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Advanced Accounting

Vol. 2

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PROFESSIONAL COMPETENCE COURSE

STUDY MATERIAL

ADVANCED ACCOUNTING

VOLUME : 2

PAPER 1

ADVANCED ACCOUNTING

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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ADVANCED ACCOUNTING

VOLUME 2

CONTENTS

CHAPTER 7:

Unit 1: Average Due Date

1.1 Introduction 7.1

1.2 Types of problems 7.1

1.3 Calculation of due date after taking into consideration days of grace 7.11

1.4 Calculating due date of bill or note payable few months after date or sight 7.12

1.5 Calculation of due date when the maturity day is a holiday 7.12

Unit 2: Account Current

2.1 Introduction 7.18

2.2 Preparation of account current 7.18

Unit 3: Self-Balancing Ledgers

3.1 Introduction 7.32

3.2 Advantages of Self-balancing System 7.32

3.3 Sectional balancing 7.33

3.4 Various Ledgers to be maintained in self-balancing system. 7.33

3.5 Ruling of subsidiary books 7.45

3.6 Secret account 7.45

CHAPTER 8: FINANCIAL STAEMENTS OF NOT FOR PROFIT ORGANISATIONS

Unit 1: Financial Statements of Non-Trading Organisations

1.1 Introduction 8.1

1.2 Nature of Receipts and Payments Account 8.1

1.3 Income and Expenditure Account 8.3

1.4 Preparation of Income and Expenditure Account from Receipts and Payments Account 8.4
1.5 Balance sheet 8.7

Unit 2: Accounting for Educational Institutions

2.1 Organisation Pattern and Salient Features 8.29
2.2 Sources of finance for running an Educational Institution 8.30
2.3 Technique of Maintaining Final Accounts 8.39

CHAPTER 9 : ACCOUNTS FROM INCOMPLETE RECORDS

1. Introduction 9.1
2. Ascertainment of Profit by capital comparison 9.2
2.1 Method of capital comparison 9.2
2.2 Preparation of Statement of affairs and determination of profit 9.3
3. Techniques of obtaining complete accounting information 9.12
3.1 General Techniques 9.12
3.2 Derivative of information from cash book 9.14
3.3 Analysis of sales ledger and purchase ledger 9.15
3.4 Distinction between business expenses and drawings 9.18
4. Application of accounting ratios 9.38
4.1 Use of gross profit ratio 9.39
4.2 Use of other Ratio 9.46

CHAPTER 10: ACCOUNTING FOR SPECIAL TRANSACTIONS

Unit 1: Hire Purchase and Instalment Sale

1.1 Introduction 10.1
1.2 Nature of Hire-Purchase Agreement 10.2
1.3 Special Features of Hire-Purchase Agreement 10.2
1.4 Accounting Arrangements of Hire-Purchase Transaction 10.2

1.5 Debtors Method 10.27
1.6 Ascertainment of Total Cash Price 10.29
1.7 Calculation of Total Cash Price when the Annuity Table is not given 10.29
1.8 Ascertainment of Interest 10.30
1.9 Repossession 10.32
1.10 Stock and Debtors System 10.36
1.11 Hire Purchase Agreement for goods of small value 10.42
1.12 Ascertainment of Profit/Loss 10.43
1.13 Calculation of Missing Figures 10.46
1.14 Instalment payment System 10.47
1.15 Difference of Hire Purchase Agreement and Instalment Payment Agreement 10.48

Unit 2: Investment Accounts

2.1 Introduction 10.57
2.2 Classification of Investments 10.57
2.3 Investment acquisitions 10.57
2.4 Carrying amount of investments 10.60
2.5 Disposal of investments 10.61

Unit 3: Departmental Accounts

3.1 Introduction 10.69
3.2 Basis of allocation of common expenditure among different departments 10.69
3.3 Inter-departmental transfers 10.70

Unit 4: Branch Accounts

4.1 Introduction 10.93
4.2 Dependent branches 10.93
4.3 Methods of charging goods to branches 10.94
4.4 Independent branches 10.120

4.5 Adjustment and reconciliation of branch and head office accounts 10.122
4.6 Incorporation of branch balance in head office books 10.126
4.7 Incomplete information in branch books 10.136
4.8 Foreign branches 10.144
4.9 Accounting for foreign branches 10.144
4.10 Change in classification 10.145
4.11 Techniques for foreign currency translation...10.146

Unit 5: Insurance Claims

5.1 Meaning of fire 10.159
5.2 Claim for loss of stock 10.159
5.3 Claim for loss of profit..10.163

CHAPTER 11: ADVANCED ISSUES IN PARTNESHIP ACCOUNTS

Unit 1: Introduction to Partnership Accounts

1.1 Definition and Features of Partnership Accounts 11.2
1.2 Partners' Capital and Current Accounts 11.3
1.3 Profit and Loss Appropriation Accounts 11.6
1.4 Treatment of Goodwill in Partnership Accounts 11.8
1.5 Admission of a Partner...11.21
1.6 Retirement of a Partner...11.27
1.7 Death of a Partner 11.34
1.8 Right of Outgoing Partner in certain cases to share subsequent profits 11.35

Unit 2: Dissolution of Partnership Firms

2.1 Introduction...11.48
2.2 Circumstances Leading to Dissolution of Partnership 11.48
2.3 Consequences of Dissolution 11.49
2.4 Closing of Partnership Books on Dissolution 11.51
2.5 Consequences of Insolvency of a Partner 11.57

2.6 Loss arising from Insolvency of a Partner 11.57
2.7 Piecemeal Payments 11.70
Unit 3: Amalgamation, Conversion and Sale of Partnership Firms
3.1 Amalgamation of Partnership firms 11.85
3.2 Conversion of Partnership firm into a Company...11.93

CHAPTER 12 : ACCOUNTING IN COMPUTERISED ENVIRONMENT

1 Introduction 12.1
2 Salient Features of Computerised Accounting System 12.2
3 Significance of Computerised Accounting System 12.2
4 Codification and Grouping of Accounts 12.2
5 Maintaining the Hierarchy of Ledgers 12.8
6 Accounting Packages and Consideration For their Selection.......................... 12.9
7 Prepackaged Accounting Software 12.10
7.1 Advantages of Pre-packaged Accounting Software......................................12.13
7.2 Disadvantage of Pre-packaged Accounting Software....................................12.13
7.3 Consideration of Selection of Pre-packaged Accounting Software.................12.14
8. Customised Accounting Software 12.14
8.1 Advantages of a Customised Accounting Package 12.15
8.2 Disadvantages of a Customised Accounting Package...................................12.15
9. Accounting Software as part of Enterprise Resource Planning (ERP) 12.16
9.1 Advantages of using an ERP...12.16
9.2 Disadvantages of an ERP 12.16
9.3 Choice of an ERP...12.16
10. Outsourcing of Accounting Function 12.17
10.1 Advantages of Outsourcing the Accounting Functions 12.17
10.2 Disadvantages of Outsourcing the Accounting Function................................12.17
11. Generating Reports from Software 12.18

Appendix I..I-1 - I-22
Appendix II.. II-1 – II-237
Appendix III... III-1 – III-12

CHAPTER 7

UNIT 1 : AVERAGE DUE DATE

Learning Objectives

After studying this unit , you will be able to:

- ♦ Understand what is average due date. How to choose 0 (zero) day for calculating average due date is crucial point to be understood carefully.
- ♦ Learn calculation of average due date where amount is lent in various instalments. See how to 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 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 following are the amounts due on different dates in between the same parties.

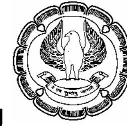
Amounts *Rs.*	*Due Dates*
500	3rd July
800	2nd August
1,000	11 September

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 3/7*	*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. 5,00 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 shold 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

Balance due to X Rs. 210 – 102 = Rs. 108.

Number of days from the base date to the date of settlement is

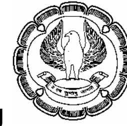
$$\frac{4,570}{108} = 42$$

Hence the date of settlement of the balance is 42 days after May 18 i.e., on June 29. On July 29 Y has to pay X Rs. 108 to clear the account.

1.2.2Calculation 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, 19......



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

$$4,49,600 \times \frac{6}{100} \times \frac{1}{365} = \text{Rs. } 73.91$$

(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, (b) 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

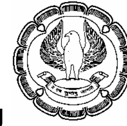
A.D.D. = $\frac{17,700}{2,700}$ months from 1.4 . . . i.e. 6.556 months i.e. 17th October.

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

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
131 -110 i.e. 21st October	110

So interest is chargeable from 21.10 . . . to 31.3 . . . i.e. for 101 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

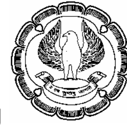
(b) If the payment is deferred to 14.7, interest is to be paid from 20.5 ... to 14.7 ... i.e., for 11 + 30 + 14 = 55 days.

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

1.2.3Case 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 a 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 :

$$\text{Average due date} = \text{Date of Loan} + \frac{\text{Sum of days/months/Years from the date of lending to the date of repayment of each instalment}}{\text{Number of instalments}}$$

I

Ilustration 5

Rs. 10,000 lent by Dass Bros. to Kumar & Sons on 1st January, 2004 is repayble in 5 equal annual instalments commencing on 1st January, 2005. Find the average due date and calculate interest at 5% per annum, which Das Bros. will recover from Kumar & Sons.

Solution

$$\text{Average due date} = \text{Date of Loan} + \frac{\text{Sum of the number of years/months/days from the date of lending to the date of repayment of each instalment}}{\text{Number of instalments}}$$

= Jan. 1, 2004 + $\frac{1+2+3+4+5}{5}$

= Jan. 1, 2004+ 3 years

= 1st Jan., 2007

Solution

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., 2007to 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., 1999 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. 2001*	*Product*
Rs.			*Rs.*
2,000	1st Jan. 2005	5 Years	10,000
2,000	1st Jan. 2006	4 Years	8,000
2,000	1st Jan. 2007	3 Years	6,000
2,000	1st Jan. 2008	2 Years	4,000
2,000	1st Jan. 2009	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., 2007 on Rs. 10,000 from average due date to 31st Dec., 2009, 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., 2005 for 5 years and if the lender gives Rs. 10,000 on 1st Jan., 2007 then both will charge the same interest from each other. There is no loss to any of the parties. But actually lender gives Rs. 10,000 on 1st Jan., 2004, therefore, he has given loan 3 years in advance and will charge interest on Rs. 10,000 for 3 years.

$$\text{Interest} = \frac{\text{Rs.} 10{,}000 \times 5 \times 3}{100} = \text{Rs. } 1{,}500 \text{ (to be charged by Dass Bros.)}$$

Illustration 6

Rs. 10,000 lent by Dass Bros. to Kumar & Sons on 1st Jan., 2005 is repayable in five six monthly equal instalments commencing on and from 1st January, 2006.

Calculate average due date and interest at 5% p.a.

Solution

Calculation of sum of period from the date of each transactions :

1st Payment is made after	12 months from the date of loan
2nd Payment is made after	18 months from the date of loan
3rd Payment is made after	24 months from the date of loan
4th Payment is made after	30 months from the date of loan
5th Payment is made after	36 months from the date of loan
	120

$$\text{Average due date} = \text{Date of Loan} + \frac{\text{Sum of the months from the date of loan to the date of each instalment}}{\text{Number of instalments}}$$

$$= \text{1st Jan., 2005} = \frac{120\,\text{months}}{5}$$

= 1st Jan., 2005 + 24 months

= 1st Jan., 2005 + 2 years

= 1st Jan., 2007.

$$\text{interest} = \frac{5 \times 2 \times \text{Rs.}10{,}000}{100} = \text{Rs. } 1{,}000 \text{ (to be charged by Dass Bros.)}$$

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 29th January, 2001 is made payable at one month after date. The due date of instrument is 3rd day after 28th February, i.e., 3rd March (in 2001, 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" inclues 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 unforseen holiday then the date shall be the next following day.

Illustration 7

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.	*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 8

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

Calculation of average due date

Due Date 2005	*Amount Rs.*	*No. of days from Jan. 1*	*Product*
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

Average due date = Base date + days equal to $\frac{\text{Sum of Products}}{\text{Sum of the amounts}}$

Jan. 1 + $\left[\frac{89,490}{3,360}\right]$ 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 9

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

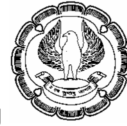
Hariram agreed to draw a Bill for the total amount due on the average due date. Ascertain that date.

Solution

Due Date	*Amount Rs.*	*No. of days from 18th April*	*Product*
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.



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. Determine the amount to be paid, in cancellation of the following bills taking 8% interest p.a. on :

   (a) 15/4 (b) 20/7

   3 months Rs. 5,000 A/S bill drawn on 5/2 and accepted on 16/3.

   Rs. 2,000 bill du on 19/6.

   2 months bill of Rs. 30,000 dated 27/5.

9. 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.

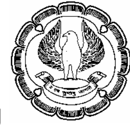
   Rs. 3,000 due on 17/7

   Rs. 2,000 due 15/8 (Independence Day)

   Rs. 7,000 due on 18/9 (Sunday)

   Rs. 3,000 due on 3/10.

10. 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
20/06/2002	15,000	3	27/06/2002	13,000	1

Holidays : 15 August, 2006, 16th August, 2006 and 6 September, 2006

UNIT 2 : ACCOUNT CURRENT

Learning Objectives

After studying this unit, you will be able to :

- Understand the meaning of Account Current.
- Learn three 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:

2005		*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.
2006			
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, 2006 @ 6% p.a.)

Dr. *Cr.*

Date	*Particulars*	*L.F.*	*Due Date*	*Amount Rs.*	*Days*	*Interest*	*Date*	*Particulars*	*L.F*	*Due Date*	*Amount Rs.*	*Days*	*Interest*
2005							2005						
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
2006							2006						

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 2005		*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	"
2006									
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, 2006 @ 6% p.a.)

Dr. Cr.

Date	*Particulars L.F.*	*Due Date*	*Amount Rs.*	*Days*	*Interest*	*Date*	*Particulars L.F.*	*Due Date*	*Amount Rs.*	*Days*	*Interest*
2005						2005					
Sept. 16	To Sales A/c	Oct. 1st	200	123	24,600	Oct. 1	By Cash A/c	Oct. 1st	90	123	11,070
Nov. 1	To Cash A/c	Nov. 1st	330	92	30,360	Oct. 21	By Purchase A/c	Dec. 1st	500	62	31,000
Dec. 1	To Cash A/c	Dec.	330	62	20,460	Dec. 5	By Purchase A/c	Jan.	500	31	15,500
						Dec. 10	By Purchase A/c	1st Jan	200	31	6,200
2006						2006					
Jan. 1	To Cash A/c	1st Jan	600	31	18,600	Feb. 1	By Balance of products				30,250
Jan.	To Sales	1st				Feb.	By Balance c/d		194.97		

9	A/c	Feb	20		1		
Feb. 1	To Interest		<u>4.97</u>	---------		----------	---------
	$\frac{30,250}{365} \times \frac{6}{100}$		<u>1,484.97</u>	<u>94,020</u>		<u>1,484.97</u>	<u>94,020</u>
2006							
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, 2006. Interest must be calculated @ 10% p.a.

2006			*Rs.*	*2006*		*Rs.*
June	11	Goods sent to Paul	1,020	July 7	Goods sent to Mr. Paul	700
"	15	Cash received from Paul	500	Aug 8	Cash received from Paul	1,100
"	20	Goods sent to Mr. Paul	650			

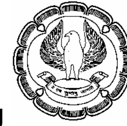
Solution

Mr. Paul in Account Current with Mr. Singh

(Interest to 31st August, 2006 @ 10% p.a.)

Dr. *Cr.*

Date	*Particulars L.F.*	*Due* Date	*Amount* Rs.	*Days*	*Interest*	*Date*	*Particulars L.F.*	*Due* Date	*Amount* Rs.	*Days*	*Interest*
2006						2006					
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.											



Date	Particulars	Amount	Products	Date	Particulars	Amount	Products
31	To Interest A/c $\frac{Rs.1,04,120}{365}\times\frac{10}{100}$	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.

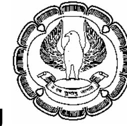
2005		*Rs.*
June 30	Balance owing by A. Halder	520
July 17	Goods sold to A. Halder	40
Aug. 1	Cash received from A. Halder	500
Aug. 19	Goods sold to A. Halder	720
Aug. 30	Goods sold to A. Halder	50
Sept. 1	Cash received from A. Halder	400
Sept. 1	A. Halder accepted Dasgupta's	
	Bill at 3 month date for	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, 2005 @ 5% p.a.)

Dr.											Cr.
Date	Particulars	Due Date	Amount Rs.	Days	Interest	Date	Particulars	Due Date	Amount Rs.	Days	Interest
2005						2005					
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		9.79								
	Rs. 71,446 x 5 / 365 x 100					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, 2005.

			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 7.2.2005	
		is honoured on this due date	10,000
"	10	X sold goods to Y (invoice dated 10.5.2005)	15,000
"	12	X received cheque form Y dated 15.5.2005	7,500

"	15	Y sold goods to X (invoice dated 15.5.2005)	6,000
"	20	X returned goods sold by Y on 15.4.2005	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 30.4.2005, taking interest into account @ 10% p.a.

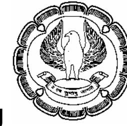
Solution

'Y' In Account Current with 'X'

(Interest to 30th April, 2005 @ 10% p.a.)

Dr. *Cr.*

Date	Particulars	Due Date	Amount Rs.	Days	Interest	Date	Particulars	Due Date	Amount Rs.	Days	Interest
2005		2005				2005		2005			
April		June				April					
7	To Bills Payable	10	5,000	-	-	1	By Balance b/d		10,000	30	3,00,000
April		May				April		May			
10	To Sales A/c	10	15,000	-	-	12	By Bank A/c (Cheque received dated 15.5.2005)	15	7,500	-	-
April		May				April		May			
20	To Purchase Returns	15	1,000	-	-	15	By Purchase A/c (invoice dated 15.5.2005)	15	6,000	-	-
April		April									
20	To Bill Receiv-able A/c	20	5,000	10	50,000						



April	May				April		June		
30	To Red Ink15 Product 15		30	1,12,500		By Red Ink10 Product		-41	2,05,000
	(Rs. 7,500 x 15)					as per contra			
	as per contra					(5,000 x 41)			
April	May				April		May		
30	To Red Ink15 Product 15		30	90,000	By Red10 Ink Product		-	10	1,50,000
	(Rs. 6,000 x 15)					as per contra			
	as per contra					(15,000 x 10)			
April					April		May		
30	To Balance of				30	By Red Ink15 Product		--	15,000
	product			4,17,500		as per contra			
						(1,000 x 15)			
					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, 2005 Vinod opened a current account with the Allahabad Bank Limited; and deposited a sum of Rs. 30,000. He further deposited the following amounts :

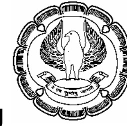
15th January	Rs.	12,000
12th March	Rs.	8,000
10th May	Rs.	16,000
His withdrawals were as follows :		
15th February	Rs.	26,000
10th April	Rs.	30,000
15th June	Rs.	14,000

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, 2005. 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*
2005								
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	By Cash	-	16,000	Cr.	10,000	36	-	3,60,000



10	Account							
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

[Ans.: 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

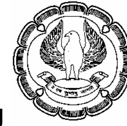
7. From the following information prepare a statement shown by B in Account Current with A. Books of A :

2006	
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.

2006	
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 Accont 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, 2003 and deposited Rs.10000.His other transactions were as follows:-

   Deposits-20th January Rs.5000; 20th March, Rs.6000; 20th May Rs.7000.

   Withdrawls-20th Feb 12000; 20th April Rs.10000; 20th June Rs.5000.

   Calculate the bank Interest @15% on Debit balance, no interest on credit balance. Close the account on 30th June, 2006.

10. Manoj owed Rs.3000 on 1st January, 2006 to Mr. Chakresh. The following are the transactions that took place between them during 2006. It is agreed between the parties that interest @12% p.a. is to be calculated on all transactions.

2006		*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, 2003.Ascertain the amount to be paid.

UNIT 3 : SELF BALANCING LEDGERS

Learning Objectives

After studying this unit, 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 such total debtors and total creditors accounts to make the ledger system self-balancing. Observe that in a 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.

3.1 INTRODUCTION

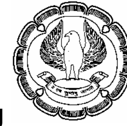
Self Balancing Ledger System implies a system of ledger keeping which classifies ledgers as per nature of transactions, namely, Sales ledger, Bought ledger, General ledger, etc. and also makes them to balance independently. In this Unit we shall discuss the self balancing ledger system and its advantages. Also we shall illustrate system.

3.2 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.

3.3 SECTIONAL BALANCING

A really simple way to prove the accuracy of say, the Sales Ledger would be to maintain in 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 credit customer 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.

3.4 VARIOUS LEDGERS TO BE MAINTAINED IN SELF-BALANCING LEDGER SYSTEM

Since in the Sales or Bought ledgers double entry is not completed, 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:

3.4.1 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.

3.4.2 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.

3.4.3General 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 from 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.

2006		*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

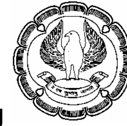
* These do not concern Total Debtors Account

Solution

(In the Debtors Ledger)

General Ledger Adjustment Account

Dr.					*Cr.*
2006		*Rs.*	*2006*		*Rs.*
Jan. 31	To Debtors Ledger Adjustment Account :		Jan. 1	By Balance b/d	16,000
	Bank	7,800	Jan. 31	Debtor Ledger 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



(In the Creditors Ledger)

General Ledger Adjustment Account

2006		Rs.	2006			Rs.
Jan. 1	To Balance b/d	18,500	Jan. 31	By	Creditors Ledger	
Jan. 31	To Creditors Ledger				Adjustment Account:	
	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				

(General Ledger)

Debtors Ledger Adjustment Account

2006			Rs.	2006			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

2006			*Rs.*	*2006*			*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 /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.

Rectification of Errors under Sectional Balancing System

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 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 oonly 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 debtor 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".

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 enteries. 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 debtor 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 debtor ledger)

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)

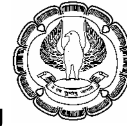
Under Self Balancing system-

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 the main ledger)
To General Ledger Adjustment A/c
(In the 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 the main ledger)
To Suspense A/c
(In main ledger)
(b) Suspense A/c Dr.
(In Debtors ledger)
To General Ledger Adjustment A/c
(In the 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	Dr.	1,000	
	(In General Ledger)			1,000
	To General Ledger Adjustment Account			
	(In Sales Ledger)			
	(The error because of the under-casting of Sales Books, rectified)			
	Suspense Account	Dr.	1,000	
	(In General Ledger)			
	To Sales Account			1,000
	(Rectification of the error resulting from under casting of the Sales Book)			
(b)	Suspense Account	Dr.	50	
	(In Sales Ledger)			50
	To Rao			
	(In Sales Ledger)			
	(Rectification of the error by which Rao was not credited, accounts in the general ledger are not affected)			
(c)	Murty	Dr.	310	
	(In Purchase Ledger)			
	To Murty			310
	(In Sales Ledger)			
	(Transfer of Murty's credit balance in the Purchase Ledger to his account in the Sales Ledger)			

Bought Ledger Adjustment Account	Dr.	310	
(In General Ledger)			310
To General Ledger Adjustment A/c			
(In Bought Ledger)			
(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	Dr.	310	
(In Sales Ledger)			310
To Sales Ledger Adjustment A/c			
(In General Ledger)			
(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	Dr.	310	
	(In Purchase Ledge)			
	To Murty			310
	(In Sales Ledger)			
	(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, 2006	91,500
Creditors, Balance on 1st January, 2006	1,09,800
Transactions for the year 2006 :	
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

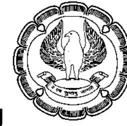
Solution

General Ledger Adjustment A/c (in Sales Ledger)

2006		Rs.	2006		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
			2007		
			Jan. 1	By Balance b/d	64,000

General Ledger Adjustment A/c (in Purchases Ledger)

2006		Rs.	2006		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
2007					
Jan. 1	To Balance b/d	67,020			

3.5 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.

3.6 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 :

1.4.2006	Received Rs. 475 from Mr. X in full settlement. He was allowed a discount of Rs. 25.		
2.4.2006	Received Rs. 2,000 from Mr. Y towards his dues in full.		
3.4.2006	Goods supplied to Mr. T. Rs. 700 and received Rs. 300 after adjustment of the advance of Rs. 400.		
4.4.2006	Bad debts recovered from Mr. Q Rs. 1,000.		
5.4.2006	Goods sold to the following :		
		Mr. A	Rs. 1,000
		Mr. B	Rs. 1,500
		Mr. C	Rs. 2,000
15.4.2006	Mr. P paid Rs. 750 towards dues. Balance thereafter due was Rs. 250.		
25.4.2006	Amount received from the following :		
		Mr. A	Rs. 750
		Mr. B	Rs. 1,000
		Mr. C	Rs. 2,000
30.4.2006	Advance received from Mr. R for supply Rs. 2,000.		

Solution

Sales Ledger

General Ledger Adjustment Account

2006			*Rs.*	*2006*			*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, 2006 :

(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, 2006 stood at Rs. 40,000

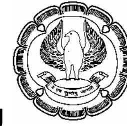
You are required to show the Debtors' Ledger Adjustment Account in the General Ledger.

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, 2006 :

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, 2006, 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

2006			Rs.	2006			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

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 journl entries.

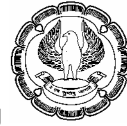
2. The monthly total of purchases day book is posted to the debit side of the purchases account in the

   (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.

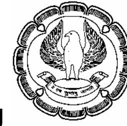
IV Practical problems

15. Prepare the Total Debtors Account from the following figures taken from the books of a firm :

	Rs.
Opening Balance on 1.2.2006	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 28.2.2006 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, given Journal entries to record the transfer.



17. From the following details extracted from the books of Y Ltd. for the year ended 31st March 2006, prepare a Sales ledger Adjustment Account as it would appear in the General Ledger :

1st April 2006 :	*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 which 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 1000 returned by Sharma were entered in the sales day book and posted therefrom to the credit of his account;
2. An amount of Rs 1500 entered in sales return book, has been posted to the debit of Vinod who returned the goods;
3. A sale of Rs 2000 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 Rs450 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 2500 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, 2005		
Debtors Ledger	50,000	2,500
Creditors' Ledger	2,300	42,800
Figures for the year ended 30th September, 2006 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

CHAPTER 8

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 know 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, 2005 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.

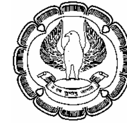
Solution

Swaraj Club

Receipts and Payments Accounts

for the year ended 31st December, 2005

Dr.			*Cr.*
Receipts	*Rs.*	*Payments*	*Rs.*
To Cash in hand b/d	200	By Salaries and Wages	1,200
" Cash with Bank b/d	400	" Purchase of Foodstuff	800
" Entrance Fees	300	" Club Pavilion	
Membership Fees	3,000	(Expenditure on its	
" Donation of Account		construction)	11,000
of Club Pavilion	10,000	" General Expenses	600
" Sales of foodstuff	1,200	" Rent and Taxes	400
		" Bank Charges	160
		" Cash in hand c/d	350
		" 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 year current 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 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 last mentioned 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 according to bye-laws of the society, is so provided), recurring grants from local authorities and Income 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 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.

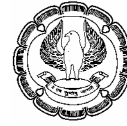
1.3.2 Distinction between Receipts and Payments Account and Income and Expenditure Account : Students are advised to study the details contained in the above statements of account for appreciating the distinguishing characteristics of Receipts and Payments and the Income ad expenditure Accounts, as well 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 adjustment 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. 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 2005, subscription received in cash in Rs. 42,000. It includes Rs. 1,600 for 2004 and Rs. 600 for 2006. Also Rs. 3,000 has still to be received for 2005. The amount to be credited to income and Expenditure Account in respect of subscription will be Rs. 42,800.

Solution

			Rs.
Amount received			42,000
Add : Outstanding on 31st Dec.,	2005		3,000
			45,000
Less : Received on account of	2004	1,600	
	2006	600	2,200
			42,800

The various accounts will appear as under :

Subscription outstanding Account

2005	*Rs.*	2005		*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
2006				
Jan. 1 To Balance b/d	3,000			

Subscription Account

2005		Rs.	2005		Rs.
Dec. 31	To Subscription A/c		Dec. 31	By Cash A/c	42,000
Dec. 31	Outstanding A/c transfer	1,600	" "	By Subscription Outstanding A/c	3,000
Dec. 31	To Subscription Received in Advance A/c	600			
Dec. 31	To transfer to Income and Expenditure A/c	42,800			
		45,000			45,000

Subscription Received in Advance Account

2005	Rs.	2005	Rs.
Dec. 31 to Balance c/d	600	Dec. 31 By Subscription A/c	600
		2006	
		Jan. 1 By Balance b/d	600

Subscription outstanding Rs. 3000 and Subscription Received in Advance Rs. 600 will be shown in the balance sheet on the assets and liabilities side respectively.

Illustration 3

Similar treatment is necessary for expenses. Suppose salaries paid during 2005 were Rs. 23,000. The following further information is available.

Salaries unpaid on 31st Dec. 2004					1,400
"	prepaid	"	"	"	4,00
"	unpaid on	"	"	2005	1,800
"	prepaid	"	"	2005	600

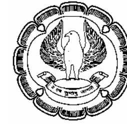
In respect of salaries unpaid and prepaid on 31st Dec., 2004, there must be opening balance on 1st Jan. 2005, the unpaid salaries showing a credit balance. These accounts will be transferred to Salaries Account.

The relevant accounts will be as follows :

Solution

Salaries Account

2005		*Rs.*	*2005*		*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 Outstanding A/c	1,800	By Transfer to Income & Expenditure A/c	23,200
	25,200		25,200

Salaries Outstanding Account

2005	*Rs.*	*2005*	*Rs.*
Jan. 1 To Salaries A/c (transfer)	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
		2006	
		Jan 1 By Balance b/d	1,800

Salaries Prepaid Account

2005		*Rs.*	*2005*		*Rs.*
Jan. 1	To Balance b/d	400		By Salaries A/c (transfer)	400
Dec. 31	To Salaries A/c	600		By Balance c/d	600
		1,000			1,000
2006					
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.

Accounting treatment of some special items like donations, entrance fee or admission fee, subscription and life membership fee is discussed below :

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

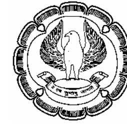
correspondingly the expenditure incurred in carrying out the purpose of the fund is debited to this account. On no account any such expense is charged to the Income and Expenditure Account. The term "Fund" is strictly applicable to the amounts collected for a special purpose when these are invested, 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.

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 other 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.

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 2005 amounted to Rs. 1850 out of which Rs. 200 represented subscription for the year 2004 Rs. 100 were subscriptions collected in advance for the year 2006, and subscriptions amounting to Rs. 500 were outstanding for recovery at the end of 2005, 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)			



	Dr.	300	
Subscription A/c	Dr.	300	
To outstanding Subscription A/c 2004			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.*
2005		*Rs.*	*2005*		*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 Expend-ture 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.

