 2008.

Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue but before conversion of debentures. Are the convertible debenture holders entitled to bonus shares?

Solution

Solid Ltd.

Journal Entries

2008			*Dr.* *Rs.*	*Cr.* *Rs.*
April 1	Equity Share Final Call A/c	*Dr.*	1,80,000	
	To Equity Share Capital A/c			1,80,000
	(Final call of Rs. 2 per share on 90,000 equity shares due as per Board's Resolution dated....)			
April 20	Bank A/c	Dr.	1,80,000	
	To Equity Share Final Call A/c			1,80,000
	(Final Call money on 90,000 equity shares received)			

	Capital Reserve A/c	Dr.	40,000	
	Securities Premium A/c	Dr.	20,000	
	General Reserve A/c	Dr.	1,20,000	
	Profit and Loss A/c	Dr.	45,000	
	To Bonus to Shareholders A/c			2,25,000
	(Bonus issue @ one share for every four shares held by utilising various reserves as per Board's Resolution dated...)			
April 20	Bonus to Shareholders A/c	Dr.	2,25,000	
	To Equity Share Capital A/c			2,25,000
	(Capitalisation of profit)			

Balance Sheet (Extract) as on 30th April, 2008 (after bonus issue)

		Rs.
Authorised Capital :		
10,000	12% Preference shares of Rs. 10 each	1,00,000
1,25,000	Equity shares of Rs. 10 each	12,50,000
Issued and Subscribed Capital :		
8,000	12% Preference shares of Rs. 10 each, fully paid	80,000
1,12,500	Equity shares of Rs. 10 each, fully paid	11,25,000
	(Out of above, 22,500 equity shares @ Rs. 10 each were issued by way of bonus)	
Reserves and Surplus :		
	Capital Reserve	35,000
	Securities premium	5,000
	Profit and Loss Account	1,55,000
Secured Loan :		
	12% Convertible Debentures @ Rs. 100 each	5,00,000

Notes

1. Capital reserve realised in cash can be utilised for issue of fully paid bonus shares.
2. As per SEBI guidelines, securities premium collected in cash can only be utilised for bonus issue.
3. It is assumed that the company will pass necessary resolution at its general body meeting for increasing the authorised capital. In anticipation, the authorised capital has been suitably increased as below :

Existing number of equity shares as authorised	1,00,000*
Add : Issue of bonus shares to equity shareholders	22,500
Add : Number of bonus shares to be issued to debenture holders after conversion	2,500
	1,25,000

*This figure covers the number of shares required for conversion of debentures.

4. As per para (*ii*) of SEBI guidelines, no company can issue bonus shares to its shareholders without extending similar benefit to convertible debenture holders. Pending such conversion, necessary number of shares should be earmarked for convertible debenture holders. Therefore, convertible debenture holders are also entitled to the bonus shares in the same ratio as the equity shareholders.

Self-Examination Questions

I. Objective type questions

1. The bonus issue shall be made out of the following except
   (a) Free reserves.
   (b) Securities premium collected in cash.
   (c) Reserves created by revaluation of fixed assets.
2. Upon the sanction of an issue of bonus shares, ________account is credited.
   (a) Share capital account.
   (b) Reserves.
   (c) Bonus to shareholders account.
3. A company which announces its bonus issue after the approval of the board of directors must implement the proposal within a period of ____________from the date of such approval.
   (a) One year.
   (b) Six months.
   (c) Three months..
4. Which of the following statements is **true** with regard to declaring and issuing of Bonus Shares?
   (a) Assets are transferred from the company to the share holders.
   (b) A Bonus issue results in decrease in retained earnings.
   (c) Share holders' equity is reduced.
   (d) A Bonus issue is same as declaration of dividends.

[**Answer: 1.** (c), **2.** (c) , **3.** (b) , **4.** (b)]

II. Short answer type questions

5. What is meant by "bonus shares"? Explain in brief.

6. How will you account for issue of bonus shares? Describe.

III. Long answer type questions

7. Discuss SEBI provisions regarding issue of bonus shares.

IV. Practical problems

8. R Ltd. has accumulated large profits in the Reserve Account and the directors decide to capitalize part of the reserves by converting partly paid shares into fully paid up shares and issuing Bonus shares.

   The paid up share capital of the company is Rs.10,00,000 consisting of 90,000 Class A Equity shares of Rs.10 each fully paid and 20,000 Class B Equity shares (face value Rs.10 each) Rs.5 per share paid up. The directors decide to issue two bonus shares at par of Rs.10 for every fully paid share held and to make the partly paid shares fully paid in respect of Class B Equity shares. At the date of the allotment of bonus shares the market value of the Class B Equity Share stands at Rs.33.

   Compute the amount of reserves to be capitalized.

9. The Balance Sheet of A Ltd. as at 31-3-2008 is as follows:

Liabilities	*Amount*	*Assets*	*Amount*
Authorised share capital:		Sundry Assets	17,00,000
1,50,000 equity shares of Rs.10 each	15,00,000		
Issued, subscribed and paid up capital:			
80,000 equity shares Rs.7.50 called up and paid up	6,00,000		
Capital Redemption Reserve	1,50,000		
Plant Revaluation Reserve	20,000		
Securities Premium	1,50,000		
Development Rebate Reserve	2,30,000		
Investment Allowance Reserve	2,50,000		
General Reserve	3,00,000		
	17,00,000		17,00,000

The company wanted to issue bonus shares to its shareholders on one-for-two basis. Necessary resolutions were passed and requisite legal requirements were complied with.

You are required to give effect to the proposal by passing journal entries in the books of A Ltd. Also show the Balance sheet after issue of bonus shares.

CHAPTER 5

INTERNAL RECONSTRUCTION

Learning Objectives

After studying this unit, you will be able to

- Understand the meaning of term “reconstruction”.
- Sub-divide and consolidate shares.
- Convert shares into stock and stock into shares.
- Account the adjustments made at the time of internal reconstruction.

1. MEANING OF RECONSTRUCTION

Reconstruction is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered by reducing the paid up value of shares and/or varying the rights attached to different classes of shares. The object of reconstruction is usually to reorganize capital or to compound with creditors or to effect economies. Such a process is called internal reconstruction which is carried out without liquidating the company and forming a new one. However, there may be external reconstruction. Wherever an undertaking is being carried on by a company and is in substance transferred, not to an outsider, but to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company, there is external reconstruction. Such external reconstruction is essentially covered under the category ‘amalgamation in the nature of merger’ in AS-14.

2. ALTRERATION OF SHARE CAPITAL

Sub-division and Consolidation of Shares: If authorised by its Articles, a company may, in a general meeting, decide to sub-divide or consolidate the shares into those of a smaller or higher denomination than that fixed by the Memorandum of Association, so long as the proportion between the paid up and unpaid amount, if any, on the shares continues to be the same as it was in the case of the original shares.

For example, a company with a capital of Rs. 10,00,000 divided into 10,000 equity shares of Rs. 100 each on which Rs. 75 is paid up decides to recognise its capital by splitting one equity share of Rs. 100 each into 10 such shares of Rs. 10 each. The consequential entry to be passed in such a case would be—

		Dr. Rs.	Cr. Rs.
Equity Share Capital (Rs. 100) A/c	Dr.	7,50,000	
To Equity Share Capital (Rs. 10) A/c			7,50,000
(Being the sub-division of 10,000 shares of Rs. 100 each with Rs. 75 paid up thereon into 1,00,000 shares of Rs. 10 each with Rs. 7.50 paid up thereon as per the resolution of shareholders passed in the General Meeting held on...)			

Similar entries will be passed on consolidation of shares of a smaller amount into those of a larger amount as well as on converting fully paid shares into stock.

Illustration 1

On 31-12-2006 B Ltd. had 20,000, Rs. 10 Equity Shares as authorised capital and the shares were all issued on which Rs. 8 was paid up. In June, 2007 the company in general meeting decided to *sub-divide* each share into two shares of Rs. 5 with Rs. 4 paid up. In June, 2008 the company in general meeting resolved to *consolidate* 20 shares of Rs. 5, Rs. 4 per share paid up into one share of Rs. 100 each, Rs. 80 paid up.

Pass entries and show how share capital will appear in the Balance Sheet as on 31-12-2006, 31-12-2007 and 31-12-2008.

Solution

Journal entries

2007			*Rs.*	*Rs.*
June	Equity Share Capital (Rs. 10) A/c	Dr.	1,60,000	
	To Equity Share Capital (Rs. 5) A/c			1,60,000
	(Being the sub-division of 20,000 Rs. 10 shares with Rs. 8 paid up into 40,000 shares Rs. 5 each with Rs. 4 paid up by resolution in general meeting dated....)			
2008				
June	Equity Share Capital (Rs. 5) A/c	Dr.	1,60,000	
	To Equity Share Capital (Rs. 100) A/c			1,60,000
	(Being consolidation of 40,000 shares of Rs. 5 with Rs. 4 paid up into 2,000 Rs. 100 shares with Rs. 80 paid up as per resolution in general meeting dated....)			

Balance Sheet *(includes)*

Liabilities :	Rs.
As on 31-12-2004	
1. Share Capital	
Authorised :	
20,000 Equity Shares of Rs. 10 each	2,00,000
Issued and Subscribed :	
20,000 Equity Shares of Rs. 10 each Rs. 8 per share called up	1,60,000
As on 31-12-2005	
1. Share Capital	
Authorised :	
40,000 Equity Shares of Rs. 5 each	2,00,000
Issued and Subscribed :	
40,000 Equity Shares of Rs. 5 each Rs. 4 per share called up	1,60,000
As on 31-12-2006	*Rs.*
1. Share Capital	
Authorised :	
2,000 Equity Shares of Rs. 100 each	2,00,000
Issued and Subscribed :	
20,000 Equity Shares of Rs. 100 each Rs. 80 per share called up	1,60,000

Note: Some accountants prefer not to make any entry as the amount remains same. Even when an entry is passed it applies only to the called up portion, and not to uncalled or unissued portion of share capital.

3. CONVERSION OF FULLY PAID SHARES INTO STOCK AND STOCK INTO SHARES

Stock is the consolidation of the share capital into one unit divisible into aliquot parts. While it is impossible of the share capital to be one share, any amount of stock may be transferred. In practice, however, companies restrict the transfer of stock to multiples of, say, Rs. 100. A company can convert its fully paid shares into stock [Section 94(c)]. Upon the company converting its shares into stock, the book-keeping entries merely record the transfer from share capital account to stock account. But a separate Stock Register is started in which details of members' holdings are entered and the annual return is modified accordingly.

Illustration 2

C Ltd. had Rs. 5,00,000 authorised capital on 31-12-2006 divided into shares of Rs. 100 each out of which 4,000 shares were issued and fully paid up. In June 2007 the Company decided to *convert* the issued shares into stock. But in June, 2008 the Company *re-converted* the stock into shares of Rs. 10 each fully paid up.

Pass entries and show how Share Capital will appear in Balance Sheet as on 31-12-2006, 31-12-2007 and 31-12-2008.

Solution

Journal Entries

2007			*Rs.*	*Rs.*
June	Equity Share Capital A/c	Dr.	4,00,000	
	To Equity Stock A/c			4,00,000
	(Being conversion of 4,000 fully paid Equity Shares of Rs. 100 into Rs. 4,00,000 Equity Stock as per resolution in general meeting dated...)			
2008				
June	Equity Stock A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Being re-conversion of Rs. 4,00,000 Equity Stock into 40,000 shares of Rs. 10 fully paid Equity Shares as per resolution in General Meeting dated...)			

Balance Sheet (includes)

Liabilities :	
As on 31-12-2006	*Rs.*
1. Share Capital	
Authorised	
5,000 Equity Shares of Rs. 100 each	5,00,000
Issued and Subscribed	
4,000 Equity Shares of Rs. 100 each fully called up	4,00,000
As on 31-12-2007	*Rs.*
1. Share Capital	
Authorised	
5,000 Equity Shares of Rs. 100 each	5,00,000

Issued and Subscribed	
Equity Stock-4,000 Equity Shares of Rs. 100 converted into Stock	4,00,000
As on 31-12-2008	*Rs.*
1. Share Capital	
Authorised	
50,000 Equity Shares of Rs. 10 each	5,00,000
Issued and Subscribed	
40,000 Equity Shares of Rs. 10 each fully called up	4,00,000

4. ENTRIES IN CASE OF INTERNAL RECONSTRUCTION

On a scheme of reconstruction being adopted (through special resolution confirmed by the Court), the entries to be passed are:

1. Debit Share Account and Credit Capital Reduction Account (or Reconstruction Account or Reorganization Account), with the amount of the reduction made. However, if the description of the share capital is changed, say, from 6% Preference Share Capital to 7% Preference Share Capital it would be better to :

Debit the original Share Capital Account so as to close it, credit new Share Capital Account with the amount treated as paid up; and credit Capital Reduction Account with the difference.

2. An appreciation in the value of an asset or reduction in the amount of a liability should be debited to the account concerned and credited to Capital Reduction Account (which should preferably then be termed as Reconstruction Account).

3. Write off all fictitious assets (including Goodwill and Patents) and eliminate all over-valuation of assets by crediting the accounts concerned and debiting the Capital Reduction (or Reconstruction) Account. For this purpose, any reserve appearing in the books of the company may be used. If any balance is left in the Capital Reduction (or Reconstruction) Account it should be transferred to the Capital Reserve Account.

While preparing the balance sheet of a reconstructed company, the following points are to be kept in mind:

(*a*) After the name of the company, the words “and Reduced” should be added *only* if the Court so orders.

(*b*) In case of fixed assets, the amount written off under the scheme of reconstruction must be shown for five years.

Illustration 3

The Balance Sheet of A & Co. Ltd. as on 31-12-2005 is as follows:

Assets	*Rs.*	*Rs.*
Fixed Assets:		
Freehold property	4,25,000	
Plant	50,000	
Patent	37,500	
Goodwill	1,30,000	6,42,500
Traded Investments (at cost)		55,000
Current Assets:		
Debtors	4,85,000	
Stock	4,25,000	
Deferred Advertising	1,00,000	10,10,000
Profit and Loss Account		4,35,000
Total		21,42,500
Liabilities		
Share Capital:		
4,000 6% Cumulative Preference Shares of Rs. 100 each	4,00,000	
75,000 Equity Shares of Rs. 10 each	7,50,000	11,50,000
6% Debentures (Secured on Freehold Property)	3,75,000	
Accrued Interest	22,500	3,97,500
Current Liabilities:		
Bank Overdraft	1,95,000	
Creditors	3,00,000	
Directors' Loans	1,00,000	5,95,000
Total		21,42,500

The Court approved a Scheme of re-organisation to take effect on 1-1-2006, whereby:

(*i*) The Preference Share to be written down to Rs. 75 each and Equity Shares to Rs. 2 each.

(*ii*) Of the Preference Share dividends which are in arrears for four years, three fourths to be waived and Equity Shares of Rs. 2 each to be allotted for the remaining quarter.

(*iii*) Accrued interest on debentures to be paid in cash.

(*iv*) Debenture-holders agreed to take over freehold property, book value Rs. 1,00,000 at a valuation of Rs. 1,20,000 in part repayment of their holdings and to provide additional cash of Rs. 1,30,000 secured by a floating charge on company's assets at an interest rate of 8% p.a.

(*v*) Patents, Goodwill and Deferred Advertising to be written off.

(*vi*) Stock to be written off by Rs. 65,000.

(*vii*) Amount of Rs. 68,500 to be provided for bad debts.

(*viii*) Remaining freehold property to be re-valued at Rs. 3,87,500.

(*ix*) Trade Investments be sold for Rs. 1,40,000.

(*x*) Directors to accept settlement of their loans as to 90% thereof by allotment of equity shares of Rs. 2 each and as to 5% in cash, and balance 5% being waived.

(*xi*) There were capital commitments totalling Rs. 2,50,000. These contracts are to be cancelled on payment of 5% of the contract price as a penalty.

(*xii*) Ignore taxation and cost of the scheme.

You are requested to show Journal entries reflecting the above transactions (including cash transactions) and prepare the Balance Sheet of the company after completion of the Scheme.

Solution :

Journal of A & Co. Ltd.

			Dr.	Cr.
			Rs.	Rs.
2005				
Dec. 31	Equity Share Capital A/c (Rs. 10)	Dr.	7,50,000	
	To Capital Reduction A/c			6,00,000
	To Equity Share Capital A/c (Rs. 2)			1,50,000
	(Reduction of equity shares of Rs. 10 each to shares of Rs. 2 each as per Reconstruction Scheme dated...)			
	6% Cum. Preference Share CapitalA/c (Rs. 100)	Dr.	4,00,000	
	To Capital Reduction A/c			1,00,000
	To Pref. Share Capital A/c (Rs. 75)			3,00,000
	(Reduction of preference shares of Rs. 100 each to shares of Rs. 75 each as per reconstruction scheme)			

2005				
Dec. 31	Freehold Property A/c	Dr.	82,500	
	To Capital Reduction A/c			82,500
	(Appreciation in the value of property: Book value — Revalued Figure Rs. 1,00,000 — Rs. 1,20,000 Rs. 3,25,000 — Rs. 3,87,500 Total Rs. 4,25,000 — Rs. 5,07,500 Profit on revaluation: Rs. 82,500)			
”	6% Debentures A/c	Dr.	1,20,000	
	To Freehold Property A/c			1,20,000
	(Claims of debenture-holders, in part, in respect of principal discharged by transfer of freehold property vide Scheme of Reconstruction)			
	Accrued Interest A/c	Dr.	22,500	
	To Bank A/c			22,500
	(Debenture interest paid)			
”	Bank A/c	Dr.	1,30,000	
	To 8% Debentures A/c			1,30,000
	(8% Debentures issued for cash)			
”	Bank A/c	Dr.	1,40,000	
	To Trade Investment A/c			55,000
	To Capital Reduction A/c			85,000
	(Sale of Trade Investment for Rs. 1,40,000 cost being Rs. 55,000; profit credited to Capital Reduction Account)			

”	Directors’ Loan A/c	Dr.	1,00,000	
	To Equity Share Capital A/c			90,000
	To Bank A/c			5,000
	To Capital Reduction A/c			5,000
	(Directors’ loan discharged by issue of equity shares of Rs. 90,000, cash payments of Rs. 5,000 and surrender of Rs. 5,000, vide Scheme of Reconstruction)			
Dec. 31	Capital Reduction Account	Dr.	24,000	
	To Equity Share Capital Account			24,000
	(Arrears of preference dividends satisfied by the issue of equity shares, 25% of the amount due, Rs. 96,000)			
”	Capital Reduction A/c	Dr.	8,48,500	
	To Patents			37,500
	To Goodwill			1,30,000
	To Deferred Advertising			1,00,000
	To Stock			65,000
	To Provision for Doubtful Debts			68,500
	To Bank			12,500
	To Profit & Loss Account			4,35,000
	(Writing off patents, goodwill, deferred advertising, profit and loss account and reducing the value of stock, making the required provision for doubtful debts and payment for cancellation of capital commitments)			

Balance Sheet of A & Co. Ltd. (And Reduced) as on 1st January, 2006

Liabilities	*Rs.*	*Assets*	*Rs*	*Rs.*
Share Capital		*Fixed Assets*		
1,32,000 Equity shares of		Goodwill	1,30,000	
Rs. 2 each	2,64,000	*Less:* Amount written		
(Of the above 45,000 shares		off under the Scheme		
have been issued for consi-		of reconstruction	1,30,000	—
deration other than cash)		Freehold Property	4,25,000	
4,000 6% Preference shares of		*Add:* Appreciation under		
Rs. 75 each	3,00,000	The Scheme of	82,500	
Reserve and Surplus		Reconstruction		
Secured Loans		*Less:* Disposed of	1,20,000	3,87,500
6% Debentures	2,55,000			
8% Debentures	1,30,000	Plant		50,000
Unsecured Loans	—	Patents	37,500	
Current Liabilities and	—	*Less:* written off		
Provisions		under the Scheme		
Sundry Creditors	3,00,000	of Reconstruction	37,500	—
		Current Assets,		
		Loans and Advances		
		A. Current Assets		
		Stock in trade		3,60,000
		Sundry Debtors	4,85,000	
		Less: Provision		
		for Doubtful Debt	68,500	4,16,500
		Cash at Bank		35,000
	12,49,000			12,49,000

Self-Examination Questions

I. Objective Type Questions

1. Choose the correct answer from the given options

   (i) When the object of reconstruction is usually to re-organise capital or to compound with creditors or to effect economies then such type of reconstruction is called

   (a) Internal reconstruction with liquidation

   (b) Internal reconstruction without liquidation of the company

   (c) External reconstruction

   (ii) Reconstruction includes all of the following except

   (a) Subdivision of shares.

   (b) Consolidation of shares.

   (c) Buy-back of shares.

[**Answer:** (i)-(b), (ii)-(c)],

II. Short Answer Type Questions

2. Differentiate between ``Internal Reconstruction'' and `External Reconstruction' of a company in brief.

III. Long Answer Type Questions

3. Explain the process of reconstruction of a company with the help of an example.

IV. Practical Questions

4. The paid-up capital of Toy Ltd. amounted to Rs. 2,50,000 consisting of 25,000 equity shares of Rs. 10 each.

   Due to losses incurred by the company continuously, the directors of the company prepared a scheme for reconstruction which was duly approved by the court. The terms of reconstruction were as under:

   (i) In lieu of their present holdings, the shareholders are to receive:

   (a) Fully paid equity shares equal to 2/5th of their holding.

(b) 5% preference shares fully paid-up to the extent of 20% of the above new equity shares.

(c) 3,000 6% second debentures of Rs. 10 each.

(ii) An issue of 2,500 5% first debentures of Rs. 10 each was made and fully subscribed in cash.

(iii) The assets were reduced as follows:

(a) Goodwill from Rs. 1,50,000 to Rs. 75,000.

(b) Machinery from Rs. 50,000 to Rs. 37,500.

(c) Leasehold premises from Rs. 75,000 to Rs. 62,500.

Show the journal entries to give effect to the above scheme of reconstruction.

CHAPTER 6

AMALGAMATION

Learning Objectives

After studying this chapter, you will be able to

- Understand the term amalgamation and the methods of accounting for amalgamations.
- Appreciate the concept of transferee Company and the transferor company.
- Calculate purchase consideration under both the methods of amalgamation as per AS 14.
- Pass the entries to close the books of the vendor company.
- Pass the journal entries in the books of purchasing company to incorporate the assets and liabilities of the vendor company and also giving effect to other adjustments.

1. MEANING OF AMALGAMATION

In an amalgamation, two or more companies are combined into one by merger or by one taking over the other. Therefore, the term 'amalgamation' contemplates two kinds of activities (*i*) two or more companies join to form a new company or (*ii*) absorption and blending of one by the other. Thus, amalgamations include absorption. In the case of amalgamation the assets and liabilities of transferor company(s) are amalgamated and the transferee company becomes vested with all such assets and liabilities.

Wherever an undertaking is being carried on by a company and is in substance transferred, not to an outsider, but to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company, there is external reconstruction. Such external reconstruction is essentially covered under the category 'amalgamation in the nature of merger' in AS-14.

2. TYPES OF AMALGAMATION

The Companies Act, 1956 has not specifically defined the term 'amalgamation'. However, from several legal decisions, the definition of amalgamation may be inferred. The Institute of Chartered Accountants of India has introduced Accounting Standard -14 (AS 14) on 'Accounting for Amalgamations'. The standard recognizes two types of amalgamation - (*a*) amalgamation in the nature of merger and (*b*) amalgamation in the nature of purchase.

Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions:

(*i*) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(*ii*) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(*iii*) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(*iv*) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(*v*) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

If any one or more of the above conditions are not satisfied in an amalgamation, such amalgamation is called *amalgamation in the nature of purchase.*

3. PURCHASE CONSIDERATION

For the purpose of accounting for amalgamations, we are essentially guided by AS-14 ‘Accounting for Amalgamations’. Para 3(*g*) of AS-14 defines the term purchase consideration as the “aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company”. Therefore purchase consideration does not include the sum which the transferee company will directly pay to the creditors of the transferor company. The purchase consideration essentially depends upon the fair value of its elements. For example, when the consideration includes securities, the value fixed by the statutory authority may be taken as the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up or in the absence of market value, book value of the assets are considered.

Sometimes adjustments may have to be made in the purchase consideration in the light of one or more future events. When the additional payment is probable and can be reasonably estimated it is to be included in the calculation of purchase consideration.

Example : Let us consider the Balance Sheet of X Ltd. as on 31st March, 2008:

Liabilities	*Rs.('000)*	*Assets*	*(Rs.'000)*
Share Capital :		Land & Buildings	50,00
Equity Shares of Rs. 10 each	75,00	Plant & Machinery	45,00
14% Preference Shares of		Furniture	10,50
Rs. 100 each	25,00	Investments	5,00
General Reserve	12,50	Stock	23,00
12% Debentures	40,00	Debtors	24,00
Sundry Creditors and other		Cash & Bank balance	15,00
Current liabilities	20,00		
	172,50		172,50

Other Information:

(*i*) Y Ltd. takes over X Ltd. on 10th April, 2008.

(*ii*) Debentureholders of X Ltd. are discharged by Y Ltd. at 10% premium by issuing 15% own debentures of Y Ltd.

(*iii*) 14% Preference Shareholders of X Ltd. are discharged at a premium of 20% by issuing necessary number of 15% Preference Shares of Y Ltd. (Face value Rs. 100 each).

(*iv*) Intrinsic value per share of X Ltd. is Rs. 20 and that of Y Ltd. Rs. 30. Y Ltd. will issue equity shares to satisfy the equity shareholders of X Ltd. on the basis of intrinsic value. However, the entry should be made at par value only. The nominal value of each equity share of Y Ltd. is Rs. 10.

Compute the purchase consideration.

Solution:

Computation of Purchase consideration	**(Rs. in '000)**	**Form**
For Preference Shareholders of X Ltd.	30,00	30,000 15% preference Share in Y Ltd.
For equity shareholders of Y Ltd.	50,00	5,00,000 equity
(2/3 × 7,50,000) × Rs. 10		shares of Y Ltd.
of Rs. 10 each		
Total Purchase consideration	80,00	

Note : Consideration for debenture holders should not be included above. Such debentures will be taken over by Y Ltd. and then discharged.

4. METHODS OF ACCOUNTING FOR AMALGAMATIONS

There are two main methods of accounting for amalgamation:

(*a*) The pooling of interests method, and

(*b*) The purchase method.

The first method is used in case of amalgamation in the nature of merger and the second method is used in case of amalgamation in the nature of purchase. Under pooling of interests method, the assets, liabilities and reserves of the transferor company will be taken over by transferee company at existing carrying amounts unless any adjustment is required due to different accounting policies followed by these companies. As a result the difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of transferor company should be adjusted in reserves.

Under purchase method, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. But no reserves, other than statutory reserves, of the transferor company should be incorporated in the financial statements of transferee company. Statutory reserves of the transferor company should be incorporated in the balance sheet of transferee company by way of the following journal entry.

Amalgamation Adjustment A/c Dr.

To Statutory Reserves

When the above statutory reserves will no longer be required to be maintained by transferee company, such reserves will be eliminated by reversing the above entry.

In purchase method any excess of the amount of purchase consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised as goodwill in the financial statement of the transferee company. Any short fall should be shown as capital reserve. Goodwill should be amortised over period of five years unless a somewhat longer period can be justified.

Example: Consider the following balance sheets of X Ltd. and Y Ltd.

Balance Sheet as on 31st March, 2008

Liabilities	*X Ltd.*	*Y Ltd.*	*Assets*	*X Ltd.*	*Y Ltd.*
	Rs.'000	*Rs.'000*		*Rs.'000*	*Rs.'000*
Equity Share Capital	50,00	30,00	Land & Building	25,00	15,50
(Rs. 10 each)			Plant & Machinery	32,50	17,00

14% Preference Share	22,00	17,00	Furniture & Fittings	5,75	3,50
Capital (Rs. 100 each)			Investments	7,00	5,00
General Reserve	5,00	2,50	Stock	12,50	9,50
Export Profit Reserve	3,00	2,00	Debtors	9,00	10,30
Investment Allowance Reserve		1,00	Cash & Bank	7,25	5,20
Profit & Loss A/c	7,50	5,00			
13% Debentures (Rs. 100 each)	5,00	3,50			
Trade Creditors	4,50	3,50			
Other Current Liabilities	2,00	1,50			
	99,00	66,00		99,00	66,00

X Ltd. takes over Y Ltd. on 1st April, 2008. X Ltd. discharges the purchase consideration as below:

(*i*) Issued 3,50,000 equity shares of Rs. 10 each at par to the equity shareholders of Y Ltd.

(*ii*) Issued 15% preference shares of Rs. 100 each to discharge the preference shareholders of Y Ltd. at 10% premium.

The debentures of Y Ltd. will be converted into equivalent number of debentures of X Ltd. The statutory reserves of Y Ltd. are to be maintained for 2 more years.

Show the balance sheet of X Ltd. after amalgamation on the assumption that:

(*a*) the amalgamation is in the nature of merger.

(*b*) the amalgamation is in the nature of purchase.

Solution:

(*a*) Amalgamation in the nature of merger:

Balance Sheet of X Ltd.

Liabilities	*Rs.'000*	*Assets*	*Rs.'000*
Equity Share Capital (Rs. 100 each)	85,00	Land & Buildings	40,50
15% Preference Share Capital		Plant & Machinery	49,50
(Rs. 100)	18,70	Furniture & Fittings	9,25
14% Preference Share Capital	22,00	Investments	12,00
(Rs. 100)		Stock	22,00
General Reserve	80*	Debtors	19,30
Export Profit Reserve	5,00	Cash & Bank	12,45

Investment Allowance Reserve	1,00		
Profit & Loss A/c	12,50		
13% Debentures (Rs. 100 each)	8,50		
Trade Creditors	8,00		
Other current liabilities	3,50		
	165,00		165,00

The difference between the amount recorded as share capital issued and the amount of share capital of transferor company should be adjusted in reserves. Thus,

General Reserve = Rs. '000 [7,50 – (53,70 – 47,00)] = Rs. ('000) 80

(b) Amalgamation in the nature of purchase :

Balance Sheet of X Ltd.

Liabilities	*Rs.' 000*	*Assets*	*Rs.' 000*
Equity share Capital (Rs. 10)	85,00	Land & Buildings	40,50
15% Preference Share Capital	18,70	Plant & Machinery	49,50
(Rs. 100)		Furniture & Fittings	9,25
14% Preference Share Capital		Investments	12,00
(Rs. 100)	22,00	Stock	22,00
General Reserve	5,00	Debtors	19,30
Capital Reserve (working)	3,80	Cash and Bank	12,45
Profit & Loss A/c	7,50	Amalgamation Adjustment A/c	3,00
Export Profit Reserve	5,00		
Investment Allowance Reserve	1,00		
13% Debentures (Rs. 100 each)	8,50		
Trade Creditors	8,00		
Other Current Liabilities	3,50		
	168,00		168,00

Workings: Capital Reserve arising on Amalgamation:

		Rs. ('000)	Rs. ('000)
(A)	Net Assets taken over :		
	Sundry Assets		66,00
	Less : 13% Debentures	3,50	
	Trade Creditors	3,50	
	Other current liabilities	1,50	
			8,50
			57,50

(B)	Purchase consideration :	
	To Equity Shareholders of Y Ltd.	35,00
	To Preference Shareholders of Y Ltd.	18,70
		53,70
(C)	Capital Reserve (A – B)	3,80

Illustration 1

S. Ltd. is absorbed by P. Ltd. The balance sheet of S. Ltd. is as under :

Balance Sheet

	Rs.		Rs.
Share Capital :			
2,000 7% Preference shares of Rs. 100 each (fully paid-up)	2,00,000	Sundry Assets	13,00,000
5,000 Equity shares of Rs. 100 each (fully paid-up)	5,00,000		
Reserves	3,00,000		
6% Debentures	2,00,000		
Trade creditors	1,00,000		
	13,00,000		13,00,000

P. Ltd. has agreed :

(*i*) to issue 9% Preference shares of Rs. 100 each, in the ratio of 3 shares of P. Ltd. for 4 preference shares in S. Ltd.

(*ii*) to issue to the debenture-holders in S. Ltd. 8% Mortgage Debentures[*] at Rs. 96 in lieu of 6% Debentures in S. Ltd. which are to be redeemed at a premium of 20%;

(*iii*) to pay Rs. 20 per share in cash and to issue six equity shares of Rs. 100 each (market value Rs. 125) in lieu of every five shares held in S. Ltd.; and

(*iv*) to assume the liability to trade creditors.

[*] According to AS-14, 'consideration' for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the **shareholders** of the transferor company. Therefore, debentures issued to the debenture holders will not be included in purchase consideration. Like trade creditors, the liability in respect of debentures of S. Ltd. will be taken by P Ltd., which will then be settled by issuing new 8% debentures.

Solution :

The purchase consideration will be

		Rs.	Form
Preference shareholders :	2,000 × 3/4 × 100	1,50,000	9% Pref. Shares
Equity shareholders :	5,000 × 20	1,00,000	Cash
	5,000 × 6/5 × 125	7,50,000	Equity Shares
		10,00,000	

Supposing the total number of fractions arising on exchange aggregate to 20 shares (equivalent to equity shares in P. Ltd.) each will have to be paid for them @ Rs. 125 per share; the remaining amount will be settled by the issue of equity shares. Alternatively, fraction certificates are issued; these are converted into shares on presentation - the holder of the fraction certificates must buy more such certificates or sell those held by him.

Illustration 2

Y Ltd. decides to absorb X Ltd. The Balance Sheet of X Ltd. is as follows :

	Rs.		*Rs.*
3,000 Equity shares of		Sundry Net Assets	2,90,000
Rs. 100 each (fully paid)	3,00,000	Profit and Loss Account	70,000
Preference shares	60,000		
	3,60,000		3,60,000

Y Ltd. agrees to take over the net assets of X Ltd. An equity share in X Ltd., for purposes of absorption, is valued @ Rs. 70. Y Ltd. agrees to pay Rs. 60,000 in cash for payment to preference shareholders and the balance in the form of its equity shares valued at Rs. 120 each.

Solution :

Value of 3,000 shares @ Rs. 70 = Rs. 2,10,000

The purchase consideration will be :

Net Assets = Rs. 2,10,000 + Liability towards preference shareholders

= Rs. 2,10,000 + Rs. 60,000 = Rs. 2,70,000

Rs. 60,000 out of the above will be in cash and Rs. 2,10,000 in the form of shares in X Ltd., issued at Rs. 120 per share; the number of shares that will be issued : 2,10,000/120 = 1,750.

Illustration 3

Suppose in Illustration 2, Y Ltd. already holds in X Ltd. 1000 equity shares. The purchase consideration will be :

Amount required to pay to outside shareholders :

	Rs.
2,000 shares @ Rs. 70 (in the form of shares)	1,40,000
Amount required to be paid in cash	60,000
	2,00,000

The total number of shares to be issued = $\frac{1,40,000}{120} = 1,166\frac{2}{3}$; 1166 shares will be issued; cash will be paid for 2/3 share i.e. Rs. 80.

Note : At the time of passing entries for the purchase of business, the account representing the investment must be credited to make it nil.

5. JOURNAL ENTRIES TO CLOSE THE BOOKS OF VENDOR COMPANY

The journal entries will be illustrated with the following case.

Wye Ltd. acquires the business of Z Ltd. whose balance sheet on 31st December, 2008 is as under :

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital divided into		Goodwill	2,00,000
shares of Rs. 100 each		Land & Buildings	4,00,000
6% Preference share capital	4,00,000	Plant and Machinery	6,00,000
Equity share capital	8,00,000	Patents	50,000
Capital Reserve	1,00,000	Stock	1,50,000
Profit & Loss A/c	50,000	Books Debts	1,80,000
6% Debentures	2,00,000	Cash at Bank	70,000
Interest outstanding on above	12,000	Underwriting Commission	40,000
Workmen's Compensation Reserve			
(Expected liability Rs. 5,000)	8,000		
Trade Creditors	1,20,000		
	16,90,000		16,90,000

Wye Ltd. was to take over all assets (except cash) and liabilities (except for interest due on debentures) and to pay following amounts :

(*i*) Rs. 2,00,000 7% Debentures (Rs. 100 each) in Wye Ltd. for the existing debentures in Zed Ltd.; for the purpose, each debenture of Wye Ltd. is to be treated as worth Rs. 105.

(*ii*) For each preference share in Zed Ltd. Rs. 10 in cash and one 9% preference share of Rs. 100 each in Wye Ltd.

(*iii*) For each equity share in Zed Ltd. Rs. 20 in cash and one equity share in Wye Ltd. of Rs. 100 each having the market value of Rs. 140.

(*iv*) Expense of liquidation of Zed Ltd. are to be reimbursed by Wye Ltd. to the extent of Rs. 10,000. Actual expenses amounted to Rs. 12,500.

Wye Ltd. valued Land and building at Rs. 5,50,000 Plant and Machinery at Rs. 6,50,000 and patents at Rs. 20,000.

Purchase Consideration :

			Rs.	Form
(*i*)	Preference Shares :Rs. 10 per share	40,000		Cash
	Preference shares	4,00,000	4,40,000	Preference shares
(*ii*)	Equity shares :Rs. 20 per share	1,60,000		Cash
	8,000 equity shares in			
	Wye Ltd. @ Rs. 140	11,20,000	12,80,000	Equity shares
			17,20,000	

Steps to close the Books of the Vendor Company

1. Open Realisation Account and transfer all assets at book value.

Exception : If cash is not taken over by the purchasing company, it should not be transferred.

Note : Profit and Loss Account (Dr.) and expenses not written off are not assets and should not be transferred to the Realisation Account.

The journal entry in the above case is :

		Rs.	Rs.
Realisation A/c	Dr.	15,80,000	
To Sundries —			
Goodwill			2,00,000
Land & Building			4,00,000
Plant & Machinery			6,00,000
Patents			50,000
Stock			1,50,000
Book debts			1,80,000
(Transfer of assets to Realisation Account on sale of business to Wye Ltd.)			

2. Transfer to the Realisation Account the liabilities which the purchasing company is to take over. In case of the provisions, the portion which represents liability expected to arise in future should be so transferred and the portion which is not required (*i.e.,* the reserve portion) should be treated as profit. Accordingly, the following entry will be recorded :

		Rs.	Rs.
6% Debentures in Wye Ltd.	Dr.	2,00,000	
Workmen's Compensation Reserve	Dr.	5,000	
Trade Creditors	Dr.	1,20,000	
To Realisation A/c			3,25,000
(Transfer of liabilities taken over by Wye Ltd. to Realisation A/c)			

3. Debit purchasing company and credit Realisation Account with the purchase consideration.

Wye Ltd.-	Dr.		17,20,000
To Realisation A/c			17,20,000
(Amount receivable from Wye Ltd. for sale of business)			

4. On receipt of the purchase consideration debit what is received (cash, debentures, shares etc.) and credit the purchasing company. Thus —

Cash	Dr.	2,00,000	
9% Preference shares in Wye Ltd.	Dr.	4,00,000	
Equity shares in Wye Ltd.	Dr.	11,20,000	
To Wye Ltd.			17,20,000
(Receipt of purchase consideration from the purchase company)			

5. Expenses of liquidation have to be dealt with according to the circumstances of each case. If the vendor company has to bear them, Realisation Account should be debited and Cash Account credited.

If the expenses are to be borne by the purchasing company, the question may be dealt within one of the two ways mentioned below :

(*i*) It may be ignored in the books of the vendor company.

(*ii*) If the expenses are to be paid first by the vendor company and afterwards reimbursed by the purchasing company, the following two entries will be passed :

(*a*) Debit Purchasing company and credit Cash Account when expenses are paid by the vendor company; and

(*b*) Debit Cash Account and credit purchasing company (on the expenses being reimbursed).

In the above mentioned case Wye Ltd. has to pay maximum of Rs. 10,000 only whereas, the amount spent is Rs. 12,500. Hence Rs. 2,500 is to be borne by Zed Ltd.; the entries required will be :

		Rs.	Rs.
Wye Ltd.	Dr.	10,000	
Realisation A/c	Dr.	2,500	
To Cash A/c			12,500
(Liquidation expenses out of which Rs. 10,000 is payable by Wye Ltd.)			
Cash A/c	Dr.	10,000	
To Wye Ltd.			10,000
(Account reimbursed by Wye Ltd. for expense)			

6. Liabilities not assumed by the purchasing company, have to be paid off. On payment, debit the liability concerned and credit cash. Any difference between the amount actually paid and the book figure must be transferred to the Realisation Account. Zed Ltd. shall pass the following entries in this respect :

		Rs.	Rs.
Interest Outstanding	Dr.	12,000	
To Debentureholders A/c			12,000
(Amount due to debenture holders for debentures interest)			
Debentureholders	Dr.	12,000	
To Cash A/c			12,000
(Debentureholders paid cash Rs. 12,000 for outstanding interest)			

7. Credit the preference shareholders with the amount payable to them, debiting Preference Share Capital with the amount shown in the books, transferring the difference between the two, if any, to the Realisation Account. Thus —

6% Pref. Share Capital A/c	Dr.	4,00,000	
Realisation A/c	Dr.	40,000	
To Preference Shareholders A/c			4,40,000
(The amount due to preference shareholders for capital and the extra amount payable under the scheme of absorption)			

Note : In the absence of any indication to the contrary, preference shareholders will be entitled only to the capital contributed by them. But if funds available after paying off creditors are not sufficient to satisfy the claim of preference shareholders fully, they will have to suffer a loss to the extent of the deficit.

8. Pay off preference shareholders by debiting them and crediting whatever is given to them. The entry in the above case is :

		Rs.	*Rs.*
Preference shareholders A/c	Dr.	4,40,000	
To Cash A/c			40,000
To 9% Preference shares in Wye Ltd.			4,00,000
(Cash and preference shares in Wye Ltd. given to preference shareholders)			

9. Transfer equity share capital and account representing profit or loss (including the balance in Realisation Account) to Equity Shareholders Account. This will determine the amount receivable by the equity shareholders. Zed Ltd. shall pass the following entries in this regard :

		Rs.	*Rs.*
Equity Share Capital A/c	Dr.	8,00,000	
Capital Reserve A/c	Dr.	1,00,000	
Profit and Loss A/c	Dr.	50,000	
Workmen's Compensation Reserve A/c	Dr.	3,000	
Realisation A/c	Dr.	4,22,500[*]	
To Sundry Equity Shareholders A/c			13,75,500
(Various accounts representing capital and profit transferred to Equity Shareholders Account)			
Equity Shareholders A/c	Dr.	40,000	
To Underwriting Commission A/c			40,000
(Underwriting Commission A/c closed by transfer to Equity Shareholders A/c)			

[*] The Realisation Account will appear as follows :

Realsation Account

	Rs.		Rs.
To Sundry Assets	15,80,000	By Sundry Liabilities	3,25,000
To Cash (excess expenses of liquidation)	2,500	By Wye Ltd.	17,20,000
To Preference Shareholders	40,000		
To Equity Shareholders A/c - profit transferred	4,22,500		
	20,45,000		20,45,000

10. On satisfaction of the claims of the equity shareholders, debit their account and credit whatever is given to them. Hence:

Equity Shareholders A/c	Dr.	13,35,500	
To Equity Shares in Wye Ltd.			11,20,000
To Cash A/c[**]			2,15,500

6. ENTRIES IN THE BOOKS OF PURCHASING COMPANY

1. Debit Business Purchase Account and Credit Liquidator of the vendor company with the account of the purchase consideration. Thus -

		Rs.	Rs.
Business Purchase A/c	Dr.	17,20,000	
To Liquidator of Zed Ltd.			17,20,000
(Amount payable to Zed Ltd. as per agreement dated....)			

2. (*i*) Debit assets acquired (except goodwill) at the value placed on them by the purchasing company;

   (*ii*) Credit liabilities taken over at agreed values and credit Business Purchase Account with the amount of purchase consideration; and

   (*iii*) Credit the account showing shares held in the company, if any, with the cost of such shares.

   (*iv*) If the creditors as per (*ii*) and (*iii*) above exceed debits as per (*i*) above, the difference should be debited to Goodwill Account, in the reverse case, the difference should be credited to Capital Reserve.

Note : The amount of Goodwill or Capital Reserve that shall be included will be the amount as has been arrived at only in foregoing manner.

In the above case the entry to be passed shall be:

		Rs.	*Rs.*
Sundries	Dr.		
Land and Building A/c		5,50,000	
Plant and Machinery A/c		6,50,000	
Patents A/c		20,000	
Stock A/c		1,50,000	
Sundry Debtors		1,80,000	

[**] The students should prepare Cash Account to ascertain the cash balance.

Goodwill		5,05,000	
To Sundries			
Provision for Workmen's Compensation A/c			5,000
Trade Creditors			1,20,000
Debentures in Z Ltd.			2,10,000
Business Purchases Account			17,20,000
(Various assets and liabilities taken over from Zed Ltd. Goodwill ascertained as a balancing figure)			

3. On the payment to the vendor company the balance at its credit, the entry to be made by Wye Ltd. shall be:

		Rs.	*Rs.*
Liquidator of Zed Ltd.	Dr.	17,20,000	
To Cash			2,00,000
To 9% Preference Share Capital A/c			4,00,000
To Equity Share Capital A/c			8,00,000
To Securities Premium A/c			3,20,000
(Payment of cash and issue of shares in satisfaction of purchase consideration)			

4. Debentures in Z Ltd. A/c	Dr.	2,10,000	
To 7% Debentures A/c			2,00,000
To Premium on Debentures A/c			10,000

5. If the purchasing company is required to pay the expenses of liquidation of the vendor company, the amount should be debited to the Goodwill or Capital Reserve Account, as the case may be. In the instant case, the entry shall be:

Goodwill Account	Dr.	10,000	
To Cash Account			10,000
(Amount paid towards liquidation expenses on Zed Ltd.)			

Entries at par value - The students will note that purchasing company is left with a large debit in the Goodwill Account (Step No. 2) accompanied by quite a large amount in the Securities Premium Account (Step No. 3). The two cannot be adjusted. However, it would be permissible to negotiate on the basis to the market value of the shares but to make entries only on the basis of par of shares of purchasing company. This will mean that Goodwill Account (or Capital Reserve) will be automatically adjusted for the share premium.

Inter Company-owing - Should the purchasing company owe an amount to the vendor company or *vice versa,* the amount will be included in the book debts of one company and creditors of the other. This should be adjusted by the entry:

Sundry Creditors Dr.

To Sundry Debtors

The entry should be made after the usual acquisition entries have been passed. At the time of preparing the Realisation Account and passing the business purchase entries, no attention need be paid to the fact that the two companies involved owed money mutually.

Adjustment of the value of stock - Inter-company owings arise usually from purchase and sale of goods; it is likely, therefore, that at the time, of the sale of business, the debtor company also has goods in stock which it purchased from the creditor company - the cost of the debtor company will include the profit made by the creditor company. After the takeover of the business it is essential that such a profit is eliminated. The entry for this will be made by the purchasing company. If it is the vendor company which has such goods in stock, at the time of passing the acquisition entries, the value of the stock should be reduced to its cost to the company which is acquiring the business; automatically goodwill or capital reserve, as the case may be, will be adjusted. But if the original sale was made by the vendor company and the stock is with the company acquiring the business, the latter company will have to debit Goodwill (or Capital Reserve) and credit stock with the amount of the profit included in the stock.

Illustration 4

The following Balance Sheets are given as on 31st March, 2008:

	(Rs. in lakhs)			*(Rs. in lakhs)*	
	Best	Better		Best	Better
	Ltd.	Ltd.		Ltd.	Ltd.
	Rs.	Rs.		Rs.	Rs.
Share Capital:			Fixed Assets	25	15
Shares of Rs. 100, each			Investments	5	–
fully paid	20	10	Current Assets	20	5
Reserve and Surplus	10	8			
Other Liabilities	20	2			
	50	20		50	20

The following further information is given —

(*a*) Investments of Best Ltd. include Rs. 3 lakhs representing shares in Better Ltd. having a face value of Rs. 2 lakhs.

(*b*) Better Limited issued shares on 1st April, 2008, in the ratio of one share for every two held, out of Reserves and Surplus.

(*c*) It was agreed that Best Ltd. will take over the business of Better Ltd., on the basis of the latter's Balance Sheet, the consideration taking the form of allotment of shares in Best Ltd.

(*d*) The value of shares in Best Ltd. was considered to be Rs. 150 and the shares in Better Ltd. were valued at Rs. 100 after the issue of the bonus shares. The allotment of shares is to be made on the basis of these values.

(*e*) Liabilities of better Ltd., included Rs. 1 lakh due to Best Ltd., for purchases from it, on which Best Ltd., made profit of 25% of the cost. The goods of Rs. 50,000 out of the said purchases, remained in stock on the date of the above Balance Sheet.

Make the closing ledger in the Books of Better Ltd. and the opening journal entries in the Books of Best Ltd., and prepare the Balance Sheet as at 1st April, 2008 after the takeover.

Solution :

LEDGER OF BETTER LIMITED

Fixed Assets Account

	Rs.		*Rs.*
To Balance b/d	15,00,000	By Realisation A/c (transfer)	15,00,000

Current Assets Account

	Rs.		*Rs.*
To Balance b/d	5,00,000	By Realisation A/c (transfer)	5,00,000

Liabilities Account

	Rs.		*Rs.*
To Realisation A/c	2,00,000	By Balance b/d	2,00,000

Realisation Account

To Fixed Assets A/c	15,00,000	By Liabilities A/c	2,00,000
" Current Assets A/c	5,00,000	" Best Limited	15,00,000

		(Purchase Consideration)	
		” Shareholders’ A/c	3,00,000
		(Loss on Realisation)	
	20,00,000		20,00,000

Share Capital Account

To Sundry shareholders		By Balance b/d	10,00,000
A/c - (transfer)	15,00,000	” Reserves & Surplus A/c	
		(Bonus issue)	5,00,000
	15,00,000		15,00,000

Reserves & Surplus A/c

To Share Capital (Bonus issue)	5,00,000	By Balance b/d	8,00,000
” Sundry Shareholders	3,00,000		
	8,00,000		8,00,000

Best Ltd.

To Realisation A/c - Purchase		By Sundry Shareholders (1/5	
Consideration	15,00,000	of Purchase Consideration)	3,00,000
		” Shares in Best Ltd.	12,00,000
	15,00,000		15,00,000

Shares in Best Ltd.

To Best Ltd.	12,00,000	By Sundry Shareholders A/c	12,00,000

Sundry Shareholders A/c

To Realisation A/c	3,00,000	By Share Capital A/c	15,00,000
(Loss)		” Reserves & Surplus A/c	3,00,000
” Best Ltd.	3,00,000		
” Share in Best Ltd.	12,00,000		
	18,00,000		18,00,000

JOURNAL OF BEST LTD.

			Dr.	*Cr.*
2008			*Rs.*	*Rs.*
Apr. 1	Fixed Assets A/c	Dr.	15,00,000	
	Current Assets A/c	Dr.	5,00,000	
	To Liabilities A/c			2,00,000
	To Liquidator of Better Ltd.			12,00,000
	To Capital Reserve A/c			3,00,000
	To Shares in Better Ltd.			3,00,000
	(Assets & Liabilities of Better Ltd. taken over for an agreed purchase consideration of Rs. 12,00,000 and cancellation of investments, held in Better Ltd., at Rs. 3,00,000 as per agreement dated....)			
	Liquidator of Better Ltd.	Dr.	12,00,000	
	To Share Capital A/c			8,00,000
	To Securities Premium A/c			4,00,000
	(Discharge of Purchase consideration by the issue of equity shares of Rs. 8,00,000 at a premium of Rs. 50 per share as per agreement)			
	Sundry Creditors A/c	Dr.	1,00,000	
	To Sundry Debtors A/c			1,00,000
	(Amount due from Better Ltd., and included in its creditors taken over, cancelled against own sundry debtors)			
	Capital Reserve A/c	Dr.	10,000	
	To Current Asset (Stock) A/c			10,000
	(Unrealized profit on stock included in current assets of Better Ltd. written off to Reserve Account)			

Working Note

Calculation of Purchase consideration :

	Rs.
Issued Capital of Better Ltd. (after bonus issue) at Rs. 100 per share	15,00,000
Less : held by Best Ltd.	3,00,000
Held by outsiders, valued at Rs. 100 per share	12,00,000

Purchase consideration has been discharged by Best Ltd. by the issue of shares for Rs. 8,00,000 at a premium of Rs. 4,00,000. This gives the value of Rs. 150 per share.

Balance Sheet of Best Ltd. (After absorption)

	Rs.		*Rs.*	*Rs.*
Share Capital				
Authorised				
... shares of Rs. 100 each				
Issued & Subscribed -		Fixed Assets		
28,000 shares of Rs. 100		Opening Balance	25,00,000	
each fully paid	28,00,000	Acquired during		
Of the above (8,000 shares		the year	15,00,000	40,00,000
have been issued for		Investment		2,00,000
consideration other than cash)		Current Assets		23,90,000
Reserves & Surplus :				
Securities Premium	4,00,000			
Capital Reserves	2,90,000			
Other Reserves and Surplus	10,00,000			
Current Liabilities	21,00,000			
	65,90,000			65,90,000

Illustration 5

K Ltd. and L Ltd. amalgamate to form a new company LK Ltd. The financial position of these two companies on the date of amalgamation was as under:

	K Ltd.	*L Ltd.*		*K Ltd.*	*L Ltd.*
	Rs.	*Rs.*		*Rs.*	*Rs.*
Share Capital			Goodwill	80,000	
Equity Shares			Land & Building	4,50,000	3,00,000
of Rs. 100 each	8,00,000	3,00,000	Plant & Machinery	6,20,000	5,00,000
7% Preference Share			Furniture and		
of Rs. 100 each	4,00,000	3,00,000	Fittings	60,000	20,000
5% Debentures	2,00,000	—	Sundry Debtors	2,75,000	1,75,000
General Reserve	—	1,00,000	Stores & Stock	2,25,000	1,40,000

Profit and Loss			Cash at Bank	1,20,000	55,000
Account	4,31,375	97,175	Cash in hand	41,375	17,175
Sundry Creditors	1,00,000	2,10,000	Preliminary		
Secured Loan	—	2,00,000	Expenses	60,000	
	19,31,375	12,07,175		19,31,375	12,07,175

The terms of amalgamation are as under:

(A) (1) The assumption of liabilities of both the Companies.

(2) Issue of 5 Preference shares of Rs. 20 each in LK Ltd. @ Rs. 18 paid up at premium of Rs. 4 per share for each preference share held in both the Companies.

(3) Issue of 6 Equity shares of Rs. 20 each in LK Ltd. @ Rs. 18 paid up at a premium of Rs. 4 per share for each equity share held in both the Companies. In addition, necessary cash should be paid to the Equity Shareholders of both the Companies as is required to adjust the rights of shareholders of both the Companies in accordance with the intrinsic value of the shares of both the Companies.

(4) Issue of such amount of fully paid 6% debentures in LK Ltd. as is sufficient to discharge the 5% debentures in K Ltd. at a discount of 5% after takeover.

(B) (1) The assets and liabilities are to be taken at book values stock and debtors for which provisions at 2% and 2 ½ % respectively to be raised.

(2) The sundry debtors of K Ltd. include Rs. 20,000 due from L Ltd.

(C) The LK Ltd. is to issue 15,000 new equity shares of Rs. 20 each, Rs. 18 paid up at premium of Rs. 4 per share so as to have sufficient working capital. Prepare ledger accounts in the books of K Ltd. and L Ltd. to close their books.

Solution :

BOOKS OF K LTD.

Realisation Account

		Rs.			*Rs.*
To	Goodwill	80,000	By	5% Debentures	2,00,000
To	Land & Building	4,50,000	By	Sundry creditors	1,00,000
To	Plant & Machinery	6,20,000	By	LK Ltd.	15,60,000
To	Furniture & Fitting	60,000		(Purchase consideration)	
To	Sundry debtors	2,75,000	By	Equity shareholders A/c	51,375
To	Stores & Stock	2,25,000		(loss)	

To	Cash at Bank	1,20,000			
To	Cash in hand	41,375			
To	Preference shareholders (excess payment)	40,000			
		19,11,375			19,11,375

Equity Shareholders A/c

		Rs.			*Rs.*
To	Preliminary Expenses	60,000	By	Share capital	8,00,000
To	Realisation A/c (loss)	51,375	By	Profit & Loss A/c	4,31,375
To	Equity Shares in LK Ltd.	10,56,000			
To	Cash	64,000			
		12,31,375			12,31,375

LK Ltd. A/c

		Rs.				*Rs.*
To	Realisation A/c	15,60,000	By	Equity Shares in LK Ltd.		
				For Equity	10,56,000	
				Pref.	4,40,000	14,96,000
			By	Cash		64,000
		15,60,000				15,60,000

BOOKS OF L LTD.

Realisation Account

		Rs.			*Rs.*
To	Land & Building	3,00,000	By	Sundry creditors	2,10,000
To	Plant & Machinery	5,00,000	By	Secured loan	2,00,000
To	Furnitures & Fittings	20,000	By	LK Ltd. (Purchase consideration)	7,90,000
To	Sundry debtors	1,75,000	By	Equity shareholders A/c— Loss	37,175
To	Stock of stores	1,40,000			
To	Cash at bank	55,000			
To	Cash in hand	17,175			
To	Pref. shareholders	30,000			
		12,37,175			12,37,175

Equity Shareholders Account

		Rs.			Rs.
To	Equity shares in LK Ltd.	3,96,000	By	Share Capital	3,00,000
To	Realisation	37,175	By	Profit & Loss A/c	97,175
To	Cash	64,000	By	Reserve	1,00,000
		4,97,175			4,97,175

LK Ltd. Account

		Rs.				Rs.
To	Realisation A/c	7,90,000	By	Equity shares in LK Ltd.		
				For Equity	3,96,000	
				Preference	3,30,000	7,26,000
			By	Cash		64,000
		7,90,000				7,90,000

Working Notes:

(i) Purchase consideration

	K Ltd. Rs.	L Ltd. Rs.
Payable to preference shareholders:		
Preference shares at Rs. 22 per share	4,40,000	3,30,000
Equity Shares at Rs. 22 per share	10,56,000	3,96,000
Cash [See W.N. (*ii*)]	64,000	64,000
	15,60,000	7,90,000

(ii) Value of Net Assets

	K Ltd. Rs.	L Ltd. Rs.
Goodwill	80,000	
Land & Building	4,50,000	3,00,000
Plant & Machinery	6,20,000	5,00,000
Furniture & Fittings	60,000	20,000
Debtors less 2.5%	2,68,125	1,70,625

Stock less 2%		2,20,500		1,37,200
Cash at Bank		1,20,000		55,000
Cash in hand		41,375		17,175
		18,60,000		12,00,000
Less : Debentures	2,00,000		–	
Creditors	1,00,000		2,10,000	
Secured Loans	–	3,00,000	2,00,000	4,10,000
		15,60,000		7,90,000
Payable in shares		14,96,000		7,26,000
Payable in cash		64,000		64,000

Self-Examination Questions

I. Objective Type Questions

Choose the correct answer from the given options

1. At the time of amalgamation, purchase consideration does not include

   (a) The sum which the transferee company will directly pay to the creditors of the transferor company

   (b) Payments made in the form of assets by the transferee company to the shareholders of the transferor company

   (c) Preference shares issued by the transferee company to the preference shareholders of the transferor company

2. As per AS 14, purchase consideration is the amount agreed payable to

   (a) Shareholders

   (b) Shareholders, debenture holders and creditors

   (c) Shareholders and debenture holders

[**Answer**: **1.** (a), **2.** (a)]

II. Short Answer Type Questions

3. Write short notes on the following:

   (a) Amalgamation and Absorption of companies—a comparison

   (b) Pooling of interests method of amalgamation

III. Long Answer Type Questions

4. What are the conditions, which, according to AS 14 on Accounting for Amalgamations, must be satisfied for an amalgamation in the nature of merger?

5. Distinguish between (i) the pooling of interests method and (ii) the purchase method of recording transactions relating to amalgamation.

IV. Practical Questions

6. (*a*) The Balance Sheet of Exe Ltd. as at 30th June, 2008 was as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital (shares ofGoodwill	80,000		
Rs. 100 each fully paid)	4,00,000	Land and Buildings	1,10,000
General Reserve	80,000	Plant and Machinery	2,50,000
Profit & Loss A/c	38,000	Stock	90,000
Workmen's Compensation Reserve		Book Debts	50,000
(expected Liability Rs. 8,000)	15,000	Underwriting Commission	10,000
Fire Insurance Fund	60,000	Prepaid Expenses	5,000
Creditors	70,000	Cash at Bank	1,18,000
Provision for Taxation	50,000		
	7,13,000		7,13,000

The Company is taken over by Wye Ltd. Determine the purchase consideration in each of the following cases :

(*i*) All assets, except cash, are taken over at the values stated in the balance sheet; and liabilities, except that for taxation, are assumed ;

(*ii*) Each shareholder is paid at Rs. 20 in cash and is issued shares of Rs. 100 each, valued at Rs. 120 for every five shares held; all assets and liabilities taken over;

(*iii*) Each share in Exe Ltd. is valued at Rs. 150, the purchase consideration is to be discharged in the form of shares in Wye Ltd. valued at Rs. 200 (entries being made at par value of Rs. 100).

Also show profit or loss on realisation in each case for Exe. Ltd. Assume that the liability for taxation in each case is Rs. 55,000 and expenses of liquidation amount to Rs. 15,000.

(*i*) Rs. 5,07,000 : loss on Realisation, Rs. 15,000.

(*ii*) Rs. 6,56,000 : Profit on Realisation, Rs. 61,000.

(*iii*) Rs. 3,00,000 : Loss on Realisation, Rs. 2,95,000 (real profit being Rs. 5,000 since real value of shares received is Rs. 6,00,000)

(*b*) What will be the value placed on goodwill by Wye Ltd. in each of the above cases assuming Land & Building to be valued at Rs. 1,50,000 and Plant Machinery at Rs. 2,30,000? (*i*) Rs. 60,000 (*ii*) Capital Reserve Rs. 2,20,000.

7. (*a*) Reckless Ltd. is reconstructed into Careful Ltd. which takes over all assets and liabilities of Reckless Ltd. The Balance Sheet of that company is as under on 31st December 2007 :

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital (fully paid		Patent Rights	1,20,000
shares of Rs. 100 each)	10,00,000	Plant & Machinery	5,00,000
5% Debentures	2,00,000	Stock	1,20,000
Creditors	3,00,000	Debtors	60,000
		Cash at Bank	5,000
		Profit & Loss A/c	6,85,000
Discount on issue of			
Debentures	10,000		
	15,00,000		15,00,000

Careful Ltd. is to issue one share of Rs. 20 each as fully paid for each share held in Reckless Ltd. and Debentureholder's in Reckless Ltd. are to receive 6% Debentures of the face value of Rs. 1,15,000. Careful Ltd. will issue to the shareholders additional 20,000 shares of Rs. 20 each. These shares are fully subscribed and out of the sum received Rs. 1,00,000 is paid to the creditors. Patent Rights are valueless and Careful Ltd. is to adjust the value of Plant and Machinery as required.

Give the Balance Sheet Careful Ltd. after all the above arrangements have been put through.

(b) Make entries assuming the above arrangements have been approved by the Court with the formation of a new company.

CHAPTER 7

UNIT 1 : AVERAGE DUE DATE

Learning Objectives

After studying this unit, you will be able to:

- Understand what is average due date and how to choose 0 (zero) day for calculating average due date.
- Learn calculation of average due date where amount is lent in various instalments.
- Calculate average due date for determining interest on drawings.
- Familiarize with the steps involved in calculation of average due date where amount is lent in one instalment but repayment is done in various instalments. Also understand days of grace and learn the technique of maturity date by counting the days of grace.
- Learn the technique of calculating due date when maturity is on a holiday.

1.1 INTRODUCTION

In business enterprises, a large number of receipts and payments by and from a single party may occur at different points of time. To simplify the calculation of interest involved for such transactions, the idea of average due date has been developed. In this Unit we shall elaborate the underlying principle of determining average due date covering the cases where the amount is lent in various instalments but repayment is made in a single instalment as well as where the amount is lent in one instalment but repayment is made by various instalments. The technique of average due date is also useful for calculating interest on drawings made by the proprietors or partners of a business firm at several points of time.

1.2 TYPES OF PROBLEMS

There are two types of problems:

(1) Calculation of equated date when amount is lent in various instalments and repayment is made in one instalment.

(2) Calculation of equated date when amount is lent in one instalment and repayment is made in various instalments.

1.2.1 Case 1. Where amount is lent in various instalments :

Calculation of average due date: Under this type of problem, average due date is calculated as follows :

a. Take the earliest due date as starting day or "O" day for convenience. Any date whatsoever, may also be taken as "O" day.

b. Consider the number of days upto each due date. Calculations may also be made in month.

c. Multiply the number of days by the corresponding amounts.

d. Add up the amount and products.

e. Divide the "Product total" and get result approximately upto a whole number. This number is the number of days from starting point upto the average due date.

f. Count the above number of days from considering the number of days in each month involved.

Thus the formula for the average due date can be under.

$$\text{Average due date} = \text{Base date} \pm \frac{\text{Total of products}}{\text{Total amounts}}$$

Illustration 1

The followings are the amounts due on different dates in between the same parties:

Amount *Rs.*	*Due Date*
500	3rd July
800	2nd August
1,000	11 September

Suggest a date on which all the bills may be paid out without any loss of interest to either party.

Solution

Considering 3rd July as the starting day the following table is prepared:

Due Dates	*Amount*	*No. of Days from 3rd July*	*Products*
3rd July	500	0	0
2nd August	800	30	24,000
11th September	1,000	70	70,000
	2,300		94,000

$$\text{Average Due Date} = \text{3rd July} + \frac{94{,}000}{2{,}300}$$

= 3rd July + 41 days = 13th August

Assuming 5% is interest rate, the debtor loses interest due to early payment of Rs. 1,000 for 29 days (from 13th August to 11th September) i.e., Rs. 4. He however, gains interest, due to late payment on Rs. 500 for 41 days from 3rd July to 13th August and on Rs. 800 for 11 days i.e. Rs. 2.80 + Rs. 1.20, i.e., Rs. 4. Thus the debtor neither loses nor gains by payment of all the amounts on 13th August.

It should be noted that in calculating the number of days only one of the dates, either the starting date or the due date is to be counted. In the same fashion bill due to one party may be cancelled as against bills of same amount due from the same party after adjustment of interest for the period elapsing between the two average due dates. Instead of payment of several bills on the same date as above, other bill starting from the average due date for agreed period together with interest for the period may be accepted.

Illustration 2

Two traders X and Y buy goods from one another, each allowing the other one month's credit. At the end of 3 months the accounts rendered are as follows :

	Goods sold by X to Y		*Goods sold by Y to X*
	Rs.		*Rs.*
April 18	60.00	April 23	52.00
May 15	70.00	May 24	50.00
June 16	80.00		

Calculate the date upon which the balance should be paid so that no interest is due either to X or Y.

Solution

Taking May 18th as the zero or base date :

For Y's payments :

Date of Transactions	*Due Date*	*Amount*	*No. of days from the base date*	*Products*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
April 18	May 18	60	0	0

May 15	June 15	70	28	1,960
June 16	July 16	80	59	4,720
Amount Due to X		210	Sum of products	6,680

For X's payments

The students should note that the same base date should be taken. Therefore, the base date will be May 18 in this case also.

Date of Transactions	*Due Date*	*Amount*	*No. of days from the base date*	*Products*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
April 23	May 23	52	5	260
May 24	June 24	50	37	1,850
Amount Due to Y		102	Total products	2,110

Excess of Y's products over X's = 6,680 – 2,110

= 4,570

Excess amount due to X Rs. 210 – 102 = Rs. 108.

Number of days from the base date to the date of settlement is

$$\frac{4,570}{108} = 42 \text{ days}$$

Hence the date of settlement of the balance is 42 days after May 18 i.e., on June 29. On June 29, Y has to pay X Rs. 108 to clear the account.

1.2.2 Calculation of interest on drawings: When different amounts are due on different dates, but they are ultimately settled on one day the interest may be calculated by means of Average Due Date. When interest is chargeable on drawings, and drawings are on different dates, interest may be calculated on the basis of Average Due Date of drawings determined on the above basis.

Illustration 3

A and B, two partners of a firm, have drawn the following amounts from the firm in the year ending 31st March, 20......

Date	*A*	*Date*	*B*
	Rs.		*Rs.*
1.7	500	12.6	1,000
30.9	800	11.8	500
1.11	1,000	9.2	400
28.2	400	7.3	900

Interest at 6% p.a. is charged on all drawings. Calculate interest chargeable (assume February of 28 days)

Solution

(1) Ordinary System :

A:	500 for 9 months	=	4,500 for 1 month
	800 for 6 months	=	4,800 for 1 month
	1,000 for 5 months	=	5,000 for 1 month
	400 for 1 month	=	400 for 1 month
			14,700 for 1 month
	14,700 @ 6% for 1 month	=	1/2% of 14,700
		=	Rs. 73.50
B:	1,000 for 292 days	=	2,92,000
	500 for 232 days	=	1,16,000
	400 for 50 days	=	20,000
	900 for 24 days	=	21,600
			4,49,600

$$4,49,600 \times \frac{6}{100} \times \frac{1}{365} = \quad \text{Rs. } 73.91$$

(2) Average Due Date System:

(a) Taking 1.7 as O - day:

Dates	*Rs.*	*Months from O-day*	*Products*
1.7	500	0	0

	30.9	800	3	2,400
A :	1.11	1,000	4	4,000
	28.2	400	8	3,200
		2,700		9,600

A.D.D. = $\frac{9{,}600}{2{,}700}$ months from 1.7 . . . i.e., 3.556 months i.e. October 17th.

Interest is chargeable from October 17 to March 31 i.e. 5.444 months

$2{,}700 \times \frac{6}{100} \times \frac{5.444}{12}$ = Rs. 73.49

Or,

Taking 1st April as O-day:

	Dates	*Rs.*	*Months from O-day*	*Products*
A :	1.7	500	3	1,500
	30.9	800	6	4,800
	1.11	1,000	7	7,000
	28.2	400	11	4,400
		2,700		17,700

A.D.D. = $\frac{17{,}700}{2{,}700}$ months from 1.4 . . . i.e. 6.556 months i.e. 17th October.

Interest is chargeable from October 17 to March 31 i.e. 5.444 months.

$2{,}700 \times \frac{6}{100} \times \frac{5.444}{12}$ = Rs. 73.49

(b) Taking 12th June as Zero-day :

	Dates	*Rs.*	*Months from O-day*	*Products*
B :	12.6	1,000	0	0
	11.8	500	60	30,000
	9.2	400	242	96,800
	7.3	900	268	2,41,200
		2,800		3,68,000

A.D.D. = $\frac{3,68,000}{2,800}$ days from 12.6 . . . i.e. 131 days.

June 18
July 31
Aug. 31
Sept. 30
110

131 days -110 days i.e. 21st October

So, interest is chargeable from 21.10 . . . to 31.3 . . . i.e. for 161 days.

$2,800 \times \frac{6}{100} \times \frac{161}{365}$ = Rs. 74.10

The Differences in amounts in the two systems (1) and (2) are due to approximation.

Illustration 4

The following amounts are due to X by Y. Y wants to pay off (a) on 18.3 ... or (b) on 14.7 ... Interest rate of 8% p.a. is taken into consideration.

Due Dates	*Rs.*
10.1	500
26.1 (Republic Day)	1,000
23.3	3,000
18.8 (Sunday)	4,000

Determine the amount to be paid in (a) and in (b).

Solution

Due Date (Normal)	*Due Date (Actual)*	*No. of days from 10.1 . . . taking as 0-Day*	*Amount Rs.*	*Product*
10.1	10.1	0	500	0
26.1	25.1	15	1,000	15,000
23.3	23.3	72	3,000	2,16,000
18.8	17.8	219	4,000	8,76,000
			8,500	11,07,000

A.D.D. = 10th Jan. + $\frac{11{,}07{,}000}{8{,}500}$ = 10th Jan + 130 days = 20th May

January	21
February	28
March	31
April	30
	110

(a) If the payment is made on 18.3 ... rebate will be allowed for unexpired time from 18.3 ... to 20.5 ... i.e., 13 + 30 + 20 i.e. for 63 days. He has to pay the discounted value of the total amount.