Life Members : For adjusting lumpsum 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.

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 expanses, 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.

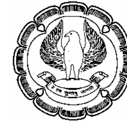
(f) Special capital receipts (as shown by receipts and payments account) will be shown in the balance sheet.

(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, 2005

Receipts	*Rs.*	*Payments*	*Rs.*
Cash in hand	100	Groundsman's Fee	750
Balance at Bank as		Moving Machine	1,500
Per Pass Book :		Rent of Ground	250
Deposit Account	2,230	Cost of Teas	250
Current Account	600	Fares	400
Bank Interest	30	Printing & Office Expenses	280
Donations and Subscriptions	2,600	Repairs to Equipment	500
Receipts from teas	300	Honoraria to Secretary	
Contribution to fares	100	and Treasurer of 2004	400
Sale of Equipment	80	Balance at Bank as per Pass Book:	
Net proceeds of Variety		Deposit Account	3,090
Entertainment	780	Current Account	150
Donation for forth		Cash in hand	250
coming Tournament	1,000		
	7,820		7,820



You are given the following additional information :

	Jan. 1 2005	*Dec. 31, 2005*
	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, 2005, the honoraria to the Secretary and Treasurer are to be increased by a total of Rs. 200.

Prepare the Income and Expenditure Account for 2005 and the relevant Balance Sheet.

Solution

Income & Expenditure Account of Exe Club for the year ending 31st Dec. 2005

		Rs.		*Rs.*
To Groundsman's fee		750	By Donations and Subscription	2,550
To Rent of Ground		250	By Receipts from teas (Fares) less expenses	50
To Travelling Expenses	400			
Less : Contribution	100	300	By Proceeds of Variety entertainment	780
To Printing & Office Expenses		260		
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. 2005

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 the Expenditure Account of the Youth Club for the Year 2005 is as follows :

		Rs.			*Rs.*
To	Salaries	4,750	By	Subscription	7,500
"	General Expenses	500	"	Entrance Fees	250
"	Audit Fee	250	"	Contribution for	
"	Secretary's Honorarium	1,000		annual dinner	1,000
"	Stationery & Printing	450	"	Profit on Annual	
"	Annual Dinner Expenses	1,500		Sport meet	750
"	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 2004	600
Subscription received in Advance on 31st December, 2004	450
Subscription received in advance on 31st December, 2005	270
Subscription outstanding on 31st Dec., 2005	750

Salaries Outstanding at the beginning and the end of 2005 were respectively Rs. 400 and Rs. 450. General Expenses include insurance prepaid to the extent of Rs. 60. Audit fee for 2005 is as yet unpaid. During 2005 audit fee for 2004 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, 2005 valued at Rs. 2,600. At the end of the year, after depreciation, this equipment amounted to Rs. 2,700. In 2004, the Club has raised a bank loan of Rs. 2,000. This was outstanding throughout 2005. On 31st December, 2005 cash in hand amounting to Rs. 1,600.

Prepare the Receipts and Payments Account for 2005 and Balance Sheet as at the end of the year.

Solution

The Youth Club

Receipts and Payments Account for the year ended 31st Dec., 2005

		Rs.	*Rs.*			*Rs.*	*Rs.*
To	Balance b/d		1,390	By Salaries		4,750	
	(balancing figure)				*Add :* Paid for 2004	400	
"	Subscriptions					-------	
	As per Income &					5,150	
	Expenditure Account	7,500			*Less :* Unpaid for 2005	450	4,700
	Add : 2004's Received	600					
"	2006's Received	270					
		8,370		"	General Expenses	500	
	Less : 2005's Received in 2004	450			*Add :* Paid for 2004	60	560
		7,920		"	Audit fee (2004)		200
	Less : 2005'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 annual dinner	1,000	"	Sports Equipments [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, 2005

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Subscription received in advance		270	Freehold Ground		10,000
Audit Fee Outstanding		250	Sport Equipment:		
Salaries Outstanding		450	As per last Balance Sheet	2,600	
Bank Loan		2,000	Additions	400	
Capital Fund :				3,000	
Balance as per previous Balance Sheet	11,540		*Less :* Depreciation	300	2,700
Add : Surplus for 2005	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, 2004

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, 2006 :

Income & Expenditure Account for the Year 2005-06

	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, 2006

Liabilities		*Rs.*	*Assets*	*Rs.*
Subscription in Advance			Furniture	9,000
(2006-07)		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 (2005-06)	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 2004-05were paid in 2005-06

(2) One-half of entrance fee has been capitalised by transfer to General Fund.

(3) Subscription outstanding in 2004-2005 was Rs. 800 and for 2005-06 Rs. 700.

(4) Subscription received in advance in 2004-2005 was Rs. 200 and in 2005-06 for 2006-07 Rs. 100.

Solution

Receipts and Payment Account for the year ending

31st March, 2006

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

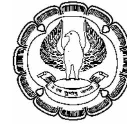
Working note : Rs. 600 paid for upkeep of ground for 2004-2005 and Rs. 240 paid for printing have been added to the amount shown as expenditure for the year to arrive at total payment under these heads.

Subscription Account

2005		*Rs.*	*2005*		*Rs.*
April	To Subscription Outstanding (2004-2005)	800	April 1	By Cash (Balancing figure)	17,320
			"	Subscription Outstanding (2005-06)	700
			"	Subscription in Advance (2004-05)	200
	" Subscription In Advance (2005-06)	100			
2006 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, 2006 :



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.*
	2005	*2006*
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, 2006 was Rs. 5,250.

From the above information you are required to prepare :

(a) The Club's Balance Sheet as at March 31, 2005;

(b) The Club's Income and Expenditure Account for the year ended March 31, 2006.

(c) The Club's Closing Balance Sheet as at March 31, 2006

(All workings are to be given as part of the answer).

Solution

(a) Sportswriters Club

Balance Sheet as on 31st March, 2005

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, 2006

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 over income	2,888
" Depreciation :				
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, 2006

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 : Dep.	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 & Electricity*	*Magazines & News-papers*	*Sundry Expenses*
	Rs.	*Rs.*	*Rs.*	*Rs.*
Paid during the year	12,000	7,220	2,172	10,278
Add : Outstanding on 31.3.2006	170	973	340	––
Prepaid on 31.3.2005	––	––	––	417
	12,170	8,193	2,512	10,695
Less : Outstanding on 31.3.2005	710	864	226	––
Less : Prepaid on 31.3.2006	––	––	––	620
Expenditure for the year	11,460	7,329	2,286	10,075

(ii) *Depreciation*

			Rs.
(*a*)	Furniture @10% on Rs. 9,600		960
(*b*)	Sports Equipment @ 20% on Rs. 8,200		1,640
(*c*)	Library books-book value	Rs. 6,000	
	Revalued at	Rs. 5,250	750

(iii) *Subscription*

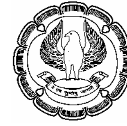
Received in cash	28,600
Add : Receivable on 31.3.2006	1,575
	30,175
Less : Receivable on 31.3.2005	1,263
	28,912

Illustration 8

From the following data, prepare an Income and Expenditure Account for the year ended 31st December. 2005, and a statement of affairs as at that date of the Mayura Hospital :

Receipts and Payments Account for the year ended 31 December, 2005

		Rs.					Rs.
To	*Balances*	*Rs.*		*By*	*Salaries :*		*Rs.*
	Cash	400			(Rs. 3,600 for 2004)		15,600
	Bank	2,600	3,000	"	Hospital Equipment		8,500
				"	Furniture purchased		3,000
"	Subscriptions :			"	Additions to Building		25,000
	For 2004		2,550	"	Printing and Stationery		1,200
	For 2005		12,250	"	Diet expenses		7,800
	For 2006		1,200	"	Rent and rates		
"	Government Grant :				(Rs. 150 for 2006)		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 capitalised)		4,000	"	Balances :		
					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 31.12.2005	70,000
Value of hospital equipment on 31.12.2005	25,500
Building Fund as on 1.1. 2005	40,000
Subscriptions in arrears as on 31.12.2004	3,250

Investments in 8% Govt. securities were made on 1st July, 2005.

Solution

Mayura hospital

Income & Expenditure Account for the year ended 31 December, 2005

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., 2005

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 received in advance	1,200	Investments-8% Govt. 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., 2004

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital Fund (Balancing Figure)	24,650	Building	45,000
		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. 2005	70,000
Paid during the year	25,000
Balance on 31st Dec. 2004	45,000

(3) Equipment

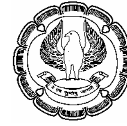
Balance on 31st Dec. 2005	25,500
Paid during the year	8,500
Balance on 31st Dec. 2004	17,000

(4) Subscription due for 2004

Receivable on 31st Dec. 2004	3,250
Received in 2005	2,550
Still Receivable for 2004	700

Illustration 9

The receipts and payments account and the income and expenditure account of a Club for the year ended 31st December, 2005 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
2004	600		By Salary	1,500
2005	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.			
2004	150			
2005	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 Statinery	200		
To Advertisement	150		
To Surplus	5,000		
	9,500		9,500

The club's assets as on 1st January 2005 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, 2004 and 31st December, 2005.

Solution:

BALANCE SHEET

As at 31st December, 2004

	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, 2005

		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 31/12/04	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

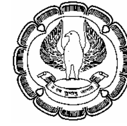
Self-examination problems

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.

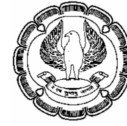
2. Admission fee income should be:
   (a) Capitalised
   (b) treated as revenue
   (c) treated as revenue unless the amount is pretty large
   (d) treated as a liability.
3. Legency is:
   (a) added to the capital fund;
   (b) shown in the income and expenditure account ;
   (c) shown as a separate liability;
   (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)

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 aclub.
13. "Receipts and payments account is same as cash book". Comment.



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

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, 2005.

    Subscriptions received from the members for the year 2005 Rs. 1,20,000, Subscription receipts for 2004 Rs. 20,000, Subscription received in advance for 2006 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, 2005 :

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, 2005.

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, 2006 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.
- Practise the illustrations.

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 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 tution 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, furnitures 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 fees : 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 has 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 miniumum 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.

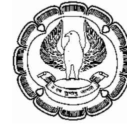


Illustration 1

From the following Trial Balance of Education Society as on 31st Dec., 2005; 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

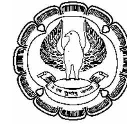
The following further information is supplied to enabel you to make the necessary adjustments:

	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. 2005 was Rs. 1,30,000. You are nor required to make any provision for this fall in value.

Bharat Education Society
Income and expenditure Account
for the year ended at 31st Dec., 2005

		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., 2005

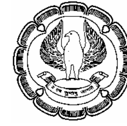
Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital Fund	3,89,150		Building cost	2,75,000	
Add: Excess of			*Less:* Depreciation	13,750	2,61,250
Income over					
Expenditure	21,870	4,11,020	Furniture & Fittings	12,500	
Investment Res.Fund		15,000			
Prize Trust Fund	16,000		*Add:* Additions		
Income 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, 2005 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 Stroes-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	
Reparis & 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 straightline 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, 2005

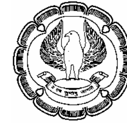
Expenditure	*Rs.*	*Rs.*	*Income*	*Rs.*	*Rs.*
To salaries: Teaching		8,50,000	ByTuitions & other fee		8,80,000
Research		1,20,000			
" Material & Supplies Consumed			" Govt. Grants		5,00,000
Teaching		50,000	" Income from		
Research		1,50,000	Investments		1,85,000
			" Hostel room Rent		1,75,000
" Repairs & 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, 2005

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

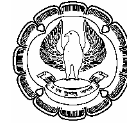
Noida School maintains separate building fund. As on 31.3.2005, balance of building fund was Rs. 10,00,000 and it was represented by fixed deposit (15% per annum) of Rs.6,00,000 and current account balance of Rs.4,00,000. During the year 2005-06, the school collected as donations towards the building 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, 2005 was Rs.8,25,000 for which contractors' bill upto 75% was paid on 14.4.2006. The extension of building was finished on 31.12.2005 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 2005-06 and show the trial balance of building fund ledger.

Solution

Journal entries for Building Fund Ledger

(1)	Bank A/c	Dr.	Rs.5,60,000	
	To Building fund A/c			Rs.5,60,000
	(On collection of donations)			
(2)	Bank A/c	Dr.	Rs.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.	Rs.90,000	
	To Interest A/c			90,000
	(On accrual of interest)			



(4)	Interst A/c	Dr.	Rs.90,000	
	To Building fund			90,000
	(Interest accrued on fixed deposit transferred)			
(5)	Capital work in progress A/c	Dr.	Rs.7,25,000	
	To Contractors' A/c			7,25,000
	(Work completed and certified during the year)			
(6)	Contractors' A/c	Dr.	Rs.13,43,750	
	To Bank A/c			13,43,750
	(Payments made during the year)			
(7)	Building A/c	Dr.	Rs.15,50,000	
	To Bank A/c			15,50,000
	(Transfer of completed buildings to Asset A/c)			
(8)	Building Fund A/c	Dr.	Rs.15,50,000	
	To General Fund A/c			15,50,000
	(Corresponding building fund transferred)			

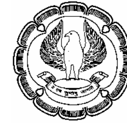
Trial Balance of Building Fund as on 31st March, 2006

	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.

[Ans. **(i)** (d); **(ii)** (a)]

II Short answer type questions

Distinguish between :

5. Funds and Reserves.
6. Entrance Fees and Membership Subscriptions
7. Donation for a general fund and donations for a special fund.
8. Receipts and Income.
9. Payment and expenditure.
10. What is meant by 'Fund base accounting'. Explain in brief.

III Long answer type questions

11. Describe the main sources of finance for running an educational institution.
12. Explain the techniques of preparing income and expenditure account and balance sheet of a school.

IV Practical Problems

13. From the following information, ascertain the amount to be credited to the Income and Expenditure Account in respect of subscriptions for 2005.

	Rs.
Subscriptions received in cash	33,500
Subscriptions received in advance on 31.12.2000	2,500
Sunscriptions Outstanding on 31.12.2000	3,000
Subscriptions Outstanding on 31.12.2005	2,000
Subscriptions received in Advance on 31.12.2005	500

14. 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 (cost Rs.300)	800	By	Stationery : 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 9

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.
- Learn how to apply debtors turnover ratios and creditors turnover ratios to find out sales and purchases espectively.

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 METHOD OF CAPITAL COMPARISON

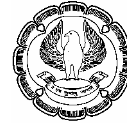
Capital is increased if there is profit, while capital is reduced if there is loss. However, if the proprietor/partners made fresh investments in the business, capital is increased; if they make withdrawal capital is reduced. So while determining the profit by capital comparison, the following rules 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 (Balancing Figures)		Building, Machinery	
		Furniture, stock,	
Loans, Bank overdraft		Sundry debtors	
Sundry creditors		Bills receivable	
Bills payable		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 31-12-2004 and 31-12-2005 are as follows :

	31-12-2004	*31-12-2005*
	Rs.	*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. 2000 p.m. for meeting family expenses.

Prepare Statement of Affairs.

Solution

Statement of Affairs

as on 31-12-2004 & 31-12-2005

Liabilities	*31-12-2004*	*31-12-2005*	*Assets*	*31-12-2004*	*31-12-2005*
	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 31-12-2005	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 31-12-2004	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.

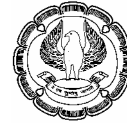


Illustration 3

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

	31-3-2005	31-3-2006
	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 31-3-2005 : A Rs. 5000 (Cr.), B Rs. 2,000 (Dr.)

Prepare Statement of Profit, Current Accounts of partners and Statement of Affairs as on 31-3-2006.

Solution

Statement of Affairs

As on 31-3-2005 and 31-3-2006

Liabilities	*31-3-2005*	*31-3-2006*	*Assets*	*31-3-2005*	*31-3-2006*
	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*

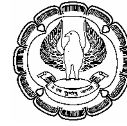
10% on Rs. 1,20,000	Rs. 12,000
10% on Rs. 10,000 for 1/4 year	250
	Rs. 12,250

(*ii*) *Furniture as on 31-3-2006*

Balance as on 31-3-2005	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 31-3-2006

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
			1,15,067

Current Accounts

Dr.							*Cr.*
	A	*B*	*C*		*A*	*B*	*C*
To Balance b/d	—	2000	—	By Balance b/d	5000	—	—
" Drawings	8000	16,000	—	" Salary	24,000	24,000	18,000
" Interest on drawings	533	534	—	" Interest on capital	5,625	4,500	3,375
				" Share of Profit	47,944	38,356	28,767
" Balance c/d	74,036	48,322	50,142				
	82,569	66,856	50,142		82,569	66,856	50,142

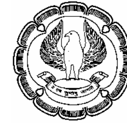
Statement of Profit

				Rs.
Current Account Balances as on 31-3-2006				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 31-3-2005 Rs. 5000 – Rs. 2,000				3,000
				1,15,067

Illustration 4

The Income Tax Officer, assuming the income of Shri Moti for the financial years 2004-2005 and 2005-2006 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 2004 and 1st April, 2006.

				Rs.
1-4-2004	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
1-4-2006	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 2004-2005 and Rs. 1,23,000 for 2005-2006 respectively.

State whether the Income-tax Officer's contention is correct. Explain by giving your workings.

Solution

Capital A/c of Shri Moti

		1-4-2004		*1-4-2006*
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 1-4-2006	5,65,000
Add : Drawings – Domestic Expenses for the two years (Rs. 4,000 × 24)	96,000
	6,61,000
Less : Capital as on 1-4-2004	3,13,000
Income earned in 2004-2005 & 2005-2006	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.*
2002	20,000
2003	32,000
2004	35,000
2005	48,000
2006	55,000

The bank appoints you to audit the statements and verify whether the figures of profits report are corrected or not; for this purpose, the following figures are made available to you:

(*a*) Position as on 31st December, 2001: 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, 2001 on which he had agreed to pay simple interest at 12% p.a. The loan was repaid alongwith interest on 31st December, 2003.

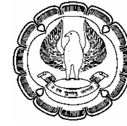
(*c*) In December, 2002, he had advanced Rs. 8,000 to A for purchase of a vacant land. The property was registered in March, 2004 after payment of balance consideration of Rs. 32,000. Costs of registration incurred for this were Rs. 7,500.

(*d*) Suresh purchased jewellery for Rs. 15,000 for his daughter in October, 2004 Marriage expenses incurred in January were Rs. 24,000.

(*e*) A new VCR was purchased by him in March 2006 for Rs. 18,000 and presented by him to his friend in November, 2006.

(*f*) His annual household expenses amounted to a minimum of Rs. 24,000.

(*g*) The position of assets and liabilities as on 31st December 2006 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 31-12-2001

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 Balancing figure		69,850		
		82,600		82,600

Statement of Affairs as on 31-12-2006

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 1-1-2002 to 31-12-2005

		Rs.
Capital as on 31-12-2006 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 31-12-2001 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 31-12-2006	600
	Net profit over the five-year period	2,08,500

Statement showing annual profits and their differences with reported profits: 2002–2006

Year ended	*Apportionment Ratio*	*Annual profit Rs.*	*Profit reported Rs.*		*Difference to bank Rs.*
31-12-2002	3	25,020	20,000	(+)	5020
31-12-2003	4	33,360	32,000	(+)	1360
31-12-2004	4	33,360	35,000	(–)	1640
31-12-2005	6	50,040	48,000	(+)	2040
31-12-2006	8	66,720	55,000	(+)	11,720
		2,08,500	1,90,000	(+)	18500

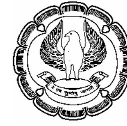
3. TECHNIQUES OF OBTAINING COMPLETE ACCOUNTING INFORMATION

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

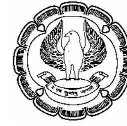
The analysis of cash as well as bank receipts and payments should be extensive but under significant heads, so that various items of income and expenditure can be posted therefrom into the ledger. However before posting the information into the ledger the same should be collected in the form of an account, the specimen whereof is shown below:

Cash and Bank Summary Account for the year ended

	Cash	*Bank*		*Cash*	*Bank*
	Rs.	*Rs.*		*Rs.*	*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 2006.



	Rs.
Cash Balance on 1st Jan., 2006	250
Bank overdraft on----	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., 2006	310
Bank balance on	1,180

Now prepare the cash and Bank Summary.

Cash and Bank Summary

Dr.			*Cr.*
	Rs.		*Rs.*
Cash Balance as on 1-1-2006	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 31-12-2006	310
		Bank balance on 31-12-2006	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. Customer Balance	Sales	Bills Disho-noured	Total Debits	Cash Recd.	Dis-counts Alld.	Bills Recd.	Sales Returns	Bad Debts	Total Credit	Balance (clg.)

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)

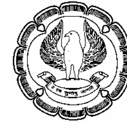
	Rs.		*Rs.*
Opening Balance	5,000	Cash/Bank	10,000
Sales	38,000	Discount	500
Bills dishonored	280	Bills Receivable	20,000
Interest	100	Bad Debts	280
		Closing Balance	12,600
	43,380		43,380

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 Particulars ment	*Amount Bank Pay-*	*Paid out of Accrued Fund*	*Total Private*	*Pre Payment*	*Expenses for the 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 (1-1-2006)	*Rs.*
Stock	20,000
Sundry Creditors	12,300
Sundry Debtors	15,000
Closing Balance (31-12-2006)	
Stock	15,000
Sundry Creditors	13,800
Sundry Debtors	25,600
Discount received during 2006	1,130
Discount allowed	1,870

What are the purchases for 2006? 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

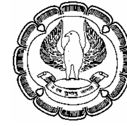
	Rs.		*Rs.*
To Balance b/d (balancing figure)	15,000	By Cash	45,600
To Credit Sales	58,070	By Discount	1,870
		By Balance c/d	25,600
	73,070		73,070

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, 2006 and a Balance Sheet as on that date:

(a)	*Balance as on 31st March, 2005*	*Balance as on 31st March, 2006*
	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, 2005 was Rs. 20,000 was sold on 30th September, 2005 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, 2005 was Rs. 8,000 and on 31st March, 2006 was Rs. 10,000 on 31st March, 2005. 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

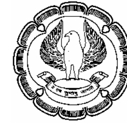
for the year ended 31st March, 2006

		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, 2006

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital as on 1st April, 2005		7,16,000	Building	3,20,000	
			Add: Addition during the year	40,000	
Profit and Loss A/c				3,60,000	
Opening balance	40,000		*Less:* Provision for		
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, 2005

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

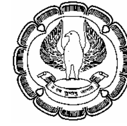


Illustration 7

A. Adamjee keeps his books on single entry basis. The analysis of the cash book for the year ended on 31st December, 2005 is given below:

Receipts	*Rs.*	*Payments*	*Rs.*
Bank Balance as on 1st January, 2005	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., 2005	6,400
		Cash in hand on 31st Dec., 2005	500
	68,000		68,000

Particulars of other assets and liabilities are as follows :

	1st January, 2005	*31st December, 2005*
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, 2005 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 1-1-2005

	Rs.		*Rs.*
Sundry Creditors	5,800	Machinery	7,500
A. Adamjee's Capital	29,100	Furniture	1,200
(balancing figure)		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			

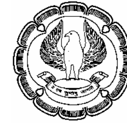
Total Creditors Account

		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 31-12-2005

	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, 2005

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
A. Adamjee's Capital			Machinery	7,500	
on 1st January, 2005	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, 2006 and a Balance Sheet as at that date. All workings should form part of your answer.

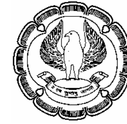
Assets and Liabilities

	As on 1st April' 2005	As on 31st March' 2006
	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 31-3-2006		1,200
Cheques issued to trade creditors		60,270

Solution

Trading and Profit & Loss Account for the year ending 31st March, 2006

	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	



	Rs.			Rs.
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 **	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, 2006

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 :

(1) 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, 2005**

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

** Expenses paid in Cash	9,570
Add : Outstanding on 31-3-2006	330
	9,900
Less : Outstanding on 1-4-2005	600
	9,300

Note *:* For want of information deprecation has not been provided on fixed assets.

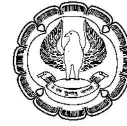


Illustration 9

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

	31-12-2004	31-12-2005
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 2004-2005

(*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. 121,000

(*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 31-12-2005 and Balance Sheet as on that date.

Solution

Trading and Profit & Loss A/c of Mr. Anup
for the year ended 31-12-2005

	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 31-12-2005

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.	*Rs.*		*Cr.* *Rs.*
To Balance b/d	70,000	By Bill Receivable A/c	
" Bill Receivable A/c-Bills Dishonoured	3,000	Bills Accepted by customers	40,000
" Bank A/c-Cheque dishonoured	5,700	By Bank A/c	
" 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

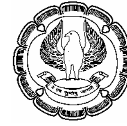
	Rs.		*Rs.*
To Balance b/d	15,000	By S. Creditors A/c	
To S. Debtors A/c Bills accepted	40,000	Bills endorsed	10,000
		By Bank A/c	19,250
		By Discount A/c	750
		(Bills discounted)	
		By Bank	
		Bills Collected on Maturity	16,000
		By S. Debtors	
		Bills dishonoured (Bal. Fig)	3,000
		By Balance c/d	6,000
	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		
" Return Outward A/c	4,200		
" Discount Received A/c	2,700		
" 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 Rs.	Bank Rs.		Cash Rs.	Bank 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		" Wages	1,10,400	
			" Drawing A/c	16,800	
To S. Debtors		5,700	" Bills Payable		22,000
To Bills Receivable		19,250	" S. Creditors	77,200	3,20,000
To Bills Receivable		16,000	" Furniture	25,000	
To Capital (maturity value of LIC policy)		20,000	" S. Debtors		5,700
To Capital (Rent received)		14,000	" Electricity & Tel. Charges	18,700	
			" Building (Bal. fig)		3,72,000
			" Balance c/d	5,300	87,000
	10,23,350	9,27,700		10,23,350	9,27,700

Statement of Affairs as on 31-12-2004

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 with which sanctioned him a loan of Rs. 20,000 on 1-1-2005. His father gifted him Rs. 5,000 on 1-1-2005. 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 31-12-2005. 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 31-12-2005

		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.

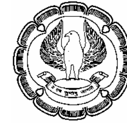
(8) Assume that all transactions are routed through Bank and no cash is handled.

Solution

Profit & Loss Account of AVL for the year ending

31st December, 2005

	Rs.	Rs.		Rs.
To Sundry Expenses	8,400		By Fees earned	35,000
Add : Outstanding	1,000	9,400	By Examination fee	4,200
" 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., 2005

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

		Rs.
(*ii*)	Interest on Bank Loan @ 12% p.a. on	
	Rs. 20,000 for Jan. to June	1,200
	Rs. 19,500 for July	195
	Rs. 19,000 for August	190

	Rs.
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

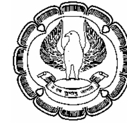
(*iv*) **Drawings Accounts**

	Rs.		Rs.
To rent	3,600	By Balance c/d	14,800
" Bank - Cash withdrawal	7,200		
" 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.

4. APPLICATION OF ACCOUNTING RATIOS

Often Accounting ratios are employed to make reasonable approximation for a missing accounting information. For example, when information about sales is available but purchase information is missing, then gross profit ratio may be used to know the cost of goods sold. From the cost of goods sold, purchase figure can be approximated. Similarly when business expenses are not known, by comparing gross profit and net profit ratio an approximation of such expenses may be made. In this



Unit we shall discuss some specific cases. Particularly the gross profit ratio is used to compute the missing information.

4.1 USE OF GROSS PROFIT RATIO

Let us suppose a firm earns 25% gross profit on sales.

This means $\frac{\text{Gross profit}}{\text{Sales}} \times 100 = 20\%.$

It makes all sales on credit which have been calculated as Rs. 20,00,000. Now given opening stock and closing stock Rs. 1,20,000 and Rs. 1,30,000 respectively, we can find out purchases as follows :

Trading Account

		Rs.			*Rs.*
To	Opening stock	1,20,000	By	Sales	20,00,000
″	Purchases (balancing figure)	16,10,000	″	Closing stock	1,30,000
″	Gross Profit	4,00,000			
		21,30,000			21,30,000

Illustration 11

Yayati is an importer of fancy goods, operating from rented premises, which is on lease of Rs. 500 per month. He prepares his accounts as on 31st December in every year.

On the night of December 31st, 2005 all his books and records were destroyed in a fire. The following was his summarised financial position as on 31st December, 2004.

Fixed Assets :	*Rs.*		*Rs.*
Motor Car	6,500		
Furniture	10,000		16,500
WORKING CAPITAL :			
Current Assets :			
Stock-in-trade (at cost)	2,00,500		
Debtors	24,000		
Prepaid rates	500		
Balance at Bank	27,060		
Cash in Hand	590		
		2,52,650	

Less : Current Liabilities :			
Creditors (after adjustment of rebate due)	1,10,200		
Accrued Rent	1,000		
Due for the Purchase Instalment	2,790	1,13,990	
			1,38,660
Net Assets			1,55,160

The following further information is also available :

(*a*) Yayati buys goods for resale only from one manufacturer in Japan, who allows a rebate of 3% on the goods purchased by him in excess of Rs. 5,00,000 in a calender year. The rebate due for the year ended 31st December, 2005 was Rs. 12,480.

(*b*) All goods are sold at a standard gross profit margins of 40% on selling price. Any rebate due is to be ignored for the purpose.

(*c*) Stock at cost on 31st December, 2001 amounted to Rs. 90,200.

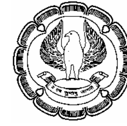
(*d*) Weekly cash expenses out of cash sales (before depositing the same into the bank) have been :

	Rs.
Drawings	250
Carriage	450
Petrol	40
Sundries	20

Cash in hand on 31st December, 2005 amounted to Rs. 670.

(*e*) His bank statement for the year reveal the following information :

	Rs.
Paid for purchase of goods	10,10,500
Car Expenses	3,680
Rent	6,500
Rates	2,800
Rebate from Japan for the year ended 31st Dec., 2004	9,800
Hire purchase instalments (final payments)	3,040
Salaries	1,02,460
General expenses	1,56,020
Drawings	37,060
Balance as on 31st Dec., 2005	2,41,800



(f) Depreciation on motor car and furniture is to be provided @ 20% and 10% respectively.

(g) Accrued rent as on 31-12-2005 Rs. 500 and rates paid in advance Rs. 700

You are required to prepare Yayati's Trading and Profit and Loss Account for the year ended on 31st Dec., 2005 and the Balance Sheet as on that date.

Solution

Trading and Profit & Loss Account of Yayati for the year ending 31st December, 2005.

	Rs.	*Rs.*		*Rs.*	*Rs.*
To Opening Stock		2,00,500	By Sales		17,10,500
To Purchases		9,16,000	By Closing Stock		90,200
To Gross Profit c/d		6,84,200			-----------
		18,00,700			18,00,700
To General Expenses (incl. Sundries)		1,57,060	By Gross Profit		6,84,200
To Salaries		1,02,460	By Rebate on Purchases		12,480
To Rent		6,000			
To Rates		2,600			
To Car Expenses		5,760			
To Depreciation :					
Car	1,300				
Furniture	1,000				
		2,300			
To Carriage Outward		23,400			
To Hire Purchase Interest		250			
To Net Profit to Capital A/c		3,96,850			
		6,96,680			6,96,680

Balance Sheet of Yayati as on 31st Dec., 2005

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital			*Fixed Assets :*		
Balance on 1st Jan.	1,55,160		Motor car	6,500	
Add : Profit for the year	3,96,850		*Less :* Depreciation	1,300	5,200
	5,52,010		Furniture	10,000	
Less : Drawings	50,060	5,01,950	*Less :* Depreciation	1,000	9,000

Sundry Creditors	13,020		
Accrued Rent	500	Current Assets :	
		Stock in Trade	90,200
		Sundry Debtors	1,67,900
		Prepaid Rates	700
		Balance at Bank	2,41,800
		Cash in Hand	670
	5,15,470		5,15,470

Working Notes :

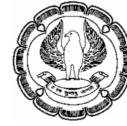
		Rs.
(*i*)	Purchase 5,00,000 + 12,480 × 100/3	9,16,000
(*ii*)	Cost of sales :Opening stock	2,00,500
	Purchases	9,16,000
		11,16,500
	Less : Closing Stock	90,200
		10,26,300
(*iii*)	Sales 100/60 of cost of sales : 100/60 × Rs. 10,26,300	17,10,500

(*iv*) **Bank Account**

	Rs.		Rs.
To Balance b/d	27,060	By Creditors	10,10,500
To Creditors—Rebate	9,800	By Car expenses	3,680
To Collection from debtors (Balancing figure)	15,27,000	By Rent	6,500
		By Rates	2,800
		By Hire Purchase Instalments	3,040
		By Salaries	1,02,460
		By General expenses	1,56,020
		By Drawings	37,060
		By Balance c/d	2,41,800
	15,63,860		15,63,860

(*v*) **Cash Account**

	Rs.		Rs.
To Balance b/d	590	By Drawings	13,000
		By Carriage—outward	23,400
To Cash Sales	39,600	By Car expenses	2,080



(Balancing figure)		By	Sundries	1,040
		By	Balance c/d	670
	40,190			40,190

(vi) **Total Debtors Account**

To Balance b/d	24,000	By	Cash Received	15,27,000
Credit sales		By	Balance c/d	1,67,900
Rs. 17,10,500 (less cash sales Rs. 39,600)	16,70,900		(Balance figure)	
	16,94,900			16,94,900

(vii) **Total Creditors Account**

	Rs.		Rs.
To Bank	10,10,500	By Balance c/d	1,10,200
To Rebate [2005]	12,480	By Purchases	9,16,000
To Balance c/d (Balance figure)	13,020	By Bank (Rebate [2004]	9,800
	10,36,000		10,36,000

ILLUSTRATION 12

The following is the Balance Sheet of Mr. Rama Shankar as on 30th June, 2005.

Liabilities	*Rs.*	*Assets*	*Rs.*
Rama Shankar's Capital A/c	96,000	Building	60,000
General Reserve	30,500	Furniture	12,000
Sundry Creditors	62,000	Motor Car	18,000
		Stock	40,000
		Sundry Debtors	34,000
		Cash in Hand	7,500
	----------	Cash at Bank	17,000
	1,88,500		1,88,500

A fire occurred in the evening of 30th June, 2006 in the premises of the trader destroying all books and records. The cashier absconded with the available cash, Mr. Rama Shankar gives you the following information :

(*a*) His sales for the year 20% higher than the previous year's. He sells his goods at cost plus 25%; 20% of the total sales were for cash. There were no cash purchases.

(*b*) From 1st July, 2006 the stock level was raised to Rs. 50,000 and maintained at that level all throughout the year.

(*c*) Collection from debtors amounted to Rs. 2,60,000 of which Rs. 60,000 was received in cash. Business expenses amounted to Rs. 42,000 of which Rs. 10,000 was outstanding on 30th June, 2006 and Rs. 12,000 was paid by cheque. Creditors were paid by cheques only.

(*d*) Analysis of the Pass Book revealed the following :

	Rs.
Payment to Creditors	2,75,000
Personal Drawings	15,000
Cash deposited in Bank	1,33,700
Cash withdrawn bank for office use	24,000

(*e*) Gross profit as per last year's audited accounts was Rs. 60,000. Provide depreciation on Building and Furniture at 5% and Motor Car at 20%.

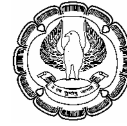
You are required to ascertain the amount defalcated by the Cashier and prepare a Trading and Profit and Loss Account for the year ended 30th June, 2006 and a Balance Sheet as on that date after defalcation.

SOLUTION

Rama Shankar

Trading and Profit & Loss Account for the year ending 30th June, 2006

Dr.					*Cr.*
			Rs.		*Rs.*
To	Opening Stock		40,000	By Sales	3,60,000
"	Purchases			By Closing Stock	50,000
"	(Balance figure)		2,98,000		
"	Gross Profit c/d		72,000		---------
			4,10,000		4,10,000
To	Sundry business				
	expenses	32,000		By Gross Profit b/d	72,000
	Add : Outstanding	10,000	42,000		



		Rs.	Rs.		Rs.
To	Depreciation :				
	Building	3,000			
	Furniture	600			
	Motor Car	3,600			
			7,200		
To	Loss of cash by theft		9,800		
To	Net Profit c/d		13,000		--------
			72,000		72,000

Balance Sheet of Mr. Rama Shankar as on 30th June, 2006

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Rama Shankar's Capital	96,000		Building	60,000	
Add : Net profit	13,000		*Less :* Depreciation	3,000	57,000
	1,09,000		Furniture	12,000	
Less : Drawings	15,000	94,000	*Less :* Depreciation	600	11,400
			Motor Car	18,000	
General Reserve		30,500	*Less :* Depreciation	3,600	
Sundry Creditors		85,000			14,400
Outstanding Expenses		10,000	Stock in trade		50,000
			Sundry Debtors		62,000
			Cash at Bank		24,700
		2,19,500			2,19,500

WORKING NOTES :

(i) **Total Debtors Account**

		Rs.			Rs.
To	Balance b/d	34,000	By	Cash	60,000
"	Sales	2,88,000	"	Bank	2,00,000
	(80% of total sales)	----------	"	Balance c/d	62,000
		3,22,000			3,22,000

(*ii*) **Total Creditors Account**

	Rs.		Rs.
To Bank	2,75,000	By Balance b/d	62,000
To Balance c/d	85,000	By Purchase	2,98,000
	3,60,000		3,60,000

(*iii*) **Calculation of Total Sales and Purchases**

		Rs.
Last year's Gross Profit @ 20% on sales		60,000
Therefore, last year's sales Rs. 60,000 × 5		3,00,000
Current year's sales Rs. 3,00,000 + 20% of Rs. 3,00,000		3,60,000
Gross Profit: 20% of sales		72,000
Cash Sales: 20% of total sales		72,000
Purchase for sales Rs. 3,60,000—Rs. 72,000	2,88,000	
Add : For increase in stock	10,000	
Total Purchase		2,98,000

(iv) **Cash Book**

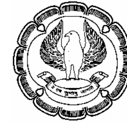
		Cash *Rs.*	*Bank* *Rs.*			*Cash* *Rs.*	*Bank* *Rs.*
To	Balance b/d	7,500	17,000	By	Sundry Exp. A/c	20,000	12,000
"	Cash Sales	72,000		By	Sundry Creditors		2,75,000
"	Sundry Debtors	60,000	2,00,000	"	Bank (Contra)	1,33,700	
"	Cash (Contra)		1,33,700		Cash (Contra)		24,000
"	Bank (Contra)	24,000		"	Drawings		15,000
				"	Balance c/d	9,800	24,700
		1,63,500	3,50,700			1,63,500	3,50,700

*Rs. 9,800 was defalcated by the Cashier.

4.2 Use of Other Ratios

Given debtors turnover, figure of sales can be determined. Suppose, opening debtors are Rs. 1,20,000 and debtors turnover is 12. Then last year's sales were 1,20,000 × 12 =Rs. 14,40,000

$$\frac{\text{Credit Sales}}{\text{Debtors}} = \text{Debtors Turnover}$$



Obviously here you have to assume that debtors turnover is calculated with reference to closing debtors only. If you can ascertain the trend of sales as compared to the last year, say 10% increasing trend, you are in a position to find out current year's sales.

Last year's sales	Rs. 14,40,000
Add : 10% increasing trend	Rs. 1,44,000
	Rs. 15,84,000

Now apply Gross Profit Ratio to find out Cost of Sales. Suppose Gross Profit Ratio is 20% on Sales, then Cost of goods sold is Rs. 12,67,200 (Rs. 15,84,000 × 80/100).

Similarly, you can use Creditors Turnover Ratio to find out missing information.

ILLUSTRATION 13

The following is the audited Balance Sheet of Shri Ram Chand as on 31st March, 2005 :

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital Account	1,62,000	Machinery	40,000
Sundry Creditors for goods	30,000	Furniture	10,000
		Stock	35,000
		Debtors	90,000
		Cash in hand	6,000
	---------	Cash at Bank	11,000
	1,92,000		1,92,000

A fire occurred in the evening of 31st March, 2006, destroying the books of account and furniture. The cashier absconded with the available cash in the Cash Box.

The trader gives the following information :

(1) Sales are effected as 20% for cash and the balance on credit. His total sales for the year ended March 31, 2006 were 20% higher than the previous year. All sales and purchases of goods were evenly spread throughout the year (as also in the last year)

(2)Terms of credit

Debtors	2 Months
Creditors	1 Month

(3) Stock level was maintained at Rs. 35,000 all throughout the year.

(4) A steady Gross Profit rate of 33 1/3% on turnover was maintained throughout. Creditors are paid by cheque only. There is no cash purchase.

(5) His private records and the Bank Pass Book kept with him disclosed the following transaction for the year :

(*i*)	Miscellaneous Business Expenses (of which Rs. 5,000 was out-standing on March 31, 2006)	Rs. 1,80,000 (including Rs. 35,000) paid by cheque)
(*ii*)	Repairs	Rs. 2,500 (paid by cash)
(*iii*)	Addition to Machinery	Rs. 50,000 (paid by cheque)
(*iv*)	Private drawings	Rs. 36,000 (paid by cash)
(*v*)	Travelling expenses	Rs. 12,000 (paid by cash)

(6) Collection from debtors (including Rs. 30,000 for cash) and payments to creditors were prompt all along.

(7) Depreciation is to be provided on machinery @ 10% on the closing book value.

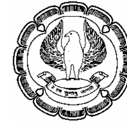
(8) The cash stolen is to be provided in the Profit & Loss Account.

Prepare Trading, Profit & Loss Account for the year ended 31st March, 2006 and a balance sheet as at that date.

SOLUTION

Trading and Profit & Loss Account of Mr. Ram Chand
for the year ending 31st March, 2006

	Rs.		Rs.
To Opening Stock	35,000	By Sales	8,10,000
To Purchases	5,40,000	By Closing Stock	35,000
To Gross Profit c/d	2,70,000		---------
	8,45,000		8,45,000
To Business expenses	1,80,000	By Gross Profit b/d	2,70,000
To Repairs	2,500		
To Depreciation	9,000		
To Travelling expenses	12,000		
To Loss by theft	7,500		



To Net Profit		59,000		----------
		2,70,000		2,70,000

Balance Sheet of Mr. Ram Chand as on 31st March, 2006

Liabilities	*Rs.*	*Rs.*	*Assets*		*Rs.*
Capital	1,62,000		Machinery	90,000	
Add : Net Profit	59,000		*Less :* Depreciation	9,000	
	2,21,000				81,000
Less : Loss of			Current Assets :		
Furniture	10,000		Stock in trade		35,000
	2,11,000		Sundry Debtors		1,08,000
Less : Drawings	36,000	1,75,000			
Sundry Creditors		45,000	Cash at Bank		1,000
Outstanding Expenses		5,000			----------
		2,25,000			2,25,000

WORKING NOTES :

(*1*)	Sales during 2005-2006		
	Sales in 2004-2005	Rs.	
	Books debts as on March 31, 2005 (being equal to two months' sales)	90,000	
	Total Credit Sales in 2004-2005, 90,000 × 6	5,40,000	
	Cash sales, being 1/4 of Credit Sales (or 1/5 of total)	1,35,000	
	Sales for 2004-2005		6,75,000
	Increase, 20% as stated in the problem		1,35,000
	Total sales during 2005-2006		8,10,000
	Cash sales : 1/5		1,62,000
	Credit sales : 4/5		6,48,000
(2)	Book Debts equal to two months credit sale		1,08,000
(3)	Purchases : Sale in 2005-2006		8,10,000
	Gross profit @ 33 1/3%		2,70,000

	Cost of goods sold, being purchases since there in so change in stock levels	5,40,000
(4)	Sundry Creditors for goods: 5,40,000/12	45,000
(5)	Collections from Debtors : Opening Balance	90,000
	Credit Sales	6,48,000
		7,38,000
	Less : Closing Balance	1,08,000
		6,30,000
(5)	Payment to Creditors: Opening Balance	30,000
	Purchases	5,40,000
		5,70,000
	Less : Closing balance	45,000
		5,25,000

(6) **Cash Book**

		Cash	*Bank*			*Cash*	*Bank*
		Rs.	*Rs.*			*Rs.*	*Rs.*
To	Opening Balance	6,000	11,000	By	Payment to Creditors		5,25,000
To	Collection from debtors	30,000	6,00,000	"	Misc. Exps.	1,40,000	35,000
To	Cash Sales	1,62,000		"	Repairs	2,500	
				"	Addition to Machinery		50,000
					Travelling Expenses	12,000	
				"	Private Drawings	36,000	
					Balance c/d	7,500*	1,000
		1,98,000	6,11,000			1,98,000	6,11,000

* Cash stolen by the Cashier was Rs. 7,500.

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 socities.
   (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 1-1-2005 when he started his business. He closed his accounts on 31st March, 2006. His single entry books (in which he did not maintain any account for the bank) showed his position as follows:

	31-3-2005	*31-3-2006*
Cash in hand	2,200	3,300
Stock in trade	20,900	31,900
Debtors	1,100	2,200
Creditors	5,500	3,300

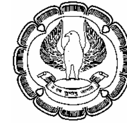
On and from 1-2-2005, he began drawing Rs. 770 per month for his personal expenses from the Cash Box of the business.

His account with the bank had the following entries :

	Deposits	*Withdrawals*
	Rs.	*Rs.*
1-1-2005	3,30,000	-
1-1-2005 to 31-3-2005	-	2,45,300
1-4-2005 to 31-3-2006	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 1-1-2005 to 31-3-2005 and from 1-4-2005 to 31-3-2005 for the purchase of machinery for the business. The deposits after 1-1-2005 consisted wholly of sale price received from the customers by cheques.

Draw up Mr. Ramesh's statement of affairs as at 31-3-2005 and 31-3-2006 respectively and work out his profit or loss for the year ended 31-3-2006.



11. Mr. Raja had Rs. 6,00,000 in bank on 1st January, 2005 when he started his business. He closed his accounts on 31st March, 2006. His single entry books (in which he did not maintain any account for the bank) showed his position as follows :

	31-3-2005	*31-3-2006*
	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, 2005 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.*
1-1-2005	6,00,000	-
1-1-2005 to 31-3-2006	-	4,46,000
1-4-2005 to 31-3-2006	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 1-1-2005 to 31-3-05 and from 1-4-2005 to 31-3-2006 for the purchases of Machinery and Furniture and Fittings respectively and the Deposits after 1st January, 2005 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 31-3-2005 and 1-3-2006 respectively and work out his profits for the year ended 31-3-2006.

12. From the following information determine credit sales :

	Rs.
Sundry debtors as on 1-1-2006	1,20,000
Sundry Debtors as on 31-12-2006	1,70,000
Bills Receivable as on 31-12-2006	50,000

Bills accepted by customers during 2006	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, 2005. You are required to prepare a Trading and Profit and Loss Account for the year ended, and a Balance Sheet as at 31st December, 2005. 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, 2005*	*31st December, 2005*
	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 2006 :

	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 2006 :

	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 31-12-2005.

	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.	
Cheque for tax	30,000
Cheque for electricity, telephone and rent	54,000

(IV) CASH PAYMENTS :

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, 2006 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 31-12-2006 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 31-12-2006.

17. A and B started a business on January 1, 2004 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:

	31-12-2004	31-12-2005
	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 31-12-2004 include Rs. 5,000 for goods sent out on consignment at 25 per cent above cost, and the goods were sold only in 2005. A cheque for Rs. 1,000 had been deposited on 31-12-2004 but was credited on 2-1-2005.

A cheque for Rs. 2,000 issued on 26-12-2005 was presented on 3-1-2006. A cheque for Rs. 1,000 was directly deposited by a customer on 27-12-2005 but no entry is made either in Pass book or in Cash Book. A cheque for Rs. 500 deposited in December, 2005, was dishonored but no adjustment for this was made.

Determine the profit for 2005 and draw up a Balance Sheet as at 31 December, 2005.

18. Mr. Ashok gives the following information.

(1) OPENING AND CLOSING BALANCES

	31-12-2004	*31-12-2005*
	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., 2004 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., 2005.

	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., 2005	30,000

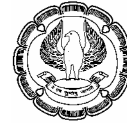
2. Weekly expenditure (52 weeks) defrayed from cash receipts before banking :

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., 2005 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., 2005 were for

   Inland Transport Ltd. 8,000

5. Debtors for air and rail tickets on 31st Dec., 2005 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, 2005 and a Balance Sheet as on 31st December, 2005.

20. A and B entered into partnership contributing Rs. 20,000 and Rs,. 30,000 capital on 1st Jan., 2005. On 1st July, 2005 C was admitted to the firm on payment of Rs. 25,000 as capital and on 1st January 2006, 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 2005	*31st Dec. 2005*	*30th June 2006*	*31 Dec. 2006*
	Rs.	*Rs.*	*Rs.*	*Rs.*
Collection from Debtors on sales made in six months period ended				
June 30, 2005	36,600	6,200	4,100	2,500
Dec. 31, 2005		1,24,200	34,500	8,200
June 30, 2006			1,92,500	53,900
Dec. 31, 2006				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., 2006 by period of origin were :

Sales made during 6 months ended

Jan 30, 2005	*Dec. 31,2005*	*Jan. 30,2006*	*Dec. 31,2006*
Rs	*Rs.*	*Rs.*	*Rs.*
1,600	3,100	8,600	26,700

Closing stock on 31st Dec., 2006, 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 10

ACCOUNTING FOR SPECIAL TRANSACTIONS

UNIT - 1 : HIRE PURCHASE AND INSTALMENT SALE TRANSACTIONS

Learning Objectives

After studying this unit, 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.

1.1 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.

1.2 NATURE OF HIRE PURCHASE AGREEMENT

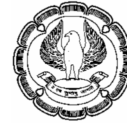
Under the Hire Purchase System the Hire Purchaser gets possession of the goods at the outset and can use it, while paying for it in instalments over a specified period of time as per the agreement. However, the ownership of the goods remains with the Hire Vendor until the hire purchaser has paid all 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.

1.3 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.

1.4 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.

1.4.1 In the books of Hire purchaser

1.4.1.1. 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 :

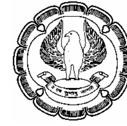
Profit and Loss A/c Dr.

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, 2003 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, 2003 to December 31, 2005; and

(b) Show the relevant items in the Balance sheet of the purchaser as on December 31, 2003 to 2005.

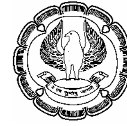
Solution

In the books of HP & Co.

Journal

Date	Particulars		L.F	*Dr.* *Rs.*	*Cr.* *Rs.*
2003	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

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
	(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)			
2004	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)			



2005	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.
1.1.2003	To	FM & Co. Ltd. A/c	1,00,000	31.12.2003	By Depreciation A/c	10,000
				31.12.2003	By Balance C/D	90,000
			1,00,000			1,00,000
1.1.2004	To	Balance b/d	90,000	31.12.2004	By Depreciation A/c	10,000
				31.12.2004	By Balance c/d	80,000
			90,000			90,000
1.1.2005	To	Balance b/d	80,000	31.12.2005	By Depreciation A/c	10,000
				31.12.2005	By Balanced A/c	70,000
			80,000			80,000

Dr. **FM & Co. Ltd. Account** *Cr.*

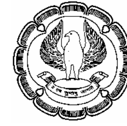
Date		Particulars	Rs.	Date	Particulars	Rs.
1.1.2003	To	Bank A/c	40,000	1.1.2003	By Pick-up Van A/c	1,00,000
31.12.2003	To	Bank A/c	23,600		By Interest c/d	3,600
31.12.2003	To	Balance c/d	40,000			
			1,03,600			1,03,600
31.12.2004	To	Bank A/c	22,400	1.1.2004	By Balance b/d	40,000
31.12.2004	To	Balance c/d	20,000	31.12.2004	By Interest A/c	2,400
			42,400			42,400
31.12.2005	To	Bank A/c	21,200	1.1.2005	By Balance b/d	20,000
				31.12.2005	By Interest A/c	1,200
			21,200			21,200

Dr. **Depreciation Account** *Cr.*

Date		Particulars	Rs.	Date	Particulars	Rs.
31.12.2003	To	Pick-up Van A/c	10,000	31.12.2003	By Profit & Loss A/c	10,000
31.12.2004	To	Pick-up Van A/c	10,000	31.12.2004	By Profit & Loss A/c	10,000
31.12.2005	To	Pick-up Van A/c	10,000		By Profit & Loss A/c	10,000

Dr. **Interest Account** *Cr.*

Date		Particulars	Rs.	Date	Particulars	Rs.
31.12.2003	To	FM & Co. Ltd. A/c	3,600	31.12.2003	By Profit & Loss A/c	3,600
31.12.2004	To	FM & Co. Ltd. A/c	2,400	31.12.2004	By Profit & Loss A/c	2,400
31.12.2005	To	FM & Co. Ltd. A/c	1,200	31.12.2005	By Profit & Loss A/c	1,200



Balance Sheet of Gopinath & Co. as at 31st December, 2003

Liabilities	*Rs.*	*Assets*	*Rs.*
FM & Co. Ltd.	40,000	Pick-up Van	90,000

Balance Sheet of Gopinath & Co. as at 31st December, 2004

Liabilities	*Rs.*	*Assets*	*Rs.*
FM & Co. Ltd.	20,000	Pick-up Van	80,000

Balance Sheet of Gopinath & Co. as at 31st December, 2005

Liabilities	*Rs.*	*Assets*	*Rs.*
FM & Co. Ltd.	20,000	Pick-up Van	70,000

1.4.1.2 Interest suspense method: Under this method, at the time of transfer of possession of asset, the total interest unaccrued is transferred to interest suspense A/c. At latter years, as and when interest becomes due, interest A/c is debited and interest suspense A/c 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:

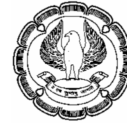
Solution

H.P. INTEREST SUSPENSE ACCOUNT

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
1.1.2003	To FM & CO. Ltd. A/c (Note 1)	7,200	31.12.2003	By Interest A/c	3,600
			31.12.2003	By Balance c/d	3,600
		7,200			7,200
1.1.2004	To Balance b/d	3,600	31.12.2004	By Interest A/c	2,400
			31.12.2004	By Balance c/d	1,200
		3,600			3,600
1.1.2005	To Balance b/d	1,200		By Interest A/c	1,200

Dr. **INTEREST ACCOUNT** *Cr.*

Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
31.12.2003	To H.P. Interest Suspense a/c	3,600	31.12.2003	By Profit & Loss A/c	3,600
31.12.2004	To H.P. Interest Suspense a/c	2,400	31.12.2004	By Profit & Loss A/c	2,400
31.12.2005	To H.P. Interest Suspense a/c	1,200	31.12.2005	By Profit & Loss A/c	1,200



Dr.		FM & Co. Ltd. Account			*Cr.*
Date	*Particulars*	*Rs.*	*Date*	*Particulars*	*Rs.*
1.1.2003	To Bank A/c	40,000	1.1.2003	By Pick-up Van a/c	1,00,000
31.12.2003	To Bank a/c	23,600	1.1.2003	By H.P. Interest Suspense A/c	7,200
31.12.2003	To Balance c/d	43,600			
		1,07,200			1,07,200
31.12.2004	To Bank a/c	22,400	1.1.2004	By Balance b/d	43,600
31.12.2004	To Balance c/d	21,200			
		43,600			43,600
31.12.2005	To Bank A/c	21,200	1.1.2005	By Balance b/d	21,200

Balance Sheet of HP & Co. Ltd. as at 31st December, 2003

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, 2004

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, 2005

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.

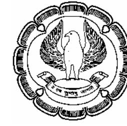
1.4.2 Books of the Hire Vendor : There are different methods of recording hire purchase transactions in the books of the hire vendor. It is selected according to the type and value of

goods sold, volume of transactions, the length of the period of purchase, etc. The different methods are discussed below:

1.4.2.1 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		
	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.

1.4.2.2 Interest Suspense Method : This method is almost similar to the sales method, excepting 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	*Less :* Balance in Interest
Less : Depreciation	suspense A/c

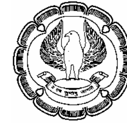
Illustration 3

X Ltd. purchased 3 milk vans from Super Motors costing Rs. 75,000 each on hire purchase system. Payment was to be made : Rs. 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.

		Rs.	*Rs.*
I Year			
Milk Vans purchased : Milk Vans A/c	Dr.	2,25,000	
To Vendor A/c			2,25,000



Particulars		Dr. (Rs.)	Cr. (Rs.)
On down payment :Vendor A/c	Dr.	45,000	
To Bank			45,000
I Year end			
Interest Due 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 due 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

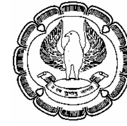
Vendor A/c	Dr.	57,300	
To Bank			57,300

Milk Vans Account

Year		*Rs.*	*Year*		*Rs.*
1	To Super Motors A/c	2,25,000	1 end	By Depreciation A/c	45,000
			″	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
				″ Supper 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% on Rs. 1,80,000	16,200
	″ Balance c/d	1,20,000			
		2,41,200			2,41,200
2	To Milk Van A/c	73,500	2	By Balance b/d	1,20,000



	" 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, 2004.*	*1st Oct., 2004*
	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, 2005 Tractor B was completely destroyed by fire. In full settlement, on 10th July, 2005 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, 2004 and 31st December, 2005 :

(a) Tractors on hire purchase.

(b) Provision for depreciation of tractors.

(c) Disposal of tractors.

(d) Hire purchase company.

Solution

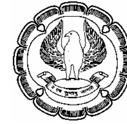
Hire Purchase accounts in the buyer's books

(a) Tractors on Hire Purchase A/c

					Rs.						Rs.
2004					*Rs.*	*2004*					*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
2005					*Rs.*	*2005*					*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
2006											
Jan.	1	To Balance b/d			14,000						

(b) Provision for Depreciation of Tractors A/c

2004			*Rs.*	*2004*					*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
2005			*Rs.*	*2005*					*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
				2006					Rs.
				Jan. 1		By Balance b/d			4,900



(c) **Disposal of Tractor A/c**

2005			Rs.	2005			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

2004			Rs.	2004			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 instal-ments @ 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 instal-ments @ Rs. 600 for Tractor A	1,800				
	"	Cash—3 instal-ments @ Rs. 800	2,400				
Dec. 31	"	Balance c/d	21,780				
			34,260				34,260
2005			Rs.	2005			Rs.
Jan. June	To	Cash—6 instalments @ Rs. 600 for Tractor A	3,600	Jan. 1	By	Balance b/d	21,780
	"	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 - finally instalment for Tractor B	10,000	Dec.31	"	Interest - for Tractor A @ Rs. 100 for 12 months	1,200
July- Dec.	"	Cash - 6 instalments @ Rs. 600 for Tractor A	3,600				
	"	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.

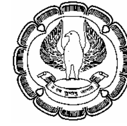
Solution

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 credit to Hire Vendor A/c with consequential changes.

Working Notes :

	Instalment Amount	*Interest*	*Principal*
4th Instalment	6,000	Rs.	Rs.
Interest $\frac{20}{120}$	1,000	1,000	5,000
	5,000		
Add : 3rd Instalment	6,000		
	11,000		
Interest $\frac{20}{120}$	1,833	1,833	4,167
	9,167		
Add : 2nd Instalment	6,000		
	15,167		
Interest $\frac{20}{120}$	2,528	2,528	3,472
	12,639		
Add : Ist Instalment	6,000		
	18,639		
Interest $\frac{20}{120}$	3,106	3,106	2,894
	15,533	8,467	15,533

Illustration 6

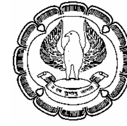
X Transport Ltd. purchased from Delhi Motors 3 Tempos costing Rs. 50,000 each on the hire purchase system on 1-1-2004. Payment was to be made Rs. 30,000 down and the remainder in 3 equal annual instalments payable on 31-12-2004, 31-12-2005 and 31-12-99 together with interest @ 9%. X Transport Ltd. write 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. 31-12-2004 but could not pay the next on 31-12-2005. Delhi Motors agreed to leave one Tempo with the purchaser on 1-1-2006 adjusting the value of the other 2 Tempos against the amount due on 31-12-2005. 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 2004, 2005 and 2006.

Solution

X Transport Ltd.

Tempo Account

Dr.							*Cr.*
2004			*Rs.*	*2004*			*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
2005				2005			
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
2006				2006			
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

				Rs.					Rs.
2004				*Rs.*	*2004*				*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
2005					2005				
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
2006				Rs.	2006				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

				Rs.					Rs.
2004				*Rs.*	*2004*				*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
2005				*Rs.*	*2005*				*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
2006				*Rs.*	*2006*				*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

2004				*Rs.*	*2004*				*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
2005				*Rs.*	*2005*				*Rs.*
Dec.	31	To	Balance c/d	38,200	Dec.	31	By	Tempos A/c	38,200
2006					2006				
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 :*

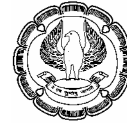
	Rs.
Cost	50,000
Depreciation @ 20% p.a. under WDV method for 2 years i.e. Rs. 10,000 + Rs. 8,000	18,000
Value of the Tempo left with the buyer at the end of 2nd year	32,000

(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 + 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) 2005 - 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
				749				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

$$\frac{\text{Rs.}16{,}800 \times \text{Rs.}1{,}800}{12} \times 749 = \text{Rs. } 9{,}36{,}250$$

Amount not yet due

$$\frac{\text{Rs.}16{,}800 \times \text{Rs.}1{,}800}{12} \times 1{,}051 = \text{Rs. } 13{,}13{,}750$$

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.

Goods lying with Hire Purchaser at Hire Purchase Price $\times \frac{\text{Cost}}{\text{Hire Purchase Price}}$

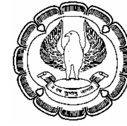
Stock at cost $= \text{Rs.}13{,}13{,}750 \times \frac{\text{Rs.}14{,}000}{\text{Rs.}16{,}800}$

= 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.