Discount = 8,500 x $\frac{8}{100}$ x $\frac{63}{365}$ = 680x $\frac{63}{365}$ = Rs. 117.37

Amount to be paid on 18.3 ... Rs. 8,500 – 117.37 = 8,382.63

(b) If the payment is deferred to 14.7, interest is to be paid from 20.5 ... to 14.7 ... i.e., for 11 + 30 + 14 = 55 days.

Interest = 8,500 x $\frac{8}{100}$ x $\frac{55}{365}$ = 680 x $\frac{55}{365}$ = Rs. 102.47

The amount to be paid on 14.7.

Rs. 8,500 + 102.47 = 8,602.47

1.2.3. Case 2 Where amount is lent in one Instalment: Calculation of average due date in a case where the amount is lent in one instalment and repayment is done in various instalments (opposite to what we have done in the first case). The problem takes a different shape. The procedure for calculating average due date can be summarised as under:

Step 1: Calculate number of days/monthly/years from the date of lending money to the date of each repayment.

Step 2: Find the total of such days/months/years.

Step 3: Quotient will be the number of days/months/years by which average due date falls away from date of commencement of loan.

Thus, the formula for the average due date can be written as under:

$$\text{Average due date} = \text{Date of Loan} + \frac{\text{Sum of days/months/Years from the date of lending to the date of repayment of each instalment}}{\text{Number of instalments}}$$

Illustration 5

Rs. 10,000 lent by Dass Bros. to Kumar & Sons on 1st January, 2006 is repayable in 5 equal annual instalments commencing on 1st January, 2007. Find the average due date and calculate interest at 5% per annum, which Dass Bros. will recover from Kumar & Sons.

Solution

$$\text{Average due date} = \text{Date of Loan} + \frac{\text{Sum of the number of years/ months/days from the date of lending to the date of repayment of each instalment}}{\text{Number of instalments}}$$

$$= \text{Jan. 1, 2006} + \frac{1+2+3+4+5}{5}$$

= Jan. 1, 2006+ 3 years

= 1st Jan., 2009

Interest at a certain rate on the instalments paid from the date of payment to any fixed date will be the same as on Rs. 10,000 (if lent on 1st Jan., 2009 to that fixed date). There will be no loss to either party. Supposing rate of interest is 5% p.a. and date of settlement is 31st Dec., 2007 then calculation of interest by product method from both parties' point of view will be as follows:

Dass Bros. pays interest as follows:

Amount	*Paid on*	*Money used by Dass Bros upto 31st Dec. 2011*	*Product*
Rs.			*Rs.*
2,000	1st Jan. 2007	5 Years	10,000
2,000	1st Jan. 2008	4 Years	8,000
2,000	1st Jan. 2009	3 Years	6,000

2,000	1st Jan. 2010	2 Years	4,000
2,000	1st Jan. 2011	1 Year	2,000
			30,000

Interest at 5% p.a. on Rs. 30,000 for one year.

$$= \frac{\text{Rs.}30{,}000 \times 5}{100} = \text{Rs. } 1{,}500$$

Dass Bros. will receive interest (if given on 1st Jan., 2009 on Rs. 10,000 from average due date to 31st Dec., 2011, i.e., for 3 years at 5% p.a.

$$= \frac{5 \times 3 \times \text{Rs.}10{,}000}{100} = \text{Rs. } 1{,}500$$

From the above, it can be concluded that if the borrower pays Rs. 2,000 yearly from 1st Jan., 2007 for 5 years and if the lender gives Rs. 10,000 on 1st Jan., 2009 then both will charge same interest from each other. There is no loss to any of the parties. But actually lender gives Rs. 10,000 on 1st Jan., 2006, therefore, he has given loan 3 years in advance and will charge interest on Rs. 10,000 for 3 years.

$$\text{Interest} = \frac{\text{Rs.}10{,}000 \times 5 \times 3}{100} = \text{Rs. } 1{,}500 \text{ (to be charged by Dass Bros.)}$$

1.3 CALCULATION OF DUE DATE AFTER TAKING INTO CONSIDERATION DAYS OF GRACE

A Bill of exchange or promissory note matures on the date on which it falls due. And every promissory note or bill of exchange (other than those payable on demand or at sight or on presentment) falls due on the third day after on which it is expressed to be payable.

Examples

(i) A bill dated 30th September is made payable three months after date. It falls due on 2nd January.

(ii) A note dated 1st January is payable one month after sight. It falls due on 4th February.

1.4 CALCULATING DUE DATE OF BILL OR NOTE PAYABLE FEW MONTHS AFTER DATE OR SIGHT

When the bill is made payable at a stated number of months after date or after sight or after certain events, then the period stated shall be held to terminate on the date of the month which corresponds with the day on which the instrument is dated. If the month in which the period would terminate has no corresponding day, the period shall be held to terminate on the last day of such month.

Example: A Bill due on 29th January, 2007 is made payable at one month after date. The due date of instrument is 3rd day after 28th February, i.e., 3rd March (in 2007, February is of 28 days only).

1.5 CALCULATION OF DUE DATE WHEN THE MATURITY DAY IS A HOLIDAY

When the day on which a promissory note or bill of exchange is at maturity (after including days of grace) is a public holiday, the instrument shall be deemed to be due on the preceding business day. The expression "public holiday" includes Sundays and other days declared by the Central Government by notification in the official gazette, to be a public holiday. But if the holiday happens to be emergency or unforeseen holiday then the date shall be the next following day.

Illustration 6

A trader having accepted the following several bills falling due on different dates, now desires to have these bills cancelled and to accept a new bill for the whole amount payable on the average due date :

Sl. No.	*Date of bill*	*Amount*	*Usance of the bill*
1	1st March 2005	400.00	2 months
2	10th March 2005	300.00	3 months
3	5th April 2005	200.00	2 months
4	20th April 2005	375.00	1 month
5	10th May 2005	500.00	2 months

You are required to find the said average due date.

Solution

Calculation of the average due date

Sl. No.	*Date of bill*	*Due Date of Maturity*	*Amount Rs.*	*No. of days from starting date (4th May)*	*Product*
1	1st March 2005	4th May	400	0	0
2	10th March 2005	13th June	300	40	12,000
3	5th April 2005	8th June	200	35	7,000

4	20th April 2005	23rd May	375	19	7,125
5	10th May 2005	13th July	500	70	35,000
	Total :		1,775		61,125

Average Due Date is 61, 125/1, 775 i.e., 34 days after the assumed due date, 4th May, 2005. The new bill should be for Rs. 1,775 payable on June 7th, 2005.

Illustration 7

A owes B Rs. 890 on 1st January, 2005. From January to March, the following further transactions took place between A and B :

January 16	A buys goods	Rs. 910
February 2	A receives Cash loan	Rs. 750
March 5	A buys goods	Rs. 810

A pays the whole amount on 31st March, 2005 together with interest at 5% per annum. Calculate the interest by the average due date method.

Solution

Due Date	*Amount*	*No. of days from Jan. 1*	*Product*
2005	*Rs.*		
Jan. 1	890	0	0
Jan. 16	910	15	13,650
Feb. 2	750	32	24,000
March 5	810	64	51,840
Total	3,360		89,490

Calculation of average due date

$$\text{Average due date} = \text{Base date} + \text{days equal to } \frac{\text{Sum of Products}}{\text{Sum of the amounts}}$$

$$\text{Jan. 1} + \left[\frac{89{,}490}{3{,}360}\right] \text{i.e., 27 days or Jan. 28}$$

Interest therefore has been calculated on Rs. 3,360 from 28th Jan. to 31st March, i.e., for 63 days.

$$3{,}360 \times \frac{5}{100} \times \frac{63}{365} = \text{Rs. } 29$$

Illustration 8

Radheshyam purchased goods from Hariram the due dates for payment is cash, being as follows:

March 15	Rs. 400 Due 18th April
April 21	Rs. 300 Due 24th May
April 27	Rs. 200 Due 30th June
May 15	Rs. 250 Due 18th July

Hariram agreed to draw a Bill for the total amount due on the average due date. Ascertain that date.

Solution

Due Date	*Amount*	*No. of days*	*Product*
	Rs.	*from 18th April*	
18th April	400	0	
24th May	300	36	10,800
30th June	200	73	14,600
18th July	250	91	22,750
Total :	1,150		48,150

Average Due Date is $\frac{48{,}150}{1{,}150}$ or 42 days after the base date.

18th April, i.e. 30 May.

Illustration 9

Calculate Average Due date from the following information:

Date of the bill	*Term*	*Amount*
		Rs.
August 10, 2007	3 months	6,000
October 23, 2007	60 days	5,000

December 4, 2007	2 months	4,000
January 14, 2008	60 days	2,000
March 08, 2008	2 months	3,000

Solution

Calculation of Average Due Date

Date of bill	*Term*	*Due date*	*No. of days from 10th August 1994*	*Amount Rs.*	*Product Rs.*
August 10, 2007	3 months	Nov. 13, 2007	95	6,000	5,70,000
October 23,2007	60 days	Dec. 25, 2007	137	5,000	6,85,000
December 04, 2007	2 months	Feb. 07, 2008	181	4,000	7,24,000
January 14, 2008	60 days	Mar. 18, 2008	220	2,000	4,40,000
March 08, 2008	2 months	May 11, 2008	274	3,000	8,22,000
				20,000	32,41,000

$$\text{Average due date} = \frac{\text{Total of product}}{\text{Total of amount}}$$

$$= \frac{32{,}41{,}000}{20{,}000} = 162.05 \text{ days}$$

= 162 days (Approx.) after August 10, 2007

i.e. January 19, 2008.

Illustration 10

Mr. Green and Mr. Red had the following mutual dealings and desire to settle their account on the average due date:

Purchases by Green from Red:	Rs.
6th January, 2008	6,000
2nd February, 2008	2,800
31st March, 2008	2,000

Sales by Green to Red:

6th January, 2008	6,600
9th March, 2008	2,400
20th March, 2008	500

You are asked to ascertain the average due date.

Solution

Calculation of Average Due Date

Taking 6th January, 2008 as base date

For Green's payments

Due date	Amount	No. of days from the base date i.e. 6th Jan. 2008	Product
2008	Rs.		
6th January	6,000	0	0
2nd February	2,800	27	75,600
31st March	2,000	84	1,68,000
Total	10,800		2,43,600

For Red's payment

2008			
6th January	6,600	0	0
9th March	2,400	62	1,48,800
20th March	500	73	36,500
Total	9,500		1,85,300

Excess of Green's products over Red's =Rs. 2,43,600-Rs. 1,85,300

=Rs. 58,300

=Rs. 10,800-Rs. 9,500

=Rs. 1,300

Number of days from the base date to the date of settlement is

58,300/1,300=45 days (approx.)

Hence, the date of settlement of the balance amount is 45 days after 6th January i.e. on 20th February.

On 20th February, 2008, Green has to pay Red Rs. 1,300 to settle the account.

Self-Examination Questions

I. Objective type questions

1. Choose the most appropriate answer from the given options:

   (i) If payment is made on the average due date it results in -

   (a) Loss of interest to the creditor.

   (b) Loss of interest to the debtor.

   (c) No loss of interest to either of them.

   (d) None of the above.

   (ii) A mean date is calculated

   (a) In connection with the settlement of contra accounts

   (b) Not for a lump sum payment

   (c) For several payments on different dates.

   (d) For a lump sum payment.

   (iii) If payment is made after average due date, the party entitled to interest is

   (a) Creditor.

   (b) Debtor.

   (c) Bank.

   (d) None of the above.

[**Answer (i)** (c); **(ii)** (c); **(iii)** (a)]

2. State whether the following statements are true or false giving appropriate reasons.

   (a) Average due date is the median average of several due dates for payments.

   (b) If payment is made on the average due date it results in loss of interest to the creditor.

   (c) In the calculation of average due date, only the due date of the first transaction must be taken as the base date.

   (d) If payment is made before average due date the party entitled to interest is the creditor.

[**Answer:** a-False, equated or mean; b-False, No loss of interest to either of the parties; c-False, any transaction; d-False, debtor]

II. Short answer type questions

3. What is meant by 'average due date'?

4. Explain the significance of calculating average due date.

5. How will you calculate average due date when the maturity date of a bill of exchange is holiday?

III. Long answer type questions

6. Explain the procedure of calculating average due date when amount is lent in various instalments but repayment is made in one instalment.

IV. Practical Problems

7. Find out Average Due Date:

Rs. 6,000 due on 5.2.2005 Rs. 5,700 due on 15.7.2005

Rs. 3,200 due on 7.4.2005 Rs. 7,000 due on 18.9.2005

8. A has the following bills due on different dates. They agree to settle up the entire account by a cheque. Decide upon the date of the cheque.

Rs. 3,000 due on 17/7

Rs. 2,000 due 15/8 (Independence Day)

Rs. 7,000 due on 18/9 (Sunday)

Rs. 3,000 due on 3/10.

9. Suderdshan had the following bills receivables and bills payable against Sohan, Calculate the average due date when the payment can be received or made without any loss of interest.

Date	*Amount Rs.*	*Bills receivable Tenure Month*	*Date*	*Bills payable Amount*	*Tenure Months*
01/06/2006	3,000	3	29/05/2006	2,000	2
05/06/2006	2,500	3	03/06/2006	3,000	3
09/06/2006	6,000	1	10/06/2006	6,000	2
12/06/2006	10,000	2	13/06/2006	9,000	2
20/06/2006	15,000	3	27/06/2006	13,000	1

Holidays: 15 August, 2006, 16th August, 2006 and 6 September, 2006.

10. ‘A’ lent Rs. 25,000 to ‘B’ on 1st January, 2007. The amount is repayable in 5 half-yearly installments commencing from 1st January, 2008. Calculate the average due date and interest @ 10% per annum.

11. E owes to F the following amounts:

    Rs. 5,000 due on 10th March, 2008

    Rs. 18,000 due on 2nd April, 2008

    Rs. 60,000 due on 30th April, 2008

    Rs. 2,000 due on 10th June, 2008

    He desires to make the full payment on 30th June, 2008 with interest at 10% per annum from the average due date. Find out the average due date and the amount of interest.

UNIT 2 : ACCOUNT CURRENT

Learning Objectives

After studying this unit, you will be able to:

- Understand the meaning of Account Current.
- Learn the methods of preparing Account Current, namely preparation of Account Current with the help of interest tables, by means of product and by means of balances.
- Grasp the calculation procedure involved in the preparation of Account Current.

2.1 INTRODUCTION

An Account Current is a running statement of transactions between parties for a given period of time and includes interest allowed or charged n various items. It takes the form of an account. It is prepared when frequent transactions regularly take place between two parties. An example is of a manufacturer who sells goods frequently to a merchant on credit and receives payments from him in instalments at different intervals and charges interest on the amount which remains outstanding. A consignee of goods can also prepare an Account Current, if he so likes. An Account Current also is frequently prepared to set out the transactions taking place between a banker and his customer.

An Account Current has two parties - one who renders the account and the other to whom the account is rendered. This is indicated in the heading of an Account Current, which is like the following: “A in Account Current with B”. It implies that A is the customer, and the account is being rendered to him by B.

2.2 PREPARATION OF ACCOUNT CURRENT

There are three ways of preparing an Account Current : (i) With the help of interest tables; (ii) By means of products; and (iii) By means of products of balances.

2.2.1 Preparation of Account Current with the help of Interest Tables : According to this method, all the transactions are arranged in the form of an account. There are two additional columns on both the sides of such an account. (a) One column is meant to indicate the number of days counted from the due date of each transaction to the date of rendering the account. If no specific date is mentioned as the date on which payment is due, the date of the transactions is presumed to be the due date. (b) The other column is meant for writing interest.

With the help of ready made tables, interest due on different amounts at given rates for different periods of time is found out and this is entered against each item separately. The interest column of both the sides are totalled up and the balance is drawn.

Illustration 1

Prepare Account Current for Nath Brothers in respect of the following transactions with Shyam:

2007		*Rs.*	
September 16	Goods sold to Shyam	200	due 1st Oct.
October 1	Cash received from Shyam	90	
October 21	Good purchased from Shyam	500	due 1st Dec.
November 1	Paid to Shyam	330	
December 1	Paid to Shyam	330	
December 5	Goods purchased from Shyam	500	due 1st Jan.
December 10	Goods purchased from Shyam	200	due 1st Jan.
2008			
January 1	Paid to Shyam	600	
January 9	Goods sold to Shyam	20	due 1st Feb.

The account is to be prepared upto 1st February. Calculate interest @ 6% per annum.

Solution

Shyam in Account Current with Nath Brothers

(Interest to 1st February, 2008 @ 6% p.a.)

Dr.											*Cr.*
Date	*Particulars*	*Due Date*	*Amount Rs.*	*Days*	*Interest*	*Date*	*Particulars*	*Due Date*	*Amount Rs.*	*Days*	*Interest*
2007						2007					
Sept.16	To Sales A/c	1st Oct.	200	123	4.04	Oct. 1	By Cash A/c	1st Oct.	90	123	1.82
Nov.1	To Cash A/c	1st Nov.	330	92	5.00	Oct. 21	By Purchase A/c	1st Dec.	500	62	5.10
Dec. 1	To Cash A/c	1st Dec.	330	62	3.36	Dec. 5	By Purchase A/c	1st Jan.	500	31	2.55
						Dec. 10	By Purchase A/c	1st Jan.	200	31	1.02
2008						2008					
Jan. 1	To Cash A/c	1st Jan.	600	31	3.06	Feb. 1	By Balance of Interest				4.97
Jan. 9	To sales A/c	1st Feb.	20			Feb. 1	By Balance c/d		194.97		-
Feb. 1	To Interest		4.97								
			1,484.97		15.46				1,484.97		15.46

Tutorial Notes:

(1) While counting the number of days, the date of due date is ignored and the date upto which the account is prepared, is included.

(2) While counting the number of days, for opening balances, the opening date as well as date upto which the account is prepared, is counted.

Calculation of days:

Transaction 2007		*Due* *Date*	*Oct.*	*Nov.*	*Dec.*	*Jan.*	*Feb.*	*Total*		
	Sept.	16	1st Oct.	30+	30+	31+	31+	1 =	123	Days
	Oct.	1	1st Oct.	30+	30+	31+	31+	1 =	123	"
	Oct.	21	1st Dec.	-	-	30+	31+	1 =	62	"
	Nov.	1	1st Nov.	-	29+	31+	31+	1 =	92	"
	Dec.	1	1st Dec.	-	-	30+	31+	1 =	62	"
	Dec.	5	1st Jan.	-	-	-	30+	1 =	31	"
	Dec.	10	1st Jan.	-	-	-	30+	1 =	31	"
2008										
	Jan.	1	1st Feb.	-	-	-	30+	1 =	31	"
	Jan.	9	1st Feb.	-	-	-	-	- =	0	"

2.2.2. Preparation of Account Current by means of Products: When this method is followed, the way of preparing the Account Current remains the same. It is only the method of calculating interest which is different.

Under the previous method, interest columns are provided on both the sides of the Account Current, and interest in respect of each item is found out from the ready-made interest tables. In this method, interest columns are replaced by "product" columns. Product in this case is the amount multiplied by the number of days for which it has been outstanding. Interest on a certain sum of money for a certain number of days is the same thing as interest on the product for one day. In other words, with a view to reduce the period of each transaction to one day, the amount of each transaction is multiplied by the number of days. This product is entered against each transaction the product column.

The remaining steps are as follows:

(a) Find out the balance of the products on the two sides.

(b) Calculate interest at the given rate on the balance of the products for a single day.

(c) Enter interest on the appropriate side in the amount column. This entry is made on the side other than that on which the balance of products appears.

Taking Illustration 1 Account Current by means of Product is explained below :

Shyam in Account Current with Nath Brothers

(Interest to 1st February, 2008 @ 6% p.a.)

Dr. Cr.

Date	*Particulars*	*Due date*	*Amount*	*Days*	*Interest*	*Date*	*Particulars .*	*Due date*	*Amount*	*Days*	*Interest*
2007			*Rs.*	*Rs.*	*Rs.*	2007			*Rs.*	*Rs.*	*Rs.*
Sept.		1st				Oct.		1st			
16 Nov.	To Sales A/c	Oct. 1st	200	123	24,600	1 Oct.	By Cash A/c	Oct. 1st	90	123	11,070
1 Dec.	To Cash A/c	Nov. 1st	330	92	30,360	21 Dec.	By Purchase A/c	Dec. 1st	500	62	31,000
1	To Cash A/c	Dec.	330	62	20,460	5	By Purchase A/c	Jan.	500	31	15,500
						Dec. 10	By Purchase A/c	1st Jan	200	31	6,200
2008						2008					
Jan. 1	To Cash A/c	1st Jan	600	31	18,600	Feb. 1	By Balance of products				30,250
Jan. 9	To Sales A/c	1st Feb	20			Feb. 1	By Balance c/d		194.97		
Feb. 1	To Interest $\frac{30,250}{365}\times\frac{6}{100}$		4.97								
			1,484.97		94,020				1,484.97		94,020
2008											
Feb	To Balance b/d		194.97								

Illustration 2

From the following particulars prepare the account current to be rendered by Mr. Singh to Mr. Paul as on 31st August, 2008. Interest must be calculated @ 10% p.a.

2008			*Rs.*	*2008*		*Rs.*
June	11	Goods sent to Paul	1,020	July 7	Goods sent to	

“	15	Cash received from Paul	500		Mr. Paul	700
				Aug 8	Cash received from Paul	1,100
“	20	Goods sent to Mr. Paul	650			

Solution

Mr. Paul in Account Current with Mr. Singh
(Interest to 31st August, 2008 @ 10% p.a.)

Dr. *Cr.*

Date	*Particulars*	*Due* Date	*Amount* Rs.	*Days*	*Interest*	*Date*	*Particulars*	*Due* Date	*Amount* Rs.	*Days*	*Interest*
2008						2008					
June 11	To Sales A/c	June 11	1,020	81	82,620	June 15	By Cash A/c	15	500	77	38,500
June 20	To Sales A/c	June 20	650	72	46,800	Aug. 8	By Cash A/c	Aug. 8	1,100	23	25,300
July 7	To Sales A/c	July 7	700	55	38,500	Aug. 31	By Balance of product				1,04,120
Aug. 31	To Interest A/c $\frac{\text{Rs.}1{,}04{,}120}{365}\times\frac{10}{100}$		28.53			Aug. 31	Balance c/d		798.53		
			2,398.53		1,67,920				2,398.53		1,67,920
Sept.	To Balance b/d		798.53								

Red - Ink Interest: In case the due date of a bill falls after the date of closing the account, then no interest is allowed for that. However, interest from the date of closing to such due date is written in “Red-Ink” in the appropriate side of the ‘Account current’. This interest is called Red-Ink interest. This Red Ink interest is treated as negative interest. In actual practice, however the product of such bill [value of bill X (due date-closing date) is written in ordinary ink in the opposite side on which the bill is entered].

Illustration 3

From the following particulars make up an Account Current to be rendered by S. Dasgupta to A. Halder at 31st Dec. reckoning interest at 5% p.a.

2008		*Rs.*
June 30	Balance owing by A. Halder	520

July 17	Goods sold to A. Halder	40
Aug. 1	Cash received from A. Halder	500
Aug. 19	Goods sold to A. Halder	720
Aug. 30	Goods sold to A. Halder	50
Sept. 1	Cash received from A. Halder	400
Sept. 1	A. Halder accepted Dasgupta's Bill at 3 month date for	300
Oct. 22	Goods bought from A. Halder	20
Nov. 12	Goods sold to A. Halder	14
Dec. 14	Cash received from A. Halder	50

Solution

A. Halder in Current Account with Mr. S. Dasgupta

(Interest to 31st December, 2008 @ 5% p.a.)

Dr. Cr.

Date	Particulars	Due Date	Amount Rs.	Days	Interest	Date	Particulars	Due Date	Amount Rs.	Days	Interest
2008						2008					
June						Aug.		Aug.			
30	To Balance b/d		520	185	96,200	1	By Cash A/c	1	500	152	76,000
July		July				Sep.		Sep.			
17	To Sales A/c	17	40	167	6,680	1	By Cash A/c	1	400	121	48,400
Aug.		Aug.				Sep.		Dec.			
19	To Sales A/c	19	720	134	96,480	1	By Bills Receivable A/c (Note : 1)	4	300	27	8,100
Aug.		Aug.				Oct.		Oct.			
30	To Sales A/c	30	50	123	6,150	22	By Purchases A/c	22	20	70	1,400
Nov.		Nov.				Dec.		Dec.			
12	To Sales A/c	12	14	49	686	14	By Cash A/c	14	50	17	850
						Dec.	By Balance of product				71,446
31	To Interest A/c $\frac{71,446\times5\%}{365}$		9.79			Aug. 31	By Balance b/d		83.79		-------
			1,353.79		2,06,196				1,353.79		2,06,196

Note: It is assumed that the bill was honoured on due date. The due date of the bill should be treated as date of payment and days to be calculated from the due date of account.

Workings:

Calculation of Days

Date of Transactions :	*Due date*	*June*	*July*	*Aug.*	*Sept.*	*Oct.*	*Nov.*	*Dec.*	*Total*
Opening Balance		1	+31	+31	+30	+31	+30	+31	= 185
July 17	July 17	–	14	+31	+30	+31	+30	+31	= 167
Aug. 1	Aug. 1	–	–	30	+30	+31	+30	+31	= 152
Aug. 19	Aug. 19	–	–	12	+30	+31	+30	+31	= 134
Aug. 30	Aug. 30	–	–	1	+30	+31	+30	+31	= 123
Sep. 1	Sep. 1	–	–	–	29	+31	+30	+31	= 121
Sep. 1	Dec. 4	–	–	–	–	–	–	27	= 27
Oct. 22	Oct. 22	–	–	–	–	9	+30	+31	= 70
Nov. 12	Nov. 12	–	–	–	–	–	18	+31	= 49
Dec. 14	Dec. 14	–	–	–	–	–	–	17	= 17

Illustration 4

Following transaction took place between X and Y during the month of April, 2008.

		Rs.
April 1	Amount payable by X to Y	10,000
7	Received acceptance of X to Y for 2 months	5,000
10	Bills receivable (accepted by Y) on 7.2.2008 is honoured on this due date	
10	X sold goods to Y (invoice dated 10.5.2008)	15,000
12	X received cheque form Y dated 15.5.2008	7,500
15	Y sold goods to X (invoice dated 15.5.2008)	6,000
20	X returned goods sold by Y on 15.4.2008	1,000
20	Bill accepted by Y is dishonoured on this due date	5,000

You are required to make out an account current by products method to be rendered by X to Y as on 30.4.2008, taking interest into account @ 10% p.a.

Solution

'Y' In Account Current with 'X'
(Interest to 30th April, 2008 @ 10% p.a.)

Dr. *Cr.*

Date	Particulars	Due Date	Amount Rs.	Days	Interest	Date	Particulars	Due Date	Amount Rs.	Days	Interest
2008		2008				2008		2008			
April 7	To Bills Payable	June 10	5,000	-	-	April 1	By Balance b/d		10,000	30	3,00,000
April 10	To Sales A/c	May 10	15,000	-	-	April 12	By Bank A/c (Cheque received dated 15.5.2008)	May 15	7,500	-	-
April 20	To Purchase Returns	May 15	1,000	-	-	April 15	By Purchase A/c (invoice dated 15.5.2008)	May 15	6,000	-	-
April 20	To Bill Receivable A/c	April 20	5,000	10	50,000						
April 30	To Red Ink Product 15 (Rs. 7,500 x 15) as per contra	May 15		30	1,12,500	April	By Red Ink Product as per contra (5,000 x 41)	June 10	-	41	2,05,000
April 30	To Red Ink Product 15 (Rs. 6,000 x 15) as per contra	May 15		30	90,000	April	By Red Ink Product as per contra (15,000 x 10)	May 10	-	10	1,50,000
April 30	To Balance of product				4,17,500	April 30	By Red Ink Product as per contra (1,000 x 15)	May 15	-	-	15,000

		April			
		30	By Interest A/c	114.38	
			4,17,500 10x 365		
		April 30	By Balance c/d	2,385.62	
26,000	6,70,000			26,000	6,70,000

No entry is required for matured bill on 10th April since party is not contracted.

2.2.3. Preparation of Account Current by Means of Product of Balances: This method, also known as periodic balance method, is usually adopted in the case of banks where the balance of account is taken out after every transaction. In this case, the number of days written against each transaction are the days counted from its date or due date to the date of the following transaction. In the case of the last transaction, the number of days is counted to the close of the period.

Each amount is multiplied with the number of days. If the amount represents a debit balance, the product is entered in the Dr. Product column; and if it represents a credit balance, the product is written in the Cr. Product column. The Dr. Product and Cr. Product columns are then totalled up. Interest is calculated on each total at the given rate of interest; and the net interest is ascertained. If net interest is payable to the customer, it will appear as “By Interest A/c”, and if it is due from the customer, it will appear as “To Interest A/c”.

Illustration 5

On 2nd January, 2008 Vinod opened a current account with the Allahabad Bank Limited; and deposited a sum of Rs. 30,000. He further deposited the following amounts :

15th January	Rs.	12,000
12th March	Rs.	8,000
10th May	Rs.	16,000
His withdrawals were as follows :		
15th February	Rs.	26,000
10th April	Rs.	30,000
15th June	Rs.	14,000

Show Vinod’s a/c in the ledger of the Allahabad Bank. Interest is to be calculated at 5% on the debit balance and 2% on credit balance. The account is to be prepared to be prepared as on 30th June, 2008. Calculation may be made correct to the nearest rupee.

Solution

Vinod Current Account with Allahabad Bank Ltd.

Date	*Particular*	*Dr.*	*Cr.*	*Dr. or Cr.*	*Balance*	*Days*	*Dr. Product*	*Cr. Product*
2008								
Jan. 2	By Cash Account	–	30,000	Cr.	30,000	13	–	3,90,000
Jan. 15	By Cash Account	–	12,000	Cr.	42,000	31	–	13,02,000
Feb. 15	To Self	26,000	–	Cr.	16,000	25	–	4,00,000
Mar. 12	By Cash Account	–	8,000	Cr.	24,000	29	–	6,96,000
April 10	To Self	30,000	–	Dr.	6,000	30	1,80,000	-
May 10	By Cash Account	-	16,000	Cr.	10,000	36	-	3,60,000
June 15	To Self	14,000	-	Dr.	4,000	15	60,000	-
June 30	By Interest A/c	-	140	Dr.	3,860		-	-
June 30	By Balance c/d		3,860	-				
		70,000	70,000				2,40,000	31,48,000
July 1	To Balance b/d	3,860						

* Interest is calculated as follows:

On Rs. 31,48,000 @ 2% for 1 day = Rs. 172.49

On Rs. 2,40,000 @ 5% for 1 day = Rs. 32.87

Net Interest = Rs. 139.62

Self-examination questions

I. Objective type questions

Choose the most appropriate answer from the given options:

1. Red ink interest is

(a) Really not interest

(b) Negative interest

(c) Used in connection with average due date .

(d) None of the above.

2. An account current is a statement of mutual transactions

   (a) Between two parties

   (b) In lieu of average due date

   (c) Prepared for a particular accounting period.

   (d) On a particular date.

3. In account current, while counting the number of days, the due date is ignored and date up to which the accounts are prepared, is

   (a) Included

   (b) Excluded

   (c) Ignored

   (d) None of the above

[Answers : 1. (b); **2.** (a); **3.** (a)**]**

II. Short answer type questions

4. What is meant by Account Current?

5. Explain the three methods of preparing Account Current?

III. Long answer type questions

6. Explain all methods of preparing account current. Describe the calculation procedure involved in preparation of account current with the help of an example.

IV. Practical problems

7. From the following information prepare a statement shown by B in Account Current with A. Books of A:

2008	
Jan. 15	sold goods to B Rs. 20,000;
Feb. 1	sold goods to B Rs. 10,000;
Feb. 15	cash received from B Rs. 18,000;
March 1	sold goods to B Rs. 25,000;
March 10	cash received from B Rs. 5,000
March 28	cash received from B Rs. 7,000

Calculate the amount of interest to be payable by one party to the other @ 15% p.a.

8. From the following transactions in the books of Mr. Hariharan, prepare an Account Current to be sent by him to Mr. Muniramappa for the quarter ending 31st March charging and or allowing interest @ 12% p.a.

2008	
Jan. 1	Balance in Muniramappa's Account (credit) Rs. 2,000;
Jan. 12	sold goods to Muniramappa Rs. 25,000;
Jan. 31	sold goods to Muniramappa Rs. 25,000;
Feb. 15	cash received Rs. 35,000;
Feb. 20	cash received 5,000;
March 1	goods returned by Muniramappa Rs. 5,000;
March 20	cash received Rs. 10,000.

Prepare an Account Current by means of product and by means of period of balances. What is the amount of interest?

9. Rishi opened an Account in HDFC Bank, Mumbai, on 1st January, 2008 and deposited Rs.10,000. His other transactions were as follows:-

Deposits-20th January Rs.5,000; 20th March, Rs.6,000; 20th May Rs.7,000.

Withdrawls-20th Feb 12,000; 20th April Rs.10,000; 20th June Rs.5,000.

Calculate the bank Interest @15% on Debit balance, no interest on credit balance. Close the account on 30th June, 2008.

10. Manoj owed Rs.3000 on 1st January, 2008 to Mr. Chakresh. The following are the transactions that took place between them during 2008. It is agreed between the parties that interest @12% p.a. is to be calculated on all transactions.

2008		*Rs.*
Jan.16	Mr. Chakresh sold goods to Manoj	2000
Jan.29	Mr. Chakresh purchased goods from Manoj	1500
Feb.10	Mr. Chakresh pays cash	1500
March 09	Mr.Manoj accepts a bill drawn by Chakresh for one month	2000

They desire to settle their accounts by one single payment on 15th March, 2008. Ascertain the amount to be paid.

CHAPTER 8

SELF BALANCING LEDGERS

Learning Objectives

After studying this chapter, you will be able to:

- Define and understand the significance of self-balancing ledger system.
- Be familiar with the three ledgers generally maintained in a self-balancing ledger system.
- Learn the technique of maintaining total debtors and total creditors accounts to make the ledger system self-balancing. Observe that in self balancing system total debtors and total creditors accounts kept in the General Ledger are called Sales Ledger Adjustment Account and Bought Ledger Adjustment Account respectively.
- Note the technique of recording transactions involving transfer from Sales Ledger to Bought Ledger and vice-versa.

1. INTRODUCTION

Self Balancing Ledger System implies a system of ledger keeping which classifies ledgers as per nature of transactions, namely, Sales ledger, Bought ledger, General ledger, etc. and also makes them to balance independently. In this Unit we shall discuss the self balancing ledger system and its advantages. Also we shall illustrate system.

2. ADVANTAGES OF SELF BALANCING SYSTEM

When a number of ledgers are kept by a concern and if their balances do not tally, the accountant would have to face great difficulty in tracing book-keeping errors, responsible for the non-agreement of the Trial Balance. In order to reduce to a minimum the trouble and time involved in locating the errors, sometimes the system of self-balancing or sectional balancing of ledger is employed.

Quite often the debit and credit entries relating to a transaction are posted in different ledgers e.g. when goods are sold on credit, the Sales Account will be credited in the General Ledger but the corresponding debit will be made in the customer's account in the Personal Ledger. In such a case for ascertaining the correctness of the posting in either of the ledgers it will be necessary to take out balances in both the ledgers; thus a mistake in one ledger will require checking of the balances in the others as well.

Such a position would be avoided if every ledger is made independent of the other by the converse aspect of entries in each ledger being posted in totals to the Control Account set up in the ledger itself. If this is done the correctness of individual balances in each ledger would be verified extracting its balances and agreeing them with the balances of the Control Account. A ledger that has a Control Account set up in it, is referred to as a self balancing ledger. It connotes that it is capable of being balanced independently, the balance in the Control Account being equal to that of the individual balance.

The advantages of this system are:

(i) It fixes the responsibility of the ledger keeper, as to the balancing of the ledger or ledger under his/her charge and the person responsible for the mistake can be called upon to work overtime to locate it. Errors are localised.

(ii) It enables preparation of interim accounts without personal ledgers having to be balanced.

(iii) The figures of total debtors or creditors is readily available.

3. SECTIONAL BALANCING

A really simple way to prove the accuracy of say, the Sales Ledger would be to maintain a Total Debtors account in the General Ledger. It would mean that whereas accounts of Individual customer would be maintained in the Sales Ledger, in the General Ledger the Total Debtors account would be posted by the (monthly) totals of various transactions with total credit sales, total amount received from credit customers, total discount allowed to them, total returns inwards, total bills receivable received; etc. The balance in the Total Debtors Account should be equal to the total of balances shown by the accounts of individual customers. If it is so, the Total Debtors Account as well as individual customers' account may be taken as correct. A difference would show that there is some error somewhere.

In the same way, the accuracy of individual supplier account may be checked by comparing total of their balances with the balance in the Total Creditors Account.

The double entry would be complete in the General Ledger itself. For instance, for credit sales– Total Debtors Account would be debited and Sales Account credited. For goods returned to suppliers– Total Creditors Account would be debited and Return Outward Account credited.

The "total accounts" are also known as adjustment accounts or control accounts since they prove the accuracy of the subsidiary (Sales or Bought) ledgers.

4. VARIOUS LEDGERS TO BE MAINTAINED IN SELF-BALANCING LEDGER SYSTEM

In the Sales or Bought ledgers double entry is not completed as in the system outlined above, a separate trial balance cannot be taken out from these ledgers. If these ledgers are maintained in such a way as to offer separate trial balances, the system would be known as "Self-balancing". In such a case "General Ledger Adjustment Account" is prepared in each of the subsidiary ledgers. The General ledger would have:

(i) Bought Ledger Adjustment Account

(in reality, Total Creditors Account) and

(ii) Sales Ledger Adjustment Account

(in reality, Total Debtors Account)

These accounts are known as Control Accounts. The system on which entries are made in the adjustment account is described below:

4.1 Bought Ledger: For recording a purchase it will be observed that the initial entry made is to the debit of the Purchases Account in the General Ledger and to credit the Supplier's Account in the Bought Ledger. If it is desired to make the General and Bought Ledger self-balancing a further entry would be made debiting the General Ledger Adjustment account in the Bought Ledger, and crediting the Bought Ledger Adjustment Account in the General Ledger with the total of purchases. Again, if part of the materials purchased is returned and the balance due is paid the entries made would be; debit the personal account of the Supplier in the Bought Ledger with the value of goods returned as well as the amount paid and credit Return Outwards Account in the General Ledger with the value of goods returned and Bank Account with the amount paid. Further, in consonance with the system of self-balancing an additional entry should be made crediting the General Ledger Adjustment Account in the Bought Ledger and debiting the Bought Ledger Adjustment Account in the General Ledger with the aforementioned amount.

Students are advised to figure out the entries which will be made in the Adjustment Account for other types of transactions that are usually recorded in the Bought Ledger e.g. in respect of Bills Payable, rebate in price etc.

It should be particularly noted that the balance in the Bought Ledger Adjustment Account in the General Ledger will be equal to that in the General Ledger Adjustment Account in the Bought Ledger but on the opposite side. Also, the Bought Ledger Adjustment Account shall self-balance the General Ledger. If there are several Bought Ledgers in use each such ledger will have a General Ledger Adjustment Account and, in the General Ledger there will be Bought Ledger Adjustment Account separately for each of these ledgers.

For the sake of economy of effort and facility of postings the additional entries for making ledgers self-balancing are made only periodically, at the end of each month or week from the totals of transactions, recorded in the subsidiary books kept for the purpose.

4.2 Sales Ledger: For recording a credit sale, it will be observed that the original entry made is to debit the customer's account in the Sales Ledger and to credit the Sales Account in the General Ledger. But to self-balance the General and Sales Ledgers a further entry is made, debiting the Sales Ledgers Adjustment A/c in the General Ledger and crediting the General Ledger Adjustment Account in the Sales Ledger with the total of sales. Again, when a part of the goods sold is received back and the balance realised, the entries made are to debit the Sales Return account with the value of goods returned as well as Bank Account with the amount collected, and credit their total to personal account of the customer in the Sales Ledger. Further to self-balance the ledgers an additional entry is made to debit the General Ledger Adjustment Account in the Sales Ledger and credit the Sales Ledger Adjustment Account in the General Ledger with the aforementioned amounts.

Students are advised to figure out the entries which will be made in the Adjustment Account for other types of transactions that are usually recorded in a Sales Ledger e.g. in respect of bills receivable, dishonoured-bills, returns inwards etc. also, to work through the illustrations.

4.3 General Ledger: As stated above, each time an entry is made in the Bought and Sales Ledger for self-balancing, the contra effect of the entries is shown in the Bought Ledger or Sales Ledger Adjustment Account set up in the General Ledger. The accounts represent the Total Debtors and Creditors Accounts in a summarised form and thus serve to self-balance the General Ledger. As a result no additional entries are required to make the General Ledger self-balancing.

It may be mentioned that in regard to several other accounts, which do not relate either to customers or suppliers, no additional entry is necessary under the self-balancing scheme since, both aspects of every transaction already exist in one or other of the accounts contained in the General Ledger such as cash sales, discounting of bills, recovery of bad debts written off, creating provision for bad debts etc.

Illustration 1

Dinesh & Co. have three ledgers in use viz, a Debtors Ledger, a Creditors Ledger and a Normal Ledger which are all kept on the system of self-balancing. From the following particulars prepare the adjustments account that would appear in each of these ledgers.

2008		*Rs.*
Jan. 1	Balance of Sundry Debtors	16,000
	Balance of Sundry Creditors	18,500

Jan. 31	Credit Purchases	4,500
	Credit Sales	9,800
	Cash Sales	1,500
	Paid to Creditors	9,875
	Discount allowed by them	325
	Cash received from debtors	7,800
	Allowed them discount	200
	Bills payable accepted	1,500
	Bills receivable received	3,000
	Returns inwards	875
	Returns outwards	600
	Rebates allowed to debtors	275
	Rebates allowed to creditors	150
	Provision for Doubtful Debts	320
	Bad Debts	450
	Bills Receivable dishonoured	375

Solution

In the Debtors Ledger

General Ledger Adjustment Account

Dr. *Cr.*

2008			*Rs.*	*2008*		*Rs.*
Jan. 31	To Debtors Ledger			Jan. 1	By Balance b/d	16,000
	Adjustment Account :			Jan. 31	Debtor Ledger	
		Bank	7,800		Adjustment A/c:	
		Discount	200		Sales	9,800
		Bills Receivable	3,000		Bills Receivable dishonoured	375
		Returns Inwards	875			
		Allowances	275			

	Bad Debts	450			
	To Balance c/d	13,575			
		26,175			26,175
			Feb. 1	By Balance b/d	13,575

Entries for cash sales and provision for doubtful debts will not affect Debtors Ledger.

In the Creditors Ledger

General Ledger Adjustment Account

2008		*Rs.*	*2008*			*Rs.*
Jan. 1	To Balance b/d	18,500	Jan. 31	By	Creditors Ledger Adjustment Account:	
Jan. 31	To Creditors Ledger Adjustment Account:				Bank	9,875
					Discount	325
	Purchases	4,500			Bills Payable	1,500
					Return outwards	600
					Allowances	150
				By	Balance c/d	10,550
		23,000				23,000
Feb. 1	To Balance b/d	10,550				

In General Ledger

Debtors Ledger Adjustment Account

2008			*Rs.*	*2008*			*Rs.*
Jan. 1	To	Balance b/d	16,000	Jan. 31	By	Nominal Ledger	
Jan. 31	To	Nominal Ledger				Adjustment Account:	
		Adjustment A/c:				Bank	7,800
		Sales	9,800			Discount	200
		Bills Receivable				Bills Receivable	3,000
		dishonoured	375			Returns inwards	875
						Allowances	275

					Bad Debts	450
				By	Balance c/d	13,575
			26,175			26,175
Feb. 1	To	Balance b/d	13,575			

Creditors Ledger Adjustment Account

2008			*Rs.*	*2008*			*Rs.*
Jan. 31	To	Nominal Ledger		Jan. 1	By	Balance b/d	18,500
		Adjustment A/c:		Jan. 31	By	Nominal Ledger	
		Bank	9,875			Adjustment A/c:	
		Discount	325			Purchases	4,500
		Bills Payable	1,500				
		Return Outwards	600				
		Allowances	150				
	To	Balance c/d	10,550				
			23,000				23,000

Transfer from one ledger to another: Whenever a balance is transferred from an account in one ledger to that in another e.g., from the Bought Ledger to the Sales Ledger, the entry is recorded through the Journal. Also an additional entry is made in the Control Accounts for recording the corresponding effect.

5. RECTIFICATION OF ERRORS UNDER SECTIONAL BALANCING SYSTEM

5.1 Rectification of errors before opening Suspense Account

If the error affects the accounts of Debtors or Creditors without affecting their total, it is rectified by adjusting the accounts of Debtors or Creditors itself. However, if it affects the totals of Debtors or Creditors, the additional entries are to be made in the main ledger through Total Debtors and Total Creditors Account. The same is discussed with the following examples:

1. If goods sold to X and wrongly posted in the account of Y, The trial balance of main ledger will tally. This error can be rectified in Debtors' ledgers by debiting X's account and crediting Y's account.
2. If goods sold to X are not recorded in the Sales Book, it means under reporting of Sales. It means sectional balancing entry will be passed with lower amount of sales and Total

debtors. The error can be rectified by debiting the total debtors account and crediting the sales account in the main ledger.

3. If goods sold to X are omitted to be recorded in his account only in the debtors ledger, main ledger will tally. This error is rectified by debiting X's account by writing "to error in omitting to record sales".

4. If goods sold to X are recorded in the debtors ledger and sales account is properly credited at the end of the period, but omitted to debit the total debtors account. The error can be rectified by writing in debit side of total debtors account "To error in omitting to record sales".

5.2 Rectification of errors under Self Balancing system

The rectification of errors will be done in the usual manner as in single ledger system but there is one difference that is, whenever the totals of Debtors or Creditors are affected, rectification will be done by making additional self balancing entries. In this case, rectification of errors in the above examples will be done as follows:

1. For rectification of errors in Debtors ledger - X's account will be debited and Y's account will be credited.

2. The rectification of error will be made by crediting sales account by writing 'By error in omitting the sales' and additional entry of self balancing with the same amount will be made, namely,

Debtor Ledger Adjustment A/c	Dr	(In main ledger)
To General Ledger Adjustment A/c		(In debtors ledger)

3. The error is rectified by debiting X's account by writing 'To error in omitting to record sales.'

4 This can be rectified by self balancing entry with the same amount, namely,

Debtor Ledger Adjustment A/c	Dr	(In main ledger)
To General Ledger Adjustment A/c		(In debtors ledger)

5.3 Rectification of errors after opening suspense account

The method of rectification of error will be same under sectional and self balancing system, with the exception that the entries which were corrected unilaterally will be corrected through suspense account. In the above examples rectification of error will be done as follows :

Under Sectional Balancing System-

1. Same as above

2. Same as above

3.		Same as above		
4.		Total Debtors A/c	Dr.	(In main ledger)
		To Suspense A/c		(In main ledger)

Under Self Balancing system-

1.		Same as above		
2.	(a)	Suspense A/c	Dr.	(In Debtors ledger)
		To Sales A/c		
	(b)	Debtors ledger Adjustment A/c	Dr.	(In main ledger)
		To General Ledger Adjustment A/c		(In Debtors Ledger)
3.		X's A/c	Dr.	(In Debtors Ledger)
		To Suspense A/c		(In Debtors Ledger)
4.	(a)	Debtors ledger Adjustment A/c	Dr.	(In main ledger)
		To Suspense A/c		(In main ledger)
	(b)	Suspense A/c	Dr.	(In Debtors ledger)
		To General Ledger Adjustment A/c		(In Debtors Ledger)

Illustration 2

Prepare journal entries in the books of Exe. Ltd. for the following:

(a) The Sales Book was found under cast by Rs. 1,000.

(b) Discount allowed to Rao Rs. 50 correctly, entered in the Cash Book was not posted to his account.

(c) Credit balance of Rs. 310 in Murty's account in the Purchase Ledger was to be transferred to his account in Sales Ledger.

Give Journal entries both under the self-balancing system and the sectional balancing system.

Solution

Journal of Exe. Ltd.

Self-Balancing System:

(a)	Sales Ledger Adjustment Account (In General Ledger)	Dr.	1,000	
	To General Ledger Adjustment Account			1,000
	(In Sales Ledger)			
	(The error because of the under-casting of Sales Books, rectified)			

	Suspense Account (In General Ledger)	Dr.	1,000	
	To Sales Account			1,000
	(Rectification of the error resulting from under casting of the Sales Book)			
(b)	Suspense Account (In Sales Ledger)	Dr.	50	
	To Rao (In Sales Ledger)			50
	(Rectification of the error by which Rao was not credited, accounts in the general ledger are not affected)			
(c)	Murty (In Purchase Ledger)	Dr.	310	
	To Murty (In Sales Ledger)			310
	(Transfer of Murty's credit balance in the Purchase Ledger to his account in the Sales Ledger)			
	Bought Ledger Adjustment Account (In General Ledger)	Dr.	310	
	To General Ledger Adjustment A/c (In Bought Ledger)			310
	(Correction of the adjustment accounts relating to the Bought Ledger because of the transfer of Murty's account, in the Purchase Ledger)			
	General Ledger Adjustment Account (In Sales Ledger)	Dr.	310	
	To Sales Ledger Adjustment A/c (In General Ledger)			310
	(Correction of the adjustment account relating to the Sales Ledger because of the transfer of Murty's account)			

Note : It is assumed that if a ledger is not balanced, a Suspense Account has been opened.

Sectional Balancing System

(a)	Total Debtors Account	Dr.	1,000	
	To Sales Account			1,000
	(Rectification of the consequence of the under- casting the Sales Book)			
(b)	Credit Rao with Rs. 50 (In Sales Ledger)			
(c)	1. Murty (In Purchase Ledge)	Dr.	310	
	To Murty (In Sales Ledger)			310
	(Transfer of Murty's credit balance Rs. 310 in the Purchase Ledger to his account in the Sales Ledger)			

2. Total Creditors A/c	Dr.	310	
To Total Debtors A/c			310
(Adjustment of total accounts because of the transfer of Murty's account, in the Purchase Ledger to the Sales Ledger)			

Illustration 3

From the following particulars as extracted from the books of Messrs Kulkarni Brothers, who keep a Debtors' Ledger, a Creditors Ledger and a General Ledger on the self-balancing system, show how the General Ledger Adjustment Account will appear in the Debtor's Ledger and the creditors' Ledger.

	Rs.
Debtors' Balance on 1st January, 2008	91,500
Creditors, Balance on 1st January, 2008	1,09,800
Transactions for the year 2008 :	
Credit purchases	41,000
Credit sales	45,400
Returns Inwards	800
Returns Outwards	1,200
Cash received from customers	51,000
Discount allowed to customers	900
Cash paid to creditors	61,400
Discount received	1,340
Acceptances received	17,000
Acceptances given	24,000
Bills Receivable dishonoured	2,400
Bills Payable dishonoured	6,000
Bad debts written off	5,000
Sundry charges debited to customers	690
Allowances from creditors	550
Transfer from Debtors Ledger	1,290

Solution

General Ledger Adjustment A/c (in Sales Ledger)

2008		*Rs.*	*2008*		*Rs.*
Jan. to			Jan. to		
Dec. 31	To Sales Ledger		Dec. 31	By Balance b/d	91,500
	Adjustment A/c in			By Sales Ledger	
	General Ledger:			Adjustment A/c	
	Return Inward	800		in General Leger	
	Bank	51,000		Sales	45,400
	Discount	900		B/R Dishonoured	2,400
	Bills Receivable	17,000		Sundry Charges	690
	Bad Debts	5,000			
	Transfer	1,290			
Dec. 31	To Balance c/d	64,000			
		1,39,990			1,39,990
			2009		
			Jan. 1	By Balance b/d	64,000

General Ledger Adjustment A/c (in Purchases Ledger)

2008		*Rs.*	*2008*		*Rs.*
Jan. 1 to			Jan. 1 to		
Dec. 31	To Balance b/d	1,09,800	Dec. 31	By Purchases Ledger	
	To Purchases Ledger			Adjustment A/c in	
	Adjustment A/c in			General Ledger:	
	General Ledger :			Bank	61,400
	Purchases	41,000		Bills Payable	24,000
	Bills Payable			Return Outward	1,200

	cancelled	6,000		Discount	1,340
				Allowance	550
				Transfer	1,290
			Dec. 31	By Balance c/d	67,020
		1,56,800			1,56,800
2009					
Jan. 1	To Balance b/d	67,020			

6. RULING OF SUBSIDIARY BOOKS

Whenever there are several Bought or Sales Ledgers in use, various books of original entry, e.g., Purchases Books, Sales Books, Cash Book and Journal are suitably ruled in a manner that they readily show the monthly total of the transactions posted in various ledgers, on the basis of which the self-balancing entries, can be recorded.

7. SECRET ACCOUNT

At time it may be considered necessary to keep the operation of certain accounts, e.g., partners' capitals, loans, deposits etc., secret from members of the staff except the senior officials. In such a case, these accounts would be segregated into a Private Ledger and posting will be made in the ledger by a confidential clerk, under the direct supervision of the Chief Accountant. Also a General Ledger Adjustment Account will be set up in the Private Ledger and a Private Ledger Adjustment Account in the General Ledger. In this way, though the individual entries in the accounts kept in the Private Ledger will be revealed to the accounting staff, their total effect will be kept secret. In case individual accounts also are desired to be kept secret separate Cash Book and Bank Account would be maintained; this would ensure complete secrecy.

When such a system is first started, the assets and other debit balances are transferred to the Private Ledger by crediting the respective accounts in the General Ledger and the Private Ledger Adjustment Account is debited with their total. The opposite are the entries made when credit balances are transferred. Also, if it is desired to transfer a part of the Bank Balance to Private Bank Account, Bank Account is credited and the Private Ledger Adjustment Account is debited. From the Private Bank Account, partners will be able to draw amounts required by them and to pay interest on deposits and loans at whatever rates they may please without the fact being disclosed to the staff.

When accounts are closed at the end of the year, the revenue accounts are closed off by transfer of the Private Ledger Adjustment Account and corresponding entries are made in the

Private Ledger by debit or credit to the General Ledger Adjustment Account. Afterwards all the balances so transferred, along with those already in the Private Ledger, are transferred to the Profit & Loss Account in the Private Ledger. In this way, complete secrecy is maintained regarding the operation of accounts in the Private Ledger; also the amount of profit made by the concern is not disclosed to the staff.

Students may note that the procedure followed for making the Private and General Ledgers self-balancing is somewhat different from that described above in so far as entries in the Adjustment Accounts are not made at the time an expense is paid or an income is collected, but only at the end of the year. This is done only to avoid making book keeping too cumbersome.

Illustration 4

M. Govind keeps self-balancing ledgers. Record the following transactions in the General Ledger Adjustment Account in the Sales Ledger :

1.4.2008 Received Rs. 475 from Mr. X in full settlement. He was allowed a discount of Rs. 25.

2.4.2008 Received Rs. 2,000 from Mr. Y towards his dues in full.

3.4.2008 Goods supplied to Mr. T. Rs. 700 and received Rs. 300 after adjustment of the advance of Rs. 400.

4.4.2008 Bad debts recovered from Mr. Q Rs. 1,000.

5.4.2008 Goods sold to the following :

Mr. A	Rs. 1,000
Mr. B	Rs. 1,500
Mr. C	Rs. 2,000

15.4.2008 Mr. P paid Rs. 750 towards dues. Balance thereafter due was Rs. 250.

25.4.2008 Amount received from the following :

Mr. A	Rs. 750
Mr. B	Rs. 1,000
Mr. C	Rs. 2,000

30.4.2008 Advance received from Mr. R for supply Rs. 2,000.

Solution

Sales Ledger

General Ledger Adjustment Account

2008			*Rs.*	*2008*			*Rs.*
April 1	To	Balance b/d	400	April 1	By	Balance b/d	3,500
April 2	To	Sales Ledger		April 3	By	Sales Ledger	
		Adjustment A/c	300			Adjustment A/c	
April 30	To	" " (P, X & Y)	3,250			(Sales)	700
	To	" " (A, B, C)	3,750	April 30	By	Sales Ledger	
	To	" " R	2,000			Adjustment A/c	4,500
April 30	To	Balance c/d		April 30	By	Balance c/d	2,000
		(A, B & P)	1,000				
			10,700				10,700
May 1	To	Balance b/d	2,000	May 1	By	Balance b/d	1,000

Working Notes :

(i) Opening balance includes the following debts :

	Rs.
X	500
Y	2,000
P	1,000
	3,500

(ii) Opening debit balance Rs. 400, is advance from T.

(iii) Closing debit balance represents advance from R Rs. 2,000.

(iv) Closing balance of Rs. 1,000 includes the following debts :

	Rs.
A	250
B	500
C	250
	1,000

Illustration 5

The following information is available from the book of a trader from January 1 to March 31, 2008:

(1) Total sales amounted to Rs. 60,000 including the sale of old furniture for Rs. 1,200 (book value Rs. 3,500). The total cash sales were 80% less than the total credit sales.

(2) Cash collection from debtors amounted to 60% of the aggregate of the opening debtors and credit sales for the period. Debtors were allowed cash discount for Rs. 2,600.

(3) Bills Receivable drawn during three months totalled Rs. 6,000 of which bills amounting to Rs. 3,000 were endorsed in favour of suppliers. Out of these endorsed B/R, a B/R for Rs. 600 was dishonoured for non-payment, as the party became insolvent, his estate realising nothing.

(4) Purchases totalled Rs. 16,000 of which 10% was for cash.

(5) A cheque received from a customer for Rs. 6,000 was dishonoured; a sum of Rs. 500 is irrecoverable: Bad Debts written off in the earlier years realised Rs. 2,500.

(6) Sundry debtors, as on 1st January, 2008 stood at Rs. 40,000

You are required to show the Debtors' Ledger Adjustment Account in the General Ledger.

Solution

General Ledger

Debtors' Ledger Adjustment Account

Dr.					*Cr.*
		Rs.			*Rs.*
To	Balance b/d	40,000	By	General Ledger	
To	General Ledger			Adjustment A/c:	
	Adjustment A/c:			Collection (Cash	
	Sales	49,000		& Bank)	53,400
	Sundry Creditors	600		Discount	2,600
	B/R Dishonoured			Bills Receivable	6,000
	Bank			Bad Debts	1,100
	Cheque dishonoured	6,000	By	Balance c/d	32,500
		95,600			95,600

Note : If credit sales is Rs. 100, cash sales will be Rs. 20. Total credit sales shall be 5/6th of Rs. 58,800, i.e., Rs. 49,000.

Illustration 6

From the following particulars, prepare the relevant adjustment account as would appear in the General Ledger of Mr. Vasu for the month of March, 2008:

Date	Particulars
1	Purchase from Mr. X Rs. 2,000
2	Paid Rs. 1,600 after adjusting the initial advance in full to Mr. X.
13	Paid Rs. 1,000 to Mr. R towards the purchases made in February in full.
13	Paid advance to Mr. Y Rs. 3,000
14	Purchased goods from Mr. A Rs. 4,000
25	Returned goods worth Rs. 500 to Mr. A.
26	Settled the balance due to A at a discount of 10 per cent.
27	Goods purchased from Mr. Y Rs. 2,500 against advance paid on 13th.
28	Received at bank the advance from Mr. P paid on 28 February, 2008, Rs. 2,000.
29	Purchased from B Rs. 2,000.
30	Goods returned to Q Rs. 750. The goods were originally purchased for cash in February.

Solution

Creditors Ledger Adjustment Account

2008			Rs.	2008			Rs.
March 1	To	Balance (X. P.)	2,400	March 1	By	Balance (R) b/d:	1,000
March 31	To	General Ledger					
		Adjustment A/c (In Bought Ledger)		March 31	By	G.L. Adjust A/c (in Bought Ledger)	
		Bank (X, R, Y & A)	8,750				
		Returns (A&Q)	1,250			Purchases	10,500
		Discount	350			Bank (Refund)	2,000
March 31	To	Balance c/d (B)	2,000	March 31	By	Balance c/d (Y,Q)	1,250
			14,750				14,750
April 1	To	Balance b/d (Y, Q)	1,250	April 1	By	Balance b/d (B)	2,000

Working Notes :

(1)	Purchases:		
	1.3.2006	X	2,000
	14.3.2006	A	4,000
	27.3.2006	Y	2,500
	30.3.2006	B	2,000
			10,500
(2)	Payments:		
	2.3.2006	X	1,600
	13.2.2006	R	1,000
	13.2.2006	Y	3,000
	26.3.2006	A Rs. 3,500 - 10%	3,150
			8,750

Illustration 7

From the following information prepare a Total Debtors Account as appearing in the General ledgers in the Books of M/s Shukla and Company.

Debit balance as on 1.7.2008, Rs.87,200; Credit balance as on 1.7.2008 in Debtors Account Rs.600.

Transactions during 6 months ended on 31.12.2008:

Total sales were Rs.94,000 including cash sales of Rs.4,000. Debtors whose balances were in credit were paid off Rs.600. Payments received by cheques from Debtors Rs.60,000. Payments received by cash from Debtors Rs.48,000. Payment received by bills receivable Rs.26,000.

Bills receivable received from Debtors were dishonoured for Rs.6,000 and noting charges of Rs.60 were paid. Cheques received from customers were dishonoured for Rs.800.

Out of bills receivable received and included in Rs.26,000 above, bills of Rs.5,000 were endorsed to suppliers.

Bad debts written-off during the period were Rs.1,000. Discount allowed for prompt payment were Rs.700 and bad debts written off in 2007 and now recovered from debtors amounted to Rs.900.

Interest debited for delay in payments were Rs.1,250. On 31.12.2008 provision for doubtful debts was created for Rs.2,100. M/s Trial & Co.'s account appeared in Debtors Ledger and also in Creditors Ledger. The balance in Creditors Ledger was Rs.900 and the same was transferred to Debtors Ledger. Goods of Rs.2,760 were rejected by the customers.

Solution

In the General Ledger of M/s.Shukla & Company

Dr.		**Total Debtors Account**					*Cr.*
Date		*Particulars*	*Rs.*	*Date*		*Particulars*	*Rs.*
1.7.2008	To	Balance b/f	87,200	1.7.2008	By	Balance b/f	600
1.7.2008 to 31.12.2008	To	Sales (Rs.94,000-Rs.4,000)	90,000	1.7.2008 to 31.12.2008	By	Bank	60,000
"	To	Cash	600	"	By	Cash	48,000
"	To	Bills Receivable (dishonoured)	6,000	"	By	Bills receivable	26,000
"	To	Bank (noting charges)	60	"	By	Bad debts	1,000
"	To	Bank (cheque dishonoured)	800	"	By	Discount allowed	700
"	To	Interest	1,250	"	By	Total Creditors A/c-Transfer	900
				"	By	Sales Return	2,760
				"	By	Balance c/d	45,950
			1,85,910				1,85,910

Notes:

(1) Bad debts of 2007 recovered in 2008 will not appear in the Total Debtors Account. It should be credited to Profit and Loss Account.

(2) Bills Receivable of Rs.5,000 endorsed to suppliers has nothing to do with Total Debtors Account because at the time of endorsement Suppliers Account is debited and Bills Receivable Account is credited.

Illustration 8

The following particulars are obtained from books of a Self Ltd. for the year ended 31st March, 2008:

	Rs.		*Rs.*
Cash Sales	25,000	Bills Receivable dishonoured	2,500
Credit Purchases	2,80,000	Return Inward	8,500
Collection from Debtors	4,25,000	Payments to creditors	1,62,000

Bills Receivable drawn	20,000	Discount allowed	3,000
Discount Received	2,500	Debtors' cheque returned dishonoured	7,500
Cash Purchases	12,000	Credit Sales	4,90,000
Bills Payable paid	6,500	Bills Receivables collected	10,000
Recovery of Bad Debts	1,500	Return outward	3,700
Bills Receivable discounted with Bank	8,000	Bills Receivable endorsed to creditors	7,900
Interest charged on overdue Customer's Accounts	1,200	Overpayments refunded by suppliers	600
Endorsed Bills Receivable dishonoured (noting charges Rs.75)	5,500	Bad Debts	1,000
Bills Payable accepted	16,000	Opening Balances	
		Sundry Debtors	78,000
		Sundry Creditors	85,000

You are required to prepare the Total Debtors Account and Total Creditors Account.

Solution

In the books of Self Ltd.
Total Debtors Account

		Rs.			*Rs.*
To	Balance b/d	78,000	By	Cash	4,25,000
To	Bank (Cheque dishonoured)	7,500	By	Discount Allowed	3,000
To	B/R (Dishonoured)	2,500	By	B/R	20,000
To	Interest	1,200	By	Returns Inward	8,500
To	Sales	4,90,000	By	Bad Debts	1,000
To	Sundry Creditors (endorsed bill dishonoured with noting charges)	5,575	By	Balance c/d	1,27,275
		5,84,775			5,84,775

Total Creditors Account

		Rs.			*Rs.*
To	Cash	1,62,000	By	Balance b/d	85,000

To	B/R (endorsed)	7,900	By	Purchases	2,80,000
To	Discount received	2,500	By	Sundry Debtors A/c (endorsed B/R dishonoured with noting charges)	5,575
To	Bills Payable	16,000	By	Cash (over payments refunded)	600
To	Return outward	3,700			
To	Balance c/d	1,79,075			
		3,71,175			3,71,175

Note: Transactions relating to cash sales or purchases; honour of bills receivable or payable; and discount or endorsement of bill will not be entered in Total Debtors and Total Creditors A/c.

Self-Examination questions

I. Objective type questions

Choose the most appropriate answer from the given options:

1. Self-balancing is a system of

   (a) Keeping ledgers.

   (b) Preparing trial balance.

   (c) Preparing final accounts.

   (d) Recording journal entries.

2. The monthly total of purchases day book is posted to the debit side of the purchases account in the

   (a) Debtors ledger.

   (b) Creditors ledger.

   (c) General ledger.

   (d) Sales ledger.

3. No self-balancing entry is required

   (a) For bad debts written off recovered.

   (b) For discounts allowed.

   (c) For bills receivable dishonoured.

(d) None of the three options.

4. The main advantage of self-balancing system is that it facilitates the quick preparation of

   (a) Debtors and creditors ledgers only.

   (b) Final accounts.

   (c) Bank reconciliation statement.

   (d) None of the three options.

5. Under sectional balancing the ledger which is usually made to balance is

   (a) Debtors ledger.

   (b) Creditors ledger.

   (c) General ledger.

   (d) Sales ledger.

6. General Ledger adjustment account is opened in

   (a) Bought ledger.

   (b) Sold ledger.

   (c) General ledger.

   (d) Both sold ledger and bought ledger.

7. Provision for doubtful debts is opened in

   (a) Debtors ledger.

   (b) Sold ledger.

   (c) General ledger.

   (d) Both sold ledger and bought ledger.

8. Sold ledger adjustment account is opened in

   (a) Sold ledger.

   (b) Bought ledger.

   (c) General ledger.

   (d) Sold ledger as well as in bought ledger.

[**Answer** :**1** (a); **2** (c); **3** (a); **4** (b); **5** (c); **6** (d); **7** (c); **8** (c)]

II. Short answer type questions

9. What is meant by self-balancing system? Explain in brief.

10. Distinguish self-balancing system from sectional balancing system.

11. List the names of the ledgers which are required to be maintained under self-balancing system.

12. Write short note on advantages of self-balancing system.

III. Long answer type questions

13. Describe the procedure of rectification of errors under sectional balancing system.

14. Explain about various ledgers maintained under self-balancing system.

IV. Practical problems

15. Prepare the Total Debtors Account from the following figures taken from the books of a firm:

	Rs.
Opening Balance on 1.2.2008	19,300
Transactions during the month:	
Sales (including Rs.5,000 cash sales)	59,200
Cash received	46,300
Discount allowed	1,500
Bad Debts written off	400
Acceptances received	800
Acceptances dishonoured	300
Transfer from Bought Ledger	1,000
Transfer of wrong debit from the amount of X to that of Y	175

here were on 28.2.2008 credit balances in the Sales Ledger totalling Rs. 560.

16. A firm has two sales ledgers, North and South, Mr. Swamy who owed Rs. 2,800 to the firm shifted to Delhi and his account was transferred from the South Sales Ledger to the North Sales Ledger. Assuming the self-balancing to be in operation, give Journal entries to record the transfer.

17. From the following details extracted from the books of Y Ltd. for the year ended 31st March 2008, prepare a Sales ledger Adjustment Account as it would appear in the General Ledger:

1st April 2008:		*Rs.*
Opening balance:		
Sales Ledger	Dr.	45,256

	Cr.	156
Provision for Bad and Doubtful debts		5,000
Sales during the period-		
Cash		15,200
Credit		1,25,656
Amount received from Customers		1,56,215
Bills accepted by the Customers		1,250
Cheques dishonoured		1,270
Bad debts written off		256
Interest on overdue accounts		82
Cash discounts allowed		1,527
Bad debts previously written off recovered		465
Returns from Customers		726

Goods of the sales value of Rs. 150 were returned by a customer for whom fresh goods were issued. Though a credit note was issued for the return of goods, the sales invoice was inadvertently not prepared for the issue of fresh goods.

Following errors are detected after opening suspense account but before preparing final account in the books of M/s Aditi Sergicals:

1. Goods of the value of Rs. 1,000 returned by Sharma were entered in the sales day book and posted therefrom to the credit of his account;
2. An amount of Rs. 1,500 entered in sales return book, has been posted to the debit of Vinod who returned the goods;
3. A sale of Rs. 2,000 made to Viney was correctly entered in the sales day book but wrongly posted to the debit Vineet (a customer) as Rs. 200.
4. No entry appeared for bad debts aggregating Rs. 450 except writing off the individual debtors in the sales ledger; and
5. The total of "Discount allowed" column in the cash book for the month of September amounting to Rs. 2,500 was not posted.

Rectify by journal entries if books are kept under Self Balancing System.

18. Prepare the General Ledger Accounts as they would appear in the Debtors' as well as Creditors' Ledger from the following particulars:

	Debit *(Rs)*	*Credit* *(Rs)*
Balance on 1st October, 2007		
Debtors Ledger	50,000	2,500

Creditors’ Ledger	2,300	42,800
Figures for the year ended 30th September, 2008 are:-		
Cash received from customers		1,50,800
Discount and allowances allowed to them		3,250
Bad Debts written off		4,000
Transfer from Debtors’ Ledger to Creditors’ Ledger to settle customers accounts		3,000
Payment to Creditors		1,05,000
Discount allowed by them		2,500
Payment to Customers		250
Credit Purchases		1,08,000
Credit Sales		1,95,000
Cash Purchases		20,000
Cash Sales		35,000
Purchases Returns		2,800
Sales Returns		3,600
Bills Receivable received		10,500
Bills payable granted		9,800
Bills Receivable dishonoured		1,500

19. Prepare the Sales ledger control account and Purchases ledger control account from the following particulars:-

	Sales Ledger	Purchases Ledger
Debit balance as on 1.1.08	1,50,000	1,000
Credit balance as on 1.1.08	200	1,25,000
Credit sales and purchases	4,00,000	3,80,000
Cheque received and paid	4,50,000	3,50,000
Advance paid to creditors	-	2,000
B/R received and B/P accepted	50,000	50,000
Discounts allowed and received	5,000	3,000
Returns	10,000	5,000
Transfer from purchases to sales ledger	10,000	10,000
Bad debts	2,000	-

Reserve for discounts	10,000	5,000
B/R and B/P dishonoured	5,000	5,000
Debit Balances as on 30.6.08	30,000	-
Credit Balances as on 31.6.08	?	72,000

20. The following transactions have been extracted from the books of Mr. X. You are required to prepare the Sales Ledger Adjustment Account as on 31.3.2008:

	Rs.
Debtors balance on 1.3.2008	50,000
Transactions during the period were:	
Sales (including cash sales of Rs. 20,000)	1,28,000
Cash received from debtors	90,000
Discount allowed to debtors	500
Acceptances received from debtors	8,000
Returns from debtors	6,000
Bills receivable dishonoured	1,500
Bad debts written off (after deducting bad debts recovered Rs.1,000)	4,000
Sundry charges debited to customers	600
Transfers to bought ledger	300

CHAPTER 9

FINANCIAL STATEMENTS OF NOT-FOR-PROFIT ORGANISATIONS

UNIT-1 : FINANCIAL STATEMENTS OF NON- TRADING ORGANISATIONS

Learning Objectives

After studying this unit, you will be able to:

- Understand the meaning of Receipts and Payments Account and Income and Expenditure Account and see the distinction between the two Accounts.
- Learn the technique of preparing Receipts and Payments Accounts.
- Identify main sources of Income and learn the technique of preparing Income and Expenditure Account from Receipts and Payments Account.
- Learn the technique of preparing Balance Sheet.