1.5. 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. 2005, instalments not yet due	5,400
Goods sold on hire purchase during 2005	25,500
Cash received from customers during 2005	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., 2005

Dr.					Cr.
		Rs.			Rs.
To	Stock with Customers on 1-1-2005 - hire purchase price	5,400	By	Cash	20,100
"	Goods sold on Hire-purchase A/c	25,500	"	Instalments due	1,800
"	Stock Reserve required	3000	"	Goods sold on Hire Purchase A/c - loading	8,500
"	Profit & Loss A/c	7,300	"	Stock Reserve (Opening)	1,800
			"	Stock with customers at hire	9,000*
		41,200			41,200

***Stock with Customers on 31-12-98 :**

			Rs.
Instalment not due on 1-1-2005			5,400
Goods sold on H.P.			25,500
			30,900
Less :	Cash received	20,100	
	Instalments due	1,800	21,900
			9,000

1.6 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.

1.7 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 a nd from the 2nd instalment to the 1st instalment.

We known 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:

$$\text{Ratiio of int erest and amount due} = \frac{\text{Rate of int erest}}{100 + \text{Rate of int erest}}$$

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 instep 1)

Step 3: Subtract the interest (as calculated instep 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 instep 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 hirepurchase 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 secondyearandRs.55,000 at theendof third year. Interest is charged @ 10% p.a.

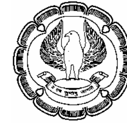
You are required to calculate the total cash price of the truck and the interest paid with each instalment.

Solution

(1) Ratio of interest and amount due = $\frac{\text{Rate of interest}}{100 + \text{Rate of interest}} = \frac{10}{110} = 1/11$

(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 ofRs.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.

1.8 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 adown 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.

1.8.1 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.

1.8.2 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.

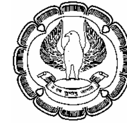
1.9 REPOSSESSION

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".

1.9.1 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.



1.9.1.1 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 To Hire Purchaser Account	 Dr.
3.	When repairing and reconditioning expenses are paid Goods Repossessed Account To Bank/Cash Account	 Dr.
4.	When repossessed goods aresold Bank/Cash Account To Goods Repossessed Account	 Dr.

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

1.9.1.2 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 To Assets Account	 Dr.
4.	When the asset account is closed Profit and Loss Account 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.	 Dr.

1.9.2 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 Calcutta Traders who sell goods on hire purchase basis at cost plus 25%.

	Rs.
Instalments not due on 31-12-2004	3,00,000
Instalments due and collected during 2005	8,00,000
Instalments due but not collected during 2005	

including Rs. 10,000 for which goods were repossessed	50,000
Instalments not due on 31-12-2005 including Rs. 20,000 for which goods were repossessed	3,70,000
Instalments collected on repossessed stock	15,000

M/s Calcutta Traders valued repossessed stock at 60% of original cost.

Solution

Working Notes :

(1) Hire Purchase Sales :

	Rs.
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 $\text{Rs. } 36,000 \times \frac{60}{10}$	21,600
Cost of instalments due + Instalments not yet due	
$(\text{Rs.} 10,000 + 20,000) \times \frac{10}{12}$	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 31-12-2005 at cost	

$\left[Rs.\ 3,50,000 \times \frac{100}{125}\right]$	2,80,000
	9,60,000
Less : Stock with customers 31-12-2004 at Cost	2,40,000
$\left[Rs.\ 3,00,000 \times \frac{100}{125}\right]$	7,20,000

(4) Bad Debt :

Instalment due but not collected	10,000
Instalment not yet due at cost	
$\left[Rs.\ 20,000 \times \frac{100}{125}\right]$	16,000
	26,000
Less: Cost of instalments due and instalments not yet due	24,000
	2,000

Hire Purchase Trading A/c

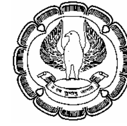
		Rs.			*Rs.*
To	Goods with customers at cost (31-12-2004)	2,40,000	By	Hire Purchase Sale	8,50,000
″	Shop Stock	7,20,000	″	Goods with customers at cost (31-12-2005)	2,80,000
″	Bad Debt	2,000			
″	Loss on Repossession	2,400			
″	Profit & Loss A/c Transfer of H.P. Profit	1,65,600			
		11,30,000			11,30,000

1.10 STOCK AND DEBTORS SYSTEM

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 Adj. 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 Adj. A/c

(v) Stock Reserve on closing Stock

Hire Purchase Adj. 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 2005. The relevant information is as follows :

	Television set	*Room coolers*
	Rs.	*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

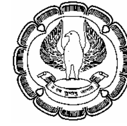
		Rs.			*Rs.*
To	Goods sold on H.P.	10,26,000	By	H.P. Debtors A/c	4,05,600
			″	Goods Repossessed A/c (Instalments not due on repossessed goods)	14,000
			″	Balance c/d (Instalment not yet due)	6,06,400
		10,26,000			10,26,000

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



		Rs.			Rs.
			"	Balance c/d	10,000
		14,000			14,000
To	Balance b/d	10,000	"	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 Purchase (Loading)	2,46,000
"	Stock Reserve	1,44,971	"	Goods Repossessed (Profit on sale)	3,000
"	Profit	1,00,029			
		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	

	Rs.
(*iii*) Instalment not yet due:	
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

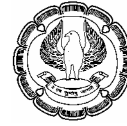
Amount of 962 instalments @ Rs. 200 each = Rs. 1,92,400

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.



		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 2005, prepare Hire Purchase Stock Account, Shop Stock Account, Hire Purchase Debtors Account, Stock Reserve Account and Hire Purchase Adjustment Account (for profit) :

2005		*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

2005			*Rs.*	*2005*			*Rs.*
Jan. 1	To	Balance b/d	9,000	Jan. 1	By	Bank A/c	2,40,000
	"	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

2005			*Rs.*	*2005*			*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

			Rs.			Rs.
"	"	H.P., Adj. A/c (25%)	66,000			
			3,84,000			3,84,000

Shop Stock Account

2005			Rs.	2005		Rs.
Jan. 1	To	Balance b/d	15,000	By	H.P. Stock A/c	
	"	Purchases A/c			(Cost of Goods sold)	1,98,000
		(Balancing fig.)	2,04,000	"	Balance c/d	21,000
			2,19,000			2,19,000

Stock Reserve Account

2005		Rs.	2005		Rs.
To	Hire Purchase Adj.		By	Balance b/d	
	(transfer)	30,000		(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

2005			Rs.	2005		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

1.11 HIRE PURCHASE AGREEMENTS 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 are 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 Agree-ment	Name of Customer	Name of Article	Cost Price	H.P. Price	Down Payment	No. of install-ments	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.

1.12 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.

1.12.1 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	

1.12.1 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

1.13 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	

1.14 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.

1.15 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, 2005. During the year ended 31st March, 2006, 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, 2006 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.

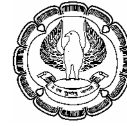
Solution

In the books of Krishna Agencies
Hire-Purchase Trading Account
for the year ended 31st March, 2006

	Rs.	Rs.		Rs.	Rs.
To Goods sold on H.P. A/c:			By Bank A/c cash received		
TVs (60×Rs. 30,000)	18,00,000		TVs (1,000×Rs. 1,000)	10,00,000	
Washing Machines (40 × Rs. 22,500)	9,00,000	27,00,000	Washing Machines (800 ×Rs. 750)	6,00,000	16,00,000
To H.P. Stock Reserve Rs. 9,90,000× $\frac{87.5}{187.5}$		4,62,000	By Instalment Due A/c: 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, 2006

	Rs.	Rs.		Rs.	Rs.
To Purchases:			By Sales:		
TVs (90×Rs. 16,000)	14,40,000		TVs (20×Rs. 20,000)	4,00,000	
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 (27,00,000–12,60,000)	14,40,000
		By Shop Stock (W. N 3)	2,80,000
	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, 2006 :

Product	Total No. of Instalments (Nos.)	Instalments Due in 2005-2006 (Nos.)	Instalments not due in 2005-2006 (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, 2006 :

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

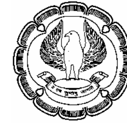
Illustration 15

A acquired on 1st January, 2006 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, 2006. 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 2005 ascertain the profit or loss on the hire purchase transactions.

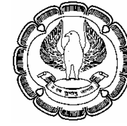
	(*Rs.*)
Instalments due, customers paying on Jan. 1, 2005	2,000
Instalments not yet due	25,000
Goods sold during the year on H.P. basis, cost	60,000
Cash received from H.P. Customers	90,000
nstalments Due on 31st Dec. 2005, customers paying	3,000

10. A refrigerator costing Rs. 2,000 is sold on 1st April, 2005 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 2005? 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, 2005 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, 2006.

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.

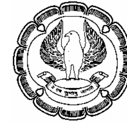
    Also explain the adjustment, if any, that you will make in the amount of interest to be credited to the profit and loss account of each year assuming that the accounts are closed each year on the 31st March on the consideration that refrigerator are sold only during the months of April to September.

16. Rama & Co. deal in refrigerators and radios. During the year ended 31st December 2005, 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	*Number of units sold*	*Total number of instalments sold*	*Number of instalments that fell due*	*Instalments collected*	*Instalments not due*
Refrigerators	5	125	30	25	95
Radios5	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 2005.



UNIT – 2 : INVESTMENT ACCOUNTS

Learning Objectives

After studying this unit, 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.

2.1 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'.

2.2 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.

2.3 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 accuring from the date of last payment to the date of purchase is entered in the Income Column.

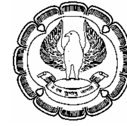
Debit : balance *i.e.*, Purchase Price - Interest Accrued, in the Capital Column.

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.

2.4 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).

2.5 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 1.4.2006, Sundar had 25,000 equity shares of 'X' Ltd.at a book value of Rs. 15 per share (Face value Rs.10). On 20.6.2006, 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 tems of the issue are as follows:

Bonus basis 1:6 (Date 16.8.2006).

Rights basis 3:7 (Date 31.8.2006) Price Rs. 15 per share.

Due date for payment 30.9.2006.

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 31.3.2006 at the rate of 20% were declared by X Ltd. and received by Sundar on 31.10.2006. Dividends for shares acquired by him on 20.6.2006 are to be adjusted against the cost of purchase.

On 15.11.2006, 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 31.12.2006 and shares are valued at average cost.

Solution

Books of Sundar

Investment Account

Equity Shares in X Ltd.

		No.	*Amount Rs.*			*No.*	*Amount Rs.*
1.4.2006	To Bal b/d	25,000	3,75,000	30.9.2006	By Bank (Sale of Rights)		10,000
20.6.2006	To Bank	5,000	80,000				
16.8.2006	To Bonus	5,000	—	31.10.2006	By Bank (dividend on shares acquired on 20/6/2006)		10,000
30.9.2006	To Bank (Rights Shares)	10,000	1,50,000				
				15.11.2006	By Bank (Sale of shares)	25,000	3,75,000
15.11.2006	To Profit ts/f		50,000	31.12.2006	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 20.6.2006 = 5,000×10×20% = Rs.10,000 is adjusted to Investment A/c

(5) Cost of shares on 31.12.2006

$$\frac{(3,75,000+80,000+1,50,000-10,000-10,000)}{45,000} \times 20,000 \quad = Rs. 2,60,000$$

Illustration 2

On 1.4.2005, 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 31.1.2006 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 31.3.2006 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, 2006

(Scrip: Equity Shares of TELCO Ltd.)

Dr.									*Cr.*
Date		*Particulars*	*Nominal Value (Rs.)*	*Cost (Rs.)*	*Date*		*Particulars*	*Nominal Value (Rs.)*	*Cost (Rs.)*
1.4.2005	To	Bank A/c	1,00,000	1,23,000	31.3.2006	By	Bank A/c	50,000	44,100
31.1.2006	To	Bonus shares	50,000	–	31.3.2006	By	Balance c/d	1,00,000	82,000
31.3.2006	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 1.4.2005 = 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, 2006 = 500 × Rs. 90 – 2% of Rs. 45,000 = Rs. 44,100.

(iii)Profit on sale of bonus shares on 31st March, 2006

= 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, 2003

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 $\frac{500}{1000} \times 62,500$ = Rs. 31,250

Cost being lower than the market price, shares are carried forward at cost.

Illustration 4

On 1st January 2006, 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 2006, Singh purchased 5,000 more equity shares in the company at a premium of Rs. 4 per share.

On 30th June, 2006, 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, 2006.

The terms of the rights issue were :

(*a*)Rights shares to be issued to the existing holders on 10th August, 2006.

(*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, 2006.

(*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, 2006, at the rate of 15% were declared by the Company and received by Singh on 20th October, 2006.

(*f*)On 1st November, 2006, Singh sold 20,000 equity shares at a premium of Rs. 3 per share.

The market price of share on 31-12-2006 was Rs. 13. Show the Investment Account as it would appear in Singh's books on 31-12-2006 and the value of shares held on that date.

Solution

Investment Account-Equity Shares in X Ltd.

Date		*No.*	*Income Rs.*	*Amount Rs.*	*Date*		*No.*	*Income Rs.*	*Amount Rs.*
2006					2006				
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. 2	To Bonus Issue	5,000		—	Nov. 1	By Bank	20,000		2,60,000
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 Divd. 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					

		Rs.
Note:	Cost of shares sold — Amount paid for 35,000 shares	
	(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) Al of the above..

{ Ans. 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.

UNIT –3 : DEPARTMENTAL ACCOUNTS

Learning Objectives

After studying this unit, you will be able to

- Allocate common expenditures of the organization among various departments on appropriate basis.
- Deal with the inter-departmental transfers and their accounting treatment.
- Calculate the amount of unrealized profit on unsold inter-departmental stock-in-hand at the end of the accounting year.
- Work on problems based on inter-departmental transfers at profit and calculation of unrealized profit on the remaining stock at the end of the accounting year.

3.1 INTRODUCTION

If a business consists of several independent activities, or is divided into several departments, for carrying on separate functions, its management is usually interested in finding out the working results of each department to ascertain their relative efficiencies. This can be made possible only if departmental accounts are prepared. Departmental accounts are of great help and assistance to the managements as an information for controlling the business more intelligently and effectively, since thereby all types of waste either of material or of money are readily detected; also attention is drawn to inadequacies or inefficiencies in the working of departments or units into which the business may be divided.

To prepare such accounts, it will be necessary first, for the income and expenditure of department to be separately recorded in subsidiary books and then for them to be accumulated under separate heads in a ledger or ledgers. This may be done by having columnar subsidiary books and a columnar ledger. Alternatively, a separate set of books may be kept for each department, including complete stock accounts of goods received from or transferred to other departments or as also sales. Even when separate sets of books are maintained for different departments, it will also be necessary to devise a basis for allocation of common expenses among the different departments.

3.2 BASIS OF ALLOCATION OF COMMON EXPENDITURE AMONG DIFFERENT DEPARTMENTS

(1) Expenses incurred specially for each department are charged directly thereto, *e.g.,* insurance charges of stock held by a department.

(2) Common expenses, the benefit of which is shared by all the departments and which are capable of precise allocation, (*e.g.,* rent, lighting expenses etc.) are distributed among the departments concerned on some equitable basis considered suitable in the circumstances of the case. Rent is charged to different departments according to the floor area occupied by each department, having regard to any favourable location specially allocated to a department. Lighting and heating expenses are distributed on the basis of consumption of energy by each department and so on.

(3) Common expenses which are not capable of accurate measurement are dealt with as follows:

   (i) Selling expenses, *e.g.,* discount, bad debts, selling commission, etc. are charged on the basis of sales.

   (ii) Administrative and other expenses, *e.g.,* salaries of mangers, directors, common advertisement expenses, depreciation on assets, etc. are allocated equally among all the departments that have benefited thereby. *Alternatively,* no allocation may be made and such expenses may be charged to the combined Profit and Loss Account.

3.3 INTER-DEPARTMENTAL TRANSFERS

Whenever goods or services are provided by one department to another, their cost should be separately recorded and charged to the department benefiting thereby and credited to that providing it. The totals of such benefits should be disclosed in the departmental Profit and Loss Accounts, to distinguish them from other items of expenditure. Goods and services may be charged by one department to another usually on either of the following three bases: (*i*) Cost, (*ii*) Ruling market price, (*iii*) Cost *plus* agreed percentage of profit. When profit is added in the inter-departmental transfers the loading included in the unsold stock at the end of the year is to be excluded before final accounts are prepared so as to eliminate any anticipatory profit included therein. This is done by creating an appropriate stock reserve by debiting the combined Profit and Loss Account.

Illustration 1

Messrs D, B and R carried on a business of Drapers and Tailors in Delhi; D was incharge of Department "A" dealing in cloth, B of department "B" for selling garments and R of Department "C" the tailoring section. It had been agreed that each of the three partners would receive 75% of the profits disclosed by the accounts of the department of which he was in charge and the balance of the profits would be shared in the proportion : D 1/2, B 1/4, and R 1/4. The following is the Trading and Profit and Loss Account of the firm for the six months ended March 31, 2006.

Dr.	Trading and Profit and Loss Account				*Cr.*
	Rs.	*Rs.*		*Rs.*	*Rs.*
To Opening Stock :			By Sales :		
Cloth (A)	37,890		Cloth (A)	1,80,000	
Ready-made Garments (B)	24,000		Ready-made Garments (B)	1,30,000	
Tailoring Jobs (C)	20,000	81,890	Tailoring Jobs (C)	90,000	4,00,000
To Purchase :			By Discount received		800
Cloth (A)	1,40,700		By Closing Stock:		
Ready-made Garments (B)	80,600		By Cloth (A)	45,100	
Tailoring Goods (C)	44,400	2,65,700	Ready-made Garments (B)	22,300	
To Salaries and Wages		48,000	Tailoring Jobs (C) [including Rs. 5,700 for goods transferred from department (A)]	21,600	89,000
To Advertising		2,400			
To Rent		10,800			
To Discount allowed		1,200			
To Sundry Exp.		12,000			
To Depreciation on Furniture and Fittings		750			
Net Profit		67,060			
		4,89,800			4,89,800

After consideration of the following, prepare Departmental Accounts and Profit and Loss Appropriation Account :

(i) Cloth of the value of Rs. 10,700 and other goods of the value of Rs. 600 were transferred at selling price by Departments A and B respectively to Department C.

(ii) Cloth and garments are sold in the show-room. Tailoring work is carried out in the workshop.

(iii) The details of salaries and wages were as follows:

(a) General Office 50%, show-room 25% and 25% for workshop, which is for tailoring.

(b) Allocate General Office Expenses, in the proportion of 3:2:1 among the Departments A, B, C.

(c) Distribute show-room expenses in the proportion of 1:2 between Departments A and B.

(iv) The workshop rent is Rs. 1,000 per month. The rent of the General Office and Show room is to be divided equally between Departments A and B.

(v) Depreciation charges are to be allocated equally amongst the three Departments.

(vi) All other expenses are to be allocated on the basis of turnover.

(vii) Discounts received are to be credited to the three Departments as follows: A: Rs. 400; B: Rs. 250; C: Rs. 150.

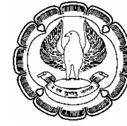
(viii) The opening stock of Department C does not include any goods transferred from Department A.

Solution

M/s D, B and R

Departmental Trading and Profit & Loss Account for the six months ended 31-3-2006

Dr.	*A*	*B*	*C*	*Total*	*Cr.*	*A*	*B*	*C*	*Total*
To Opening Stock	37,890	24,000	20,000	81,890	By Sales	1,80,000	1,30,000	90,000	4,00,000
To Purchases	1,40,700	80,600	44,400	2,65,700	By Transfer	10,700	600	-	11,300
To Transfer	–	-	11,300	11,300	By Closing				
To Wages	–	-	12,000	12,000	Stock	45,100	22,300	21,600	89,000
To Gross profit c/d	57,210	48,300	23,900	1,29,410					
	2,35,800	1,52,900	1,11,600	5,00,300		2,35,800	1,52,900	1,11,600	5,00,300
To Salaries & Wages					By Gross				
General Office	12,000	8,000	4,000	24,000	profit b/d	57,210	48,300	23,900	1,29,410
Showroom	4,000	8,000	–	12,000	By Discounts				
Advertising	1,080	780	540	2,400	Received	400	250	150	800
To Rent	2,400	2,400	6,000	10,800					
To Discount Allowed	540	390	270	1,200					



To Sundry Expenses	5,400	3,900	2,700	12,000				
To Depreciation	250	250	250	750				
To Net Profit c/d	31,940	24,830	10,290	67,060				
	57,610	48,550	24,050	1,30,210	57,610	48,550	24,050	1,30,210

Note: Gross profit of Department A is 30% in Sales (including transfer to Department C).

There is some unrealised profit only on inter departmental stock. 30% of Rs. 5,700 is required as stock reserve. This will be debited to Profit and Loss Appropriation Account.

Profit & Loss Appropriation Account

		Rs.	*Rs.*			*Rs.*
To	Stock Reserve (See Note)		1,710	By	Net Profit, from Profit &	
To	D: 75% of Profit of				Loss A/c	67,060
	Deptt. A	23,955				
	50% of Common Pool	7,527	31,482			
To	B : 75% of Profit of					
	Deptt. B	18,623				
	25% of Common Pool	3,763	22,386			
To	R: 75% of Profit of					
	Deptt. C	7,718				
	25% of Common Pool	3,764	11,482			
			67,060			67,060

Illustration 2

Complex Ltd., has 3 departments, A, B, C. The following information is provided:

	A	B	C
	Rs.	Rs.	Rs.
Opening Stock	3,000	4,000	6,000
Consumption of direct materials	8,000	12,000	–
Wages	5,000	10,000	–
Closing Stock	4,000	14,000	8,000
Sales	–	– -	34,000

Stock of each department is valued at cost to the department concerned, Stocks of A department are transferred to B at a margin of 50% above departmental cost, Stocks, of B department are transferred to C department at a margin of 10% above departmental cost. Other expenses were:

	Rs.
Salaries	2,000
Printing & Stationery	1,000
Rent	6,000
Interest paid	4,000
Depreciation	3,000

Allocate expenses in the ratio of departmental gross profit. Opening figures of reserves for unrealised profits on departmental stock were:

Department B Rs. 1,000

Department C Rs. 2,000

Prepare Departmental Trading and Profit & Loss Accounts for the year ending March 31, 2006.

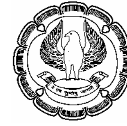
Solution

Complex Ltd.

Departmental Trading and Profit & Loss Account for year ended 31-3-2006

Dr. *Cr.*

	A	*B*	*C*	*Total*		*A*	*B*	*C*	*Total*
	Rs.	*Rs.*	*Rs.*	*Rs.*		*Rs.*	*Rs.*	*Rs.*	*Rs.*
To Opening Stock	3,000	4,000	6,000	13,000	By Internal				
To Direct material					transfer	18,000	33,000	-	51,000
consumption	8,000	12,000	-	20,000	By Sales	-	-	34,000	34,000
To Wages	5,000	10,000	-	15,000	By Closing stock	4,000	14,000	8,000	26,000
To Internal transfer	-	18,000	33,000	51,000					
To Gross Profit c/d	6,000	3,000	3,000	12,000					
	22,000	47,000	42,000	1,11,000		22,000	47,000	42,000	1,11,000
To Salaries	1,000	500	500	2,000	By Gross				
To Printing &					profit b/d	6,000	3,000	3,000	12,000



Stationery	500	250	250	1,000	By Net Loss c/d	2,000	1,000	1,000	4,000
To Rent	3,000	1,500	1,500	6,000					
To Depreciation	1,500	750	750	3,000					
To Interest paid	2,000	1,000	1,000	4,000					
	8,000	4,000	4,000	16,000		8,000	4,000	4,000	16,000
To Net Loss b/d	-	-	-	4,000	By Reserve for unrealised profit (on opening stock)	-	-	-	3,000
To Reserve for unrealised profit on closing stock	-	-	-	3,918	By Balance transferred to P & L A/c	-	-	-	4,918
				7,918					7,918

Working Notes:

Calculation of Unrealised Profit on Closing Stock:

Dept. B: Closing Stock Rs. 14,000

Cost element transferred from Deptt. A $\text{Rs.}14{,}000 \times \frac{18{,}000}{40{,}000}$ = Rs. 6,300

Profit added by Deptt. A $\text{Rs.}\,6{,}300 \times \frac{50}{150}$ = Rs. 2,100

Clarification: Cost increased during the current period by Deptt. B are Direct Material Rs. 12,000, Wages Rs. 10,000 and Transfer received from Deptt. A Rs. 18,000; Total Rs. 40,000.

So cost element of Deptt. A Rs. 18,000 in closing stock is $\frac{\text{Rs.}18{,}000}{\text{Rs.}40{,}000}$

(FIFO formula for stock issue is assumed)

Deptt. C: Closing Stock Rs. 8,000.

Profit added by Deptt. B: $\text{Rs.}\,8{,}000 \times \frac{10}{110}$ = Rs. 727

Cost element from Deptt. A:

$(Rs. 8{,}000 - Rs. 727) \times \frac{Rs. 18{,}000}{Rs. 40{,}000}$ = Rs. 3,273

Profit added by Deptt. A: $Rs. 3{,}273 \times \frac{50}{150}$ = Rs. 1,091

Rs. 1,818

Total Unrealised Profit: Rs. 2,100 + Rs. 1,818 = Rs. 3,918

Illustration 3

Alpha Ltd., has a factory with two manufacturing departments 'X' and 'Y'. Part of the output of department X is transferred to department Y for further processing and the balance is directly transferred to selling department. The entire production of department Y is directly transferred to the selling department. Inter-departmental stock transfers are made as follows:

X department to Y department at 33-1/3% over departmental cost.

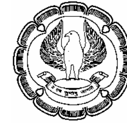
X department to selling department at 50% over departmental cost.

Y department to selling department at 25% over departmental cost.

The following information is given for the year ending 31st March, 2006.

	Department X		*Department Y*		*Selling Department*	
	Units	*Rs.*	*Units*	*Rs.*	*Units*	*Rs.*
Opening stock						
Finished Goods	60	60,000	20	40,000	50	1,28,000
Raw materials	–	–	–	–	–	–
Raw material consumed	–	1,82,000	–	20,000	–	–
Labour charges	–	70,000	–	32,000	–	–
Sales	–	–	–	–	120	4,80,000
Closing stock						
Finished Goods	40	–	50	–	60	–

Out of the total transfer by X department 30 units were transferred to selling department, while the remaining to department Y. Per unit material and labour consumption of X department on production to be transferred directly to the selling department is 300 per cent of the labour and material consumption on units transferred to Y department. General Administration expenses Rs. 1,80,000.



Prepare Departmental Profit and Loss Account and General Profit and Loss Account.

Solution

Working Notes:

(1) Calculation of production made by Department X

	Selling Deptt.	*Deptt. Y*	*Deptt. X*
	Units	*Units*	*Units*
Sales	120	–	–
Transfer to Selling Deptt.	–	100	30
Transfer to X Deptt.	–	–	–
Transfer to Y Deptt.	–	–	130
Closing Stock	60	50	40
	180	150	200
Opening Stock	50	20	60
Transfer from X Deptt.	30	130	–
Transfer from Y Deptt. (balancing figure)	100	–	–
Production during year (balancing figure)			140
	180	150	200

(2) Cost of Production and Transfer price

Department: X	*Units*	*Rs.*
Cost of output including opening stock		3,12,000
Transfer to selling department		
30 Units : Equivalent units	90	
Transfer to Y Department	130	
Closing Stock	40	
	260	

Cost of goods transferred to selling Department $\frac{3,12,000}{260} \times 90 = 1,08,000$

Transfer Price. Cost plus 50%: (Rs. 1,08,000 + 50% of Rs. 1,08,000) 1,62,000

Output meant for transfer to Department Y.

Cost of output: $\frac{3,12,000}{260} \times 130$ = Rs. 1,56,000

Transfer price: Cost plus 33.1/3%:

(Rs. 1,56,000 + 33.1/3% of Rs. 1,56,000)=		2,08,000
Total Transfer (Rs. 2,08,000 + Rs. 1,62,000)		3,70,000
Department Y		*Rs.*
Total cost of output		3,00,000
Total output	150 units	
Cost per unit		2,000
Cost of transfer to selling Deptt.	100 units	2,00,000
Transfer Price: Cost plus 25%		2,50,000

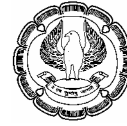
(3) Calculation of Closing Stock

			Rs.
Deptt. X $\frac{Rs.3,12,000}{260} \times 40$			48,000
Deptt. Y $\frac{Rs.3,00,000}{150} \times 50$			1,00,000
Selling Deptt (Closing Stock 60 units)	Units	Rs.	
Opening Stock	50	1,28,000	
Transfer from Deptt. X	30	1,62,000	
Transfer from Deptt. Y	100	2,50,000	
	180	5,40,000	
Average Cost		3,000	1,80,000

(4) Calculation of unrealised profit on stock

Deptt. Y: Increase in Stock (Rs. 1,00,000 — Rs. 40,000) = Rs. 60,000

Cost element of Deptt. X	Rs. 2,08,000
Cost of Deptt. Y	Rs. 52,000
Total Cost excluding	
Value of the Opening Stock:	Rs. 2,60,000



Proportion: $\frac{\text{Rs. }2,08,000}{\text{Rs. }2,60,000}$

Unrealised Profit: $\text{Rs. }60,000 \times \frac{2,08,000}{2,60,000} \times \frac{1}{4}$ = Rs. 12,000

Selling Deptt.:

Increase in Stock (Rs. 1,80,000 — Rs. 1,28,000) = Rs. 52,000

Total transfer from two departments = Rs. 4,12,000

Proportion of Deptt. X $\frac{\text{Rs. }1,62,000}{\text{Rs. }4,12,000}$

Proportion of Deptt. Y $\frac{2,50,000}{4,12,000}$

Output of Deptt. X in increase in Stock $\text{Rs. }52,000 \times \frac{1,62,000}{4,12,000}$ = Rs. 20,447

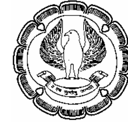
Output of Deptt. Y in increase in Stock $\text{Rs. }52,000 \times \frac{2,50,000}{4,12,000}$ = Rs. 31,553

Profit loaded by Deptt. Y $\text{Rs. }31,553 \times \frac{1}{5}$ =	Rs. 6,311
Profit loaded by Deptt. X	
For transfer from Deptt. Y $(\text{Rs. }31,553 - \text{Rs. }6,311) \times \frac{2,08,000}{2,60,000} \times \frac{1}{4}$ =	Rs. 5,048
For Direct Transfer $\text{Rs. }20,447 \times \frac{1}{3}$	Rs. 6,816
	Rs. 18,175

Departmental Profit and Loss Account for the year ended 31-3-2006

Dr. | | | | | | | | | | | | | | Cr.