1.1 INTRODUCTION

Non-profit making organisations such as public hospitals, public educational institutions, clubs, etc., conventionally prepare Receipts and Payments Account and Income and Expenditure Account to show periodic performance and Balance Sheet to show financial position at the end of the period. In this Unit, we shall discuss the technique of preparing Receipts and Payments Account, Income and Expenditure Accounts and Balance Sheet of non profit making non-trading) organisations. Also we shall discuss and illustrate the technique of preparing Income and Expenditure Account from Receipts and Payments Account. It may be mentioned that Income and Expenditure Account is just similar to Profit and Loss Account prepared for the profit making organisations. In case of Income and Expenditure Account, the excess of expenditure over income is treated as surplus. In non-profit making organisations, total cash receipts and total cash payments are highlighted through Receipts and Payments Account.

1.2 NATURE OF RECEIPTS AND PAYMENTS ACCOUNT

Receipts and Payments Account is an elementary form of account commonly adopted by non-profit making concerns such as hospitals, clubs, societies, etc., for presenting periodically the result of their working. It consists of a classified summary of cash receipts and payments over a certain period together with the cash balances at the beginning and close of the period. The receipts are entered on the left hand side, and payments on the right hand side i.e., same sides as those on which they appear in Cash Book.

For convenience of preparation of the account, the Cash Book is usually provided with a sufficient number of analysis columns on each side to record separately the principal items of income and expenditure. A sundries column is also provided for extraordinary items, which are analysed at the end of the year. As regards its form, the account usually contains as much of details as possible.

Illustration 1

The receipts and payments for the Swaraj Club for the year ended December 31, 2008 were: Entrance fees Rs.300; Membership Fees Rs.3,000; Donation for Club Pavilion Rs.10,000, Foodstuff sales Rs.1,200; Salaries and Wages Rs.1,200 Purchase of Foodstuff Rs.800; Construction of Club Pavilion Rs.11,000; General Expenses Rs.600; Rent and Taxes Rs.400; Bank Charges Rs.160.

Cash in hand–Jan. 1st Rs.200, Dec. 31st Rs.350

Cash in Bank–Jan. 1st Rs.400; Dec. 31st Rs.590

Prepare the Receipts and Payments Account of the Club.

Solution

Swaraj Club

Receipts and Payments Accounts

for the year ended 31st December, 2008

Dr.					*Cr.*
	Receipts	*Rs.*		*Payments*	*Rs.*
To	Cash in hand b/d	200	By	Salaries and Wages	1,200
To	Cash with bank b/d	400	By	Purchase of Foodstuff	800
To	Entrance Fees	300	By	Club Pavilion	
To	Membership Fees	3,000		(Expenditure on its	
To	Donation of Account			construction)	11,000
	of Club Pavilion	10,000	By	General Expenses	600
To	Sales of foodstuff	1,200	By	Rent and Taxes	400
			By	Bank Charges	160
			By	Cash in hand c/d	350
			By	Cash in bank c/d	590
		15,100			15,100

1.2.1. Limitations of Receipts and Payments Account: From a study of the above account, it will be apparent that the increase in the cash and bank balances at the end of the year, as compared to those in beginning, does not truly represent the surplus for the year since it does not take into account the cost of construction of the pavilion, which is in excess of the donation received, the outstanding subscription or those which were collected in advance, etc. Ordinarily one must ascertain whether for a current year income is sufficient to meet the current expenses. Since the Receipts and Payments Account includes items relating to all periods or of all types, it does not serve the purpose mentioned above. On account of these drawbacks, the preparation of Receipts and Payments Account is not favoured except where the activities of the organisation, the results of which are to be exhibited, are simple and modest, involve no carry over from one period to the next and it has no assets, apart from cash balance and no liabilities.

1.3 INCOME AND EXPENDITURE ACCOUNT

It is an account which is widely adopted by non-profit making concerns and is prepared by following accrual principle. Only items of revenue nature pertaining to the period of account are included therein. The preparation of the account, therefore, requires adjustment in relevant accounts of outstanding items of income and expenditure as also exclusion of amounts paid in advance before these are included in Income and Expenditure Account. In so far as this, it resembles a Profit & Loss Account and serves the same function in respect of a non-profit making concern as the later account does for a firm, carrying on business or trade.

1.3.1. Main Sources of Income: These are subscriptions, ordinary donations, membership fees or entrances fees (if the amount is normal or provided according to bye-laws of the society), recurring grants from local authorities and iIncome from investments, etc. Any amount raised for a special activity, e.g. on sale of match tickets, is deducted from the expenditure of that activity and net amount is shown in the income and expenditure account. Any receipt of capital nature shall not be shown as income but will be credited to the Capital Fund or special purpose fund e.g. "Building Fund' or if the receipts is on account of sale of a fixed asset, it shall be credited to the asset account.

The funds so collected are spent for meeting various expenses of the society such as payment of rent, salary, repair and maintenance of the fixed assets, travelling, expenses of the canteen and consumable stores. Some of the expenses are peculiar to the nature of the society concerned.

Examples:

Hospital - medicines and cost of tests and investigations.

Sports Club - sports materials, tournament expenses, etc.

Drama Club - expenses of staging plays, rent of the hall, payment to artists, etc.

Educational Societies - award of scholarships, organisation of seminars, etc.,

Library Societies - newspapers and magazines.

Any expenditure for acquisition of a fixed asset will be capitalised, though the amount of annual depreciation shall be debited to revenue expenditure.

It may be noted that after various accounts have been adjusted as is considered necessary and all the revenue accounts have been closed off by transfer to the Income and Expenditure Account, there will still be a number of balances left over. These are included in the balance sheet. A balance sheet is thus a complement to such an account. If a regular Trial Balance is available, the preparation of the Income and Expenditure Account and the Balance Sheet is on the lines of final accounts.

1.3.2. Distinction between Receipts and Payments Account and Income and Expenditure Account: Students are advised to study the details contained in the above statements of account for appreciating the distinguishing characteristics of Receipts and Payments and the Income and Expenditure Accounts, as well as, the nature of adjustments required for converting one account into the other. The distinguishing features of the above mentioned two accounts are briefly stated below.

1.4 PREPARATION OF INCOME AND EXPENDITURE ACCOUNT FROM RECEIPTS AND PAYMENTS ACCOUNT

Often problems set in examinations require compilation of Income and Expenditure Account and the Balance Sheet from the Receipts and Payments Account after making adjustments in respect of Income accrued but not collected and expenses outstanding. The preparation of Balance Sheet in such a case in also necessary since an Income and Expenditure Account must always be accompanied by a Balance Sheet. The procedure which should be followed in this regard is briefly outlined below.

(i) Compute the opening balance of the Accumulated Fund, or Capital Fund of the Institution. It will be excess of the total value of the assets over that of the liabilities at the commencement of the period.

(ii) Open ledger accounts in respect of various items of income and expenditure (e.g. subscription, rents, printing, purchase of sports materials etc.) in which accruals or outstanding at the beginning or at the end of period have to be adjusted. Enter therein any accrual or outstanding at the end of the period as well as amounts which relate to an earlier period or the following period. The balance of the ledger accounts, therefore will represent the amounts or income or expenditure pertaining to the period. These should be transferred to the Income and Expenditure Account.

(iii) Post from the debit of the Receipts & Payments Account to the credit of the Income and Expenditure Account other items of income wherein accruals and outstanding amount have to be adjusted. Likewise, post item of expenses in which no adjustment is to be made directly to debit of income and Expenditure Account.

(iv) Transfer the balance of Income and Expenditure Account to the Accumulated Fund Account.

(v) Post the receipts and payments of capital nature from the Receipts and Payments Account to the appropriate asset or liability account for incorporating in the Balance Sheet. If a part or whole of an asset has been sold, the capital profit/loss, if any, is credited / debited in the Income and Expenditure Account. The balance of Income and Expenditure Account should be transferred to the Accumulated Fund Account.

(vi) Prepare a Balance Sheet by including therein all the balances left over after transfers to the Income and Expenditure Account have been made.

Illustration 2

During 2008, subscription received in cash is Rs. 42,000. It includes Rs. 1,600 for 2007 and Rs. 600 for 2009. Also Rs. 3,000 has still to be received for 2008. Calculate the amount to be credited to Income and Expenditure Account in respect of subscription.

Solution

			Rs.
Amount received			42,000
Add : Outstanding on 31st Dec., 2008			3,000
			45,000
Less : Received on account of	2007	1,600	
	2009	600	2,200
			42,800

The various accounts will appear as under :

Subscription Outstanding Account

2008		*Rs.*	2008		*Rs.*
Jan. 1	To Balance b/d (transfer)	1,600	Dec. 31	By Subscription A/c	1,600
Dec. 31	To Subscription A/c	3,000	Dec. 31	By Balance c/d	3,000
		4,600			4,600

2009		
Jan. 1	To Balance b/d	3,000

Subscription Account

2008		*Rs.*	2008		*Rs.*
Dec. 31	To Subscription Outstanding A/c (transfer)	1,600	Dec. 31	By Cash A/c	42,000
Dec. 31	To Subscription received in advance A/c	600	Dec. 31	By Subscription outstanding A/c	3,000
Dec. 31	To Income and Expenditure A/c (transfer)	42,800			
		45,000			45,000

Subscription Received in Advance Account

2008		*Rs.*	2008		*Rs.*
Dec. 31	To Balance c/d	600	Dec. 31	By Subscription A/c	600
			2009		
			Jan. 1	By Balance b/d	600

Subscription outstanding Rs.3,000 and Subscription received in advance Rs.600 will be shown in the balance sheet on the assets and liabilities side respectively.

Illustration 3

Suppose salaries paid during 2008 were Rs.23,000. The following further information is available:

Salaries unpaid on 31st Dec. 2007	1,400
" prepaid on " " "	400
" unpaid on " " 2008	1,800
" prepaid " " 2008	600

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

Solution

Salaries Account

2008		*Rs.*	*2008*		*Rs.*
Jan. 1	To Prepaid Salaries A/c	400	Jan. 1	By Salaries Outstanding A/c	1,400
Dec. 31	To Cash	23,000	Dec. 31	By Salaries Prepaid A/c	600
	To Salaries			By Transfer to Income	
	Outstanding A/c	1,800		& Expenditure A/c	23,200
		25,200			25,200

Salaries Outstanding Account

2008		*Rs.*	*2008*		*Rs.*
Jan. 1	To Salaries A/c	1,400	Jan. 1	By Balance b/d	1,400
Dec. 31	To Balance c/d	1,800	Dec. 31	By Salaries A/c	1,800
		3,200			3,200
			2009		
			Jan 1	By Balance b/d	1,800

Salaries Prepaid Account

2008		*Rs.*	*2008*		*Rs.*
Jan. 1	To Balance b/d	400	Jan. 1	By Salaries A/c	400
Dec. 31	To Salaries A/c	600		(transfer)	
			Dec. 31	By Balance c/d	600
		1,000			1,000
2009					
Jan. 1	To Balance b/d	600			

1.5 BALANCE SHEET

It is classified summary of the ledger balances left over, after accounts of all the revenue items have been closed off by transfer to the Income and Expenditure Account. The Balance Sheet includes fixed and floating assets, liabilities and the Capital fund or the Accumulated Fund. The Capital fund represents the amount contributed by members. If however, members have not contributed any amount, the name should be Accumulated Fund. The surplus or deficit, if any, on the year's working as disclosed by the Income and Expenditure Account is shown either as an addition to or deduction from the Capital / Accumulated Fund brought forward from the previous period.

1.6 ACCOUNTING TREATMENT OF SOME SPECIAL ITEMS

1.6.1. Donations: These may have been raised either for meeting some revenue or capital expenditure; those intended for the first mentioned purpose are credited directly to the Income and Expenditure Account but others, if the donors have declared their specific intention, are credited to special fund account and in the absence thereof, to the Capital Fund Account. If any investments are purchased out of a special fund or an asset is acquired therefrom, these are disclosed separately. Any income received from such investments or any donations collected for a special purpose are credited to an account indicating the purpose and correspondingly the expenditure incurred in carrying out the purpose of the fund is debited to this account. On no account any such expense is charged to the Income and Expenditure Account. The term "Fund" is strictly applicable to the amounts collected for a special purpose when these are invested, e.g. Scholarship Fund, Prize Fund etc. In other cases, when the amounts collected are not invested in securities or assets distinguishable from those belonging to the institution, the word "Account" is more appropriate e.g. Building Account, Tournament Account etc.

Instead of paying cash, a donor may sometimes give away or transfer a security or some other readily realisable asset. In such a case, the value of asset on valuation, must be credited to the fund for which the amount has been donated. The Bombay Public Trust Rules, 1951. (under revision) required that such amounts should be included in the Income and Expenditure Account of the Trust. If this is done the amount should be simultaneously transferred to the special fund by raising a debit of an equivalent amount in the Income and Expenditure Account.

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

1.6.3. Subscription: Subscriptions being an income, should be allocated over the period of their accrual. For testing the knowledge of candidates of this important accounting principle, questions are often set in examinations wherein figures of subscription collected by a society during the year as well as those outstanding at the beginning of the year and at its close are given. If some subscriptions have been received in advance, their amount is also indicated. In such cases, it is always desirable to set up a Subscription Account for determining the amount of subscription pertaining for the period for which accounts are being prepared. For example, if it is stated that subscriptions collected by a society during the year 2008 amounted to Rs.1,850 out of which Rs.200 represented subscription for the year 2007; Rs.100 were subscriptions collected in advance for the year 2009, and subscriptions amounting to Rs.500 were outstanding for recovery at the end of 2008, the adjusting journal entries and the Subscription Account should be set up as follows :

		Rs.	*Rs.*
Subscription Outstanding Account	Dr.	500	
To Subscriptions Account			500
(The amount outstanding for this year credited to Subscription Account)			
Subscription A/c	Dr.	300	
To Outstanding Subscription A/c			200
To Subscriptions Received in Advance A/c			100
(Subscription received Rs.200 for the previous year and Rs.100 for the next year, adjusted)			

Subscription Account

Dr.					*Cr.*
2008		*Rs.*	*2008*		*Rs.*
Jan 1	To Outstanding Subscriptions	200	Dec.	By Cash A/c	1,850
Dec. 31	To Subscriptions received in advance	100		By Subscriptions outstanding	500
	To Income and Expenditure Account, transfer	2,050			
		2,350			2,350

The amount of outstanding subscription is adjusted in the Subscription Account by debit to Outstanding Subscription Account and that balance is shown as an asset in Balance Sheet. The Subscription Account is closed off by transferring its balance at the end of the year to the Income and Expenditure Account.

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

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

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

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

1.7 PREPARATION OF BALANCE SHEET

(a) Assets appearing in previous balance sheet should be adjusted for (i) addition, (ii) sale, and (iii) depreciation during the year.

(b) New assets acquired (for which payment must have bee entered on the credit side of the receipts and payments account) will be entered in the balance sheet. This also applies to the new liabilities incurred e.g. loans taken. The debit side of receipts and payments account will show this.

(c) Outstanding and prepaid expenses, subscriptions, etc. will be shown in the balance sheet. This also applies to income received in advance.

(d) The closing balance of cash in hand and at bank (as shown in the Receipts and Payments account) will be entered in the Balance Sheet.

(e) Previous year's liabilities should be adjusted for payments made.

(f) Special capital receipts (as shown by receipts and payments account) will be shown in the balance sheet.

(g) Capital Fund (as disclosed by the previous balance sheet) should be adjusted for surplus or deficit and then shown in the balance sheet. Capital fund at any date can be ascertained by deducting liabilities from assets.

Illustration 4

The following was the Receipts and Payments Account of Exe Club for the year ended Dec. 31, 2008

Receipts	*Rs.*	*Payments*	*Rs.*
Cash in hand	100	Groundsman's Fee	750
Balance at Bank as per Pass Book :		Moving Machine	1,500
Deposit Account	2,230	Rent of Ground	250
Current Account	600	Cost of Teas	250
Bank Interest	30	Fares	400

Donations and Subscriptions	2,600	Printing & Office Expenses	280
Receipts from teas	300	Repairs to Equipment	500
Contribution to fares	100	Honoraria to Secretary	
Sale of Equipment	80	and Treasurer of 2007	400
Net proceeds of Variety		Balance at Bank as per Pass Book:	
Entertainment	780	Deposit Account	3,090
Donation for forth		Current Account	150
coming Tournament	1,000	Cash in hand	250
	7,820		7,820

You are given the following additional information:

	Jan. 1 2008	*Dec. 31, 2008*
	Rs.	Rs.
Subscription due	150	100
Amount due for printing etc.	100	80
Cheques unpresented being payment for repairs	300	260
Estimated value of machinery and equipment	800	1750
Interest not yet entered in the Pass book		20
Bonus to Groundsman		300

For the year ended Dec. 31, 2008, the honoraria to the Secretary and Treasurer are to be increased by a total of Rs. 200.

Prepare the Income and Expenditure Account for 2008 and the relevant Balance Sheet.

Solution

Income & Expenditure Account of Exe Club

for the year ending 31st Dec. 2008

		Rs.		*Rs.*
To Groundsman's fee		750	By Donations and Subscription	2,550
To Rent of Ground		250	By Receipts from teas	50
To Travelling Expenses	400		(Fares) less expenses	
Less : Contribution	100	300	By Proceeds of Variety	

To Printing & Office Expenses		260	Entertainment	780
To Repairs		460	By Interest	50
To Depreciation on Machinery				
Op. balance and				
Purchases	2,300			
Less: Closing Balance	1,750			
	550			
Less: Sale	80	470		
To Honoraria				
To Sect. & Treasurer		600		
To Bonus to Groundsman		300		
To Excess of Income over				
Expenditure		40		
		3,430		3,430

Balance Sheet of Exe Club as on 31st Dec. 2008

Liabilities		*Rs.*	*Assets*	*Rs.*
Outstanding Expenses:				
Groundsman Bonus		300	Cash in hand	250
Printing		80	Cash in Deposit A/c	3,090
Honoraria		600	Subscription Due	100
Bank Overdraft (260-150)		110	Interest Due	20
Capital Fund: Opening	3,080		Machinery & Equipments	1,750
Add: Surplus for the year	40	3,120		
Tournament Fund (Donation)		1,000		
		5,210		5,210

Opening Balance Sheet

	Rs.		*Rs.*
Outstanding Expenses		Cash in hand	100
and Honoraria	500	Cash in Deposit A/c	2,230
Capital Fund (Balancing Figure)	3,080	Cash in Current A/c	300
		Subscription Due	150
		Machinery	800
	3,580		3,580

Illustration 5

The Income and Expenditure Account of the Youth Club for the Year 2008 is as follows :

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

This account had been prepared after the following adjustments:

	Rs.
Subscription outstanding at the end of 2007	600
Subscription received in Advance on 31st December, 2007	450
Subscription received in advance on 31st December, 2008	270
Subscription outstanding on 31st Dec., 2008	750

Salaries Outstanding at the beginning and the end of 2008 were respectively Rs. 400 and Rs. 450. General Expenses include insurance prepaid to the extent of Rs. 60. Audit fee for 2008 is as yet unpaid. During 2008 audit fee for 2007 was paid amounting to Rs. 200.

The Club owned a freehold lease of ground valued at Rs. 10,000. The club had sports equipment on 1st January, 2008 valued at Rs. 2,600. At the end of the year, after depreciation, this equipment amounted to Rs. 2,700. In 2007, the Club has raised a bank loan of Rs. 2,000. This was outstanding throughout 2005. On 31st December, 2008 cash in hand amounting to Rs. 1,600.

Prepare the Receipts and Payments Account for 2008 and Balance Sheet as at the end of the year.

Solution

The Youth Club
Receipts and Payments Account
for the year ended 31st Dec., 2008

	Rs.	*Rs.*		*Rs.*	*Rs.*
To Balance b/d		1,390	By Salaries	4,750	
(balancing figure)			*Add:* Paid for 2007	400	
" Subscriptions					
As per Income &				5,150	
Expenditure Account	7,500		*Less:* Unpaid for 2008	450	4,700
Add: 2007's Received	600				
" 2009's Received	270				
	8,370		" General Expenses	500	
Less: 2008's Received in 2007	450		*Add :* Paid for 2007	60	560
	7,920		" Audit fee (2008)		200
Less: 2008's Outstanding	750	7,170	" Secy. Honorarium		1,000
			" Stationery & Printing		450
			" Annual Dinner Expenses		1,500
" Entrance Fees		250	" Interest & Bank Charges		150
" Contribution for			" Sports Equipments		
annual dinner		1,000	[2700-(2600-300)]		400
" Profit on Sport meet :					
Receipt less expenses		750	" Balance c/d		1,600
		10,560			10,560
To Balance b/d		1,600			

Balance Sheet of Youth Club as at December 31, 2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Subscription received			Freehold Ground		10,000
in advance		270	Sport Equipment:		
Audit Fee Outstanding		250	As per last		
Salaries Outstanding		450	Balance Sheet	2,600	
Bank Loan		2,000	Additions	400	
Capital Fund :				3,000	

Balance as per previous			*Less :* Depreciation	300	2,700
Balance Sheet	11,540				
Add : Surplus for 2008	600	12,140	Subscription Outstanding		750
			Insurance Prepaid		60
			Cash in hand		1,600
		15,110			15,110

Balance Sheet of Youth Club as at 31st December, 2008

Liabilities	*Rs.*	*Assets*	*Rs.*
Subscriptions received in advance	450	Freehold Ground	10,000
Salaries Outstanding	400	Sports Equipment	2,600
Audit fees unpaid	200	Subscriptions Outstanding	600
Bank Loan	2,000	Cash in hand	1,390
Capital Fund (balancing figure)	11,540		
	14,590		14,590

Illustration 6

From the following Income and Expenditure Account and the Balance Sheet of a club, prepare its Receipts and Payments Account and Subscription Account for the year ended 31st March, 2008:

Income & Expenditure Account for the year 2007-08

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

Balance Sheet as at 31st March, 2008

Liabilities		*Rs.*	*Assets*	*Rs.*
Subscription in Advance			Furniture	9,000
(2008-09)		100	Ground and Building	47,000
Prize Fund :			Prize Fund Investment	20,000
Opening Balance	25,000		Cash in Hand	2,300

Add : Interest	1,000		Subscription (2007-08)	700
	26,000			
Less : Prizes	2,000	24,000		
General Fund :				
Opening Balance	56,420			
Less : Deficit	2,820			
	53,600			
Add : Entrance Fee	1,300	54,900		
		79,000		79,000

The following adjustment have been made in the above accounts:

(1) Upkeep of ground Rs. 600 and Printing Rs.240 relating to 2006-07 were paid in 2007-08

(2) One-half of entrance fee has been capitalised by transfer to General Fund.

(3) Subscription outstanding in 2006-2007 was Rs. 800 and for 2007-08 Rs. 700.

(4) Subscription received in advance in 2006-2007 was Rs. 200 and in 2007-08 for 2008-09 Rs. 100.

Solution

Receipts and Payment Account

for the year ending 31st March, 2008

Receipts	*Rs.*	*Payments*	*Rs.*
To Balance b/d		By Upkeep of Ground	
(Balancing figure)	4,660	(10,000+600)	10,600
" Subscription	17,320	" Printing (1000+240)	1,240
" Interest on Prize Fund Investments	1,000	" Salaries	11,000
Lecture (fee)	1,500	" Rent	600
" Entrance Fee	2,600	" Prizes	2,000
" Sale of Newspapers (old)	260	" Balance c/d	2,300
" Misc. Income	400		
	27,740		27,740

Working note: Rs. 600 paid for upkeep of ground for 2006-2007 and Rs. 240 paid for printing have been added to the amount shown as expenditure for the year to arrive at total payment under these heads.

Subscription Account

2007			*Rs.*	*2007*			*Rs.*
April	To	Subscription Outstanding (2006-2007)	800	April 1	By	Cash (Balancing figure)	17,320
	"	Subscription In Advance (2007-08)	100		"	Subscription Outstanding (2007-08)	700
					"	Subscription in Advance (2006-07)	200
2008 March		Income & Expenditure A/c	17,320				
			18,220				18,220

Illustration 7

The Sportwriters Club gives the following Receipts and Payments Account for the year ended March 31, 2008 :

Receipts and Payments A/c

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

Figures of other assets and liabilities are furnished as follows:

		as at March 31
	Rs.	*Rs.*
	2007	*2008*
Salaries outstanding	710	170
Outstanding rent & electricity	84	973

Outstanding for magazines and newspapers	226	340
Fixed Deposit (10%) with bank	20,000	20,000
Interest accrued thereon	500	500
Subscription receivable	1,263	1,575
Prepaid expenses	417	620
Furniture	9,600	
Sports equipments	7,200	
Library books	5,000	

The closing values of furniture and sports equipments are to be determined after charging depreciation at 10% and 20% p.a. respectively inclusive of the additions, if any, during the year. The Club's library books are revalued at the end of every year and the value at the end of March 31, 2008 was Rs. 5,250.

From the above information you are required to prepare:

(a) The Club's Balance Sheet as at March 31, 2007;

(b) The Club's Income and Expenditure Account for the year ended March 31, 2008.

(c) The Club's Closing Balance Sheet as at March 31, 2008

Solution

(a) **Sportswriters Club**

Balance Sheet as on 31st March, 2007

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*
Outstanding expenses :			Furniture	9,600
Salaries	710		Library Books	5,000
Rent & Electricity	864		Sports Equipment	7,200
Magazines & Newspapers	226	1,800	Fixed Deposit	20,000
			Cash in hand & at Bank	4,820
Capital Fund (Balancing figure)		47,000	Prepaid Expenses	417
			Subscription receivable	1,263
			Interest accrued	500
		48,800		48,800

(b) Income and Expenditure Account for the year ending 31st March, 2008

Expenditure		*Rs.*	*Income*	*Rs.*
To Salaries		11,460	By Subscription	28,912
" Rent & Electricity		7,329	" Interest	2,000
" Magazines & Newspapers		2,286	" Misc. Income	700
" Sundry Expenses		10,075	" Excess of expenditure	
" Depreciation :			over income	2,888
Furniture	960			
Sports Equipment	1,640			
Library Books	750	3,350		
		34,500		34,500

(c) **Balance Sheet of Sports Writers Club**

as on 31st March, 2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Outstanding Expenses :			Furniture		
Salaries	170		Cost	9,600	
Rent & Electricity	973		*Less* : Depreciation	960	8,640
Newspapers	340	1,483	Magazines &		
Capital Fund:			Sport Equipment:		
Opening balance	47,000		Opening balance	7,200	
Less : Excess of			Addition	1,000	
exp. over income	2,888	44,112		8,200	
			Less : Depreciation	1,640	6,560
			Library Books :		
			Opening Balance	5,000	
			Addition	1,000	
				6,000	
			Less : Depreciation	750	5,250
			Fixed Deposit		20,000
			Cash in hand & at Bank		2,450
			Prepaid Expenses		620
			Subscription Receivable		1,575
			Interest accrued		500
		45,595			45,595

Working Notes :

(i)	*Expenses*	*Salaries*	*Rent &*	*Magazines*	*Sundry*
			Electricity	*& News-*	*Expenses*
			Papers		
		Rs.	*Rs.*	*Rs.*	*Rs.*
	Paid during the year	12,000	7,220	2,172	10,278
	Add : Outstanding on 31.3.2008	170	973	340	––
	Prepaid on 31.3.2007	––	––	––	417
		12,170	8,193	2,512	10,695
	Less : Outstanding on 31.3.2007	710	864	226	––
	Less : Prepaid on 31.3.2008	––	––	––	620
	Expenditure for the year	11,460	7,329	2,286	10,075

				Rs.
(ii)	*Depreciation*			
	(*a*)	Furniture @10% on Rs. 9,600		960
	(*b*)	Sports Equipment @ 20% on Rs. 8,200		1,640
	(*c*)	Library books-book value	6,000	
		Revalued at	5,250	750
(iii)	*Subscription*			
		Received in cash		28,600
		Add : Receivable on 31.3.2008		1,575
				30,175
		Less : Receivable on 31.3.2007		1,263
				28,912

Illustration 8

From the following data, prepare an Income and Expenditure Account for the year ended 31st December. 2008, and a statement of affairs as at that date of the Mayura Hospital :

Receipts and Payments Account for the year ended 31 December, 2008

To	Balances	*Rs.*		By	Salaries :	*Rs.*
	Cash	400			(Rs. 3,600 for 2007)	15,600
	Bank	2,600	3,000	"	Hospital Equipment	8,500
				"	Furniture purchased	3,000
"	Subscriptions :			"	Additions to Building	25,000

	For 2007	2,550	"	Printing and Stationery		1,200
	For 2008	12,250	"	Diet expenses		7,800
	For 2009	1,200	"	Rent and rates		
"	Government Grant :			(Rs. 150 for 2009)		1,000
	For building	40,000	"	Electricity and water		
	for maintenance	10,000		charges		1,200
	Fees from sundry patients	2,400	"	office expenses		1,000
			"	Investments		10,000
"	Donations (not to be	4,000	"	Balances :		
	capitalised)			Cash	700	
"	Net collections from			Bank	3,400	
	benefit shows	3,000				4,100
		78,400				78,400

Additional information :

	Rs.
Value of building under construction as on 31.12.2008	70,000
Value of hospital equipment on 31.12.2008	25,500
Building Fund as on 1.1. 2008	40,000
Subscriptions in arrears as on 31.12.2007	3,250

Investments in 8% Govt. securities were made on 1st July, 2008.

Solution

Mayura hospital

Income & Expenditure Account for the year

ended 31 December, 2008

	Expenditure	*Rs.*		*Income*	*Rs.*
	To Salaries	12,000		By Subscriptions	12,250
"	Diet expenses	7,800	"	Govt. Grants (Maintenance)	10,000
"	Rent & Rates	850	"	Fees, Sundry Patients	2,400
"	Printing & Stationery	1,200	"	Donations	4,000
"	Electricity & Water-charges	1,200	"	Benefit shows (net collections)	3,000
"	Office expenses	1,000	"	Interest on Investments	400
"	Excess of Income over				
	expenditure transferred to	8,000			
	Capital Fund	32,050			32,050

Statement of Affairs as on 31st Dec., 2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital Fund :			Building :		
Opening balance	24,650		Opening balance	45,000	
Excess of Income			Addition	25,000	70,000
Over Expenditure	8,000	32,650			
			Hospital Equipment :		
Building Fund :			Opening balance	17,000	
Opening balance	40,000		Addition	8,500	25,500
Add : Govt. Grant	40,000	80,000			
			Furniture		3,000
Subscriptions			Investments-8% Govt.		
received in advance		1,200	Securities		10,000
			Subscriptions receivable		700
			Accrued interest		400
			Prepaid expenses (Rent)		150
			Cash at Bank		3,400
			Cash in hand		700
		1,13,850			1,13,850

Working Notes :

(1) Statements of Affairs as on 31st Dec., 2007

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital Fund		Building	45,000
(Balancing Figure)	24,650	Equipment	17,000
Building Fund	40,000	Subscription Receivable	3,250
Creditors for Expenses :		Cash at Bank	2,600
Salaries payable	3,600	Cash in hand	400
	68,250		68,250

(2) Building

	Rs.
Balance on 31st Dec. 2008	70,000
Paid during the year	25,000
Balance on 31st Dec. 2007	45,000

(3) Equipment

Balance on 31st Dec. 2008	25,500
Paid during the year	8,500
Balance on 31st Dec. 2007	17,000

(4) Subscription due for 2007

Receivable on 31st Dec. 2007	3,250
Received in 2008	2,550
Still Receivable for 2007	700

Illustration 9

The receipts and payments account and the income and expenditure account of a Club for the year ended 31st December, 2008 were as follows:

Receipts and Payments Account

Receipts		*Rs.*	*Payments*	*Rs.*
To Balance c/d.		2,500	By Books purchased	1,000
To Subscriptions:	Rs.		By Printing and Stationery	200
2007	600		By Salary	1,500
2008	4,300	4,900	By Advertisement	200
			By Electric Charge	400
To Interest		500	By Balance c/d	7,350
To Donation for special fund		300		
To Rent:	Rs.			
2007	150			
2008	300	450		
To Govt. Grants		2,000		
		10,650		10,650

Income and Expenditure Account

Expenditure	*Rs.*	*Income*	*Rs.*
To Salary	2,800	By Interest	400
To Tent Hire	200	By Subscription	4,800
To Electric charges	400	By Rent	2,300
To Depreciation on Building	750	By Govt. Grant	2,000
To Printing and Stationery	200		
To Advertisement	150		
To Surplus	5,000		
	9,500		9,500

The club's assets as on 1st January 2008 were :

Building Rs. 15,000; Books Rs. 10,000

Furniture Rs. 4,000; Investments Rs. 10,000

Liabilities as on that date were Rs. 50 for advertisement and Rs.100 for salary.

You are required to prepare the balance sheet of the club on 31st December, 2007 and 31st December, 2008.

Solution:

Balance Sheet

As at 31st December, 2007

	Rs.		*Rs.*
Capital fund	42,200	Cash in hand	2,500
Outstanding for advertisement	50	Subscriptions outstanding	600
Outstanding for salary	100	Interest outstanding	100
		Rent receivable	150
		Buildings	15,000
		Books	10,000
		Books Purchased	4,000
		Investments	10,000
	42,350		42,350

Balance Sheet

As at 31st December, 2008

		Rs.			*Rs.*
Donation for Special Fund		300	Cash in hand		7,350
Outstanding for salary		1,400	Subscriptions outstanding		500
Outstanding for Tent hire		200	Books	10,000	
Capital Fund			*Add*: Purchase	1,000	11,000
Balance on 31/12/07	42,200				
Add: Surplus	5,000	47,200	Books	15,000	
			Less: Dep.	750	14,250
			Furniture		4,000
			Investments		10,000
			Accrued Rent		2,000
		49,100			49,100

Self-examination problems

I. Objective type questions

Choose the most appropriate answer from the give options:

1. The Receipts and Payments Account record receipts and payments of

   (a) Revenue nature only.

   (b) Capital nature only.

   (c) Revenue as well as capital nature.

   (d) None of the above.

2. Admission fee income should be

   (a) Capitalised.

   (b) Treated as revenue.

   (c) Treated as revenue unless the amount is pretty large.

   (d) Treated as a liability.

3. Legency is

   (a) Added to the capital fund.

   (b) Shown in the income and expenditure account.

   (c) Shown as a separate liability.

   (d) None of the above.

4. The Income and Expenditure Account begins with

   (a) Debit balance.

   (b) Credit balance.

   (c) No balance.

   (d) None of the above.

5. If Rs.1,500 was outstanding at the beginning of the year towards subscription and Rs.10,000 is received during the year, with Rs.2,500 still outstanding at the end of the year the amount to be taken to receipts and payments account is :

   (a) Rs.11,000.

   (b) Rs.8,500.

   (c) Rs.10,000.

   (d) None of the above.

6. A profit on the sale of furniture of a club will be taken to:

   (a) Cash account..

   (b) Receipts and payments account.

   (c) Income and expenditure account.

   (d) Profit and loss account.

7. Sale of old materials must be shown on the credit side of

   (a) Cash Book

   (b) Income & Expenditure Account

   (c) Balance Sheet

   (d) None of the above.

8. Receipts and Payment Account shows

   (a) Income & expenditure.

   (b) Cash receipts and payments.

   (c) Assets and liabilities.

   (d) None of the above.

9. Income and expenditure account reveals:

   (a) Cash in hand.

   (b) Surplus or deficiency.

   (c) Capital account.

   (d) None of the above.

10. Donation received for a specific purpose

   (a) Should be credited to a separate account and shown on the liabilities side of the Balance Sheet.

   (b) Should be credited to income and expenditure account.

   (c) Should not be recorded at all.

   (d) None of the above.

[**Ans. : 1**(c); **2**(c); **3**(a); **4**(c); **5**(a); **6**(c); **7**(b); **8**(b); **9**(b); **10**(a)]

II. Short answer type questions

11. Explain the limitations of Receipts and Payments account in brief.

12. Discuss the accounting treatment of donations received for a specific purpose while preparing balance sheet of a club.

13. “Receipts and payments account is same as cash book”. Comment.

III. Long answer type questions

14. Explain the purposes of Receipts and Payments Account prepared by a non-profit making organisation. How does it differ from Income and Expenditure Account?

15. Describe he procedure of preparing income and expenditure account from the given receipts and payments account.

IV. Practical problems

16. From the following information prepare Receipts and Payments Account and Income and Expenditure Account of ABC Club for the year ended 31st December, 2008.

    Subscriptions received from the members for the year 2008 Rs. 1,20,000, Subscription receipts for 2007 Rs. 20,000, Subscription received in advance for 2009 Rs. 5,000, Donations received Rs. 25,000, Sale of old furniture Rs. 200 (Cost Rs. 500, W.D.V. Rs. 400) Wages of the groundsman Rs. 24,000, General expenses Rs. 30,000, Expenses for the tournaments Rs. 50,000, Repairs to ground Rs. 10,000, Audit fee Rs. 500, Cash at Bank Rs. 60,000, Subscription Outstanding Rs. 15,000 Wages outstanding Rs. 10,000, Office Furniture Rs. 15,000, Depreciation is usually charged @ 20% p.a. The club decided to keep Rs. 500 in hand at the end of the year and to invest the balance other than balance lying with bank in 20% in shares of XYZ Ltd.

17. The Receipts and Payments Account of Holy Family Hospital is given below from which you are required to prepare an Income and Expenditure Account for the year ended 31st December, 2008 :

Receipts & Payments Account

Receipts	*Rs.*	*Payments*	*Rs.*
Sale of Investment	50,000	Salary to Staff	4,25,000
Bill of Cost	11,25,000	General Expenses	75,000
		Audit Fees	10,000
		Balance :	
		Cash at Bank	3,25,000
		Cash in hand	3,40,000
	11,75,000		11,75,000

Other Information:

(i) Specialists fees Rs. 2,50,000.

(ii) Bill for Equipment Rs. 5,50,000.

(iii) Charge depreciation @10% on equipment, balance of which at the beginning of the year was Rs. 7,50,000.

(iv) Miscellaneous Income not accounted for Rs. 500.

(v) Donations not accounted for Rs. 15,000.

vi) During the year the hospital authority made a camp for charitable eye operation for which is expended Rs. 15,000. The contractor did not raise the bill yet.

(vii) The Chairman of the hospital travelled to U.K. and collected donations amounting to Rs. 15,000,000 which are not yet accounted and travelling expenses amounting to Rs. 40,000 are yet to be adjusted.

You are also required to redraft the Receipts and Payments Account.

18. Delhi Football club gives you the following Balance Sheet dated 31st December, 2007:

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital Fund	11,00,000	Lease hold ground	4,50,000
Tournament Funds	2,00,000	Furniture	50,000
Prize Fund	1,00,000	Tournament Fund investment	2,00,000
Current Liabilities	50,000	Private Fund Investment	1,00,000
		Other Investments	3,00,000
		Sports Equipments	50,000
		Cash at Bank	2,80,000
		Cash in hand	20,000
	14,50,000		14,50,000

Receipts during the year: Subscriptions are Rs. 10 Lakhs, Donations for Tournament are Rs. 15,000, Donations for Prize are Rs. 25,000, Income from Investment is Rs. 60,000.

Expenditure: Sports Material is Rs. 2,50,000, Repair to the ground is Rs. 50,000, Wages to the office staff is Rs. 2,50,000, Expenses for Tournament are Rs. 50,000, Expenses for prizes are Rs. 40,000, Construction cost of Club Building is Rs. 1,25,000.

Outstanding Expenses: Audit Fees is Rs. 3,000. Stationery is Rs. 4000, fees of the coach is Rs. 40,000, Bills of the supplies of Sports Material is Rs. 25,000, Bills of the suppliers of prizes is Rs. 5,000, Charges Depreciation @20% on office equipments, Construction of Building is in Progress : Contractor raises the bill of Rs. 2,50,000 which has been approved by management committee.

You are asked to prepare Income and Expenditure Account for the year ended 31st December, 2008 and Balance Sheet as on that date.

UNIT – 2 : ACCOUNTING FOR EDUCATIONAL INSTITUTIONS

Learning Objectives

After studying this unit, you will be able to:

- Understand various sources of income and avenues of expenses in an educational institution.
- Learn the techniques of preparation of Income and Expenditure Account and Balance Sheet of an Educational institution.

2.1 ORGANISATIONAL PATTERN & SALIENT FEATURES OF AN EDUCATIONAL INSTITUTION

The educational institutions which are functioning in India are mostly registered as Societies under the Indian Societies Registration Act of 1860, in some of the States, where Public Trust Acts have been passed all the Societies registered under the Indian Societies Registration Act, 1860 are required to be simultaneously registered under the Trust Act. Accordingly, in the State of Maharastra, all the Societies have simultaneously been registered under the Bombay Public Trust Act, 1950.

The Trust Societies are autonomous bodies with office bearers consisting of President, Secretary, Treasurer and Executive Committee Members. The General Body consists of all the Members of the Society. In case of Societies/Trusts which run a number of colleges and schools etc., for managing the affairs of each individual school or college, there is a governing body, wherein the head of the Unit, such as Principal of the college or Head Master of the school as, the case may be, are also members of the Governing Body.

The function of the Governing Body is to supervise the smooth functioning of the individual school or college. Under the University Act, each college has a Governing Body which is a statutory requirement. The Principal of the College is an Ex-officio Secretary of the said Governing Body.

The basic tenets pre-suppose, that part of the expenses of the educational institutions are to met from the funds raised by the educational institutions themselves, either from donations, or from charities, collected from benevolent citizens in the country.

The State Governments through grant-in-aid-code have evolved different patterns of giving assistance to the educational institutions. There is, as such, no uniformity in the giving of assistance to the educational institutions in the form of grants.

All the educational institutions follow financial year as their accounting year.

2.2 SOURCES OF FINANCE FOR RUNNING THE EDUCATIONAL INSTITUTION

There are three main sources through which amounts are collected by the educational institutions. These are:

(1) Donation from Public;

(2) Fees in the from of annual tuition fees, term fees, admission fees, laboratory fee etc., and

(3) Grants received from the Government.

The Government grants are of four kinds namely Maintenance Grant, Equipment grant, Building Grant and such other grants as may be sanctioned by the Government from time to time.

2.2.1. Donation from Public: These are received either for recurring or non-recurring purposes. Donations are received either in cash or in kind. The 'in kind' donations are in the form of land and building, shares and securities, utensils, furniture and fixtures and the like, generally with a desire to perpetuate the memory of a distinguished member of the family of the donor.

2.2.2. Capitation fee or admission fee: Amounts are collected from parents/guardians of the students who seek admission in the educational institution. These are either in the form of capitation fees or admission fees and are generally collected by the Parent Body which runs the institution. In recent times, such collections have been a matter of severe attack and ban.

2.2.3. Laboratory and Library deposit: These are generally collected by schools and colleges and they remain with the institution till the student finally leaves it.

The School Code prescribes the rates of tuition and other fees, to be charged from the students.

2.2.4. Use of Term Fee: A separate account of receipts and expenditures shall be maintained and surplus carried over to the next year. The following are main items on which term fee can be used:

(1) Medical Inspection.

(2) School Magazine-manuscript and/or printing.

(3) Examination expenses i.e. printing, including cyclo-styling of question papers and supply of answer books if there is sufficient balance.

(4) Contribution to athletic and cultural associations, connected with school activities.

(5) School functions and festivals.

(6) Inter-class and Inter-school tournaments.

(7) Sports and Games-major and minor.

(8) Newspapers and magazines.

(9) Extra-curricular excursion and visits.

(10) School competition such as elocution competition etc.

(11) Scouting and Guiding.

(12) School Band.

(13) Social and Cultural activities and equipment required for the same.

(14) Vocational Guidance in general.

(15) Prizes for Co-curricular activities.

(16) Any other extra-curricular or co-curricular activities.

(17) Maintenance of playground.

(18) Purchase of books for Pupils Library.

(19) Drawing and Craft material.

(20) Audio-Visual Education.

(21) Curricular visits and excursions.

(22) Equipment for Physical education.

(23) A.C.C., N.C.C and N.D.S.

2.2.5. Recurring grants: Recurring grants in the form of Maintenance Grants are received in instalments spread out throughout the year.

The School Code provides that proprietary school or college i.e. institutions which are not registered either under the Societies Registration Act, 1860 or the Bombay Public Trust Act, 1950 or any other Act that may be specified by the Government and communal schools will not be eligible for any grant from the Government.

2.2.6. Use of grant-in-aid: The School Code provides a detailed list of items of expenditure which are admissible for grant-in-aid:

(1) Staff salaries and allowances

(2) Leave Allowance.

(3) Bad Climate Allowance.

(4) Water Allowance.

(5) Leave Salary.

(6) Expenditure on training of teachers.

(7) Pension and Gratuity as may be applicable.

(8) Expenditure on the appointment of Librarian.

(9) Rent, Taxes and Insurance.

(10) Other Contingencies: Under this head is covered expenditure of printing and stationery, conveyance expenditure, expenditure on purchase of books and furniture equipment (for which no special grant has been claimed provided it is upto the limit of 12 percent of the total admissible expenditure in Maharashtra).

(11) Current repairs to the extent of 5 percent of the amount of grant of total expenditure of the School or 1-1/2 percent of the cost of the building calculated as directed under Government Resolution No.2321 dated 1-9-1923 as modified from time to time.

(12) Miscellaneous Expenses:

School Garden, Physical Education.

(13) Prizes.

(14) Expenditure on co-operative stores.

(15) Registration fee paid to the Board for recognition.

(16) Maintenance of Tiffin Rooms.

(17) Bonus to Teachers.

(18) Electrical charges.

(19) Telephone Charges.

(20) Expenditure in connection with Conferences.

(21) Subscription to educational Association etc.

(22) Medical charges.

(23) Audit fees of the auditors in accordance with prescribed scale. The minimum being Rs.75 upto admissible expenditure Rs.50,000 and minimum Rs.300 for expenditure over Rs.50,000.

(24) Sales-tax and General tax on purchase of the school requirements.

(25) Payments for merit scholarships.

Illustration 1

From the following Trial Balance of Education Society as on 31st Dec., 2008; prepare an Income & Expenditure Account and a Balance Sheet:

	Dr. *Rs.*	*Cr.* *Rs.*
Furniture & Fittings	12,500	
Additions to Furniture (during the year)	3,200	
Library Books	17,500	
Addition to Library (during the year)	4,300	
Building	2,75,000	
General Investment	1,50,000	
Investment Reserve fund		15,000
Sundry Debtors and Creditors	5,000	14,500
Entrance Fee		15,200
Examination Fee		2,400
Subscription Received		20,000
Certificate fee		500
Hire of Society's Hall		6,500
Interest on Investment		5,500
Sundry receipts		600
Staff Salaries	10,200	
Printing, Stationery & Advertising	1,000	
Taxes & Insurance	800	
Examination Expenses	600	
Subscription of Periodicals	1,200	
Prize Trust Fund		16,000
Prize Trust Investment	15,800	
Prize Trust Income		650
Prize Awarded	450	
Prize Fund Bank	275	
Donations received (to be capitalised)		18,000
General Expenses	375	
Capital Fund		3,89,150
Cash at Bank	5,500	
Cash in hand	300	
	5,04,000	5,04,000

The following further information is supplied to enable you to make the necessary adjustments:

	Rs.
Subscriptions receivable	4,500
Subscription received in advance	500
Interest on General Investment accrued	450
Staff salaries outstanding	1,800
Taxes & Insurance Paid in Advance	500

Provide depreciation at the following rates (including the additions):

Library books	15% p.a.
Furniture & fittings	5% p.a.
Building	5% p.a.

The market value of General Investments on 31st Dec. 2008 was Rs.1,30,000. You are not required to make any provision for this fall in value.

Bharat Education Society
Income and expenditure Account
for the year ended at 31st Dec., 2008

		Rs.	*Rs.*		*Rs.*	*Rs.*
To	Staff salaries	10,200		By Subscription	20,000	
"	*Add:* Outstanding	1,800	12,000	*Add:* Outstanding	4,500	
"	Printing, Stationery				24,500	
	& Advertising		1,000	*Less:* Received		
"	Taxes & Insurance	800		in advance	500	
	Less: Prepaid	500	300			24,000
"	Examination Expenses		600	" Entrance Fee		15,200
"	Subscription to			" Examination Fee		2,400
	Periodicals		1,200	" Certificate Fee		500
"	General expenses		375			
"	Depreciation :			" Hire of Society's Hall		6,500
	Library Books	3,270				
	Furniture & Fittings	785		" Interest on Investment		
				Received	5,500	
	Building	13,750	17,805	*Add:* Accrued	450	5,950
"	Excess of Income			" Sundry Receipts		600
	Over Expenditure		21,870			
			55,150			55,150

Balance Sheet of Bharat Education Society as on 31st Dec., 2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital Fund	3,89,150		Building cost	2,75,000	
Add: Excess of			*Less:* Depreciation	13,750	2,61,250
Income over					
Expenditure	21,870	4,11,020	Furniture & Fittings	12,500	
Investment Res. Fund		15,000			
Prize Trust Fund	16,000		*Add:* Additions		
Income less Prizes	200	16,200	during the year	3,200	
Capital Reserve		18,000		15,700	
Subscription received			*Less:* Depreciation	785	14,915
in advance		500			
Salaries Outstanding		1,800			
Sundry Creditors		14,500	Library Books	17,500	
			Add: Additions		
			during the year	4,300	
				21,800	
			Less: Depreciation	3,270	18,530
			General Investment		1,50,000
			(M.V. Rs.1,30,000)		
			Interest Accrued		450
			Sundry Debtors		5,000
			Prize Trust Investments		15,800
			Prize Fund cash at bank		275
			Cash at Bank		5,500
			Cash in hand		300
			Subscription due		4,500
			Taxes & Insurance prepaid		500
		4,77,020			4,77,020

Illustration 2

From the following balances and particulars of Republic College prepare Income & Expenditure Account for the year ended March, 2008 and a Balance Sheet as on the date :

	Rs.	*Rs.*
Seminars & Conference Receipts		4,80,000
Consultancy Receipts		1,28,000
Security Deposit-Students		1,50,000
Capital fund		16,06,000
Research Fund		8,00,000
Building Fund		25,00,000
Provident Fund		5,10,000
Tuition Fee received		8,00,000
Government Grants		5,00,000
Donations		50,000
Interest & Dividends on Investments		1,85,000
Hostel Room Rent		1,75,000
Mess Receipts (Net)		2,00,000
College Stores-Sales		7,50,000
Outstanding expenses		2,25,000
Stock of-stores and Supplies	3,00,000	
Purchases-Stores & Supplies	8,00,000	
Salaries-Teaching	8,50,000	
Research	1,20,000	
Scholarships	80,000	
Students Welfare expenses	38,000	
Repairs & Maintenance	1,12,000	
Games & Sports Expenses	50,000	
Misc. Expenses	65,000	
Research Fund Investments	8,00,000	
Other Investments	18,50,000	
Provident Fund Investment	5,10,000	
Seminar & Conference Expenses	4,50,000	
Consultancy Expenses	28,000	
Land	1,00,000	
Building	16,00,000	
Plant and Machinery	8,50,000	
Furniture and Fittings	6,00,000	

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

Adjustments:

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

Solution

Republic College
Income and Expenditure Account
for the year ending 31st March, 2008

Expenditure	*Rs.*	*Rs.*	*Income*	*Rs.*	*Rs.*
To Salaries: Teaching		8,50,000	ByTuitions & other fee		8,80,000
Research		1,20,000			
" Material & Supplies Consumed			" Govt. Grants		5,00,000
Teaching		50,000	" Income from		
Research		1,50,000	Investments		1,85,000

			" Hostel room Rent		1,75,000
" Repairs & Maintenance		1,12,000	" Mess Receipts		2,00,000
" Sports & Games Exp.			" profit-stores sales		75,000
Cash	50,000		" Seminar and Conferences		
Materials	25,000	75,000	Income	4,80,000	
			Less : Exp.	4,50,000	30,000
To Students Welfare Exp.					
Cash	38,000		" Consultancy charges :		
Materials	75,000	1,13,000	Income	1,28,000	
			Less : Exp.	28,000	
" Misc. Expenses		65,000			1,00,000
" Scholarships		80,000	" Donations		50,000
" Depreciation					
Building		80,000			
Plant & Equipment		85,000			
Furniture		60,000			
Motor Vehicle		36,000			
" Excess of Income over					
Expenditure		3,19,000			
		21,95,000			21,95,000

Republic College

Balance Sheet as on 31st March, 2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
			Fixed Assets:		
Capital Fund			Land		1,00,000
Opening balance	16,06,000		Building Cost	16,00,000	
Add : Excess of Income					
over Expenditure	3,19,000	19,25,000	*Less:* Dep.	5,60,000	
Other Funds					10,40,000
Research Fund		8,00,000	Equipment		
Building Fund		25,00,000	Cost	8,50,000	
			Less : Dep.	5,95,000	2,55,000
Current Liabilities :					
Outstanding Expenses		2,25,000	Furniture & Fittings:		

Provident Fund	5,10,000	Cost	6,00,000	
Security Deposit	1,50,000	*Less :* Dep.	3,96,000	
				2,04,000
		Motor Vehicles		
		Cost :	1,80,000	
		Less : Dep.	36,000	
				1,44,000
		Library		3,60,000
		Investments:		
		Capital Fund Investments		18,50,000
		Research Fund Investment		8,00,000
		P.F. Investment		5,10,000
		Stock :		
		Material & Supplies		1,25,000
		Grants receivable		80,000
		Cash in hand & at Bank		6,42,000
	61,10,000			61,10,000

Working Notes :

(1) Material & Supplies-Closing Stock

Opening Stock		3,00,000
Purchases		8,00,000
		11,00,000
Less : Cost of Sales	6,75,000	
Consumed	3,00,000	9,75,000
Balance		1,25,000

(2) Provisions for Depreciation

	Building	*Plant & Equipment*	*Furniture & Fitting*
	Rs.	*Rs.*	*Rs.*
Opening Balance	4,80,000	5,10,000	3,36,000
Addition	80,000	85,000	60,000
Closing Balance	5,60,000	5,95,000	3,96,000

2.3 TECHNIQUE OF MAINTAINING FUND ACCOUNTS

Fund based accounting essentially involves preparation of financial statements fund-wise. In case of institution like colleges, schools and universities-separate ledgers are maintained for each fund. Fund ledgers are self balancing in nature. A fund may be created for purchase, acquisition or construction of fixed assets or for any specific activities of the organisations or for both. For example, a building fund may be created with a view to purchase, acquire or construct buildings. All receipts in connection with the acquisition or construction of buildings are separated from the main accounts and shown in the building fund. Any expenditure incurred for the purpose of construction or acquisition of building are made out of this fund. When building is ultimately acquired or constructed, the asset is recognised in the general balance sheet and consequently that portion of the building fund which has been utilised for the acquisition or construction of the building should be transferred to general fund. Depreciation can be charged on such funds only after its completion or acquisition.

In the same way, separate funds may be created for equipments, major repairs to fixed assets and for other developmental activities.

Illustration 3

Noida School maintains separate building fund. As on 31.3.2007, balance of building fund was Rs. 10,00,000 and it was represented by fixed deposit (15% per annum) of Rs.6,00,000 and current account balance of Rs.4,00,000. During the year 2007-08, the school collected as donations towards the building fund Rs.5,60,000 and transferred 40% of developmental fees collected Rs.22,56,500 to building fund. Capital work progress as on 31st March, 2007 was Rs.8,25,000 for which contractors' bill upto 75% was paid on 14.4.2008. The extension of building was finished on 31.12.2007 costing Rs.7,25,000 for which contractors' bill was fully met. It was decided to transfer the cost of completed building (Rs.15,50,000) to the corresponding asset account.

You are required to pass journal entries to incorporate the above transactions in the books of Noida School for the year 2007-08 and show the trial balance of building fund ledger.

Solution

Journal Entries for Building Fund Ledger

			Rs.	Rs.
(1)	Bank A/c	Dr.	5,60,000	
	To Building fund A/c			5,60,000
	(On collection of donations)			
(2)	Bank A/c	Dr.	9,02,600	
	To Building fund A/c			9,02,600
	(40% of the development fees directly transferred to building fund)			

(3)	Fixed deposit A/c	Dr.	90,000	
	To Interest A/c			90,000
	(On accrual of interest)			
(4)	Interst A/c	Dr.	90,000	
	To Building fund			90,000
	(Interest accrued on fixed deposit transferred)			
(5)	Capital work in progress A/c	Dr.	7,25,000	
	To Contractors' A/c			7,25,000
	(Work completed and certified during the year)			
(6)	Contractors' A/c	Dr.	13,43,750	
	To Bank A/c			13,43,750
	(Payments made during the year)			
(7)	Building A/c	Dr.	15,50,000	
	To Bank A/c			15,50,000
	(Transfer of completed buildings to Asset A/c)			
(8)	Building Fund A/c	Dr.	15,50,000	
	To General Fund A/c			15,50,000
	(Corresponding building fund transferred)			

Trial Balance of Building Fund as on 31st March, 2008

	Dr. *Rs.*	*Cr.* *Rs.*
Building Fund		10,02,600
Contractors' A/c		2,06,250
Fixed Deposit A/c	6,90,000	
Current A/c	5,18,850	------------
	12,08,850	12,08,850

Self-Examination Problems

I. Objective type questions

1. Should the following be debited to the Income & Expenditure Account of a School?
   - (i) Scholarship granted to Harijan students out of funds provided by Government.
   - (ii) Prizes on the annual day.
   - (iii) Cost of maps for the geography classes.
   - (iv) Cost of erection of a pavillion on the playground.
   - (v) Purchase of bats, hockey, sticks etc., out of the games fund.

(vi) Laboratory expenses.

[**Answer**: Only(ii) and (vi) should be debited; also depreciation on (iii) and (iv)].

2. State which of the following expenses will be debited/credited in the current year's Income and Expenditure Account of a Society.
   (i) Expense against a project grant from the State Government.
   (ii) Travelling expenses of a delegation sent to West Germany.
   (iii) Subsidy received for publication of low priced text books.
   (iv) Collection from advertisers in the Society's Journal.
   (v) Prize awarded out of prize fund.
   (vi) Subscription recovered which was written off in a previous year.
   (vii) Interest on Investment against a Prize fund.

[**Answers** : **1.** (v); **2.** (vii) will be excluded]

3. Choose the most appropriate answer from the given options:
   (i) Main sources of finance for running an educational institution are
      (a) Donations.
      (b) Admission fees.
      (c) Government grants.
      (d) All of he above.
   (ii) Fund ledgers are
      (a) Self-balancing.
      (b) Sectional balancing.
      (c) Balanced with the help of suspense account.
      (d) None of the above.

[**Answers**. **(i)** (d); **(ii)** (a)]

II. Short answer type questions

Distinguish between :

4. Funds and Reserves.
5. Entrance Fees and Membership Subscriptions
6. Donation for a general fund and donations for a special fund.
7. Receipts and Income.
8. Payment and Expenditure.
9. What is meant by ‘Fund base accounting’? Explain in brief.

III. Long answer type questions

10. Describe the main sources of finance for running an educational institution.

11. Explain the techniques of preparing income and expenditure account and balance sheet of a school.

IV. Practical Problems

12. From the following information, ascertain the amount to be credited to the Income and Expenditure Account in respect of subscriptions for 2008.

	Rs.
Subscriptions received in cash	33,500
Subscriptions received in advance on 31.12.2007	2,500
Sunscriptions Outstanding on 31.12.2007	3,000
Subscriptions Outstanding on 31.12.2008	2,000
Subscriptions received in Advance on 31.12.2008	500

13. Able Accountants Society prepared the following "Income and Expenditure Account":

	Rs.	*Rs.*		*Rs.*	*Rs.*
To Balance b/d		8,000	By Salaries		
To Subscriptions:			Paid	7,200	
Received	26,000		*Add:* Outstanding	800	8,000
Due	1,500	27,500			
To Sale of old Books			By Stationery:		
(cost Rs.300)		800	Purchased	1,100	
To Interest Received & due		1,200	*Less:* In Stock	200	900
			By Cost of Entertainment		7,500
			By Books added to the Library		1,700
			By Periodicals (light & technical)		900
			By Rent		5,000
			By Cost of Lectures		4,000
			By Balance c/d		9,500
		37,500			37,500

Criticize the account by pointing out the errors in preparation.

CHAPTER 10

ACCOUNTS FROM INCOMPLETE RECORDS

Learning Objectives

After studying this unit, you will be able to:

- Learn how to derive capitals at two different points of time through statement of affairs.
- Learn the technique of determining profit by comparing capital at two different points of time.
- Learn how to adjust fresh capital investment and withdrawals by the proprietors/partners.
- Learn how to apply standard gross profit ratio to find out cost of sales and purchases.
- Learn how to find out sales using gross profit ratio given purchases and stock.
- Learn how to find out sales, applying gross profit ratio and adjusting for trend.

1. INTRODUCTION

Very often the small sole proprietorship and partnership businesses do not maintain double entry book keeping system. Sometimes they keep record only of the cash transactions and credit transactions. Sometimes they maintain no record of many transactions. But at the end of the accounting period they want to know the performance and financial position of their businesses. This creates some special problems to the accountants. This study paper discusses how to complete the accounts from available incomplete records.

The term "Single Entry System" is popularly used to describe the problems of accounts from incomplete records. In fact there is no such system as single entry system. In practice the quack accountants follow some hybrid methods. For some transactions they complete double entries. For some others they just maintain one entry. Still for some others, they even do not pass any entry. This is no system of accounting. Briefly, this may be stated as incomplete records. The task of the accountant is to establish linkage among the available information and to finalise the accounts.

2. ASCERTAINMENT OF PROFIT BY CAPITAL COMPARISON

In the study material of Fundamentals of Accounting of Common Proficiency Test, we have discussed that profit is given by the difference between the capital balances of two different dates.

This means:-

Closing Capital - Opening Capital = Profit

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

2.1 Methods of Capital Comparison

Capital is increased if there is profit, while capital is reduced if there is loss. However, if the proprietor/partners made fresh investments in the business, capital is increased; if they make withdrawal capital is reduced. So while determining the profit by capital comparison, the following rules should be followed.

	Rs.
Capital at the end	
Add: Drawings	....
Less: Fresh capital introduced	.....
Capital in the beginning	.....
Profit	.....

It is clear from the above discussion that to follow the capital comparison method one should know the opening capital and closing capital. This should be determined by preparing statement of affairs at the two respective points of time. Capital always equals assets minus liabilities.

Thus preparation of statement of affairs will require listing up of assets and liabilities and their amount. The accountant should try to find out various fixed assets like building, machinery, furniture, vehicles, etc. and various current assets like stock in-trade, sundry debtors, bills receivable, loans and advances, cash and bank balances etc. Similarly he should identify various liabilities like loans from banks and other organisations, bank overdraft, sundry creditors, bills payable, outstanding expenses, etc. He may get some information from the current account statement of the business, from cash book and the personal diary maintained by the proprietor/partners.

After obtaining all necessary information about assets and liabilities, the next task of the accountants is to prepare statement of affairs at two different points of time. The design of the statement of affairs is just like balance sheet as given below:

Statement of affairs as on ....

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital (Bal. Fig.)		Building	

Loans, Bank overdraft	Machinery
Sundry creditors	Furniture
Bills payable	Stock
	Sundry debtors
	Bills receivable
	Loans and advances
	Cash and bank

Now from the statement of affairs prepared for two different dates, opening and closing capital balances can be obtained. These capital balances would prepare balancing figures as shown in the above statement of affairs.

2.2 Preparation of Statement of Affairs and Determination of Profit

It has been discussed in Para 2.1 that figures of assets and liabilities should be collected for preparation of statement of affairs. Given below an example:

Illustration 1

Assets and Liabilities of Mr. X as on 31-12-2007 and 31-12-2008 are as follows:

	31-12-2007 *Rs.*	*31-12-2008* *Rs.*
Assets		
Building	1,00,000	
Furniture	50,000	
Stock	1,20,000	2,70,000
Sundry Debtors	40,000	90,000
Cash at Bank	70,000	85,000
Cash in Hand	1,200	3,200
Liabilities		
Loans	1,00,000	80,000
Sundry Creditors	40,000	70,000

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

Prepare Statement of Affairs.

Statement of Affairs

as on 31-12-2007 & 31-12-2008

Liabilities	*31-12-2007*	*31-12-2008*	*Assets*	*31-12-2007*	*31-12-2008*
	Rs.	*Rs.*		*Rs.*	*Rs.*
Capital	2,41,200	4,40,700	Building	1,00,000	97,500
(Balancing Figures)			Furniture	50,000	45,000
Loans	1,00,000	80,000	Stock	1,20,000	2,70,000
Sundry Creditors	40,000	70,000	Sundry Debtors	40,000	90,000
			Cash at Bank	70,000	85,000
			Cash in Hand	1,200	3,200
	3,81,200	5,90,700		3,81,200	5,90,700

Illustration 2

Take figures given in Illustration 1. Find out profit of Mr. X.

Solution

Determination of Profit by applying the method of the capital comparison.

	Rs.
Capital Balance as on 31-12-2008	4,40,700
Less : Fresh capital introduced	40,000
	4,00,700
Add : Drawings (Rs. 2000 × 12)	24,000
	4,24,700
Less : Capital Balance as on 31-12-2007	2,41,200
Profit	1,83,500

Note :

- Closing capital is increased due to fresh capital introduction, so it is deducted.
- Closing capital was reduced due to withdrawal by proprietor; so it is added back.

Illustration 3

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

	31-3-2007	*31-3-2008*
	Rs.	*Rs.*
Furniture	1,20,000	

Advances	70,000	50,000
Creditors	32,000	30,000
Debtors	40,000	45,000
Stock	60,000	74,750
Loan	80,000	—
Cash at Bank	50,000	1,40,000

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

Drawings of A and B

	A	*B*
	Rs.	*Rs.*
April 30	2,000	—
May 31	—	2000
June 30	4,000	—
Sept. 30	—	6,000
Dec. 31	2,000	—
Feb. 28	—	8,000

On 30th June, they took C as 1/3rd partner who contributed Rs. 75,000. C is entitled to share of 9 months' profit. The new profit ratio becomes 1:1:1. A withdrew his proportionate share. Depreciate furniture @ 10% p.a., new purchases Rs. 10,000 may be depreciated for 1/4th of a year.

Current account as on 31-3-2007: A Rs. 5,000 (Cr.), B Rs. 2,000 (Dr.)

Prepare Statement of Profit, Current Accounts of partners and Statement of Affairs as on 31-3-2008.

Solution

Statement of Affairs

As on 31-3-2007 and 31-3-2008

Liabilities	*31-3-2007*	*31-3-2008*	*Assets*	*31-3-2007*	*31-3-2008*
	Rs.	*Rs.*		*Rs.*	*Rs.*
Capital A/cs					
A	1,50,000	75,000	Furniture	1,20,000	1,17,750
B	75,000	75,000	Advances	70,000	50,000
C	—	75,000	Stock	60,000	74,750
Loan	80,000	—	Debtors	40,000	45,000

			Cash at Bank	50,000	1,40,000
Creditors	32,000	30,000	Current A/c		
			B	2,000	—
Current A/cs					
A	5,000	74,036*			
B	—	48,322*			
C	—	50,142*			
	3,42,000	4,27,500		3,42,000	4,27,500

**See* current A/cs.

Notes:

(*i*) *Depreciation on Furniture*

10% on Rs. 1,20,000	Rs. 12,000
10% on Rs. 10,000 for 1/4 year	Rs.250
	Rs. 12,250

(*ii*) *Furniture as on 31-3-2008*

Balance as on 31-3-2007	Rs. 1,20,000
Add: new purchase	Rs. 10,000
	Rs. 1,30,000
Less: Depreciation	Rs. 12,250
	Rs. 1,17,750

(*iii*) Total of Current Accounts as on 31-3-2008

Total of Assets	Rs. 4,27,500
Less : Fixed Capital + Liabilities	Rs. 2,55,000
	Rs. 1,72,500

This is after adding salary, interest on capital and deducting drawings and interest on drawings.

(*iv*) *Interest on Capital* :

A :	on	Rs. 1,50,000	@ 6% for 3 months	Rs. 2,250
	on	Rs. 75,000	@ 6% for 9 months	Rs. 3,375
				Rs. 5,625
B :	on	Rs. 75,000	@ 6% for 1 year	Rs. 4,500
C :	on	Rs. 75,000	@ 6% for 9 months	Rs. 3,375
				Rs. 7,875

(*v*) *Interest on Drawings* :

A	: on	Rs. 2,000	@ 10% for 11 months	Rs. 183
	: on	Rs. 4,000	@ 10% for 9 months	Rs. 300
	: on	Rs. 2,000	@ 10% for 3 months	Rs. 50
				533
B	: on	Rs. 2,000	@ 10% for 10 months	167
	: on	Rs. 6,000	@ 10% for 6 months	300
	: on	Rs. 8,000	@ 10% for 1 month	67
				534

Allocation of Profit	Rs.1,15,067
3 months Profit	Rs. 28,767
9 months Profit	Rs. 86,300
A : 2/3 × Rs. 28,767 + 1/3 × Rs. 86,300	= Rs. 47,944
B : 1/3 × Rs. 1,15,067	= Rs. 38,356
C: 1/3 × Rs. 86,300	= Rs. 28,767
	Rs.1,15,067

Current Accounts

Dr. *Cr.*

	A	*B*	*C*		*A*	*B*	*C*
To Balance b/d	—	2,000	—	By Balance b/d	5,000	—	—
" Drawings	8,000	16,000	—	" Salary	24,000	24,000	18,000
" Interest on drawings	533	534	—	" Interest on capital	5,625	4,500	3,375
" Balance c/d	74,036	48,322	50,142	" Share of Profit	47,944	38,356	28,767
	82,569	66,856	50,142		82,569	66,856	50,142

Statement of Profit

					Rs.
Current Account Balances as on 31-3-2008					1,72,500
Less: Salary	A Rs. 2,000 × 12	=	Rs.	24,000	
	B Rs. 2,000 × 12	=	Rs.	24,000	
	C Rs. 2,000 × 9	=	Rs.	18,000	(66,000)
Less: Interest on Capital		A	Rs.	5,625	

	B	Rs.	4,500	
	C	Rs.	3,375	(13,500)
Add: Drawings	A	Rs.	8,000	
	B	Rs.	16,000	24,000
" Interest on Drawings	A		533	
	B		534	1,067
				1,18,067
Less: Current A/c Balances as on 31-3-2007 Rs. 5,000 – Rs. 2,000				3,000
				1,15,067

Illustration 4

The Income Tax Officer, assuming the income of Shri Moti for the financial years 2006-2007 and 2007-2008 feels that Shri Moti has not disclosed the full income. He gives you the following particulars of assets and liabilities of Shri Moti on 1st April 2006 and 1st April, 2008.