	X Deptt. Qty	X Deptt. Amount Rs.	Y Deptt. Qty	Y Deptt. Amount Rs.	Selling Deptt Qty	Selling Deptt Amount Rs.		X Deptt. Qty	X Deptt. Amount Rs.	Y Deptt. Qty	Y Deptt. Amount Rs.	Selling Deptt. Qty	Selling Deptt. Amount Rs.
To Opening Stock	60	60,000	20	40,000	50	1,28,000	By Stock transf.	160	3,70,000	100	2,50,000	–	–
To Raw Material consumption		1,82,000	–	20,000	–	–	By Sales	–	–	–	–	120	4,80,000
Units produced	140	–	–	–	–	–	By Closing Stock	40	48,000	50	1,00,000	60	1,80,000
To Labour Charges		70,000		32,000									
To Stock Transferred from X Deptt.			130	2,08,000	30	1,62,000							
To Stock Transferred from Y Deptt.					100	2,50,000							
To Departmental Profit Transf. to General P.L A/c		1,06,000	–	50,000	–	1,20,000							
	200	4,18,000	150	3,50,000	180	6,60,000		200	4,18,000	150	3,50,000	180	6,60,000



GENERAL PROFIT AND LOSS A/C

		Rs.			Rs.
To	General Expenses	1,80,000	By	Profit transferred from	
"	Stock Reserve for			X Deptt.	1,06,000
	Closing Stock:			Y Deptt.	50,000
	on Deptt. Y	12,000		Selling Deptt.	1,20,000
	on Selling Deptt.	18,175			
"	Net Profit	65,825			
		2,76,000			2,76,000

Illustration 4

Gram Udyog, a retail store, has two departments, 'Khadi and Silks' for each of which stock account and memorandum 'mark up' accounts are kept. All the goods supplied to each department are debited to the stock account at cost plus a 'mark up', which together make-up the selling-price of the goods and in the account of the sale proceeds of the goods are credited. The amount of 'mark-up' is credited to the Departmental Mark up Account. If the selling price of any goods is reduced below its normal selling price, the reduction 'marked down' is adjusted both in the Stock Account and the Departmental 'Mark up' Account. The rate of 'Mark up' for Khadi Department is 33-1/3% of the cost and for Silks Department it is 50% of the cost.

The following figures have been taken from the books for the year ended December 31, 2005:

	Khadi D	Silks D
	Rs.	Rs.
Stock as on January 1st at cost	10,500	18,600
Purchases	75,900	93,400
Sales	95,600	1,25,000

(1) The stock of Khadi on January 1, 2005 included goods the selling price of which had been marked down by Rs. 1,260. These goods were sold during the year at the reduced prices.

(2) Certain stock of the value of Rs. 6,900 purchased for the Khadi Department were later in the year transferred to the Silks department and sold for Rs. 10,350. As a result though cost of the goods is included in the Khadi Department the sale proceeds have been credited to the Silks Department.

(3) During the year 2005 to promote sales the goods were marked down as follows :

	Cost	*Marked down*
	Rs.	*Rs.*
Khadi	5,600	360
Silk	10,000	2,000

All the goods marked down, were sold except Silks of the value of Rs. 5,000 marked down by Rs. 1,000.

(4) At the time of stock-taking on December 31, 2005 it was discovered that Khadi cloth of the cost of Rs. 390 was missing and it was decided that the amount be written off.

You are required to prepare for both the departments for the year 2005.

(a) The Memorandum Stock Account; and

(b) The Memorandum Mark up Account.

Solution

Silk Stock Account

Dr.						Cr.
			Rs.			Rs.
2005				2005		
Jan. 1	To Balance b/d			Jan.	By Sales A/c	1,25,000
	Cost	18,600		"	Mark-up A/c	2,000
	Mark-up	9,300	27,900	"	Balance c/d	51,350
"	Purchases	93,400				
	Mark-up	46,700	1,40,100			
"	Khadi A/c	6,900				
	Mark-up	3,450	10,350			
			1,78,350			1,78,350

Silk Mark-up Account

Dr.					*Cr.*
		Rs.			*Rs.*
2005			*2005*		
Jan. 1	To Stock A/c	2,000	Jan. 10	By Balance b/d	9,300

" Profit & Loss A/c	41,000		" Stock A/c	46,700
" Balance [1/3 of 52,350) - 1000]	16,450		" Stock A/c	3,450
	59,450			59,450

Working Notes:

Verification of Profit

Sales	1,25,000
Add : Mark down in goods sold	1,000
	1,26,000
Gross Profit 1/3	42,000
Less : Mark down	1,000
Gross profit as per books	41,000

Khadi Stock Account

2005			*Rs.*	*Rs.*	*2005*		*Rs.*	*Rs.*
Jan.	1	To Balance b/d (10,500 + 2,240)		12,740	By	Sales		95,600
	"	Purchases	75,900		"	Silk Deptt.	6,900	
	"	Markup	25,300	1,01,200	"	Mark-up A/c	2,300	9,200
					"	Loss of stock A/c	390	
					"	Mark-up A/c	130	520
						Mark-up A/c		360
					"	Balance c/d		8,260
				1,13,940				1,13,940

Khadi Mark-up Account

2005			*Rs.*	*2005*			*Rs.*
	To	Stock A/c (transfer)	2,300	Jan. 1	By	Balance b/d (3,500 – 1,260)	2,240
	"	Stock A/c (re-sale)	130		"	Stock A/c	25,300
	"	Stock A/c (mark down)	360				
	"	Profit & Loss A/c	22,685				
	"	Balance (1/4 of Rs. 8,260)	2,065				

	27,540		27,540

Working Note:

Verification of Profit

Sales as per books	95,600
Add : Mark-down (1260+360)	1,620
	97,220
Gross Profit on fixed selling price @ 25% on Rs. 97,220	24,305
Less : Mark down	1,620
	22,685

Illustration 5

Fairways Limited is a retail organisation with several departments. Goods supplied to each department are debited to a memorandum departmental stock account at cost, plus a fixed percentage (mark-up) to give the normal selling price. (The mark up is credited to a memorandum departmental 'Mark-up account"; any reduction in selling prices (mark-down) will require adjustment in the stock account and in mark-up account. The mark up for Department A for the last three years has been 40%.

Figures relevant to Department A for the year ended 30th June, 2006 were as follows :

Stock 1st July, 2005, at cost	80,000
Purchases, at cost	1,80,000
Sales	3,20,000

It is further ascertained that:

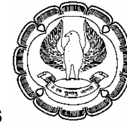
(1) Goods purchased in the period were marked down by Rs. 1,400 from a cost of Rs. 16,000. Marked-down stock costing Rs. 4,000 remained unsold on 30th June, 2006.

(2) Stock shortages at the year end, which had cost Rs. 1,200, were to be written off.

(3) Stock at 1st July, 2005 including goods costing Rs. 8,200 had been sold during the year and had been marked down in the selling price by Rs. 740. The remaining stock had been sold during the year.

(4) The departmental closing stock is to be valued at cost subject to adjustments for mark-up and mark-down.

You are required to prepare:



(i) A Departmental Trading Account for A Department for the year ended June, 2006 in Head Office books;

(ii) A Memorandum Stock Account for the year;

(iii) A Memorandum Mark-up Account for the year.

Solution

(i) Trading Account (Department A)

		Rs.			Rs.
To	Opening Stock	80,000	By	Sales	3,20,000
"	Purchases	1,80,000	"	Shortage	1,200
"	Gross Profit c/d	90,150	"	Closing stock (Working Note 3)	28,950
		3,50,150			3,50,150

(ii) Memorandum Stock Account for the department

2005			Rs.	2005			Rs.
July 1	To Balance b/d				By Stock shortage A/c		
	Cost	80,000			P & L A/c	1,200	
	Mark-up	32,000			Mark-up A/c	480	1,680
		1,12,000			" Mark up A/c		1,400
	Less : Mark down	740	1,11,260		" Debtors A/c (Sales)		
	To Purchases :				Ex. Opening		
	Cost	1,80,000			Stock	1,11,260	
	Mark-up	72,000	2,52,000		Current		
					Purchase	2,08,740	3,20,000
				2006			
				June 30	By Balance c/d (W.N. 1)		40,180
			3,63,260				3,63,260

(iii) Memorandum Mark up Accounts

2005-06			Rs.	2005			Rs.
	To Memo. Stock A/c			July 1	By	Balance b/d	
	re-shortage	480				(32,000 – 740)	31,260
	mark down	1,400	1,880		"	Stock A/c	72,000
	" Gross Profit transferred to P&L A/c		90,150				
2006							
June 30	" Balance c/d		11,230				
			1,03,260				1,03,260

Working Notes :

(1) *Closing stock on FIFO basis*

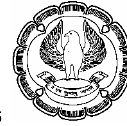
		Rs.
Current purchases including mark-up		2,52,000
Sales Ex-current purchases	2,08,740	
Add : Mark-down in sales 3/4 of 1,400	1,050	2,09,790
		42,210
Less : Mark-down 1/4 of 1,400		350
		41,860
Less : Shortage		1,680
Stock on 30th June, 2006		40,180

(2) *Cost of Sales and Standard Gross Profit*

Sales as per books	3,20,000
Add : Mark-down in opening stock	740
Add : Mark-down Sales Ex-current purchases	1,050
Value of sales if there was no mark-down	3,21,790
Gross Profit 40/140 of Rs. 3,21,790	91,940
Cost of sales	2,29,850

(3) *Closing Stock*

Opening Stock	80,000
Add: Purchases	1,80,000



		2,60,000
	Less: Cost of Sales	2,29,850
		30,150
	Less: Shortage	1,200
	Closing Stock	28,950
(4)	*Gross profit*	
	Standard Gross Profit on Sales	91,940
	Less: Mark-down (740+1,050)	1,790
		90,150
(5)	*Sales Ex-current purchases*	
	Total Sales	3,20,000
	Sales Ex-opening stock	1,11,260
		2,08,740

Illustration 6

X Ltd. has two departments, A and B. From the following particulars prepare the consolidated Trading Account and Departmental Trading Account for the year ending 31st December, 2006:

	A	B
	Rs.	Rs.
Opening Stock (at cost)	20,000	12,000
Purchases	92,000	68,000
Sales	1,40,000	1,12,000
Wages	12,000	8,000
Carriage	2,000	2,000
Closing Stock:		
(i) Purchased goods	4,500	6,000
(ii) Finished goods	24,000	14,000
Purchased goods transferred:		
by B to A	10,000	
by A to B		8,000

Finished goods transferred:		
by A to B	35,000	
by B to A		40,000
Return of finished goods:		
by A to B	10,000	
by B to A		7,000

You are informed that purchased goods have been transferred mutually at their respective departmental purchase cost and finished goods at departmental market price and that 20% of the finished stock (closing) at each department represented finished goods received from the other department.

Solution

X Ltd.

Departmental Trading A/c for the year ending 31st Dec., 2006

	Deptt. A.	Deptt. B		Deptt. A	Deptt. B
	Rs.	Rs.		Rs.	Rs.
To Stock	20,000	12,000	By Sales	1,40,000	1,12,000
" Purchases	92,000	68,000	" Pur. Goods Tr.	8,000	10,000
" Wages	12,000	8,000	" F.G. Transferred	35,000	40,000
" Carriage	2,000	2,000	Ret. finished Goods	10,000	7,000
" Purchased Goods			" Closing Stock:		
Transferred	10,000	8,000	Purchased Goods	4,500	6,000
" F.G. Transferred	40,000	35,000	Finished Goods	24,000	14,000
" Ret. of finished Goods	7,000	10,000			
	1,83,000	1,43,000			
" Gross profit c/d	38,500	46,000			
	2,21,500	1,89,000		2,21,500	1,89,000

Consolidated Trading Account for the year ending 31st December, 2006

	Rs.			Rs.
To Opening Stock	32,000	By	Sales	2,52,000
" Purchases	1,60,000	"	Closing Stock:	
" Wages	20,000		Purchased Goods	10,500
" Carriage	4,000		Finished Goods	38,000
" Stock Reserve	2,196			
" Gross Profit c/d	82,304			
	3,00,500			3,00,500

Working note:

	Deptt. A	Deptt. B
Closing Stock out of transfer	4,800	2,800
Sale	1,40,000	1,12,000
Add : Transfer	35,000	40,000
	1,75,000	1,52,000
Less: Returns	7,000	10,000
Net Sales plus Transfer	1,68,000	1,42,000
Rate of Gross profit	$\frac{38,500}{1,68,000} \times 100$ = 22.916%	$\frac{46,000}{1,42,000} \times 100$ = 32.394%
Unrealised Profit	4,800 × 32.394% = 1,555	2,800 × 22.916% = 641

Self-examination questions

I. Objective Type Questions

1. Selling commission is apportioned among departments in the proportion of
   - (a) Average stock carried by each department
   - (b) Number of units sold by each department
   - (c) Sales of each department
   - (d) None of the above

2. If goods are transferred from department A to department B at a price so as to include a profit of 50% on cost, the amount of stock reserve on closing stock of Rs. 9,000 in department B will be
   (a) Rs. 3,000
   (b) Rs. 4,500
   (c) Rs. 1,500
   (d) None of the above

[Answer 1-(c), 2-(a)]

II. Short Answer Type Questions

3. What are departmental accounts?
4. How would the following expenses be distributed among the various departments :
   (i) Managing director's salary and commission
   (ii) Advertisement charges
   (iii) Interest on borrowed capital

III. Long Answer Type Questions

5. Explain the basis of allocation of common expenditure among different departments.
6. Describe the term 'unrealised profit' and explain by the example the calculation of unrealised profit under different circumstances.

IV. Practical Questions

7. Becket & Co. Purchased goods for its three departments as follows :

Department: X	4,000 Units	
Department: Y	9,000 Units }	Total cost Rs. 1,10,000
Department: Z	4,000 Units	

Sales of three departments were as follows:

Department: X	3,600 Units @ Rs. 7.50 per unit
Department: Y	9,800 Units @ Rs. 9.00 per unit
Department: Z	3,650 Units @ Rs. 13.50 per unit

Opening Stock as on 1-1-2005 was as follows:

Department: X	200 Units

Department: Y	1,400 Units
Department: Z	150 Units

Assuming that the gross profit ratio is uniform in all the three departments, prepare trading a/c for the year ended 31st December, 2005.

8. Booming Limited has three departments. They are Alpha, Beta and Gamma. The profit of these departments are Rs. 30,000, Rs. 40,000 and Rs. 17,400 respectively. (Before charging manager's commission) and unrealised profit on stock transfers.

   Department Alpha transfers its goods @ 20% profit on cost to other departments while Beta transfers its goods @ 10% profit on cost. However, department Gama transfers its goods at cost to other departments. However, respective Deptt.'s original goods are only transferred.

   On scrutiny of records you find,

   (i) Purchases made for Alpha Deptt. Rs. 10,000 has been debited in Beta Deptt. Account.

   (ii) Goods sent on 'Sale or return basis' by Beta Deptt. @ 12% have been recorded as regular Sale at Rs. 8,400.

   (iii) General expenses amounting to Rs. 2,100 have been excessively charged in Gama Deptt. instead of Beta Deptt.

   (iv) The following transfers were made :

Deptt. Alpha	To Beta	Rs. 24,000	(Rs. 12,000 still in closing stock)
	To Gama	Rs. 3,600	
Deptt. Beta	To Gama	Rs. 11,000	(Rs. 4,400 still in closing stock)
Deptt. Gama	To Alpha	Rs. 7,700	(Rs. 3,000 still in closing stock)

   (v) Commission payable to the Manager @ 10% on correct overall Company profit after charging such commission.

   Find correct Net Profit of the Company and the commission payable to the General Manager.

9. Moon Ltd. has three departments. They are 'Cloth Stitching Deptt.', Selling Department and General Administration Department. Cloth Deptt. transfers its goods to Selling Deptt. @ 20% profit on Cost. From the following details, prepare Departmental Trading A/c and Profit and Loss A/c for the year ended 31st Dec., 2005.

	Cloth Stitching Deptt.	Selling Deptt.
	Rs.	Rs.
Opening Stock	1,20,000	80,000
Purchases	5,00,000	—
Wages and other exp.	1,25,000	25,000
Closing Stock	45,000	95,000
Sales	—	11,05,000

During the year goods costing Rs. 50,000 to selling department, were returned back to cloth department.

The expenses of General Admn. Deptt. are as follows :

Manager's Salary	@ Rs. 1,000 p.m.
Clerk's Salary (2 Nos.)	@ Rs. 600 p.m. (each)
Maintenance Expenses	Rs. 9,600

Apportion General Deptt. Expenses equally to the 'Cloth stitching' and 'Selling Deptt'.

UNIT - 4 : BRANCH ACCOUNTS

Learning Objectives

After studying this unit, you will be able to

- ♦ Distinguish between the accounting treatment of dependent branches and independent branches.
- ♦ Learn various methods of charging goods to branches.
- ♦ Solve the problems, when goods are sent to branch at wholesale price.
- ♦ Prepare the reconciliation statement of branch and head office transactions after finding the reasons for their disagreement.
- ♦ Incorporate branch balances in the head office book.
- ♦ Prepare branch accounts even on the basis of incomplete information
- ♦ Differentiate between integral and non-integral foreign branches.
- ♦ learn the techniques of foreign currency translation.

4.1 INTRODUCTION

The dictionary meaning of the word 'branch' is any subordinate division of a business, subsidiary shop, office, etc. According to the provisions contained in Section 29 of the Companies Act, 1956, it would appear that a branch is any establishment carrying on either the same or substantially the same activity as that carried on by head office of the company. It must also be noted that the concept of a branch means existence of a head office for there can be no branch without a head office - the principal place of business. From the accounting point of view, branches may be classified as follows :

(*i*)Branches in respect of which the whole of the accounting records are kept at the head office,

(*ii*) Branches which maintain independent accounting records, and

(*iii*) Foreign Branches.

4.2 DEPENDENT BRANCHES

When the business policies and the administration of a branch are wholly controlled by the head office, its accounts also are maintained by it. Branch accounts, in such a case, are written up at the head office out of reports and returns received from the branch. Some of the significant types of branches that are operated in this manner are described below :

(*a*) A branch set up merely for booking orders that are executed by the head office. Such a branch only transmits orders to the head office;

(*b*) A branch established at a commercial centre for the sale of goods (wholesale) supplied by the head office, and under its direction all collections are made by the H.O.; and

(*c*) A branch for the retail sale of goods, supplied by the head office.

Accounting in the case of first two types is simple. Only a record of expenses incurred at the branch has to be maintained. But it is not so in the case of the third type. A retail branch is essentially a sales agency that principally sells goods supplied by the head office for cash and, if so authorised, also on credit to approved customers. Generally, cash collected is deposited into a local bank to the credit of the head office and the head office issues cheques thereon for meeting the expenses of the branch. In addition, the Branch Manager is provided with a 'float' for petty expanses which is replenished from time to time on an imprest basis. If, however, the branch also sells certain lines of goods, directly purchased by it, the branch retains a part of the sale proceeds to pay for the goods so purchased.

There are various methods of recording transactions between the head office and a branch which vary from one another.

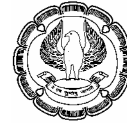
4.3 METHODS OF CHARGING GOODS TO BRANCHES

Goods may be invoiced to branches (1) at cost; or (2) at selling price; or (3) in case of retail branches, at wholesale price.

Note: The selling price method is adopted where the goods would be sold at a fixed price by the branch. It is suitable for dealers in tea, petrol, vanaspati ghee, etc. In this way, greater control can be exercised over the working of a branch inas much as that the branch balance in the head office books would always be composed of the value of unsold stock at the branch and remittances or goods in transit, any difference wherein being easily located. The arbitrary price method is usually adopted if the selling price is not known or when it is not considered desirable to disclose to the branch manager the profit made by the branch.

4.3.1 When goods are invoiced at cost : If goods are invoiced to the branch at cost, the trading results of branch can be ascertained by following either the Debtors Method or Stock and Debtors method. For the purpose, it is assumed that the branch is an entity separate from the head office. On the basis, a Branch Account is started in the head office books to which the price of goods or services provided or expenses paid out are debited and correspondingly, the value of benefits and cash received from the branch are credited.

(a) Debtors method : The opening balance of stock, debtors (if any), petty cash (if any), are debited to the Branch Account; the cost of goods sent to branch as well as expenses of the branch paid by the head office, *e.g.,* salaries, rent, insurance, etc., are also debited to it. Conversely, amounts remitted by the branch and the cost of goods returned by the branch are credited. At the end of the year, the value of unsold stock, the total customers' balances outstanding and that of petty cash are brought into the branch account on the credit side and then, the branch account will



reveal profit or loss; debit 'balance' will be the loss suffered by the working of the branch and *vice versa*. If the branch also is allowed to make small purchases of goods locally as well as to incur expenses as only details of such expenditure will be furnished by the branch to the head office. If on the other hand, purchases are made out of cash receipts, it will also be necessary for the branch to supply to the head office a copy of the Cash Account, showing details of cash collections and disbursements. To illustrate the various entries which are made in the Branch Account, the proforma of a Branch Account is shown below:

Proforma Branch Account

To Balance b/f	By Cash remitted
Stock	Return to H.O.
Debtors	Balance c/d
Petty Cash	Cash
Goods sent to Branches	Debtors
Bank	Petty Cash
Salaries	Profit and Loss A/c—Loss
Rent	(if debit side is larger)
Sundry Expenses	
Profit & Loss A/c—Profit	
(if credit side larger)	

Note: Having credited the Branch Account by the actual cash received from debtors it would be wrong to debit the Branch Account, in respect of discount or allowances to debtors.

The accuracy of the trading results as disclosed by the Branch Account, so maintained, if considered necessary, can be proved by preparing a Memorandum Branch Trading and Profit & Loss Account, in the usual way, from the balances of various items of income and expenses contained in the Branch Account.

Illustration 1

Buckingham Bros, Bombay have a branch at Nagpur. They send goods at cost to their branch at Nagpur. However, direct purchases are also made by the branch for which payments are made at head office. All the daily collections are transferred from the branch to the head office.

From the following, prepare Nagpur branch account in the books of head office by Debtors method:

Opening balance 1-1-2005	Rs.		Rs.
Imprest Cash	2,000	Bad Debts	1,000

Sundry Debtors	25,000	Discount to Customers	2,000
Stock: Transferred from H.O.	24,000	Remittances to H.O.	
Direct Purchases	16,000	(recd. by H.O.)	1,65,000
Cash Sales	45,000	remittances to H.O.	
Credit Sales	1,30,000	(not recd. by H.O. so far)	5,000
Direct Purchases	45,000	Branch Exp. directly paid by H.O.	30,000
Returns from Customers	3,000	Closing Balance (31-12-2005)	
Goods sent to branch from H.O.	60,000	Stock: Direct Purchase	10,000
Transfer from H.O. for Petty		Transfer from H.O.	15,000
Cash Exp.	4,000	Debtors	?
		Imprest Cash	?

Solution

In the Books of Buckingham Bros, Bombay

Nagpur Branch Account

Dr.		*Rs.*				*Cr.* *Rs.*
To	Opening Branch Assets		By	Bank - Remittances		
	Stock	40,000		rec. from the branch		
	Debtors	25,000		Cash Sales	45,000	
	Imprest Cash	2,000		Cash from Drs.	1,20,000	
"	Goods sent to Branch A/c	60,000		Cash from Drs.		
	Creditors (direct Pur.)	45,000		in transit	5,000	1,70,000
	Bank (Sundry exp.)	30,000		Branch Assets at close		
	Bank (Petty Cash exp.)	4,000		Stock: transfer from H.O.		15,000
	Net Profit transferred to			: Direct Purchase		10,000
	General Profit & Loss A/c	15,000		Sundry Debtors (W.N. 2)		24,000
				Imprest Cash (W.N. 3)		2,000
		2,21,000				2,21,000

Working Notes:

(1) *Collections from debtors:*

		Rs.
Total remittances (Rs. 1,65,000 + Rs. 5,000)	=	1,70,000
Less: Cash sales		45,000
		1,25,000

(2) *Calculation of Sundry Debtors closing Balance:*

	Rs.
Opening Balance	25,000
Add: Credit Sales	1,30,000
	1,55,000
Less: Returns, Discount, Bad debts & collections	
(Rs. 3,000 + 2,000 + 1,000 + 1,25,000)	1,31,000
Closing balance	24,000

3. It is assumed that petty cash expenses of the branch for the year were Rs. 4,000.

(b) Branch Trading and Profit and Loss Account Method : In this approach, Profit and Loss accounts are prepared taking each branch as a separate entity. The main advantage in this method is that, it is easy to prepare and understand.

Illustration 2

From the information given in the illustration 1, prepare Nagpur Branch Trading and Profit and Loss Account in the books of head office.

Solution

Buckingham Bros. Bombay

Nagpur Branch-Trading and Profit and Loss Account

For the Year ending 31st December, 2005

		Rs.			Rs.	Rs.
To	Opening Stock	40,000	By	Sales		
"	Goods transferred from			Cash	45,000	
	Head Office	60,000		Credit sales	1,30,000	

" Purchases	45,000			1,75,000	
" Gross Profit c/d	52,000		*Less:* Returns	3,000	1,72,000
		"	Closing Stock		25,000
	1,97,000				1,97,000
To Expenses	30,000	By	Gross Profit b/d		52,000
" Discounts	2,000				
" Bad Debts	1,000				
" Petty Cash Expenses	4,000				
" Net Profit transferred to General P/L A/c	15,000				
	52,000				52,000

The students may note that Gross Profit and Net Profit earned by the branch are ascertainable in this method and also evaluating the performance of the branch is very much easier in this method than in the 'Debtors method'.

(c) Stock and Debtors method : If it is desired to exercise a more detailed control over the working of a branch, the accounts of the branch are maintained under what is described as the Stock and Debtors Method. According to this method, the undermentioned four accounts have to be kept:

(*a*) Branch Stock Account (or Branch Trading Account).

(*b*)Branch Profit & Loss Account.

(*c*)Branch Debtors Account (if any).

(*d*)Branch Expenses Account.

If the branch is also allowed to purchase goods locally and to incur expenses out of its cash collections, it would be necessary to maintain (*i*) a Branch Cash Account, and (*ii*) an independent record of branch assets. All these accounts are kept by the H.O.

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

	Transaction	Account debited	Account credited
(*a*)	Cost of goods sent to the Branch	Br. Stock A/c	Goods sent to Br. A/c
(*b*)	Remittances for expenses	Br. Cash A/c	(H.O.) Cash A/c

(*c*) Any assets (*e.g.* furniture) provided by H.O.	Br. Asset (Furniture) A/c	(*i*) (H.O.) Cash A/c or (*ii*) Creditors A/c (*iii*) (H.O.) Furniture A/c
(*d*) Cost of goods returned by the branch	Goods sent to Br. A/c	Br. Stock A/c
(*e*) Cash Sales at the Branch	Br. Cash A/c	Br. Stock A/c
(*f*) Credit Sales at the Branch	Br. Debtor A/c	Br. Stock A/c
(*g*) Return of goods by debtors to the Branch	Br. Stock A/c	Br. Debtors A/c
(*h*) Cash paid by debtors	Br. Cash A/c	Br. Debtors A/c
(*i*) Discount & allowance to debtors, bad debts	Br. Expenses A/c	Br. Debtors A/c
(*j*) Remittances to H.O.	(H.O.) Cash A/c	Br. Cash A/c
(*k*) Expenses met by H.O.	Br. Expenses A/c	(H.O.) Cash A/c

(*l*) *Closing Stock* : Credit the Branch Stock Account with the value of closing stock at cost. It will be carried down as opening balance (debit) for the ensuing period. The Balance of the Branch Stock Account, (after adjustment therein the value of closing stock), if in credit, will represent the gross profit on sales and vice versa.

Other Steps

(*m*)Transfer Balance of Branch Stock Account to the Branch Profit and Loss Account.

(*n*)Transfer Balance of Branch Expenses Account to the debit of Branch Profit & Loss Account.

(o)The balance in the Branch P&L A/c will be transferred to the (H.O.) Profit & Loss Account.

The credit balance in the Goods sent to Branches Account is afterwards transferred to the Head Office Purchase Account or Trading Account (in case of manufacturing concerns), it being the value of goods transferred to the Branch.

Given below is a simple problem, the solution whereto has been prepared in all the three methods so as to show the distinguishing features of these methods.

Illustration 3

The Bombay Trading Company invoiced goods to its Delhi branch at cost. Head Office paid all the branch expenses from its bank account except petty cash expenses which were met by the Branch. All the cash collected by the branch was banked on the same day to the credit of the Head

Office. The following is a summary of the transactions entered into at the branch during the year ended December 31, 2005.

	Rs.		Rs.
Stock January 1	7,000	Bad Debts	600
Debtors, January 1	12,600	Goods returned by customers	500
Petty Cash, January 1	200	Salaries & Wages	6,200
Goods sent from H.O.	26,000	Rent & Rates	1,200
Goods returned to H.O.	1,000	Sundry Expenses	800
Cash Sales	17,500	Cash received from Sundry	
Credit Sales	28,400	Debtors	28,500
Allowances to customers	200	Stock, Dec. 31	6,500
Discount to customers	1,400	Debtors, Dec. 31,	9,800
		Petty Cash, Dec. 31	100

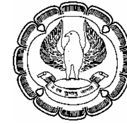
Prepare: (*a*) Branch Account (Debtors Method), (*b*) Memorandum Branch Trading and Profit & Loss Account to prove the results as disclosed by the Branch Account and (*c*) Branch Stock Account, Branch Profit & Loss Account, Branch Debtors and Branch Expenses Account by adopting the Stock and Debtors Method.

Solution

Debtors Method

(A) Delhi Branch Account

Dr.								Cr.
2005			Rs.	Rs.	2005		Rs.	Rs.
Jan. 1	To	Balance b/d			Dec. 31	By Bank		
		Stock	7,000			Cash Sales	17,500	
		Debtors	12,600			Cash from		
		Petty cash	200	19,800		Sundry Debts.	28,500	46,000
Dec. 31								
To		Goods sent to			By	Goods sent to		
		Branch A/c		26,000		Br. A/c - Returns		



		Rs.	Rs.			Rs.	Rs.
To	Bank:				to H.O.		1,000
	Salaries & Wages	6,200		By	Balance c/d		
	Rent & Rates	1,200			Stock	6,500	
	Sundry Exp.	800	8,200		Debtors	9,800	
To	Balance being				Petty Cash	100	16,400
	Profit carried to (H.O.) P & L A/c		9,400				
			63,400				63,400
Jan. 1, 2006							
To	Balance b/d		16,400				

(B) Memorandum Branch Trading and Profit and Loss Account

Dr.								Cr.
Jan. 1		Rs.	Rs.				Rs.	Rs.
To	Stock		7,000	By	Sales:			
To	Goods sent				Cash		17,500	
	from H.O.	26,000			Credit	28,400		
	Less : Returns to H.O.	1,000	25,000		*Less:* Returns	500	27,900	45,400
To	Gross profit c/d		19,900	By	Closing Stock			6,500
			51,900					51,900
To	Salaries & Wages		6,200	By	Gross Profit b/d			19,900
To	Rent & Rates		1,200					
To	Sundry Exp.		800					
To	Petty Cash Exp.		100					
To	Allowances to Customers		200					
To	Discounts		1,400					
To	Bad Debts		600					
To	Net Profit		9,400					
			19,900					19,900

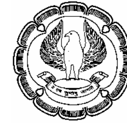
Stock And Debtors Method

Branch Stock Account

Dr.							Cr.
2005			2005				
Jan. 1		Rs.	Dec. 31			Rs.	Rs.
To	Stock	7,000	By	Sales:			
Dec. 31				Cash		17,500	
To	Goods Sent to			Credit	28,400		
	Branch A/c	26,000		*Less* Ret.	500	27,900	45,400
To	Branch P & L A/c	19,900	By	Goods sent to Br.			
	(Gross profit c/d)			A/c - Return			1,000
			By	Balance c/d (Stock)			6,500
		52,900					52,900
2006							
Jan. 1	To balance b/d	6,500					

Delhi Branch Debtors Account

Dr.					Cr.
2005		Rs.	2005		Rs.
Jan. 1	To Balance b/d	12,600	Dec. 31	By Cash	28,500
Dec. 31	To Sales	28,400		By Returns	500
				By Allowances	200
				By Discounts	1,400
				By Bad Debts	600
				By Balance c/d	9,800
		41,000			41,000
Jan 1	To Balance b/d	9,800			



Delhi Branch Expenses Account

Dr.					Cr.
2005		Rs.	2005		Rs.
Dec. 31	To Salaries & Wages	6,200	Dec. 31	By Branch P & L A/c	10,500
	To Rent & Rates	1,200			
	To Sundry Expenses	800			
	To Petty Cash Expenses	100			
	To Allowances to customers	200			
	To Discounts	1,400			
	To Bad Debts	600			
		10,500			10,500

Delhi Branch Profit & Loss Account

2005		Rs.	2005		Rs.
Dec. 31	To Branch Exp. A/c	10,500	Dec. 31	By Gross Profit b/d	19,900
	To Net Profit to General P & L A/c	9,400			
		19,900			19,900

4.3.2 When goods are invoiced at selling price : The consideration on which this method is applied and types of business for which it is considered suitable have already been stated. It would be obvious that if Branch Account is debited with the sales price of goods and subsequent to the debit being raised there is a change in the sale price, the amount of debit either has to be increased or reduced on a consideration of the quantity of unsold stock that was there at the branch at the time the change took place. Such an adjustment will be necessary as often as the change in sale price occurs.

Moreover the amount of anticipatory profit, included in the value of unsold stock with the branch at the close of the year will have to be eliminated before the accounts of the branch are incorporated with that of the head office. This will be done by creating a reserve. It may also be necessary to adjust the value of closing stock on account of the physical losses of stock due to either pilferage or wastages which may have occurred during the year. The last mentioned adjustments are made by debiting the cost of the goods to Goods Lost Account and the amount of loading (included in the

lost goods), to the Branch Adjustment Account. The three different methods that are usually adopted for maintaining accounts on this basis are described below :

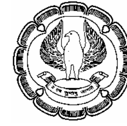
(*a*) *Stock and Debtors Method* : For the purpose, it would be necessary to maintain accounts mentioned below at the head office:

- Branch Stock Account.
- Goods sent to Branches Account.
- Branch Adjustment Account.

Some important points should be kept in mind while following stock and debtors method:

(*i*) Entries in the accounts are made in the following manner:

	Transaction	Accounts debited	Accounts credited
(*a*)	Sale price of the goods sent from H.O. to the Branch	Branch Stock A/c (at selling price)	(*i*) Goods sent to Branches A/c with cost of the goods sent. (*ii*) Branch Adjustment A/c (with the loading *i.e.*, difference between the selling and cost price).
(*b*)	Return of goods By the Branch to H.O.	(*i*) Goods sent to Br. A/c (with the cost of goods returned). (*ii*) Branch Adjustment A/c (with the loading)	Branch Stock A/c
(*c*)	Cash sales at the Br.	Cash/Bank A/c	Branch Stock A/c
(*d*)	Credit Sales at the Br.	Branch Debtors A/c	Branch Stock A/c
(*e*)	Goods returned to Branch by customers	Branch Stock A/c	Branch Debtors A/c (at selling price)
(*f*)	Goods lost in Transit or stolen	(*i*) Goods Lost in Transit A/c or Goods Stolen A/c (with cost of the goods)	Branch Stock A/c



(*ii*) Branch Adj. A/c
(with the loading)

(***ii***) ***Closing Stock*** : The balance in the Branch Stock Account at the close of the year normally should be equal to value of the unsold stock at the Branch valued at sale price. But quite often the value of stock actually held at the branch is either more or less than the balance of the Branch Stock Account. In that event it will be necessary that the balance in the Branch Stock Account is increased or reduced by debit or credit to Goods Lost Account (at cost price of goods) and Branch Adjustment Account (with the loading). The Stock Account at selling price, thus reveals loss of stock (or surplus) and serves as a check on the branch in this respect.

The discrepancy in the amount of balance in the Branch Stock Account and the value of stock actually in hand, valued at sale price, may be the result of one or more of the undermentioned factors :

- An error in applying the percentage of loading.
- Goods having been sold either below or above the established selling price.
- A Commission to adjust returns or allowances.
- Physical loss of stock due to natural causes or pilferage.
- Errors in Stock-taking.

For example, the balance brought down in the Branch Stock Account is Rs. 100 in excess of the value of stock actually held by the branch when the goods were invoiced by the head office to the branch at 20% above cost and the discrepancy is either due to pilferage or loss by fire, the actual loss to the firm would be Rs. 80, since 20% of the invoice price would represent the element of profit. The adjusting entry in such a case would be:

		Rs.	Rs.
Goods Lost A/c	Dr.	80	
Branch Adjustment A/c	Dr.	20	
To Branch Stock A/c			100

If on the other hand, a part of the sale proceeds has been misappropriated, then the adjusting entry would be :

Loss by theft A/c	Dr.	—
Branch Adjustment A/c	Dr.	—
To Branch Stock A/c		

Rebates and allowances allowed to customers are adjusted by debiting the amounts of such allowances to Branch Adjustment Account and crediting Branch Stock Account. But, if the gross amount of sale has been debited to Branch debtors Account, this account would be credited instead of Branch Stock Account, since the last mentioned account would have already received credit for the full value.

In the Goods Sent To Branch Account, the cost of the goods sent out to a branch for sale is credited by debiting Branch Stock Account. Conversely, the cost of goods returned by the branch is debited to this account. As such the balance in the account at the end of the year will be the cost of goods sent to the branch; therefore, it will be transferred either to the Trading Account or to Purchases Account of the head office.

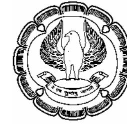
To the Branch Adjustment Account the amount of profit anticipated on sale of goods sent to the branch is credited and conversely, the amount of profit not realised in respect of goods returned by the branch to head office or that in respect to stock remaining unsold with the branch at the close of the year is debited. The balance in this account, at the end of year thus will consist of the amount of Gross Profit earned on sale by the branch. On that account, it will be transferred to the Branch Profit and Loss Account.

(*iii*) *Elimination of unrealised profit in the closing stock* : The balance in the Branch Stock account would be at the sale price; therefore it would be necessary to eliminate the element of profit included in such closing stock. This is done by creating a reserve against unrealised profit, by debiting the Branch Adjustment Account and crediting Stock Reserve Account with an amount equal to the difference in the cost and selling price of unsold stock. Sometimes instead of opening a separate account in respect of the reserve, the amount of the difference is credited to Branch Stock Account. In that case, the credited balance of such a reserve is also carried forward separately, along with the debit balance in the Branch Stock Account; the difference between the two would be the value of stock at cost.

In either case, the credit balance will be deducted out of the value of closing stock for the purpose of disclosure in the balance sheet, so that the stock is shown at cost.

In either case, the credit balance will be deducted out of the value of closing stock for the purpose of disclosure in the balance sheet, so that the stock is shown at cost.

An Alternative method : Where the gross profit of each branch is not required to be ascertained separately, although the selling price is uniform, the amount of goods sent on to the branch is recorded only in two accounts namely - Branch Stock Account and Goods Sent to Branch A/c. At the end of the year the Branch Stock Account is closed by transfer of the balance representing the value of closing stock, at sale price, to the Goods Sent To Branch Account. This has the effect of altogether eliminating from the books the value of stock at the branch. The balance of Goods sent to Branch Account is afterwards transferred to the Trading Account representing the net sale price of goods sold at the branch. In that case, the value of closing stock at the branch at cost will be



subsequently introduced in the Trading Account together with that of closing stock at the head office. Alternatively, a balance equal to the value of the closing stock in both the accounts would be carried forward.

Illustration 4

Harrison Ltd., Madras has a branch at New Delhi to which goods are sent @ 20% above cost. The branch makes both cash and credit sales. Branch expenses are met partly from H.O. and partly by the branch. The statement of expenses incurred by the branch every month is sent to head office for recording.

Following further details are given for the year ended 31st December, 2005.

	Rs.
Cost of goods sent to Branch at cost	2,00,000
Goods received by Branch till 31-12-2005 at invoice price	2,20,000
Credit Sales for the year @ invoice price	1,65,000
Cash Sales for the year @ invoice price	59,000
Cash Remitted to head office	2,22,500
Expenses paid by H.O.	12,000
Bad Debts written off	750

Balances as on	1-1-2005	31-12-2005	
	Rs.	Rs.	
Stock	25,000 (Cost)	28,000	(invoice price)
Debtors	32,750	26,000	
Cash in Hand	5,000	2,500	

Show necessary ledger accounts in the books of the head office and determine the Profit and Loss of the Branch for the year ended 31st December, 2005.

Books of Harrison Ltd.

Branch Stock A/c

		Rs.			Rs.
1-1-05	To Balance b/d	30,000		By Branch Debtors	1,65,000
	To Goods Sent to			By Branch Bank	59,000
	Branch A/c	2,40,000	31-12-05	By Balance c/d	

		Rs.				Rs.
	To Branch Adj. A/c (Excess of sale over invoice price)	2,000			Goods in Transit (Rs. 2,40,000 – Rs. 2,20,000)	20,000
					Stock at Branch	28,000
		2,72,000				2,72,000

Bank Debtors A/c

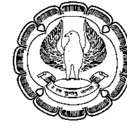
		Rs.				Rs.
1-1-05	To Balance b/d	32,750		By	Bad Debts w/o	750
	To Branch Stock	1,65,000		By	Branch Cash-collection (balancing figure)	1,71,000
			31-12-05	By	Balance c/d	26,000
		1,97,750				1,97,750

Branch Cash A/c

		Rs.				Rs.
1-1-05	To Balance b/d	5,000		By	Bank Remit to H.O.	2,22,500
	To Branch Stock	59,000		By	Branch Adj. A/c (exp. paid by H.O.)	12,000
	To Bank (as per contra)	12,000				
	To Branch Debtors	1,71,000		By	Branch Adj. A/c (Balancing fig. (exp. paid by Branch)	10,000
			31.12.05	By	Balance c/d	2,500
		2,47,000				2,47,000

Branch Adjustment A/c

		Rs.		Rs.
To	Stock Reserve (on closing stock 48,000 × 1/6)	8,000	By Stock Reserve opening	5,000
			By Goods sent to Branch A/c	40,000
To	Gross Profit c/d	39,000	By Branch Stock A/c	2,000
		47,000		47,000
To Branch Expenses			By Gross Profit b/d	39,000



	(paid by HO : Rs. 12,000 and paid by Branch Rs. 10,000)	22,000		
To	Branch Debtors-Bad debts	750		
To	Net Profit	16,250		
		39,000		39,000

Goods Sent to Branch A/c

To Branch Adjustment A/c	40,000	By Branch to Stock A/c	2,40,000
To Purchase A/c - Transfer	2,00,000		
	2,40,000		2,40,000

(*b*) *Debtors Method* : Under such a method, the principal accounts that will be maintained are :

- The Branch Account;
- The Goods Sent To Branch Account; and
- The Stock Reserve Account.

Entries in these accounts will be made in the following manner :

	Transaction	Account debited	Account credited
(*a*)	Goods sent to Branch at selling price	Branch A/c	Goods Sent To Br. A/c
(*b*)	'Loading being the difference between selling price and cost of goods	Goods Sent To Br. A/c	Branch A/c
(*c*)	Returns to H.O. at selling price	Goods Sent To Br. A/c	Branch A/c
(*d*)	'Loading' in respect of goods returned to H.O.	Branch A/c	Goods Sent To Br. A/c
(*e*)	'Loading' included in the opening stock to reduce it	Stock Reserve A/c	Branch A/c
(*f*)	Closing stock at selling price	Branch Stock A/c	Branch A/c

(*g*)	'Loading' included in closing stock to reduce it to cost	Branch A/c	Stock Reserve A/c

It will be observed that entries in the Branch Account in respect of goods sent to a branch or returned by it, as well as those for the opening and closing stock, will be at selling price. In consequence, the Branch Account is written up at selling price. Hence the Branch Account will not correctly show the trading profit of the Branch unless these amounts are adjusted to cost. Such an adjustment is effected by making contra entries in 'Goods Sent to Branch A/c' and 'Stock Reserve Account'. In respect of closing stock at branch for the purpose of disclosure in the Balance Sheet, the credit balance in the 'Stock Reserve Account' at the end of the year will be deducted from the value of the closing stock, so as to reduce it to close; it will be carried forward as a separate balance to the following year, for being transferred to the credit of the Branch Account.

Illustration : 5

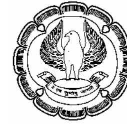
Take figures from Illustration 4 and prepare branch account following debtors method.

Books of Harrison Ltd.

New Delhi Branch Account

Dr. Cr.

1-1-2005						
To	Balance b/d	Rs.	By	Balance b/d		Rs.
	Stock	30,000		Stock Reserve		5,000
	Debtors	32,750	By	Goods Sent to Branch A/c		40,000
	Cash	5,000	By	Bank-Remittance		
To	Goods Sent to Branch A/c	2,40,000		received from the Branch		
To	Bank (Exp. paid by H.O.)	12,000		Cash sales	59,000	
To	Net Profit Transferred to H.O.			Drs. Collection	1,63,500	2,22,500
	Profit and Loss A/c	16,250		(Net of expense)		
To	Balance c/d (Stock reserve			(Rs. 2,22,500 –		
	on closing stock)	8,000		Rs. 59,000)		
			By	Balance c/d		
				Stock (including Transit)		48,000
				Debtors		26,000



	Cash	2,500
3,44,000		3,44,000

(*c*) ***Double Column Method*** : Without writing up a Branch Stock and a Branch Adjustment Account, it is also practicable to record all the relevant figures only in one account, by having two separate columns, one to show the value of goods sent out to branch at cost, entries wherein will be part of the double entry system and in second column memorandum entries in respect of the value of the same stock at the selling price. Under such a method, while the first column would disclose the amount of gross profit and the value of stock carried forward at cost the second column would not disclose profit or loss, but would balance by including therein the value of closing stock at selling price provided that there has been no physical loss of stocks.

This method is similar to the Memorandum Column Method for recording the value of goods sent out for sale on consignment basis both at the invoice and cost prices.

Illustration 6

Prepare Branch Account using the figures given in Illustration 4 following Double Column method :

Harrison Limited

New Delhi Branch Account

		Inv.	Cost			Inv.	Cost
		Rs.	Rs.			Rs.	Rs.
To	Balance b/d			By	Cash Sales	59,000	59,000
	Opening Stock	30,000	25,000	By	Credit Sales	1,65,000	1,65,000
To	Goods Sent to			By	Balance c/d		
	Branch A/c	2,40,000	2,00,000		Closing stock	48,000	40,000
To	Stock Adj. A/c	2,000	1,667				
To	Gross Profit trans-						
	ferred to P&L A/c		37,333				
		2,72,000	2,64,000			2,72,000	2,64,000

Gross Profit = (Rs. 2,24,000 × 20/120) = Rs. 37,333.

Illustration 7

Sell Well Ltd. who carried on a retail business opened a branch X on January 1st, 2006 where all sales were on credit basis. All goods required by the branch were supplied from the Head Office and were invoiced to the branch at 10% above cost. The following were the transactions:

	Jan. '06	Feb. 06	March '06
	Rs.	Rs.	Rs.
Goods sent to Branch (Purchase Price)	40,000	50,000	60,000
Sales as shown by the branch monthly report	38,000	42,000	55,000
Cash received from Debtors and remitted to H.O.	20,000	51,000	35,000
Returns to H.O. (Invoice price to Branch)	1,200	600	2,400

The stock of goods held by the branch on March 31, 2006 amounted to Rs. 53,400 at invoice to branch.

Record these transactions in the Head Office books, showing balances as on 31st March, 2006 and the branch gross profit for the three months ended on that date.

All workings should form part of your solution.

Solution

Books of Sell Well Ltd.

Branch Account

Dr.						Cr.
		Rs.				Rs.
To	Goods sent to Branch A/c		By	Cash-collected from debts		1,06,000
	$\frac{110}{100} \times 1,50,000$	1,65,000	By	Goods sent to Br.-returns		4,200
To	Stock Reserve (W.N.2)	4,855	By	Goods sent to Br. (W.N. 1)		14,618
To	Balance Profit to General					
	Profit & Loss A/c	37,363	By	Balance c/d		
				Stock	53,400	
				Debtors	29,000	82,400
		2,07,218				2,07,218

Memorandum Branch Debtors Account

2006		Rs.	2006		Rs.
Jan. 1	To Balance b/d	-	Jan-		
Jan-			Mar.	By Cash/Bank	1,06,000
Mar.	To Sales	1,35,000		By Balance c/d	29,000
		1,35,000			1,35,000

Goods Sent To Branch Account

	Rs.		Rs.
To Branch A/c (Returns)	4,200	By Branch A/c	1,65,000
To Branch A/c (Loading)	14,618		
To Purchases A/c	1,46,182		
	1,65,000		1,65,000

Working Notes:

- Loading on Goods sent to Branch 1/11 of (Rs. 1,65,000 – Rs. 4,200) *i.e.* Rs. 1,60,800 = Rs. 14,618
- Stock Reserve 1/11 of 53,400 = Rs. 4,855

Illustration 8

Hindustan Industries Bombay has a branch in Cochin to which office goods are invoiced at cost plus 25%. The branch sells both for cash and on credit, Branch Expenses are paid direct from head office and the Branch has to remit all cash received into the Head Office Bank Account.

From the following details, relating to calendar year 2005, prepare the accounts in the Head Office Ledger and ascertain the Branch Profit. Branch does not maintain any books of account, but sends weekly returns to the Head Office:

	Rs.
Goods received from Head Office at invoice price	6,00,000
Returns to Head Office at invoice price	12,000
Stock at Cochin as on 1st Jan., 2005	60,000
Sales in the year - Cash	2,00,000
Credit	3,60,000

Sundry Debtors at Cochin as on 1st Jan. 2005	72,000
Cash received from Debtors	3,20,000
Discount allowed to Debtors	6,000
Bad Debts in the year	4,000
Sales returns at Cochin Branch	8,000
Rent, Rates, Taxes at Branch	18,000
Salaries, Wages, Bonus at Branch	60,000
Office Expenses	6,000
Stock at Branch on 31st Dec. 2005 at invoice price	1,20,000

Solution

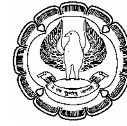
Books of Hindustan Industries, Bombay

Cochin Branch Stock Account

2005		Rs.	2005	Rs.
Jan.	To Balance b/d	60,000	By Bank A/c (Cash sales)	2,00,000
	To Goods sent to Branch A/c	6,00,000	By Branch Debtors (Cr. sales)	3,60,000
	To Branch Debtors A/c		By Goods sent to Branch	
	(sales return)	8,000	(Ret. to H.O.)	12,000
	To Branch P & L A/c (surplus)	24,000	By Balance c/d (closing stock)	1,20,000
		6,92,000		6,92,000

Cochin Branch Stock Adjustment Account

2005		Rs.	2005		Rs.
To	Goods sent to Branch A/c		Jan.	By Balance b/d	
	(1/5 of Rs. 12,000) (on returns)	2,400		(1/5 of Rs. 60,000)	12,000
To	Branch P & L A/c (Profit on			By Goods sent to Br. A/c	
	sale at invoice price)	1,05,600		(1/5 of Rs. 6,00,000)	1,20,000
To	Balance c/d (1/5 of Rs. 1,20,000)	24,000			
		1,32,000			1,32,000



Goods sent to Branch Account

2005		Rs.	2005		Rs.
To	Cochin Branch		By	Cochin Br. Stock A/c	6,00,000
	Stock Adjustment A/c	1,20,000	By	Cochin Br. Stock Adj. A/c	2,400
To	Cochin Br. Stock A/c (Ret.)	12,000			
To	Purchases A/c	4,70,400			
		6,02,400			6,02,400

Branch Debtors Account

2005			Rs.	2005			Rs.
Jan.	To	Balance b/d	72,000	By	Bank		3,20,000
	To	Branch Stock A/c	3,60,000	By	Branch P & L A/c		
				By	Discount	6,000	
				By	Bad Debts	4,000	10,000
				By	Branch Stock (Sales Ret.)		8,000
				By	Balance c/d		94,000
			4,32,000				4,32,000

Bank Expenses Account

		Rs.			Rs.
To	Bank A/c (Rent, Rates & Taxes)	18,000	By	Branch Profit & Loss A/c	84,000
To	Bank A/c (Salaries & Wages)	60,000		(Transfer)	
To	Bank A/c (office exp.)	6,000			
		84,000			84,000

Branch Profit & Loss Account for the year ending 31st Dec. 2005

			Rs.		Rs.
To	Branch Expenses A/c		84,000	By Branch Stock Adj. A/c	1,05,600
	Branch Debs. Discount	6,000		By Branch stock A/c	
	Bad debtors	4,000	10,000	(Sale over invoice price)	24,000

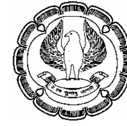
To Net Profit to		
Profit & Loss A/c	35,600	
	1,29,600	1,29,600

Illustration 9

Arnold Ltd. Delhi, trades in Ghee and Oil. It has a branch at Lucknow. The company despatches 25 tins of Oil @ Rs. 1,000 per tin and 15 tins of Ghee @ Rs. 1,500 per tin on 1st of every month. The branch incurs some expenditure which is met out of its collections; this is in addition to expenditure directly paid by Head Office.

Following are the other details:

		Delhi	Lucknow
		Rs.	Rs.
Purchases	Ghee	14,75,000	-
	Oil	29,32,000	-
Direct expenses		3,83,275	-
Expenses paid by H.O.		-	14,250
Sales	Ghee	18,46,350	3,42,750
	Oil	27,41,250	3,15,730
Collection during the year (including Cash Sales)		-	6,47,330
Remittance by Branch to Head Office		-	6,13,250
		(Delhi)	
Balance as on:		1-1-2005	31-12-2005
Stock : Ghee		1,50,000	3,12,500
Oil		3,50,000	4,17,250
Debtors		7,32,750	-
Cash on Hand		70,520	55,250
Furniture & Fittings		21,500	19,350
Plant/Machinery		3,07,250	7,73,500



		(Lucknow)	
Balance as on:		1-1-2005	31-12-2005
Stock :	Ghee	17,000	13,250
	Oil	27,000	44,750
Debtors		75,750	-
Cash on Hand		7,540	12,350
Furniture & Fittings		6,250	5,625
Plant/Machinery		-	-

Addition to Plant/Machinery on 1-1-2005 Rs. 6,02,750.

Rate of Depreciation: Furniture / Fittings @ 10% and Plant / Machinery @ 15% (already adjusted in the above figures).

The Branch Manager is entitled to 10% commission after charging such commission whereas, the General Manager is entitled to 10% commission on overall company profits after charging such commission. General Manager is also entitled to a salary of Rs. 2000 p.m. General expenses incurred by H.O. Rs. 24,000.

Prepare Branch Account in the head office books and also prepare the company's Trading and Profit and Loss A/c (excluding branch transactions).

Solution

In the Books of Arnold Ltd.

Lucknow Branch Account

Dr.			Cr.
	Rs.		Rs.
To Balance b/d		By Bank (Remittance to H.O.)	6,13,250
Opening stock:		By Balance c/d	
Ghee	17,000	Closing stock:	
Oil	27,000	Ghee	13,250
Debtors	75,750	Oil	44,750
Cash on hand	7,540	Debtors (W.N. 1)	86,900
Furniture & fittings	6,250	Cash on hand (W.N. 2)	12,350
To Goods sent to Branch A/c		Furniture & fittings	5,625

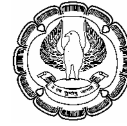
			Rs.			Rs.
	Ghee		2,70,000			
	Oil		3,00,000			
To	Bank (Expenses paid by H.O.)		14,250			
To	Branch Manager					
	Commission (Rs. 58,335 × 1/11)		5,303			
To	Net Profit Transferred					
	to General P & L A/c		53,032			
			7,76,125			7,76,125

Arnold Ltd.

Trading and Profit and Loss account for the year ended 31st December, 2005

(Excluding branch transactions)

			Rs.			Rs.
To	Opening Stock:			By	Sales:	
	Ghee		1,50,000		Ghee	18,46,350
	Oil		3,50,000		Oil	27,41,250
To	Purchases:			By	Closing Stock:	
	Ghee	14,75,000			Ghee	3,12,500
	Less: Goods sent				Oil	4,17,250
	to Branch	2,70,000	12,05,000			
	Oil	29,32,000				
	Less: Goods sent					
	to Branch	3,00,000	26,32,000			
To	Direct Expenses		3,83,275			
To	Gross Profit		5,97,075			
			53,17,350			53,17,350
To	Manager's Salary		24,000	By	Gross Profit	5,97,075
To	General Expenses		24,000	By	Branch Profit transferred	53,032
To	Depreciation					
	Furniture @ 10%	2,150				



	Plant & Machinery					
	@ 15%	1,36,500	1,38,650			
To	General Manager's					
	Commission @ 10%					
	i.e., 4,63,457 × 1/11		42,132			
To	Net profit		4,21,325			
			6,50,107			6,50,107

Working Notes :

(1) Debtors Account

Dr.							Cr.
			Rs.				Rs.
1-1-05	To	Balance b/d	75,750		By	Cash Collections	6,47,330
	To	Sales made during the year:		31-12-05	By	Balance c/d	86,900
		Ghee	3,42,750				
		Oil	3,15,730				
			7,34,230				7,34,230

(2) Branch Cash A/c

			Rs.				Rs.
1-1-05	To	Balance b/d	7,540		By	Remittance	6,13,250
	To	Collections	6,47,330		By	Exp. (Balance fig.)	29,270
				31-12-05	By	Balance c/d	12,350
			6,54,870				6,54,870

4.3.3 Goods invoiced at wholesale price to retail branches : When retail branches (Shops) are started by manufacturers, the profit properly attributable to such shops is the difference between the sale proceeds of goods at the shops and the wholesale price of the goods sold. For the purpose, it is assumed that the manufacturer would always be able to sell the goods on wholesale terms and thereby realise profit equal to the difference between the wholesale price and the cost. Many concerns, therefore, invoice, goods to such shops at wholesale price and determine profit or

loss on sale of goods on this basis. Accordingly, Branch Stock Account or the Trading Account is debited with:

(*a*) the value of opening stock at the Branch; and

(*b*) price of goods sent during the year at wholesale price.

It is credited by :

(*a*) sales effected at the shop; and

(*b*) closing stock of goods valued at wholesale price.

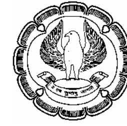
The value of goods lost due to accident, theft etc. also is credited to the Branch Stock Account or Trading Account calculated at the wholesale price. At this stage, the Branch Stock or Trading Account will reveal the amount of gross profit (or loss). It is transferred to the Branch Profit and Loss Account. On further being debited with the expenses incurred at the shop (including any allowance that may have been made in favour of a customer after sales being recorded) and the wholesale price of goods lost, the Branch Profit and Loss Account will disclose the net profit (or loss) at the shop.

Since the closing stock at the branch has to be valued at wholesale price, it would be necessary to create a stock reserve equal to the difference between its wholesale price and its cost (to the head office) by debiting the amount in the *Head Office Profit and Loss Account.* This Stock Reserve is carried down to the next year and then transferred to the credit of the (Head Office) Profit and Loss Account.

4.4 Independent Branches

Independent branches maintain comprehensive account books for recording their transactions, therefore a separate trial balance of each branch can be prepared. The head office maintains one ledger account for each such branch, wherein all transactions between the head office and the branches are recorded. The head office A/c in branch books and Branch A/c in head office books should tie up whereby completeness of recording of transactions can be ensured.

	Transactions	Head office books		Branch books	
(*i*)	Dispatch of goods to branch by H.O.	Branch A/c To Good sent to Branch A/c	Dr.	Goods recd. from H.O. A/c To Head Office A/c	Dr.
(*ii*)	When goods are returned by the	Goods sent to Branch A/c	Dr.	Head Office A/c To Goods recd. from	Dr.



	Branch to H.O.	To Branch A/c		H.O. A/c	
(*iii*)	Branch Expenses are paid by the Br.	No Entry		Expenses A/c To Cash A/c	Dr.
(*iv*)	Branch Expenses paid by H.O.	Branch A/c To Bank	Dr.	Expenses A/c To Head Office A/c	Dr.
(*v*)	Outside purchases made by the Br.	No Entry		Purchases A/c To Bank (or) Crs. A/c	Dr.
(*vi*)	Sales effected by the Branch	No Entry		Cash or Debtors A/c To Sales	Dr.
(*vii*)	Collection from Debts. of the Br. recd. by H.O.	Cash or Bank A/c To Branch A/c	Dr.	Head office A/c To Sundry Drs. A/c	Dr.
(*viii*)	Payment by H.O. for purchase made by Br.	Branch A/c To Bank	Dr.	Purchase (or) Sundry Creditors A/c To Head Office	Dr.
(*ix*)	Purchase of Asset by Branch	No Entry		Sundry Assets To Bank (or) Liability	Dr.
(*x*)	Asset purchased by the Br. but Asset A/c retained at H.O. books	Branch Asset A/c To Branch A/c	Dr.	Head office To Bank (or) Liability	Dr.
(*xi*)	Depreciation on (*x*) above	Branch A/c To Branch Asset	Dr.	Depreciation A/c To Head Office A/c	Dr.
(*xii*)	Remittance of funds by H.O. to Branch	Branch A/c To Bank	Dr.	Bank A/c To Head Office	Dr.
(*xiii*)	Remittance of funds by Branch to H.O.	Reverse entry of (*xii*) above		Reverse entry of (*xii*) above	
(*xiv*)	Transfer of goods from one Branch to another branch	(Recipient) Br. A/c To Supplying Branch A/c	Dr.	Supplying Branch H.O. A/c To Goods Received	Dr.

from H.O. A/c

Recipient Branch

Goods Received from

H.O. A/c Dr.

To Head Office A/c

Students may find a few further practical situations and it is hoped that they can pass entries on the basis of accounting principles explained above.