				Rs.
1-4-2006	Assets	:	Cash in hand	25,500
			Stock	56,000
			Sundry Debtors	41,500
			Land and Building	1,99,000
			Wife's Jewellery	75,000
	Liabilities	:	Owing to Moti's Brother	40,000
			Sundry Creditors	35,000
1-4-2008	Assets	:	Cash in hand	16,000
			Stock	91,500
			Sundry Debtors	52,500
			Land and Building	1,90,000
			Motor Car	1,25,000
			Wife's Jewellery	1,25,000
			Loan to Moti's Brother	20,000
	Liabilities	:	Sundry Creditors	55,000

During the two years the domestic expenditure was Rs. 4,000 p.m. The declared income of the financial years were Rs. 1,05,000 for 2006-2007 and Rs. 1,23,000 for 2007-2008 respectively.

State whether the Income-tax Officer's contention is correct. Explain by giving your workings.

Solution

Capital A/c of Shri Moti

		1-4-2006		*1-4-2008*
Assets	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Cash in hand		25,500		16,000
Stock		56,000		91,500
Sundry Debtors		41,500		52,500
Land & Building		1,90,000		1,90,000
Wife's Jewellery		75,000		1,25,000
Motor Car		—		1,25,000
Loan to Moti's Brother		—		20,000
		3,88,000		6,20,000
Liabilities:				
Owing to Moti's Brother	40,000		—	
Sundry Creditors	35,000	75,000	55,000	55,000
Capital		3,13,000		5,65,000
Income during the two years:				
Capital as on 1-4-2008				5,65,000
Add: Drawings – Domestic Expenses for the two years (Rs. 4,000 × 24)				96,000
				6,61,000
Less: Capital as on 1-4-2006				3,13,000
Income earned in 2006-2007 & 2007-2008				3,48,000
Income declared (Rs. 1,05,000 + Rs. 1,23,000)				2,28,000
Suppressed Income				1,20,000

The Income-tax officer's contention that Shri Moti has not declared his true income is correct. Shri Moti's true income is in excess of the disclosed income by Rs. 1,20,000.

Illustration 5

Suresh does not maintain his books of accounts under the double entry system but keeps slips of papers from which he makes up his annual accounts. He has borrowed moneys from a bank to whom he has to render figures of profits every year. He has given the bank the following profit figures:

Year ending 31st December	*Profits Rs.*
2004	20,000
2005	32,000

2006	35,000
2007	48,000
2008	55,000

The bank appoints you to audit the statements and verify whether the figures of profits report is corrected or not; for this purpose, the following figures are made available to you:

(*a*) Position as on 31st December, 2003: Sundry debtors Rs. 20,000; Stock in trade (at 95% of the cost) Rs. 47,500; Cash in hand and at bank Rs. 12,600; Trade creditors Rs. 6,000; Expenses due Rs. 1,600.

(*b*) He had borrowed Rs. 5,000 from his wife on 30th September, 2003 on which he had agreed to pay simple interest at 12% p.a. The loan was repaid alongwith interest on 31st December, 2005.

(*c*) In December, 2004, he had advanced Rs. 8,000 to A for purchase of a vacant land. The property was registered in March, 2006 after payment of balance consideration of Rs. 32,000. Costs of registration incurred for this were Rs. 7,500.

(*d*) Suresh purchased jewellery for Rs. 15,000 for his daughter in October, 2006. Marriage expenses incurred in January were Rs. 24,000.

(*e*) A new VCR was purchased by him in March 2008 for Rs. 18,000 and presented by him to his friend in November, 2008.

(*f*) His annual household expenses amounted to a minimum of Rs. 24,000.

(*g*) The position of assets and liabilities as on 31st December 2008 was found to be Overdraft with bank (secured against property) Rs. 12,000; Trade creditors Rs. 10,000. Expenses payable Rs. 600; Sundry debtors (including Rs. 600 due from a peon declared insolvent by Court) Rs. 28,800; Stock in trade (at 125% of cost to reflect market value) Rs. 60,000 and Cash in hand Rs. 250.

It is found that the rate of profit has been uniform throughout the period and the proportion of sales during the years to total sales for the period was in the ratio of 3:4:4:6:8.

Ascertain the annual profits and indicate differences, if any, with those reported by Suresh to the bank earlier.

All workings are to form part of your answer.

Solution

Statement of Affairs as on 31-12-2003

Liabilities		*Rs.*	*Assets*	*Rs.*
Loan from	*Rs.*		Sundry Debtors	20,000
Mrs. Suresh	5,000		Stock on trade-at cost	
Add: Interest Outstanding	150	5,150	$\left(47{,}500\times\frac{100}{95}\right)$	50,000
Trade Creditors		6,000	Cash in hand & at bank	12,600
Outstanding expenses		1,600		
Capital (Bal. fig.)		69,850		
		82,600		82,600

Statement of Affairs as on 31-12-2008

Liabilities	*Rs.*	*Assets*	*Rs.*
Bank overdraft-secured		Sundry Debtors	28,800
against property	12,000	Stock in trade	
Trade Creditors	10,000	at cost (Rs. 60,000 × 100/125)	48,000
Outstanding expenses	600	Cash in hand	250
Capital Balancing figure	54,450		
	77,050		77,050

Statement of Profit for the period 1-1-2004 to 31-12-2008

		Rs.
Capital as on 31-12-2008 as per statement		54,450
Add:	Drawings during the period (Rs. 24,000 × 5)	1,20,000
	Purchase of property	47,500
	Purchase of jewellery & marriage expenses of Mr. Suresh's daughter	39,000
	Purchase of new VCR for presentation to the proprietor's friend	18,000
		278,950
Less:	Capital as on 31-12-2003 as per statement	69,850
	Profit for the five-year period	2,09,100
Less:	Bad debts not accounted for in the Statement of Affairs as on 31-12-2008	600
	Net profit over the five-year period	2,08,500

Statement showing annual profits and their differences with reported profits: 2004–2008

Year ended	*Apportionment Ratio*	*Annual profit Rs.*	*Profit reported Rs.*		*Difference to bank Rs.*
31-12-2004	3	25,020	20,000	(+)	5020
31-12-2005	4	33,360	32,000	(+)	1360
31-12-2006	4	33,360	35,000	(–)	1640
31-12-2007	6	50,040	48,000	(+)	2040
31-12-2008	8	66,720	55,000	(+)	11,720
		2,08,500	1,90,000	(+)	18500

3. TECHNIQUES OF OBTAINING COMPLETE ACCOUNTING INFORMATION

When books of accounts are incomplete, it is essential in the first instance to complete double entry in respect of all transactions. The whole accounting process should be carefully followed and Trial Balance should be drawn up.

3.1 General Techniques

Where the accounts of a business are incomplete, it is advisable to convert them first to the double entry system and then to draw up the Profit and Loss Account and the Balance Sheet, instead of determining the amount of profit/loss by preparing the statement of affairs. This no doubt involves a more detailed analysis of accounts but the final result will be more informative about the profit or loss, as also showing how it has been earned and disposed of.

As books of accounts of different firms being incomplete in varying degrees, it is not possible to suggest a formula which could uniformly be applied for preparing final accounts therefrom. As a general rule, it is essential first to start the ledger accounts with the opening balances of assets, liabilities and the capital. Afterwards, each book of original entry should be separately dealt with, so as to complete the double entry by posting into the ledger such entries as have not been posted. For example, If only personal accounts have been posted from the Cash Book, debits and credits pertaining to nominal accounts and real accounts that are not posted, should be posted into the ledger. If there are Discount Columns in the Cash Book, the totals of discounts paid and received should be posted to Discounts Allowed and Discounts Received Accounts respectively, for completing the double entry.

Afterwards, the other subsidiary books, *i.e.,* Purchases Day Book, Sales Day Book, Return Book and Bills Receivable and Payable, etc. should be totalled up and their totals posted into the ledger to the debit or credit of the appropriate nominal or real accounts, the personal aspect of the transactions having been posted already.

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

(1) In the Cash Book, there might be entered several receipts which have no connection with the business but which belong to the proprietor, e.g., interest collected on his private investment, legacies received by him, amount contributed by the proprietor from his private resources, etc. All those amounts should be credited to his capital account. Also the Cash Book may contain entries in respect of payments for proprietor's purchases made by the business. All such items should be debited to his capital account.

(2) Amounts belonging to the business after collection may have been directly utilised for acquiring business assets or for meeting certain expenses instead of being deposited into the Cash Book. On the other hand, the proprietor may have met some of the business expenses from his private resources. In that case, the appropriate asset or expense account should be debited and the source which had provided funds credited.

(3) If cash is short, because the proprietor had withdrawn amount without any entry having been made in the cash book the proprietor's capital account should be debited. In fact, it will be necessary to debit or credit the proprietor's capital account in respect of all unidentified amounts which cannot be adjusted otherwise.

(4) Where the benefit of an item of an expense is received both by the proprietor and business, then it should be allocated between them on some equitable basis e.g. rent of premises when the proprietor lives in the same premises, should be allocated on the basis of the area occupied by him for residence.

(5) The schedules of sundry debtors and creditors, extracted from respective ledgers maintained for the purpose should be examined to find out if, by mistake, an item of revenue or expense has found its way therein. Having done so and, if necessary after eliminating such amounts, the schedules should be totalled and the total debited to Sundry Debtors Account in the ledger. Similarly, the total of schedules of sundry creditors should be credited to Sundry Creditors Account. One should note that since Sales Account, Purchase Account and other nominal accounts having already been written up on the basis of Day Books, it is not necessary to adjust them further. It is expected that the opening balances in these accounts would have been adjusted by recovery or payment and the receipt from debtors and the payment to creditors correctly posted to the accounts instead of having been recorded as Sales or Purchases. If however, it has been done, these balances would require to be adjusted by transfer to Sales or Purchases Accounts or to Bad Debts or Discount Account, as the case may be.

In the end, it will be possible to extract a Trial Balance. Students are advised always to do so as it will disclose any mistakes committed in making adjustments.

3.2 Derivation of Information from Cash Book

The analysis of cash as well as bank receipts and payments should be extensive but under significant heads, so that various items of income and expenditure can be posted therefrom into the ledger. However before posting the information into the ledger the same should be collected in the form of an account, the specimen whereof is shown below:

Cash and Bank Summary Account for the year ended

	Cash *Rs.*	*Bank* *Rs.*		*Cash* *Rs.*	*Bank* *Rs.*
To Balance in hand (opening)	590	7,400	By Expenses (Sundry Payments)	3,000	-
To Sales	6,500	-	By Purchases	100	6,000
To Collection from			By Sundry Creditors	-	5,000
Debtors	-	10,000	By Drawings	1,500	-
			By Petty Expenses	800	-
			By Rent	-	1,000
			By Electricity and water	350	-
			By Repairs	350	-
			By Wages	-	1,000
			By Balance in Hand	990	4,400
	7,090	17,400		7,090	17,400

The important point about incomplete records is that much of the information may not be readily available and that the relevant information has to be ascertained. A good point is to prepare Cash and Bank Summary (if not available in proper form with both sides tallied). The cash and bank balance at the end should be reconciled with the cash and bank books. Having done so, the various items detailed on the Summary Statements, should be posted into the ledger.

It is quite likely that some of the missing information will then be available. Consider the following about a firm relating to 2008.

	Rs.
Cash Balance on 1st Jan., 2008	250
Bank overdraft on 1st Jan., 2008	5,400
Cash purchases	3,000
Collection from Sundry Debtors	45,600
Sale of old furniture	750
Purchase of Machinery	12,000
Payment of Sundry Creditors	26,370

Expenses	8,450
Fresh Capital brought in	5,000
Drawings	3,230
Cash Balance on 31st Dec., 2008	310
Bank balance on 31st Dec., 2008	1,180

Now prepare the cash and Bank Summary.

Cash and Bank Summary

Dr.			*Cr.*
	Rs.		*Rs.*
Cash Balance as on 1-1-2008	250	Bank Overdraft	5,400
Collection from S. Debtors	45,600	Cash Purchases	3,000
		Purchase of Machinery	12,000
Sale of old furniture	750	Payment to S. Creditors	26,370
Fresh Capital brought in	5,000	Expenses	8,450
Balancing figure	8,340	Drawings	3,230
		Cash balance on 31-12-2008	310
		Bank balance on 31-12-2008	1,180
	59,940		59,940

See that debit side is short by Rs. 8,340. What may be the possible source of cash inflow?

May be cash sales.

3.3 Analysis of Sales Ledger and Purchase Ledger

Sales Ledger: It is a fact that where sales are made on credit, a Sundry Debtors Ledger will be kept. By analysing the amounts entered in various accounts kept in this ledger, it is possible to build up the sales accounts as also to obtain information in regard to other items of income and expenditure posted into the ledger, the converse of which has not been adjusted in the nominal accounts.

Analysis of Sales Ledger of the year

Opg.	Sales	Bills	Total	Cash	Dis-	Bills	Sales	Bad	Total	Balance
Customer		Disho-	Debits	Recd.	counts	Recd.	Returns	Debts	Credit	(clg.)
Balance		noured			Alld.					

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

Account in the following form:

Total Debtors Account (assumed figures)

	Rs.		*Rs.*
Opening Balance	5,000	Cash/Bank	10,000
Sales	38,000	Discount	500
Bills dishonored	280	Bills Receivable	20,000
Interest	100	Bad Debts	280
		Closing Balance	12,600
	43,380		43,380

It is evident that any single amount comprised in the total Debtors Account can be ascertained if the other figures are provided. For instance, if the information about sales is not available it could be ascertained as a balancing figure, *i.e.,* in the total Debtors Account given above, if all other figures are given sales would be Rs. 38,000.

Purchases Ledger: Generally speaking, a Purchases Ledger is not as commonly in existence as the Debtors Ledger for it is convenient to make entries in respect of outstanding liabilities at the time they are paid rather than when they are incurred. In such a case, it will be necessary only to list up the outstanding for payment at the end of the period as well as those for which bills have not been received. The totals of the schedule will then be credited to Sundry Creditors Account by debit to appropriate expense heads. Once this has been done, the balance in purchase and expenses accounts will represent amounts chargeable to the Trading Account of the period.

Where, however, Sundry Creditors Ledger is kept, it should be analysed and a Total Creditors Accounts prepared in the same way as the Total Debtors Account. From the Total Creditors Account, various items, not already posted in the General Ledger, should be posted and the amount paid to sundry creditors reconciled with that shown by the summary of cash and bank statement.

If a proper record of return to creditors, discount allowed by them etc., has not been kept, it will not be possible to write up the Total Creditors A/c. In such a case, net credit purchase will be ascertained as follows:

Cash paid to Creditors including on account of Bills

Payable during the period ....

Closing balance of Creditors and Bills Payable ....

Total ___________

Less: Opening balance of Creditors and Bills Payable ....

Net credit purchase during the period ....

Alternatively

Cash paid to creditors during the period ....

Add: Bills Payable issued to them ....

Total ___________

Closing balance of Creditors

Less: Opening balance of creditors ....

Credit Purchases during the period ....

The information may also be put in the form of an account, just like the Total Debtors Account.

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

	Cash and	*Amount*	*Paid out of*	*Total*	*Pre*	*Expenses*
	Particulars	*Bank Pay-*	*Accrued*	*Private*	*Payment*	*for the*
		ment		*Fund*		*period*
1	*2*	*3*	*4*	*5*	*6*	*7*
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Rent & Rates	2,200	300	100	2,600	150	2,450
Salaries	4,500	500	1,000	6,000	250	5,750

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

Let us continue with the example given in para 2.2. Given some other information, how to compute credit purchase and credit sale is discussed below:

Opening Balance (1-1-2008)	*Rs.*
Stock	20,000
Sundry Creditors	12,300
Sundry Debtors	15,000
Closing Balance (31-12-2008)	
Stock	15,000
Sundry Creditors	13,800
Sundry Debtors	25,600

Discount received during 2008	1,130
Discount allowed	1,870

What are the purchases for 2008? Let us prepare the Sundry Creditors Account.

Sundry Creditors A/c

	Rs.		*Rs.*
To Cash	26,370	By Balance b/d	
To Discount	1,130	(opening)	12,300
To Balance c/d (closing)	13,800	By Purchases (balancing figure)	29,000
	41,300		41,300

The credit purchases are Rs. 29,000; cash purchases are Rs. 3,000: hence total purchases are Rs. 32,000.

Likewise prepare the Sundry Debtors Account:

Sundry Debtors Account

	Rs.		*Rs.*
To Balance b/d (balancing figure)	15,000	By Cash	45,600
To Credit Sales	58,070	By Discount	1,870
		By Balance c/d	25,600
	73,070		73,070

So total sales = credit sales + cash sales

= Rs. 58,070 + Rs. 8,340 = Rs. 66,410

3.4 Distinction between Business Expenses and Drawings

It has been already stated that often the distinction is not made between business expenses and drawings. While completing accounts from incomplete records, it is necessary to scan the business transactions carefully to identify the existence of drawings.

The main items of drawings are:

- rent of premises commonly used for residential as well as business purposes ;
- common electricity and telephone bills ;
- life insurance premiums of proprietor/partners paid from business cash ;
- household expenses met from business cash ;
- private loan paid to friends and relatives out of business cash ;
- personal gifts made to any friends and relatives out of business cash ;

- goods or services taken from the business for personal consumption ;
- cash withdrawals to meet family expenses.

So it is necessary to scan the summary of cash transactions, business resources and their utilisation to assess the nature of drawings and its amount.

3.4.1 Fresh Investment by proprietors / partners: Like drawings, often fresh investments made by proprietors' partners are not readily identifiable. It becomes necessary to scan the business transactions carefully. Apart from direct cash investment, fresh investments may take the following shape:

- Money collected and put in the business on maturity of Life Insurance Policy of the proprietors;
- Interest and dividend collected and put in the business of personal investment of the proprietors;
- Income from non-business property collected and put in the business.

Unless these items are properly identified and segregated, business income will be inflated and proper statement of affairs cannot be prepared.

Illustration 6

The following information relates to the business of Mr. Shiv Kumar, who requests you to prepare a Trading and Profit & Loss Account for the year ended 31st March, 2008 and a Balance Sheet as on that date:

(a)	*Balance as on 31st March, 2007*	*Balance as on 31st March, 2008*
	Rs.	*Rs.*
Building	3,20,000	3,60,000
Furniture	60,000	68,000
Motorcar	80,000	80,000
Stocks	–	40,000
Bills payable	28,000	16,000
Cash and Bank balances	1,80,000	1,04,000
Sundry Debtors	1,60,000	–
Bills receivable	32,000	28,000
Sundry Creditors	1,20,000	–

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

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

(c) Other information:

- Bills receivable drawn during the year amount to Rs. 20,000 and Bills payable accepted Rs. 16,000.
- Some items of old furniture, whose written down value on 31st March, 2007 was Rs. 20,000 was sold on 30th September, 2007 for Rs. 8,000. Depreciation is to be provided on Building and Furniture @ 10% p.a. and on Motorcar @ 20% p.a. Depreciation on sale of furniture to be provided for 6 months and for additions to Building for whole year.
- Of the Debtors, a sum of Rs. 8,000 should be written off as Bad Debt and a reserve for doubtful debts is to be provided @ 2%.
- Mr. Shivkumar has been maintaining a steady gross profit rate of 30% on turnover.
- Outstanding salary on 31st March, 2007 was Rs. 8,000 and on 31st March, 2008 was Rs. 10,000 on 31st March, 2007. Profit and Loss Account had a credit balance of Rs. 40,000.
- 20% of total sales and total purchases are to be treated as for cash.
- Additions in Furniture Account took place in the beginning of the year and there was no opening provision for doubtful debts.

Solution

Trading and Profit and Loss Account of Mr. Shiv Kumar

for the year ended 31st March, 2008

		Rs.			Rs.
To	Opening stock (balancing figure)	80,000	By	Sales	4,00,000
			By	Closing stock	40,000
To	Purchases	2,40,000			

To	Gross profit c/d @ 30% on sales	1,20,000			
		4,40,000			4,40,000
To	Miscellaneous expenses (Rs.80,000 – Rs.8,000 + Rs.10,000)	82,000	By	Gross profit b/d	1,20,000
			By	Miscellaneous receipts	20,000
			By	Net loss transferred to Capital A/c	25,840
To	Depreciation: Building Rs. 36,000 Furniture Rs. 7,800 (Rs.6,800 + Rs.1,000) Motor Car Rs. 16,000	59,800			
To	Loss on sale of furniture	11,000			
To	Bad debts	8,000			
To	Provision for doubtful debts	5,040			
		1,65,840			1,65,840

Balance Sheet of Mr. Shivkumar

as on 31st March, 2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital as on 1st April, 2007		7,16,000	Building	3,20,000	
			Add: Addition during the year	40,000	
Profit and Loss A/c			*Less:* Provision for	3,60,000	
Opening balance	40,000				
Less: Loss for the			depreciation	36,000	3,24,000
year	25,840	14,160	Furniture	60,000	
Sundry creditors		1,12,000	*Less:* Sold during the year	20,000	
Bills payable		16,000		40,000	

Outstanding salary	10,000	*Add:* Addition during the year	28,000	
			68,000	
		Less: Depreciation	6,800	61,200
		Motor car (at cost)	80,000	
		Less: Depreciation	16,000	64,000
		Stock in trade		40,000
		Sundry debtors	2,52,000	
		Less: Provision for doubtful debts @ 2%	5,040	2,46,960
		Bills receivable		28,000
		Cash in hand and at bank		1,04,000
	8,68,160			8,68,160

Working Notes:

Sundry Debtors Account

		Rs.			*Rs.*
To	Balance b/d	1,60,000	By	Cash/Bank A/c	2,00,000
To	Sales A/c	3,20,000	By	Bills Receivable A/c	20,000
			By	Bad debts A/c	8,000
			By	Balance c/d (balancing fig.)	2,52,000
		4,80,000			4,80,000

Sundry Creditors Account

		Rs.			*Rs.*
To	Cash/Bank A/c	1,84,000	By	Balance b/d	1,20,000
To	Bills Payable A/c	16,000	By	Purchases A/c	1,92,000
To	Balance c/d (balancing figure)	1,12,000			
		3,12,000			3,12,000

Bills Receivable Account

		Rs.			Rs.
To	Balance b/d	32,000	By	Cash/ Bank A/c (balancing figure)	24,000
To	Sundry Debtors A/c	20,000			
			By	Balance c/d	28,000
		52,000			52,000

Bills Payable Account

		Rs.			Rs.
To	Cash/Bank A/c (balancing figure)	28,000	By	Balance b/d	28,000
			By	Sundry Creditors A/c	16,000
To	Balance c/d	16,000			
		44,000			44,000

Furniture Account

		Rs.			Rs.
To	Balance b/d	60,000	By	Bank/Cash A/c	8,000
To	Bank A/c	28,000	By	Depreciation A/c	1,000
			By	Profit and loss A/c (loss on sale)	11,000
			By	Depreciation A/c	6,800
			By	Balance c/d	61,200
		88,000			88,000

Cash/Bank Account

		Rs.			Rs.
To	Balance b/d	1,80,000	By	Misc. trade expenses A/c	80,000
To	Miscellaneous receipts A/c	20,000	By	Purchases A/c	48,000
To	Sundry Debtors A/c	2,00,000	By	Furniture A/c (balancing figure)	28,000
To	Sales A/c	80,000	By	Sundry Creditors A/c	1,84,000
To	Furniture A/c (sale)	8,000	By	Bills Payable A/c	28,000

To	Bills Receivable A/c	24,000	By	Building A/c	40,000
			By	Balance c/d	1,04,000
		5,12,000			5,12,000

Opening Balance Sheet of Mr. Shivkumar as on 31st March, 2007

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital (balancing figure)	7,16,000	Building	3,20,000
Profit and loss A/c	40,000	Furniture	60,000
Sundry Creditors	1,20,000	Motor car	80,000
Bills Payable	28,000	Stock in trade	80,000
Outstanding salary	8,000	Sundry Debtors	1,60,000
		Bills Receivable	32,000
		Cash in hand and at bank	1,80,000
	9,12,000		9,12,000

Illustration 7

A. Adamjee keeps his books on single entry basis. The analysis of the cash book for the year ended on 31st December, 2008 is given below:

Receipts	*Rs.*	*Payments*	*Rs.*
Bank Balance as on 1st January, 2008	2,800	Payments to Sundry creditors	35,000
Received from Sundry Debtors	48,000	Salaries	6,500
		General expenses	2,500
Cash Sales	11,000	Rent and Taxes	1,500
Capital brought during the year	6,000	Drawings	3,600
Interest on Investments	200	Cash purchases	12,000
		Balance at Bank on 31st Dec., 2008	6,400
		Cash in hand on 31st Dec., 2008	500
	68,000		68,000

Particulars of other assets and liabilities are as follows:

	1st January, 2008	*31st December, 2008*
Sundry Debtors	14,500	17,600
Sundry Creditors	5,800	7,900
Machinery	7,500	7,500

Furniture	1,200	1,200
Stock	3,900	5,700
Investments	5,000	5,000

Prepare final accounts for the year ending 31st December, 2008 after providing depreciation at 10 percent on machinery and furniture and Rs. 800 against doubtful debts.

Solution

Statement of Affairs of A. Adamjee as on 1-1-2008

	Rs.		*Rs.*
Sundry Creditors	5,800	Machinery	7,500
A. Adamjee's Capital (balancing figure)	29,100	Furniture	1,200
		Stock	3,900
		Sundry Debtors	14,500
		Investments	5,000
		Bank balance (from Cash Statement)	2,800
	34,900		34,900

Ledger Accounts

A. Adamjee's Capital Account

Dr.				*Cr.*
	Rs.			*Rs.*
To Drawings	3,600	Jan. 1	By Balance	29,100
To Balance c/d	31,500	Dec. 31	By Cash	6,000
	35,100			35,100

Sales Account

				Rs.
Dec. 31	To Trading A/c	62,100	Dec. 31 By Cash	11,000
			Dec. 31 By Total Debtors Account	51,100
		62,100		62,100

Total Debtors Account

		Rs.			*Rs.*
Jan. 1	To Balance b/d	14,500	Dec. 31	By Cash	48,000
Dec. 31	To Credit sales (Balancing figure)	51,100	Dec. 31	By Balance c/d	17,600
		65,600			65,600

Jan. 1	To Balance b/d	17,600

Total Creditors Account

		Rs.			*Rs.*
Dec. 31	To Cash	35,000	Jan. 1	By Balance b/d	5,800
Dec. 31	To Balance b/d	7,900	Dec. 31	By Credit Purchases	
				(Balancing figure)	37,100
		42,900			42,900

A. Adamjee

Trading and Profit & Loss Account for the year ended 31-12-2008

		Rs.		*Rs.*
To Opening Stock		3,900	By Sales	62,100
To Purchases		49,100	By Closing Stock	5,700
To Gross profit c/d		14,800		
		67,800		67,800
To Salaries		6,500	By Gross Profit b/d	14,800
To Rent and Taxes		1,500	By Interest on Investment	200
To General Expenses		2,500		
To Depreciation :				
Machinery	Rs. 750			
Furniture	Rs. 120	870		
To Provision for Doubtful Debts		800		
To Balance being profit carried to Capital A/c		2,830		
		15,000		15,000

Balance Sheet as on 31st December, 2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
A. Adamjee's Capital			Machinery	7,500	
on 1st January, 2008	29,100		*Less :* Depreciation	750	6,750
Add : Fresh Capital	6,000		Furniture	1,200	
Add : Profit for the year	2,830		*Less :* Depreciation	120	1,080
	37,930				
Less : Drawings	3,600	34,330	Stock-in-trade		5,700
			Sundry Debtors	17,600	

Sundry Creditors	7,900	*Less :* Provision for		
		Double Debts	800	16,800
		Investment		5,000
		Cash at Bank		6,400
		Cash in Hand		500
	42,230			42,230

Illustration 8

From the following data, you are required to prepare a Trading and Profit and Loss Account for the year ended 31st March, 2008 and a Balance Sheet as at that date. All workings should form part of your answer.

Assets and Liabilities	*As on*	*As on*
	1st April 2007	*31st March 2008*
	Rs.	*Rs.*
Creditors	15,770	12,400
Sundry expenses outstanding	600	330
Sundry Assets	11,610	12,040
Stock in trade	8,040	11,120
Cash in hand and at bank	6,960	8,080
Trade debtors	-	7,870
Details relating to transactions in the year:		
Cash and discount credited to debtors		64,000
Sales return		1,450
Bad debts		420
Sales (cash and credit)		71,810
Discount allowed by trade creditors		700
Purchase returns		400
Additional capital-paid into Bank		8,500
Realisations from debtors-paid into Bank		62,500
Cash purchases		1,030
Cash expenses		9,570
Paid by cheque for machinery purchased		430
Household expenses drawn from Bank		3,180

Cash paid into Bank	5,000
Cash drawn from Bank	9,240
Cash in hand on 31-3-2008	1,200
Cheques issued to trade creditors	60,270

Solution

Trading and Profit & Loss Account

for the year ending 31st March, 2008

	Rs.	*Rs.*		*Rs.*	*Rs.*
To Opening Stock		8,040	By Sales		
			Cash	4,600	
To Purchases	59,030		Credit	67,210	
Less : Returns	400	58,630		71,810	
To Gross Profit c/d		14,810	*Less :* Returns	1,450	70,360
			By Closing Stock		11,120
		81,480			81,480
To Sundry Expenses (W.N.v)		9,300	By Gross Profit		14,810
To Discount		1,500	By Discount		700
To Bad Debts		420			
To Net Profit to Capital		4,290			
		15,510			15,510

Balance Sheet of M/s ....

as on 31st March, 2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*
Capital			Sundry Assets	12,040
Opening balance	26,770		Stock in trade	11,120
Add Addition	8,500		Sundry Debtors	17,870
” Net Profit	4,290		Cash in Hand & at Bank	8,080
	39,560			
Less : Drawings	3,180	36,380		
Sundry Creditors		12,400		
Outstanding Expenses		330		
		49,110		49,110

Working Notes:

(i) ***Cash sales***

Combined Cash & Bank Account

	Rs.		*Rs.*
To Balance b/d	6,960	By Sundry Creditors	60,270
To Sundries (Contra)	5,000	By Sundries (Contra)	5,000
To Sundries (Contra)	9,240	By Sundries (Contra)	9,240
To Sundry Debtors	62,500	By Drawings	3,180
To Capital A/c	8,500	By Machinery	430
To Sales (Cash Sales		By Sundry Expenses	9,570
Balancing Figure)	4,600	By Purchases	1,030
		By Balance c/d	8,080
	96,800		96,800

(ii)

Total Debtors Account

	Rs.		*Rs.*
To Balance b/d	16,530	By Bank	62,500
(Balancing figure)		By Discount	1,500
To Sales (71,810–4,600)	67,210	By Return Inward	1,450
		By Bad Debts	420
		By Balance c/d	17,870
	83,740		83,740

(iii)

Total Creditors Account

	Rs.		*Rs.*
To Bank	60,270	By Balance b/d	15,770
To Discount	700	By Purchases	58,000
To Return Outward	400	(Balancing figure)	
To Balance c/d	12,400		
	73,770		73,770

(iv)

Balance Sheet as on 1st April, 2007

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital (balancing figure)	26,770	Sundry Assets	11,610
Sundry Creditors	15,770	Stock in Trade	8,040
Outstanding Expenses	600	Sundry Debtors	16,530
		Cash in hand & at bank	6,960
	43,140		43,140

(v)	Expenses paid in Cash	9,570
	Add : Outstanding on 31-3-2008	330
		9,900
	Less : Outstanding on 1-4-2007	600
		9,300

(vi) Due to lack of information deprecation has not been provided on fixed assets.

Illustration 9

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

	31-12-2007	31-12-2008
Sundry Debtors	70,000	92,000
Bills Receivable	15,000	6,000
Bills Payable	12,000	14,000
Sundry Creditors	40,000	56,000
Stock	1,10,000	1,90,000
Bank	90,000	87,000
Cash	5,200	5,300

Summary of cash transactions during 2007-2008:

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

(*ii*) Withdrawals Rs. 1,21,000.

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

(*iv*) Cheques collected from customers but dishonoured Rs. 5,700.

(*v*) Bills accepted by customers Rs. 40,000.

(*vi*) Bills endorsed Rs. 10,000.

(*vii*) Bills discounted Rs. 20,000, discount Rs. 750.

(*viii*) Bills matured and duly collected Rs. 16,000.

(*ix*) Bills accepted Rs. 24,000.

(*x*) Paid suppliers by cheque Rs. 3,20,000.

(*xi*) Received Rs. 20,000 on maturity of one LIC policy of the proprietor by cheque.

(*xii*) Rent received Rs. 14,000 by cheque.

(*xiii*) A building was purchased on 30-11-2005 for opening a branch for Rs. 3,50,000 and some expenses were incurred details of which are not maintained.

(*xiv*) Electricity and telephone bills paid by cash Rs. 18,700, due Rs. 2,200:

Other transactions:

(*i*) Claim against the firm for damage Rs. 1,55,000 is under legal dispute. Legal expenses Rs.17,000. The firm anticipates defeat in the suit.

(*ii*) Goods returned to suppliers Rs. 4,200.

(*iii*) Goods returned by customers Rs. 1,200.

(*iv*) Discount offered by suppliers Rs. 2,700.

(*v*) Discount offered to the customers Rs. 2,400.

(*vi*) The business is carried on at the premises owned by the proprietor. 50% of the ground floor space is used for business and remaining 50% is let out for an annual rent of Rs. 20,000.

Prepare Trading and Profit & Loss A/c of Mr. Anup for the year ended 31-12-2008 and Balance Sheet as on that date.

Solution

Trading and Profit & Loss A/c of Mr. Anup
for the year ended 31-12-2008

	Rs.	*Rs.*		*Rs.*	*Rs.*
To Opening Stock		1,10,000	By Sales	9,59,750	
To Purchases	4,54,100		*Less:* Sales Return	1,200	9,58,550
Less: Purchases Return	4,200	4,49,900	By Closing Stock		1,90,000
To Gross Profit		5,88,650			
		11,48,550			11,48,550
To Wages		1,10,400	By Gross Profit		5,88,650
Electricity & Tel. Charges		20,900	By Discount		2,700
To Legal expenses		17,000			
To Discount		3,150			
To Shop exp.		7,200			
To Provision for claims for damages		1,55,000			

To Shop Rent (Notional)	20,000		
To Net Profit	2,57,700		
	5,91,350		5,91,350

Balance-Sheet as on 31-12-2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*
Capital A/c	2,38,200		Building	3,72,000
Add : Fresh capital introduced			Furniture	25,000
Maturity value from LIC	20,000		Stock	1,90,000
Rent	14,000		S. Debtors	92,000
Add : Notional Rent	20,000		Bills Receivable	6,000
Add : Net Profit	2,57,700		Cash at Bank	87,000
	5,49,900		Cash in Hand	5,300
Less : Drawing	16,800	5,33,100		
S. Creditors		56,000		
Bills Payable		14,000		
Outstanding expenses				
Legal Exp.	17,000			
Electricity &				
Telephone charges	2,200	19,200		
Provision for claims for damages		1,55,000		
		7,77,300		7,77,300

Working Notes :

Sundry Debtors A/c

Dr.			*Cr.*
	Rs.		*Rs.*
To Balance b/d	70,000	By Bill Receivable A/c-	
To Bill Receivable A/c-Bills Dishonoured	3,000	Bills Accepted by customers	40,000
To Bank A/c-Cheque dishonoured	5,700	By Bank A/c -	
To Credit sales (Balancing Figure)	9,59,750	Cheque received	5,700
		By Cash	8,97,150
		By Return inward A/c	1,200
		By Discount A/c	2,400
		By Balance c/d	92,000
	10,38,450		10,38,450

Bills Receivable A/c

	Rs.		Rs.
To Balance b/d	15,000	By S. Creditors A/c	
To S. Debtors A/c Bills accepted	40,000	Bills endorsed	10,000
		By Bank A/c	19,250
		By Discount A/c	750
		(Bills discounted)	
		By Bank	
		Bills Collected on Maturity	16,000
		By S. Debtors	
		Bills dishonoured (Bal. Fig)	3,000
		By Balance c/d	6,000
	55,000		55,000

Sundry Creditors A/c

	Rs.		Rs.
To Bank	3,20,000	By Balance c/d	40,000
To Cash	77,200	By Credit purchase	
		(Balancing figure)	4,54,100
To Bill Payable A/c	24,000		
To Bill Receivable A/c	10,000		
To Return Outward A/c	4,200		
To Discount Received A/c	2,700		
To Balance b/d	56,000		
	4,94,100		4,94,100

Bills Payable A/c

	Rs.		Rs.
To Bank A/c Balance figure	22,000	By Balance b/d	12,000
To Balance c/d	14,000	S. Creditors A/c	
		Bills accepted	24,000
	36,000		36,000

Summary Cash Statement

	Cash	*Bank*		*Cash*	*Bank*
	Rs.	*Rs.*		*Rs.*	*Rs.*
To Balance b/d	5,200	90,000	By Bank	7,62,750	
To S. Debtors (Bal. Fig)	8,97,150		By Cash		1,21,000
To Cash		7,62,750	By Shop exp.	7,200	
To Bank	1,21,000		By Wages	1,10,400	
			By Drawing A/c	16,800	
To S. Debtors		5,700	By Bills Payable		22,000
To Bills Receivable		19,250	By S. Creditors	77,200	3,20,000
To Bills Receivable		16,000	By Furniture	25,000	
To Capital (maturity value of LIC policy)		20,000	By S. Debtors		5,700
To Capital (Rent received)		14,000	By Electricity & Tel. Charges	18,700	
			By Building (Bal. fig)		3,72,000
			By Balance c/d	5,300	87,000
	10,23,350	9,27,700		10,23,350	9,27,700

Statement of Affairs as on 31-12-2007

Liabilities	*Rs.*	*Assets*	*Rs.*
S. Creditors	40,000	Stock	1,10,000
Bills Payable	12,000	Debtors	70,000
Capital: Balancing figure	2,38,200	Bills Receivable	15,000
		Cash at Bank	90,000
		Cash in Hand	5,200
	2,90,200		2,90,200

Illustration 10

AVL is an unemployed science graduate with typewriting qualification. Being unable to get employment for more than Rs. 500 p.m. he decided to start his own typewriting institute. He approached U.B.C. Bank which sanctioned him a loan of Rs. 20,000 on 1-1-2008. His father gifted him Rs. 5,000 on 1-1-2008. He purchased 6 typewriters worth Rs. 24,000.

Unable to understand the accounts properly, he seeks your help in preparing a Profit and Loss Account and Balance Sheet relating to the year ending 31-12-2008. His Pass Book reveals the following:

		Rs.
(*a*)	Expenses of the Institute	8,400
(*b*)	Salary to self	4,000
(*c*)	Monthly Fees Collected	32,700
(*d*)	Examination Fees Collected	4,200

The following are the additional details available:

(1) During the year AVL purchased a second-hand cycle costing Rs. 400 from a student who owed monthly fees of Rs. 100. The balance was paid. The cycle is used for the institute only.

(2) AVL helped a friend by encashing a cheque for Rs. 1,000 which was dishonoured. The friend has so far repaid only Rs. 400.

(3) AVL has taken Rs. 600 per month for personal expenses in addition to his salary.

(4) AVL runs the institute from his house for which a rent of Rs. 600 p.m. is paid. 50% may reasonably be allocated for his own living.

(5) The following are outstanding as at end of 31-12-2008

		Rs.
(*a*)	Fees Receivable	2,200
(*b*)	Expenses Payable	1,000
(*c*)	Salary to Self for Nov. and Dec.,	
(*d*)	Stock of stationery on hand	200

(6) Provide Depreciation 20% on typewriters and cycle.

(7) The loan from Bank is repayable at Rs. 500 p.m. from the beginning of July onwards. Interest is payable at 12% per annum in addition to instalments for principal.

(8) Assume that all transactions are routed through Bank and no cash is handled.

Solution

Profit & Loss Account of AVL for the year ending

31st December, 2008

	Rs.	*Rs.*		*Rs.*
To Sundry Expenses	8,400		By Fees earned	35,000
Add : Outstanding	1,000	9,400	By Examination fee	4,200

To Rent		3,600	By Stock of Stationery	200
By Depreciation				
Typewriters	4,800			
Cycle	80	4,880		
" Interest on Loan		2,295		
" Net Profit transferred				
to Capital A/c		19,225		--------
		39,400		39,400

Balance Sheet of Mr. AVL as on 31st Dec., 2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital	5,000				
Add : Net Profit	19,225		Typewriters	24,000	
	24,225		*Less :* Dep.	4,800	19,200
Less : Drawings	14,800	9,425	Cycle	400	
			Less : Dep.	80	320
Bank loan		17,000	Stock of stationery		200
Expenses payable		1,000	Fees receivable		2,200
			Loan to friend		600
			Cash at bank		4,905
		27,425			27,425

AVL has made a wise decision in starting the Institute. After starting the Institute AVL's cash position as well as net profit position is better than the earning from employment.

Working Notes :

		Rs.
(i)	Fees earned	32,700
	Add : Due on the closing date	2,200
	Adjustment in payment for cycle purchased	100
		35,000
(ii)	Interest on Bank Loan @ 12% p.a. on	*Rs.*
	Rs. 20,000 for Jan. to June	1,200
	Rs. 19,500 for July	195
	Rs. 19,000 for August	190
	Rs. 18,500 for September	185
	Rs. 18,000 for October	180

Rs. 17,500 for November	175
Rs. 17,000 for December	170
	2,295

(iii)

Bank Account

	Rs.		Rs.
To Capital A/c (Gift)	5,000	By Typewriters	24,000
" Bank Loan	20,000	" Sundry Expenses	8,400
" Students' fees	32,700	" Drawings (salary)	4,000
" Exam. fees	4,200	" Cycle (Purchase)	300
" Sundries (friend's Cheque)	1,000	" Advance (friend's)	1,000
To Advance (Recovered)	400	" Sundries (friend's cheque dishonoured)	1,000
		" Drawings	7,200
		" Rent Paid	7,200
		" Bank loan (500 × 6)	3,000
		" Bank Interest	2,295
		" Balance c/d	4,905
	63,300		63,300

(iv)

Drawings Accounts

	Rs.		Rs.
To Rent	3,600	By Balance c/d	14,800
To Bank - Cash withdrawal	7,200		
To Bank - Taken as salary	4,000		
	14,800		14,800

(v) Salaries to proprietor is not considered as an item of expense. Profit is believed to be the product of capital, labour and management.

Self-Examination Questions

I. Objective type questions

Choose the most appropriate answer from the given options:

1. The capital at the beginning of the accounting year in case of single entry system is ascertained by preparing

   (a) Opening statement of affairs.

(b) Cash account.

(c) Bank account.

(d) Bank reconciliation statement.

2. Single entry system can be followed by

(a) Small firms.

(b) Joint stock companies.

(c) Co-operative societies.

(d) Big firms.

3. Credit sales is ascertained by

(a) Preparing a profit and loss account.

(b) Preparing a balance sheet.

(c) Comparing the capital at the beginning of the accounting period and capital at the end of the accounting period.

(d) None of the above.

4. In case of net worth method, profit is determined by

(a) Preparing a profit and loss account.

(b) Preparing a balance sheet.

(c) Comparing the capital at the beginning of the accounting period and capital at the end of the accounting period.

(d) None of the above.

[**Answer** : **1.** (a); **2**. (a); **3**. (c); **4.** (c)]

II. Short answer type questions

5. What is Capital method? What are its advantages?

6. Distinguish between statement of affairs and balance sheet.

7. What do you mean by single entry system? What are its advantages?

8. How does single entry system differ from double entry system? Explain in brief.

III. Long answer type questions

9. How will you calculate profit under single entry system of maintaining accounts?

IV. Practical problems

10. Mr. Ramesh had Rs. 3,30,000 in the bank account on 1-1-2007 when he started his business. He closed his accounts on 31st March, 2008. His single entry books (in which he did not maintain any account for the bank) showed his position as follows:

	31-3-2007	*31-3-2008*
Cash in hand	2,200	3,300
Stock in trade	20,900	31,900
Debtors	1,100	2,200
Creditors	5,500	3,300

On and from 1-2-2007, he began drawing Rs. 770 per month for his personal expenses from the Cash Box of the business.

His account with the bank had the following entries :

	Deposits	*Withdrawals*
	Rs.	*Rs.*
1-1-2007	3,30,000	-
1-1-2007 to 31-3-2007	-	2,45,300
1-4-2007 to 31-3-2008	2,53,000	2,97,000

The above withdrawals included payment by cheques of Rs. 2,20,000 and Rs. 66,000 respectively during the period from 1-1-2007 to 31-3-2007 and from 1-4-2007 to 31-3-2007 for the purchase of machinery for the business. The deposits after 1-1-2007 consisted wholly of sale price received from the customers by cheques.

Draw up Mr. Ramesh's statement of affairs as at 31-3-2007 and 31-3-2008 respectively and work out his profit or loss for the year ended 31-3-2008.

11. Mr. Raja had Rs. 6,00,000 in bank on 1st January, 2007 when he started his business. He closed his accounts on 31st March, 2008. His single entry books (in which he did not maintain any account for the bank) showed his position as follows :

	31-3-2007	*31-3-2008*
	Rs.	*Rs.*
Cash in hand	4,000	6,000
Stock in trade	38,000	58,000

Sundry debtors	2,000	4,000
Sundry Creditors	10,000	6,000

From 1st April, 2007 he was drawing Rs. 1,400 p.m. for his domestic expenses from the cash box of the business.

His Bank account showed the following entries:

	Deposits	*Withdrawals*
	Rs.	*Rs.*
1-1-2007	6,00,000	-
1-1-2007 to 31-3-2008	-	4,46,000
1-4-2007 to 31-3-2008	4,60,000	5,40,000

The above withdrawals included payments by cheque of Rs. 4,00,000 and Rs. 1,20,000 respectively during the periods from 1-1-2007 to 31-3-07 and from 1-4-2007 to 31-3-2008 for the purchases of Machinery and Furniture and Fittings respectively and the Deposits after 1st January, 2007 consisted wholly of sale price received from customers by cheques. Depreciation is to be provided for machinery @ 15% and for Furniture and fittings at 10% under W.D.V. Method for the whole year.

Draw up Mr. Raja's Statement of affairs as at 31-3-2007 and 1-3-2008 respectively and work out his profits for the year ended 31-3-2008.

12. From the following information determine credit sales :

	Rs.
Sundry debtors as on 1-1-2008	1,20,000
Sundry Debtors as on 31-12-2008	1,70,000
Bills Receivable as on 31-12-2008	50,000
Bills accepted by customers during 2008	1,20,000
Bill endorsed in favour of suppliers	40,000
Bills receivable dishonoured	4,000
Expenses on dishonoured Bill	100
Fresh Bill accepted by customers in lieu of dishonoured Bill	3,100
Bank collections from debtors (excluding collection of dishonoured Bill) and dishonoured cheques	6,82,200

Goods returned	13,000
Discount offered	17,500
Customer's cheque dishonoured on becoming insolvent (collected only 40% from the insolvent customer's estate)	21,200
Bills Payable endorsed back through debt	7,200
Adjusted against Sundry Creditors	5,000

13. "A" submits to you the following figures relating to his business in respect of the year 31st December, 2008. You are required to prepare a Trading and Profit and Loss Account for the year ended, and a Balance Sheet as at 31st December, 2008. Any difference in the cash balance is assumed to be drawings :

	Rs.
Cash paid into bank	1,50,000
Private dividends paid into bank	2,000
Private payments out of Bank	26,000
Payments for goods out of Bank	1,22,000
Cash received from debtors	2,50,000
Payments for goods by cash and cheques	1,60,000
Wages	40,000
Delivery Expenses	7,000
Rents & Rates	2,000
Lighting & Heating	1,000
General Expenses	4,600

The Assets & Liabilities are as follows:

Assets and Liabilities	*1st January, 2008*	*31st December, 2008*
	Rs.	*Rs.*
Stock	20,000	15,000
Bank Balance	8,000	12,000
Cash in hand	300	400
Trade Debtors	14,000	20,000
Trade Creditors	27,300	30,000
Investments	50,000	50,000

14. From the following information determine sales made by a firm during the calender year 2008 :

	Rs.
Opening Stock	80,000
Closing Stock	90,000
Goods taken by the proprietor at cost	10,000
Goods lost by fire at cost	5,000
Purchases	5,70,000
Gross Profit Ratio	33 1/3% on cost

15. From the following information find out purchase made by the firm during the calender year 2008 :

	Rs.
Opening debtors	17,000
Closing debtors	28,000
Collections	2,12,000
Excess of closing stock over opening stock	5,000
Gross profit ratio	25%

16. A runs a wholesale business. He did not maintain proper books of accounts. He supplies the following information :

(i) Statement of Affairs as on 31-12-2007:

	Rs.
Furniture and other fixed assets	80,000
Stock at cost	2,50,000
Debtors	10,000
Creditors	30,000
Cash in Hand	150
Cash at Bank	11,000

(ii) Details from Bank Pass Book:

		Rs.
	Deposit	8,70,000
	Withdrawals	3,50,000
	Cheque to Suppliers	3,20,000
		Rs.
(iii)	Cheque for tax	30,000
	Cheque for electricity, telephone and rent	54,000

(iv) Cash Payments:

		Rs.
	Salaries, Wages and Bonus	1,74,000
	Staff expenses	47,000
	Personal Expenses	84,000
(v)	Discount Received	4,200
	Discount Allowed	8,200

(vi) He made all purchases and sales on credit. But he follows a practice to deposit all collections to bank immediately. But sometime in September, 2008, his Cashier left taking the cash in hand which represent both withdrawals from banks for payment of salaries and some collections pending for deposit.

(*vii*) Cash in hand as on 31-12-2008 Rs. 500

(*viii*) He earns Gross Profit @ 25% on cost of goods sold. Closing stock Rs. 3,00,000.

(*ix*) Closing balance of creditors Rs. 50,000

Closing of debtors Rs. 27,000

Finalise accounts of Mr. A for the year ended 31-12-2008.

17. A and B started a business on January 1, 2007 with Rs. 50,000 as capital, contributed equally but the profit sharing ratio was 3:2. Their drawings were Rs. 300

and 200 per month respectively. They had kept no accounts but given you the following information:

	31-12-2007	31-12-2008
	Rs.	Rs.
Machinery at cost	20,000	25,000
Stock in trade	30,000	30,000
Debtors	50,000	60,000
Cash	2,000	500
Creditors	30,000	20,000
Outstanding Expenses	4,000	3,000
Bank Balance (as per Pass Book)	6,000	8,000

Provision is to be made for depreciation at 10 percent on the cost of machinery as at the end of each year. Debtors on 31-12-2007 include Rs. 5,000 for goods sent out on consignment at 25 per cent above cost, and the goods were sold only in 2008. A cheque for Rs. 1,000 had been deposited on 31-12-2007 but was credited on 2-1-2008.

A cheque for Rs. 2,000 issued on 26-12-2008 was presented on 3-1-2009. A cheque for Rs. 1,000 was directly deposited by a customer on 27-12-2008 but no entry is made either in Pass book or in Cash Book. A cheque for Rs. 500 deposited in December, 2008, was dishonored but no adjustment for this was made.

Determine the profit for 2005 and draw up a Balance Sheet as at 31 December, 2008.

18. Mr. Ashok gives the following information.

(1) Opening and Closing Balances

	31-12-2007	*31-12-2008*
	Rs.	*Rs.*
Stock	1,70,000	1,80,000
Debtors	1,10,000	2,10,000
Bills Receivable	40,000	60,000
Bills Payable	20,000	30,000
Sundry Creditors	40,000	2,20,000
Bank	70,000	75,000
Cash	5,200	6,100

(2) He made all sales and purchases on credit.

(3) Summary of Cash Transactions

For dishonoured cheque and bill – Cash 12,14,000

Direct collections through Bank		5,72,000
Investment in Shares		72,000
Payment to creditors	– cash	1,70,000
	– cheque	5,11,000
Salaries & wages	– cash	4,40,000
Office expenses	– cash	80,000
Bills discounted	– credited to account	60,000
	– discount	1,200
Bills collected on maturity	– credited to account	12,000
Bills dishonoured	– amount of the bills	5,000
	– noting charges	100
Cheque dishoboured	– amount of the cheque	40,000
	– bank charges	20
Draft to suppliers	– amount	1,00,000
	– commission	100

The proprietor is constructing a house for which he takes from cash but no account is maintained.

		Rs.
	Bills met on maturity	10,000
	Bills endorsed	12,000
	Bills payable endorsed back	5,000
(4)	Return Inwards	17,000
	Return Outwards	5,000
	Discount received	12,000
	Discount allowed	24,000

(5) A customer, whose bill was dishonoured, paid Rs. 3,000 in cash and accepted a new bill for the balance. This has not yet recorded in the accounts.

(6) A customer, whose cheque was dishonoured became insolvent. Only 20% was collected from his estate.

Finalise accounts of Mr. Ashok.

19. Indian Travel Agency sells tickets for Inland Transport Ltd. Bharat Air Lines and Government Railways. The rate of commission due to Agency, on account of sales of tickets are 10 per cent, 7.5 per cent, and 5 per cent, respectively on the sale price of tickets.

The firm closes its books on 31st December. The balances as on 31st Dec., 2007 were as follows :

	Rs.	*Rs.*
Capital		50,000
Deposits from customers of Inland Transport Ltd.		10,000
Deposits from general public		10,000
Interest due for half year on above		500
Auditors' fees		1,500
Advertising		1,000
Rates and taxes		500
Fixtures and fittings	20,000	
Motor car	18,000	
Debtors for Rail Tickets	5,000	
Debtors for Air Tickets	2,000	
Rent Paid in advance	1,250	
Bank Balance	27,250	
	73,500	73,500

Other available particulars are :

1. From the Bank statements, returned cheques and the pay-in-slips for the year ended 31st Dec., 2008.

	Rs.
Banking (cheques and cash)	8,97,500
Payment for tickets	

Inland Transport Ltd.	6,20,000
Bharat Air Lines	1,69,000
Government Railways	84,000
Rent Paid for 4 quarters	5,000
Electricity	5,000
Rates and Taxes	3,000
Interest paid to public on their deposits	1,000
Amount paid to auditors	1,500
Advertising	6,250
Bank balance as on 31st Dec., 2008	30,000

2. Weekly expenditure (52 weeks) defrayed from cash receipts before banking:

Staff wages	1,100
Petty Expenses (total for 52 weeks)	4200

In addition to the above, the owner, has drawn Rs. 2000 per month to meet personal expenses and spent Rs. 1000 per month for maintenance of car in the interest of Agency out of the cash receipts before banking:

3. Liabilities of the firm as on 31st Dec., 2008 include:

	Rs.
Auditors	1,500
Advertising charges	1,250
Rates and taxes	1,000
Inland Transport Ltd.	5,500
Bharat Air Lines	16,000
Government Railways	11,000

4. Customers deposits on 31st Dec., 2008 were for

Inland Transport Ltd.	8,000

5. Debtors for air and rail tickets on 31st Dec., 2008 were Rs. 2,500 and Rs. 800 respectively.

6. Depreciation on car and fixtures is allowed at the rate of 20% and 10% of the last year's balance respectively.

7. Owner agrees to treat the cash differences, if any, as his drawings.

You are required to draw a Profit and Loss Account showing commission earned for each class of tickets sold for the year ending 31st December, 2008 and a Balance Sheet as on 31st December, 2008.

20. A and B entered into partnership contributing Rs. 20,000 and Rs. 30,000 capital on 1st Jan., 2007. On 1st July, 2007 C was admitted to the firm on payment of Rs. 25,000 as capital and on 1st January 2008, D was admitted who paid Rs. 12,000 as his capital. During the time A, B, C, and D were partners, they were paid annual salaries of Rs. 8,000, Rs. 8,000, Rs. 7,500 and Rs. 6,000 respectively. Drawings on account of salary were limited to Rs. 300 per month for each partner. The partnership agreement as finally drawn up, provided for distribution of profits, after salary for each six months in the following ratio;

A 3/10, B 3/10, C 2/10, D 2/10

Proper books of accounts were not maintained, but analysis of the cash book revealed the following facts:

	Six months ending			
	30th June	*31st Dec.*	*30th June*	*31 Dec.*
	2007	*2007*	*2008*	*2008*
	Rs.	*Rs.*	*Rs.*	*Rs.*
Collection from Debtors on sales made in six months period ended				
June 30, 2007	36,600	6,200	4,100	2,500
Dec. 31, 2007		1,24,200	34,500	8,200
June 30, 2008			1,92,500	53,900
Dec. 31, 2008				3,47,300
Payments for Purchases	65,871	1,52,382	1,85,699	3,38,546
Rent & other fixed costs	5,698	6,550	10,891	12,141
Other expenses	2,620	14,120	22,620	23,341
Drawings	3,600	5,400	7,200	7,200

Trade Debtors outstanding, considered goods on 31st Dec., 2008 by period of origin were :

Sales made during 6 months ended

Jan 30, 2007	*Dec. 31,2007*	*Jan. 30,2008*	*Dec. 31,2008*
Rs	*Rs.*	*Rs.*	*Rs.*
1,600	3,100	8,600	26,700

Closing stock on 31st Dec., 2008, including unpaid bills of Rs. 14,285 was valued at Rs. 83,084. The partners have agreed that

(a) "rents and other fixed costs" are to be divided equally over the four six months period;

(b) the cost of goods sold during these periods may be assumed to have been 70%, 75%, 80% and 80% respectively of sales;

(c) any shortages of goods resulting from the application of above amounts and percentages may be regarded as proper addition to "other expenses"; and

(d) "other expenses" are to be spread over the four periods in proportion to sales.

Prepare Trading and Profit & Loss Accounts for the four half year periods.

CHAPTER 11

Hire Purchase and Instalment Sale Transactions

Learning Objectives

After studying this chapter, you will be able to:

Understand the salient features and nature of Hire purchase transactions.

Journalise the Hire purchase entries both in the books of hire purchaser and the hire vendor.

Learn various methods of accounting for hire purchase like Debtors method and Stock and Debtors method.

Ascertain various missing values, required while accounting the hire purchase transactions, on the basis of given information.

Calculate and record the value of repossessed goods and also to calculate the profit on re-sale of such goods.

Draw the Hire-purchase Trading Account and calculate the profit on such transactions.

Evaluate the profit on hire purchase of goods of small value.

Understand the instalment payment system and also how it is different from hire purchase transactions.

1. INTRODUCTION

With an increasing demand for better life, the consumption of goods has been on the expanding scale. But, this has not been backed up by adequate purchasing power, transforming it into effectual demand, i.e., actual sale at set or settled prices. This has created the market for what is called **hire purchase.**

When a person wants to acquire an asset but is not sure to make payment within a stipulated period of time he may pay in instalments if the vendor agrees. This enables the purchaser to use the asset while paying for it in instalments over an agreed period of time. This type of a business deal is known as hire purchase transaction. Here, the customer pays the entire amount either in monthly or quarterly or yearly instalments, while the asset remains the property of the seller until the buyer squares up his entire liability. For the seller, the agreed instalments include his interest on the assets given on credit to the purchaser. Therefore, when the total amount is paid in instalments over a period of time is certainly higher than the cash down price of the article because of interest charges. Obviously, both the parties gain in the bargain. By virtue of this, the purchaser has the right of immediate use of the asset. By this, he gets both credit and product from the same seller. From seller's view point, he derives the benefit by increase in sale and also he recovers his own cost of credit.

2. NATURE OF HIRE PURCHASE AGREEMENT

Under the Hire Purchase System the Hire Purchaser gets possession of the goods at the outset and can use it, while paying for it in instalments over a specified period of time as per the agreement. However, the ownership of the goods remains with the Hire Vendor until the hire purchaser has paid all the instalments. Each instalment paid by the hire purchaser is treated as hire charges for using the asset. In case he fails to pay any of the instalments (even the last one) the hire vendor will take back his goods without compensating the buyer, i.e., the hire vendor is not going to pay back a part or whole of the amount received through instalments till the date of default from the buyer.

3. SPECIAL FEATURES OF HIRE PURCHASE AGREEMENT

1. *Possession:* The hire vendor transfers only possession of the goods to the hire purchaser immediately after the contract for hire purchase is made.
2. *Instalments:* The goods is delivered by the hire vendor on the condition that a hire purchaser should pay the amount in periodical instalments.
3. *Down Payment:* The hire purchaser generally makes a down payment on signing the agreement.
4. *Constituents of Hire purchase instalments:* Each instalment consists partly of a finance charge (interest) and partly of a capital payment.
5. *Ownership:* The property in goods is to pass to the hire purchaser on the payment of the last instalment and exercising the option conferred upon him under the agreement.
6. *Repossession:* In case of default in respect of payment of even the last instalment, the hire vendor has the right to take the goods back without making any compensation.

4. ACCOUNTING ARRANGEMENTS OF HIRE PURCHASE TRANSACTION

The method of accounting for hire purchase transactions depends on the value of sales. If the goods have substantial sales value the accounting methods adapted may be (i) Cash price method or (ii) Interest suspense method. Hire purchase accounting methods for goods of small sales value may be (i) Debtors method or (ii) Stock and debtors method.

Asset taken on hire purchase basis should be considered like ordinary purchase. However, it is necessary to disclose this fact by classifying it as "Asset on Hire Purchase". Accordingly, amount due to the hire vendor should also be shown in his books as a liability—"Hire Purchase Creditors" with additional such classifications of amount of hire purchase instalment due and amount of hire purchase instalment not yet due.

4.1 In the Books of Hire Purchaser

4.1.1. Cash price method

Under this method, the full cash price of the asset is debited to the Asset Account and credited to the Hire Vendor Account. At the time of payment of instalment, Interest Account is debited and Hire Vendor Account is credited (with the interest on outstanding balance). When instalment is paid, the Hire Vendor Account is debited and Bank Account is credited. At the time of preparation of Final Accounts, interest is transferred to Profit and Loss Account and asset is shown in the Balance Sheet at cost less depreciation. The balance due to hire vendor is shown in the Balance Sheet as a liability (alternatively it can be shown as a deduction from Asset Account).

Depreciation on asset acquired on hire purchase must be calculated on *cash price.*

Accounting

To have proper accounting record, one should know: (1) Date of purchase of the asset; (2) Cash price of the asset; (3) Hire purchase price of the asset; (4) The amount of down payment; (5) Number and amount of each instalment; (6) Rate of interest; (7) Method and rate of depreciation; (8) Date of payment of every instalment; and (9) Date of closing the books of account.

Journal Entries

1. *When the asset is acquired on hire purchase*

   Asset Account Dr. [Full cash price]

   To Hire Vendor Account

2. *When down payment is made*

   Hire Vendor Account Dr. [Down payment]

   To Bank Account

3.	*When an instalment becomes due*		
	Interest Account	Dr.	[Interest on outstanding balance]
	To Hire Vendor Account		
4.	*When an instalment is paid*		
	Hire Vendor Account	Dr.	[Amount of instalment]
	To Bank Account		
5.	*When depreciation is charged on the asset*		
	Depreciation Account	Dr.	[Calculated on cash price]
	To Asset Account		
6.	*For closing interest and depreciation account*		
	Profit and Loss Account	Dr.	
	To Interest Account		
	To Depreciation Account		

However, a firm may maintain Provision for Depreciation A/c instead of charging depreciation to Hire Purchase Asset A/c. In such case the journal entry is:

Profit and Loss A/c	Dr.
To Provision for Depreciation for Asset on Hire Purchase A/c	

and naturally, Asset on Hire Purchase is shown at its historical cost.

Disclosure in the balance sheet

Assets	
Fixed Assets :	
Asset (at cash price)	xxxxxxx.xx
Less : Depreciation	xxxx.xx
	xxxxxxx.xx
Creditors :	
Hire Purchase Creditors :	
Balance in hire vendor's A/c	xxxxx.xx

Instalment due	xxxxx.xx
Instalment not yet due	xxxxx.xx

Illustration 1

On January 1, 2006 HP and Co. acquired a pick-up Van on hire purchase from FM & Co. Ltd. The terms of the contract were as follows:

(a) The cash price of the van was Rs.1,00,000.

(b) Rs.40,000 were to be paid on signing of the contract.

(c) The balance was to be paid in annual instalments of Rs.20,000 plus interest.

(d) Interest chargeable on the outstanding balance was 6% p.a.

(e) Depreciation at 20% p.a. is to be written-off using the straight-line method.

You are required to:

(a) Give Journal Entries and show the relevant accounts in the books of HP and Co. from January 1, 2006 to December 31, 2008; and

(b) Show the relevant items in the Balance Sheet of the purchaser as on December 31, 2006 to 2008.

Solution

In the books of HP & Co.

Journal

Date	*Particulars*		*Dr.* *Rs.*	*Cr.* *Rs.*
2006	Pick-up Van A/c	Dr.	1,00,000	
Jan. 1	To FM & Co. Ltd. \A/c			1,00,000
	(Being the purchase of a pick-up van on hire purchase from FM & Co. Ltd.)			
“	FM & Co. Ltd. A/c	Dr.	40,000	
	To Bank A/c			40,000
	(Being the amount paid on signing the H.P. contract)			
Dec. 31	Interest A/c	Dr.	3,600	
	To FM & Co. Ltd. A/c			3,600
	(Being the interest payable @ 6% on Rs.60,000			

“	FM & Co. Ltd. A/c (Rs.20,000+Rs.3,600)	Dr.	23,600	
	To Bank A/c			23,600
	(Being the payment of 1st instalment along with interest)			
“	Depreciation A/c	Dr.	10,000	
	To Pick-up Van A/c			10,000
	(Being the depreciation charged @ 10% p.a. on Rs.1,00,000)			
“	Profit & Loss A/c	Dr.	13,600	
	To Depreciation A/c			10,000
	To Interest A/c			3,600
	(Being the depreciation and interest transferred to Profit and Loss Account)			
2007	Interest A/c	Dr.	2,400	
Dec. 31	To FM & Co. Ltd. A/c			2,400
	(Being the interest payable @ 6% on Rs.40,000)			
	FM & Co. Ltd. A/c (Rs.20,000 + Rs.2,400)	Dr.	22,400	
	To Bank A/c			22,400
	(Being the payment of 2nd instalment along with interest)			
	Depreciation A/c	Dr.	10,000	
	To Pick-up Van A/c			10,000
	(Being the depreciation charged @ 10% p.a.)			
	Profit & Loss A/c	Dr.	12,400	
	To Depreciation A/c			10,000
	To Interest A/c			2,400
	(Being the depreciation and interest charged to Profit and Loss Account)			
2008	Interest A/c	Dr.	1,200	
Dec. 31	To FM & Co. Ltd.A/c			1,200
	(Being the interest payable @ 6% on Rs.20,000)			
	FM & Co. Ltd. A/c (Rs.20,000 + Rs.1,200)	Dr.	21,200	
	To Bank A/c			21,200
	(Being the payment of final instalment along with interest)			

Depreciation A/c	Dr.	10,000	
To Pick-up Van A/c			10,000
(Being the depreciation charged @ 10% p.a. on Rs.1,00,000)			
Profit & Loss A/c	Dr.	11,200	
To Depreciation A/c			10,000
To Interest A/c			1,200
(Being the interest and depreciation charged to Profit and Loss Account)			

Ledger of HP & Co. Ltd.

Dr. **Pick-up Van Account** *Cr.*

Date		*Particulars*	*Rs.*	*Date*		*Particulars*	*Rs.*
1.1.2006	To	FM & Co. Ltd. A/c	1,00,000	31.12.2006	By	Depreciation A/c	10,000
				31.12.2006	By	Balance c/d	90,000
			1,00,000				1,00,000
1.1.2007	To	Balance b/d	90,000	31.12.2007	By	Depreciation A/c	10,000
				31.12.2007	By	Balance c/d	80,000
			90,000				90,000
1.1.2008	To	Balance b/d	80,000	31.12.2008	By	Depreciation A/c	10,000
				31.12.2008	By	Balance c/d	70,000
			80,000				80,000

Dr. **FM & Co. Ltd. Account** *Cr.*

Date		*Particulars*	*Rs.*	*Date*		*Particulars*	*Rs.*
1.1.06	To	Bank A/c	40,000	1.1.06	By	Pick-up Van A/c	1,00,000
31.12.06	To	Bank A/c	23,600		By	Interest c/d	3,600
31.12.06	To	Balance c/d	40,000				
			1,03,600				1,03,600
31.12.07	To	Bank A/c	22,400	1.1.07	By	Balance b/d	40,000

31.12.07	To	Balance c/d	20,000	31.12.07	By	Interest A/c	2,400
			42,400				42,400
31.12.08	To	Bank A/c	21,200	1.1.08	By	Balance b/d	20,000
				31.12.08	By	Interest A/c	1,200
			21,200				21,200

Dr. **Depreciation Account** *Cr.*

Date		*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
31.12.2006	To	Pick-up Van A/c	10,000	31.12.2006	By Profit & Loss A/c	10,000
31.12.2007	To	Pick-up Van A/c	10,000	31.12.2007	By Profit & Loss A/c	10,000
31.12.2008	To	Pick-up Van A/c	10,000	31.12.2008	By Profit & Loss A/c	10,000

Dr. **Interest Account** *Cr.*

Date		*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
31.12.2006	To	FM & Co. Ltd. A/c	3,600	31.12.2006	By Profit & Loss A/c	3,600
31.12.2007	To	FM & Co. Ltd. A/c	2,400	31.12.2007	By Profit & Loss A/c	2,400
31.12.2008	To	FM & Co. Ltd. A/c	1,200	31.12.2008	By Profit & Loss A/c	1,200

Balance Sheet of Gopinath & Co. as at 31st December, 2006

Liabilities	*Rs.*	*Assets*	*Rs.*
FM & Co. Ltd.	40,000	Pick-up Van	90,000

Balance Sheet of Gopinath & Co. as at 31st December, 2007

Liabilities	*Rs.*	*Assets*	*Rs.*
FM & Co. Ltd.	20,000	Pick-up Van	80,000

Balance Sheet of Gopinath & Co. as at 31st December, 2008

Liabilities	*Rs.*	*Assets*	*Rs.*
FM & Co. Ltd.	20,000	Pick-up Van	70,000

4.1.2 Interest suspense method: Under this method, at the time of transfer of possession of asset, the total interest unaccrued is transferred to interest suspense account.

At latter years, as and when interest becomes due, interest account debited and interest suspense account is credited.

Journal Entries

1.	*When the asset is acquired on hire purchase*		
	Asset Account	Dr.	[Full cash price]
	To Hire Vendor Account		
2.	*For total interest payment is made*		
	H.P. Interest Suspense Account	Dr.	[Total interest]
	To Hire Vendor Account		
3.	*When down payment is made*		
	Hire Vendor Account	Dr.	
	To Bank Account		
4.	For Interest of the relevant period		
	Interest Account	Dr.	[Interest of the relevant period]
	To H.P. Interest Suspense Account		
5.	When an instalment is paid		
	Hire Vendor Account	Dr.	
	To Bank Account		
6.	*When depreciation is charged on the asset*		
	Depreciation Account	Dr.	[Calculated on cash price]
	To Asset Account		
7.	*For closing interest and depreciation account*		
	Profit and Loss Account	Dr.	
	To Interest Account		
	To Depreciation Account		

Illustration 2

If we apply this method to the figures from Illustration 1, the H.P. Interest Suspense Account, Interest Account and FM & Co. Ltd. Accounts and Balance Sheets will appear as follows:

Solution

H.P. Interest Suspense Account

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
1.1.2006	To FM & Co. Ltd. A/c (Note 1)	7,200	31.12.2006	By Interest A/c	3,600
			31.12.2006	By Balance c/d	3,600
		7,200			7,200
1.1.2007	To Balance b/d	3,600	31.12.2007	By Interest A/c	2,400
			31.12.2007	By Balance c/d	1,200
		3,600			3,600
1.1.2008	To Balance b/d	1,200	31.12.2008	By Interest A/c	1,200

Dr. **Interest Account** *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
31.12.2006	To H.P. Interest Suspense A/c	3,600	31.12.2006	By Profit & Loss A/c	3,600
31.12.2007	To H.P. Interest Suspense a/c	2,400	31.12.2007	By Profit & Loss A/c	2,400
31.12.2008	To H.P. Interest Suspense A/c	1,200	31.12.2008	By Profit & Loss A/c	1,200

Dr. **FM & Co. Ltd. Account** *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
1.1.2006	To Bank A/c	40,000	1.1.2006	By Pick-up Van A/c	1,00,000
31.12.2006	To Bank A/c	23,600	1.1.2006	By H.P. Interest Suspense A/c	7,200
31.12.2006	To Balance c/d	43,600			
		1,07,200			1,07,200
31.12.2007	To Bank A/c	22,400	1.1.2007	By Balance b/d	43,600
31.12.2007	To Balance c/d	21,200			
		43,600			43,600
31.12.2008	To Bank A/c	21,200	1.1.2008	By Balance b/d	21,200

Balance Sheet of HP & Co. Ltd. as at 31st December, 2006

Liabilities		*Rs.*	*Assets*		*Rs.*
FM & Co. Ltd.	43.600		Pick-up Van	1,00,000	
Less: H.P. Interest Suspense	3,600	40,000	*Less*: Depreciation	10,000	90,000

Balance Sheet of HP & Co. Ltd. as at 31st December, 2007

Liabilities		*Rs.*	*Assets*	*Rs.*	
FM & Co. Ltd.	21,200		Pick-up Van	90,000	
Less: H.P. Interest Suspense	1,200	20,000	Less: Depreciation	10,000	80,000

Balance Sheet of HP & Co. Ltd.. as at 31st December, 2008

Liabilities	*Rs.*	*Assets*		*Rs.*
		Pick-up Van	80,000	
		Less: Depreciation	10,000	70,000

Working Notes: (1) Total Interest = Rs.3,600 + Rs.2,400 + Rs.1,200 = Rs.7,200.

4.2 Books of the Hire Vendor: There are different methods of recording hire purchase transactions in the books of the hire vendor. It is selected according to the type and value of goods sold, volume of transactions, the length of the period of purchase, etc. The different methods are discussed below:

4.2.1 Sales Method: A business that sells relatively large items on hire purchase may adopt this method. Under this method, hire purchase sale is treated as a credit sale. The only exception is that the vendor agrees to accept payments in instalments and for that he charges interest. Generally, a special Sales Day Book is maintained for recording all sales under hire purchase agreement. The amount due from the hire purchaser at the end of the year is shown in the Balance sheet on the assets side as Hire Purchase Debtors.

Journal Entries

1. *When goods are sold and delivered under hire purchase*

   Hire Purchaser Account Dr. [Full cash price]

   To H.P. Sales Account

2.	*When the down payment is received*	
	Bank Account	Dr.
	To Hire Purchaser Account	
3.	*When an instalment becomes due*	
	Hire Purchaser Account	Dr.
	To Interest Account	
4.	*When the amount of instalment is received*	
	Bank Account	Dr.
	To Hire Purchaser Account	
5.	*For closing interest Account*	
	Interest Account	Dr.
	To Profit and Loss Account	
6.	*For closing Hire Purchase Sales Account*	
	H.P. Sales Account	Dr.
	To Trading Account	

In this connection, the student should note the following:

(i) The entire profit on sale under hire purchase agreement is credited to the Profit and Loss account of the year in which the sale has taken place.

(ii) Interest pertaining to each accounting period is credited to the Profit and Loss Account of that year.

4.2.2 Interest Suspense Method: This method is almost similar to the sales method, except the accounting for interest. Under this method, the hire purchaser is debited with full cash price and interest (total) included in the hire selling price. Credit is given to the H.P. Sales Account and Interest Suspense Account. When the instalment is received, the Bank Account is debited and the Hire Purchaser Account is credited. At the same time an appropriate amount of interest (i.e., interest for the relevant accounting period) is removed from the Interest Suspense Account and credited to the Interest Account. At the time of preparation of Final Accounts, interest is transferred to the credit of the Profit and Loss

Account. The balance of the Interest Suspense Account is shown in the Balance Sheet as a deduction from Hire Purchase Debtors.

Journal Entries

1.	When goods are sold and delivered under hire purchase		
	Hire Purchase Account	Dr.	[Full cash price + total interest]
	To H.P. Sales Account		[Full cash price]
	To Interest Suspense Account		[Total Interest]
2.	When down payment/instalment is received		
	Bank Account	Dr.	
	To Hire Purchaser Account		
3.	For interest of the relevant accounting period		
	Interest Suspense Account	Dr.	
	To Interest Account		
4.	For closing interest Account		
	Interest Account	Dr.	
	To Profit and Loss Account		
5.	For closing Hire Purchase Sales Account		
	H.P. Sales Account	Dr.	
	To Trading Account		

The disclosure in balance sheet of the respective parties will be:

Balance Sheet of Hire Purchaser	**Balance Sheet of Vendor**
Assets	Assets
Fixed assets :	Current assets :
Asset on Hire purchase	Hire purchase debtors
Add : Balance in Interest suspense A/c	*Less :* Balance in Interest suspense A/c
Less : Depreciation	

Illustration 3

X Ltd. purchased 3 milk vans from Super Motors costing Rs. 75,000 each on hire purchase system. Payment was to be made: Rs. 45,000 down and the remainder in 3 equal instalments together with interest @ 9%. X Ltd. writes off depreciation @ 20% on the diminishing balance. It paid the instalment at the end of the 1st year but could not pay the next. Super Motor agreed to leave one milk van with the purchaser, adjusting the value of the other two milk vans against the amount due. The milk vans were valued on the basis of 30% depreciation annually on written down value basis. X Ltd. settled the seller's dues after three months.

Solution

In the Books of X Ltd.

		Dr. (Rs.)	*Cr. (Rs.)*
I Year			
Milk Vans purchased:			
Milk Vans A/c	Dr.	2,25,000	
To Vendor A/c			2,25,000
On down payment:			
Vendor A/c	Dr.	45,000	
To Bank			45,000
I Year end			
Interest A/c	Dr.	16,200	
(Rs. 1,80,000 @ 9%)			
To Vendor A/c			16,200
Vendor A/c	Dr.	76,200	
To Bank A/c			76,200
Depreciation @ 20%			
Depreciation A/c	Dr.	45,000	
To Milk Vans A/c			45,000
II Year end			
Depreciation @ 20%			
Depreciation A/c	Dr.	36,000	
To Milk Vans A/c			36,000
Interest A/c	Dr.	10,800	
(1,20,000 @ 9%)			
To Vendor A/c			10,800

Return of goods			
Vendor A/c	Dr.	73,500	
To Milk Vans A/c			73,500
For Loss in Repossession			
Profit/Loss A/c	Dr.	22,500	
To Milk Vans A/c			22,500
IIIrd Year Depreciation			
Depreciation A/c	Dr.	9,600	
To Milk Vans A/c			9,600
Settlement of A/cs			
Vendor A/c	Dr.	57,300	
To Bank			57,300

Milk Vans Account

Year		*Rs.*	*Year*		*Rs.*
1	To Super Motors A/c	2,25,000	1 end	By Depreciation A/c	45,000
			”	By Balance c/d	1,80,000
		2,25,000			2,25,000
2	To Balance b/d	1,80,000	2 end	By Depreciation	36,000
				” Super Motors (value of 2 vans after depreciation for 2 years @ 30%)	73,500
				” P & L A/c (balancing figure)	22,500
				” Balance c/d (one van less depreciation for 2 years)	48,000
		1,80,000			1,80,000

Super Motors Account

Year		*Rs.*	*Year*		*Rs.*
1	To Bank	45,000	1	By Milk Vans A/c	2,25,000
	" Bank	76,200		" Interest @ 9%	
	" Balance c/d	1,20,000		on Rs. 1,80,000	16,200
		2,41,200			2,41,200
2	To Milk Van A/c	73,500	2	By Balance b/d	1,20,000
	" Balance c/d	57,300		" Interest	10,800
		1,30,800			1,30,800
3	To Bank	57,300	3	By Balance b/d	57,300

Illustration 4

A firm acquired two tractors under hire purchase agreements, details of which were as follows:

	Tractor A	*Tractor B*
Date of Purchase	*1st April, 2007*	*1st Oct., 2007*
	Rs.	*Rs.*
Cash price	14,000	19,000
Deposit	2,000	2,680
Interest (deemed to accrue evenly over the period of agreement)	2,400	2,880

Both agreements provided for payment to be made in twenty-four monthly instalments, commencing on the last day of the month following purchase, all instalments being paid on due dates.

On 30th June, 2008, Tractor B was completely destroyed by fire. In full settlement, on 10th July, 2008 an insurance company paid Rs. 15,000 under a comprehensive policy out of which Rs. 10,000 was paid to the hire purchase company in termination of the agreement. Any balance on the hire purchase company's account in respect of these transactions was to be written off.

The firm prepared accounts annually to 31st December and provided depreciation on tractors on a straight-line basis at a rate of 20 per cent per annum rounded off to nearest ten rupees, apportioned as from the date of purchase and up to the date of disposal.

You are required to record these transactions in the following accounts, carrying down the balances on 31st December, 2007 and 31st December, 2008:

(a) Tractors on hire purchase.

(b) Provision for depreciation of tractors.

(c) Disposal of tractors.

(d) Hire purchase company.

Solution

Hire Purchase accounts in the buyer's books

(a) Tractors on Hire Purchase A/c

2007			*Rs.*	*2007*			*Rs.*
April 1	To HP Co. - Cash price		14,000	Dec.31	By Balance c/d		
					Tractor A	14,000	
Oct. 1	" HP Co. - Cash price				Tractor B	19,000	33,000
	Tractor B		19,000				
			33,000				33,000
2008			*Rs.*	*2008*			*Rs.*
Jan. 1	To Balance b/d			June30	By Disposal of		
	Tractor A	14,000			Tractor A/c - Transfer		19,000
	Tractor B	19,000	33,000	Dec.31	" Balance c/d		14,000
			33,000				33,000
2009							
Jan. 1	To Balance b/d		14,000				

(b) Provision for Depreciation of Tractors A/c

2007		*Rs.*	*2007*			*Rs.*
Dec. 31	To Balance c/d	3,050	Dec.31	By P & L A/c :		
				Tractor A	2,100	
				Tractor B	950	3,050
		3,050				3,050
2008		*Rs.*	*2008*			*Rs.*
June 30	To Disposal of Tractor		Jan. 1	By Balance b/d		3,050
	account—Transfer	2,850	Jun. 30	" P & L A/c		
Dec. 31	" Balance c/d	4,900		(Depn. for Tractor B)		1,900
			Dec.31	" P & L A/c		

				(Depn. for Tractor A)	2,800
		7,750			7,750
			2009		Rs.
			Jan. 1	By Balance b/d	4,900

(c)

Disposal of Tractor A/c

2008		*Rs.*	*2008*		*Rs.*
June 30	To Tractors on hire purchase—Tractor B	19,000	June30	By Provision for Depn. of Tractors A/c	2,850
			July 10	” Cash : Insurance	15,000
			Dec.31	” P & L A/c : Loss	1,150
		19,000			19,000

Hire Purchase Co. A/c

2007		*Rs.*	*2007*		*Rs.*
April 1	To Cash (deposit for Tractor A)	2,000	April 1	By Tractors on Hire Purchase A/c - Tractor A	14,000
April Sept.	” Cash—6 instalments @ Rs. 600	3,600	Oct. 1	” Tractors on Hire Purchase A/c —Tractor B	19,000
Oct. 1	” Cash—deposit for Tractor B	2,680	Dec.31	” Interest A/c : For Tractor A @ Rs. 100 for 9 months Rs. 900 For Tractor B @ Rs. 120 for 3 months Rs. 360	1,260
Oct. - Dec.	” Cash—3 instalments @ Rs. 600 for Tractor A	1,800			
	” Cash—3 instalments @ Rs. 800	2,400			
Dec. 31	” Balance c/d	21,780			
		34,260			34,260
2008			2008		
Jan.	To Cash—6 instalments @ Rs. 600 for Tractor A	3,600	Jan. 1	By Balance b/d	21,780
June	” Cash—6 instalments @ Rs. 800 for Tractor B	4,800	Jun. 30	” Interest A/c—for Tractor B @ Rs. 120 for 6 months	720
July 10	” Cash - final instalment for Tractor B	10,000	Dec.31	” Interest - for Tractor A @ Rs. 100 for 12 months	1,200
July-	” Cash - 6 instalments @				

		Rs. 600 for Tractor A	3,600	
Dec.	”	Balance c/d	1,500	
	”	P & L A/c—unpaid amount	200	
			23,700	23,700

Illustration 5

A machinery is sold on hire purchase. The terms of payment is four annual instalments of Rs. 6,000 at the end of each year commencing from the date of agreement. Interest is charged @ 20% and is included in the annual payment of Rs. 6,000.

Show Machinery Account and Hire Vendor Account in the books of the purchaser who defaulted in the payment of the third yearly payment whereupon the vendor re-possessed the machinery. The purchaser provides depreciation on the machinery @ 10% per annum. All workings should form part of your answers.

Solution

Machinery Account

		Rs.				*Rs.*
I Yr.	To Hire Vendor A/c	15,533	I Yr.	By	Depreciation A/c	1,553
				”	Balance c/d	13,980
		15,533				15,533
II Yr.	To Balance b/d	13,980	II Yr.	By	Depreciation A/c*	1,398
				”	Balance c/d	12,582
		13,980				13,980
III Yr.	To Balance b/d	12,582	III Yr.	By	Depreciation A/c*	1,258
				”	Hire Vendor	11,000
				”	Profit & Loss A/c (Loss on Surrender)	324
		12,582				12,582

*It has been assumed that depreciation has been written off on written down value method. Alternatively straight line method may be assumed.

Depreciation has been directly credited to the Machinery Account; it could have been accumulated in provision for depreciation account.

Hire Vendor Account

			Rs.				*Rs.*
I Yr.	To	Bank A/c	6,000	I Yr.	By	Machinery A/c	15,533
	”	Balance c/d	12,639		”	Interest A/c	3,106
			18,639				18,639
II Yr.	To	Bank A/c	6,000	II Yr.	By	Balance b/d	12,639
	”	Balance c/d	9,167		”	Interest A/c	2,528
			15,167				15,167
III Yr.	To	Machinery A/c (transfer)	11,000	III Yr.	By	Balance b/d	9,167
					”	Interest A/c	1,833
			11,000				11,000

Note : Alternatively, total interest could have been debited to Interest Suspense A/c and credited to Hire Vendor A/c with consequential changes.

Working Notes:

		Instalment Amount	*Interest*	*Principal*
4th Instalment		6,000	Rs.	Rs.
Interest	$6{,}000 \times \frac{20}{120}$	1,000	1,000	5,000
		5,000		
Add : 3rd Instalment		6,000		
		11,000		
Interest	$11{,}000 \times \frac{20}{120}$	1,833	1,833	4,167
		9,167		
Add : 2nd Instalment		6,000		
		15,167		
Interest	$15{,}167 \times \frac{20}{120}$	2,528	2,528	3,472
		12,639		
Add : Ist Instalment		6,000		
		18,639		
Interest	$18{,}639 \times \frac{20}{120}$	3,106	3,106	2,894
		15,533	8,467	15,533

Illustration 6

X Transport Ltd. purchased from Delhi Motors 3 Tempos costing Rs. 50,000 each on the hire purchase system on 1-1-2006. Payment was to be made Rs. 30,000 down and the remainder in 3 equal annual instalments payable on 31-12-2006, 31-12-2007 and 31-12-2008 together with interest @ 9%. X Transport Ltd. write off depreciation at the rate of 20% on the diminishing balance. It paid the instalment due at the end of the first year i.e. 31-12-2006 but could not pay the next on 31-12-2007. Delhi Motors agreed to leave one Tempo with the purchaser on 1-1-2008 adjusting the value of the other 2 Tempos against the amount due on 31-12-2007. The Tempos were valued on the basis of 30% depreciation annually. Show the necessary accounts in the books of X Transport Ltd. for the years 2006, 2007 and 2008.

Solution

X Transport Ltd.

Tempo Account

Dr.						*Cr.*
2006			*Rs.*	*2006*		*Rs.*
Jan.	1	To Delhi Motors	1,50,000	Dec.31	By Depreciation A/c :	
					20% on 1,50,000	30,000
					" Balance c/d	1,20,000
			1,50,000			1,50,000
2007				2007		
Jan.	1	To Balance b/d	1,20,000	Dec.31	By Depreciation A/c	24,000
					" Delhi Motors A/c (Value of 2 tempos taken away)	49,000
					" Profit and Loss A/c (balancing figure)	15,000
					" Balance c/d (Value of one tempo left)	32,000
			1,20,000			1,20,000
2008				2008		
Jan.	1	To Balance b/d	32,000	Dec.31	By Depreciation A/c	6,400
					" Balance b/d	25,600
			32,000			32,000

Delhi Motors Account

2006			*Rs.*	*2006*			*Rs.*
Jan. 1	To	Bank (Down Payment)	30,000	Jan. 1	By	Tempos A/c	1,50,000
Dec. 31	”	Bank	50,800	Dec.31	”	Interest (9% on Rs. 1,20,000)	10,800
	”	Balance c/d	80,000				
			1,60,800				1,60,800
2007				2007			
Jan. 1	To	Tempo	49,000	Jan. 1	By	Balance b/d	80,000
Dec. 31	”	Balance c/d	38,200	Dec.31	”	Interest (9% on Rs. 80,000)	7,200
			87,200				87,200
2008			Rs.	2008			Rs.
Dec. 31	To	Bank	41,638	Jan. 1	By	Balance b/d	38,200
				Dec.31	”	Interest (9% on Rs. 38,200)	3,438
			41,638				41,638

Alternative Method

Tempo Account

2006			*Rs.*	*2006*			*Rs.*
Jan. 1	To	Bank A/c (down payment)	30,000	Dec. 31	By	Depreciation @ 20% on Rs. 1,50,000	30,000
Dec. 31	”	Delhi Motors A/c (Ist instalment)	40,000		”	Balance c/d	40,000
			70,000				70,000
2007			*Rs.*	*2007*			*Rs.*
Jan. 1	To	Balance b/d	40,000	Dec. 31	By	Depreciation A/c	24,000
Dec. 31	”	Delhi Motors A/c - creating a liability for Rs. 38,200, amount due (see 1st method)	38,200		”	Profit & Loss A/c (balancing figure)	22,200
					”	Balance c/d (Value of tempo left)	32,000
			78,200				78,200
2008			*Rs.*	*2008*			*Rs.*
Jan. 1	To	Balance b/d	32,000	Dec. 31	By	Depreciation A/c	6,400
					”	Balance b/d	25,600
			32,000				32,000

Delhi Motors

2006		*Rs.*	*2006*		*Rs.*
Dec. 31	To Bank A/c	50,800	Dec. 31	By Tempo A/c	40,000
				By Interest A/c	10,800
		50,800			50,800
2007		*Rs.*	*2007*		*Rs.*
Dec. 31	To Balance c/d	38,200	Dec. 31	By Tempos A/c	38,200
2008			*2008*		
Dec. 31	To Bank A/c	41,638	Jan. 1	By Balance b/d	38,200
			Dec. 31	” Interest (9% on Rs. 38,200)	3,438
		41,638			41,638

Working Notes :

(1) Value of a Tempo left with the buyer:

	Rs.
Cost	50,000
Depreciation @ 20% p.a. under WDV method for 2 years i.e. Rs.10,000 + Rs.8,000	18,000
Value of the Tempo left with the buyer at the end of 2nd year	32,000

(2) *Value of Tempos taken away by the seller:*

No. of tempos Two

	Rs.
Cost Rs. 50,000 × 2 =	1,00,000
Depreciation @ 30% Under WDV method for 2 years i.e. Rs. 30,000 + Rs. 21,000	51,000
Value of tempos taken away at the end of 2nd year	49,000

Illustration 7

M/s Delhi Electronics sells colour TVs., on hire purchase basis. Cost per set is Rs. 14,000, Cash sale price Rs. 15,500 and hire purchase sale price is Rs. 16,800 for 12 monthly instalments payable by 10th of every month. However, the buyer has to make cash down Rs. 1,800 at the time of purchase.

Hire Purchase transactions (No. of sets) in 2008 - Jan. 10, Feb. 12, March 10, April 12, May 10, June 10, July 10, August 15, Sept. 11, Oct. 20, Nov. 20, Dec. 10.

Let us suppose all instalments are duly collected. Show necessary Journal Entries.

Solution

Various relevant accounting information in relation to hire purchase transactions are computed as follows :

Total No. of Transactions	:	150
Cash down	:	Rs. 1,800 × 150 = Rs. 2,70,000

Instalments Collected/Due

Transactions	*No. of Instalments collected*				*No. of Instalments Due*			
Jan.	10 ×	11	=	110	10 ×	1	=	10
Feb.	12 ×	10	=	120	12 ×	2	=	24
March	10 ×	9	=	90	10 ×	3	=	30
April	12 ×	8	=	96	12 ×	4	=	48
May	10 ×	7	=	70	10 ×	5	=	50
June	10 ×	6	=	60	10 ×	6	=	60
July	10 ×	5	=	50	10 ×	7	=	70
Aug.	15 ×	4	=	60	15 ×	8	=	120
Sept.	11 ×	3	=	33	11 ×	9	=	99
Oct.	20 ×	2	=	40	20 ×	10	=	200
Nov.	20 ×	1	=	20	20 ×	11	=	220
Dec.	10 ×	0	=	—	10 ×	12	=	120
	150			749	150			1051

Check:

Total Instalments for 150 hire purchase transactions are 1800. (150×12) of which 749 instalments fell due and collected and the balance 1051 instalments are not yet paid.

Amount collected for 749 instalments

$$\frac{\text{Rs.}16{,}800 - \text{Rs.}1{,}800}{12} \times 749 = \text{Rs. } 9{,}36{,}250$$

Amount not yet due

$$\frac{\text{Rs.}16{,}800 - \text{Rs.}1{,}800}{12} \times 1{,}051 = \text{Rs. } 13{,}13{,}750$$

Cash Down = Rs. 2,70,000

Total (Rs. 16,800 × 150) = Rs. 25,20,000

Hire Vendor should recognise the amount of instalments collected and cash down value (i.e. Rs. 2,70,000 + Rs. 9,36,250) Rs. 12,06,250 as sale. Balance Rs. 13,13,750 is value of goods lying with the customer at hire purchase price. Stock Reserve should be computed and deducted from such amount to show the Hire Purchase Stock at cost.

$$\text{Goods lying with Hire Purchaser at Hire Purchase Price} \times \frac{\text{Cost}}{\text{Hire Purchase Price}}$$

$$\text{Stock at cost} \qquad = \text{Rs.}13{,}13{,}750 \times \frac{\text{Rs.}14{,}000}{\text{Rs.}16{,}800}$$

= Rs. 10,94,792

Stock Reserve = (Rs. 13,13,750 – 10,94,792) = Rs. 2,18,958

Journal Entries

				Rs.	Rs.
(1)	For Cash down at the time of hire transaction	Cash/Bank A/c	Dr.	2,70,000	
		To Hire Purchase Sale A/c			2,70,000
(2)	When instalments fall due	Instalment Due A/c	Dr.	9,36,250	
		To Hire Purchase Sales			9,36,250
(3)	On collection of instalments	Cash/Bank A/c	Dr.	9,36,250	
		To Instalment Due A/c			9,36,250
(4)	For instalment not due at the year	Hire Purchase Stock A/c	Dr.	13,13,750	
		To Trading A/c			13,13,750
(5)	For Stock Reserve	Stock Reserve A/c	Dr.	2,18,958	
		To Hire Purchase Stock A/c			2,18,958

If some instalments become due but not collected at the year end, such would appear in the Balance Sheet as an asset just like Sundry Debtors.

5. DEBTORS METHOD

In this method the Hire purchase Trading account is prepared.

The objective of preparing Hire Purchase Trading Account is to measure the profitability of the Hire Purchase division separately. Let us see how to prepare Hire Purchase Trading Account.

(1) Credit all down payments and instalments falling due to hire purchase sales account. Transfer balance in Hire Purchase Sales Account to Hire Purchase Trading Account.

(2) Transfer cost of all transactions to Hire Purchase Trading Account.

Hire Purchase Trading A/c Dr.
To Shop Stock A/c

(3) Charge any special expenses to Hire Purchase Trading Account.

(4) Treat instalments not yet due as stock lying with customers and transfer to Hire Purchase Trading Account.

(5) Charge appropriate stock reserve.

Illustration 8

With the information given in Illustration 6, prepare Hire Purchase Trading A/c.

Solution

Hire Purchase Trading A/c

		Rs.			*Rs.*
To	Shop Stock (14,000 × 150)	21,00,000	By	Hire Purchase Sales A/c	12,06,250
”	Stock Reserve	2,18,958	”	Stock (with customers)—at hire purchase price	13,13,750
”	Profit—transferred to P & L A/c	2,01,042			
		25,20,000			25,20,000

Illustration 9

M/s Wye & Co. sell goods on hire purchase, adding 50% to cost. From the following figures prepare the Hire Purchase Trading Account:

	Rs.
Goods with customers in Jan. 2008, instalments not yet due	5,400

Goods sold on hire purchase during 2008	25,500
Cash received from customers during 2008	20,100
Instalments due but not yet received at the end of the year, customers paying	1,800

All figures are on the basis of hire purchase price.

Solution

Hire-purchase Trading Account for the year ending 31st Dec., 2008

Dr.			Cr.
	Rs.		Rs.
To Stock with Customers on 1-1-2008 - hire purchase price	5,400	By Cash	20,100
		" Instalments due	1,800
" Goods sold on Hire-purchase A/c	25,500	" Goods sold on Hire Purchase A/c - loading	8,500
" Stock Reserve required	3000	" Stock Reserve (Opening)	1,800
" Profit & Loss A/c	7,300	" Stock with customers	9,000*
	41,200		41,200

***Stock with Customers on 31-12-2008**		Rs.
Instalment not due on 1-1-2008		5,400
Goods sold on H.P.		25,500
		30,900
Less : Cash received	20,100	
Instalments due	1,800	21,900
		9,000

6. ASCERTAINMENT OF TOTAL CASH PRICE

We know that the basis for accounting in the books of the hire purchaser is the total cash price. Sometimes, the total cash price may not be given. For the purpose of ascertaining the total cash price we can use any of the following methods according to the need.

(1) Calculation of total cash price when no annuity table is given.

(2) Calculation of total cash price when annuity table is given.

7. CALCULATION OF TOTAL CASH PRICE WHEN THE ANNUITY TABLE IS NOT GIVEN

In this method, the interest included in the last instalment is to be calculated first with the help of the appropriate formula (explained below).

For example in a hire purchase transaction, apart from down payment, four other instalments are payable. The interest will be calculated first on the 4th instalment, then on the 3rd instalment, then on the 2nd instalment and lastly on the 1st instalment. Interest on down payment will be nil.

In this connection, it should be noted that the amount of interest will go on increasing from the 4th instalment to the 3rd instalment, from the 3rd instalment to the 2nd instalment and from the 2nd instalment to the 1st instalment.

We know that interest is to be calculated on the outstanding balance of cash price.

In this case, we will have to calculate the interest with the help of the total amount due on hire purchase price since the cash price is not known. For the purpose of calculating the interest, the following steps should be followed:

Step 1: Calculation the ratio between interest and the amount due with the help of the following formula:

$$\text{Ratio of interest and amount due} = \frac{\text{Rate of interest}}{100 + \text{Rate of interest}}$$

Step 2: Calculate the interest included in the last instalment by applying the following formula:

Interest = Total amount due at the time of instalment x Ratio of interest and amount due (as calculated in step 1)

Step 3: Subtract the interest (as calculated in step 2) from this instalment to get the amount of outstanding cash price at the time of last instalment.

Step 4: Add the cash price calculated in Step 3 to the amount of instalment due at the end of the third year.

Step 5: Calculate the interest on the entire sum (cash price included in the 4th instalment + amount of 3rd instalment). Deduct this interest from the total amount due at the end of 3rd year to get the outstanding cash price at the time of 3rd instalment.

Step 6: Add the cash price calculated in step 5 to the amount of instalment due at the end of 2nd year.

Step 7: Calculate the interest on the entire sum so obtained in Step 6. Deduct this interest from the total amount due at the end of 2nd year to get the outstanding cash price at the time of 2nd instalment.

Step 8: Add the cash price calculated in Step 7 to the amount of instalment due at the end of 1st year.

Step 9: Calculate the interest on the entire sum so obtained in Step 8. Deduct this interest from the total amount due at the end of 1st year to get the outstanding cash price at the time of 1st instalment.

Step 10: Add the cash price calculated in Step 9 to the amount of down payment, if any. The sum so obtained will be the total cash price.

Illustration 10

A & Co. purchased a truck on hire purchase system. As per terms he is required to pay Rs.70,000 down, Rs.53,000 at the end of first year, Rs.49,000 at the end of second year and Rs.55,000 at the end of third year. Interest is charged @ 10% p.a.

You are required to calculate the total cash price of the truck and the interest paid with each instalment.

Solution

(1) Ratio of interest and amount due = $\frac{\text{Rate of int erest}}{100+\text{Rate of int erest}} = \frac{10}{110} = {}^{1}\!/_{11}$

(2) **Calculation of Interest and Cash Price**

No. of instalments	Amount due at the time of instalment	Interest	Cash price
[1]	**[2]**	**[3]**	**[4]**
3rd	55,000	1/11 of Rs.55,000 =Rs.5,000	50,000
2nd	*99,000	1/11 of Rs.99,000 = Rs.9,000	90,000
1st	**1,43,000	1/11of Rs.1,43,000 = Rs.13,000	1,30,000

Total cash price = Rs.1,30,000+ 70,000 (down payment) =Rs.2,00,000.

*Rs.50,000 + 2nd instalment of Rs.49,000 = Rs.99,000.

** Rs.90,000 + 1st instalment of Rs. 53,000 = Rs.1,43,000.

8. ASCERTAINMENT OF INTEREST

We know that the hire purchase price consists of two elements: (i) cash price; and (ii) interest. Cash price is the capital expenditure incurred for the acquisition of an asset and (ii) interest is the revenue expense for the delay in making the full payment. Ascertainment of any of these two gives the answer for the other, e.g., if we ascertain the total amount of interest, it becomes very simple to ascertain the cash price just by deducting the interest from the hire purchase price.

Interest is charged on the amount outstanding. Therefore, if the hire purchaser makes a down payment on signing the contract, it will not include any amount of interest. It should be noted that though the instalments of a hire purchase agreement may be equal, the interest element in each instalment is not the same.

At the time of calculating interest, students may face the following two situations:

(a) When the cash price, rate of interest and the amount of instalments are given; and

(b) When the cash price and the amount of instalments are given, but the rate of interest is not given.

Now, let us consider the above two situations.

8.1 When the cash price, rate of interest and the amount of instalments are given: In this situation, the total amount of interest is to be ascertained first. It is the difference between the hire purchase price (down payment + total instalments) and the cash price. To calculate the amount of interest involved in each instalment the following steps are followed:

Step 1: Deduct down payment from the cash price. Calculate the interest at the given rate on the remaining balance. This represents the amount of interest included in the first instalment.

Step 2: Deduct the interest of Step 1 from the amount of first instalment. The resultant figure is the cash price included in the first instalment.

Step 3: Deduct the cash price of the 1st instalment (Step 2) from the balance due after down payment. It represents the amount outstanding after the 1st instalment is paid.

Step 4: Calculate the interest at the given rate on the balance outstanding after the 1st instalment. Deduct this interest from the amount of the 2nd instalment to get the cash price included in the 2nd instalment.

Step 5: Deduct the cash price of the 2nd instalment (Step 4) from the balance due after the 1st instalment. It represents the amount outstanding after the 2nd instalment is paid.

Repeat the above steps till the last instalment is paid.

8.2 When the cash price and the amount of instalments are given, but the rate of interest is not given. When the rate of interest is not given, but the cash price and the amount of instalments are given, the following steps are followed to calculate the interest:

Step 1: Calculate the total interest by deducting the cash price from the hire purchase price (i.e., down payment + amount of instalment x number of instalments).

Step 2: Deduct down payment from the hire purchase price.

Step 3: Calculate the amount of outstanding balance of the hire purchase price at the beginning of each year.

Step 4: Calculate the ratio of outstanding balance of Step 3.

Step 5: Calculate the amount of interest of each instalment on the basis of the ratio of Step 4.

9. REPOSSESSION

In a hire purchase agreement the hire purchaser has to pay up to the last instalment to obtain the ownership of goods. If the hire purchaser fails to pay any of the instalments, the hire vendor takes the asset back in its actual form without any refund of the earlier payments to the hire purchaser. The amounts received from the hire purchaser through down payment and instalments are treated as the hire charges by the hire vendor. This act of recovery of possession of the asset is termed as **repossession.**

Repossessed assets are resold to any other customer after repairing or reconditioning (if necessary). Accounting figures relating to repossessed assets are segregated from the normal hire purchase entries. Repossessions are then accounted for in a separate "Goods Repossessed Account".

So far as the repossession of assets are concerned, the hire vendor can take back the whole of the asset or a part thereof depending on the agreement between the parties. The former is called "Complete Repossession" and the latter "Partial Repossession".

9.1 Complete Repossession In this case of a complete repossession, the hire vendor closes the Hire Purchaser's Account in his books by transferring the balance of the Hire Purchaser Account to the Goods Repossessed Account. Likewise, the hire purchaser closes the Hire Vendor's Account in his books by transferring the balance of the Hire Purchase Assets Account to the Hire Vendor Account.

9.1.1 Entries in the Books of the Hire Vendor

1. All the entries (excep ot the entry for payment) are passed in the usual manner upto the date of default.	
2. When the goods are repossessed and the account of the hire purchaser is closed.	
Goods Repossessed Account	Dr.
To Hire Purchaser Account	
3. When repairing and reconditioning expenses are paid	
Goods Repossessed Account	Dr.
To Bank/Cash Account	

4. When repossessed goods aresold

Bank/Cash Account Dr.

To Goods Repossessed Account

When all the above entries are incorporated in the Goods Repossessed Account, it may show a balance. If it is a debit balance, it shows a loss. Conversely, if it is a credit balance, it indicates a profit. The balance is ultimately transferred to the Profit and Loss Account

5. For Closing goods repossessed account

(i) Profit and Loss Account Dr. [In case of Loss]

To Goods Repossessed Account

OR

(ii) Goods Repossessed Account Dr. [In case of Profit]

To Profit and Loss Account

9.1.2 Entries in the Books of the Hire Purchaser: The hire purchaser keeps two accounts – Asset Account and the Hire Vendor Account. At the time of complete repossession, both the accounts are to be closed. The following are the important Journal Entries.

1. All the entries (except the entry for payment) are passed in the usual manner upto the date of default.

2. Usual entry for depreciation is also passed.

3. When the asset is taken back and the account of the hire vendor is closed

Hire Vendor Account Dr.

To Assets Account

4. When the asset account is closed

Profit and Loss Account Dr.

To Asset Account

Generally, an asset is repossessed at a priceless than the book value. Therefore, it is a loss to the hire purchaser. In case of profit, the above entry will be reversed.

9.2 Partial Repossession: In case of a partial repossession, only apart of the asset is taken back by the hire vendor and other part is left with the hire purchaser. The Journal Entries are as usual up to the date of default (excepting entry for payment) in the books of both the parties. As a portion of the asset is still left with the hire purchaser, neither party closes the account of the other in their respective books.

Assets are repossessed at a mutually agreed value (based on agreed rate of depreciation which is an enhanced rate). The hire vendor debits the Goods Repossessed Account and credit the Hire Purchaser Account with the value as agreed upon on the repossession. Similarly, the hire purchaser debits the Hire Vendor Account and credits the Assets Account with the same amount. If the repossessed value is less than the book value of the asset, the difference is charged to the Profit and Loss Account of the hire purchaser as **'loss on surrender'.**

For the remaining portion of the asset lying with the hire purchaser, the (Hire Purchaser) applies the usual rate of depreciation and shows the Asset Account at its usual written-down value.

Illustration 11

From the following prepare Hire Purchase Trading Account of M/s Kolkata Traders who sells goods on hire purchase basis at cost plus 25%.

	Rs.
Instalments not due on 31-12-2007	3,00,000
Instalments due and collected during 2008	8,00,000
Instalments due but not collected during 2008 including Rs. 10,000 for which goods were repossessed	50,000
Instalments not due on 31-12-2008 including Rs. 20,000 for which goods were repossessed	3,70,000
Instalments collected on repossessed stock	15,000

M/s Kolkata Traders valued repossessed stock at 60% of original cost.

Solution

Working Notes:

		Rs.
(1)	Hire Purchase Sales:	
	Instalments due and collected	8,00,000
	Add: Instalments due but not collected	50,000
		8,50,000
(2)	Loss on Repossessed stock:	
	Hire Purchase Price of Repossessed Stock	
	Instalments Collected	15,000
	Instalments Due	10,000

	Instalments Not Due	20,000
		45,000
	Cost $\text{Rs. } 45{,}000 \times \frac{100}{125}$	36,000
	Valuation on repossession $\text{Rs. } 36{,}000 \times \frac{60}{100}$	21,600
	Cost of instalments due + Instalments not yet due	
	$(\text{Rs. } 10{,}000 + 20{,}000) \times \frac{100}{125}$	24,000
	Loss (Rs. 24,000 – Rs. 21,600)	2,400
(3)	Goods taken from shop stock at cost:	
	H.P. Sales at cost $\left[8{,}50{,}000 \times 100/125\right]$	6,80,000
	Stock with customers 31-12-2008 at cost	
	$\left[\text{Rs. } 3{,}50{,}000 \times \frac{100}{125}\right]$	2,80,000
		9,60,000
	Less : Stock with customers 31-12-2007 at Cost	2,40,000
	$\left[\text{Rs. } 3{,}00{,}000 \times \frac{100}{125}\right]$	7,20,000
(4)	Bad Debt :	
	Instalment due but not collected	10,000
	Instalment not yet due at cost	
	$\left[\text{Rs. } 20{,}000 \times \frac{100}{125}\right]$	16,000
		26,000
	Less: Cost of instalments due and instalments not yet due	24,000
		2,000

Hire Purchase Trading A/c

		Rs.			*Rs.*
To	Goods with customers at cost (31-12-2007)	2,40,000	By	Hire Purchase Sale	8,50,000
"	Shop Stock	7,20,000	"	Goods with customers at cost (31-12-2008)	2,80,000

”	Bad Debt	2,000	
”	Loss on Repossession	2,400	
”	Profit & Loss A/c		
	Transfer of H.P. Profit	1,65,600	
		11,30,000	11,30,000

10. STOCK AND DEBTORS METHOD

In this method, Hire Purchase Stock Account, Hire Purchase Adjustment Account is maintained. Following are the entries to be made.

(i) When goods are sold on hire purchase

Hire purchase stock A/c Dr. Full H.P. Price

To Stock A/c Actual cost price

To Hire Purchase Adjustment A/c

(Being the difference between cost and H.P. price)

(ii) When instalments become due for payment

Hire purchase Debtors A/c Dr.

To Hire purchase Stock A/c

(iii) When cash is received
Cash A/c Dr.

To Hire Purchase Debtors A/c

(iv) Stock Reserve on opening Stock

Stock Reserve A/c Dr.

To Hire Purchase Adjustment A/c

(v) Stock Reserve on closing Stock
Hire Purchase Adjustment A/c Dr.
To Stock Reserve A/c

Hire purchase Debtors Account will consist of opening balance instalment due on goods sold on hire purchase on the debit side while cash received and closing balance on the credit side.

Hire purchase stock account will consist of opening balance and goods sold on hire purchase during the year in the debit side, while instalments due from debtors and closing balance on the credit side. The stock values are recorded at hire purchase price (i.e. cost + profit on H.P. Sales).

Hire purchase adjustment account will consist of stock reserve on opening stock and closing stock in the credit side and debit side respectively. Further the loading element in goods sold on hire purchase (profit) will be credited in this account. This account shows the actual profit earned by means of hire purchase system.

Illustration 12

The hire purchase department of B.G. Ltd. sells television sets and room coolers. This department was newly started in 2008. The relevant information is as follows:

	Television set *Rs.*	*Room coolers* *Rs.*
Cost	5,400	2,000
Cash Price	6,300	2,400
Cash down payment	900	400
Monthly instalment	600	200
Number of instalments	10	12

During the year, 100 television sets and 120 room coolers were sold on hire purchase basis. Two television sets on which 3 instalments only could be collected and 4 room coolers on which 5 instalments had been collected were repossessed. These were valued at Rs. 10,000 and after reconditioning at a cost of Rs. 1,000 were sold outright for Rs. 14,000. Other instalments collected and those due (customer still paying) were respectively as follows :

Television sets	270 and 20
Room coolers	400 and 30

Prepare Accounts on stocks and debtors system to reveal the profit of the Department.

Solution

B.G. Limited

Hire Purchase Stock A/c

	Rs.		*Rs.*
To Goods sold on H.P.	10,26,000	By H.P. Debtors A/c	4,05,600
		" Goods Repossessed A/c (Instalments not due on repossessed goods)	14,000

			”	Balance c/d	
				(Instalment not yet due)	6,06,400
		10,26,000			10,26,000

Hire Purchase Debtors A/c

To	Hire Purchase Stock A/c	4,05,600	By	Bank A/c	3,87,600
			By	Balance c/d	18,000
		4,05,600			4,05,600

Goods Repossessed A/c

To	Hire Purchase Stock A/c	14,000	By	Hire Purchase Adjustment A/c	
				(Balancing Figure)	4,000
			”	Balance c/d	10,000
		14,000			14,000
To	Balance b/d	10,000	By	Bank (Sales)	14,000
”	Bank (Exp.)	1,000			
”	Hire Purchase Adjustment A/c				
	(Profit)	3,000			
		14,000			14,000

Goods sold on Hire Purchase A/c

To	Hire Purhcase		By	Hire Purchase Stock A/c	10,26,000
”	Adjustment A/c (loading)	2,46,000			
”	Profit	7,80,000			
		10,26,000			10,26,000

Hire Purchase Adjustment A/c

To	Goods repossessed A/c (Loss)	4,000	By	Goods sold on Hire	
”	Stock Reserve	1,44,971		Purchase (Loading)	2,46,000
”	Profit	1,00,029	”	Goods Repossessed	
				(Profit on sale)	3,000
		2,49,000			2,49,000

Working Notes :

(*i*) Hire Purchase Price is Rs. 6,900 for each television set and Rs. 2,800 for each room cooler. Total cost and sales on this basis are as follows:

	H.P. Price	*Cost*
	Rs.	*Rs.*
Television sets (100)	6,90,000	5,40,000
Room Coolers (120)	3,36,000	2,40,000
	10,26,000	7,80,000

		Television sets	*Room Coolers*	
		Rs.	*Rs.*	
(*ii*) Cash collected				
Down payment				
	(900 × 100)	90,000	48,000	(400 × 120)
Instalments collected				
	(600 × 270)	1,62,000	80,000	(400 × 200)
Amount collected on				
Repossessed goods				
	(3 × 2 × 600)	3,600	4,000	(5 × 4 × 200)
		2,55,600	1,32,000	

(*iii*) Instalment not yet due:	*Rs.*
Television: Total instalments on 98 sets	980
Instalments collected & due	290
	690
Amount of 690 instalments @ Rs. 600 each	4,14,000
Room Coolers:	
Total instalment on 116 Room Coolers	1,392
Less : Instalments collected & due	430
	962

Amount of 962 instalments @ Rs. 200 each = Rs. 1,92,400

Total amount (4,14,000 + 1,92,400) = Rs. 6,06,400 (*iv*) Stock Reserve :

Television sets	$\frac{1,500}{6,900} \times 4,14,000$	90,000
Room Coolers	$\frac{800}{2,800} \times 1,92,400$	54,971
		1,44,971

(*v*) Instalment not due on repossessed goods:

	Rs.
2 Television sets 7 instalments on each @ Rs. 600	8,400
4 Room Coolers 7 instalments on each @ Rs. 200	5,600
	14,000

(*vi*) Instalment due but not collected :

	Rs.
Television sets (20 × Rs. 600)	12,000
Room Cooler (30 × Rs. 200)	6,000
	18,000

Illustration 13

Y Ltd. sells products on hire purchase terms, the price being cost plus 33-1/3%. From the following particulars for 2008, prepare Hire Purchase Stock Account, Shop Stock Account, Hire Purchase Debtors Account, Stock Reserve Account and Hire Purchase Adjustment Account (for profit) :

2008		*Rs.*
Jan. 1	Stock out on hire at Hire Purchase Price	1,20,000
	Stock in hand, at Shop	15,000
	Instalment due (Customers still paying)	9,000
Dec. 31	Stock out on hire at Hire Purchase Price	1,38,000
	Stock in hand, at Shop	21,000
	Instalments due (Customers still paying)	15,000
	Cash received during the year	2,40,000

Solution

Hire Purchase stock Account

2008		*Rs.*	*2008*		*Rs.*
Jan. 1	To Balance b/d	9,000	Jan. 1	By Bank A/c	2,40,000

		Rs.			Rs.
	” Hire Purchase Stock A/c (instalments due during the year) (Balancing fig.)	2,46,000		” Balance c/d	15,000
		2,55,000			2,55,000

Hire Purchase Stock Account

2008		Rs.	2008		Rs.
Jan. 1	To Balance b/d	1,20,000	Jan. - Dec.	By H.P. Debtors A/c	2,46,000
”	” Goods sold on Hire Purchase (75%)	1,98,000	Dec. 31	” Balance c/d	1,38,000
”	” H.P., Adj. A/c (25%)	66,000			
		3,84,000			3,84,000

Shop Stock Account

2008		Rs.	2008		Rs.
Jan. 1	To Balance b/d	15,000		By H.P. Stock A/c (Cost of Goods sold)	1,98,000
	” Purchases A/c (Balancing fig.)	2,04,000		” Balance c/d	21,000
		2,19,000			2,19,000

Stock Reserve Account

2008		Rs.	2008		Rs.
	To Hire Purchase Adjustment (transfer)	30,000		By Balance b/d (25% on 1,20,000)	30,000
	” Balance c/d	34,500		“ Hire Purchase Adjustment A/c	34,500
		64,500			64,500

Hire Purchase Adjustment Account

2008		Rs.	2008		Rs.
	To Stock Reserve-Closing	34,500		By Stock Reserve-Opening	30,000
	” Profit & Loss Account	61,500		“ H.P. Stock	66,000
		96,000			96,000

11. HIRE PURCHASE AGREEMENT FOR GOODS OF SMALL VALUE

Till now, we have discussed on the hire purchase transactions for goods of substantial sales value – generally the fixed assets and the transactions were between **two business units.**

Now, we should discuss on the transactions between a retailer and the consumers and the hire purchase of consumer durable. Here, it should be noted that accounting is important only from the point of view of the seller and not the buyer.

Due to numerous transactions on the sale of such items and that too of small value, it becomes practically inconvenient for a particular retailer to maintain separate accounts for each transaction. Also, the retailer does not want to know the profit earned or losses incurred on each transaction – rather he will be interested in knowing the overall profit or loss arising from all the transactions in a particular accounting period.

When the hire purchase transactions are numerous and value of the items is small, it is preferable to open separate **memorandum** hire purchase books. A Hire Purchase Sales Register is kept, to disclose both the hire purchase price and the cost price of the goods. This register should also show the number of instalments payable amount of down payment and the number of hire purchase agreement. In memorandum Hire Purchase Ledger accounts of the customers are kept. The sale price is debited to the individual customers' accounts and these accounts being credited with all instalments paid. The total of the "sale price" column is credited to a Control Account, which is debited with the total instalments received.

It must be noted that above entries are of a memorandum nature only, and do not form a part of the double entry system. In the general ledger, personal aspect is ignored, the entries being recorded in total only. A specimen of the Hire Purchase Sales Register is given below:

Hire Purchase Sales Register

S.No.	Date of Agreement	Name of Customer	Name of Article	Cost Price	H.P. Price	Down Payment	No. of installments	Instalments Due				Total Instalments Received	Instalments due but not received	Instalment not yet due
								1	2	3	4			

The book keeper should be very alert in recording the different items in the register and casting (totaling) of the individual column, because these are the basis for the ascertainment of the profit or loss from hire purchase business.

12. ASCERTAINMENT OF PROFIT/LOSS

There are two common methods of ascertaining profit/loss of goods of small value sold on hire purchase. These are:

(a) the Hire Purchase Trading Account Method.

(b) The Stock and Debtors Method.

12.1 Hire Purchase Trading Account Method

Under this method, a Hire Purchase Trading Account is prepared as follows:

(a) Debit the Hire Purchase Trading Account by:

(i) *Opening balance of H.P. Stock (Instalments not yet due)* brought forward from the previous year. Generally, it is shown at hire purchase price. If it is given at cost, convert that into Hire Purchase price by adding loading.

(ii) *Opening balance of H.P. Debtors (Instalment due but not yet paid)* brought forward from the previous year.

(i) Value of goods sold on Hire Purchase during the accounting period.

(ii) Expenses incurred during the accounting period.

(iii) Loss on repossession of goods.

(b) Credit the Hire Purchase Trading Account by:

(i) *Cash received from hire purchase customers* during the accounting period. It includes down payment, hire purchase instalments of the previous year as well as of the current year collected during the accounting period.

(ii) *Instalments due but not paid on goods repossessed.*

(iii) *Closing balance of H.P. Stock (Instalment not yet due)* at hire purchase price carried forward to the next period. If it is not given in the problem, it can be calculated by preparing Memorandum Goods with H.P. Customers Account.

(iv) *The closing balance of H.P. Debtors (Instalments due but not yet paid)* is carried forward to next period. If the closing balance of H.P. Debtors is not given in the problem, it can be calculated by preparing Memorandum H.P. Debtors Account.

Pass adjustment entries for the following:

(i) *For loading on opening balance of Hire Purchase Stock (Instalments not yet due/Goods with H.P. Customers)*

Stock Reserve Account	Dr.
To Hire Purchase Trading Account	

(ii) *For loading on goods sold on Hire Purchase during the year*

Goods sold on Hire Purchase Account Dr.

To Hire Purchase Trading

(iii) *For loading on closing balance of Hire Purchase Stock (Instalments not yet due/Goods with H.P. Customers)*

Hire Purchase Trading Account Dr.

To Stock Reserve Account

The proforma of a Hire Purchase Trading Account is given below:

Dr. **Hire Purchase Trading Account** Cr.

Date		*Particulars*	*Rs.*	*Date*		*Particulars*	*Rs.*
	To	Balance b/d:			By	Cash A/c	
		Hire Purchase Stock (at H.P. price)			By	Goods Repossessed A/c (Instalments due but not paid)	
		Hire Purchase Debtors			By	Stock Reserve A/c	
	To	Goods Sold on H.P. A/c (H.P. price)				(Loading on opening H.P. stock)	
	To	Loss on Goods Repossessed A/c			By	Goods sold on H.P. A/c	
	To	Expenses A/c				(Loading on goods sold)	
	To	Stock Reserve A/c			By	Balance c/d:	
		(Loading on closing H.P. stock)				H.P. Stock (at H.P. price)	
	To	Profit & Loss A/c				H.P. Debtors	

12.1.1 Repossession: When goods are repossessed for default in payment, the number of instalments due but not yet received on the goods are not recoverable. The amounts of these instalments in respect to the repossessed goods are transferred from the Memorandum Hire

Purchase Debtors Account to the Goods Repossessed Account by debiting the latter and crediting the former in the Memorandum Hire Purchase Ledger.

The following are the Journal Entries for repossession*:*

(1) *When the goods are repossessed*

Goods Repossessed Account Dr. [Instalments due but not yet paid]

To Hire Purchase Trading Account

(2) *When there is a loss on repossession*

[Selling price/market price is less than Instalments due but not yet paid]

Hire Purchase Trading Account Dr.

To Loss on Repossession Account

(3) *When there is a profit on repossession*

[Selling price/market price is greater than Instalments due but not yet paid]

Profit on Repossession Account Dr.

To Hire Purchase Trading Account

13. CALCULATION OF MISSING FIGURES

Sometimes in the examination, some figures required to calculate profit/loss are not given. These may be: (i) Hire Purchase Stock; (ii) Hire Purchase Debtors; (iii) Purchases; or (iv) Cash received, etc., Before preparing the Hire Purchase Trading Account, the missing item(s) should be calculated first. The following steps are followed:

Step 1: Draw up the following Memorandum Accounts.

(a) Memorandum Stock at Shop Account.

(b) Memorandum H.P. Stock Account/Stock with H.P. Customers Account.

(c) Memorandum H.P. Debtors Account/Instalments Due Account

Step 2: Place the available figures in the respective accounts.

Step 3: Balance the account having maximum figures available. It will be helpful in finding out the missing figure of that account.

Step 4: Place the figures so calculated in Step 3 to the relevant account.

Step 5: Continue the process of transfer until all the figures are available.

The proforma of these accounts are given below:

Dr. **Memorandum Stock at Shop Account** Cr.

	Particulars	*Rs.*		*Particulars*	*Rs.*
To	Balance b/d (at cost)		By	Goods sold on Hire Purchase A/c (at cost)	
To	Purchases		By	Balance c/d	

Dr. **Memorandum Hire Purchase Stock** Cr.

	Particulars	*Rs.*		*Particulars*	*Rs.*
To	Balance b/d (at H.P. Price)		By	Cash A/c	
To	H.P. Stock A/c (total instalments due)		By	Goods Repossessed A/c (instalments not yet due)	
			By	Balance c/d	

Dr. **Memorandum Hire Purchases Debtors Account** Cr.

	Particulars	*Rs.*		*Particulars*	*Rs.*
To	Balance b/d (at H.P. price)		By	Cash A/c	
To	H.P. Stock A/c (total instalments due)		By	Goods Repossessed A/c (install, due but not yet recd.)	
			By	Balance c/d	

14. INSTALMENT PAYMENT SYSTEM

In instalment payment system the ownership of the goods is passed immediately to the buyer on the signing the agreement. Because of this basic difference the accounting entries under instalment payment system are slightly different from those passed under the hire-purchase system. The scheme of entries is as under:

Books of buyer: Buyer debits asset account with full cash price, credits vendor’s account with full instalment price and debits interest suspense account with the difference between full cash price and full instalment price. Interest is debited to interest suspense account (not interest account) because it includes interest in respect of a number of years. Every year interest account is debited and interest suspense account is credited with the interest of current year. Interest account, at the end of the year, is closed by transferring to profit and loss account. The balance of interest suspense account (this is a debit balance) is shown in the balance sheet on the asset side. Vendor is paid the instalment due to him and entry for the depreciation is passed in the usual way.

Books of Seller: The seller debits the purchaser with the full amount (instalment price) payable by him and credits sales account by the full cash price and credits interest suspense account by the difference between the total instalment price and total cash price. Seller, like the buyer, also transfers the amount of interest due from the interest suspense account interest account every year. Interest account is closed by transferring to profit and loss account and the balance of interest suspense account is shown in the balance sheet on the liability side. On receiving the instalment the vendor debits cash/bank account and credits purchaser's account.

15. DIFFERENCE OF HIRE PURCHASE AGREEMENT AND INSTALMENT PAYMENT AGREEMENT

A hire purchase agreement is a contract of bailment coupled with an option to the hire purchaser to acquire the goods delivered to him under such an agreement. By the delivery of goods to the hire purchaser, the hire vendor merely parts with their possession, but not the ownership. The property or title to the goods is transferred to the hire-purchaser, on his paying the last instalment of the hire price or complying with some other conditions stipulated in the contract. At any time before that the hire-purchaser has the option to return the goods and, if he does so, he has only to pay the instalments of price that by then have fallen due. The right or option to purchase is the essence of hire-purchase agreement. In the event of a default by the buyer (hire purchaser) in the payment of any of the instalments of hire price, the vendor can take back the goods into his possession. This is legally permissible since the property in the goods is still with the vendor.

On the other hand, it may have been agreed between the buyer and the seller that the price of the goods would be payable by instalments and the property would immediately pass to the buyer; in the event of a default of instalments, it would not be possible for the vendor to recover back the goods. He, however, would have the right to bring an action against the purchaser for the recovery of the part of the price that has not been paid to him.

Analysis of the hire purchase price : The hire purchase price is always greater than the cash price, since it includes interest payable over and above the price of the goods to compensate the seller for the sacrifice he has made by agreeing to receive the price by instalments and the risk that he thereby undertakes. It is thus made up of following elements:

(a) cash price;

(b) interest on unpaid instalments; and

(c) a charge to cover the risk involved in the buyer defaulting to pay one or more of instalments of price or that of his returning the goods in a damaged condition.

Interest is the charge for the facility to pay the price for the goods by instalments after they have been delivered. The rate of interest is generally higher than that payable in respect of an advance or a loan since it also includes a charge to cover the risk that the hirer may fail to pay any of the instalments and, in such an event, the goods may have to be taken back into possession in whatever condition they are at the time. A separate charge on this account is not made as that would not be in keeping with the fundamental character of the hire-purchase sale.

Illustration 14

Krishna Agencies started business on 1st April, 2007. During the year ended 31st March, 2008, they sold under-mentioned durables under two schemes — Cash Price Scheme (CPS) and Hire-Purchase Scheme (HPS).

Under the CPS they priced the goods at cost plus 25% and collected it on delivery.

Under the HPS the buyers were required to sign a Hire-purchase Agreement undertaking to pay for the value of the goods including finance charges in 30 instalments, the value being calculated at Cash Price plus 50%.

The following are the details available at the end of 31st March, 2008 with regard to the products :

Product	Nos. purchased	Nos. sold under CPS	Nos. sold under HPS	Cost per unit Rs.	No. of instalments due during the year	No. of instalments received during the year
TV sets	90	20	60	16,000	1,080	1,000
Washing Machines	70	20	40	12,000	840	800

The following were the expenses during the year :

	Rs.
Rent	1,20,000
Salaries	1,44,000
Commission to Salesmen	12,000
Office Expenses	1,20,000

From the above information, you are required to prepare :

(a) Hire-purchase Trading Account, and

(b) Trading and Profit & Loss Account.

Solution

In the books of Krishna Agencies

Hire-Purchase Trading Account

for the year ended 31st March, 2008

	Rs.	*Rs.*		*Rs.*	*Rs.*
To Goods sold on H.P. A/c:			By Bank A/c cash received		
TVs			TVs		
(60×Rs. 30,000)	18,00,000		(1,000×Rs. 1,000)	10,00,000	
Washing Machines			Washing Machines		
(40 × Rs. 22,500)	9,00,000	27,00,000	(800 ×Rs. 750)	6,00,000	16,00,000
To H.P. Stock Reserve			By Instalment Due A/c:		
Rs. 9,90,000× $\frac{87.5}{187.5}$		4,62,000	TVs (80×Rs.1,000)	80,000	
To Profit & Loss A/c (H.P. profit transferred)		7,98,000	Washing Machines (40×Rs. 750)	30,000	1,10,000
			By Goods sold on HP A/c: (Cancellation of loading)		
			Rs.27,00,000 × $\frac{87.5}{187.5}$		12,60,000
			By H.P. Stock (W.N 2)		9,90,000
		39,60,000			39,60,000

Trading and Profit & Loss Account

for the year ended 31st March, 2008

	Rs.	*Rs.*		*Rs.*	*Rs.*
To Purchases:			By Sales:		
TVs			TVs		
(90×Rs. 16,000)	14,40,000		(20×Rs. 20,000)	4,00,000	

	Rs.	Rs.		Rs.	Rs.
Washing Machines (70 × Rs. 12,000)	8,40,000	22,80,000	Washing Machines (20 ×Rs. 15,000)	3,00,000	7,00,000
To Gross profit c/d		1,40,000	By Goods sold on H.P. A/c		14,40,000
			(27,00,000–12,60,000)		2,80,000
			By Shop Stock (W. N 3)		
		24,20,000			24,20,000
To Salaries		1,44,000	By Gross profit b/d		1,40,000
To Rent		1,20,000	By H.P. Trading A/c		
To Commission		12,000	(H.P. Profit)		7,98,000
To Office expenses		1,20,000			
To Net Profit		5,42,000			
		9,38,000			9,38,000

Working Notes:

(1) Calculation of per unit cash price, H.P. price and Instalment Amount:

Product	*Cost Rs.*	*Cash Price Rs. (Cost × 1.25)*	*H.P. price Rs. (Cash Price×1.50)*	*Instalment Amount (Rs.) (H.P. price/No. of instalments)*
TV sets	16,000	20,000	30,000	1,000
Washing Machines	12,000	15,000	22,500	750

(2) Calculation of H.P. Stock as on 31st March, 2008:

Product	Total No. of Instalments (Nos.)	Instalments Due in 2007-2008 (Nos.)	Instalments not due in 2007-2008 (Nos.)	Amount Rs.
TV sets	1800	1080	720	7,20,000
Washing Machines	1,200	840	360	2,70,000
				9,90,000

(3) Calculation of Shop Stock as on 31st March, 2008:

Product	*Purchased(Nos.)*	*Sold (Nos.)*	*Balance (Nos.)*	*Amount Rs.*
TV sets	90	80	10	1,60,000
Washing Machines	70	60	10	1,20,000
				2,80,000

Illustration 15

A acquired on 1st January, 2008 a machine under a Hire-Purchase agreement which provides for 5 half-yearly instalments of Rs. 6,000 each, the first instalment being due on 1st July, 2008. Assuming that the applicable rate of interest is 10 per cent per annum, calculate the cash value of the machine. All working should form part of the answer.

Solution

Statement showing cash value of the machine acquired on hire-purchase basis

	Instalment Amount	*Interest @ 5% half yearly (10% p.a.) = 5/105 = 1/21)* *(in each instalment)*	*Principal Amount (in each instalment)*
	Rs.	Rs.	Rs.
5th Instalment	6,000	286	5,714
Less: Interest	– 286		
	5,714		
Add: 4th Instalment	6,000		
	11,714	558	5,442
Less: Interest	558		(11,156–5,714)
	11,156		
Add: 3rd instalment	6,000		
	17,156	817	5,183
Less: Interest	817		(16,339–11,156)
	16,339		
Add: 2nd instalment	6,000		
	22,339	1,063	4,937
Less: Interest	1,063		(21,276–16,339)
	21,276		

Add: 1st instalment	6,000		
	27,276	1,299	4,701
Less: Interest	1,299		(25,977–21,276)
	25,977	4,023	25,977

The cash purchase price of machinery is Rs. 25,977.

Self-examination questions

I. Objective Type Questions

Pick up the correct answers from the given options

1. The amount paid at the time of entering the hire-purchase transaction for the goods purchased is known as

   (a) Cash price

   (b) Down payment

   (c) First instalment

   (d) Hire purchase price.

2. Total interest on hire purchased goods is the difference between

   (a) Hire purchase price and cash price

   (b) Hire purchase price and down payment

   (c) Cash price and first instalment

   (d) None of the above

3. Depreciation on hire purchased asset is claimed by

   (a) Hire vendor

   (b) Hire purchaser

   (c) Either the hire vendor or the hire purchaser as per the agreement between them

   (d) No depreciation is claimed till the last instalment is paid/ received

4. Under instalment payment system, ownership of goods

   (a) is transferred at the time of payment of last instalment

   (b) is not transferred

   (c) is transferred at the time of signing the contract

   (d) None of the above

[**Answer**: **1** (b); **2**(a); **3** (b); **4**(c)]

II. Short Answer Type Questions

5. Write a short note on Hire Purchase Trading Account.

6. Discuss the accounting treatment of repossessed goods on default made by hire purchaser.

III. Long Answer Type Questions

7. What do you understand by Hire purchase System? In what respect does it differ from Instalment Payment system?

8. M/s ABC sell daily a number of small articles of very small value on the hire purchase system and request you to recommend to them a simple but satisfactory system of keeping accounts. What will be your advice to them?

IV. Practical Problems

9. D Ltd. sells goods on hire purchase basis, the price being cost plus 60%. From the following particulars relating to 2008 ascertain the profit or loss on the hire purchase transactions.

	(*Rs.*)
Instalments due, customers paying on Jan. 1, 2008	2,000
Instalments not yet due	25,000
Goods sold during the year on H.P. basis, cost	60,000
Cash received from H.P. Customers	90,000
Instalments Due on 31st Dec. 2008, customers paying	3,000

10. A refrigerator costing Rs. 2,000 is sold on 1st April, 2008 for Rs. 3,000 on hire purchase basis, payment to be made in 20 monthly instalments of Rs. 150 each. If interest is ignored, what will be the profit for 2008? What will be the answer if interest is not ignored?

11. A Ltd. purchased from F Ltd. a truck on hire purchase basis, payment be made as follows: 1st year—Rs. 1,30,000, 2nd year—Rs. 1,20,000, 3rd year—Rs. 1,10,000. 10% p.a. with yearly interest is included in the amounts stated above. A Ltd. closes its book on 30th June each year and writes off depreciation 30% p.a. on diminishing value basis.

    Prepare the Truck Account.

12. K. Industries Ltd. acquired plant delivered on January 1, 2007 on the following hire purchase terms.

    (i) an initial payment of Rs. 40,000 payable on or before delivery;

    (ii) four half yearly payment of Rs. 30,000 each commencing from June 30, 2008.

    In arriving at terms the plant manufacturers computed interest at 6% per annum with *yearly* rests.

    What is the cash price of the plant?

13. Colliery Ltd. entered into a hire purchase agreement on January 1 with the Wagons Ltd. in respect of purchase of wagons the price of which was payable over a period of two years by four equal instalments of Rs. 4,000 payable at interval of six months. The cash price of the wagons was Rs. 14,770. Show the finance charges to be debited to the Profit & Loss Account each year.

14. Messrs. Rahim Bux & Co. sell a piano for Rs. 10,200 on hire purchase basis. The price is payable as follows: Rs. 1,600 on delivery, at the end of the first year Rs. 2,700, second year Rs. 1,500 and third year Rs. 4,400. In computing the H.P. interest has been calculated at 10% per annum. What is the cash price of the piano.

15. A refrigerator is sold for Rs. 1,599 in a manner that Rs. 123 is payable on delivery and the balance in 12 quarterly instalments of Rs. 123 each. The cash price is Rs. 1,365. Determine the amount of interest included in the hire purchase price which should be credited to the Profit & Loss Account of the seller each year.

    Also explain the adjustment, if any, that you will make in the amount of interest to be credited to the profit and loss account of each year assuming that the accounts are closed each year on the 31st March on the consideration that refrigerator are sold only during the months of April to September.

16. Rama & Co. deal in refrigerators and radios. During the year ended 31st December 2008, the firm sold 5 refrigerators each at Rs. 2,500, payable in 5 instalments of Rs. 100 each. 5 radios at Rs. 1,000 each payable in 10 instalments of Rs. 100 each, the gross profit in each case being 20% of sale price. The number of instalments due and collected during the year were:

Description of goods sold	*Number of units sold that fell due*	*Total number of instalments*	*Number of instalments*	*Instalments collected*	*Instalments not due*
Refrigerators	5	125	30	25	95
Radios	5	50	25	25	25

One refrigerator on which five instalments has been paid was repossessed due to the inability of the hire purchaser to continue payment of instalments.

Set up the necessary accounts in the books of Rama & Co. to record the transactions and determine the profit of the firm on the hire-purchase sale for the period ended 31st December 2008.

CHAPTER 12

INVESTMENT ACCOUNTS

Learning Objectives

After studying this chapter, you will be able to:

Understand the meaning of the term ‘investments’.

Learn the classification of investments.

Compute the acquisition cost and carrying amounts of investments.

Calculate the profit/loss on disposal of investments.

1. INTRODUCTION

Investments are 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. Assets held as Stock-in-trade are not ‘Investments’.

2. CLASSIFICATION OF INVESTMENTS

The investments are classified into two categories as per AS 13, *viz.*, Current Investments and Long-term Investments.

A current Investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

A long-term investment is an investment other than a current investment.

3. INVESTMENT ACQUISITIONS

1. The cost of an investment includes acquisition charges such as brokerage, fees and duties.

2. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued (which in appropriate cases, may be indicated by the issue price as determined by statutory authorities).

The fair value may not necessarily be equal to the nominal or par value of the securities issued.

If an investment is acquired in exchange, or part exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value of the asset given up. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

3. A separate Investment Account should be made for each scrip purchased. The scrips purchased may be broadly divided into two categories *viz.*, fixed income bearing scrips and variable income bearing scrips. The entries in Investment Account for these two broad categories of scrips will be made as under:

(*i*) *Fixed income Bearing Securities:* The investment in Government securities or debentures comes under this category. In this type of scrip, the interest accrued from the date of last payment to the date of transaction can be easily calculated. In case the transaction is on 'Ex-interest' basis *i.e.*, the amount of interest accrued to the date of transaction has to be paid in addition to the price of security.

The following entries are made in the books of Purchaser:

Debit: the amount of price settled as on ex-interest basis is entered in the Capital Column.

Debit: the interest accrued to the date of transaction in the Income Column.

In case the transaction is on cum-interest basis, a part of purchase price is related to the interest accrued from the date of the last interest paid to the date of transaction. And hence in this case the cost of investment has to be calculated by subtracting the amount of accrued interest from the Purchase Price.

The following entries are made in the books of Purchaser:

Debit: the interest accruing from the date of last payment to the date of purchase is entered in the Income Column.

Debit: balance *i.e.*, Purchase Price - Interest Accrued, in the Capital Column.

When the interest amount is actually received, it is entered in the Income Column credit side. The net effect of these entries will be that the amount credited to the income will be only the interest arising between the date of purchase and the one on which it next falls due.

Note: (*a*) Interest amount is always calculated with respect to nominal value.

(*b*) In case the quotation is not qualified, the same will be treated as ex-interest quotation.

(ii) Variable Income Bearing Securities: The investment in equity shares comes under this category. The following points should be noted with respect to investment in equity shares:

(*a*) dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established;

(*b*) the amount of dividend accruing between the date of last dividend payment and the date of purchase cannot be immediately ascertained;

(*c*) the dividend received for a particular period of time is assumed to be evenly distributed over the period.

In the following way the information is incorporated in the books of investor at the time of purchase:

Debit: The Capital column of the Investment Account by the entire purchase price.

The adjustment with respect to dividend is made when the dividend is actually received as under:

Credit: The Capital column of the Investment Account by the amount of dividend for the period for which the investor did not hold the share.

Credit: The amount after subtracting the above amount from the total dividends in Income column of Investment Account.

The important point with respect to investment in equity shares is that the amount of dividends for the period, for which the shares were not held by the investor, should not be treated as revenue receipt but they should be treated as capital receipt.

When dividends on equity shares are declared from pre-acquisition profits, similar treatment is done *i.e.*, the amount of such dividend received by the investor is entered on the credit side in the capital column, so as to reduce the acquisition cost.

If it is difficult to make an allocation between pre and post acquisition periods except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable, if they clearly represent recovery of part of cost.

4. When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be

appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

For *e.g.*, Mr. X acquires 200 shares of a company on cum-right basis for Rs.50,000. He subsequently receives an offer of right to acquire fresh shares in the company in the proportion of 1:1 at Rs.110 each. X subscribes for the right issue. Thus, the total cost of X's holding of 400 shares would amount to Rs.72,000.

Suppose, he does not subscribe but sells the rights for Rs. 15,000. The ex-right market value of 200 shares bought by X immediately after the rights falls to Rs. 40,000. In this case out of sale proceeds of Rs.15,000, Rs.10,000 may be applied to reduce the carrying amount to the market value Rs.40,000 and Rs.5,000 would be credited to the profit and loss account.

5. Where an investment is acquired by way of issue of bonus shares, no amount is entered in the capital column of investment account since the investor has not to pay anything.

4. CARRYING AMOUNT OF INVESTMENTS

1. (*i*) *Current Investments* : These investments should be carried in the financial statements at the lower of their cost and fair value.

Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

Market value is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

Valuation of current investments on overall (or global) basis is not considered appropriate. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment, and accordingly the investments may be carried at the lower of cost and fair value computed category wise (*i.e.*, equity shares, preference shares, convertible debentures, etc.) However, the more prudent and appropriate method is to carry investments individually at the lower of cost and fair value.

(*ii*) *Long-term Investments*: These are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline. Long-term investments are of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an individual investment basis.

Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and result and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. Restrictions on distributions by the investee or on disposal by the investor may affect the value attributed to the investment.

2. Any reduction in the carrying amount of investment and any reversals of such reductions should be charged or credited to the profit and loss account by giving respective debit or credit to Investment A/c (Capital Column).