The final result of these adjustments will be that so far as the Head Office is concerned, the branch will be looked upon either as a debtor or creditor, as a debtor if the amount of its assets is in excess of its liabilities and as a creditor if the position is reverse. A debit balance in the Branch Account should always be equal to the net assets at the branch. The important thing to remember, when independent sets of accounts are maintained, is that the branch and head office books are connected with each other only through the medium of the Branch and the Head Office Account of their component which are converse of each other. Therefore, whatever adjustments have to be made must be passed only through them; also when accounts of the branch and head office are consolidated both the Branch and Head Office Accounts will be eliminated.

4.5 Adjustment and reconciliation of Branch and Head Office Accounts

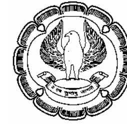
If the branch and the head office accounts, converse of each other, do not tally, these must be reconciled before the preparation of the final accounts of the concern as a whole.

It is very important to note that the Balance of Head Office A/c in Branch books and Branch A/c in Head Office books are tallied before financial statements are prepared.

The point at which an action has been effected should be taken as the basis and the other point should adjust its books on the basis of the transaction effected at the other end. In Accounting language, if Head Office has sent goods worth Rs. 50,000 but the branch has received till the closing date goods only Rs. 40,000, then the branch should treat Rs. 10,000 as goods in transit and should pass the following entry :

		Dr.	Cr.
Goods in transit A/c	Dr.	10,000	
To Head Office A/c			10,000

However, there will be no entry in Head office books being the point where the event has been recorded in full, hence no further entries in Head office books.



4.5.1 Reasons for Disagreement : Following are the possible reasons for the disagreement between Branch A/c in Head office books and Head office A/c in Branch books on the closing date :

- Goods dispatched by the Head office not received by the branch. These goods may be in transit or loss in transit.
- Goods returned by the branch to Head Office may have been received by the H.O. Again, these goods may be in transit or lost in transit.
- Sum remitted by Head office to branch or *vice versa* remaining in transit on the closing date.
- Receipt of income or payment or expenses relating to the Branch transacted by the head office or *vice versa*, hence not recorded at the respective ends wherein they are normally to be recorded.

The technique of reconciliation has been illustrated through the example given below :

	Head office		Branch	
	Dr.	Cr.	Dr.	Cr.
Goods sent to Branch		1,50,000	-	
Goods recd. from H.O. A/c		-	1,40,000	
Branch A/c	1,12,000			
Head office A/c	-	-	-	78,500

On analysis of Branch A/c in Head office books and Head office A/c in branch books, you find :

- Rs. 15,000 remitted by the branch has not been received, hence not recorded in the head office books.
- Direct collection of Rs. 10,500 from a customer of the branch by Head office not informed to the branch, hence not recorded by the branch.
- A sum of Rs. 14,500 paid by branch to the suppliers of head office not recorded at Head office.
- Head office expenditure allocation to the branch Rs. 12,000 not recorded in the branch.
- Rs. 7,500 being FD interest of head office received by the branch on oral instructions from H.O., not recorded in the head office books.

	Head Office Books		Branch Books		
	Dr.	Cr.		Dr.	Cr.
	Rs.	Rs.		Rs.	Rs.
(*i*) *Goods in transit*	-	-	Goods in Transit A/c	10,000	

		Branch Books			Head Office Books	
	(Rs. 10,000)				To Head office A/c	10,000
(*ii*)	*Cash in Transit* :	Cash in Transit A/c	15,000		(No Entry)	
		To Branch A/c		15,000		
(*iii*)	*Direct Collection by H.O. on behalf of the Branch*				Head Office A/c 10,500	
					To Debtors A/c	10,500
(*iv*)	*Direct payment of Rs. 14,500 by Branch on behalf of H.O.*	Sundry Cr. A/c	14,500			
		To Branch A/c		14,500		
(*v*)	*Expenditure Allocated to Branch*			-	Branch Exp. A/c. 12,000	
					To H.O. A/c	12,000
(*vi*)	*Fixed Deposit interest of Rs. 7,500 directly received by the Branch*	Branch A/c	7,500			
		To Sundry Income		7,500		

In Branch Books

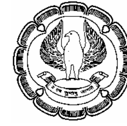
Head Office Account

Dr.		Rs.			Cr. Rs.
To	Sundry Debtors A/c	10,500	By	Balance b/d	78,500
To	Balance c/d	90,000	By	Goods in transit	10,000
			By	Branch expenses	12,000
		1,00,500			1,00,500
			By	Balance b/d	90,000

In the Books of Head Office

Branch A/c

Dr.		Rs.			Cr. Rs.
To	Balance b/d	1,12,000	By	Cash in Transit	15,000
To	Sundry Income	7,500	By	Sundry Creditors	14,500
			By	Balance c/d	90,000
		1,19,500			1,19,500
To	Balance b/d	90,000			



Students may note (*i*) the balance of Head Office A/c in Branch books and Branch A/c in Head Office books have tallied (*ii*) Adjustment are made only at the point:

- Where the recording has been omitted, and
- Other than the point where action has been effected.

4.5.2 Other points

(1) Inter-branch transactions are usually adjusted as if they were entered into only with the head office. It is a very convenient method of treating such transaction especially where the number of branches are large. Suppose Calcutta Branch incurred an expenditure on advertisement of Rs. 1,000 on account of Delhi Branch, the entries that would be made in such a case would be as follows:

			Dr.	Cr.
			Rs.	Rs..
In Calcutta Books :	Head Office A/c	Dr.	1,000	
	To Cash			1,000
In Delhi Books:	Advertisement A/c	Dr.	1,000	
	To H.O. A/c			1,000
In H.O. Books:	Delhi Branch A/c	Dr.	1,000	
	To Calcutta Branch A/c			1,000

(2) Often the accounts of fixed assets of a branch are kept in the head office books; in such a case, at the end of the year, the amount of depreciation on the assets is debited to the branch concerned by recording the following entry:

Branch Account Dr.

To Branch Asset Account

The branch will pass the following entry:

Depreciation Account Dr.

To Head Office A/c

(3) Usually the head office has to devote considerable time in attending to the affairs of the branch; on that account, it may decide to raise a charge against the branch in respect of the cost of such time. In such a case the amount is debited to the branch as 'Expenses' and is credited to appropriate revenue head such as Salaries Accounts, General Charges Account, Entertainment Account etc. The branch credits the H.O. Account and debits Expenses Account.

4.6 Incorporation of Branch Balance in Head Office Books

The method that will be adopted for incorporating the trading result of the branch with that of the head office would depend on whether it is desired to prepare separate Profit & Loss Account and Balance Sheet of the branch and the Head Office or consolidated statement of account of both branch and head office.

In the first-mentioned case, the amount of profit or loss shown by the Profit & Loss Account of the branch only will be transferred to Head office Account in the branch books and a converse entry will be passed in the Head Office books by debit to the Branch Account. This method has already been illustrated above. In such a case, not only the Profit & Loss Account of the branch and that of the head office would be prepared separately but also there would be separate Balance Sheet for the branch and the head office. The branch Balance Sheet would show the amount advanced by the head office to it, as capital. In the head office Balance Sheet, the same amount would be shown as an advance to the branch.

If however, it is desired to prepare a consolidated Profit & Loss Account and Balance Sheet, individual balances of all the revenue accounts would be separately transferred to the Head Office Account by debit or credit in the branch books and the converse entries would be passed in the head office books. The effect thereof will be similar to the amount of net profit or loss of the branch having been transferred since it would be composed of the balances that have been transferred. In case it is also desired that consolidated balance sheet of the branch and the head office should be prepared, it will also be necessary to transfer the balance of assets and liabilities of the branch to the head office. The adjusting entries that would be passed in this respect are shown below:

(*a*)Head Office Account Dr.

To (individual) Asset Account

(*b*)(Individual) Liability Account Dr.

To Head Office Account

Converse entries are passed in the head office books.

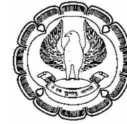
It is obvious that after afore-mentioned entries have been passed, the Branch Account in the Head Office books and Head Office Account in the branch books will be closed and it will be necessary to restart them at the beginning of the next year.

In consequence, at the beginning of the following year, the under-mentioned entry is recorded by the branch:

Asset Account (In Detail) Dr.

To Liability Accounts

To H.O. Account (The difference



between assets and liabilities)

Illustration 10

Messrs Ramchand & Co., Hyderabad have a branch in Delhi. The Delhi Branch deals not only in the goods from Head Office but also buys some auxiliary goods and deals in them. They, however, do not prepare any Profit & Loss Account but close all accounts to the Head Office at the end of the year and open them afresh on the basis of advise from their Head Office. The fixed assets accounts are also maintained at the Head Office.

The goods from the Head Office are invoiced at selling prices to give a profit of 20 per cent on the sale price. The goods sent from the branch to Head Office are at cost. From the following prepare the Branch Account, Branch Trading and Profit & Loss Account and Branch Assets Account in the Head Office Books.

Trial Balance of the Delhi Branch as on 31-12-2005

Debit	Rs.	**Credit**	Rs.
Head office opening balance 1-1-05	15,000	Sales	1,00,000
Goods from H.O.	50,000	Goods to H.O.	3,000
Purchases	20,000	Head Office Current A/c	15,000
Opening Stock (H.O. goods at invoice prices)	4,000	Sundry Creditors	3,000
Opening Stock of other goods	500		
Salaries	7,000		
Rent	3,000		
Office expenditure	2,000		
Cash on Hand	500		
Cash at Bank	4,000		
Sundry Debtors	15,000		
	1,21,000		1,21,000

The Branch balances as on 1st January, 2005, were as under: Furniture Rs. 5,000; Sundry Debtors Rs. 9,500; Cash Rs. 1,000, Creditors Rs. 30,000; Stock (H.O. goods at invoice price) Rs. 4,000; other goods Rs. 500. The closing stock at branch of the head office goods at invoice price is

Rs. 3,000 and that of purchased goods at cost is Rs. 1,000. Depreciation is to be provided at 10 per cent on branch assets.

Solution

Delhi Branch

Branch Trading and Profit & Loss Account

for the year ended 31st Dec., 2005

Dr.			Cr.		
		Rs.			Rs.
To Opening Stock:			By Sales		1,00,000
Head office Goods	3,200		By Goods from Branch		3,000
Others	500	3,700	By Closing Stock :		
To Goods (To Branch)		40,000	Head Office goods	2,400	
To Purchases		20,000	Others	1,000	3,400
To Gross Profit c/d		42,700			
		1,06,400			1,06,400
To Salaries		7,000	By Gross profit b/d		42,700
To Rent		3,000			
To Office Expenses		2,000			
To Deprec. on furniture @ 10%		500			
To Net profit		30,200			
		42,700			42,700

Branch (Fixed) Assets Account (In Head Office Books)

2005		Rs.	2005		Rs.
Jan. 1	To Balance b/d	5,000	Dec. 31	By Delhi Branch A/c (Depreciation)	500
				By Balance c/d	4,500
		5,000			5,000
2006					
Jan. 1	To Balance b/d	4,500			

Cash/Bank Account (Branch Books)

		Rs.	Rs.			Rs.
To	Balance b/d		1,000	By	Salaries	7,000
To	Sales Proceeds		94,500	By	Rent	3,000
	Sales	1,00,000		By	Office Exp.	2,000
	Opening balance			By	Creditors*	47,000
	of Debtors	9,500		By	Head Office (Balancing fig.)	32,000
		1,09,500		By	Cash Balance	500
	Less: Closing balance	15,000		By	Bank Balance	4,000
	Cash Received	94,500				
			95,500			95,500

*Opening Balance + Purchases – Closing balance = Payment

Rs. 30,000 + Rs. 20,000 – Rs. 3,000 = Rs. 47,000.

Trial Balance of Delhi Branch as on 1-1-2005

			Dr. Rs.	Cr. Rs.
Debtors			9,500	
Cash			1,000	
Stock	H.O. Goods	4,000		
	Others	500	4,500	
Creditors				30,000
Head Office Account			15,000	
			30,000	30,000

Head Office Account

2005 Jan. 1		Rs.			Rs.
To	Balance (transfer)	15,000	By	Goods from Head Office	50,000
To	Cash	32,000			
To	Goods sent	3,000			
		50,000			50,000

Credit balance in Head Office Account before this transfer will be Rs. 15,000 credit.

Note : Furniture A/c is maintained in Head office books; it is not a part of either opening or closing balance.

Illustration 11

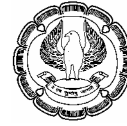
Ring Bell Ltd. Delhi has a Branch at Bombay where a separate set of books is used. The following is the trial balance extracted on 31st December, 2005.

Head Office Trial Balance

	Rs.	Rs.
Share Capital (Authorised: 10,000		
Equity Shares of Rs. 100 each):		
Issued: 8,000 Equity Shares		8,00,000
Profit & Loss Account - 1-1-2005		25,310
Interim Dividend paid - Aug. 2005	30,000	
General Reserve		1,00,000
Fixed Assets	5,30,000	
Stock	2,22,470	
Debtors and Creditors	50,500	21,900
Profit for 2005		82,200
Cash Balance	62,730	
Branch Current Account	1,33,710	
	10,29,410	10,29,410

Branch Trial Balance

	Rs.	Rs.
Fixed Assets	95,000	
Profit for 2005		31,700
Stock	50,460	
Debtors and Creditors	19,100	10,400
Cash Balance	6,550	
Head Office Current Account		1,29,010
	1,71,110	1,71,110



The difference between the balances of the Current Account in the two sets of books is accounted for as follows :

(*a*) Cash remitted by the Branch on 31st December, 2005, but received by the Head Office on 1st January 2006 - Rs. 3,000.

(*b*) Stock stolen in transit from Head Office and charged to Branch by the Head Office, but not credited to Head Office in the Branch books as the Branch Manager declined to admit any liability (not covered by insurance) - Rs. 1,700.

Give the Branch Current Account in Head Office books after incorporating Branch Trial Balance through journal. Also prepare the company's Balance Sheet as on 31st December, 2005.

Solution

The Branch Current Account in the Head Office Books and Head Office Current Account in the Branch Books do not show the same balances. Therefore, in order to reconcile them, the following journal entries will be passed in the Head Office books :

Journal

		Dr.	Cr.
2005		Rs.	Rs.
Dec., 31	Cash in Transit A/c	3,000	
	To Branch Current A/c		3,000
	(Cash sent by the Bench on 31st Dec., 2005		
	but received at H.O. on Ist Jan., 2006)		
	Loss by theft A/c	1,700	
	To Branch Current A/c		1,700
	(Stock lost in transit from H.O. to Branch)		

In order to incorporate, in the H.O. books, the given Branch trial balance which has been drawn up after preparing the Branch Profit & Loss Account, the following journal entries will be necessary :

Journal

2005		Rs.	Rs.
Dec. 31	Branch Current Account	31,700	
	To Profit & Loss Account		31,700
	(Branch Profit for 2005)		

	Rs.	Rs.
Branch Fixed Assets	95,000	
Branch Stock	50,460	
Branch Debtors	19,100	
Branch Cash	6,550	
To Branch Current Account		1,71,110
(Branch assets brought into H.O. Books)		
Branch Current A/c	10,400	
To Branch Creditors		10,400
(Branch creditors brought into H.O. Books)		

Branch Current Account

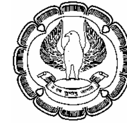
Dr.		Rs.	Cr.		Rs.
To	Balance b/d	1,33,710	By	Cash in transit	3,000
To	Profit & Loss A/c	31,700	By	Loss of theft	1,700
To	Branch Creditors	10,400	By	Sundry Branch Assets	1,71,110
		1,75,810			1,75,810

Profit and Loss Account for 2005

		Rs.				Rs.
To	Loss by Theft	1,700	By	Balance b/d		25,310
To	Interim Dividend for Aug., 2005	30,000	By	Year's Profit :	H.O.	82,200
To	Balance c/d	1,07,510			Branch	31,700
		1,39,210				1,39,210

Balance Sheet of the Company as on 31st Dec., 2005

Liabilities	*Rs.*	*Assets*		*Rs.*
Authorised capital :		Fixed Assets :		
10,000 Equity Shares of		H.O.	5,30,000	
Rs. 100 each	10,00,000	Branch	95,000	6,25,000
Issued and Subscribed		Stock :		
Capital : 8,000 Equity		H.O.	2,22,470	



Shares of Rs. 100 each			Branch	50,460	2,72,930
Fully paid		8,00,000	Debtors :		
General Reserve		1,00,000	H.O.	50,500	
Profit & Loss Account		1,07,510	Branch	19,100	69,600
Creditors :			Cash in Hand :		
H.O.	21,900		H.O.	62,730	
Branch	10,400	32,300	Branch	6,550	69,280
			Cash in Transit		3,000
		10,39,810			10,39,810

Illustration 12

KP Ltd. manufactures a range of goods which it sells to wholesale customers only from its head office. In addition, the H.O. transfers goods to a newly opened branch at factory cost *plus* 15%. The branch then sells these goods to the general public on only cash basis.

The selling price to wholesale customers is designed to give a factory profit which amounts to 30% of the sales value. The selling price to the general public is designed to give a gross margin (*i.e.,* selling price less cost of goods from H.O.) of 30% of the sales value.

The company operates from rented premises and leases all other types of fixed assets. The rent and hire charges for these are included in the overhead costs shown in the trial balances.

From the information given below, you are required to prepare for the year ended 31st Dec., 2005 in columnar form.

(*a*) A Profit & Loss account for (*i*) H.O. (*ii*) the branch (*iii*) the entire business.

(*b*) Balance Sheet as on 31st Dec., 2005 for the entire business.

	H.O. Branch		Branch	
	Rs.	Rs.	Rs.	Rs.
Raw materials purchased	35,000			
Direct wages	1,08,500			
Factory overheads	39,000			
Stock on 1-1-2005				
Raw materials	1,800			
Finished goods	13,000		9,200	

Debtors	37,000			
Cash	22,000		1,000	
Administrative Salaries	13,900		4,000	
Salesmen's Salaries	22,500		6,200	
Other administrative & selling overheads	12,500		2,300	
Inter-unit accounts	5,000			2,000
Capital		50,000		
Sundry Creditors		13,000		
Provision for Unrealised profit in stock		1,200		
Sales		2,00,000		65,200
Goods sent to Branch		46,000		
Goods Received from H.O.			44,500	
	3,10,200	3,10,200	67,200	67,200

Notes :

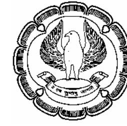
(1) On 28th Dec., 2005 the branch remitted Rs. 1,500 to the H.O. and this has not yet been recorded in the H.O. books. Also on the same date, the H.O. despatched goods to the branch invoiced at Rs. 1,500 and these too have not yet been entered into the branch books. It is the company's policy to adjust items in transit in the books of the recipient.

(2) The stock of raw materials held at the H.O. on 31st Dec., 2005 was valued at Rs. 2,300.

(3) You are advised that :

- there were no stock losses incurred at the H.O. or at the branch.
- it is the company's practice to value finished goods stock at the H.O. at factory cost.
- there were no opening or closing stock of work-in-progress.

(4) Branch employees are entitled to a bonus of Rs. 156 under a bilateral agreement.



Solution

K.P. Ltd.

Trading and Profit & Loss Account for the year ended 31st Dec., 2005

	H.O.	Branch	Total		H.O.	Branch	Total
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Material consumed	34,500			By Sales	2,00,000	65,200	2,65,200
″ Wages	1,08,500			″ Goods Sent to Branch	46,000		
″ Factory Overheads	39,000			″ Closing stock	15,000	9,560	24,560
″ Factory cost	1,82,000		1,82,000				
″ Opening stock of finished goods	13,000	9,200	22,200				
	1,95,000						
″ Goods from H.O.		46,000					
″ Gross Profit	66,000	19,560	85,560				
	2,61,000	74,760	2,89,760		2,61,000	74,760	2,89,760
To Admn. Salaries	13,900	4,000	17,900	By Gross Profit	66,000	19,560	85,560
″ Salesmen Salaries	22,500	6,200	28,700				
″ Other Admn. & Overheads	12,500	2,300	14,800				
″ Stock Reserve (increase)	47	-	47				
Bonus to Staff	-	156	156				
″ Net Profit	17,053	6,904	23,957				
	66,000	19,560	85,560		66,000	19,560	85,560

Balance Sheet as on 31st Dec., 2005

		H.O.	Branch	Total		H.O.	Branch	Total
	Rs.	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
Capital		50,000	-	50,000	Fixed Assets	-	-	-

Profit : H.O.	17,053				Current Assets			
Branch	6,904	23,957		23,957	Raw material	2,300		2,300
Trade Creditors		13,000		13,000	Finished Goods	15,000	9,560	23,313*
Bonus Payable			156	156	(Less Stock Res.)			
H.O. Account			10,404		Debtors	37,000	-	37,000
Stock Reserve		1,247			Cash (including transit item)	23,500	1,000	24,500
					Branch A/c	10,404**		
		88,204	10,560	87,113		88,204	10,560	87,113

*9,560 × 100/115 *i.e.,* 8,313 + 15,000 = 23,313

** 5,000 + 6,904 – 1500 = 10,404.

4.7 Incomplete Information in Branch Books

If it is desired that profitability of the branch should be kept secret from the branch staff, the head office would hold back some key information from the branch, e.g., amount of opening stock, cost of goods sent to the branch, etc. The head office, in such a case would maintain a record of goods sent to the branch by passing the entry :

Goods Supplied to the Branch Account Dr.

To Purchases Account

The value of the closing stock will also be adjusted only in head office books.

In such a case, for closing its books at the end of the year, the branch will simply transfer various revenue accounts to the head office without drawing up a Trading and Profit & Loss Account.

On that basis, supplemented by the record of transactions maintained at the head office, it will be possible to construct the Trading and Profit & Loss Account of the branch.

Illustration 13

AFFIX Ltd. of Calcutta has a branch at Delhi to which the goods are supplied from Calcutta but the cost thereof is not recorded in the Head Office books. On 31st March, 2006 the Branch Balance Sheet was as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors Balance	40,000	Debtors Balance	2,00,000
Head Office	1,68,000	Building Extension A/c closed	

		by transfer to H.O. A/c	
		Cash at Bank	8,000
	2,08,000		2,08,000

During the six months ending on 30-9-2006, the following transactions took place at Delhi.

	Rs.		*Rs.*
Sales	2,40,000	Manager's Salary	4,800
Purchases	48,000	Collections from Debtors	1,60,000
Wages paid	20,000	Discounts allowed	8,000
Salaries (inclusive of advance		Discount earned	1,200
of Rs. 2,000)	6,400	Cash paid to Creditors	60,000
General Expenses	1,600	Building Account (further payment)	4,000
Fire Insurance (paid for one year)	3,200	Cash in Hand	1,600
Remittance to H.O.	38,400	Cash at Bank	28,000

Set out the Head Office Account in Delhi books and the Branch Balance Sheet as on 30-9-2006. Also give journal entries in the Delhi books.

Solution

Journal

		Dr.	Cr.
2006		Dr.	Cr.
30 Sept.		Rs.	Rs.
Salary Advance A/c	Dr.	2,000	
To Salaries A/c			2,000
(The amount paid as advance adjusted by debit to Salary Advance Account)			
Prepared Insurance A/c	Dr.	1,600	
To Fire Insurance A/c			1,600
(Six months premium transferred to the Prepaid Insurance A/c)			
Head Office Account	Dr.	88,400	
To Purchases A/c			48,000
To Wages A/c			20,000

To Salaries A/c			4,400
To General Expenses A/c			1,600
To Fire Insurance A/c			1,600
To Manager's Salary A/c			4,800
To Discount Allowed A/c			8,000
(Transfer of various revenue accounts (Dr.) to the H.O. Account for closing the accounts)			
Sales Accounts	Dr.	2,40,000	
Discount Earned A/c	Dr.	1,200	
To Head Office A/c			2,41,200
[Revenue accounts (cr) transferred to H.O.]			
Head Office Account	Dr.	4,000	
To Building Account			4,000
(Transfer of amounts spent on building extension to H.O. A/c)			

Head Office Account

Dr.						Cr.
2006		Rs.	2006			Rs.
Sep. 30	To Cash-remittance	38,400	April 1	By	Balance b/d	1,68,000
	" Sundries (Revenue A/cs)	88,400	Sep. 30	"	Sundries (Revenue A/cs)	2,41,200
	" Building A/c	4,000				
	" Balanced c/d	2,78,400				
		4,09,200				4,09,200

Balance Sheet of Delhi Branch as on Sept. 30, 2006

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors Balances	26,800	Debtors Balances	2,72,000
Head Office Account	2,78,400	Salary Advance	2,000
		Prepaid Insurance	1,600
		Building Extension A/c transferred to H.O.	—

			Cash in Hand	1,600
			Cash at Bank	28,000
		3,05,200		3,05,200

Cash and Bank A/c

Dr.						Cr.
31st March 2006						
To	Balance b/d	8,000	By	Wages		20,000
″	Collection from Drs.	1,60,000	″	Salaries		6,400
			″	Insurance		3,200
			″	General Exp.		1,600
			″	H.O. A/c		38,400
			″	Manager's Salary		4,800
			″	Creditors		60,000
			″	Building A/c		4,000
			″	Balance c/d		
				Cash in Hand	1,600	
				Cash at Bank	28,000	29,600
		1,68,000				1,68,000

Debtors Account

March 2006			Sept. 2006		
To	Balance b/d	2,00,000	By	Cash Collection	1,60,000
Sept. 2006			″	Discount (allowed)	8,000
″	Sales	2,40,000	By	Balance c/d	2,72,000
		4,40,000			4,40,000
1 Oct. 2006					
″	Balance b/d	2,72,000			

Creditors Account

Sept. 2006				
To Cash	60,000	March 2006		
" Discount (earned)	1,200	By Balance b/d		40,000
		Sept. 2006		
To Balance c/d	26,800	By Purchases		48,000
	88,000			88,000
		1, Oct. 2006		
		By Balance b/d		26,800

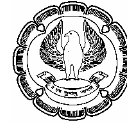
Illustration 14

The following Trial balances as at 31st December, 2006 have been extracted from the books of Major Ltd. and its branch at a stage where the only adjustments requiring to be made prior to the preparation of a Balance Sheet for the undertaking as a whole.

	Head Office		Branch	
	Dr.	Cr.	Dr.	Cr.
	Rs.	Rs.	Rs.	Rs.
Share Capital		1,50,000		
Sundry Fixed Assets	75,125		18,901	
Sundry Current Assets	1,21,809		23,715	(Note 3)
Sundry Current Liabilities		34,567		9,721
Stock Reserve, 1st Jan., 2006				
(Note 2)		693		
Revenue Account		43,210		10,250
Branch Account	31,536			
Head Office Account				22,645
	2,28,470	2,28,470	42,616	42,616

Notes :

1. Goods transferred from Head Office to the Branch are invoiced at cost plus 10% and both Revenue Accounts have been prepared on the basis of the prices charged.
2. Relating to the Head Office goods held by the Branch on 1st January, 2006.
3. Includes goods received from Head Office at invoice price Rs. 4,565.



4. Goods invoiced by Head Office to Branch at Rs. 3,641 were in transit at 31st December, 2006, as was also a remittance of Rs. 3,500 from the Branch.
5. At 31st December, 2006, the following transactions were reflected in the Head Office books but unrecorded in the Branch books.

The purchase price of lorry, Rs. 2,500, which reached the Branch on December 25; a sum received on December 30, 2006 from one of the Branch debtors, Rs. 750.

You are required :

(*i*) to record the foregoing in the appropriate ledger accounts in both sets of books;

(*ii*)to prepare a Balance Sheet as at 31st December, 2006 for the undertaking as a whole.

Solution

H.O. Books

Branch Account

2006			Rs.	2006			Rs.
Dec. 31	To	Balance b/d	31,536	Dec. 31	By	Cash in transit	3,500
					"	Balance b/d	28,036
			31,536				31,536

Cash in Transit Account

			Rs.				Rs.
2006				2006			
Dec. 31	To	Branch A/c	3,500	Dec. 31	By	Balance c/d	3,500

Stock Reserve Account

2006			Rs.	2006			Rs.
Dec. 31	To	Balance c/d	746	Jan. 1	By	Balance c/d	693
					"	Reserve A/c	53
			746				746

Revenue Account

2006			Rs.	2006			Rs.
Dec. 31	To	Stock Reserve	53	Dec. 31	By	Balance c/d	43,210
	"	Balance c/d	43,157				
			43,210				43,210

Branch Books

Head Office Account

2006			Rs.	2006			Rs.
Dec.31	To	Current Assets (Debtors)	750	Dec. 31	By	Balance b/d	22,645
					"	Goods in transit	3,641
	"	Balance c/d	28,036		"	Motor Vehicle	2,500
			28,786				28,786

Goods in Transit Account

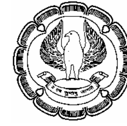
2006			Rs.	2006			Rs.
Dec. 31	To	Head Office	3,641	Dec. 31	By	Balance c/d	3,641

Motor Vehicle Account

2006			Rs.	2006			Rs.
Dec. 31	To	Head Office	2,500	Dec. 31	By	Balance c/d	2,500

Sundry Current Assets A/c

2006			Rs.	2006			Rs.
Dec. 31	To	Balance b/d	23,715	Dec. 31	By.	H.O. (Remittance by Debtor)	750
					"	Balance c/d	22,965
			23,715				23,715



Balance Sheet of Major Ltd. as on 31st Dec., 2006

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital		*Fixed Assets*	
Issued & Subscribed		Sundry Fixed Assets	
.............Shares of		(cost less Depreciation)	96,526
Rs..... each fully paid	1,50,000	*Investments*	
Reserve & Surplus		*Current Assets*	
Revenue Reserve	-	*Loan & Advances*	
Secured Loans	53,407	Sundry Current Assets	1,51,169
Unsecured Loans	-		
Current Liabilities & Provisions			
Sundry Current Liabilities	44,288		
	2,47,695		2,47,695

Working Notes :

		Rs.
(*i*) Fixed Assets:	Head Office	75,125
	Branch	18,901
	Motor Vehicle	2,500
		96,526
(*ii*) Current Assets :	Head Office	1,21,809
	Cash in transit	3,500
	Branch (23,715–750)	22,965
	Stock in transit	3,641
		1,51,915
	Less : Stock Reserve	746
		1,51,169
(*iii*) Revenue Account :	Head Office (43,210 – 53)	43,157
	Branch	10,250
		53,407

(*iv*) Current Liabilities :	Head Office	34,567
	Branch	9,721
		44,288

(*v*) While incorporating branch profit, Head Office will credit its Profit & Loss A/c by Debiting Branch. This will increase the branch balance. Similarly branch will transfer net profit and loss to Head Office Account resulting in an increase in the balance of Head Office A/c by similar amount.

4.8 Foreign Branches

Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate. Thus problems of incorporating balances of foreign branches relate mainly to translation of foreign currency into Indian rupees. This is because exchange rate of Indian rupees is not stable in relation to foreign currencies due to international demand and supply effects on various currencies.