5. DISPOSAL OF INVESTMENTS

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses is recognised in the profit and loss statement. When a part of the holding of an individual investment is disposed, the carrying amount is required to be allocated to that part on the basis of the average carrying amount of the total holding of the investment.

In respect of shares, debentures and other securities held as stock-in-trade, the cost of stocks disposed of may be determined by applying an appropriate cost formula (*e.g.* first-in, first-out, average cost, etc.). These cost formulae are the same as those specified in AS 2, 'Valuation of Inventories'.

(*i*) *Fixed Income Bearing Securities*: The amount of accrued interest from the date of last payment to the date of sale is credited in the income column and only the sale proceeds, net of accrued interest, is credited in the capital column of investment account.

In case the transaction is on 'Ex-interest' basis, entire sale proceeds is credited in the capital column and the amount of accrued interest from the date of last payment to the date of sale, separately received from the buyer will be taken to the credit side of the income column of investment account.

(*ii*) *Variable Income Bearing Securities* : In case of these securities, the entire amount of sale proceeds should be credited in the capital column of investment account, unless the amount of accrued dividend can be specifically established.

The entries in the books at the time of sale of investments will be just the reverse of the entries passed for their acquisition as mentioned in para 2.3.

Illustration 1

On 1.4.2008, Sundar had 25,000 equity shares of 'X' Ltd. at a book value of Rs.15 per share (Face value Rs.10). On 20.6.2008, he purchased another 5,000 shares of the company at

Rs.16 per share. The directors of 'X' Ltd. announced a bonus and rights issue. No dividend was payable on these issues. The terms of the issue are as follows:

Bonus basis 1:6 (Date 16.8.2008).

Rights basis 3:7 (Date 31.8.2008) Price Rs.15 per share.

Due date for payment 30.9.2008.

Shareholders can transfer their rights in full or in part. Accordingly Sundar sold 33.33% of his entitlement to Sekhar for a consideration of Rs. 2 per share.

Dividends: Dividends for the year ended 31.3.2008 at the rate of 20% were declared by X Ltd. and received by Sundar on 31.10.2008. Dividends for shares acquired by him on 20.6.2008 are to be adjusted against the cost of purchase.

On 15.11.2008, Sundar sold 25,000 equity shares at a premium of Rs. 5 per share.

You are required to prepare in the books of Sundar.

(1) Investment Account

(2) Profit & Loss Account.

For your exercise, assume that the books are closed on 31.12.2008 and shares are valued at average cost.

Solution

Books of Sundar

Investment Account

Equity Shares in X Ltd.

		No.	*Amount* *Rs.*			*No.*	*Amount* *Rs.*
1.4.2008	To Bal b/d	25,000	3,75,000	30.9.2008	By Bank (Sale of Rights)		10,000
20.6.2008	To Bank	5,000	80,000	31.10.2008	By Bank (dividend on shares acquired on 20/6/2008)		10,000
16.8.2008	To Bonus	5,000	—				

30.9.2008	To Bank (Rights Shares)	10,000	1,50,000	15.11.2008	By Bank (Sale of shares)	25,000	3,75,000
15.11.2008	To Profit		50,000	31.12.2008	By Bal. c/d	20,000	2,60,000
		45,000	6,55,000			45,000	6,55,000

Profit & Loss A/c

To Balance c/d	1,00,000	By Profit transferred	50,000
		By Dividend	50,000
	1,00,000		1,00,000

Working Notes:

(1) Bonus Shares = $\frac{(25,000+5,000)}{6}$ 5,000 shares

(2) Right Shares = $\frac{25,000+5,000+5,000}{7}\times 3$ = 15,000 shares

(3) Rights shares renounced = 15,000×1/3 = 5,000 shares

(4) Dividend received = 25,000×10×20% = Rs. 50,000

Dividend on shares purchased on 20.6.2008 = 5,000×10×20% = Rs.10,000 is adjusted to Investment A/c

(5) Cost of shares on 31.12.2008

$$\frac{(3,75,000+80,000+1,50,000-10,000-10,000)}{45,000}\times 20,000 = \text{Rs. } 2,60,000$$

Illustration 2

On 1.4.2007, Mr. Krishna Murty purchased 1,000 equity shares of Rs. 100 each in TELCO Ltd. @ Rs. 120 each from a Broker, who charged 2% brokerage. He incurred 50 paise per Rs. 100 as cost of shares transfer stamps. On 31.1.2008 Bonus was declared in the ratio of 1 : 2. Before and after the record date of bonus shares, the shares were quoted at Rs. 175 per share and Rs. 90 per share respectively. On 31.3.2008 Mr. Krishna Murty sold bonus shares to a Broker, who charged 2% brokerage.

Show the Investment Account in the books of Mr. Krishna Murty, who held the shares as Current assets and closing value of investments shall be made at Cost or Market value whichever is lower.

Solution

In the books of Mr. Krishna Investment Account
for the year ended 31st March, 2008
(Scrip: Equity Shares of TELCO Ltd.)

Dr. *Cr.*

Date		*Particulars*	*Nominal Value (Rs.)*	*Cost (Rs.)*	*Date*		*Particulars*	*Nominal Value (Rs.)*	*Cost (Rs.)*
1.4.2007	To	Bank A/c	1,00,000	1,23,000	31.3.2008	By	Bank A/c	50,000	44,100
31.1.2008	To	Bonus shares	50,000		31.3.2008	By	Balance c/d	1,00,000	82,000
31.3.2008	To	Profit & loss A/c		3,100					
			1,50,000	1,26,100				1,50,000	1,26,100

Working Notes:

(i) Cost of equity shares purchased on 1.4.2007 = 1,000 Rs. 120 + 2% of Rs. 1,20,000 + ½% of Rs. 1,20,000 = Rs. 1,23,000

(ii) Sale proceeds of equity shares sold on 31st March, 2008 = 500 Rs. 90 – 2% of Rs. 45,000 = Rs. 44,100.

(iii) Profit on sale of bonus shares on 31st March, 2008

= Sales proceeds – Average cost

Sales proceeds = Rs. 44,100

Average cost = Rs. (1,23,000 50,000)/1,50,000

= Rs. 41,000

Profit = Rs. 44,100 – Rs. 41,000 = Rs. 3,100.

(iv) Valuation of equity shares on 31st March, 2008

Cost = (Rs. 1,23,000 × 1,00,000)/1,50,000 = Rs. 82,000)

Market Value = 1,000 shares × Rs. 90 = Rs. 90,000

Closing balance has been valued at Rs. 82,000 being lower than the market value.

Illustration 3

Mr. X purchased 500 equity shares of Rs.100 each in Omega Co. Ltd. for Rs. 62,500 inclusive of brokerage and stamp duty. Some years later the company resolved to capitalize its profits and to issue to the holders of equity shares, one equity bonus share for every share held by them. Prior to capitalisation, the shares of Omega Co. Ltd. were quoted at Rs.175 per share. After the capitalisation, the shares were quoted at Rs.92.50 per share. Mr. X. sold the bonus shares and received at Rs.90 per share.

Prepare the Investment Account in X's books on average cost basis.

Investment Account in the books of A

[Equity shares in Omega Co. Ltd.]

	Nominal Value	*Cost*		*Nominal Value*	*Cost*
	Rs.	*Rs.*		*Rs.*	*Rs.*
To Cash	50,000	62,500	By Cash Sale	50,000	45,000
To Bonus shares	50,000		By Balance c/d	50,000	31,250
To P & L A/c		13,750			
	1,00,000	76,250		1,00,000	76,250
To Balance b/d	50,000	31,250			

Note : The total cost of 1,000 share including bonus is Rs. 62,500

Therefore, cost of 500 shares (carried forward) is $\frac{500}{1,000}$ 62,500 = Rs. 31,250

Cost being lower than the market price, shares are carried forward at cost.

Illustration 4

On 1st January 2008, Singh had 20,000 equity shares in X Ltd. Face value of the shares was Rs. 10 each but their book value was Rs. 16 per share. On 1st June 2008, Singh purchased 5,000 more equity shares in the company at a premium of Rs. 4 per share.

On 30th June, 2008, the directors of X Ltd. announced a bonus and rights issue. Bonus was declared at the rate of one equity share for every five shares held and these shares were received on 2nd August, 2008.

The terms of the rights issue were:

(*a*) Rights shares to be issued to the existing holders on 10th August, 2008.

(*b*) Rights issue would entitle the holders to subscribe to additional equity shares in the Company at the rate of one share per every three held at Rs. 15 per share-the whole sum being payable by 30th September, 2008.

(*c*) Existing shareholders may, to the extent of their entitlement, either wholly in part, transfer their rights to outsiders.

(*d*) Singh exercised his option under the issue for 50% of his entitlements and the balance of rights he sold to Ananth for a consideration of Rs. 1.50 per share.

(*e*) Dividends for the year ended 31st March, 2008, at the rate of 15% were declared by the Company and received by Singh on 20th October, 2008.

(*f*) On 1st November, 2008, Singh sold 20,000 equity shares at a premium of Rs. 3 per share.

The market price of share on 31-12-2008 was Rs. 13. Show the Investment Account as it would appear in Singh's books on 31-12-2008 and the value of shares held on that date.

Solution

Investment Account-Equity Shares in X Ltd.

Date		*No*	*Income*	*Amount*	*Date*		*No*	*Income*	*Amount*
			Rs.	*Rs.*				*Rs.*	*Rs.*
2008					2008				
Jan. 1	To Balance b/d	20,000	-	3,20,000	Sep. 30	By Bank (Sale of rights) 5,000 @ Rs. 1.5		7,500	
June 1	To Bank	5,000	-	70,000	Oct. 20	By Bank (dividend)		30,000	7,500
Aug.	To	5,000		—	Nov. 1	By Bank			2,60,000

2	Bonus Issue						20,000		
Sep. 30	To Bank (Right)	5,000	-	75,000	Nov. 1	By Profit & Loss A/c (Loss on sale)			1,429
Nov. 1	To Profit & Loss A/c (Sale of rights and Dividend income)		37,500		Dec. 31	By Balance c/d*	15,000		1,95,000
						By Profit & Loss A/c (diminish in value)			1,071
		35,000	37,500	4,65,000			35,000	37,500	4,65,000
Jan. 1	To Balance b/d	15,000		1,95,000					

Note:	Cost of shares sold — Amount paid for 35,000 shares	Rs.
	(Rs. 3,20,000 + Rs. 70,000 + Rs. 75,000)	4,65,000
	Less: Dividend on shares purchased on June 1	7,500
	Cost of 35,000 shares	4,57,500
	Cost of 20,000 shares (Average cost basis)	2,61,429
	Sale proceeds	2,60,000
	Loss	1,429

Self Examination Questions

I. Objective Type Questions

Choose the most appropriate answer from the given options.

1. The cost of Right shares is

   (a) Added to the cost of investments.

   (b) Subtracted from the cost of investments.

   (c) No treatment is required.

   (d) None of the above.

2. Long term investments are carried at

   (a) Fair value.

   (b) Cost price.

   (c) Cost or market value whichever is less.

   (d) Market value.

3 Short term investments are carried at

   (a) Fair value.

   (b) Cost price.

   (c) Cost or market value whichever is less.

   (d) Market value.

4. A Ltd. acquired 2,000 equity shares of Omega Ltd. on cum-right basis at Rs. 75 per share. Subsequently, omega Ltd. made a right issue of 1:1 at Rs. 60 per share, which was subscribed for by A. Total cost of investments at the year end will be Rs.

   (a) 2,70,000.

   (b) 1,50,000.

   (c) 1,20,000.

   (d) 30,000.

5. Cost of investment includes

   (a) Purchase costs. .

(b) Brokerage paid.

(c) Stamp duty paid.

(d) All of the above..

[**Answers** : **1.** (a), **2.** (b), **3.** (c), **4.** (a), **5.** (d)]

II. Short Answer Type Questions

6. How will you classify investment for the purpose of valuation of investments as on a particular date?

7. What is meant by 'Fixed income bearing securities'?

8. Describe the procedure for valuation of current investments in brief.

III. Long Answer Type Questions

9. Explain the method of calculation of profit or loss on disposal of investments.

10. Describe the procedure of computing requisition costs and carrying amount of investments with the help of examples.

IV. Practical Problems

11. On 1st April, Madan purchased 12% debentures in Mohan Ltd. for Rs.7,50,000. The face value of these debentures were Rs.6,00,000. Interest on debentures falls due for payment on 30th June and 31st December. Compute the cost of acquisition of debentures.

12. Dua Ltd. acquired 2,000 debentures in Kundra Ltd. by issue of 10,000 Equity Shares having a face of Rs.100 each, whose market value is Rs.150 per share. The debentures of Kundra Ltd. were listed at Rs.800 but the face value is Rs.500 only. What should be the cost of the investments? Ignore per-acquisition interest.

CHAPTER 13

INSURANCE CLAIMS FOR LOSS OF STOCK AND LOSS OF PROFIT

Learning Objectives

After studying this chapter, you will be able to compute:

Claim for loss of stock.

Claim for loss of profit.

1. MEANING OF FIRE

For purposes of insurance, fire means:

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

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

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

2. Lightning.

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

   (i) of boilers used for domestic purposes only;

   (ii) of any other boilers or economisers on the premises;

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

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

Usually, fire policies covering stock or other assets do not cover explosion of boilers used for domestic purposes or other boilers or economisers in the premises but policies in respect of profit cover such explosions.

2. CLAIM FOR LOSS OF STOCK

Fire insurance being a contract of indemnity, a claim can be lodged only for the actual amount of the loss, not exceeding the insured value. In dealing with problems requiring determination of the claim the following point must be noted:

(*a*) Fire insurance is a contract of indemnity. Therefore, the claim will be limited to the actual loss suffered even though the insured value of the goods may be higher.

(*b*) If the insured value of the stock is less than the total cost, then the average clause may apply, that is the loss be limited to that proportion of the loss as the insured value bears to the total cost. The actual amount would, therefore, be determined by the following formula:

$$\text{Claim} = \frac{\text{Insured Value}}{\text{Total Cost}} \times \text{Loss Suffered}$$

One should note that the average clause applies only where the insured value is less than the total cost and not vice-versa.

The under-mentioned points are relevant:

(i) Where stock records are maintained and such records are not destroyed by fire, the value of the stock as at the date of the fire can be easily arrived at.

(ii) Where either stock records are not available or where they are destroyed by the fire the value of stock at the date of the fire has to be estimated. The usual method of arriving at this value is to build up a Trading Account as from the date of last accounting year. After allowing for the usual gross profit, the figure of closing stock on the date of the fire can be ascertained as the balancing item.

(iii) Where books of account are destroyed the task of building up the Trading Account becomes difficult. In that case information is obtained from the customers and suppliers have to be circularised to ascertain the amount of sales and purchases.

(iv) After the insurance company makes payment for total loss, it has the same rights which the insured had over the damaged stock: These are subrogated to the insurance company. In practice, in determining the amount of the claim, credit is given for damaged and salvaged stock.

(v) Frequently salvaged stock can be made saleable after it is reconditioned. In that case, the cost of such stock must be credited to the Trading Account and debited to a salvaged stock account. The expenses on reconditioning must be debited and the sales credited to this account, the final balance being transferred to the Profit & Loss Account.

Illustration 1

On 12th June, 2008 fire occurred in the premises of N.R. Patel, a paper merchant. Most of the stocks were destroyed, cost of stock salvaged being Rs.11,200. In addition, some stock was salvaged in a damaged condition and its value in that condition was agreed at Rs. 10,500. From the books of account, the following particulars were available.

1. His stock at the close of account on December 31, 2007 was valued at Rs.83,500.
2. His purchases from 1-1-2008 to 12-6-2008 amounted to Rs.1,12,000 and his sales during that period amounted to Rs.1,54,000.

On the basis of his accounts for the past three years it appears that he earns on an average a gross profit of 30% of sales.

Patel has insured his stock for Rs.60,000. Compute the amount of the claim.

Solution

Computation of claim for loss of stock

	Rs.	*Rs.*
Opening Stock on 1-1-2008		83,500
Add : Purchases during the period		1,12,000
		1,95,500
Less : Sales during the period	1,54,000	
Gross Profit thereon	46,200	1,07,800
		87,700
Less : Stock Salvaged	11,200	
Agreed value of damage Stock	10,500	21,700
		66,000

Amount of Claim $= \frac{60{,}000}{87{,}700} \times 66{,}000$ = Rs. 45,154

Illustration 2

On 1st April, 2008 the stock of Shri Ramesh was destroyed by fire but sufficient records were saved from which following particulars were ascertained:

	Rs.
Stock at cost-1st January, 2007	73,500
Stock at cost-31st December, 2007	79,600
Purchases-year ended 31st December, 2007	3,98,000
Sales-year ended 31st December, 2007	4,87,000
Purchases-1-1-2008 to 31-3-2008	1,62,000
Sales-1-1-2008 to 31-3-2008	2,31,200

In valuing the stock for the Balance Sheet at 31st December, 2007 Rs.2,300 had been written off on certain stock which was a poor selling line having the cost Rs.6,900. A portion of these goods were sold in March, 2008 at loss of Rs.250 on original cost of Rs.3450. The remainder of this stock was now estimated to be worth its original cost. Subject to the above exception, gross profit had remained at a uniform rate throughout the year.

The value of stock salvaged was Rs.5,800. The policy was for Rs.50,000 and was subject to the average clause. Work out the amount of the claim of loss by fire.

Solution

Shri Ramesh
Trading Account for 2007
(to determine the rate of gross profit)

Dr.						*Cr.*
		Rs.			*Rs.*	*Rs.*
To	Opening Stock	73,500	By	Sales A/c		4,87,000
To	Purchases	3,98,000	By	Closing Stock :		
To	Gross Profit	97,400		As valued	79,600	
				Add : Amount written off) to restore stock to full cost	2,300	81,900
		5,68,900				5,68,900

The (normal) rate of gross profit to sales is = $\frac{97,400}{4,87,000} \times 100 = 20\%$

Memorandum Trading Account upto March 31, 2008

Dr.							*Cr.*
	Normal	*Abnormal*	*Total*		*Normal*	*Abnormal*	*Total*
	items	*items*				*items*	*items*
	Rs.	*Rs.*	*Rs.*		*Rs.*	*Rs.*	*Rs.*
To Opening Stock	75,000	6,900*	81,900	By Sales	2,28,000	3,200	2,31,200
To Purchases	1,62,000	—	1,62,000	By Loss	—	250	250
To Gross Profit (20% on Rs.2,28,000)	45,600	—	45,600	By Closing Stock (bal. fig.)	54,600	3,450	58,050
	2,82,600	6,900	2,89,500		2,82,600	6,900	2,89,500

* at cost, book value is Rs. 4,600

Calculation of Insurance Claim

	Rs.
Value of Stock on March 31, 2008	58,050
Less : Salvage	5,800
Loss of stock	52,250

Claim subject to average clause :

$$= \frac{\text{Amount of Policy}}{\text{Value of Stock}} \times \text{Actual Loss of Stock}$$

$$= \text{Rs.}\frac{50,000}{58,050} \times 52,250 \ = \text{Rs. } 45,004$$

3. CLAIM FOR LOSS OF PROFIT

When a fire occurs, apart from the direct loss on account of stock or other assets destroyed, there is also a consequential loss because, for sometime, the business is disorganised or has to be discontinued, and during that period, the standing expenses of the business like rent, salaries etc. continue. Moreover, there is loss of profits which the business would have earned during the period. This loss can be insured against by a "Loss of Profit" or "Consequential Loss" policy; there must be a separate policy in respect of the consequential loss but claim will be admitted in respect of the policy unless the claim on account of fire is also admitted under other policies.

The Loss of Profit Policy normally covers the following items:

(1) Loss of net profit

(2) Standing charges.

(3) Any increased cost of working *e.g.,* renting of temporary premises.

In every business, there is some standard by which its activity or progress can be accurately judged: it may be sales affected or the quantity of goods (or services) produced. To measure the loss suffered by a firm due to fire, it is necessary to set up some standard expressed in such units to represents the volume of work. There should be a direct relation between the amount of standard and the amount of profit raised. A comparison between the amount of the standard before and after the fire will give a reliable indication of the loss of profit sustained. The most satisfactory unit of measuring the prosperity (and therefore profits) is usually turnover:

A claim for loss of profits can be established only if :

(i) the insured's premises, or the property therein, are destroyed or damaged by the peril defined in the policy; and

(ii) the insured's business carried on the premises is interrupted or interfered with as a result of such damage.

A claim for loss of profits cannot arise if the claim for loss of property as a result of the fire is not also admitted. This is very convenient as it avoids independent investigation into loss of property for purposes of loss of profits policy. It is possible that the business of the insured may suffer because of fire in the neighbourhood, not causing damage to the property of the insured, say by closing the street for some time. Such eventualities may be covered by agreement with the insurer on payment of extra premium. If fire does not affect the volume of business, there can be no claim for loss of profits.

Also, it does not follow that if there is a large property claim, there will be necessarily a large claim for loss of profit or vice versa.

3.1 Terms Defined

The following terms should be noted:

Gross Profit: The sum produced by adding to the Net Profit the amount of the Insured Standing Charges, or, if there be no Net profit, the amount of the Insured Standing Charges less such a proportion of any net trading loss as the amount of the Insured Standing Charges bears to all the standing charges of the business.

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

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

3.2 Conditions included in a Loss of Profit Insurance Policy

Insurance policies covering loss of profit contain the following conditions usually:

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

Annual Turnover: The turnover during the twelve months immediately before the damage.

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

To which such adjustment shall be made as may be necessary to provide for the trend of the business and for variations in or special circumstances affecting the business either before or after the damage or which would have affected the business had the damage not occurred, so that the figures thus adjusted shall represent, as nearly as may be reasonably practicable the results which but for the damage would have been obtained during the relative period after damage.

Indemnity Period: The period beginning with the occurrence of the damage and ending not later than twelve months thereafter during which the results of the business shall be affected in consequence of the damage.

Memo 1: If during the indemnity period goods shall be sold or services shall be rendered elsewhere than at the premises for the benefit of the business either by the insured or by others on the Insured's behalf, the money paid or payable in respect of such sales or service shall be brought into account in arriving at the turnover during the indemnity period.

Memo 2: If any standing charges of the business be not insured by this policy then in computing the amount recoverable hereunder as increase in cost of workings that proportion only of the additional expenditure shall be brought into account which the sum of the Net Profit and the insured Standing Charges bear to the sum of the Net Profit and all standing charges.

Memo 3: This insurance does not cover loss occasioned by or happening through or in consequence of destruction of or damage to a dynamo motor, transformer, rectifier or any part of an electrical installation resulting from electric currents however arising.

The student should note the following:

(i) The word 'turnover' used above may be replaced by any other term denoting the basis for arriving at the loss of profit e.g., output.

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

(iii) Net profit means profit before income tax based on profit.

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

The insurance for Loss of Profit is limited to loss of gross profit due to (*i*) reduction in turnover, and (*ii*) increase in the cost of working. The amount payable as indemnity is the sum of (*a*) and (*b*) below :

(a) *In respect of reduction in turnover* : The sum produced by applying the rate of gross profit to the amount by which the turnover during the indemnity period shall, in consequence of the damage, falls short of the standard turnover.

(b) *In respect of increase in cost of working* : The additional expenditure [subject to the provisions of Memo (2) given above] necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in turnover which, but for that expenditure, would have taken place during the indemnity period in consequence of the damage : the amount allowable under this provision cannot exceed the sum produced by applying the rate of gross profit to the amount of reduction avoided by the additional expenditure.

The amount payable arrived at as above is reduced by any sum saved during the indemnity period in respect of such of the insured standard charges as may cease or be reduced in consequence of the damage.

Insurance policies provide that if the sum insured in respect of loss of profit is less than the sum produced by applying the rate of gross profit to the annual turnover (as adjusted by the trend of the business or variation in special circumstances affecting the business either before or after the damage or which would have affected the business had the damage not occurred), the amount payable by the insurer shall be proportionately reduced. This is nothing but application of the average clause.

The turnover of a business rarely remains constant and where there has been an upward or downward trend since the date of the last accounts and upto the date of the fire, the "standard turnover" should be appropriately adjusted, as per definition given above.

Similarly, where the earning capacity of the business has changed, the rate of gross profit may not represent a correct indication of the lots and mutually agreed rate may be used for the computation.

Students should carefully go through the working of the following illustration to understand the process of the computation of the claim made on a "Loss of Profit" policy. Suppose the following information is given:

(i) Indemnity period 13 months

(ii) Sum insured Rs. 2,00,000

(iii) Turnover, last financial year ended Dec. 31, 2007 Rs. 12,00,000.

(iv) Gross Profit, i.e., Net profit plus insured standing charges, Rs. 2,00,000 giving a gross profit rate of 20%.

(v) Net profit plus all standing charges, Rs. 2,50,000 i.e., 50,000 of the standing charges are not insured.

(vi) Fire occurs on 31st March, 2008, and affects business for 6 months.

(vii) Turnover for 12 months ended 31st March, 2008, Rs. 11,70,000.

(viii)	Turnover: 1-4-2007 to 30-9-2007	5,00,000
	1-4-2008 to 30-9-2008	3,00,000
	Reduction in turnover	2,00,000

(ix) Increase in cost of working, Rs. 30,000 otherwise of which turnover during 1-4-2008 to 30-9-2008 would reduce hereinafter by Rs. 1,60,000.

(x) Saving in insured charges in the indemnity period Rs. 10,000.

The claim in respect of profit will be calculated as follows:

(a)	Short Sales :	*Rs.*
	Reduction in Turnover 1-4-2007 to 30-9-2007	5,00,000
	Less : 10% down-trend	50,000
		4,50,000
	Less : Turnover 1-4-2008 to 30-9-2008	3,00,000
		1,50,000

Down-trend:

Quarterly sales in 2007 $\left[\dfrac{\text{Rs.}12{,}00{,}000}{12}\times 3\right]$	Rs. 3,00,000
Sales of first quarter in 2008 : $\text{Rs.}11{,}70{,}000 - \left[\dfrac{\text{Rs.}12{,}00{,}000}{12}\times 9\right]$	Rs. 2,70,000
	Rs. 30,000

Quarterly downfall

Down-trend (%) : $\dfrac{\text{Rs.}30{,}000}{\text{Rs.}3{,}00{,}000}\times 100$ = 10%

Adjusted Annual Turnover :	*Rs.*
Sales for the period 1-4-2007 to 31-12-2007 (11,70,000—2,70,000)	9,00,000
Less: Downward trend 10%	90,000
	8,10,000
Add: Sales from 1-1-2008 to 31-3-2008	2,70,000
	10,80,000
(*b*) Gross Claim: Gross Profit @ 20% on (*a*)	30,000
Add: Claim for increase in cost of working	24,361
	54,361
Less: Saving in insured standing charges	10,000
	44,361

Claim for increased cost of working is subject to two tests

(*i*) $\text{Increased cost of working}\times\dfrac{\text{G.P. on Annual Turnover}}{\text{G.P. as above} + \text{Uninsured Standing Charges}}$

$$=\text{Rs. }30{,}000\times\frac{\text{Rs. }10{,}80{,}000\times\dfrac{20}{100}}{\text{Rs.}10{,}80{,}000\times\dfrac{20}{100}+\text{Rs.}50{,}000}$$

= Rs. 24,361.

(*ii*) Gross Profit on sales generated by increased cost of workings

$= \text{Rs.}1{,}60{,}000 \times \frac{20}{100}$ = Rs. 32,000

Lower of the two, *i.e.,* Rs. 24,361 is allowable

(*c*)	Application of average clause : Gross Profit of annual	Rs.
	turnover, 20% on Rs. 10,80,000	2,16,000
	Sum insured	2,00,000
	Hence claim limited to $44{,}361 \times \frac{\text{Rs.}2{,}00{,}000}{\text{Rs.}2{,}16{,}000}$	41,075

Illustration 3

A fire occurred on 1st February, 2008, in the premises of Pioneer Ltd., a retail store and business was partially disorganised upto 30th June, 2008. The company was insured under a loss of profits for Rs. 1,25,000 with a six months period indemnity. From the following information, compute the amount of claim under the loss of profit policy.

	Rs.
Actual turnover from 1st February to 30th June, 2008	80,000
Turnover from 1st February to 30th June, 2007	2,00,000
Turnover from 1st February, 2007 to 31st January, 2008	4,50,000
Net Profit for last financial year	70,000
Insured standing charges for last financial year	56,000
Total standing charges for last financial year	64,000
Turnover for the last financial year	4,20,000

The company incurred additional expenses amounting to Rs.6,700 which reduced the loss in turnover. There was also a saving during the indemnity period of Rs.2,450 in the insured standing charges as a result of the fire.

There had been a considerable increase in trade since the date of the last annual accounts and it has been agreed that an adjustment of 15% be made in respect of the upward trend in turnover.

Solution

Computation of the amount of claim for the loss of profit

Reduction in turnover	*Rs.*
Turnover from 1st Feb. 2007 to 30th June, 2007	2,00,000
Add: 15% expected increase	30,000
	2,30,000
Less: Actual Turnover from 1st Feb., 2008 to 30th June, 2008	80,000
Short Sales	1,50,000
Gross Profit on reduction in turnover @ 30% on Rs.1,50,000 (see working note 1)	45,000
Add: Additional Expenses	
	Rs.
Lower of (i) Actual	Rs. 6,700
(ii) $\text{Additional Exp.} \times \dfrac{\text{G.P. on Annual Turnover}}{\text{G.P. on Annual Turnover} + \text{Uninsured Standing Charges}}$	
$6{,}700 \times \dfrac{1{,}55{,}250}{1{,}63{,}250} =$	6,372
(iii) G.P. on sales generated by additional expenses — not available	51,372
Less: Saving in Insured Standing Charges	2,450
Amount of claim before Application of Average Clause	48,922
Application of Average Clause:	
$\dfrac{\text{Amount of Policy}}{\text{G.P. on Annual Turnover}} \times \text{Amount of Claim}$	
$= \dfrac{1{,}25{,}000}{1{,}55{,}250} \times 48{,}922$	39,390

Amount of claim under the policy = Rs. 39,390

Working Notes :

(*i*)	Rate of Gross Profit for last Financial Year:	*Rs.*
	Gross Profit:	
	Net Profit	70,000
	Add: Insured Standing Charges	56,000
		1,26,000
	Turnover for the last financial year	4,20,000

Rate of Gross Profit = $\frac{1,26,000}{4,20,000}\times 100$ = 30%

(*ii*)	Annual Turnover:	
	Turnover from 1st Feb., 2007 to 31st January, 2008	4,50,000
	Add: 15% expected increase	67,500
		5,17,500
	Gross Profit on Rs.5,17,500 @ 30%	1,55,250
	Standing charges not Insured	8,000
	Gross Profit *plus* non-insured standing charges	1,63,250

Illustration 4

The premises of XY Limited were partially destroyed by fire on 1st March, 2008 and as a result, the business was practically disorganised upto 31st August, 2008. The company is insured under a loss of profits policy for Rs.1,65,000 having an indemnity period of 6 months.

From the following information, prepare a claim under the policy :

(*i*)	Actual turnover during the period of dislocation	*Rs.*
	(1-3-2008 to 31-8-2008)	80,000
(*ii*)	Turnover for the corresponding period (dislocation)	
	in the 12 months immediately before the fire	
	(1-3-2007 to 31-8-2007)	2,40,000
(*iii*)	Turnover for the 12 months immediately preceding	
	the fire (1-3-2007 to 28-2-2008)	6,00,000

(*iv*)	Net profit for the last financial year	90,000
(*v*)	Insured standing charges for the last financial year	60,000
(*vi*)	Uninsured standing charges	5,000
(*vii*)	Turnover for the last financial year	5,00,000

Due to substantial increase in trade, before and up to the time of the fire, it was agreed that an adjustment of 10% should be made in respect of the upward trend in turnover. The company incurred additional expenses amounting to Rs.9,300 immediately after the fire and but for this expenditure, the turnover during the period of dislocation would have been only Rs.55,000. There was also a saving during the indemnity period of Rs.2,700 in insured standing charges as a result of the fire.

Solution

Computation of loss of profit Insurance claim

		Rs.
(1)	Rate of gross profit:	
	Net profit for the last financial year	90,000
	Add: Insured standing charges	60,000
		1,50,000
	Turnover for the last financial year	5,00,000

Rate of gross profit = $\left[\frac{\text{Rs.}1,50,000}{\text{Rs.}5,00,000}\times 100\right]$ = 30%

(2)	Short sales:	
	Standard Turnover	2,40,000
	Add: 10% increasing trend	24,000
		2,64,000
	Less: Turnover during the dislocation period (which is at par with the indemnity period of 6 months)	80,000
		1,84,000
(3)	Annual (Adjusted) Turnover:	
	Annual Turnover (1-3-2007 to 23-2-2008)	6,00,000
	Add: 10% increasing trend	60,000
		6,60,000

Note: Assumed that trend adjustment is required on total amount of annual turnover. However, part of the annual turnover represents trend adjusted figure. Alternatively, the students may ignore trend and take simply annual turnover. The claim would be Rs.55,000 which is more than the claim computed in Para (5). So the Insurance Company would insist on trend adjusted on annual turnover.

			Rs.
(4)	Additional Expenses:		
	(*i*)	Actual Expenses	9,300
	(*ii*)	Gross profit on sales generated by additional expenses	
		30/100× (Rs. 80,000 – Rs. 55,000)	7,500

(iii) $$\frac{\text{Gross Profit on Annual (Adjusted) Turnover} \times \text{Additional Expenses}}{\text{Gross Profit shown in the numerator} + \text{Uninsured standing charges}}$$

$$\frac{30\% \text{ on Rs.6,60,000}}{30\% \text{ on Rs.6,60,000} + \text{Rs.5,000}} \times \text{Rs.9,300}$$

$$\frac{\text{Rs. 1,98,000}}{\text{Rs. 2,03,000}} \times \text{Rs.9,300} = \qquad 9{,}071$$

Least of the above three figures, *i.e.* Rs. 7,500 allowable.

(5) *Claim:*

	Rs.
Loss of profit on short sales (30% on Rs. 1,84,000)	55,200
Add : Allowable additional expenses	7,500
	62,700
Less : Savings in insured standing charges	2,700
	60,000
Application of average clause	
$\left[\text{Rs.60,000} \times \frac{\text{Rs.1,65,000}}{\text{Rs.1,98,000}}\right]$	50,000

Illustration 5

S & M Ltd. give the following Trading and Profit and Loss Account for year ended 31st December, 2007:

Trading and Profit and Loss Account for the year ended 31st December, 2007

	Rs.		*Rs.*
To Opening Stock	50,000	By Sales	8,00,000

To Purchases	3,00,000	By Closing Stock	70,000
To Wages (Rs. 20,000 for skilled labour)	1,60,000		
To Manufacturing Expenses	1,20,000		
To Gross Profit	2,40,000		
	8,70,000		8,70,000
To Office Administrative Expenses	60,000	By Gross Profit	2,40,000
To Advertising	20,000		
To Selling Expenses (Fixed)	40,000		
To Commission on Sales	48,000		
To Carriage Outward	16,000		
To Net Profit	56,000		
	2,40,000		2,40,000

The company had taken out policies both against loss of stock and against loss of profit, the amounts being Rs.80,000 and Rs.1,72,000. A fire occurred on 1st May, 2008 and as a result of which sales were seriously affected for a period of 4 months. You are given the following further information:

(*a*) Purchases, wages and other manufacturing expenses for the first 4 months of 2008 were Rs.1,00,000, Rs.50,000 and Rs.36,000 respectively.

(*b*) Sales for the same period were Rs.2,40,000.

(*c*) Other sales figures were as follows :

	Rs.
From 1st January 2007 to 30th April, 2007	3,00,000
From 1st May 2007 to 31st August, 2007	3,60,000
From 1st May, 2008 to 31st August, 2008	60,000

(*d*) Due to rise in wages, gross profit during 2008 was expected to decline by 2% on sales.

(*e*) Additional expenses incurred during the period after fire amounted to Rs.1,40,000. The amount of the policy included Rs.1,20,000 for expenses leaving Rs.20,000 uncovered. Ascertain the claim for stock and for loss of profit.

All workings should form part of your answers.

Solution

Claim for loss of stock:

Memorandum Trading Account for the period 1st January to 1st May, 2008

	Rs.		*Rs.*
To Opening Stock	70,000	By Sales	2,40,000
To Purchases	1,00,000	By Closing stock	
To Wages	50,000	(Balancing figure)	83,200
To Manufacturing expenses	36,000		
To Gross Profit @ 28% on sales	67,200		
	3,23,200		3,23,200

Claim for loss of Stock will be limited to Rs.80,000 which is the amount of Insurance policy.

Working Notes:

(1) Rate of Gross Profit in 2007

$$\frac{\text{Gross Pr ofit}}{\text{Sales}} \times 100$$

$$\frac{2{,}40{,}000}{8{,}00{,}000} \times 100 = 30\%$$

In 2008 Gross Profit had declined by 2% as a result of rise in wages, hence the rate of Gross Profit for loss of stock is taken at 28%.

Loss of Profit

(*a*) Short Sales :

Sales from 1st May, 2007 to 31st August, 2007	3,60,000
Less: 20% decline observed in 2008 over 2007	
(Jan - April Rs.2,40,000 instead of Rs.3,00,000)	72,000
	2,88,000
Less: Sales from 1st May, 2008 to 31st August, 2008	60,000
Short-Sales	2,28,000

(*b*) Gross profit ratio

$$\frac{\textit{Net}\text{ Profit} + \text{Insured standing charges (2007)}}{\text{Sales (2007)}} \times 100$$

$\frac{56{,}000 + 1{,}20{,}000}{8{,}00{,}000} \times 100 =$	22%	
Less: Expected decrease due to increase in wages	2%	20%

(*c*) Loss of Gross Profit:

20% on short sales Rs.2,28,000 =	Rs. 45,600

(*d*) Annual turnover: (12 months to 1st May, 2008) :

	Rs.
Sales for Jan-Dec., 2007	8,00,000
Less: From 1-1-2007 to 30-4-2007	3,00,000
	5,00,000
Less: 20% downward trend	1,00,000
	4,00,000
Add: From 1-1-2008 to 30-4-2008	2,40,000
	6,40,000
Gross Profit on annual turnover @ 20%	1,28,000

(*e*) Amount allowable in respect of additional expenses — Rs.

Least of the following:

(i)	Actual expenses	1,40,000
(ii)	Gross Profit on sales during indemnity period 20% of Rs. 60,000	12,000
(iii)	$\frac{\text{Gross profit on annual (adjusted) turnover}}{\text{Gross profit as above} + \text{Uninsured charges}} \times \text{Additional Expenses}$	
	$\frac{1{,}28{,}000}{1{,}48{,}000} \times 1{,}40{,}000 =$	1,21,081

Least *i.e.* Rs.12,000 is admissible.

N.B.: On the amount of final claim, the average clause will not apply since the amount of the policy Rs.1,72,000 is higher than Gross Profit on annual turnover Rs.1,28,000.

Illustration 6

Sony Ltd.'s. Trading and profit and loss account for the year ended 31st December, 2007 were as follows:

Trading and Profit and Loss Account for the year ended 31.12.2007

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

The company had taken out a fire policy for Rs. 3,00,000 and a loss of profits policy for Rs. 1,00,000 having an indemnity period of 6 months. A fire occurred on 1.4.2008 at the premises and the entire stock were gutted with nil salvage value. The net quarter sales i.e. 1.4.2008 to 30.6.2008 was severely affected. The following are the other information:

Sales during the period	1.1.08 to 31.3.08	2,50,000
Purchases during the period	1.1.08 to 31.3.08	3,00,000
Manufacturing expenses	1.1.08 to 31.3.08	70,000
Sales during the period	1.4.08 to 30.6.08	87,500
Standing charges insured		50,000
Actual expense incurred after fire		60,000

The general trend of the industry shows an increase of sales by 15% and decrease in GP by 5% due to increased cost.

Ascertain the claim for stock and loss of profit.

Solution

Calculation of loss of stock:

Sony Ltd.
Trading A/c
for the period 1.1.2008 to 31.3.2008

Dr.			*Cr.*
	Rs.		*Rs.*
To Opening stock	90,000	By Sales	2,50,000
To Purchases	3,00,000	By Closing stock	2,60,000
To Manufacturing expenses	70,000	(balancing figure)	
To Gross profit (20% of Rs. 2,50,000)	50,000		
	5,10,000		5,10,000

	Rs.
Stock destroyed by fire	2,60,000
Amount of fire policy	3,00,000

As the value of stock destroyed by fire is less than the policy value, the entire claim will be admitted.

Calculation of loss of profit:

Computation of short sales:

	Rs.	
Average sales for the period 1.4.2007 to 30.6.2007 (W.N.1) (Rs. 7,82,610/3)	2,60,870	
Add: Increasing trend of sales (15%)	39,130	(Approx.)
	3,00,000	
Less: Sales during the period 1.4.2008 to 30.6.2008	87,500	
Short sales	2,12,500	

Computation of G.P. Ratio:

$$\text{Gross profit ratio} = \frac{\textit{Net}\text{ profit} + \text{Insured standing charges}}{\text{Sales}} \times 100$$

$=- \dfrac{\text{Rs.}50{,}000 + \text{Rs.}50{,}000}{\text{Rs.}10{,}00{,}000} \times 100 \quad =$	10%
Less: Decreasing trend in G. P.	5%
	5%

Loss of profit = 5% of Rs.2,12,500 = Rs. 10,625

Amount allowable in respect of additional expenses:

Least of the following:-

(i) Actual expenditure	Rs. 60,000
(ii) G.P. on sales generated by additional expenses 5% of Rs. 87,500	Rs. 4,375

(assumed that entire sales during disturbed period is due to additional expenses)

(iii) Additional expenses x $\dfrac{G.P. on\ \text{annual turnover}}{G.P.\ on\ \text{annual turnover} + \text{Uninsured standing charges}}$

Rs. 60,000 x- $\dfrac{57{,}500}{57{,}500 + 1{,}30{,}000}$ =	Rs. 18,400 (approx.)

least i.e. Rs. 4,375 is admissible.

G.P. on annual turnover:

Adjusted annual turnover:

	Rs.
Average turnover for the period 1.4.2007 to 31.12.2007 (W.N.1)	7,39,130
Turnover for the period 1.1.2008 to 31.3.2008	2,50,000
	9,89,130
Add: Increase in trend (15% of Rs. 7,39,130)(W.N.2)	1,10,870
	11,00,000
Gross profit on annual turnover (5% of Rs. 11,00,000)	55,000

As the gross profit on annual turnover (Rs.55,000) is less than policy value (Rs.1,00,000), average clause is not applicable.

Insurance claim to be submitted:

	Rs.
Loss of stock	2,60,000
Loss of profit	10,625
Additional expenses	4,375
	2,75,000

Note: According to the given information standing charges include administrative expenses (Rs.80,000) and finance charges (Rs.1,00,000). Insured standing charges being Rs.50,000, uninsured standing charges would be Rs.1,30,000.

Working Note:

	Rs.
1. Break up of sales for the year 2007:	
Sales of the last quarter of 2007	
(Rs. 2,50,000 x 100/115)	2,17,390* (approx.)
Sales for the remaining three quarters of 2007 Rs. (10,00,000-2,17,390)	7,82,610

*Sales for the last quarter of 2007 is computed on the basis of sales of the first quarter of 2008.

2. The increase in trend of sales has been applied to the sales of 2007 only, as the sales figure of the first quarter of 2008 was already trend adjusted.

Self-examination questions

I. Objective Type Questions

Choose the most appropriate answer from the given options:

1. Goods costing Rs.1,00,000 were insured for Rs.50,000. Out of these goods, ¾ are destroyed by fire. The amount of claim will be

   (a) Rs.37,500.

   (b) Rs.50,000.

   (c) Rs.75,000.

   (d) None of the above.

2. Fire insurance claim will be limited to the

   (a) Actual loss suffered even though the insured value of the goods may be higher.

   (b) Proportion of the loss as the insured value bears to the total cost.

   (c) Both (a) and (b)).

   (d) None of the above.

3. The Loss of Profit Policy normally covers the following items:

   (a) Loss of net profit.

   (b) Standing charges.

   (c) Any increased cost of working *e.g.,* renting of temporary premises.

   (d) All of the above.

4. A plant worth Rs.40,000 has been insured for Rs.30,000, the loss on account of fire is Rs.25,000. The insurance company will bear the loss to the extent of

   (a) Rs.18,750.

   (b) Rs.25,000.

   (c) Rs.30,000.

   (d) Rs.40,000.

   [**Answers** : **1.** (a), **2.** (c), **3.** (d), **4.** (a)]

II. Short Answer Type Questions

5. Briefly discuss the following terms in the context of loss of profit insurance policy :

   (i) Average clause

   (ii) Short sales or Reduction in Turnover

   (iii) Annual Turnover

   (iv) Indemnity Period.

III. Long Answer Type Questions

6. Describe the procedure of computing the amount of insurance claim under 'loss of profit policy'.

IV. Practical Problems

7. There was a serious fire in the premises of M/s. Fortunate on 1st September, 2008. Their business activities were interrupted until 31st December 2008, when normal trading conditions were re-established. M/s. Fortunate is insured under the loss of profit policy for Rs.42,000, the period of indemnity being six month.

   You are able to ascertain the following information:

   (1) The net profit for the year ended 31st December, 2007 was Rs. 20,000;

   (2) The annual insurable standing charges amounted to Rs. 30,000 of which Rs. 2,000 was not included in the definition of insured standing charges under the policy;

   (3) The additional cost of working in order to mitigate the damage caused by the fire amounted to Rs. 600, and, but for this expenditure, the business would have had to shut down;

   (4) The saving in insured charges in consequence of the fire amounted to Rs. 1,500;

   (5) The turnover for the period of four months ended April 30th, August 31st and December 31st in each of the years 2007 and 2008 was as under :

	Rs.	*Rs.*	*Rs.*
2007......	65,000	80,000	95,000
2008......	70,000	80,000	15,000

   You are required to compute the relevant claim under the terms of the loss of profits policy.

8. The premises of a company were partly destroyed by fire which took place on 1st March, 2008 and as a result of which the business was disorganised from 1st March to 31st July, 2008. Accounts are closed on 31st December every year. The company is insured under a Loss of Profits policy for Rs. 7,50,000. The period of indemnity specified in the policy is 6 months. From the following information, you are required to compute the amount of claim under the Loss of Profits policy:

	Rs.
Turnover for the year 2007	40,00,000
Net profits for the year 2007	2,40,000
Insured standing charges	4,80,000

Uninsured standing charges	80,000
Turnover during the period of dislocation i.e. from 1-3-2008 to 31-7-2008	8,00,000
Standard turnover for the corresponding period in the preceding year i.e. from 1-3-2007 to 28-2-2008	20,00,000

9. On 31st December 2007, a fire damaged the premises of Shankar Ltd. and the business of the Company was disorganised until 31st March, 2008. The Company was insured under a loss of profits for Rs. 1,95,000 with a six months' period indemnity.

   The Company's account for the year ended 31st October, 2007 showed a turnover of Rs.5,25,000 with a net profit of Rs.60,00. The amount of standing charges covered by the insurance and debited in that year was Rs.1,50,000.

   The turnover for the twelve months ended on 31st December, 2007 was Rs.5,85,000. The turnover during the period the business was dislocated amounted to Rs.60,000 while during the corresponding period in the preceding year it was Rs.1,27,500.

   A sum of Rs.15,000 was spent as additional expenses to mitigate the effect of the loss, there being however no saving in standing charges as a result of fire.

   Prepare a claim to be submitted in respect of the consequential loss policy.

CHAPTER 14

ISSUES IN PARTNERSHIP ACCOUNTS

Learning Objectives

After studying this unit, you will be able to:

Understand the features of a partnership firm and the need for a Partnership Deed.

Understand the points to be covered in a Partnership Deed regarding accounts.

Learn the technique of maintaining Profit and Loss Appropriation Account.

Familiarise with the two methods of maintaining Partners' Capital Accounts, namely Fixed Capital Method and Fluctuating Capital Method.

Learn where to show interest on capital and drawings, salaries/commissions to partners etc. Also learn that drawings by partners will not appear in the Appropriation Account.

Learn the accounting of goodwill and see when valuation of goodwill becomes essential in partnership accounts.

Deal with change in profit sharing ratio without any change in the constitution of partnership.

Understand the reasons for which revaluation of assets and recomputation of liabilities is required in case of admission of a new partner. Also understand the logic of revaluation of assets and recomputation of liabilities at the time of admission, retirement of a partner and death of a partner.

Learn the treatment of reserve balance on admission, retirement or death of a partner.

Know how to arrive at new profit-sharing ratio after admission, retirement or death of a partner.

Learn how to keep records if the balance due to the retiring partner is transferred to loan account.

Understand the accounting implications if death of a partner takes place at any date during the accounting period.

Learn to record the above mentioned transaction and how to record payment of profit to the Executor of the deceased partner for part of the accounting year.

1. DEFINITION AND FEATURES OF PARTNERSHIP ACCOUNTS

The Indian Partnership Act defines partnership as the relationship between persons who have agreed to share the profit or loss of a business carried on by all or any of them acting for all. Such persons are individually known as partners and they do business in the name of their firm. Generally, partners agree among themselves as regards terms and conditions on which the business of the firm will be carried on. But often they carry on business on the basis of a verbal agreement.

The essential features of partnership are:

(i) Association of two or more persons;

(ii) An agreement entered by all persons concerned;

(iii) Expenses of a business;

(iv) The carrying on of business by all or any of them acting for all;

(v) Sharing of profits and losses of the business at an agreed ratio.

So a partnership is run by a mutual written agreement called partnership deed which may be either registered or unregistered but for the sake of settlement of future disputes among the partners, it is better to have a registered partnership deed. The partnership deed generally details out the following clauses:

(i) Name of the firm and nature of the partnership business;

(ii) Commencement and tenure of the business;

(iii) Amount of capital to be contributed by each partner;

(iv) The ratio for sharing profit and loss of the partnership business among the partners;

(v) Arrangement of drawings by partners, making limit thereon and interest if any, to be charged on drawings;

(vi) Salary to be given to the partners;

(vii) Interest, if any, to be allowed on capital contributed by the partners;

(viii) Rent to be paid to the partners whose premises are used for the purpose of business;

(ix) Process of appropriation in case of any dispute among the partners;

(x) Procedure for maintenance of accounts and audit thereof;

(xi) Valuation of goodwill in case of admission of new partners, retirement of existing partners and death of a partner;

(xii) Procedure for settlement of partners' claims in case of retirement or death.

(xiii) Procedure for dissolution of partnership, etc.

If any situation or circumstances is not either covered in the partnership deed or adequately explained, such situation or circumstance should be settled by applying the provisions of the Partnership Act, 1932.

The partners are supposed to have the power to act in certain matters and not to have such powers in others. Students are advised to go through Unit 1, Chapter 8 of CPT Study Material to understand the powers in details.

2. PARTNERS' CAPITAL AND CURRENT ACCOUNTS

From the point of view of accounting, maintenance of the partners' capital accounts and current accounts are very important. The relevant accounting transactions and events are:

Initial contribution by partners towards capital of the firm.

Fresh capital contributed by partners.

Interest entitlements (if agreed in the partnership deed) on capital so contributed;

Amount withdrawn by the partners from time to time;

Interest liability of partners on such drawings (if agreed in the partnership deed);

Salary to partners for services rendered to run the partnership business;

Rent of premises let out to partnership by the partners;

Share of profit or loss of the partnership business.

How to account for all such transactions and events in the partnership accounts should be understood properly. There are two methods of accounting - **fixed capital method** and **fluctuating capital method.** In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed. On the contrary, under fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

Illustration 1

A and B start business on 1st January, 2008, with capitals of Rs. 30,000 and Rs. 20,000. According to the Partnership Deed, B is entitled to a salary of Rs. 500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2008 the firm earned a profit, before charging salary to B and interest on capital amounting to Rs. 25,000. During the year A withdrew Rs. 8,000 and B withdrew Rs. 10,000 for domestic purposes. Show the capital accounts of the partners following fluctuating capital method.

Solution

A's Capital Account

Dr.						*Cr.*
2008		*Rs.*	*2008*			*Rs.*
Dec. 31	To Cash (Drawings)	8,000	Jan. 1	By	Cash	30,000
	To Balance c/d	33,800	Dec. 31	By	Profit and Loss A/c (Interest)	1,800
				By	Profit and Loss A/c (5/8 Profit)	10,000
		41,800				41,800
			2009			
			Jan. 1	By	Balance b/d	33,800

B's Capital Account

2008			*Rs.*	*2008*			*Rs.*
	To	Cash (Drawings)	10,000	Jan. 1	By	Cash	20,000
	To	Balance c/d	23,200	Dec. 31	By	Profit and Loss A/c	
						Salary	6,000
						Interest	1,200
					By	Profit and Loss A/c (3/8 Profit)	6,000
			33,200				33,200
				2009			
				Jan. 1	By	Balance b/d	23,200

Illustration 2

Ram and Rahim started business with capital of Rs. 50,000 and Rs. 30,000 on 1st January, 2008. Rahim is entitled to a salary of Rs.400 per month. Interest is allowed on capitals and is charged on drawings at 6% per annum. Profits are to be distributed equally after the above noted adjustments. During the year Ram withdrew Rs. 8,000 and Rahim withdrew Rs. 10,000. The profit for the year before allowing for the terms of the Partnership Deed came to Rs. 30,000.

Assuming the capitals to be fixed, prepare the Capital and Current Accounts of the partners.

Solution

Ram's Capital Account

2008			*Rs.*	*2008*			*Rs.*
Dec.31	To	Balance c/d	50,000	Jan. 1	By	Cash	50,000
				2009			
				Jan. 1	By	Balance b/d	50,000

Rahim's Capital Account

2008			*Rs.*	*2008*			*Rs.*
Dec. 31.	To	Balance c/d	30,000	Jan. 1	By	Cash	30,000
				2009			
				Jan. 1	By	Balance b/d	30,000

Ram's Current Account

2008			*Rs.*	*2008*			*Rs.*
	To	Cash (Drawings)	8,000	Dec. 31	By	Profit and Loss A/c	
Dec. 31	To	Profit and Loss A/c				Interest	3,000
		Interest on Drawings	240		By	Profit and Loss A/c	
	To	Balance c/d	5,230			1/2 Profit	10,470
			13,470				13,470
				2009			
				Jan. 1	By	Balance b/d	5,230

Rahim's Current Account

2008			*Rs.*	*2008*			*Rs.*
?	To	Cash (Drawings)	10,000	Dec. 31	By	Profit and Loss A/c	
Dec. 31	To	Profit and Loss A/c				Salary	4,800
		Interest on	300			Interest	1,800

		drawings				
	To	Balance c/d	6,770	By	Profit and Loss A/c	
					Profit	10,470
			17,070			17,070
2009						
Jan. 1				By	Balance b/d	6,770

3. PROFIT AND LOSS APPROPRIATION ACCOUNT

Profit and Loss Appropriation Account is prepared by a partnership firm to distribute the net profit among the partners in accordance with the partnership deed. Any interest on drawing is added to the net profit and thereafter out of such total profit, interest on partners' capital, salaries, commission, rent etc. are distributed as per agreement. Lastly, the balance of profit is distributed among the partners at the profit sharing ratio.

Students are advised to read CPT Study Material, Chapter 8-Unit 1 for details.

Illustration 3

X, Y & Z are in partnership. Y and Z are entitled to 15% commission on net profit to be shared equally for the special service rendered by them to the partnership. However, all the partners are entitled to 8% interest on fixed capital of Rs.5,00,000 each. The business is run at the premises of Mr. X who is further entitled to get a monthly rent of Rs.2,000 to be adjusted against his current account. They share profits and losses equally. Net profit during the year 2008 was Rs.7,00,000.

During the year they were discussing to change the profit sharing ratio because X could not attend to business work. Finally they decided to increase interest on capital to 12% p.a. with effect from 1-10-2008 and to change the profit sharing ratio to 1:2:2 with effect from the same date. With that Y and Z would not get any commission. Prepare Profit and Loss Appropriation Account.

Solution

Profit and Loss Appropriation Account

		Rs.	*Rs.*			*Rs.*
To	Commission			By	Net Profit	7,00,000

	Y	39,375		
	Z	39,375	78,750	
To	Interest			
	X	45,000		
	Y	45,000		
	Z	45,000	1,35,000	
To	Rent-X		24,000	
To	Current A/cs			
	X	1,37,550		
	Y	1,62,350		
	Z	1,62,350	4,62,250	
			7,00,000	7,00,000

Working Notes :

(1) *Interest*

	Jan-Sept. 2008 @ 8%	*Oct-Dec. 2008 @ 12%*	*Total*
	Rs.	*Rs.*	*Rs.*
X	30,000	15,000	45,000
Y	30,000	15,000	45,000
Z	30,000	15,000	45,000
	90,000	45,000	1,35,000

(2) *Commission*

¾ of (15% on Rs. 7,00,000) = Rs. 78,750

(3) *Share of Profit*

	Jan-Sept. 2008	*Oct-Dec. 2008*	*Total*
	Rs.	*Rs.*	*Rs.*
Net Profit	5,25,000	1,75,000	7,00,000
Less : Commission	78,750		78,750
Less : Interest	90,000	45,000	1,35,000
Less : Rent	18,000	6,000	24,000

Profit available for distribution in the profit sharing ratio	3,38,250	1,24,000	4,62,250
X	1,12,750	24,800	1,37,550
Y	1,12,750	49,600	1,62,350
Z	1,12,750	49,600	1,62,350

4. TREATMENT OF GOODWILL IN PARTNERSHIP ACCOUNTS

Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits. The implication of the above is that there is always a certain normal rate of profits earned by similar firms in the same locality. The excess profit earned by a firm may be due to its locational advantage, better customer service, possession of a unique patent right, personal reputation of the partners or for similar other reasons. The necessity for valuation of goodwill in a firm arises in the following cases:

(a) When the profit sharing ratio amongst the partners is changed;

(b) When a new partner is admitted;

(c) When a partner retires or dies, and

(d) When the business is dissolved or sold.

There are four methods for valuation of goodwill:

(1) Average profit basis,

(2) Super profit basis,

(3) Annuity basis, and

(4) Capitalisation basis.

4.1 Methods for Goodwill Valuation

1. **Average Profit Basis:** In this case the profits of the past few years are averaged and adjusted for any expected change in future. For averaging the past profit, either simple average or weighted average may be employed depending upon the circumstances. If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits of the recent years than those of earlier years. But, if there is no clear trend of profit, it is better to go by simple average.

   Let us suppose profits of a partnership firm for the last five years were Rs. 30,000, Rs. 40,000, Rs. 50,000, Rs. 60,000 and Rs. 70,000. In this case, a clear increasing trend is noticed and therefore, average profit may be arrived at by assigning appropriate weight as shown below:

Year	*Profit* *Rs.*	*Weight*	*Weighted Profit* *Rs.*
1	30,000	1	30,000
2	40,000	2	80,000
3	50,000	3	1,50,000
4	60,000	4	2,40,000
5	70,000	5	3,50,000
		15	8,50,000

So Weighted Average Profit = $\frac{\text{Rs.8,50,000}}{15}$ = Rs.56,667

If goodwill is valued at three years' purchase of profit, then in this case the value of goodwill is Rs.56,667 × 3 = Rs. 1,70,000.

However, if any such trend is not visible from the figures of past profits, then one should take simple average profit and calculate goodwill accordingly. Let us suppose, profits of a partnership firm for five years were Rs.30,000, Rs.25,000, Rs.20,000, Rs.30,000 and Rs.28,000. In this case, there is no clear increasing or decreasing trend of profit. So average profit comes to Rs.26,600 (arrived at by taking simple average). If the goodwill is valued by taking three years' purchase of profit, value of goodwill becomes Rs.79,800.

2. **Super Profit Basis:** In case of average profit basis, goodwill is calculated on the basis of average profit multiplied by certain number of years. The implication is that such profit will be maintained for so many numbers of years and the partner(s) who gains in terms of profit sharing ratio should contribute for such gains in profit to the partners who make the sacrifice. On the other hand, super profit means, excess profit that can be earned by a firm over and above the normal profit usually earned by similar firms under similar circumstances. Under this method, the partner who gains in terms of profit sharing ratio has to contribute only for excess profit because he can earn normal profit by joining any partnership. Under super profit method, what excess profit a partnership firm can earn is to be determined first. The steps to be followed are given below:

   (a) Identify the capital employed by the partnership firm;

   (b) Identify the average profit earned by the partnership firm based on past few years' figures;

(c) Determine normal rate of return prevailing in the locality for similar firms;

(d) Apply normal rate of return on capital employed to arrive at normal profit;

(e) Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

Let us suppose total capital employed by a partnership firm was Rs.1,00,000 and its average profit was Rs.25,000. Normal rate of return is 22% in case of similar firms working under similar conditions. So normal profit is Rs.22,000 and average profit is Rs.25,000. The partnership firm earns Rs.3,000 super profit.

Goodwill is generally valued by multiplying the amount of super profit by certain number of years depending upon the expectation about the maintenance of such super profit in future. If it is expected that the super profit can be maintained for another five years in future, then value of goodwill may be taken as Rs.3,000 × 5 = Rs.15,000.

3. **Annuity Method:** In the super profit method explained above, time value of money is not considered. Although it was expected that super profit would be earned in five future years, still no devaluation was done on the value of money for the time difference. In fact when money will be received in different points of time, its values should be different depending upon the rate of interest. If 15% rate of interest is considered appropriate, then discounted value of super profit to be earned in different future years will be as follows :

Year	*Super Profit*	*Discount Factor @ 15%*	*Discounted value of Super Profit*
	Rs.	*Rs.*	*Rs.*
1	3,000	.8696	2,608.80
2	3,000	.7561	2,268.30
3	3,000	.6575	1,972.50
4	3,000	.5718	1,715.40
5	3,000	.4972	1,491.60
			10,056.60

So under the annuity method, discounted value of super profit becomes Rs.10,056.60 and not Rs.15,000 as was done under super profit method.

The word annuity is used to mean identical annual amount of super profit, so for discounting it is possible to refer to annuity table. As per the annuity table, present value of Re.1 to be received at the end of each year for 5 years @ 15% interest p.a. is 3.3522.

So value of goodwill under annuity method is Rs.3000 × 3.3522 = Rs.10,056.60.

4. **Capitalisation Basis:** Under this basis value of whole business is determined applying normal rate of return. If such value (arrived at by applying normal rate of return) is higher than the capital employed in the business, then the difference is goodwill. The steps to be followed under this method are given below:

   (a) Determine the normal rate of return,

   (b) Find out the average profit of the partnership firm for which goodwill is to be determined,

   (c) Determine the capital employed by the partnership firm for which goodwill is to be determined,

   (d) Find out normal value of the business by dividing average profit by normal rate of return.

   (e) Deduct average capital employed from the normal value of the business to arrive at goodwill.

   Let us suppose capital employed by a partnership firm is Rs.1,00,000, its average profit is Rs.20,000, Normal rate of return is 15%.

   Normal Value of business = $\frac{20,000}{15}$ x 100 = Rs.1,33,333

   Value of goodwill = Rs.1,33,333 – Rs.1,00,000 = Rs.33,333

Illustration 4

Lee and Lawson are in equal partnership. They agreed to take Hicks as one-fourth partner. For this it was decided to find out the value of goodwill. M/s Lee and Lawson earned profits during 2005-2008 as follows:

Year	*Profit*
	Rs.
2005	1,20,000
2006	1,25,000
2007	1,30,000
2008	1,50,000

On 31.12.2008 capital employed by M/s Lee and Lawson was Rs. 5,00,000. Rate of normal profit is 20%.

Find out the value of goodwill following various methods.

Solution

Average Profit:

Year	*Profit (Rs.)*	*Weight*	*Weighted Profit (Rs.)*
2005	1,20,000	1	1,20,000
2006	1,25,000	2	2,50,000
2007	1,30,000	3	3,90,000
2008	1,50,000	4	6,00,000
		10	13,60,000

Weighted Average Profit = Rs.1,36,000

Method (1): Average Profit Basis

Assumption: Goodwill is valued at 3 year's purchase

Value of Goodwill: Rs.1,36,000 × 3 = Rs.4,08,000

Method (2): Super Profit Basis

	Rs.
Average Profit	1,36,000
Normal Profit (20% on Rs.5,00,000)	1,00,000
	36,000

Assumption: Goodwill is valued at 3 years purchase.

Value of Goodwill: Rs.36,000 × 3 = Rs.1,08,000

Method (3): Annuity Basis

Assumptions:

(a) Interest rate is equivalent to normal profit rate i.e. 20% p.a.

(b) Goodwill is valued at 3 years' purchases

Valuation of Goodwill: Rs.36,000 × 2.1065 = Rs.75,834

Method (4): Capitalisation Basis

Normal Value of Capital employed:

1,36,000 x 100/ 20 = Rs. 6,80,000

Capital Employed in M/s Lee and Lawson	=	Rs. 5,00,000
Goodwill	=	Rs. 1,80,000

4.2 Accounting Treatment : Para 16 of AS-10 'Accounting for Fixed Assets' states that goodwill can be recorded in the books only when some consideration in money or money's worth has been paid for it. Para 35 of AS 26 'Intangible Assets' also states that internally generated goodwill should not be recognized as an asset. Internally generated (self generated) goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Therefore, only purchased goodwill should be recorded in the books. In case of admission/retirement/death of a partner or in case of change in profit sharing ratio among partners, goodwill cannot be raised in the books of the firm because no consideration in money or money's worth' is paid for it. If any partner brings any premium over and above his capital contribution at the time of his admission, such premium should be distributed to other existing partners.

Sometimes at the time of any change in the constitution of the firm (by way of admission/ retirement/death/change in profit sharing ratio) goodwill of the firm is evaluated. In that situation the value of the goodwill should not be brought to books since it is inherent goodwill. Rather the value of goodwill should be adjusted through partners' capital accounts.

Accounting treatment of goodwill in case of admission of a partner

Example 1

A & B are equal partners. They wanted to take C as third partner and for this purpose goodwill was valued at Rs. 1,20,000. The journal entry for adjustment of value of goodwill through partners' capital accounts will be:

C's Capital A/c	Dr.	Rs. 40,000	
To A's Capital A/c			Rs. 20,000
To B's Capital A/c			Rs. 20,000
(Adjustment for goodwill)			

The net effect in partner's capital accounts is shown on the basis of profit sacrificing ratio:

A $= \frac{1}{6}$ Rs. 1,20,000 = Rs. 20,000(Cr.)

The enterprise while doing business develops goodwill over a period of time. Goodwill generated in the process of doing business is called internally generated goodwill.

B	$= \frac{1}{6} \times$ Rs. 1,20,000 =	Rs. 20,000(Cr.)
C	$= \frac{2}{6}$ Rs. 1,20,000=	Rs. 40,000(Dr.)

Example 2

A & B are equal partners. They wanted to admit C as 1/6th partner who brought Rs. 60,000 as goodwill. The new profit sharing ratio is 3:2:1. Profit sacrificing ratio is to be computed as follows:

Partners	*Old share*	–	*New share*	=	*Share sacrificed*	*Share gained*
A	$\frac{1}{2}$	–	$\frac{1}{2}$	=	0	
B	$\frac{1}{2}$	–	$\frac{2}{6}$	=	$\frac{1}{6}$	
C			$\frac{1}{6}$			$\frac{1}{6}$

So the entire goodwill should be credited to B's Capital A/c.

Cash A/c	Dr.	Rs. 60,000	
To B's Capital A/c			Rs. 60,000
(Goodwill brought in by C credited to B's Capital A/c in the profit sacrificing ratio)			

Accounting treatment of goodwill in case of change in the profit sharing ratio

In case of change in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through capital accounts of the partners on the basis of profit sacrificing ratio.

Example 3

A, B & C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. The goodwill was valued as Rs. 90,000. Make the necessary journal entries.

Solution

Journal Entries

		Rs.	*Rs.*
A's Capital	Dr.	10,000	

To C's Capital A/c	10,000
(Being adjusting entry passed for change in profit ratio)	

In this case, due to change in profit sharing ratio

A's gain is = 4/9 less 1/3= 1/9

B's gain is = 1/3 less 1/3= 0

C's loss is = 1/3 less 2/9= 1/9

So, A should compensate C to the extent of 1/9th of goodwill i.e.

Rs. 90,000 ×1/9 = Rs. 10,000

Example 4

A, B and C are in partnership sharing profits and losses in the ratio of 4:3:3. They decided to change the profit sharing ratio to 7:7:6. Goodwill of the firm is valued at Rs. 20,000. Calculate the sacrifice/gain by the partners and make the necessary journal entry.

Solution

Partners	*New share*	*Old share*	*Difference*	
			Sacrifice	*Gain*
A	$\frac{7}{20}$	$\frac{4}{10}$	$\frac{1}{20}$	
B	$\frac{7}{20}$	$\frac{3}{10}$		$\frac{1}{20}$
C	$\frac{6}{20}$	$\frac{3}{10}$	-	-

Thus, B gained 1/20th share while A sacrificed 1/20th share. For C there was no loss no gain.

Example 5

A, B, C and D are in partnership sharing profits and losses equally. They mutually agreed to change the profit sharing ratio to 3:3:2:2.

A gains by $\frac{3}{10}-\frac{1}{4}=\frac{1}{20}$

B gains by $\frac{3}{10}-\frac{1}{4}=\frac{1}{20}$

C losses by $\frac{1}{4}-\frac{2}{10}=\frac{1}{20}$

D losses by $\frac{1}{4}-\frac{2}{10}=\frac{1}{20}$

So, if goodwill is valued at Rs.20,000, A and B should pay @ Rs.1,000 each as (i.e., Rs.20,000 × 1/20) compensation to C and D respectively for their sacrifice.

Journal Entry

		Rs.	*Rs.*
A's Capital Account	Dr.	1,000	
B's Capital Account	Dr.	1,000	
To C's Capital Account			1,000
To D's Capital Account			1,000

It is only when there is amalgamation, conversion or sale of partnership firms, the question of recording goodwill will arise. If an existing partnership firm acquires another firm, and if the purchase consideration exceeds the net assets acquired, the difference will be shown as goodwill in the books of the transferee firm.

Accounting treatment of goodwill in case of retirement or death of a partner

In case of retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. Therefore they have to pay to retiring partner for his share of goodwill in the firm in the gaining ratio. Similarly, in case of death of the partner, the continuing partners should bear the share of goodwill due to the heirs of the deceased partner. For this purpose, the goodwill is valued on the date of the retirement of death and adjusted through the capital accounts of the partners.

Example 6

A, B & C are equal partners. C wanted to retire for which value of goodwill is considered as Rs. 90,000. The necessary journal entry will be

A's Capital A/c	Dr.	Rs. 15,000	
B's Capital A/c	Dr.	Rs. 15,000	
To C's Capital A/c			Rs. 30,000

(C's share of goodwill adjusted to existing partners' capital accounts in profit gaining ratio)

Illustration 5

Wise, Clever and Dull were trading in partnership sharing profits and losses 4:3:3 respectively. The accounts of the firm are made up to 31st December every year.

The partnership provided, *inter alia,* that:

On the death of a partner the goodwill was to be valued at three years' purchase of average profits of the three years upto the date of the death after deducting interest @ 8 per cent on capital employed and a fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

On 30th June, 2008, Wise died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet.

It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be Rs.15,000 per annum and that the capital employed would be Rs.1,56,000. Clever and Dull were to continue the partnership, sharing profits and losses equally after the death of Wise.

The following were the amounts of profits of earlier years before charging interest on capital employed.

	Rs.
2005	67,200
2006	75,600
2007	72,000
2008	62,400

You are requested to compute the value of goodwill and show the adjustment thereof in the books of the firm.

Solution

Computation of the value of goodwill:

		Rs.	*Rs.*
(i)	Average Profit for three years, ending 30th June; before death:		
	Year ending 30th June, 2006 :		
	1/2 of 2005 profits	33,600	
	1/2 of 2006 Profits	37,800	71,400
	Year ending 30th June, 2007 :		

	1/2 of 2006	37,800	
	1/2 of 2007 Profits	36,000	73,800
	Year ending 30th June, 2008 :		
	1/2 of 2007	36,000	
	1/2 of 2008 profits	31,200	67,200
	Total		2,12,400
	Average		70,800
(ii)	Super Profit :		*Rs.*
	Average profits earned		70,800
	Less : Partner's remuneration	45,000	
	Less : 8% on capital employed	12,480	57,480
			13,320
	Super Profits		
(iii)	Goodwill @ three years' purchase (13,320 x 3)		39,960

Adjustment entries for Goodwill

Journal

		Dr. *Rs.*	*Cr.* *Rs.*
Clever's Capital Account	Dr.	7,992	
Dull's Capital Account	Dr.	7,992	
To Wise's Capital Account			15,984
(Being goodwill valued @ Rs. 39,960 adjusted in the capital accounts of partners on the death of Mr. Wise)			

Illustration 6

Vasudevan, Sunderarajan and Agrawal are in partnership sharing profit and losses at the ratio of 2:5:3. The Balance Sheet of the partnership as on 31.12.2008 was as follows:

Balance Sheet of M/s Vasudevan, Sunderarajan & Agrawal

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital A/cs		Sundry fixed assets	5,00,000
Vasudevan	85,000	Stock	1,00,000
Sunderarajan	3,15,000	Debtors	50,000

Agrawal	2,25,000	Bank	5,000
Sundry Creditros	30,000		
	6,55,000		6,55,000

The partnership earned profit Rs. 2,00,000 in 2008 and the partners withdrew Rs. 1,50,000 during the year. Normal rate of return 30%.

Find out the value of goodwill on the basis of 5 years' purchase of super profit. For this purpose calculate super profit using average capital employed.

Solution

Valuation of Goodwill:		*Rs.*
(1)	*Average Capital Employed*	
	Total Assets *less* Sundry creditors as on 31.12.2008	6,25,000
	Add : 1/2 of the amount withdrawn by partners	75,000
		7,00,000
	Less : 1/2 of the profit earned in 2008	1,00,000
		6,00,000
(2)	*Super Profit :*	
	Profit of M/s Vasudevan, Sunderarajan & Agrawal	2,00,000
	Normal profit @ 30% on Rs.6,00,000	1,80,000
	Super Profit	20,000
(3)	*Value of Goodwill*	
	5 Years' Purchase of Super profit (Rs.20,000 × 5) = Rs.1,00,000	

5. CHANGE IN PROFIT SHARING RATIO

Sometimes, change in profit sharing ratio takes place without any change in the n (i.e. admission, retirement or death) of the firm. When such a change takes place, one or more partners purchase interest in the business from the other partner(s). Therefore, the aggregate amount of gain by one or more partner(s) is equal to the aggregate amount of sacrifices made by the other partner(s). The required adjustments in regard to the profit-sharing ratio, revaluation of assets and liabilities, treatment of goodwill or reserves or partners' capitals are same as what is done in case of admission or retirement or death of a partner. The only exception is that neither a partner is coming into the business nor a partner is going out.

Sometimes a single entry is passed through partners' capital accounts in gaining/sacrificing ratio, when such changes are not to be incorporated in the balance sheet, as is passed for adjustment of goodwill.

Illustration 7

P, Q and R are partners sharing profits and losses in the ratio of 3:2:1. The goodwill of the firm is valued at Rs.12,000. They have decided to change the profit-sharing ratio to 2:2:1. Pass Journal Entries.

Solution

In the books of the firm

Journal

			Dr.	**Cr.**
Date	*Particulars*		*Rs.*	*Rs.*
	Q's Capital A/c (Refer Working Note)	Dr.	800	
	R's Capital A/c	Dr.	400	
	To P's Capital A/c			1,200
	(Being the adjustment for goodwill through the Partners' Capital Accounts)			

Working Note:

Calculation of share of sacrifice/gain

	P	Q	R
Old ratio (3:2:1)	$\frac{3}{6}$	$\frac{2}{6}$	$\frac{1}{6}$
New ratio (2:2:1)	$\frac{2}{5}$	$\frac{2}{5}$	$\frac{1}{5}$
	(Sacrifice) $\frac{1}{10}$.	(Gain) $\frac{2}{30}$	(Gain) $\frac{1}{30}$
	12,000 x 1/10	12,000 x 2/30	12,000 x 1/30

Illustration 8

The following is the Balance sheet of Anil and Bimal, who are equal partners as on 31.12.2008:

Liabilities		*Rs.*	*Assets*	*Rs.*
Capital Accounts:	Anil	12,000	Sundry Assets	28,000
	Bimal	6,000		

Reserves	6,000	
Creditors	4,000	
	28,000	28,000

From 1.1.2009, the partners decided to share profits and losses in the ratio of 2:1. For this purpose, the goodwill of the firm is valued at Rs.6,000 which will not be shown in the Balance Sheet.

Pass necessary Journal Entries and re-draft the Balance Sheet.

Solution **In the books of the firm**

Journal Entry

Particulars		*Dr.* *Rs.*	*Cr.* *Rs.*
Reserves A/c	Dr.	6,000	
To Anil's Capital A/c			3,000
To Bimal's Capital A/c			3,000
(Being reserve transferred to the Partners' Capital Accounts in the old ratio before change in the constitution)			
Anil's Capital A/c (Refer W.N.)		1,000	
To Bimal's Capital A/c			1,000
(Being the adjustment for goodwill made through the Partners' Capital Accounts)			

Balance Sheet of Anil and Bimal as at 1.1.2009

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital Accounts:		Sundry Assets	28,000
Anil: Rs.(12,000+3,000-1,000)	14,000		
Bimal: Rs.(6,000+3,000+1,000)	10,000		
Creditors	4,000		
	28,000		28,000

Working Note:

Calculation of share of sacrifice/gain

	Anil	Bimal

Old ratio (1:1)	$\frac{1}{2}$	$\frac{1}{2}$
New ratio (2:1)	$\frac{2}{3}$	$\frac{1}{3}$
	(Gain) $\frac{1}{6}$.	(Sacrifice) $\frac{1}{6}$
	6,000 x 1/6	6,000 x 1/6

Illustration 9

Any and Many are partners sharing profits as to ¾ and ¼ and their capitals are Rs.90,000 and Rs.30,000 respectively. It is decided that with effect from 1st April, 2008 the profit-sharing ratio will be: Any 5/8 and Many 3/8. The Deed states that goodwill is to be valued at 2 years' purchase of three years' profits and that capitals of the two partners should be proportionate to the profit-sharing ratio. The profits for the years ended 31st March, 2006, 31st March, 2007 and 31st March, 2008 were Rs.42,000, Rs.39,000 and Rs.45,000 respectively. Make necessary journal entries.

Solution

		Rs.
Value of Goodwill: Total profits for 3 years -	2005-06	42,000
	2006-07	39,000
	2007-08	45,000
	Total	1,26,000
Average profit		42,000
Goodwill at 2 years' purchase		84,000

Calculation of share of sacrifice/gain

	Any	Many
Old ratio (3:1)	$\frac{3}{4}$	$\frac{1}{4}$
New ratio (5:3)	$\frac{5}{8}$	$\frac{3}{8}$
	(Sacrifice) $\frac{1}{8}$.	(Gain) $\frac{1}{8}$

	84,000 x 1/8 = 10,500	84,000 x 1/8=10,500

New capital required after the change in ratio-

		Rs.
Total Capital	(90,000 + 30,000)	1,20,000
Any's capital	1,20,000 x 5/8	75,000
Many's capital	1,20,000 x 3/8	45,000

Journal Entries

		Rs.	*Rs.*
Many's Capital Account	Dr.	10,500	
To Any's Capital Account			10,500
[The value of 1/8 share of goodwill (total value Rs.84,000) which Many acquires from Any]			
Bank Account	Dr.	25,500	
To Many's Capital Account			25,500
[The sum required to make up Many's capital upto Rs.45,000 after the debit of Rs.10,500, i.e., Rs.45,000 – (30,000 – 10,500)]			
Any's Capital Account	Dr.	25,500	
To Bank Account			25,500
[The sum to be returned to Any to bring his capital down to Rs.75,000 i.e., Rs.(90,000 + 10,500 – 75,000).]			

6. ADMISSION OF A PARTNER

When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for that purpose.

This account is debited with all reduction in the value of assets and increase in liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio, The entries to be passed are :

1. Revaluation Account Dr.

To the assets (Individually which with the reduction in the value of

	show a decrease)		the assets.
	To the Liabilities (Individually which have to be increased.)		with the increase in the liabilities.
2.	Assets Account (Individually)	Dr.	with the increase in the value of the assets.
	Liabilities Account (Individually)	Dr.	
	To Revaluation Account		with the reduction in the amount of liabilities
3.	Revaluation Account	Dr.	with the profit in the old profit sharing ratio.
	To Capital A/cs of the old partners		
	or,		
	Capital A/cs of the old partners	Dr.	with the loss in old profit sharing ratio.
	To Revaluation Account		

As a result of the above entries, the capital account balances of the old partners will change and the assets and liabilities will have to be adjusted to their proper values. They will now appear in the Balance Sheet at revised figures.

Alternatively, the partners may agree that revalued figures will not be shown in the Balance Sheet. Assets and liabilities would appear in the Balance Sheet at their old values. For this one additional entry is necessary.

Capital A/cs	Dr.	With the amount of revaluation
(of all partners including newly admitted partner)		
To Revaluation A/c		profit in the new profit sharing ratio.
Or		
Revaluation A/c	Dr.	With the amount of revaluation loss
To Capital A/cs		in the new profit sharing ratio.
(of all partners including newly admitted partners)		

In this case entries 1 and 2 are not required.

Whenever a new partner is admitted, any reserve etc. which may be lying in the Balance Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio. (In examination problems, it should be done even if there are no instructions on this point).

Illustration 10

Messers Dalal, Banerji and Mallick is a firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March, 2008 is as below :

Liabilities		*Rs.*	*Assets*	*Rs.*
Sundry Creditors		12,850	Land and Buildings	25,000
Outstanding Liabilities		1,500	Furniture	6,500
General Reserve		6,500	Stock of goods	11,750
Capital Account :			Sundry Debtors	5,500
Mr. Dalal	12,000		Cash in hand	140
Mr. Banerji	12,000		Cash at Bank	960
Mr. Malick	5,000	29,000		
		49,850		49,850

The partners have agreed to take Mr. Mistri as a parner with effect from 1st April, 2008 on the following terms :

(1) Mr. Mistri shall bring 5,000 towards his capital.

(2) The value of stock should be increased by Rs. 2,500 and Furniture should be depreciated by 10%.

(3) Reserve for bad and doubtful debts should be provided at 10% of the debtors.

(4) The value of land and buildings should be enhanced by 20% and the value of the goodwill be fixed at Rs. 15,000.

(5) The value of the goodwill be fixed at Rs. 15,000.

(6) General Reserve will be transferred to the partner's Capital Accounts.

(7) The new profit sharing ratio shall be : Mr. Dalal 5/15, Mr. Banerji 5/15,Mr. Mallick 3/15 and Mr. Mistri 2/15.

(8) The goodwill account shall be written back to the Partner's account in accordance with the new profit sharing proportion.

The outstanding liabilities include Rs. 1,000 due to Mr. Sen which has been paid by Mr. Dalal. Necessary entries were not made in the books.

Prepare (i) Revaluation Account, and (ii) The Capital Accounts of the partners, and (iii) the Balance Sheet of the firm as newly constituted (Journal entries are not required)

Solution

Revaluation Account

2008			*Rs.*	*2008*		*Rs.*
April1	To Provision for bad and			April 1	By Stock in trade	2,500
"	doubtful debts		550	"	By Land and Building	5,000
"	To Furniture and fittings		650			
	Capital A/cs					
"	Profit on revaluation transferred					
	Dalal	2,520				
	Banerji	2,520				
	Mallick	1,260	6,300			
			7,500			7,500

Capital Accounts of Partners

Dr.									*Cr.*
Particulars	*Dalal*	*Banerji*	*Mallick*	*Mistri*	*Particulars*	*Dalal*	*Benerji*	*Mallick*	*Mistri*
	Rs.	*Rs.*	*Rs.*	*Rs.*		*Rs.*	*Rs.*	*Rs.*	*Rs.*
To Dalal & Benerjii				2,000	By Balance b/d	12,000	12,000	5,000	
To Balance c/d	19,120	18,120	7,560	3,000	By General Reserve	2,600	2,600	1,300	
					By Cash				5,000
					By Mistri	1,000	1,000		
					By Out-standing Liabilities	1,000	-	-	
					By Reval-uation A/c	2,520	2,520	1,260	
	19,120	18,120	7,560	5,000		19,120	18,120	7,560	5,000

Balance Sheet of M/s Dalal, Banerji, Mallick and Mistri as on 1-4-2008

Liabilities		*Rs.*	*Assets*		*Rs.*
Sundry creditors		12,850	Land and Buildings		30,000
Outstanding Liabilities		500	Furniture		5,850
Capital Accounts of partners :			Stock of goods		14,250
Mr. Dalal	19,120		Sundry Debtors	5,500	
Mr. Banerji	18,120		*Less:* Provision	550	4,950
Mr. Mallick	7,560		Cash in hand		140
Mr. Mistri	3,000	47,800	Cash at Bank		5,960
		61,150			61,150

6.1 Proportionate capital and goodwill inference: 'Proportionate Capital' means Capital Account balances of partners in accordance with the profit sharing ratio. In other words, ratio of Capital Account balances is equal to profit sharing ratio. Proportionate capital is maintained generally following 'fixed capital method'. For example, A and B are in partnership, sharing profit or loss at the ratio of 3:2. If total capital is Rs. 1,00,000, A should contribute Rs. 1,00,000 × 3/5 *i.e.,*Rs. 60,000 and B should contribute Rs. 1,00,000 × 2/5 *i.e.,* Rs. 40,000.

The question of inferring goodwill arises only in case of proportionate capital. If the newly admitted partner brings capital more than what is required as per profit sharing ratio, then it is to be presumed that he has contributed the excess for goodwill. For example, A and B are in partnership who contributed proportionate capital of Rs. 60,000 and Rs, 40,000. Now they want to admit C giving him 1/5th share for which C agrees to bring Rs. 30,000. Since total capital is Rs. 1,00,000, C should contribute Rs. 20,000 (Rs. 1,00,000 × 1/5) for 1/5th share. Instead he agrees to pay Rs. 30,000. So for 1/5th share he is paying Rs. 10,000, for goodwill. Thus total value of goodwill is Rs. 10,000 × 5 *i.e.,* 50,000.

Illustration 11

A and B are in partnership sharing profits and losses equally. The Balance Sheet of M/s A and B as on 31-12-08 was as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital A/cs :		Sundry Fixed Assets	60,000
A	45,000	Stock	30,000
B	45,000	Bank	20,000

Sundry Creditors	20,000	
	1,10,000	1,10,000

On 1-1-09 they agreed to take C as 1/3rd partner to increase the capital base to Rs. 1,35,000. C agrees to pay Rs. 60,000. Show the necessary journal entries, Partners' Capital A/cs and Balance Sheet as on 1-1-09.

Solution

In the Books of M/s A, B and C

Journal Entries

		Rs.	*Rs.*
Bank A/c	Dr.	60,000	
To C's Capital A/c			60,000
(Cash brought in by C for 1/3rd share)			
C's Capital A/c	Dr.	15,000	
To A's Capital A/c			7,500
To B's Capital A/c			7,500
(Inferred value of goodwill adjusted in the books through capital accounts)			
A's Capital A/c	Dr.	7,500	
B's Capital A/c	Dr.	7,500	
To Bank			15,000
(To keep capital intact by Rs. 1,35,000, excess capital (due to goodwill) withdrawn)			

Working Notes :

(1) Old profit sharing ratio - 1:1

(2) New profit sharing ratio - 1:1:1

(3) C's share of Capital = Rs. 1,35,000 $\frac{1}{3}$ = Rs. 45,000

(4) Goodwill : Rs. 60,000 — Rs. 45,000 = Rs. 15,000 for 1/3rd share.

Total Goodwill : Rs. 15,000   3 = Rs. 45,000

Partner's Capital A/cs

Dr. *Cr.*

Particulars	*A*	*B*	*C*	*Particulars*	*A*	*B*	*C*
	Rs.	*Rs.*	*Rs.*		*Rs.*	*Rs.*	*Rs.*
To A & B	-	-	15,000	By Balance b/d	45,000	45,000	-
To Bank	7,500	7,500	-	By Bank	-	-	60,000
To Balance c/d	45,000	45,000	45,000	By C	7,500	7,500	-
	52,500	52,500	60,000		52,500	52,500	60,000

Balance Sheet of M/s A, B & C as on 1-1-2009

Liabilities		*Rs.*	*Assets*	*Rs.*
Capital A/cs :			Sundry Fixed Assets	60,000
A	45,000		Stock	30,000
B	45,000		Bank	65,000
C	45,000	1,35,000		
Sundry Creditors		20,000		
		1,55,000		1,55,000

7. RETIREMENT OF A PARTNER

On retirement of a partner, it is required to revalue assets and liabilities just as in the case of admission of a partner. If there is revaluation profit, then such profit should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio. On the other hand, if there is loss on revaluation such is also to be distributed to all the partners including the retiring partner at the existing profit sharing ratio. To arrive at profit or loss on revaluation of assets and liabilities, a Revaluation Account or Profit and Loss Adjustment Account is opened. Revaluation Account or Profit and Loss Adjustment Account is closed automatically by transfer of profit or loss balance to the Partners' Capital Accounts.

If it is decided that revalued figures of assets and liabilities will not appear in the balance sheet of the continuing partners, then a journal entry should be passed only counting the amount payable or chargeable to the retiring partner which the continuing partners will share at the ratio of gain. In the first instance, the journal entry for distribution of profit or loss on revaluation which will appear in the balance sheet also is as follows :

Revaluation A/c Dr.
To Partners' Capital A/c
(For profit on revaluation)
Or,
Partners' Capital A/c Dr.
To Revaluation A/c
(For loss on revaluation)

Now let us see how to deal with a situation where revaluation profit will not appear in the Balance Sheet.

If A, B & C share profits and losses equally and there is a revaluation profit of Rs. 30,000 calculated on A's retirement, then Rs. 10,000 becomes due to A which is to be borne by B and C equally. So the journal entry will be as follows :

		Rs.	*Rs.*
B's Capital A/c	Dr.	5,000	
C's Capital A/c	Dr.	5,000	
To A's Capital A/c			10,000

Alternatively it is possible to account for the increase in the value of assets or decrease in the value of liabilities by debiting the appropriate asset account or liability account and crediting Partners' Capital Accounts at the existing profit sharing ratio. Simultaneously the partners' Capital Accounts are to be debited for such gain at the new profit sharing ratio and the respective assets/liabilities account is to be credited again. So the following journal entries are necessary for Rs. 10,000 increase in sundry fixed assets and Rs. 2,000 decrease in sundry creditors :

			Rs.	*Rs.*
(1)	Sundry Fixed Assets A/c	Dr.	10,000	
	Sundry Creditors A/c	Dr.	2,000	
	To A's Capital A/c			4,000
	To B's Capital A/c			4,000
	To C's Capital A/c			4,000
	(Distribution of Revaluation Profit amongst the existing partners at the profit sharing ratio)			
(2)	B's Capital A/c	Dr.	6,000	
	C's Capital A/c	Dr.	6,000	

	To Sundry Fixed Assets A/c			10,000
	To Sundry Creditors A/c			2,000

In this case it is not necessary to open a separate Revaluation Account.

On the retirement of a partner, any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio. Alternatively, only the retiring partner's share may be transferred to his Capital Account if the others continue at the same profit sharing ratio.

For example, A, B and C were in partnership sharing profits and losses at the ratio of 5:3:2. A retired and B and C agreed to share profit and loss at the ratio 3:2. Reserve balance was Rs. 10,000. In this case either of the following journal entries can be passed :

			Rs.	*Rs.*
(1)	Reserves A/c	Dr.	10,000	
	To A's Capital A/c			5,000
	To B's Capital A/c			3,000
	To C's Capital A/c			2,000
	(Transfer of reserve A/c to partners' capital A/cs in 5:3:2 ratio on A's retirement)			
or				
(2)	Reserves A/c	Dr.	5,000	
	To A's Capital A/c			5,000
	(Transfer of A's share of reserve to his Capital Account on his retirement)			

Note that alternative (2) has the same implications because B and C continued at the same ratio 3:2 as they did before A's retirement.

Take another example: X, Y, and Z were equal partners. Z decided to retire. X and Y decided to continue in the ratio 3:2. Reserve standing at the date of retirement of Z was Rs. 9,000. In this case adjustment of Z's share was not sufficient since the relationship between X and Y was also changed.

X's gain : $\frac{3}{5}-\frac{1}{3}=\frac{9-5}{15}=\frac{4}{15}$

Y's gain : $\frac{2}{5}-\frac{1}{3}=\frac{6-5}{15}=\frac{1}{15}$

Gaining Ratio : X : Y

4 : 1

This is different from 1:1. So alternative (1) is to be followed in this case.

		Rs.	*Rs.*
Reserve A/c	Dr.	9,000	
To X's Capital A/c			3,000
To Y's Capital A/c			3,000
To Z's Capital A/c			3,000

(Transfer of Reserve on Z's retirement)

If the continuing partners want to show reserve in the Balance Sheet, the journal entry will be :

		Rs.	*Rs.*
X's Capital A/c	Dr.	2,400	
Y's Capital A/c	Dr.	600	
To Z's capital A/c			3,000

(Adjustment entry for Z's share of reserve)

7.1 Final payment to retiring partner: The following adjustments are necessary in the Capital A/cs :

(i) Transfer of reserve

(ii) Transfer of goodwill

(iii) Transfer of profit/loss on revaluation.

After adjustment of the above mentioned items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him.

The continuing partners may discharge the whole claim at the time of retirement. Then the journal entry will appear as follows :

Retiring Partner's Capital A/c	Dr.
To Bank A/c	

Sometimes the retiring partner agrees to retain some portion of his claim in the partnership as loan. The journal entry will be as follows :

Retiring Partner's Capital A/c		Dr.
	To Retiring Partners' Loan A/c	
	To Bank A/c	

Illustration 12

Fairbrother, Greatbatch and Kristen were partners sharing profit and losses at the 2:2:1. Kristen wants to retire on 31-12-2008. Given below the Balance Sheet of the partnership as well as other information:

Balance Sheet as on 31-12-2008

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital A/cs.		Sundry Fixed Assets	1,50,000
Fairbrother	1,20,000	Stock	50,000
Greatbatch	80,000	Debtors	50,000
Kristen	60,000	Bills Receivable	20,000
Reserve	10,000	Bank	50,000
Sundry creditors	50,000		
	3,20,000		3,20,000

Fairbrother and Greatbatch agree to share profits and losses at the ratio of 3:2 in future. Value of goodwill is taken to be Rs. 50,000. Sundry Fixed Assets are revalued upward by Rs. 30,000 and stock by Rs. 10,000. Bills Receivable dishonoured Rs. 5,000 on 31-12-2008 but not recorded in the books. Dishonour of bill was due to insolvency of the customer. Fairbrother and Greatbatch agree to bring sufficient cash to discharge claim of Kristen and to make their capital proportionate. Also they wanted to maintain Rs. 75,000 bank balance for working capital. However they did not want to show goodwill in the books of accounts. Pass necessary journal entries and draft the Balance Sheet of M/s Fairbrother and Greatbatch.

Solution

Journal Entries

			Rs.	*Rs.*
(1)	Reserve A/c	Dr.	10,000	
	To F's Capital A/c			4,000
	To G's Capital A/c			4,000
	To K's Capital A/c			2,000

	(Transfer of Reserve to Partners' Capital A/cs on K's retirement).			
(2)	Sundry Fixed Assets A/c	Dr.	30,000	
	Stock A/c	Dr.	10,000	
	To Profit and Loss Adjustment A/c			40,000
	(Increase in the value of Sundry Fixed Assets and Stock recorded).			
(3)	Profit and Loss Adjustment A/c	Dr.	5,000	
	To Bills Receivable A/c			5,000
	(Loss arising out of dishonoured bill recorded).			
(4)	Profit and Loss Adjustment A/c	Dr.	35,000	
	To F's Capital A/c			14,000
	To G's Capital A/c			14,000
	To K's Capital A/c			7,000
	(Profit on revaluation transferred to Partners' Capital A/cs on K's retirement)			
(5)	F's Capital A/c	Dr.	10,000	
	To K's Capital A/c			10,000
	(Adjusting off the value of goodwill in the profit sacrificing ratio of partners)			
(6)	Bank A/c	Dr.	1,04,000	
	To F's Capital A/c			70,000
	To G's Capital A/c			34,000
	(Cash brought in by F and G as per agreement).			
(7)	K's Capital A/c	Dr.	79,000	
	To Bank A/c			79,000
	(Payment made to K on retirement)			

Balance Sheet

(After K's retirement)

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital A/cs		Sundry Fixed Assets	1,80,000
F	1,98,000	Stock	60,000
G	1,32,000	Debtors	50,000
Sundry Creditors	50,000	Bill Receivable	15,000
		Bank	75,000
	3,80,000		3,80,000

Working Notes :

1. Partner's Capital A/cs

	F	*G*	*K*		*F*	*G*	*K*
	Rs.	*Rs.*	*Rs.*		*Rs.*	*Rs.*	*Rs.*
To K	10,000	-	-	By Balance b/d	1,20,000	80,000	60,000
To Balance c/d	1,28,000	98,000	79,000	By E	-	-	10,000
				By P & L Adj. A/c	14,000	14,000	7,000
				By Reserve	4,000	4,000	2,000
	1,38,000	98,000	79,000		1,38,000	98,000	79,000
To Bank			79,000	By Balance b/d	1,28,000	98,000	79,000
To Balance c/d	1,98,000	1,32,000		By Bank	70,000	34,000	
	1,98,000	1,32,000	79,000		1,98,000	1,32,000	79,000

2. Total capital

	Rs.
Sundry Fixed Assets (Rs. 1,50,000 + 30,000)	1,80,000
Stock (Rs. 50,000 + Rs. 10,000)	60,000
Debtors	50,000
Bills Receivable (Rs. 20,000—Rs. 5,000)	15,000
Bank	75,000
	3,80,000
Less: Sundry Creditors	50,000
	3,30,000
F's Share (Rs. 3,30,000 × 3/5)	1,98,000
G's Share (Rs. 3,30,000 × 2/5)	1,32,000

3. **Bank A/c**

	Rs.		Rs.
To Balance b/d	50,000	By K's capital A/c	79,000
To F's Capital A/c	70,000	By Balance c/d	75,000
To G's Capital A/c	34,000		
	1,54,000		1,54,000

Often the retiring partner's claim is not fully paid but kept in the business as loan. As per arrangement such loan is repaid by instalments alongwith agreed interest. Sometimes joint life policy is taken to meet the claim of the retiring partner.

8. DEATH OF A PARTNER

The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the Capital Accounts of all partners including the deceased partner. Goodwill is dealt with exactly in the way already discussed in the case of retirement. The only additional point is that as death may occur on any day, the representatives of the deceased partner will be entitled to the partner's share of profit from the beginning of the year to the date of death. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

The amount due to the deceased partner carries interest at the mutually agreed upon rate. In the absence of agreement, the representatives of the deceased partner can receive, at their option, interest at the rate of 6% per annum or the share of profit earned for the amount due to the deceased partner.

The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although revaluation of goodwill is done in the same way as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death.

For example, A, B and C are in partnership sharing profits and losses at the ratio of 2:2:1. A died on 15th April, 2008. The firm closes its books of account as on 31st December every year. So the executor of A is entitled for 3½ months profit. If A's share is immediately paid off, then profit for 2007 can be taken as base for calculating 3½ months profit in 2008. If M/s. A, B & C earned Rs. 96,000 in 2007, then 3½ months profit is Rs. 28,000. A's share comes to Rs. 28,000 × 2/5 *i.e.,* Rs. 11,200.

Journal entry is :

Profit and Loss Suspense A/c	Dr.	Rs. 11,200	
To A's Capital A/c			Rs. 11,200
(Share of A in 3½ months profit in 2008 is transferred to his Capital Account on death)			

Students are advised to see CPT study material chapter 8-unit 5 for details.

9. RIGHT OF OUTGOING PARTNER IN CERTAIN CASES TO SHARE SUBSEQUENT PROFITS

As per provisions of Section 37 of the Indian Partnership Act :

Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of six per cent per annum on the amount of his share in the property of the firm :

Provided that where by contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section. This way, the outgoing partner has the option to receive, interest at the rate of 6% p.a. or the share of profit earned on the unsettled amounts for the period till his dues are settled by the firm in the absence of any contract made to the contrary.

It may be noted that the outgoing partner is not bound to make election until the share of the profit that would be payable to him has been ascertained.

For example, A, B and C are in a partnership business-sharing profits and losses equally. C retires on 31st October, 2008. The capitals of the partners, after all necessary adjustments stood at Rs.50,000, Rs.75,000 and Rs.1,20,000 respectively. A and B continued to carry on the business further without settling the accounts of C. Final payment to C is made on

February 1, 2009. The profit made during the period of three months amounts to Rs. 28,000.

Under Section 37 of the Partnership Act, C can exercise any of the following two options.

(i) Share in subsequent profits of firm :

Profit made—Rs. 28,000

C's share – 28,000 $\frac{1,20,000}{2,45,000}$ = Rs. 13,714

(ii) Interest at 6% p.a.

1,20,000 $\frac{6}{100}$ $\frac{3}{12}$ = Rs. 1,800

Since, (*i*) option is beneficial for C, he will necessarily go for his proportionate share in profits.

Illustration 12

Rohan, Sohan and Mohan were partners sharing profits and losses in the ratio of 2:2:1. Their Balance Sheet as on 1-1-2008 stood as follows :

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*
Capital Accounts :			Fixed Assets	1,00,000
Rohan	50,000		Stock	25,000
Sohan	40,000		Debtors	35,000
Mohan	30,000	1,20,000	Cash and bank	10,000
Reserves		10,000		
Creditors		40,000		
		1,70,000		1,70,000

On 1st July, 2008 Mohan died. His representatives agreed that :

(i) Goodwill of the firm be valued at Rs. 50,000;

(ii) Fixed Assets be written down by Rs. 10,000; and

(iii) In lieu of profits, Mohan should be paid at the rate of 25% per annum on his capital as on 1-1-2008.

Current years (2008) profit after charging depreciation of Rs. 9,500 (Rs. 5,000 related to the 1st half) was Rs. 40,500. The year-end figures of Stock, Debtors and Creditors and Cash and Bank Balances were respectively Rs. 23,000, 19,000, 35,000 and 4,377. The particulars regarding their drawings are given below :

	Upto 1-7-2008	April 1-7-2008
	Rs.	*Rs.*
Rohan	4,125	5,000
Sohan	4,125	5,000
Mohan		1,750

Prepare the balance sheet of the firm as on 31st December, 2008.

Solution

		Rs.
(a)	Profit after Depreciation	40,500
	Add : Depreciation	9,500
	Profit before Depreciation	50,000
(b)	Profit for the 1st half (assumed : evenly spread)	25,000
	Less : Depreciation with respect to 1st half	5,000
	Post Depreciation profit	20,000
(c)	Profit for the 2nd half	25,000
	Less : Depreciation for the 2nd half	4,500
	2nd half profit after Depreciation	20,500

(d) **Profit and Loss Appropriation A/c**

(for the first half)

Dr.					*Cr.*
		Rs.	*Rs.*		*Rs.*
To	Interest on Mohan's Capital (30,000 × 25% for 6 months)		3,750	By Profit	20,000
To	Rohan	8,125			
	Sohan	8,125	16,250		
			20,000		20,000

(e) **Capital Account as on 1-7-2008**

Dr.							Cr.
	Rohan	*Sohan*	*Mohan*		*Rohan*	*Sohan*	*Mohan*
To Revaluation Loss				By Balance b/d	50,000	40,000	30,000
of Fixed Assets	4,000	4,000	2,000	By Reserves	4,000	4,000	2,000
To Drawings	4,125	4,125	1,750	By Rohan &			
To Mohan	5,000	5,000	—	Sohan	—	—	10,000
To Executors A/c			42,000	By Profit and Loss			
To Balance c/d	49,000	39,000		Appn. A/c	8,125	8,125	3,750
	62,125	52,125	45,750		62,125	52,125	45,750

(f) **Application of Section 37 of the Partnership Act**

Either

(i) Interest of 42,000 $\frac{6}{100}\times\frac{6}{12}$ = Rs. 1,260

Or

(ii) Profit earned out of unsettled capital

20,500 $\frac{42{,}000}{(49{,}000+39{,}000+42{,}000)}$ = Rs. 6,623

(g) In the absence of specific agreement amongst partners on the above subject matter, the representatives of the deceased partner can receive at their option, interest at the rate of 6% p.a. or the share of profit earned for the amount due to the decease partner.

In the above case, it would be rational to assume that the representatives would opt for Rs. 6,623.

(h) **Profit and Loss Appropriation A/c for the second half**

Dr.					*Cr.*
			Rs.		*Rs.*
To	Executors A/c		6,623	By Net Profit	20,500
To	Rohan	6,938			
	Sohan	6,939	13,877		
			20,500		20,500

(i) **Capital Accounts as on 31-12-2008**

Dr. *Cr.*

	Rohan	*Sohan*		*Rohan*	*Sohan*
	Rs.	*Rs.*		*Rs.*	*Rs.*
To Drawings	5,000	5,000	By Balance b/d	49,000	39,000
To Balance c/d	50,938	40,939	By Profit & Loss Appn. A/c	6,938	6,939
	55,938	45,939		55,938	45,939

(j) **Executors Account**

Dr.			*Cr.*
	Rs.		*Rs.*
To Bank	48,623	By Mohan's Capital A/c	42,000
		By Profit & Loss Appn. A/c	6,623
	48,623		48,623

(k) **Balance Sheet as on 31-12-2008**

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital Accounts			Fixed Assets	1,00,000	
Rohan	50,938		*Less* : Written down	10,000	
Sohan	40,939	91,877		90,000	
Creditors		35,000	*Less* : Depreciation	9,500	80,500
			Debtors		19,000
			Stock		23,000
			Cash and Bank		4,377
		1,26,877			1,26,877

Note: Students are advised to see CPT Study Material Chapter 8 for details.

Self-Examination Questions

I. Objective type questions

Choose the most appropriate answer from the given options:

1. Seeta and Geeta are partners sharing profits and losses in the ratio 4:1. Meeta was

manager who received the salary of Rs. 4,000 p.m. in addition to a commission of 5% on net profits after charging such commission. Profits for the year is Rs. 6,78,000 before charging salary. Find the total remuneration of Meeta.

(a) Rs. 78,000.

(b) Rs. 88,000.

(c) Rs. 87,000.

(d) Rs. 76,000.

2. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was Rs. 6,000 and Y determined interest @ 24% p.a. on his loan of Rs. 80,000. There was no agreement on this point. Calculate the amount payable to X, Y and Z respectively.

(a) Rs. 2,000 to each partner.

(b) Loss of Rs. 4,400 for X and Z & Y will take home Rs. 14,800.

(c) Rs. 400 for X, Rs. 5,200 for Y and Rs. 400 for Z.

(d) Rs. 2,400 to each partner.

3. The profits of last three years are Rs. 42,000; Rs. 39,000 and Rs. 45,000. Find out the goodwill of two years purchase.

(a) Rs. 42,000.

(b) Rs. 84,000.

(c) Rs. 1,26,000.

(d) Rs. 36,000.

4. Find the goodwill of the firm using capitalization method from the following information:

Total Capital Employed in the firm Rs. 8,00,000

Reasonable Rate of Return 15%

Profits for the year Rs. 12,00,000

(a) Rs. 82,00,000.

(b) Rs. 12,00,000.

(c) Rs. 72,00,000.

(d) Rs. 42,00,000

5. X and Y share profits and losses in the ratio of 2 : 1. They take Z as a partner and the new profit sharing ratio becomes 3 : 2 : 1. Z brings Rs. 4,500 as premium for goodwill. The full value of goodwill will be

(a) Rs. 4,500.

(b) Rs. 18,000.

(c) Rs. 27,000.

(d) Rs. 24,000.

6. X, Y and Z are partners sharing profits and losses in the ratio 5:3:2 decide to share the future profits in the ratio 2:3:5. What will be the treatment for workmen compensation fund appearing in the balance sheet on the date if no information is available for the same?

(a) Distributed to the partners in old profit sharing ratio.

(b) Distributed to the partners in new profit sharing ratio.

(c) Distributed to the partners in capital ratio.

(d) Carried forward to new balance sheet without any adjustment.

7. A and B are partners sharing profits in the ratio 5:3, they admitted C giving him 3/10th share of profit. If C acquires 1/5th share from A and 1/10th from B, new profit sharing ratio will be:

(a) 5:6:3.

(b) 2:4:6.

(c) 18:24:38.

(d) 17:11:12

8. Outgoing partner is compensated for parting with firm's future profits in favour of remaining partners. In what ratio do the remaining partners contribute to such compensation amount?

(a) Gaining Ratio.

(b) Capital Ratio.

(c) Sacrificing Ratio.

(d) Profit Sharing Ratio.

9. The capitals of A, B and C are Rs. 1,00,000; Rs. 75,000 and Rs. 50,000, profits are shared in the ratio of 3:2:1. B retires on the basis of firm purchased by other partners then the new ratio between A and C is 3:1. Find the capital of A and C.

(a) Rs. 1,50,000 and Rs. 1,00,000.

(b) Rs. 1,46,250 and Rs. 42,000.

(c) Rs. 1,56,250 and Rs. 68,750.

(d) Rs. 86,250 and Rs. 46,250.

10. In the absence of proper agreement, representative of the deceased partner is entitled to the Dead partner's share in the following items.

(a) Profits till date, goodwill, interest on capital, share in revalued assets and liabilities.

(b) Capital, goodwill, interest on capital, share in revalued assets and liabilities.

(c) Capital, profits till date, goodwill, interest on capital, share in revalued assets and liabilities.

(d) Capital, profits till date, goodwill, share in revalued assets and liabilities.

[**Answers** :. **1.** (i) (a); **2.** (c); **3.** (b); **4.** (c); **5.** (c); **6.** (a); **7.** (d); **8.** (a); **9.** (c); **10.** (d)]

II. Short answer type questions

11. Why it is necessary to make adjustments in the book value of assets and liabilities at the time of admission of a partner?

12. What is revaluation account? What purpose does it serve?

13. Write short notes on:

(a) Gaining Ratio,

(b) Capital Ratio,

(c) Sacrificing Ratio.

14. Give the accounting treatment of goodwill at the time of admission of a partner when goodwill adjusted through partners' capital accounts.

III. Long answer type questions

15. How is goodwill treated in the books of account on the retirement of a partner? Explain.

16. Explain various methods of valuation of goodwill.

IV. Practical problems

17. Ram and Rahim were working in partnership sharing profits equally. On 31st December, 2008, Ram decided to retire and in his place it was decided that Suresh, his son, would be admitted as a partner from 1 January, 2009 and his share in profits would be one third.

Balance Sheet of the firm as at 31st December, 2008 is given below :

Liabilities	*Rs.*	*Assets*	*Rs.*
Sundry Creditors	14,700	Goodwill	15,000
Capital :		Land & Buildings	40,050
Ram	54,300	Motor Car	12,000
Rahim	48,000	Furniture	9,300
		Sundry Debtors	24,150
		Cash and Bank	16,500
	1,17,000		1,17,000

It was further decided as follows: (*a*) The goodwill should be raised to Rs. 20,000 (*b*) the Motor Car would be taken over by Ram at its book value. (*c*) The value of Land and Building would be increased by Rs. 8,280 (*d*) Rahim and Suresh would introduce sufficient capital to pay off Ram to leave thereafter a sum of Rs. 7,350 as cash on hand/Bank in a manner that the capital of the new partners will be in proportion to their profit sharing ratio. (*e*) The capital payable by Suresh was to be gifted by his father, Ram. (*f*) The new partners decided not to show goodwill as an asset.

Show the resultant effect of the above arrangements in partners' Capital Accounts and Balance Sheet after the admission of Suresh.

18. Gopal and Govind are partners sharing profits and losses in the ratio 60:40. The firms' balance sheet as on 31.03.2008 was as follows:

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital accounts:			
Gopal	1,20,000	Fixed assets	3,00,000

Govind	80,000	Investments	50,000
Long term loan	2,00,000	Current assets	2,00,000
Current liabilities	2,50,000	Loans and advances	1,00,000
	6,50,000		6,50,000

Due to financial difficulties, they have decided to admit Guru as partner in the firm from 01.04.2008 on the following terms:

Guru will be paid 40% of the profits.

Guru will bring in cash Rs. 1,00,000 as capital. It is agreed that goodwill of the firm will be valued at 2 years' purchase of 3 years' normal average profits of the firm and Guru will bring in cash his share of goodwill. It was also decided that the partners will not withdraw their share of goodwill nor will the goodwill appear in the books of account.

The profits of the previous three years were as follows:

For the year ended 31.3.2006: profit Rs. 20,000 (includes insurance claim received of Rs. 40,000).

For the year ended 31.3.2007: loss Rs. 80,000 (includes voluntary retirement compensation paid Rs. 1,10,000).

For the year ended 31.3.2008: profit of Rs. 1,05,000 (includes a profit of Rs. 25,000 on the sale of assets).

It was decided to revalue the assets on 31.03.2008 as follows:

	Rs.
Fixed assets (net)	4,00,000
Investments	Nil
Current assets	1,80,000
Loans and advances	1,00,000

The new profit sharing ratio after the admission of Guru was 35:25:40.

Pass journal entries on admission, show goodwill calculation and prepare revaluation account, partners' capital accounts and balance sheet as on 01.04.2008 after the admission of Guru.

19. On 31st March, 2008, the balance sheet of M/s Ram, Rahul and Rohit sharing profits and losses in proportion to their capital, stood as follows:

	Rs.	*Rs.*		*Rs.*
Capital accounts:			Land & buildings	2,00,000

Ram	3,00,000		Machinery	2,00,000
Rahul	2,00,000		Closing stock	1,00,000
Rohit	1,00,000	6,00,000	Sundry debtors	2,00,000
Sundry creditors		2,00,000	Cash and bank balances	1,00,000
		8,00,000		8,00,000

On 31st March, 2008, Ram desired 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 and buildings be appreciated by 30%.
2. Machinery be depreciated by 20%.
3. Closing stock to be valued at Rs. 80,000.
4. Provision for bad debts be made at 5%.
5. Old credit balances of sundry creditors Rs. 10,000 be written back.
6. Goodwill of the entire firm be valued at Rs. 1,80,000 and Ram's share of the goodwill be adjusted in the accounts of Rahul and Rohit who share the future profits equally. No goodwill account being raised.
7. The total capital of the firm is to be the same as before retirement. Individual capital be in their profit sharing ratio.
8. Amount due to Ram is to be settled on the following basis:-

   50% on retirement and the balance

   50% within one year

Prepare revaluation account, capital account of partners: Rahul & Rohit, loan account of Ram, cash account and balance sheet as on 1.4.2008 of M/s Rahul and Rohit.

20. The following was the balance sheet of Om & Co. in which X, Y, Z were partners sharing profits and losses in the ratio of 1:2:2 as on 31.3.2008. Mr. Z died on 31st December, 2008. His account ha stop be settled under the following terms.

Balance sheet of Om & Co. as on 31.3.2008

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*
Sundry creditors		20,000	Goodwill	30,000
Bank loan		50,000	Building	1,20,000

General reserve		30,000	Computers	80,000
Capital accounts:			Stock	20,000
X	40,000		Sundry debtors	20,000
Y	80,000		Cash at bank	20,000
Z	80,000	2,00,000	Investments	10,000
		3,00,000		3,00,000

Goodwill is to be calculated at the rate of two years purchase on the basis of average of three years' profits and losses. The profits and losses for the three years were as detailed below:

Year ending on	profit/loss
31.3.2008	30,000
31.3.2007	20,000
31.3.2006	(10,000) Loss

Profit for the period from 1.4.2008 to 31.12.2008 shall be ascertained proportionately on the basis of average profits and losses of the preceding three years.

During the year ending on 31.3.2008 a car costing Rs. 40,000 was purchased on 1.4.2007 and debited to travelling expenses account on which depreciation is to be calculated at 20%p.a. This asset is to be brought into account at the depreciate value.

Other values of assets were agreed as follows:

Stock at Rs. 16,000, building at Rs. 1,40,000, computers at Rs. 50,000; investments at Rs. 6,000. Sundry debtors were considered good. You are asked to prepare partners capital accounts and balance sheet of the firm Om & C0. as on 31.12.2008 assuming that other items of assets and liabilities remained the same.

21. A and B were partners in a firm sharing profits & losses in the ratio of 2:1. They decided that with effect from January 1, 20X8 they would share profits and losses in the ratio of 3:2. But, this decision was taken after the profits for the year 20X8 amount to Rs.30,000 had been distributed in the old ratio. Goodwill was to be valued at the aggregate of two years' profits preceeding the date the decision became effective. The profits for 20X5, 20X6 and 20X7 were Rs.15,000, Rs.20,000 and Rs.25,000 respectively. It was decided that no goodwill would be raised and the necessary adjustment be made through Capital accounts which on December 31 stood at Rs.50,000 for A and Rs.30,000 for B. Give the necessary Journal entries.

CHAPTER 15

ACCOUNTING IN COMPUTERISED ENVIRONMENT

Learning Objectives

After studying this chapter, you will be able to:

Learn the significance and salient features of accounting in computerised environment.

Understand the classification and grouping of accounts.

Familiarize with the hierarchy of ledgers.

Understand the meaning and significance of accounting packages and consideration for their selection.

1. INTRODUCTION

By now the students are familiar with the concepts of accounting and how different methods of accounting are to be adopted in different situations. We now look into accounting in a computerised environment. The first and foremost thing to remember is that the fundamentals of accounting does not change whether books of account are maintained manually or are computerised. The same principles of debit and credit that we apply for recording income or expenditure, purchase or sale of assets or creation or discharge of liability in a manual accounting system is equally applicable in a computerised environment. However, since the recording medium is something else compared to hard copy documents and considerable reliance have to be placed on the software for the input, processing and output of the data certain precautions, methodologies and techniques are to be adopted while maintaining accounts in a computerised environment.

2. SALIENT FEATURES OF COMPUTERISED ACCOUNTING SYSTEM

Computer information system environment exists when one or more computer(s) of any type or size is (are) involved in the processing of financial information, including quantitative data, of significance to the audit, whether those computers are operated by the entity or by a third party. A computerised accounting environment will therefore have the following salient features :

1. The processing of financial information will be by one or more computers.

2. The computer or computers may be operated by the entity or by a third party.
3. The processing of financial information by the computer is done with the help of one or more computer software.
4. A computer software includes any program or routine that performs a desired function or set of functions and the documentation required to describe and maintain that program or routine.
5. The computer software used for the accounting system may be an acquired software or may be developed for the business.
6. Acquired software may consist of a spread sheet package or may be prepackaged accounting software. Larger organisations may use an Enterprise Resource Planning (ERP) package for: .
    1. Developing a customised accounting package is an option that some organisation prefers so as to suit the peculiarities of their business function.
    2. Outsourcing of the accounting system is also becoming popular where an organisation is having the financial accounting processed from a third party.

3. SIGNIFICANCE OF COMPUTERISED ACCOUNTING SYSTEM

With computers becoming extensively used in business today, it is obvious that accounts which were earlier maintained in a manual form will be gradually replaced with computerised accounts. The speed with which accounts can be maintained is several fold higher. Basic difficulties faced like balancing of trial balance, correct posting into the general ledger and subsidiary ledger is a thing of the past. Today any person maintaining accounts in the computer does not have to consider that while making say a cash expense entry through the cash payment screen that the corresponding ledger posting of the expense has been done properly or not. Similarly the trial balance should automatically tally unless some mistake is made while recording the opening balances. The only concerns that has increased today are concerns for controls, security and integrity of the computer system as more and more information is stored not in the hard print but as soft copies inside the computer. Issues like unauthorised access to the data either through the local area network or through the internet by hacking into the company server are becoming potential threat to the computer usage.

4. CODIFICATION AND GROUPING OF ACCOUNTS

Unlike a manual accounting system where account codes are rarely used a computerised accounting system frequently uses a well defined coding system. However, it should not be concluded that computerised account must always have account codes. There are many accounting softwares available which support a non-coded accounting system. A coded accounting system is more convenient where there are numerous account heads and the complexity is high. It also to some extent reduces the possibility of the same account existing in several names due to spelling mistakes or abbreviations used.

A proper codification requires a systematic grouping of accounts. The major groups or heads could be Assets, Liabilities, Revenue Receipts, Capital Receipt, Revenue Expenditure, Capital Expenditure. The sub-groups or minor heads could be "Cash" or "Receivables" or "Payables" and so on. The grouping and codification is dependant upon the type of organisation and the extent of sub-division required for reporting on the basis of profit centres or product lines. There could a classification based on geographical location as well.

An example of an account code classification could be the following:

ASSETS (0-399)

CASH (100-129)

101 Petty Cash

110 Main Cash

112 Cash at Bank

115 Cheques in hand

RECEIVABLES (130-139)

130 Debtors - Secured

132 Debtors – Unsecured

139 Other

INVENTORIES (140-179)

140 Stores and Spare Parts

150 Raw Materials

160 Work in progress

170 Finished Goods

PREPAID EXPENSES (180-199)

180 Insurance

190 Other

FIXED ASSETS (200-299)

210 Land

220 Buildings

250 Plant & Machinery

270 Furniture & Fixtures

280 Vehicles

OTHER ASSETS (300-399)

343 Employee Advances

LIABILITIES & SHARE HOLDER FUND (400-9999)

PAYABLES (400-429)

420 Sundry Creditors

424 Commissions Payable

426 Rates and Taxes Payable

429 Sundry Deposits

PAYROLL PAYABLES (430-459)

431 Salaries & Wages Payable

435 Leave Encashment Payable

452 TDS Salaries

453 Professional Tax Payable

454 Gratuity Payable

455 Provident Fund Payable

ACCRUED EXPENSES (460-479)

461 Rent

463 Electricity

465 Telephone

479 Other

OTHER LIABILITIES (600-699)

601 Bank Loan

PROVISIONS (700-799)

701 Income Tax

710 Fringe Benefit Tax

720	Depreciation
730	Proposed Dividend
735	Tax on Proposed Dividend
SHAREHOLDER FUND (900-999)	
901	Paid up Share Capital
920	General Reserve
930	Capital Reserve
950	Contingency Reserve
NET PROFITS (1000-9999)	
REVENUE (1000-1999)	
1100	Domestic
1200	Export
1900	Other
EXPENSE (2000-9999)	
COST OF SALES (2000-2999)	
2100	Raw Material Consumed
2200	Labor
2990	Other
MANUFACTURING EXPENSE (3000-3999)	
3210	Salaries/Wages and Bonus
3220	Contribution to Provident and Other Funds
3230	Power and Fuel
3295	Consumption of Stores and Spare Parts
3350	Outward Freight and Handling Charges
3351	Vacation Rate Change
SELLING EXPENSE (6000-6999)	
6250	Advertisement/Sales Promotion
6251	Commissions
6295	Market Research

6350	Brokerage & Discount
ADMINSTRATIVE EXPENSE (7000-7999)	
7250	Postage Telephone
7260	Repairs to Building
7265	Repairs to Machinery
7266	Other repairs
7270	Legal Expenses
7280	Audit Expenses
7600	Travel & Conveyance
7605	Other Expense
7701	Depreciation
7730	Insurance
7740	Rates & Taxes
7750	Rent
7760	Donations and contributions
OTHER EXPENSE (8000-8999)	
8100	Loan Interest
8900	Other
OTHER TAX (9000-9999)	
9800	Income Tax
9900	VAT

The above chart of accounts is only an illustration. The actual account classification may contain fewer, more or different accounts depending upon the industry and complexity of the business. Here account codes were 3 digits for assets and liabilities and 4 digits for revenue and expenditure. However, many organisations prefer to have uniformly 4 digits.

Let us go for another example where only 4 digit account codes have been used. The system could be that the first digit in the code will indicate whether it is revenue receipt or a capital receipt or a revenue expenditure or a capital expenditure or loans and advances or share holder fund. Thus if the first digit is '0' or '1', the Head of Account will represent Revenue Receipt; '2' or '3' will represent Revenue Expenditure; '4' or '5' Capital Expenditure; '6' or '7' Loans and Advances Head; and '8' will represent Shareholders Fund.

Adding 2 to the first digit of the Revenue Receipt will give the Code Number allotted to corresponding Revenue Expenditure Head; adding another 2—the Capital Expenditure Head and another 2—the Loans and Advances Head of Accounts; e.g.

0401	represents the Receipt Head for car manufacture
2401	represents the Revenue Expenditure Head for car manufacture
4401	represents the Capital Outlay on car manufacture
6401	represents Loans for car manufacture.

Such a pattern may not be relevant for those departments which do not operate Capital/Loan head of accounts. Where receipt/expenditure is not heavy, certain major heads may be combined under a single number, the major heads themselves forming sub-major heads under that number.

The range of code numbers allotted under the scheme of codification is shown below:-

	Major Head Code Nos.
Receipt Heads (Revenue Account)	0020-1999
Expenditure Heads (Revenue Account)	2011-3999
Receipt Head (Capital Account)	4000
Expenditure Heads (Capital Account)	4046-5999
Loans & Advances	6001-7999
Shareholders Fund	8001-8995

(a) The main unit of classification in accounts should be the major head which should be divided into minor heads, each of which should have a number of subordinate heads, generally shown as sub-heads. The sub-heads are further divided into detailed heads. Sometimes major heads may be divided into 'sub-major heads' before their further division into minor heads.

The Major heads, Minor heads, Sub-heads and Detailed heads together may constitute a four tier arrangement of the classification structure of Accounts.

(b) Major heads of account falling within the Receipt Heads (Revenue Account) may correspond to different activities or line of business of the company such as car manufacture, servicing of cars, repairs and maintenance of cars, while minor heads subordinate to them shall identify the specific manufacturing activity like manufacture of car body, components and spare parts, etc. A manufacture of car body may consist of a number of activities like the manufacture of the chasis, the door, the front panel, the rear panel, etc. These will then correspond to 'sub-heads' below the minor head represented by the main activity - car manufacture.

(c) A "detailed head" is often termed as an object classification. In the expenditure account being considered in the above example the main purpose of the detailed head is to control expenditure on an item to item basis and at the same time group the objects according to the nature. Example of such detailed head could be 'Salaries', 'Office Expenses', 'Salesman Expenses', 'Workshop Overhead', etc.

(d) The detailed classification of account heads and the order in which the Major and Minor heads shall appear in all account records should be approved by the top management of the organisation and should be reviewed by the auditor before they are introduced in the computerised accounting environment.

5. MAINTAINING THE HIERARCHY OF LEDGERS

Once the classification of accounts into various groups is complete and codification is done after formation of major, minor, sub and detailed heads the same is required to be inserted into the computer system. Account master files are created with codes and description of the accounts. Some accounting software allows ledgers and subsidiary ledgers to be created from the main ledgers. The subsidiary ledgers can further be subdivided to sub subsidiary ledgers thereby allowing grouping under various profit centres. These are particularly useful where accounts are maintained without codes. In a coded system this is easily achieved by alloting codes to major, minor, sub and detailed heads and thereafter obtaining reports based on these codes.

Apart from the general ledger and the subsidiary ledger (or the sub-subsidiary ledger as is available in some software) there are other ledger accounts that are automatically created by any standard accounting software. These are the debtors ledger and the creditors ledger. At the time of creation of the account heads some of account heads are indicated to the system as cash account, bank account, debtors account and creditors account. Thereafter whenever an entry is made say with a cash account and a bank account the computer automatically indicates it as a contra in the reports. Similarly when a sale transaction is made, the reflection is given in the debtors account and when a purchase transaction is made the reflection goes to the creditors account.

Another important ledger which forms part of most standard accounting package is the inventory ledger. In simple accounting softwares this may give only the movement of inventory items without valuation of inventories. However, many of the packages give the option of valuation of inventories based on the method of costing set like the FIFO, LIFO , weighted average, etc.

6. ACCOUNTING PACKAGES AND CONSIDERATION FOR THEIR SELECTION

We have stated earlier that account can be maintained in a computerised environment even by using a spread sheet package. To do so the user will have to use his knowledge and skills of spread sheet software to keep control of the figures. Special spreadsheet controls including physical spreadsheet controls like spreadsheets locked on a protected shared drive with restricted access and read/write access controls and password-protected cells and formulas with passwords should be used. Spreadsheet softwares allow grouping of accounts, replication of cell contents, formulas and macros, pivot tables, calculations and functions which help in the maintainance of the accounts. The limitations of a spreadsheet could be that double entry is not automatically completed thereby requiring the users to set formulas or other means to complete the double entry. Further, where large number of data is involved spreadsheet software may not work. It may also be difficult in a lan environment where users may require to simultaneously access a spreadsheet.

To sum up the advantages of a spreadsheet software as an accounting tool are :

1. It is simple to use and easy to understand
2. Most of the common functions like doing calculations, setting formulas, macros, replication of cell contents, etc can be easily done in a spreadsheet.
3. Grouping and regrouping of accounts can be done.
4. Presentation can be made in various forms including graphical presentations like bar diagram, histogram, pie-chart, etc.
5. Basic protection like restricted access and password protection of cell can be used to give security to the spread sheet data.

The disadvantages of a spreadsheet as an accounting tool are :

1. It has data limitations. Depending upon the package they can accept data only upto a specified limit.
2. Simultaneous access on a network may not be possible. Many of the modern softwares allow locking of the table when updation is taking place. This is not possible in a spread sheet.

3. Double entry is not automatically completed. Formulas or other means have to be adopted to complete the double entry.
4. Reports are not automatically formatted and generated but have to be user controlled. Each time a report has to be printed, settings have to be checked and data range has to be set. In many accounting software this is automatically taken care of by the program.

7. PREPACKAGED ACCOUNTING SOFTWARE

There are several prepackaged accounting software which are available in the market and are used extensively for small and medium sized organisations. These softwares are easy to use, relatively inexpensive and readily available. The installation of these softwares are very simple. An installation diskette or CD is provided with the software which can be used to install the software on a personal computer. A network version of this software is also generally available which needs to be installed on the server and work can be performed from the various workstations or nodes connected to the server. Along with the software an user manual is provided which guides the user on how to use the software. After installation of the software, the user should check the version of the software to ensure that they have been provided with the latest. The vendor normally provides regular updates to take care of the changes of law as well as add features to the existing software. These softwares normally have a section which provides for the creation of a company. The name, address, phone numbers and other details of the company like VAT registration number, PAN and TAN numbers are feeded into the system. The accounting period has to be set by inserting the first and the last day of the financial year. The next step in the use of this software could be the creation of accounts. This is done by adding the accounts along with their codes into the master file files. Each account has to be classified into whether it is an asset or liability or an income or expenditure account. Whether the account has other subsidiary ledgers under it needs to be indicated to the system. The opening balances are to be entered into the master file files. The company parameters need to be set at this point of time so that the accounts which are the cash, bank, sundry debtors, sundry creditors, etc are known to the system. The customers name, address and other basic details are also entered in the customer master file. Similarly, the creditors details are entered into the creditor master file files. Product details are entered through the product master file files. Here the unit of measurement and the opening stock quantities including the values are provided. The system of valuation of stock like the FIFO, LIFO, Weighted average, etc are defined in the product master file files.

Once the basic parameters are set and the master files are updated, the system is ready for use.

To summarise any standard pre packaged software will have the following master file screens:

Company master file

Accounts master file

Sub ledger master file

Customer master file

Vendor master file

Product master file

Division master file

The entry screens differ in look and feel from software to software and from vendor to vendor. However, the basic entry screens are the following :

Cash Receipts and Payment Entry

Bank Receipts and Payment Entry

Petty Cash Voucher Entry

Journal Entry

Purchase Order, GRN, Bill, Purchase return Entry

Sales Order, Challan, Invoice, Sales Return Entry

Debit Notes and Credit Notes Entry

Cash Sales & Purchase Memos

Production

Consumption

Stock Transfer

Each of the screens are provided with the add, modify or delete options. Special options like the date modification and voucher number modifications are provided in some of the softwares.

The next section that the software provides is the reports section where the following reports are common to most of the softwares :

Cash Book

Bank Book

Petty Cash Book

Purchase Book

Sales Book

Cash Sales Book,

Cash Purchase Book,

Sales Return register

Purchase Return register

Journal Book

General Ledger

Subsidiary Ledger

Debtors Ledger

Creditors Ledger

Debit Note Register

Credit Note Register

Stock Ledger

Stock movement register

Production register

Consumption register

Document printing options like printing of purchase orders, challans and bills, sales order, challans and invoices, declaration forms and return forms.

Trial Balance

Profit and Loss Account

Balance Sheet

Some of the softwares provide bank reconciliation options. In the entry screen date of clearances can be inserted. Reports can thereafter be generated of all uncleared items to make the BRS report.

There are special reports also provided by some softwares like the cash, bank maintenance reports which shows any date on which the cash or bank by mistake had credit balance. There are also MIS reports like aging of debtors, slow moving and non-moving stock, etc.

The last section also called the house keeping section of these softwares provide the system maintenance features. Backup can be taken and restored under the housekeeping section. Clean-up, fine tuning and re-indexing of the software is part of this section of the software.

7.1 Advantages of Pre-Packaged Accounting Software :

1. *Easy to install*: The CD or floppy disk is to be inserted and the setup file should be run to complete the installation. Certain old DOS based accounting softwares required some settings to be added in the system configuration file and the system batch file. These instructions are generally provided in the user manuals.
2. *Relatively inexpensive*: These packages are sold at very cheap prices nowadays.
3. *Easy to use*: Mostly menu driven with help options. Further the user manual provides most of the solutions to problems that the user may face while using the software.
4. *Backup procedure is simple*: Housekeeping section provides a menu for backup. The backup can be taken on floppy disk or CD or harddisk.

4. *Certain flexibility of report formats provided by some of the s*oftwares: This allows the user to make the invoice, challan, GRNs look the way they want.

6. *Very effective for small and medium size businesses*: Most of their functional areas are covered by these standardised packages.

7.2 Disadvantage of Pre-packaged Accounting Software :

1. *Does not cover peculiarities of specific business*: Business today are becoming more and more complex. A standard package may not be able to take care of these complexities.
2. *Does not cover all functional area*: For example production process may not be covered by most pre-packaged accounting software.
3. *Customisation may not be possible in most such softwares*: The vendors for these softwares believe in mass sale of an existing source. The expertise for customisation may not have been retained by the vendor.
4. *Reports generated is not sufficient or serve the purpose*: The demands for modern day business may make the management desire for several other reports for exercising management control. These reports may not be available in a standard package.
5. *Lack of security*: Any person can view data of all companies with common access password. Levels of access control as we find in many customised accounting software packages are generally missing in a pre-packaged accounting package.
6. *Bugs in the software*: Certain bugs may remain in the software which takes long to be rectified by the vendor and is common in the initial years of the software.

7.3 Consideration for Selection of Pre-Packaged Accounting Software

There are many accounting softwares available in the market. To choose the accounting software appropriate to the need of the organisation is a difficult task. Some of the criteria for selection could be the following:

1. *Fulfilment of business requirements*: Some packages have few functionalities more than the others. The purchaser may try to match his requirement with the available solutions.
2. *Completeness of reports*: Some packages might provide extra reports or the reports matches the requirement more than the others.
3. *Ease of use* : Some packages could be very detailed and cumbersome compare to the others.
4. *Cost* : The budgetary constrainsts could be an important deciding factor. A package having more features cannot be opted because of the prohibitive costs.
5. *Reputation of the vendor*: Vendor support is essential for any software. A stable vendor with reputation and good track records will always be preferred.
6. *Regular updates* : Law is changing frequently. A vendor who is prepared to give updates will be preferred to a vendor unwilling to give updates.

8. CUSTOMISED ACCOUNTING SOFTWARE

A customised accounting software is one where the software is developed on the basis of requirement specifications provided by the organisation. The choice of customised accounting software could be because of the typical nature of the business or else the functionality desired to be computerised is not available in any of the pre-packaged accounting software. An organisation desiring to have an integrated software package covering most of the functional area may have the financial module as part of the entire customised system.

A feasibility study is first made before the decision to develop a software is made. The life cycle of a customised accounting software begins with the organisation providing the user requirements. Based on these user requirement the system analyst prepares a requirement specification which is given for approval by the user management. Once the requirement specification is approved, the designing process begins. Development, testing and implementation are the other components of the system development life cycle.

8.1 Advantages of a Customised Accounting Package

Advantages of a customised accounting package are the following:

1. The functional areas that would otherwise have not been covered gets computerised.
2. The input screens can be tailor made to match the input documents for ease of data entry.
3. The reports can be as per the specification of the organisation. Many additional MIS reports can be included in the list of reports.
4. Bar-code scanners can be used as input devices suitable for the specific needs of an individual organisation.
5. The system can suitably match with the organisational structure of the company.

8.2 Disadvantages of a Customised Accounting Package

The disadvantages which may arise in a customised accounting package are the following :

1. Requirement specifications are incomplete or ambiguous resulting in a defective or incomplete system.
2. Inadequate testing results in bugs remaining in the software.
3. Documentation is not complete.
4. Frequent changes made to the system with inadequate change management procedure resulting in system compromise.
5. Vendor unwilling to give support of the software due to other commitments.
6. Vendor not willing to part with the source code or enter into an escrow agreement.
7. Control measures are inadequate.
8. Delay in completion of the software due to problems with the vendor or inadequate project management.

The choice of customised accounting packages is made on the basis of the vendor proposals. The proposals are evaluated as to the suitability, completeness, cost and vendor profiles. Generally preference is given to a vendor who has a very good track record of deliverables.

9. ACCOUNTING SOFTWARE AS PART OF ENTERPRISE RESOURCE PLANNING (ERP)

Larger organisations often go for an ERP package where finance comes as a module. An ERP is an integrated software package that manages the business process across the entire enterprise.

9.1 Advantages of Using an ERP

The advantages of using an ERP for maintaining accounts are as follows:

1. *Standardised processes and procedures* : An ERP is a generalised package which covers most of the common functionalities of any specific module.
2. *Standardised reporting* : Majority of the desired reports are available in an ERP package. These reports are standardised across industry and are generally acceptable to the users.
3. *Duplication of data entry* is avoided as it is an integrated package.
4. *Greater information* is available through the package.

9.2 Disadvantages of an ERP

The disadvantages of an ERP are the following:

1. *Lesser flexibility* : The user may have to modify their business procedure at times to be able to effectively use the ERP.
2. *Implementation hurdles* : Many of the consultants doing the implementation of the ERP may not be able to fully appreciate the business procedure to be able to do a good implementation of an ERP
3. *Very expensive* : ERP are normally priced at an amount which is often beyond the reach of small and medium sized organisation. However, there are some ERP coming into the market which are moderately priced and may be useful to the small businesses.
4. *Complexity of the software* : Generally an ERP package has large number of options to choose from. Further the parameter settings and configuration makes it a little complex for the common users.

9.3 Choice of an ERP

Choice of an ERP depends upon the following factors:

1. *Functional requirement of the organisation* : The ERP that matches most of the requirements of an organisation is preferred over the others.

2. *Reports available in the ERP* : The organisation visualises the reporting requirements and choses a vendor which fulfils its reporting requirements.
3. *Background of the vendors* : The service and deliverable record of a vendor is extremely important in chosing the vendor.
4. *Cost comparisons* :The budget constraints and fund position of an enterprise often becomes the deciding factor for choosing a particular package.

10. OUTSOURCING OF ACCOUNTING FUNCTION :

Recently a growing trend has developed for outsourcing the accounting function to a third party. The consideration for doing this is to save cost and to utilise the expertise of the outsourced party. The third party maintains the accounting software and the client data, does the processing and hands over the report from time to time.

10.1 Advantages of Outsourcing the Accounting Functions

The advantages of outsourcing the accounting functions are the following:

1. The organisation that outsources is able to save time to concentrate on the core area of business activity.
2. The organisation is able to utilise the expertise of the third party in undertaking the accounting work.
3. Storage and maintenance of the data is in the hand of professional people.
4. The organisation is not bothered about people leaving the organisation in key accounting positions.
5. The proposition often proves to be economically more sensible.

10.2 Disadvantages of Outsourcing the Accounting Functions

The disadvantages of outsourcing are as follows:

1. *The data of the organisation is handed over to a third party:* This raises two issues, one of security and second of confidentiality. There have been instances of information leaking out of the third party data centres.
2. *Inadequate services provided* :The third party is unable to meet the standards desirable.
3. The *cost* may ultimately be higher than initially envisaged.
4. *Delay in obtaining services:* The third party service providers are catering to number of clients thereby processing as per priority basis.

The choice of outsourcing vendor is made on the basis of the proposals received from these vendors. The proposals are evaluated and the decision is often taken based on the following criteria:

1. The amount of services provided and whether the same matches with the requirements.
2. The reputation and background of the vendor.
3. The comparative costs of the various propositions.
4. The assurance of quality.

After having discussed about the possible alternatives for having accounting in a computerised environment it is important to understand how a choice can be made from all the alternatives viz. spread sheet packages, pre-packaged accounting software, customised accounting package, ERP package and outsourcing the accounting function to a third party. The possible considerations are as follows:

1. *Size of business operation:* If the size of the operation is small or medium the organisation can opt for a prepackaged accounting package. However, if the size is big, the organisation may decide upon a customised software or an ERP package.
2. *Complexity of operation:* If the operation is complex with several functional areas which needs to be computerised the choice is usually a customised software or an ERP package.
3. *Business requiremen:.* If the organisation has several non-standard requirements then customised software could be the solution.
4. *Budgetary constraints:* Cost consideration could also be a deciding factor for the choice of a particular alternative. Normally the spread sheet and the prepackaged accounting software works out to be the cheapest. The customised software and the ERP are of higher cost considerations.

11. GENERATING REPORTS FROM SOFTWARE

Spreadsheet softwares can be utilised to generate accounting reports. Formats have to be defined by the user and can be used to view or print the reports. In a pre-packaged accounting software reports are generated from the package. The user is allowed to define the period of the report which should fall within the accounting period for which the report is required. Reports as on a particular date should also be falling within the accounting period. The reports generally have the option of being viewed on the screen, or printed out through the printer or saved on to a file. Saved file may be in the text format or spreadsheet format depending upon the software being used. Reports from the pre-packaged software is mostly in a pre-determined format. However, some of the softwares allow certain customisation of the formats of the report. For example the look of the invoice or challan can be printed according to the style normally used by the company.

Self-Examination Questions

I Objective Type Questions

Choose the most appropriate answer from the given options

1. All of the following are advantages of a spreadsheet software except

   (a) It is simple to use and easy to understand

   (b) calculations can be easily done in a spreadsheet.

   (c) Grouping and regrouping of accounts.

   (d) Double entry is not automatically completed.

2. Pre packaged accounting softwares

   (a) Don't cover peculiarities of specific business.

   (b) Don't cover all functional areas.

   (c) Are easy to install.

   (d) All of the above.

3. ERP

   (a) Standardizes reporting.

   (b) Is expensive.

   (c) Is less flexible.

   (d) All of the above

   [**Ans. 1.** (d); **2.** (d); **3.** (d)]

II Short Answer type Questions

4. What is the significance of a computerised accounting system ?

5. How computerised accounting system is different from a manual system? Explain in brief.

6. Why are codes preferred in a computerised accounting ?

7. How are grouping done in the computer ?

8. How do we chose a pre-packaged accounting software ?

9. How will you select a customised accounting software vendor ?

III Long Answer type Questions

10. What are the advantages and disadvantages of spread sheet as a tool for maintaining computerised accounts ?

11. What are the advantages and disadvantages of a pre-packaged accounting software ?

12. What are the advantages and disadvantages of a customised accounting software ? How is it different from a pre-packaged accounting software ?

13. What are the advantages and disadvantages of an ERP package ?

14. What are the advantages and disadvantages of outsourcing the accounting functions ?

15. What will the computerised accounting (pre-packaged, customised, ERP or outsourced) which will be most suitable in the following situations and why :

    (a) Small business enterprise doing mainly trading

    (b) Large size tailoring shop

    (c) Pathological laboratory

    (d) Company having global business

    (e) Share broker

    (f) Medicine shop.

APPENDIX - I

ACCOUNTING STANDARDS

AS 1 : DISCLOSURE OF ACCOUNTING POLICIES*

The following is the text of the Accounting Standard 1 (AS-1) issued by the Accounting Standards Board, the Institute of Chartered Accountants of India on "Disclosure of Accounting Policies". The Standard deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

Introduction

1. This statement deals with the disclosure of significant accounting policies followed in preparing presenting financial statements.

2. The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

3. The disclosure of some of accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.

4. The Institute of Chartered Accountants of India has, in Statements issued by it, recommended the disclosure of certain accounting policies, *e.g.*, translation policies in respect of foreign currency items.

5. In recent years, a few enterprises in India have adopted the practice of including in their annual reports to shareholders a separate statement of accounting policies followed in preparing and presenting the financial statements.

* Issued in November, 1979

6. In general, however, accounting policies are not at present regularly and fully disclosed in all financial statements. Many enterprises include in the Notes on the Accounts, descriptions of some of the significant accounting policies. But the nature and degree of disclosure vary considerably between the corporate and the non-corporate sectors and between units in the same sector.

7. Even among the few enterprises that presently include in their annual reports a separate statement of accounting policies, considerable variation exists. The statement of accounting policies form part of accounts in some cases while in others it is given as supplementary information.

8. The purpose of this statement is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

Explanation

Fundamental Accounting Assumptions

9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

10. The following have been generally accepted as fundamental accounting assumptions :

(*a*) *Going Concern*

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 the operations.

(*b*) *Consistency*

It is assumed that accounting policies are consistent from one period to another.

(*c*) *Accrual*

Revenues and costs are accrued, that is recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this statement).

Nature of Accounting Policies

11. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

12. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgment by the management of the enterprise.

13. The various statements of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of corporate enterprises. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those principles is not likely to be eliminated altogether in view of the differing circumstances faced by the enterprises.

Areas in Which Differing Accounting Policies are Encountered

14. The following are examples of the areas in which different accounting policies may be adopted by different enterprises.

- Methods of depreciation, depletion and amortisation
- Treatment of expenditure during construction
- Conversion or translation of foreign currency items
- Valuation of inventories
- Treatment of goodwill
- Valuation of investments
- Treatment of retirement benefits
- Recognition of profit on long-term contracts
- Valuation of fixed assets
- Treatment of contingent liabilities

15. The above list of examples is not intended to be exhaustive.

Considerations in the Selection of Accounting Policies

16. The primary consideration in the selection of Accounting Policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the Balance Sheet date and of the profit or loss for the period ended on that date.

17. For this purpose, the major considerations governing the selection and application of accounting policies are :—

(*a*) *Prudence*

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

(*b*) *Substance over Form*

The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.

(*c*) *Materiality*

Financial statements should disclose all “material” items, *i.e.*, items the knowledge of which might influence the decisions of the user of financial statements.

Disclosure of Accounting Policies

18. To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

19. Such disclosure should form part of the financial statements.

20. It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.

21. Examples of matters in respect of which disclosure of accounting policies adopted will be required are contained in paragraph 14. This list of examples is not, however, intended to be exhaustive.

22. Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If 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.

23. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

Accounting Standard

(*The Accounting Standard comprises paragraphs 24-27 of this Statement. The Standard should be read in the context of paragraphs 1-23 of this Statement and of the Preface to the Statements of Accounting Standards.*)

24. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

25. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

26. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

27. If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

AS 2 (REVISED) : VALUATION OF INVENTORIES

The following is the text of the revised Accounting Standard (AS) 2, 'Valuation of Inventories', issued by the Council of the Institute of Chartered Accountants of India. This revised Standard supersedes Accounting Standard (AS) 2, 'Valuation of Inventories', issued in June, 1981. The revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1999 and is mandatory in nature.

Objective

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised. This Statement deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

Scope

1. ***This Statement should be applied in accounting for inventories other than:***

(a) work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, Accounting for Construction[1] Contracts);

(b) work in progress arising in the ordinary course of business of service providers;

(c) shares, debentures and other financial instruments held as stock-in-trade; and

(d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

2. The inventories referred to in paragraph 1 (d) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Statement.

Definitions

3. ***The following terms are used in this Statement with the meanings specified:***

Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and

[1] This standard has been revised and titled as 'Construction Contracts.'

loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.[2]

Measurement of Inventories

5. ***Inventories should be valued at the lower of cost and net realisable value.***

Cost of Inventories

6. ***The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.***

Costs of Purchase

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Costs of Conversion

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in

[2] Refer to Accounting Standards interpretation (ASI)2.

which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

10. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other Costs

11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

12. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Exclusions from the Cost of Inventories

13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d)selling and distribution costs.

Cost Formulas

14. ***The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.***

15. Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. However, when there are large numbers of items of inventory which are ordinari ly interchangeable, specific identification of costs is inappropriate since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting a particular method of ascertaining the items that remain in inventories.

16. ***The cost of inventories, other than those dealt with in paragraph 14, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.***

17. A variety of cost formulas is used to determine the cost of inventories other than those for which specific identification of individual costs is appropriate. The formula used in determining the cost of an item of inventory needs to be selected with a view to providing the fairest possible approximation to the cost incurred in bringing the item to its present location and condition. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

Techniques for the Measurement of Cost

18. Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

19. The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other

costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

Net Realisable Value

20. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs necessary to make the sale have increased. The practice of writing down inventories below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use.

21. Inventories are usually written down to net realisable value on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular business segment.

22. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

23. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date*.

* Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1.4.2004, all paragraphs of

24. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

25. An assessment is made of net realisable value as at each balance sheet date.

Disclosure

26. *The financial statements should disclose:*

(a) the accounting policies adopted in measuring inventories, including the cost formula used; and

(b) the total carrying amount of inventories and its classification appropriate to the enterprise.

27. Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are raw materials and components, work in progress, finished goods, stores and spares, and loose tools.

AS 3 (REVISED 1997) CASH FLOW STATEMENTS

The following is the text of the revised Accounting Standard (AS 3), Cash Flow Statements, issued by the Council of the Institute of Chartered Accountants of India. This Standard supersedes Accounting Standard (AS 3), Changes In Financial Position, issued in June, 1981.This standard is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004 for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidence by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs.50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs.10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

The enterprises which do not fall in any of the above categories are encouraged, but are not required, to apply this Standard.

Where an enterprise has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from application of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise has previously qualified for exemption from application of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable from the current period. However, the corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not present a cash flow statement, should disclose the fact.

The following is the text of the Accounting Standard.

Objective

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

The 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.

Scope

1. An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.

2. Users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with financial enterprise. Enterprises need cash for essentially the same reasons, however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

Benefits of Cash Flow Information

3. A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency), and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

4. Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

Definitions

5. The following terms are used in this Statement with the meanings specified :

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.)

Cash and Cash Equivalents

6. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

7. Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Presentation of a Cash Flow Statement

8. The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

9. An enterprise presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

10. A single transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

Operating Activities

11. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans, and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

12. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are :

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions, and other revenue;

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments relating to futures contracts, forward contracts, option contracts, and swap contracts when the contracts are held for dealing or trading purposes.

13. Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

14. An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

Investing Activities

15. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;

(b) cash receipts from disposal of fixed assets (including intangibles);

(c) cash payments to acquire shares, warrants, or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(d) cash receipts from disposal of shares, warrants, or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);

(f) cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

(g) cash payments for futures contracts, forward contracts, option contracts, and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts, and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

16. When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Financing Activities

17. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are :

(a) cash proceeds from issuing shares or other similar instruments;

(b) cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and

(c) cash repayments of amounts borrowed.

Reporting Cash Flows from Operating Activities

18. An enterprise should report cash flows from operating activities using either :

(a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) the indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

19. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either :

(a) from the accounting records of the enterprise; or

(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:

(i) changes during the period in inventories and operating receivables and payables;

(ii) other non-cash items; and

(iii) other items for which the cash effects are investing or financing cash flows.

20. Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of :

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and

(c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses, excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Reporting Cash Flows from Investing and Financing Activities

21. An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in Paragraphs 22 and 24 are reported on a net basis.

Reporting Cash Flows on a Net Basis

22. Cash flows arising from the following operating, investing or financing activities may be reported on a net basis :

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

23. Examples of cash receipts and payments referred to in Paragraph 22(a) are :

(a) the acceptance and repayment of demand deposits by a bank;

(b) funds held for customers by an investment enterprise; and

(c) rents collected on behalf of, and paid over to, the owners of properties.

Examples of cash receipts and payments referred to in Paragraph 22(b) are advances made for, and the repayments of :

(a) principal amounts relating to credit card customers;

(b) the purchase and sale of investments; and

(c) other short-term borrowings, for example, those which have a maturity period of three months or less.

24. Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis :

(a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;

(b) the placement of deposits with and withdrawal of deposits from other financial enterprises; and

(c) cash advances and loans made to customers and the repayment of those advances and loans.

Foreign Currency Cash Flows

25. Cash flows arising from transactions in a foreign currency should be recorded in an enterprise’s reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used. The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency should be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period.

26. Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange

Rates[*]. This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions.

27. Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of-period exchange rates.

Extraordinary Items

28. The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

29. The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by Accounting Standard (AS) 5, Net Profit or loss for the Period, Prior Period Items, and Changes in Accounting Policies.

Interest and Dividends

30. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

31. The total amount of interest paid during the period is disclosed in the cash flow statement whether it has been recognised as an expense in the statement of profit and loss or capitalised in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.[*]

[*] This standard has been revised in 2003, and titled as ‘The Effects of Changes in Foreign Exchange Rates’.

[*] Pursuant to the issuance of AS 16, Borrowing Costs, which came into effect in respect of accounting periods commencing on or after 1.4.2004, accounting for borrowing costs is governed by As 16 from that date.

32. Interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise. However, there is no consensus on the classification of these cash flows for other enterprises. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments.

33. Some argue that dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

Taxes on Income

34. Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

35. Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Investments in Subsidiaries, Associates, and Joint Ventures

36. When accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee/joint venture, for example, cash flows relating to dividends and advances.

Acquisitions and Disposals of Subsidiaries and Other Business Units

37. The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately and classified as investing activities.

38. An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following :

(a) the total purchase or disposal consideration; and

(b) the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

39. The separate presentation of the cash flow effects of acquisitions and disposals of subsidiaries and other business units as single line items helps to distinguish those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

Non-Cash Transactions

40. Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

41. Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are :

(a) the acquisition of assets by assuming directly related liabilities;

(b) the acquisition of an enterprise by means of issue of shares; and

(c) the conversion of debt to equity.

Components of Cash and Cash Equivalents

42. An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

43. In view of the variety of cash management practices, an enterprise discloses the policy which it adopts in determining the composition of cash and cash equivalents.

44. The effect of any change in the policy for determining components of cash and cash equivalents is reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items, and Changes in Accounting Policies.

Other Disclosures

45. An enterprise should disclose, together with a commentary management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it.

46. There are various circumstances in which cash and cash equivalent balances held by an enterprise are not available for use by it. Examples include cash and cash equivalent balances held by a branch of the enterprise that operates in a country where exchange controls or other legal restrictions apply as a result of which the balances are not available for use by the enterprise.

47. Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise. Disclosure of this information, together with a commentary by management, is encouraged and may include :

(a) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and

(b) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.

48. The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is investing adequately in the maintenance of its operating capacity. An enterprise that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

Appendix I

Cash flow statement for an enterprise other than a financial enterprise

The appendix is illustrative only and does not form part of the accounting standard. The purpose of this appendix is to illustrate the application of the accounting standard.

1. The example shows only current period amounts.

2. Information from the statement of profit and loss and balance sheet is provided to show how the statements of cash flows under the direct method and the indirect method have been derived. Neither the statement of profit and loss nor the balance sheet is presented in conformity with the disclosure and presentation requirements of applicable laws and accounting standards. The working notes given towards the end of this appendix are intended to assist in understanding the manner in which the various figures appearing in the cash flow statement have been derived. These working notes do not form part of the cash flow statement and, accordingly, need not be published.

3. The following additional information is also relevant for the preparation of the statement of cash flows (figures are in Rs. ’000).

(a) An amount of 250 was raised from the issue of share capital and a further 250 was raised from long-term borrowings.

(b) Interest expense was 400 of which 170 was paid during the period. 100 relating to interest expense of the prior period was also paid during the period.

(c) Dividends paid were 1,200.

(d) Tax deducted at source on dividends received (included in the tax expense of 300 for the year) amounted to 40.

(e) During the period, the enterprise acquired fixed assets for 350. The payment was made in cash.

(f) Plant with original cost of 80 and accumulated depreciation of 60 was sold for 20.

(g) Foreign exchange loss of 40 represents the reduction in the carrying amount of a short-term investment in foreign currency designated bonds arising out of a change in exchange rate between the date of acquisition of the investment and the balance sheet date.

(h) Sundry debtors and sundry creditors include amounts relating to credit sales and credit purchases only.

Balance Sheet as at 31-12-1996

				(Rs. ’000)
		1996		*1995*
Assets				
Cash on hand and balances with banks		200		25
Short-term investments		670		135
Sundry debtors		1,700		1,200
Interest receivable		100		-
Inventories		900		1,950
Long-term investments		2,500		2,500
Fixed assets at cost	2,180		1,910	
Accumulated depreciation	(1,450)		(1,060)	

Fixed assets (net)	730	850
Total Assets	6,800	6,660
Liabilities		
Sundry creditors	150	1,890
Interest payable	230	100
Income taxes payable	400	1,000
Long-term debt	1,110	1,040
Total liabilities	1,890	4,030
Shareholders' Funds		
Share capital	1,500	1,250
Reserves	3,410	1,380
Total shareholders funds	4,910	2,630
Total liabilities and Shareholders' funds	6,800	6,660

Statement of Profit and Loss for the period ended 31-12-1996

	(Rs. '000)
Sales	30,650
Cost of sales	(26,000)
Gross profit	4,650
Depreciation	(450)
Administrative and selling expenses	(910)
Interest expense	(400)
Interest income	300
Dividend income	200
Foreign exchange loss	(40)
Net profit before taxation and extraordinary item	3,350
Extraordinary item - Insurance proceeds from earthquake disaster settlement	180
Net profit after extraordinary item	3,530
Income tax	(300)
Net Profit	3,230

Direct Method Cash Flow Statement [Paragraph 18(*a*)]

			(Rs. '000) **1996**
Cash flows from operating activities			
Cash receipts from customers	30,150		
Cash paid to suppliers and employees	(27,600)		
Cash generated from operations	2,550		
Income taxes paid	(860)		
Cash flow before extraordinary item	1,690		
Proceeds from earthquake disaster settlement	180		
Net cash from operating activities			1,870
Cash flows from investing activities			
Purchase of fixed assets	(350)		
Proceeds from sale of equipment	20		
Interest received	200		
Dividend received	160		30
Net cash from investing activities			
Cash flows from financing activities			
Proceeds from issuance of share capital	250		
Proceeds from long-term borrowings	250		
Repayments of long-term borrowings	(180)		
Interest paid	(270)		
Dividend paid	(1,200)		
Net cash used in financing activities			(1,150)
Net increase in cash and cash equivalents			750
Cash and cash equivalents at beginning of period (See Note 1)		160	
Cash and cash equivalents at end of the period (see Note 1)			910

Indirect Method Cash Flow Statement [Paragraph 18 (b)]

		(Rs. '000) 1996
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	(1,740)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities		1,870
Cash flows from investing activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	160	
Net cash from investing activities		30
Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interest paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing activities		(1,150)

Net increase in cash and cash equivalents	750
Cash and cash equivalents at beginning of period (See Note 1)	160
Cash and cash equivalents at end of period (See note 1)	910

Notes to the cash flow statement

(direct method and indirect method)

1. Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money-market instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts.

	1996	1995
Cash on hand and balances with banks	200	25
Short-term investments	670	135
Cash and cash equivalents	870	160
Effect of exchange rate changes	40	-
Cash and cash equivalents as restated	910	160

Cash and cash equivalents at the end of the period include deposits with banks of 100 held by a branch which are not freely remissible to the company because of currency exchange restrictions.

The company has undrawn borrowing facilities of 2,000 of which 700 may be used only for future expansion.

2. Total tax paid during the year (including tax deducted at source on dividends received) amounted to 900.

Alternative Presentation (indirect method)

As an alternative, in an indirect method cash flow statement, operating profit before working capital changes is sometimes presented as follows :

Revenues excluding investment income	30,650	
Operating expense excluding depreciation	(26, 910)	
Operating profit before working capital changes		3,740

Working Notes

The working notes given below do not form part of the cash flow statement and, accordingly need not be published. The purpose of these working notes is merely to assist in understanding the manner in which various figures in the cash flow statement have been derived.

(Figures are in Rs. '000)

1. Cash receipts from customers

Sales		30,650
Add : Sundry debtors at the beginning of the year		1,200
		31,850
Less : Sundry debtors at the end of the year		1,700
		30,150

2. Cash paid to suppliers and employees

Cost of sales		26,000
Administrative and selling expenses		910
		26,910
Add : Sundry creditors at the beginning of the year	1,890	
Inventories at the end of the year	900	2,790
		29,700
Less : Sundry creditors at the end of the year	150	
Inventories at the beginning of the year	1,950	2,100
		27,600

3. Income taxes paid (including tax deducted at source from dividends received)

Income tax expense for the year (including tax deducted at source from dividends received)	300
Add : Income tax liability at the beginning of the year	1,000
	1,300
Less : Income tax liability at the end of the year	400
	900

Out of 900, tax deducted at source on dividends received (amounting to 40) is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities (See Paragraph 34).

4. Repayment of long-term borrowings

Long-term debt at the beginning of the year	1,040
Add : Long-term borrowings made during the year	250
	1,290
Less : Long-term borrowings at the end of the year	1,110
	180

5. Interest paid

Interest expense for the year	400
Add : Interest payable at the beginning of the year	100
	500
Less : Interest payable at the end of the year	230
	270

Appendix II

Cash Flow Statement for a Financial Enterprise

The appendix is illustrative only and does not form part of the accounting standard. The purpose of this appendix is to illustrate the application of the accounting standard.

1. The example shows only current period amounts.
2. The example is presented using the direct method.

		(Rs. '000) **1996**
Cash flows from operating activities		
Interest and commission receipts	28,447	
Interest payments	(23,463)	
Recoveries on loans previously written off	237	
Cash payments to employees and suppliers	(997)	
Operating profit before changes in operating assets	4,224	

(Increase) decrease in operating assets :		
Short-term funds	(650)	
Deposits held for regulatory or monetary control purposes	234	
Funds advanced to customers	(288)	
Net increase in credit card receivables	(360)	
Other short-term securities	(120)	
Increase (decrease) in operating liabilities :		
Deposits from customers	600	
Certificates of deposit	(200)	
Net cash from operating activities before income tax	3,440	
Income taxes paid	(100)	
Net cash from operating activities		3,340
Cash flows from investing activities		
Dividends received	250	
Interest received	300	
Proceeds from sales of permanent investments	1,200	
Purchase of permanent investments	(600)	
Purchase of fixed assets	(500)	
Net cash from investing activities		650
Cash flows from financing activities		
Issue of shares	1,800	
Repayment of long-term borrowings	(200)	
Net decrease in other borrowings	(1,000)	
Dividends paid	(400)	
Net cash from financing activities		200
Net increase in cash and cash equivalents		4,190
Cash and cash equivalents at beginning of period		4,650
Cash and cash equivalents at end of the period		8,840

AS 6 (REVISED) : DEPRECIATION ACCOUNTING

Accounting Standard (AS) 6, 'Depreciation Accounting', was issued by the Institute in 1985. Subsequently, in the context of insertion of Schedule XIV in the Companies Act in 1988, the Institute brought out a Guidance Note on Accounting for Depreciation in Companies. The Guidance Note differed from AS-6 in respect of accounting treatment of (*a*) change in the method of depreciation, and (*b*) change in the rates of depreciation.

Based on the recommendations of the Accounting Standards Board, the Council of the Institute at its 168th meeting held on May 26-29, 1994, decided to bring AS-6 in line with the Guidance Note in respect of the aforementioned matters. Accordingly, it was decided to modify paragraphs 11, 15, 22 and 24 and delete paragraph 19 of AS-6. Also, in the context of delinking of rates of depreciation under the Companies Act from those under the Income-tax Act/Rules by the Companies (Amendment) Act, 1988, the Council decided to suitably modify paragraph 13 of AS 6. From the date of AS 26 'Intangible Assets' becoming mandatory for the concerned enterprises, the standard stands withdrawn in so far as it relates to the amortization(depreciation of intangible assets).

The complete text of the revised AS-6, which incorporates the above changes, is given below.

Introduction

1. This Statement deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:

(i) forests, plantations and similar regenerative natural resources;

(ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;

(iii) expenditure on research and development;

(iv) goodwill;

(v) live stock.

This statement also does not apply to land unless it has a limited useful life for the enterprise.

2. Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed by an enterprise is necessary to appreciate the view presented in the financial statements of the enterprise.

Definitions

3. The following terms are used in this statement with the meanings specified :

3.1 '*Depreciation*' is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

3.2 '*Depreciable assets*' are assets which :

(i) are expected to be used during more than one accounting period;

(ii) have a limited useful life; and

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

3.3 '*Useful life*' is either (*i*) the period over which a depreciable asset is expected to be used by the enterprise; or (*ii*) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

3.4 '*Depreciable amount*' of a depreciable asset is its historical cost, or other amount substituted for historical cost* in the financial statements, less the estimated residual value.

Explanation

4. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

5. Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

(i) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset had been revalued;

(ii) expected useful life of the depreciable asset; and

* This statement does not deal with the treatment of the revaluation difference which may arise when historical costs are substituted by revaluations.

(iii) estimated residual value of the depreciable asset.

6. Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof. The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long-term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

7. The useful life of a depreciable asset is shorter than its physical life and is :

(i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;

(ii) directly governed by extraction or consumption;

(iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and

(iv) reduced by obsolescence arising from such factors as :

(a) technological changes;

(b) improvement in production methods;

(c) change in market demand for the product or service output of the asset; or

(d) legal or other restrictions.

8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

9. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.

10. Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of

subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

11. The quantum of depreciation to be provided in an accounting period involves the exercise of judgment by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

12. There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors, e.g. (*i*) type of asset, (*ii*) the nature of the use of such asset, and (*iii*) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value depreciation is often allocated fully in the accounting period in which they are acquired.

13. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the managements' estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

14. Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

15. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method is adjusted in

the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

16. Where the historical cost of an asset has undergone a change due to circumstances specified in para 6 above, the depreciation on the revised unamortised depreciable amount is provided prospectively over the residual useful life of the asset.

Disclosure

17. The depreciation methods used, the total depreciation for the period for each class of assets, the gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements along with the disclosure of other accounting policies. The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in the statute governing the enterprise.

18. In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.

19. A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.[*]

Accounting Standard

(*The Accounting Standard comprises paragraphs 20-29 of this Statement. The Standard should be read in the context of paragraphs 1-19 of this Statement and of the 'Preface to the Statements of Accounting Standards'.*)

20. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

21. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting

[*] Refer to AS 5

standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

22. The useful life of a depreciable asset should be estimated after considering the following factors:

(i) expected physical wear and tear;

(ii) obsolescence;

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

23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life.

24. Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset. Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life.

**25. Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long-term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset.*

26. Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.

27. If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

28. The following information should be disclosed in the financial statements :

(i) the historical cost or other amount substituted for historical cost of each class of depreciable assets;

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

(iii) the related accumulated depreciation.

29. The following information should also be disclosed in the financial statements along with the disclosure of other accounting policies:

(i) depreciation methods used; and

(ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

AS 7 (REVISED)[1] : CONSTRUCTION CONTRACTS

Construction Contracts

Accounting Standard (AS) 7, Construction Contracts (revised), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date. Accordingly, Accounting Standard (AS) 7, 'Accounting for Construction Contracts', issued by the Institute in December 1983, is not applicable in respect of such contracts. Early application of this Standard is, however, encouraged.

The following is the text of the revised Accounting Standard.

Objective

The objective of this Statement is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Statement uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements

[1] Revised in 2002

to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.

Scope

1. This Statement should be applied in accounting for construction contracts in the financial statements of contractors.

Definitions

2. The following terms are used in this Statement with the meanings specified:

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

A cost plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

3. A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

4. For the purposes of this Statement, construction contracts include:

(a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

(b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

5. Construction contracts are formulated in a number of ways which, for the purposes of this Statement, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 22 and 23 in order to determine when to recognise contract revenue and expenses.

Combining and Segmenting Construction Contracts

6. The requirements of this Statement are usually applied separately to each construction contract. However, in certain circumstances, 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 of a contract or a group of contracts.

7. When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

8. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

(a) the group of contracts is negotiated as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence.

9. A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) the price of the asset is negotiated without regard to the original contract price.

Contract Revenue

10. Contract revenue[*] should comprise:

(a) the initial amount of revenue agreed in the contract; and

[*] See also ASI 29.

(b) variations in contract work, claims and incentive payments:

(i) to the extent that it is probable that they will result in revenue; and

(ii) they are capable of being reliably measured

11. Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

(a) a contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;

(c) the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) when a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

12. A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when:

(a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and

(b) the amount of revenue can be reliably measured.

13. A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are only included in contract revenue when:

(a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and

(b) the amount that it is probable will be accepted by the customer can be measured reliably.

14. Incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when:

(a) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and

(b) the amount of the incentive payment can be measured reliably.

Contract Costs

15. Contract costs should comprise:

(a) costs that relate directly to the specific contract;

(b) costs that are attributable to contract activity in general and can be allocated to the contract; and

(c) such other costs as are specifically chargeable to the customer under the terms of the contract.

16. Costs that relate directly to a specific contract include:

(a) site labour costs, including site supervision;

(b) costs of materials used in construction;

(c) depreciation of plant and equipment used on the contract;

(d) costs of moving plant, equipment and materials to and from the contract site;

(e) costs of hiring plant and equipment;

(f) costs of design and technical assistance that is directly related to the contract;

(g) the estimated costs of rectification and guarantee work, including expected warranty costs; and

(h) claims from third parties.

These costs may be reduced by any incidental income that is not included in contract revenue, for example income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract.

17. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

(a) insurance;

(b) costs of design and technical assistance that is not directly related to a specific contract; and

(c) construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs as per Accounting Standard (AS) 16, Borrowing Costs.

18. Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.

19. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) general administration costs for which reimbursement is not specified in the contract;

(b) selling costs;

(c) research and development costs for which reimbursement is not specified in the contract; and

(d) depreciation of idle plant and equipment that is not used on a particular contract.

20. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

Recognition of Contract Revenue and Expenses

21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.

22. In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

(a) total contract revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the contract will flow to the enterprise;

(c) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and

(d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

23. In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

(a) it is probable that the economic benefits associated with the contract will flow to the enterprise; and

(b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

24. The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

25. Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35.

26. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

27. When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

28. An enterprise is generally able to make reliable estimates after it has agreed to a contract which establishes:

(a) each party's enforceable rights regarding the asset to be constructed;

(b) the consideration to be exchanged; and

(c) the manner and terms of settlement.

It is also usually necessary for the enterprise to have an effective internal financial budgeting and reporting system. The enterprise reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

29. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

(a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

(b) surveys of work performed; or

(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

30. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Examples of contract costs which are excluded are:

(a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

(b) payments made to subcontractors in advance of work performed under the subcontract.

31. When the outcome of a construction contract cannot be estimated reliably:

(a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

(b) contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.

32. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably,no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenue. In

such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35.

33. Contract costs recovery of which is not probable are recognised as an expense immediately. Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may, therefore, need to be recognised as an expense immediately include contracts:

(a) which are not fully enforceable, that is, their validity is seriously in question;

(b) the completion of which is subject to the outcome of pending litigation or legislation;

(c) relating to properties that are likely to be condemned or expropriated;

(d) where the customer is unable to meet its obligations; or

(e) where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

34. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract should be recognised in accordance with paragraph 21 rather than in accordance with paragraph 31.

Recognition of Expected Losses

35. When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

36. The amount of such a loss is determined irrespective of:

(a) whether or not work has commenced on the contract;

(b) the stage of completion of contract activity; or

(c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with paragraph 8.

Changes in Estimates

37. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies). The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

Disclosure

38. An enterprise should disclose:

(a) the amount of contract revenue recognised as revenue in the period;

(b) the methods used to determine the contract revenue recognised in the period; and

(c) the methods used to determine the stage of completion of contracts in progress.

39. An enterprise should disclose the following for contracts in progress at the reporting date:

(a) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;

(b) the amount of advances received; and

(c) the amount of retentions.

40. Retentions are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed.

41. An enterprise should present:

(a) the gross amount due from customers for contract work as an asset; and

(b) the gross amount due to customers for contract work as a liability.

42. The gross amount due from customers for contract work is the net amount of:

(a) costs incurred plus recognised profits; less

(b) the sum of recognised losses and progress billings

for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.

43. The gross amount due to customers for contract work is the net amount of:

(a) the sum of recognised losses and progress billings; less

(b) costs incurred plus recognised profits

for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).

44. An enterprise discloses any contingencies in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date. Contingencies may arise from such items as warranty costs, penalties or possible losses.*

APPENDIX

The appendix is illustrative only and does not form part of the Accounting Standard. The purpose of the appendix is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Disclosure of Accounting Policies

The following are examples of accounting policy disclosures:

Revenue from fixed price construction contracts is recognised on the percentage of completion method, measured by reference to the percentage of labour hours incurred upto the reporting date to estimated total labour hours for each contract.

Revenue from cost plus contracts is recognised by reference to the recoverable costs incurred during the period plus the fee earned, measured by the proportion that costs incurred upto the reporting date bear to the estimated total costs of the contract.

The Determination of Contract Revenue and Expenses

The following example illustrates one method of determining the stage of completion of a contract and the timing of the recognition of contract revenue and expenses (see paragraphs 21 to 34 of the Standard). (Amounts shown herein below are in Rs. lakhs)

A construction contractor has a fixed price contract for Rs. 9,000 to build a bridge. The initial amount of revenue agreed in the contract is Rs. 9,000. The contractor's initial estimate of contract costs is Rs. 8,000. It will take 3 years to build the bridge.

By the end of year 1, the contractor's estimate of contract costs has increased to Rs. 8,050.

In year 2, the customer approves a variation resulting in an increase in contract revenue of Rs. 200 and estimated additional contract costs of Rs. 150. At the end of year 2, costs incurred include Rs. 100 for standard materials stored at the site to be used in year 3 to complete the project.

* Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1.4.2004, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed upto the reporting date bear to the latest estimated total contract costs. A summary of the financial data during the construction period is as follows:

(amount in Rs. lakhs)

	Year 1	Year 2	Year 3
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation	—	200	200
Total contract	9,000	9,200	9,200
Contract costs incurred upto the reporting date	2,093	6,168	8,200
Contract costs to complete	5,957	2,032	—
Total estimated contract costs	8,050	8,200	8,200
Estimated Profit	950	1,000	1,000
Stage of completion	26%	74%	100%

The stage of completion for year 2 (74%) is determined by excluding from contract costs incurred for work performed upto the reporting date, Rs. 100 of standard materials stored at the site for use in year 3.

The amounts of revenue, expenses and profit recognised in the statement of profit and loss in the three years are as follows:

	Upto the Reporting Date	Recognised in Prior years	Recognised in current year
Year 1			
Revenue (9,000x .26)	2,340		2,340
Expenses (8,050x .26)	2,093		2,093
Profit	247		247
Year 2			
Revenue (9,200x .74)	6,808	2,340	4,468

Expenses (8,200x .74)	6,068	2,093	3,975
Profit	740	247	493
Year 3			
Revenue (9,200x 1.00)	9,200	6,808	2,392
Expense	8,200	6,068	2,132
Profit	1,000	740	260

Contract Disclosures

A contractor has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance upto the reporting date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of year 1 is as follows:

Contract

(amount in Rs. lakhs)

	A	B	C	D	E	Total
Contract Revenue recognised in accordance with paragraph 21	145	520	380	200	55	1,300
Contract Expenses recognised in accordance with paragraph 21	110	450	350	250	55	1,215
Expected Losses recognised in accordance with paragraph 35	—	—	—	40	30	70
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
Contract Costs incurred in the period	110	510	450	250	100	1,420
Contract Costs incurred recognised as contract expenses in the period						

in accordance with paragraph 21	110	450	350	250	55	1,215
Contract Costs that relate to future activity recognised as an asset in accordance with paragraph 26	—	60	100	—	45	205
Contract Revenue (see above)	145	520	380	200	55	1,300
Progress Billings (paragraph 40)	100	520	380	180	55	1,235
Unbilled Contract Revenue	45	—	—	20	—	65
Advances (paragraph 40)	—	80	20	—	25	125

The amounts to be disclosed in accordance with the Standard are as follows:

Contract revenue recognised as revenue in the period (paragraph 38(a))	1,300
Contract costs incurred and recognised profits (less recognised losses) upto the reporting date (paragraph 39(a))	1,435
Advances received (paragraph 39(b))	125
Gross amount due from customers for contract work— presented as an asset in accordance with paragraph 41(a)	220
Gross amount due to customers for contract work— presented as a liability in accordance with paragraph 41(b)	(20)

The amounts to be disclosed in accordance with paragraphs 39(a), 41(a) and 41(b) are calculated as follows:

(amount in Rs. lakhs)

	A	B	C	D	E	TOTAL
Contract Costs incurred	110	510	450	250	100	1,420
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
	145	580	480	160	70	1,435

Progress billings	100	520	380	180	55	1,235
Due from customers	45	60	100	—	15	220
Due to customers	—	—	—	(20)	—	(20)

The amount disclosed in accordance with paragraph 39(a) is the same as the amount for the current period because the disclosures relate to the first year of operation.

AS 9 : REVENUE RECOGNITION

The following is the 'text of the Accounting Standard 9 (AS 9) issued by the Institute of Chartered Accountants of India on "Revenue Recognition[1] ".

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

Introduction

1. This Statement deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Statement is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

— the sale of goods[*]

— the rendering of services, and

— the use by others of enterprise resources yielding interest, royalties and dividends.

2. This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:

(i) Revenue arising from construction contracts;

(ii) Revenue arising from hire-purchase, lease agreements;

(iii) Revenue arising from government grants and other similar subsidies;

(iv) Revenue of insurance companies arising from insurance contracts.

[1] It is reiterated that this AS (as in the case of other AS) assumes that the three fundamental accounting assumptions i.e. going concern, consistency and accrual have been followed in the preparation and presentation of financial statements.

[* *] Refer to ASI 14.

3. Examples of items not included within the definition of “revenue” for the purpose of this Statement are:

(i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of non-current assets *e.g.* appreciation in the value of fixed assets;

(ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;

(iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

(iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;

(v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

Definitions

4. The following terms are used in this Statement with the meanings specified:

4.1 *Revenue* is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise[€] from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

4.2 *Completed Service contract method* is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed.

4.3 *Proportionate completion method* is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract.

Explanation

5. Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. When

[€] the Institute has issued an announcement in 2005 titled ‘Treatment of Inter-divisional Transfers’. As per this announcement, the recognition of inter divisional transfers as sales is an inappropriate treatment and is inconsistent with AS 9.

uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

6. Sale of Goods

6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods, does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.

6.2 At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit and loss and appropriately described.

7. Rendering of Services

7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

(*i*) *Proportionate completion method*: Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

(*ii*) *Completed service contract method* : Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

8. The Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

8.1 The use by others of such enterprise resources gives rise to :

(i) interest - charges for the use of cash resources or amounts due to the enterprise;

(ii) royalties - charges for the use of such assets as know how, patents, trade marks and copyrights;

(iii) dividends - rewards from the holding of investments in shares.

8.2 Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period to maturity.

8.3 Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.

8.4 Dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established.

8.5 When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittance is anticipated, revenue recognition may need to be postponed.

9. Effect of Uncertainties on Revenue Recognition

9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale of goods or the rendering of the service it would not be unreasonable to expect ultimate collection.

9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, *e.g.*, for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

9.3 When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

9.4 An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods,the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

9.5 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.

Accounting Standard

> (*Accounting Standard comprises paragraphs 10-14 of this Statement. 'The Standard should be read in the context of paragraphs 1-9 of this Statement and of the Preface to the Statements of Accounting Standards'.*)

10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled :

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

12. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

13. Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases :

(i) Interest : on a time proportion basis taking into account the amount outstanding and the rate applicable;

(ii) Royalties : on an accrual basis in accordance with the terms of the relevant agreement; and

(iii) Dividends from Investments in shares : when the owner's right to receive payment is established.

Disclosure

14. In addition to the disclosures required by Accounting Standard 1 on Disclosure of Accounting Policies (AS 1), an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

APPENDIX

This appendix is illustrative only and does not form part of the accounting standard set forth in this Statement. The purpose of the appendix is to illustrate the application of the Standard to a number of commercial situations in an endeavour to assist in clarifying application of the Standard.

A. Sale of goods

1 *Delivery is delayed at buyer's request and buyer takes title and accepts billing*

Revenue should be recognised not withstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

2 *Delivered subject to conditions*

(a) installation and inspection i.e., goods are sold subject to installation, inspection etc.

Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (*e.g.* installation of a factory tested television receiver normally only requires unpacking and connecting of power of antennae).

(b) on approval

Revenue should not be recognised until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

(c) guaranteed sales i.e., delivery is made giving the buyer an unlimited right of return

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

(d) consignment sales i.e., a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor

Revenue should not be recognised until the goods are sold to a third party.

(e) cash on delivery sales

Revenue should not be recognised until cash is received by the seller or his agent.

3. *Sales where the purchaser makes a series of instalment payments to the seller and the seller delivers the goods only when the final payment is received*

Revenue from such sales should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

4. *Special orders and shipments, i.e. where payment (or partial payment) is received for goods not presently held in stock, e.g. the stock is still to be manufactured or is to be delivered directly to the customer from a third party.*

Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

5. *Sale - repurchase agreements, i.e. where seller concurrently agrees to repurchase the same goods at a later date*

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognised as revenue.

6. *Sales to intermediate parties,* i.e. *where goods are sold to distributors, dealers or others for resale*

   Revenue from such sales can generally be recognised if significant risks of ownership have passed; however, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

7. *Subscriptions for publications*

   Revenue received or billed should be differed and recognised either on a straight line basis over time or, where the items delivered vary in value from period of period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

8. *Instalment sales*

   When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller.

9. *Trade discounts and volume rebates*

   Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

B. Rendering of services

1. *Installation fees*

   In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

2. *Advertising and insurance agency commissions*

   Revenue should be recognised when the service is completed. For advertising agencies, media commissions will normally be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognised when the project is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

3. *Financial service commissions*

A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made, or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to :

(a) whether the service has been provided "once and for all" or is on a "continuing" basis;

(b) the incidence of the costs relating to the service; and

(c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

4. *Admission fees*

Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

5. *Tuition fees*

Revenue should be recognised over the period of instruction.

6. *Entrance and membership fees*

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance free received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

AS 10 : ACCOUNTING FOR FIXED ASSETS

The following is the text of the Accounting Standard 10 (AS 10) issued by the Institute of Chartered Accountants of India on "Accounting for fixed assets".

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

Introduction

1. Financial statements disclose certain information relating to fixed assets. In many enterprises these assets are grouped into various categories, such as land and buildings, plant and machinery, vehicles, furniture and fittings, goodwill, patents, trademarks and designs. This Statement deals with accounting for such fixed assets except as described in paragraphs 2 to 5 below. *

2. This statement does not deal with the specialised aspects of accounting for fixed assets that arise under a comprehensive system reflecting the effects of changing prices but applies to financial statements prepared on historical cost basis.

3. This statement does not deal with accounting for the following items to which special considerations apply:

(i) forests, plantations and similar regenerative natural resources ;

(ii) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources ;

(iii) expenditure on real estate development ; and

(iv) livestock.

Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (*i*) to (*iv*) above, but separable from those activities, are to be accounted for in accordance with this statement.

4. This statement does not cover the allocation of the depreciable amount of fixed assets to future periods since this subject is dealt with in Accounting Standard 6 on "Depreciation Accounting".

* From the date of AS 26, becoming mandatory for the concerned enterprises, the relevant paragraphs of the standard that deal with patents and know-how, stand withdrawn and therefore, the same are omitted from this standard.

5. This statement does not deal with the treatment of Government grants and subsidies, and assets under leasing rights. It makes only a brief reference to the capitalisation of borrowing costs[£] and assets acquired in an amalgamation or merger. These subjects require more extensive consideration than can be given within the statement.

Definitions

6. The following terms are used in this Statement with their meanings specified :

6.1 *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.

6.2 *Fair market value* is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

6.3 *Gross book value* of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

Explanation

7. Fixed assets often comprise a significant portion of the total assets of an enterprise and therefore, are important in the presentation of financial position. Furthermore, the determination of whether an expenditure represents an asset or an expense can have a material effect on an enterprise's reported results of operations.

8. Identification of Fixed Assets

8.1 The definition in paragraph 6.1 gives criteria for determining whether items are to be classified as fixed assets. Judgment is required in applying the criteria to specific circumstances or specific types of enterprises. It may be appropriate to aggregate individually insignificant items, and to apply the criteria to the aggregate value. An enterprise may decide to expense an item which could otherwise have been included as fixed assets, because the amount of the expenditure is not material.

8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed assets and their use is expected to be

[£] The relevant requirements in this regard are omitted from this standard pursuant to As 16, Borrowing Costs, becoming mandatory in respect of accounting periods commencing on or after 1.4.2004.

irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.[€]

8.3 In certain circumstances, the accounting for an item of fixed asset may be improved if the total expenditure thereon is allocated to its component parts, provided they are in practice separable, and estimates are made of the useful lives of these components. For example, rather than treat an aircraft and its engines as one unit, it may be better to treat the engines as a separate unit if it is likely that their useful life is shorter than that of the aircraft as a whole.

9. Components of Cost

9.1 The cost of an item of fixed assets comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use ; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are :

(i) site preparation ;

(ii) initial delivery and handling costs ;

(iii) installation cost, such as special foundations for plant ; and

(iv) professional fees, for example fees of architects and engineers.

The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

9.2[1] Financing costs relating to deferred credits or to borrowed funds attributable to construction or acquisition of fixed assets for the period up to the completion of construction or acquisition of fixed assets are also sometimes included in the gross book value of the asset to which they relate. However, financing costs (including interest) on fixed assets purchased on a deferred credit basis or on monies borrowed for construction or acquisition of fixed assets are not capitalised to the extent that such costs relate to periods after such assets are ready to be put to use.

9.3 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances,

[€] See also ASI 2

[1] Pursuant to the issuance of AS 16, Borrowing costs, which comes into effect in respect of accounting periods commencing on or after 1.4.2000, this paragraph stands withdrawn from the aforesaid date.

such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.

9.4 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production *i.e.,* production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.

9.5 If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement. However, the expenditure incurred during this period is also sometimes treated as deferred revenue expenditure to be amortised over a period not exceeding 3 to 5 years after the commencement of commercial production[2].

10. Self-Constructed Fixed Assets

10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.5. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.

11. Non-monetary Consideration

11.1 When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of asset given

[2] It may be noted that this paragraph relates to "all expenses" incurred during the period. This expenditure would also include borrowing costs incurred during the said period. Since AS 16, Borrowing Costs, specifically deals with the treatment of borrowing costs, the treatment provided by AS 16 would prevail over the provisions in this respect contained in this paragraph as these provisions are general in nature and apply to "all expenses". Accordingly, this paragraph stands withdrawn in so far as borrowing costs are concerned.

up. In each case an adjustment is made for any balancing receipt or payment of cash or other consideration.

11.2 When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

12. Improvements and Repairs

12.1 Frequently, it is difficult to determine whether subsequent expenditure related to fixed assets represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, *e.g.* an increase in capacity.

12.2 The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value. Any addition or extension which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately.

13. Amount Substituted for Historical Cost

13.1 Sometimes financial statements that are otherwise prepared on a historical cost basis include part or all of fixed assets at a valuation in substitution for historical costs and depreciation is calculated accordingly. Such financial statements are to be distinguished from financial statements prepared on a basis intended to reflect comprehensively the effects of changing prices.

13.2 A commonly accepted and preferred method of restating fixed assets is by appraisal, normally undertaken by competent valuers. Other methods sometimes used are indexation and reference to current prices which when applied are cross checked periodically by appraisal method.

13.3 The revalued amounts of fixed assets are presented in financial statements, either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. An upward revaluation does not provide a basis for crediting to the profit and loss statement the accumulated depreciation existing at the date of revaluation.

13.4 Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis.

13.5 Selective revaluation of assets can lead to unrepresentative amounts being reported in financial statements. Accordingly, when revaluations do not cover all the assets of a given class, it is appropriate that the selection of assets to be revalued be made on a systematic basis. For example, an enterprise may revalue a whole class of assets within a unit.

13.6 It is not appropriate for the revaluation of class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class.

13.7 An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease.

14. Retirements and Disposals

14.1 An item of fixed asset is eliminated from the financial statements on disposal.

14.2 Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognised immediately in the profit and loss statement.

14.3 In historical cost financial statements, gains or losses arising on disposal are generally recognised in the profit and loss statement.

14.4 On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

15. Valuation of Fixed Assets in Special Cases

15.1 In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.[3]

[3] AS 19, Leases has come into effect in respect of assets leased during accounting periods commencing on or after 1.4.2001. AS 19 also applies to assets acquired on hire purchase during accounting periods commencing on or after 1.4.2001. Accordingly, this paragraph is not applicable in respect of assets acquired on hire purchase during accounting periods commencing on or after 1.4.2001.

15.2 Where an enterprise owns fixed assets jointly with others (otherwise than as a partner in a firm), the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the *pro rata* cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

15.3 Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

16. Fixed Assets of Special Types

16.1 Goodwill in general, is 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 either in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess is termed as goodwill. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.

16.2 As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.[2]

17. Disclosure

17.1 Certain specific disclosures on accounting for fixed assets are already required by Accounting Standard 1 on "Disclosure of Accounting Policies" and Accounting Standard-6 on "Depreciation Accounting".

17.2 Further disclosures that are sometimes made in financial statements include :

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

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

(iii) revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

[2] From the date of AS 26 becoming mandatory for the concerned enterprises, paragraphs 16.4 to 16.7 stand withdrawn and hence not given here.

Accounting Standard

(The Accounting Standard comprises paragraphs 18 to 39 of this Statement. The Standard should be read in the context of paragraphs 1 to 17 of this Statement and of the 'Preface to the Statements of Accounting Standards'.)

18. The items determined in accordance with the definition in paragraph 6.1 of this statement should be included under fixed assets in financial statements.

19. The gross book value of a fixed asset should be either historical cost or a revaluation computed in accordance with this Standard. The method of accounting for fixed assets included at historical cost is set out in paragraphs 20 to 26 ; the method of accounting for revalued assets is set out in paragraphs 27 to 32.

***20. The cost of a fixed asset should comprise its purchase price and any attributable costs of bringing the asset to its working condition for its intended use. [Financing costs relating to deferred credits or to borrowed funds attributable to construction or acquisition of fixed assets for the period up to the completion of 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 deffered credit basis or on monies borrowed for construction or acquisition of fixed assets should not be capitalised to the extent that such costs relate to periods after such assets are ready to be put to use.]**[*]

21. The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.

22. When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident. Fixed asset acquired in exchange for shares or other securities in the enterprise should be recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance.

[*] The marked portion of this paragraph has been withdrawn after issuance of AS16, 'Borrowing Costs'.

24. Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.

25. Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal.

26. Losses arising from the retirement or gains or losses arising from disposal of fixed asset which is carried at cost should be recognised in the profit and loss statement.

27. When a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed.

28. The revaluation in financial statements of a class of assets should not result in the net book value of that class being greater than the recoverable amount of assets of that class.

29. When a fixed asset is revalued upwards, any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss statement.

30. An increase in net book value arising on revaluation of fixed assets should be credited directly to owner's interests under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account.

31. The provisions of paragraphs 23, 24 and 25 are also applicable to fixed assets included in financial statements at a revaluation.

32. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value should be charged or credited to the profit and loss statement except that to the extent that such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account.

33. Fixed assets acquired on hire purchase terms should be recorded at their cash value, which, if not readily available, should be calculated by assuming an appropriate rate of interest. They should be shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof[6].

[6] Refer footnote 3.

34. In the case of fixed assets owned by the enterprise jointly with others, the extent of the enterprise's shares in such assets, and the proportion of the original cost, accumulated depreciation and written down value should be stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets may be grouped together with similar fully owned assets with an appropriate disclosure thereof.

35. Where several fixed assets are purchased for a consolidated price, the consideration should be apportioned to the various assets on a fair basis as determined by competent valuers.

36. 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 in excess of the value of the net assets of the business taken over, the excess should be termed as "goodwill".

37. { }[*]

38. { }[*]

Disclosure

39. 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 showing additions, disposals, acquisitions and other movements ;

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

(iii) revalued amount substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

[*] From the date of AS 26 becoming mandatory for the concerned enterprises, paragraphs 37 and 38 stand withdrawn and hence not given here.

AS 13* : ACCOUNTING FOR INVESTMENTS

Introduction

1. This statement deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.[1]

2. This statement does not deal with:

(a) the bases for recognition of interest, dividends and rentals earned on investments which are covered by Accounting Standard 9 on Revenue Recognition;

(b) operating or finance leases;

(c) investments of retirement benefit plans and life insurance enterprises; and

(d) mutual funds and venture capital funds[2] and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

Definitions

3. The following terms are used in this Statement with the meanings assigned :

Investments are 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. Assets held as stock-in-trade are not 'investments'.

A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

* A limited revision to this standard has been made in 2003, pursuant to which paragraph 2(d) of this standard has been revised (See footnote 2 to this standard)

[1] Shares, debentures and other securities held as stock-in-trade (i.e. for sale in the ordinary course of business) are not 'investments' as defined in this statement. However, the manner in which they are accounted for and disclosed in the financial statements is quite similar to that applicable in respect of current investments. Accordingly, the provisions of this statement, to the extent that they relate to current investments, are also applicable to shares, debentures and other securities held as stock-in-trade, with suitable modifications as specified in this statement.

[2] The Council of the Institute decided to make the limited revision to AS 13 in 2003 pursuant to which the words 'and venture capital funds' have been added in paragraph 2(d) of AS 13. This revision comes into effect in respect of accounting periods commencing on or after 1.4.2002.

A long-term investment is an investment other than a current investment.

An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

Market value is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

Explanation

Forms of Investments

4. Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

5. Some investments have no physical existence and are represented merely by certificates or similar documents (*e.g.,* shares) while others exist in a physical form (*e.g.,* buildings). The nature of an investment may be that of a debt, other than a short or long- term loan or a trade debt, representing a monetary amount owing to the holder and usually bearing interest, alternatively, it may be a stake in the results and net assets of an enterprise such as an equity share. Most investments represent financial rights, but some are tangible, such as certain investments in land or buildings.

6. For some investments, an active market exists from which a market value can be established. For such investments, market value generally provides the best evidence of fair value. For other investments, an active market does not exist and other means are used to determine fair value.

Classification of Investments

7. Enterprises present financial statements that classify fixed assets, investments and current assets into separate categories. Investments are classified as Long Term Investments and Current Investments. Current investments are in the nature of current assets, although the common practice may be to include them in investments.[3]

8. Investments other than current investments are classified as long-term investments, even though may be readily marketable.

Cost of Investments

9. The cost of an investment includes acquisition charges such as brokerage, fees and duties.

[3] Shares, debentures and other securities held for sale in the ordinary course of business are disclosed as 'stock-in-trade' under the head 'current assets'.

10. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued (which, in appropriate cases, may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued.

11. If an investment is acquired in exchange, or part exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value of the asset given up. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

12. Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

13. When rights shares offered are subscribed for, the cost of the rights shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

Carrying Amount of Investments

Current Investments

14. The carrying amount for current investments is the lower of cost and fair value. In respect of investments for which an active market exists, market value generally provides the best evidence of fair value. The valuation of current investments at lower of cost and fair value provides a prudent method of determining the carrying amount to be stated in the balance sheet.

15. Valuation of current investments on overall (or global) basis is not considered appropriate. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment, and accordingly the investments may be carried at the lower of cost and fair value computed category wise (*i.e.* equity shares, preference

shares, convertible debentures, etc.). However, the more prudent and appropriate method is to carry investments individually at the lower of cost and fair value.

16. For current investments, any reduction to fair value and any reversals of such reductions are included in the profit and loss statement.

Long-Term Investments

17. Long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long-term investment, the carrying amount is reduced to recognise the decline. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. Restrictions on distributions by the investee or on disposal by the investor may affect the value attributed to the investment.

18. Long-term investments are usually of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an individual investment basis.

19. Where there is a decline, other than temporary, in the carrying amounts of long-term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

Investment Properties

20. The cost of any shares in co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

Disposal of Investments

21. On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

22. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment[4].

[4] In respect of shares, debentures and other securities held as stock-in-trade. The cost of stocks disposed of is determined by applying an appropriate cost formula (e.g. first-in, first-out, average

Reclassification of Investments

23. Where, long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

24. Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

Disclosure

25. The following disclosures in financial statements in relation to investments are appropriate :

(a) the accounting policies for the determination of carrying amount of investments;

(b) the amounts included in profit and loss statement for :

  (i) interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long-term and current investments, Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;

  (ii) profits and losses on disposal of current investments and changes in carrying amount of such investments;

  (iii) profits and losses on disposal of long-term investments and changes in the carrying amount of such investments;

(c) significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal;

(d) the aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;

(e) other disclosures as specifically required by the relevant statute governing the enterprise.

Accounting Standard

(The Accounting Standard comprises paragraphs 26-35 of this Statement. The Standard should be read in the context of paragraphs 1-25 of this Statement and of the 'Preface to the Statements of Accounting Standards'.)

Classification of Investments

26. An enterprise should disclose current investments and long-term investments distinctly in its financial statements.

cost, etc.). These cost formulae are the same as those specified in AS 2 in respect of Valuation of Inventories.

27. Further classification of current and long-term investments should be as specified in the statute governing the enterprise. In the absence of a statutory requirement, such further classification should disclose, where applicable, investments in:

(a) Government or Trust securities;

(b) Shares, debentures or bonds;

(c) Investment properties; and

(d) Others - specifying nature.

Cost of Investments

28. The cost of an investment should include acquisition charges such as brokerage, fees and duties.

29. If an investment is acquired, or partly acquired, by the issue of shares or other securities the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

Investment Properties

30. An enterprise holding investment properties should account for them as long-term investments.

Carrying Amount of Investments

31. Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

32. Investments classified as long-term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Changes in Carrying Amounts of Investments

33. Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement.

Disposal of Investments

34. On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the profit and loss statement.

Disclosure

35. The following information should be disclosed in the financial statements :

(a) the accounting policies for determination of carrying amount of investments;

(b) classification of investments as specified in paragraphs 26 and 27 above;

(c) the amounts included in profit and loss statement for:

(i) interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long-term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;

(ii) profits and losses on disposal of current investments and changes in the carrying amount of such investments; and

(iii) profits and losses on disposal of long term investments and changes in the carrying amount of such 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, giving the aggregate market value of quoted investments;

(f) other disclosures as specifically required by the relevant statute governing the enterprise.

Effective Date

36. This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995.

AS 14 : ACCOUNTING FOR AMALGAMATIONS*

The following is the text of Accounting Standard (AS) 14, 'Accounting for Amalgamations', issued by the council of the Institute of Chartered Accountants of India.

This standard will come into effect in respect of accounting periods commencing on or after 1-4-1995 and will be mandatory in nature. The Guidance Note on Accounting Treatment of Reserves in Amalgations issued by the Institute in, 1983 will stand withdrawn from the aforesaid date.

* A limited revision to the standard has been made I 2004, pursuant to which paragraphs 23 and 42 of the standard have been revised.

Introduction

1. This statement deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

2. This statement does not deal with cases of acquisitions which arise when there is a purchase by one company (referred to as the acquiring company) of the whole or part of the shares, or the whole or part of the assets, of another company (referred to as the acquired company) in consideration for payment in cash or by issue of shares or other securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

Definitions

3. The following terms are used in this statement with the meanings specified :

(a) *Amalgamation* means an amalgamation pursuant to the provisions of the Companies Act, 1956, or any other statute which may be applicable to companies.

(b) *Transferor company* means the company which is amalgamated into another company.

(c) *Transferee company* means the company into which a transferor company is amalgamated.

(d) *Reserve* means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.

(e) *Amalgamation in the nature of merger* is an amalgamation which satisfies all the following conditions :

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

(f) *Amalgamation in the nature of purchase* is an amalgamation which does not satisfy any one or more of the conditions specified in sub-paragraph (*e*) above.

(g) *Consideration* for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

(h) *Fair value* is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

(i) *Polling of interests* is a method of accounting for amalgamations the object of which is to account for the amalgamations as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.

Explanation

Types of Amalgamations

4. Generally speaking, amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. Such amalgamations are amalgamations which are in the nature of 'merger' and the accounting treatment of such amalgamations should ensure that the resultant figures of assets, liabilities, capital and reserves more or less represent the sum of the relevant figures of the amalgamating companies. In the second category are those amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company or the business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of 'purchase'.

5. An amalgamation is classified as an 'amalgamation in the nature of merger' when all the conditions listed in paragraph 3(*e*) are satisfied. There are, however, differing views regarding the nature of any further conditions that may apply. Some believe that, in addition to an exchange of equity shares, it is necessary that the shareholders of the transferor company obtain a substantial share in the transferee company even to the extent that it should not be possible to identify any one party as dominant therein. This belief is based in part on the view that the exchange of control of one company for an insignificant share in a larger company does not amount to a mutual sharing or risks and benefits.

6. Others believe that the substance of an amalgamation in the nature of merger is evidenced by meeting certain criteria regarding the relationship of the parties, such as the former independence of the amalgamating companies, the manner of their amalgamation, the absence of planned transactions that would undermine the effect of the amalgamation, and the continuing participation by the management of the transferor company in the management of the transferee company after the amalgamation.

Methods of Accounting for Amalgamations

7. There are two main methods of accounting for amalgamations :

(*a*) the pooling of interests method; and

(*b*) the purchase method.

8. The use of the pooling of interests method is confined to circumstances which meet the criteria referred to in paragraph 3(*e*) for an amalgamation in the nature of merger.

9. The object of the purchase method is to account for the amalgamation by applying the same principles as are applied in the normal purchase of assets. This method is used in accounting for amalgamations in the nature of purchase.

The Pooling of Interests Method

10. Under the pooling of interests method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making the adjustments required in paragraph 11).

11. If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with Accounting Standard (AS) 5, 'Prior Period and Extraordinary Items and Changes in Accounting Policies'[1].

[1] AS 5 has been revised in February, 1997. The title of revised AS 5 is 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

The Purchase Method

12. Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

13. Where assets and liabilities are restated on the basis of their fair values, the determination of fair values may be influenced by the intentions of the transferee company. For example, the transferee company may have a specialised use for an asset, which is not available to other potential buyers. The transferee company may intend to effect changes in the activities of the transferor company which necessitate the creation of specific provisions for the expected costs, *e.g.* planned employee termination and plant relocation costs.

Consideration

14. The consideration for the amalgamation may consist of securities, cash or other assets. In determining the value of the consideration, an assessment is made of the fair value of its elements. A variety of techniques is applied in arriving at fair value. For example, when the consideration includes securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

15. Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [see Accounting Standard (AS) 4, Contingencies and Events Occurring after the Balance Sheet Date].

Treatment of Reserves on Amalgamation

16. If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. Thus, for example, the General Reserve of the transferor company becomes the General Reserve of the transferee company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The

difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

17. If the amalgamation is an 'amalgamation in the nature of purchase',the identity of the reserves, other than the statutory reserves dealt with in paragraph 18, is not preserved. The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and dealt with in the manner stated in paragraphs 19-20. If the result of the computation is positive, the difference is credited to Capital Reserve.

18. Certain reserves may have been created by the transferor company pursuant to the requirements of, or to avail of the benefits under the Income-tax Act, 1961; for example, Development Allowance Reserve, or Investment Allowance Reserve. The Act requires that the identity of the reserves should be preserved for a specified period. Likewise, certain other reserves may have been created in the financial statements of the transferor company in terms of the requirements of other statutes. Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases, the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (*e.g.* 'Amalgamation Adjustment Account') which is disclosed as a part of "miscellaneous expenditure" or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

Treatment of Goodwill arising on Amalgamation

19. Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, however, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

20. Factors which may be considered in estimating the useful life of goodwill arising on amalgamation include :

- the foreseeable life of the business or industry;
- the effects of product obsolescence, changes in demand and other economic factors;
- the service life expectancies of key individuals or groups of employees;
- expected actions by competitors or potential competitors; and
- legal, regulatory or contractual provisions affecting the useful life.

Balance of Profit and Loss Account

21. In the case of an 'amalgamation in the nature of merger', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any.

22. In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

Treatment of Reserves Specified in a Scheme of Amalgamation

23. The scheme of amalgamation sanctioned under the provisions of the Companies Act, 1956 or any other statute may prescribe the treatment to be given to the reserves of the transferor company after its amalgamation. Where the treatment is so prescribed, the same is followed. In some cases, the scheme of amalgamation sanctioned under a statute may prescribe a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Statement that would have been followed had no treatment been prescribed by the scheme. In such cases, the following disclosures are made in the first financial statements following the amalgamation:

(a) A description of the accounting treatment given to the reserves and the reasons for following the treatment different from that prescribed in this Statement.

(b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Statement that would have been followed had no treatment been prescribed by the scheme.

(c) The financial effect, if any, arising due to such deviation."[€]

[€] As a limited revision to AS 14, the council of the Institute decided to rvise this paragraph in 2004. the erstwhile para was as under:

Disclosure

24. For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation :

(a) names and general nature of business of amalgamating companies;

(b) effective date of amalgamation for accounting purposes;

(c) the method of accounting used to reflect the amalgamation; and

(d) particulars of the scheme sanctioned under a statute.

25. For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation :

(a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

26. For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any good-will arising on amalgamation.

Amalgamation after the Balance Sheet Date

27. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS 4, 'Contingencies and Events Occurring after the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

The scheme of amalgamation sanctioned under the provisions of the Companies Act, 1956 or any other statute may prescribe the treatment to be given to the reserves of the transferor company after its amalgamation. Where the treatment is so prescribed, the same is followed.

Accounting Standard

(The Accounting Standard comprises paragraphs 28 to 46 of this statement. The 'Standard should be read in the context of paragraphs 1 to 27 of this Statement and of the Preface to the Statements of Accounting Standards'.)

28. An amalgamation may be either :

(a) an amalgamation in the nature of merger, or

(b) an amalgamation in the nature of purchase.

29. An amalgamation should be considered to be an amalgamation in the nature of merger when all the following conditions are satisfied :

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

30. An Amalgamation should be considered to be an amalgamation in the nature of purchase, when any one or more the conditions specified in paragraph 29 is not satisfied.

31. When an amalgamation is considered to be an amalgamation in the nature of merger, it should be accounted for under the pooling of interests method described in paragraphs 33-35.

32. When an amalgamation is considered to be an amalgamation in the nature of purchase, it should be accounted for under the purchase method described in paragraphs 36-39.

The Pooling of Interests Method

33. In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of the amalgamation. The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to the General Reserve, if any.

34. If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting polices should be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with Accounting Standard (AS) 5, 'Prior Period and Extraordinary Items and Changes in Accounting Policies'[2].

35. The difference between the amount recorded as share capital issued (*plus *any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves.

The Purchase Method

36. In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company except as stated in paragraph 39.

37. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.

[2] AS 5 has been revised in February, 1997. The title of revised AS 5 is 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

38. The goodwill arising amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.

39. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of "miscellaneous expenditure" or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

Common Procedures

40. The consideration for the amalgamation should include any non-cash element at fair value. In case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

41. Where the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration if payment is probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognised as soon as the amount is determinable [See Accounting Standard (AS) 4, Contingencies and Events Occurring after the Balance Sheet Date].

Treatment of Reserves Specified in a Scheme of Amalgamation

42. Where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed. Where the scheme of amalgamation sanctioned under a statute prescribes a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Statement that would have been followed had no treatment been prescribed by the scheme, the following disclosures should be made in the first financial statements following the amalgamation:

(a) A description of the accounting treatment given to the reserves and the reasons for following the treatment different from that prescribed in this Statement.

(b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Statement that would have been followed had no treatment been prescribed by the scheme.

(c) The financial effect, if any, arising due to such deviation."[€]

Disclosure

43. ***For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation :***

(a) names and general nature of business of the amalgamating companies;

(b) effective date of amalgamation for accounting purposes;

(c) the method of accounting used to reflect the amalgamation; and

(d) particulars of the scheme sanctioned under a statute.

44. ***For amalgamations accounted for under the pooling of interests method, the following additional disclosures should be made in the first financial statements following the amalgamation :***

(a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

45. ***For amalgamations accounted for under the purchase method, the following additional disclosures should be made in the first financial statements following the amalgamations :***

(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

[€] As a limited revision to AS 14, the council of the Institute decided to rvise this paragraph in 2004. the erstwhile para was as under:

Where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed.

Amalgamation after the Balance Sheet Date

46. ***When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made in accordance with AS-4, 'Contingencies and Events Occurring after the Balance Sheet Date', but the amalgamation should not be incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance by allowing the going concern assumption to be maintained.***

APPENDIX - II

ACCOUNTING STANDARDS INTERPRETATIONS

The authority of the Accounting Standards Interpretations (ASI) is the same as that of the Accounting Standard to which it relates. The contents of this ASI are intended for the limited purpose of the Accounting Standard to which it relates. ASI is intended to apply only to material items. The Institute of Chartered Accountants of India has, so far, issued 30 ASIs. The ASIs relevant for the Accounting Standards covered under the PCC curriculum are as follows:

Accounting Standards Interpretation (ASI) 2

Accounting for Machinery Spares

Accounting Standard (AS) 2, Valuation of Inventories and

AS 10, Accounting for Fixed Assets

ISSUE

1. Which machinery spares are covered under AS 2 and AS 10 and what should be the accounting for machinery spares under the respective standards.

CONSENSUS

2. Machinery spares which are not specific to a particular item of fixed asset but can be used generally for various items of fixed assets should be treated as inventories for the purpose of AS 2. Such machinery spares should be charged to the statement of profit and loss as and when issued for consumption in the ordinary course of operations.

3. Whether to capitalise a machinery spare under AS 10 or not will depend on the facts and circumstances of each case. However, the machinery spares of the following types should be capitalised being of the nature of capital spares/insurance spares -

   (i) Machinery spares which are specific to a particular item of fixed asset, i.e., they can be used only in connection with a particular item of the fixed asset, and

   (ii) their use is expected to be irregular.

4. Machinery spares of the nature of capital spares/insurance spares should be capitalised separately at the time of their purchase whether procured at the time of purchase of the fixed asset concerned or subsequently. The total cost of such capital spares/insurance spares

should be allocated on a systematic basis over a period not exceeding the useful life of the principal item, i.e., the fixed asset to which they relate.

5. When the related fixed asset is either discarded or sold, the written down value less disposal value, if any, of the capital spares/insurance spares should be written off.

6. The stand-by equipment is a separate fixed asset in its own right and should be depreciated like any other fixed asset.

BASIS FOR CONCLUSION

7. Paragraphs 8.2 and 25 of AS 10, 'Accounting for Fixed Assets', state as below:

"8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item."

"25. Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal."

8. Paragraph 4 of AS 2, 'Valuation of Inventories', states as below:

"4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets."

9. Machinery spares of the nature of capital spares/insurance spares are capitalised. Capital spares/insurance spares are meant for occasional use. Since they can be used only in relation to a specific item of fixed asset, they are to be discarded in case that specific fixed asset is disposed of. In other words, such spares are integral parts of the fixed asset.

10. A stand-by equipment is not of the nature of a spare but is of the nature of another piece of equipment which is being used in the manufacturing process. For example, a generator set kept in store as a stand-by to the generator set which is being used in the manufacturing process. Therefore, the stand-by equipment is a separate fixed asset in its own right and is depreciated like any other fixed asset.

Accounting Standards Interpretation (ASI) 14

Disclosure of Revenue from Sales Transactions

Accounting Standard (AS) 9, Revenue Recognition

[Pursuant to the issuance of this Accounting Standards Interpretation, General Clarification (GC) – 3/2002, issued in June 2002 stands withdrawn.]

ISSUE

1. What should be the manner of disclosure of excise duty in the presentation of revenue from sales transactions (turnover) in the statement of profit and loss.

CONSENSUS

2. The amount of turnover should be disclosed in the following manner on the face of the statement of profit and loss:

Turnover (Gross)	XX
Less: Excise Duty	XX
Turnover (Net)	XX

BASIS FOR CONCLUSIONS

3. Financial analysts and other users of financial statements, sometimes, require the information related to turnover gross of excise duty as well as net of excise duty for meaningful understanding of financial statements. However, it was noted that some enterprises disclose turnover net of excise duty while others disclose turnover at gross amount. Accordingly, this Interpretation requires disclosure of turnover gross of excise duty as well as net of excise duty on the face of the statement of profit and loss.

Accounting Standards Interpretation (ASI) 29

Turnover incase of Contractors

Accounting Standard (AS) 7, Construction Contr4acts

(Revised 2002)

ISSUE

1. As 7, Construction Contracts (revised 2002) deals, *inter alia*, with revenue recognition in respect of construction contracts in the financial statements of contractors. It requires recognition of revenue by reference to the stage of completion of a contract (referred to as 'percentage of completion method'). This method results in reporting of revenue which can be attributed to the proportion of work completed. Under this method, contract revenue is recognized as revenue in the statement of profit and loss in the accounting period in which the work is performed.

The issue is whether the revenue so recognized in the financial statements of contractors as per the requirements of AS 7 can be considered as 'turnover'.

CONSENSUS

2. The amount of contract revenue recognized as revenue in the statement of profit and loss as per the requirements of AS 7 should be considered as 'turnover'.

BASIS FOR CONCLUSIONS

3. The paragraph dealing with the 'Objective' of AS 7 provides as follows:

"Objective

The objective of this Statement is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting period in which construction work is performed. This Statement uses the recognition criteria established in the Frame work for the Preparation and Presentation of financial Statements to determine when contract revenue and contract costs should be recognized as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria."

From the above, it may be noted that AS 7 deals, *inter alia,* with the allocation of contract revenue to the accounting periods in which constructions work is performed.

4. Paragraphs 21 and 31 of AS 7 provide as follows:

> ***"21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35."***
>
> **"31. When the outcome of a construction contract cannot be estimated reliably:**
>
> **(a) revenue should be recognized only to the extent of contract costs incurred of which recovery is probable; and**
>
> **(b) contract costs should be recognized as an expense in the period in which they are incurred.**

An expected loss on the construction contract should be recognized as an expense immediately in accordance with paragraph 35."

From the above, it may be noted that the recognition of revenue as per AS 7 may be inclusive of profit (as per paragraph 21 reproduced above) or exclusive of profit (as per paragraph 31 above) depending on whether the outcome of the construction contact can be estimated reliably or not. When the outcome of the construction contract can be estimated reliably, the revenue is recognized inclusive of profit and when klthe same cannot be estimated reliably, it is recognized exclusive of profit. However , in either case it is considered as revenue as per AS 7.

5. 'Revenue' is a wider term. For example, within the meaning of AS 9, revenue Recognition, the term 'revenue' includes revenue from sales transactions, rendering of services and from the use by others of enterprise resources yielding interest, royalties and dividends. The term 'turnover' is used in relation to the source of revenue that arises from the principal revenue generating activity of an enterprise. In case of a contractor, the construction activity is its principal revenue generating activity. Hence, the revenue recognized in the statement of profit and loss of a contractor in accordance with the principles laid down in AS 7, by whatever nomenclature described in the financial statements, is considered as 'turnover'.