4.9 Accounting for foreign branches

For the purpose of accounting, AS 11 (revised 2003) classifies the foreign branches may be classified into two types:

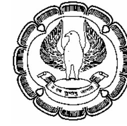
- Integral Foreign Operation;
- Non- Integral Foreign Operation.

Let us discuss these two types of foreign branches in detail.

4.9.1 Integral Foreign Operation (IFO): It is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. The business of IFO is carried on as if it were an extension of the reporting enterprise's operations. Generally, IFO carries on business in a single foreign currency, ie. of the country where it is located. For example, sale of goods imported from the reporting enterprise and remittance of proceeds to the reporting enterprise.

4.9.2 Non-Integral Foreign Operation (NFO): It is a foreign operation that is not an Integral Foreign Operation. The business of a NFO is carried on in a substantially independent way by accumulating cash and other monetary items, incurring expenses, generating income and arranging borrowing in its local currency. An NFO may also enter into transactions in foreign currencies, including transactions in the reporting currency. An example of NFO may be production in a foreign currency out of the resources available in such country independent of the reporting enterprise.

The following are the indicators of Non- Integral Foreign Operation-



- *Control by reporting enterprises* - While the reporting enterprise may control the foreign operation, the activities of foreign operation are carried independently without much dependence on reporting enterprise.
- Transactions with the reporting enterprises are not a high proportion of the foreign operation's activities.
- Activities of foreign operation are mainly financed by its operations or from local borrowings. In other words it raises finance independently and is in no way dependent on reporting enterprises.
- Foreign operation sales are mainly in currencies other than reporting currency.
- All the expenses by foreign operations are primarily paid in local currency, not in the reporting currency.
- Day-to-day cash flow of the reporting enterprises is independent of the foreign enterprises cash flows.
- Sales prices of the foreign enterprises are not affected by the day-to-day changes in exchange rate of the reporting currency of the foreign operation.
- There is an active sales market for the foreign operation product.

The above are only indicators and not decisive/conclusive factors to classify the foreign operations as non-integral, much will depend on factual information, situations of the particular case and, therefore, judgment is necessary to determine the appropriate classification.

Controversies may arise in deciding the foreign branches of the enterprises into integral or non-integral. However, there may not be any controversy that subsidiary associates and joint ventures are non-integral foreign operation.

In case of branches classified as independent for the purpose of accounting are generally classified as non-integral foreign operations.

4.10 Change in classification

When there is a change in classification from –

Integral to non-integral

Non-integral to integral.

Accounting treatment is as under-

4.10.1 Integral to non-integral

(i) Translation procedure applicable to non-integral shall be followed from the date of change.

(ii) Exchange difference arising on the translation of non-monetary assets at the date of re-classification is accumulated in foreign currency translation reserve.

4.10.2 From Non-integral to integral

(i) Translation procedure as applicable to integral should be applied from the date of change.

(ii) Translated amount of non-monetary items at the date of change is treated as historical cost.

(iii) Exchange difference lying in foreign currency translation reserve is not to be recognized as income or expense till the disposal of the operation even if the foreign operation becomes integral.

4.11 Techniques for Foreign Currency Translation

4.11.1 Integral Foreign Operation IFO

Following are the standard recommendations for foreign currency translation :

(1)All transactions of IFO be translated at the rate prevailing on the date of transaction. This will require dte wise details of the transaction entered by that operation together with the rates. Weekly or monthly average rate is permitted if there are no significant variations in the rate.

(2) translation at the balance sheet date-

(i) Monetary items[1] at closing rate;

(ii) Non-monetary items[2]: The cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If tangible fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation.

(iii) The cost of inventories is translated a t the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate.

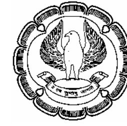
(iv) Exchange difference arising on the translation of the financial statement of integral foreign operation should be charged to profit and loss account.

4.11.2 Non-Integral Foreign Operation – Accounts of non-integral foreign operation are translated using the following principles:

- Balance sheet items i.e. Assets and Liabilities both monetary and non-monetary – apply closing exchange rate.

[1] Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. Cash, receivables and payables are examples of monetary items.

[2] Non-monetary items are assets and liabilities other than monetary items. Fixed assets, investments in equity shares, inventories are examples of non-monetary assets.



- Items of income and expenses – At actual exchange rates on the date of transactions. However, accounting standard allows average rate subject to materiality.
- Resulting exchange rate difference should be accumulated in a "foreign currency translation reserve" until the disposal of "net investment in non-integral foreign operation".

Illustration 15

S & M Ltd., Bombay, have a branch in Sydney, Australia. Sydney branch is an integral foreign operation of S & M Ltd.

At the end of 31st March, 2005, the following ledger balances have been extracted from the books of the Bombay Office and the Sydney Office :

	Bombay (Rs. thousands)		Sydney (Austr dollars thousands)	
	Debit	Credit	Debit	Credit
Share Capital	–	2,000	–	–
Reserves & Surplus	–	1,000	–	–
Land	500	–	–	–
Buildings (Cost)	1,000	–	–	–
Buildings Dep. Reserve	–	200	–	–
Plant & Machinery (Cost)	2,500	–	200	–
Plant & Machinery Dep. Reserve	–	600	–	130
Debtors / Creditors	280	200	60	30
Stock (1.4.2004)	100	–	20	–
Branch Stock Reserve	–	4	–	–
Cash & Bank Balances	10	–	10	–
Purchases / Sales	240	520	20	123
Goods sent to Branch	–	100	5	–
Managing Director's salary	30	–	–	–
Wages & Salaries	75	–	45	–
Rent	–	–	12	–
Office Expenses	25	–	18	–

Commission Receipts	–	256	–	100
Branch / H.O. Current A/c	120	–	–	7
	4,880	4,880	390	390

The following information is also available :

(1)Stock as at 31.3.2005 :

Bombay Rs. 1,50,000

Sydney A $ 3,125

You are required to convert the Sydney Branch Trial Balance into rupees;

(use the following rates of exchange :

Opening rate	A $ = Rs. 20
Closing rate	A $ = Rs. 24
Average rate	A $ = Rs. 22
For Fixed Assets	A $ = Rs. 18).

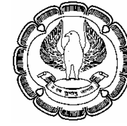
Solution

Sydney Branch Trial Balance (in Rupees)

As on 31 st March, 2005

(Rs. '000)

	Conversion rate per A$	*Dr.*	*Cr.*
Plant & Machinery (cost)	Rs 18	36,00	
Plant & Machinery Dep. Reserve	Rs. 18		23,40
Debtors / Creditors	Rs. 24	14,40	7,20
Stock (1.4.2004)	Rs. 20	4,00	
Cash & Bank Balances	Rs. 24	2,40	
Purchase / Sales	Rs. 22	4,40	27,06
Goods received from H.O.	–	1,00	
Wages & Salaries	Rs. 22	9,90	
Rent	Rs. 22	2,64	



Office expenses	Rs. 22	3,96	
Commission Receipts	Rs. 22		22,00
H.O. Current A/c			1,20
		78,70	80,86
Exchange loss (balancing figure)		2,16	
		80,86	80,86

Illustration 16

Co. has head office at New York (U.S.A.) and branch at Mumbai (India). Mumbai branch is an integral foreign operation of carlin & Co.

Mumbai branch furnishes you with its trial balance as on 31st March, 2006 and the additional information given thereafter :

	Dr.	Cr.
	Rupees in thousands	
Stock on 1st April, 2005	300	–
Purchases and sales	800	1,200
Sundry Debtors and creditors	400	300
Bills of exchange	120	240
Wages and salaries	560	–
Rent, rates and taxes	360	–
Sundry charges	160	–
Computers	240	–
Bank balance	420	–
New York office a/c	–	1,620
	3,360	3,360

Additional information :

(a) Computers were acquired from a remittance of US $ 6,000 received from New York head office and paid to the suppliers. Depreciate computers at 60% for the year.

(b) Unsold stock of Mumbai branch was worth Rs. 4,20,000 on 31st March, 2006.

(c) The rates of exchange may be taken as follows :

- on 1.4.2005 @ Rs. 40 per US $
- on 31.3.2006 @ Rs. 42 per US $
- average exchange rate for the year @ Rs. 41 per US $
- conversion in $ shall be made upto two decimal accuracy.

You are asked to prepare in US dollars the revenue statement for the year ended 31st March, 2006 and the balance sheet as on that date of Mumbai branch as would appear in the books of New York head office of Carlin & Co. You are informed that Mumbai branch account showed a debit balance of US $ 39609.18 on 31.3.2006 in New York books and there were no items pending reconciliation.

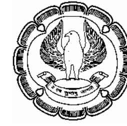
Solution

Carlin & Co. Ltd.

Mumbai Branch Trial Balance in (US $)

as on 31st March, 2006

	Conversion rate per US $ (Rs.)	*Dr. US $*	*Cr. US $*
Stock on 1.4.05	40	7,500.00	–
Purchases and sales	41	19,512.20	29,268.29
Sundry debtors and creditors	42	9,523.81	7,142.86
Bills of exchange	42	2,857.14	5,714.29
Wages and salaries	41	13,658.54	–
Rent, rates and taxes	41	8,780.49	–
Sundry charges	41	3,902.44	–
Computers–		6,000.00	–
Bank balance	42	10,000.00	–
New York office A/c	–	–	39,609.18
		81,734.62	81,734.62



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

	US $		US $
To Opening Stock	7,500.00	By Sales	29,268.29
To Purchases	19,512.20	By Closing stock	10,000.00
To Wages and salaries	13,658.54	By Gross Loss c/d	1,402.45
	40,670.74		40,670.74
To Gross Loss b/d	1,402.45	By Net Loss	17,685.38
To Rent, rates and taxes	8,780.49		
To Sundry charges	3,902.44		
To Depreciation on computers (US $ 6,000 × 0.6)	3,600.00		
	17,685.38		17,685.38

Balance Sheet of Mumbai Branch
as on 31st March, 2006

Liabilities		*US $*	*Assets*	*US $*	*US $*
New York Office A/c	39,609.18		Computers	6,000.00	
Less : Net Loss	17,685.38	21,923.80	*Less* :Depreciation	3,600.00	2,400.00
Sundry creditors		7,142.86	Closing stock		10,000.00
Bills payable		5,714.29	Sundry debtors		9,523.81
			Bank balance		10,000.00
			Bills receivable		2,857.14
		34,780.95			34,780.95

Self-examination questions

I. Objective Type Questions

Choose the most appropriate answer from the given options:

1. Goods may be invoiced to branch at

   (a) cost.

(b) selling price.

(c) wholesale price.

(d)all of the above.

2. Under debtors method, opening balance of debtors is

(a) debited to branch account.

(b) credited to branch account.

(c) debited to H.O account.

(d) credited to H.O account.

3. Cost of goods returned by branch will have the following effect

(a).goods sent to branch account will be debited.

(b). goods sent to branch account will be debited.

(c) Branch stock account will be credited.

(d) (a) and (c).

4. Assets and liabilities of a non- integral foreign operation should be converted at

(a) closing rate.

(b) average rate.

(c) opening rate.

(d) none of the above.

5. All of the following are examples of monetary assets except:

(a) Cash.

(b) Inventory.

(c) Receivables.

(d) Payables.

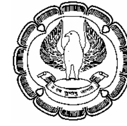
6. If asset is carried at cost, cost and depreciation of tangible fixed assets is translated at

(a) average rate.

(b) closing rate.

(c) opening rate.

(d) exchange rate at the date of purchase of asset.



7. Incomes and expenses of a NFO is translated at

   (a) average rate that approximates the actual exchange rates.

   (b) opening rate.

   (c) exchange rate at the date of transaction.

   (d) either (a)or (c)

8. AS 11 classifies foreign branches are classified as

   (a)Autonomous branches and non-autonomous branches

   (b)Uncontrolled and fully controlled branches.

   (c) Statutory and non-statutory branches.

   (d) Integral and non- integral foreign operation

{ Answer: 1- (d), 2- (a), 3- (d), 4-(a), 5- (b), 6- (d), 7- (d), 8- (d)}

II. Short Answer Type Questions

9. Distinguish between integral and non- integral foreign operation.

10. What do you understand by the term ' Branch Adjustment accoount'?

11. Write short note on Dependent and independent branches.

III. Long Answer Type questions

12. (a) Explain the procedure for incorporation of branch balance in head office books.

(b) How would you treat the changes in classification of foreign operation?

13. What is the purpose behind creating a reserve for the unsold stock in the branch, where stocks are sent by the head office at invoice price?

IV. Practical Problems

14. ABC Ltd. based in India has branches in London. The Vice-President (Accounts) is of the opinion that the net exchange difference of Rs.20 lakhs on the translation of items in financial statements of London Branches should be credited to the P &L Account of the Company and disclosed as follows –

Favourable exchange differences on items other than Fixed Assets	Rs.50 lakhs
Less: Unfavourable exchange difference on account of increase in	
Term liability on purchase of Fixed Asses	Rs.30 lakhs
Net Exchange Difference transferred to P & L account	Rs.20 lakhs

Do you agree with the Vice-President (Accounts)? Give reasons.

15. (*a*) A company charges out goods to its Bangalore Branch at cost. The branch remits daily to the H.O. all the cash collected by it on its sale; branch expenses are paid out of the amounts provided to the Branch by the H.O. as an imprest. The following is the summary of transactions of the branch during the year ended Dec. 31.

	Rs.		Rs.
Stock Jan. at cost	10,000	Credit Sales	70,500
Stock Dec. 31 at cost	17,900	Cash received from debtors	61,000
Goods received from H.O.	1,00,000	Discount allowed to debtors	2,000
Debtors, Jan. 1	7,000	Allowance of selling price	
Debtors Dec. 31	14,000	(in invoice)	1,500
Cash Sales	40,000	Expenses at the Branch	8,000

Ascertain the profit earned by the Branch in three different methods.

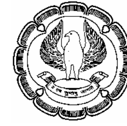
(*b*) What difference would have been made to Branch profit in the above mentioned case if the goods were invoiced to the Branch at cost plus 25% instead of at cost?

16. The Head Office of the ABC Ltd. invoiced goods to its Northern Branch during the year at selling price 33.1/3% added to cost. During the year the cost of goods sent to the branch was Rs. 65,400. The cash sales of the branch were Rs. 31,000. The Branch returned stock valued at selling price Rs. 2,000 to the head office and had Rs. 1,000 returned to it by customers. The discount allowed to customers by the Branch amounted to Rs. 200. The Branch remitted all the cash received by way of cash sales and receipts for customers. The opening and closing stock at the branch at invoice price were Rs. 15,000 and Rs. 36,000, respectively. The Branch had debtors of Rs. 12,000 at the beginning and of Rs. 9,200 at the end. loss (at invoice value) through pilferage was ascertained to be Rs. 1,000.

Write up the necessary accounts for recording the abovementioned transactions in the Head office books.

17. A head office had fixed retail price at cost plus 100%. It has a retail branch to which goods are invoiced at wholesale price which is 20% less than the list price. From the following particulars ascertain the profit earned by the branch.

	Rs.
Opening Stock (Invoice Price)	16,000
Goods sent to the Branch (cost to H.O.)	50,000
Sale at Branch	95,000



Ascertain the profit at the branch on wholesale price. What will be the Stock Reserve Account balance at the end of the year?

18. What are the distinguishing features between a Department and a branch? What advantages are derived from departmental accounts? How would the following expenses be apportioned between departments (*a*) Rent; (*b*) M.D.'s salary and commission; (*c*) Advertisement; (*d*) Insurance; (*e*) Income-tax; (*f*) Interest on borrowed capital?

19. Bombay Trading Co. Ltd., has a branch in Utopia which is an integral foreign operation. The currency of Utopia fluctuates in value. At the close of the accounting period the branch in Utopia sends its Trial Balance and financial statements of account made up in local currency. Describe the procedure to incorporate the branch figures in head office books. At what rate would you convert (*i*) Remittances from Utopia, (*ii*) Current Assets, (*iii*) Goodwill, (*iv*) Depreciation of furniture, (*v*) Bad Debts, (*vi*) Provision for Doubtful Debts?

20. The Head Office of a company invoices goods to its branch at cost plus a loading of 33.1/3%. At the end of the accounting period it is found that actual stock in hand at invoice price had fallen short of the balance by Rs. 1,000. This difference is due to the following factors:

- Goods destroyed by fire at invoice price Rs. 1,000.
- Goods of the invoice value of Rs. 1,000 having been stolen.
- Cash stolen from the branch till amounting to Rs. 2,000.
- Allowances from selling price granted to customers to Rs. 2,400.
- Normal wastage of stock during the period amounting to Rs. 4,000.

Set up the adjusting entries in books of the Head Office.

21. A London firm has a branch (integral foreign peration) at Calcutta and following is the summary of balances appearing in Calcutta books at the first year as at 30th June, 2006. London Account Rs. 3,16,080. Purchase Rs. 3,43,106. Wages and Salaries Rs. 62,416, Sales Rs. 4,63,413. Interest credit Rs. 7,616. Freight Rs. 35,004. Creditors Rs. 75,108, Debtors Rs. 16,512, Bank Rs. 63,094, General charges Rs. 32,116, Investments Rs. 1,38,928, Cash Rs. 2,012, Loan Rs. 30,000.

Rates of Exchange :

1st June, 2005 Rs. 40 to £1

30 June, 2006 Rs. 38 to £1

Average Rate Rs. 39 to £1

On the date of purchase of furniture Rs. 23 to £1

You are required to give the branch's converted Trial Balance. The branch balance in the Head Office Books appear at £15,804.

22. Evergreen & Co., Calcutta, has branches at Murshidabad and Hooghly. The Head Office makes purchases and sends goods to Branches at cost plus 75 per cent. Branches remit their collection to H.O. after meeting their expenses. Following are the further details for the year ended 31-3-2006.

	Murshidabad	Hooghly
	Rs.	Rs.
Opening Balance 1-4-2005		
Stock (Invoice price)	30,000	40,000
Debtors	56,000	62,000
Cash on hand	7,200	10,300
Furniture & fittings	7,200	8,500
Goods sent to branch (Invoice price)	3,60,000	4,20,000
Goods returned by the Branch		
(Invoice price)	3,600	-
Sales : Cash Sales	1,12,000	1,32,500
Credit Sales	2,45,000	2,95,000
Collection from debtors	2,60,000	2,97,000
Remittance to H.O.	3,55,000	4,20,000
Closing Balance :		
Stock (Invoice price)	30,400	35,000
Cash on hand	12,000	4,500

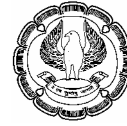
Provide depreciation @ 10% on furniture/fittings.

Prepare Branch A/c as it would appear in H.O. books under (*i*) Debtors Method, (*ii*) Stock and Debtors Method, and (*iii*) Memorandum Trading and Profit & Loss A/c Method.

23. An Indian company has a branch at Washington. Washington branch is a non-integral foreign operation of the Indian Company.

The Trial Balance of Washington branch as at 30th September, 2006 is as follows:

	Dr.	Cr.
	US $	US $
Plant and machinery	1,20,000	–



Furniture and fixtures	8,000	–
Stock, Oct. 1, 2005	56,000	–
Purchases	2,40,000	–
Sales –		4,16,000
Goods from Indian Co. (H.O.)	80,000	–
Wages	2,000	–
Carriage inward	1,000	–
Salaries	6,000	–
Rent, rates and taxes	2,000	–
Insurance	1,000	–
Trade expenses	1,000	–
Head Office A/c	–	1,14,000
Trade debtors	24,000	–
Trade creditors	–	17,000
Cash at bank	5,000	–
Cash in hand	1,000	–
	5,47,000	5,47,000

The following further information is given :

- Wages outstanding – $ 1,000.
- Depreciate Plant and Machinery and Furniture and Fixtures @ 10 % p.a on WDV basis..
- The Head Office sent goods to Branch for Rs. 39,40,000.
- The Head Office shows an amount of Rs. 43,00,000 due from Branch.
- Stock on 30th September, 2006 – $ 52,000.
- There were no in transit items either at the start or at the end of the year.
- On September 1, 2004, when the fixed assets were purchased, the rate of exchange was Rs. 38 to one $.

  On October 1, 2005, the rate was Rs. 39 to one $.

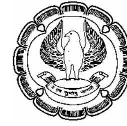
  On September 30, 2006, the rate was Rs. 41 to one $.

Average rate during the year was Rs. 40 to one $.

You are asked to prepare :

(a) Trial balance incorporating adjustments given under 1 to 4 above, coverting dollars into rupees.

(b) Trading and Profit and Loss Account for the year ended 30th September, 2006 and Balance Sheet as on that date depicting the profitability and net position of the Branch as would appear in India for the purpose of incorporating in the main Balance Sheet.



UNIT - 5 : INSURANCE CLAIMS FOR LOSS OF STOCK AND LOSS OF PROFIT

Learning Objectives

After studying this unit, you will be able to compute

- Claim for loss of stock
- Claim for loss of profit

5.1 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.

5.2 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 undermentioned 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, 2006 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, 2005 was valued at Rs. 83,500.
2. His purchases from 1-1-2006 to 12-6-2006 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 1-1-2006		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, 2006 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, 2005	73,500
Stock at cost-31st December, 2005	79,600
Purchases-year ended 31st December, 2005	3,98,000

Sales-year ended 31st December, 2005	4,87,000
Purchases-1-1-2006 to 31-3-2006	1,62,000
Sales-1-1-2006 to 31-3-2006	2,31,200

In valuing the stock for the Balance Sheet at 31st December, 2005 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, 2006 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 2005

(to determine the rate of gross profit)

Dr.				*Cr.*
	Rs.		*Rs.*	*Rs.*
To Opening Stock	73,500	By Sales A/c		4,87,000
" Purchases	3,98,000	" Closing Stock :		
" 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, 2006

Dr.							*Cr.*
	Normal items	*Abnormal items*	*Total*		*Normal items*	*Abnormal items*	*Total*
	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				By Closing Stock			
(20% on				(balancing figure)	54,600	3,450	58,050
Rs 2,28,000)	45,600	—	45,600				
	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, 2006	58,050
Less : Salvage	5,800
Loss of stock	52,250

Claim subject to average clause :

$$= \frac{\text{Amount of Policy}}{\text{Value of Stock}} \times \text{Actual Loss of Stock}$$

$$= \text{Rs.} \frac{50,000}{58,050} \times 52,250 = \text{Rs. } 45,004$$

5.3 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 effected 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.

5.3.1 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].

5.3.2 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, 2005 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, 2006, and affects business for 6 months.

(vii) Turnover for 12 months ended 31st March, 2006, Rs. 11,70,000.

(viii) Turnover : 1-4-2005 to 30-9-2005	5,00,000
1-4-2006 to 30-9-2006	3,00,000
Reduction in turnover	2,00,000

(ix) Increase in cost of working, Rs. 30,000 otherwise of which turnover during 1-4-2006 to 30-9-2006 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 1-4-2005 to 30-9-2005	5,00,000
Less : 10% down-trend	50,000
	4,50,000
Less : Turnover 1-4-2006 to 30-9-2006	3,00,000
	1,50,000

Down-trend :

Quarterly sales in 2005 $\left[\frac{\text{Rs.}12{,}00{,}000}{12}\times 3\right]$ Rs. 3,00,000

Sales of first quarter in 2006 : Rs.11,70,000 - $\left[\frac{\text{Rs.}12{,}00{,}000}{12}\times 9\right]$ Rs. 2,70,000

Rs. 30,000

Quarterly downfall

Down-trend (%) : $\frac{\text{Rs.}30{,}000}{\text{Rs.}3{,}00{,}000}\times 100$ = 10%

Adjusted Annual Turnover :	*Rs.*
Sales for the period 1-4-2005 to 31-12-2005 (11,70,000—2,70,000)	9,00,000
Less : Downward trend 10%	90,000
	8,10,000
Add : Sales from 1-1-2006 to 31-3-2006	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*) $\text{Increased cost of working} \times \frac{\text{G.P. on Annual Turnover}}{\text{G.P. as above} + \text{Uninsured Standing Charges}}$

$$= \text{Rs. } 30{,}000 \times \frac{\text{Rs.}10{,}80{,}000 \times \frac{20}{100}}{\text{Rs.}10{,}80{,}000 \times \frac{20}{100} + \text{Rs.}50{,}000}$$

= 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

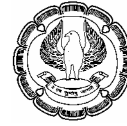


Illustration 3

A fire occurred on 1st February, 2006, in the premises of Pioneer Ltd., a retail store and business was partially disorganised upto 30th June, 2006. 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, 2006	80,000
Turnover from 1st February to 30th June, 2005	2,00,000
Turnover from 1st February, 2005 to 31st January, 2006	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

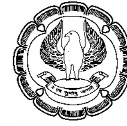
Reduction in turnover	*Rs.*
Turnover from 1st Feb. 2005 to 30th June, 2005	2,00,000
Add: 15% expected increase	30,000
	2,30,000
Less: Actual Turnover from 1st Feb., 2006 to 30th June, 2006	80,000
Short Sales	1,50,000
Gross Profit on reduction in turnover @ 30% on Rs. 1,50,000 (see working note 1)	45,000
Add: Additional Expenses	

		Rs.
Lower of (i) Actual	Rs. 6,700	
(ii) $\text{Additional Exp.} \times \frac{\text{G.P. on Annual Turnover}}{\text{G.P. on Annual Turnover} + \text{Uninsured Standing Charges}}$		
$6{,}700 \times \frac{1{,}55{,}250}{1{,}63{,}250} =$		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 :		
$\frac{\text{Amount of Policy}}{\text{G.P. on Annual Turnover}} \times \text{Amount of Claim}$		
$= \frac{1{,}25{,}000}{1{,}55{,}250} \times 48{,}922$		39,390

Amount of claim under the policy = Rs. 39,390

Working Notes :

		Rs.
(*i*)	Rate of Gross Profit for last Financial Year :	
	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., 2005 to 31st January, 2006	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, 2006 and as a result, the business was practically disorganised upto 31st August, 2006. The company is insured under a loss of profits policy for Rs. 1,65,000 having an indemnity period of 6 months.

From the following information, prepare a claim under the policy :

		Rs.
(*i*)	Actual turnover during the period of dislocation (1-3-2006 to 31-8-2006)	80,000
(*ii*)	Turnover for the corresponding period (dislocation) in the 12 months immediately before the fire (1-3-2005 to 31-8-2005)	2,40,000
(*iii*)	Turnover for the 12 months immediately preceding the fire (1-3-2005 to 28-2-2006)	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.

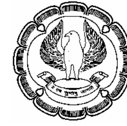
Solution

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 (1-3-2005 to 23-2-2006)	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) $\frac{\text{Gross Profit on Annual (Adjusted) Turnover} \times \text{Additional Expenses}}{\text{Gross Profit shown in the numerator} + \text{Uninsured standing charges}}$

$\frac{30\% \text{ on Rs.}6,60,000}{30\% \text{ on Rs.}6,60,000 + \text{Rs.}5,000} \times \text{Rs.}9,300$

$\frac{\text{Rs.}1,98,000}{\text{Rs.}2,03,000} \times \text{Rs.}9,300$ = 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 Decembver, 2005 :

Trading and Profit and Loss Account for the year ended 31st December, 2005

		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, 2006 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 2006 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 2005 to 30th April, 2005	3,00,000
From 1st May 2005 to 31st August, 2005	3,60,000
From 1st May, 2006 to 31st August, 2006	60,000

(*d*) Due to rise in wages, gross profit during 2006 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 uncoverd. Ascertain the claim for stock and for loss of profit.

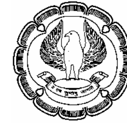
All workings should form part of your answers.

Solution

Claim for loss of stock :

Memorandum Trading Account for the period 1st January to 1st May, 2006

	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 2005

$$\frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

$$\frac{2,40,000}{8,00,000} \times 100 = 30\%$$

In 2006 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, 2005 to 31st August, 2005	3,60,000
Less: 20% decline observed in 2006 over 2005	
(Jan - April Rs. 2,40,000 instead of Rs. 3,00,000)	72,000
	2,88,000
Less : Sales from 1st May, 2006 to 31st August, 2006	60,000
Short-Sales	2,28,000

(*b*) Gross profit ratio

$$\frac{\text{Net Profit} + \text{Insured standing charges (2000)}}{\text{Sales (2000)}} \times 100$$

$$\frac{56,000 + 1,20,000}{8,00,000} \times 100 = \quad 22\%$$

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, 2006) :

	Rs.
Sales for Jan-Dec., 2005	8,00,000
Less : From 1-1-2005 to 30-4-2005	3,00,000
	5,00,000
Less : 20% downward trend	1,00,000
	4,00,000
Add : From 1-1-2006 to 30-4-2006	2,40,000
	6,40,000
Gross Profit on annual turnover @ 20%	1,28,000

(*e*) Amount allowable in respect of additional expenses

Least of the following :

(i) Actual expenses 1,40,000

(ii) Gross Profit on sales during indemnity period 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.

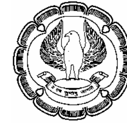
N.B. : On the amount of final claim, the average clause will not apply since the amount of the policy Rs. 1,72,000 is higher than Gross Profit on annual turnover Rs. 1,28,000.

Illustration 6

Sony Ltd.'s. trading and profit and loss account for the year ended 31st December, 2005 were as follows:

Trading and Profit and Loss Account for the year ended 31.12.2005

	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 1.4.2006 at the premises and the entire stock were gutted with nil salvage value. The net quarter sales i.e. 1.4.2006 to 30.6.2006 was severely affected. The following are the other information:

Sales during the period	1.1.06 to 31.3.06	2,50,000
Purchases during the period	1.1.06 to 31.3.06	3,00,000
Manufacturing expenses	1.1.06 to 31.3.06	70,000
Sales during the period	1.4.06 to 30.6.06	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 1.1.2006 to 31.3.2006

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

	Rs.		Rs.
To Manufacturing expenses	70,000	(balancing figure)	
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 1.4.2005 to 30.6.2005 (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 1.4.2006 to 30.6.2006	87,500	
Short sales	2,12,500	

Computation of G.P. Ratio:

$$\text{Gross profit ratio} = \frac{\text{Net profit} + \text{Incurred standing charges}}{\text{Sales}} \times 100$$

$$= \frac{\text{Rs.}50{,}000 + \text{Rs.}50{,}000}{\text{Rs.}10{,}00{,}000} \times 100 = 10\%$$

Less: Decreasing trend in G. P. 5%

5%

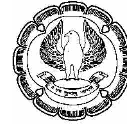
Loss of profit =5% of Rs, 2,12,500=Rs. 10,625

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 $\dfrac{\text{G.P.on annual turnover}}{\text{G.P.on annual turnove} + \text{Uninsured standing charges}}$

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 1.4.2005 to 31.12.2005 (W.N.1)	7,39,130
Turnover for the period 1.1.2006 to 31.3.2006	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 2005:**	
	Sales of the last quarter of 2005 (Rs. 2,50,000 x 100/115)	2,17,390* (approx.)
	Sales for the remaining three quarters of 2005 Rs. (10,00,000-2,17,390)	7,82,610

*Sales for the last quarter of 2005 is computed on the basis of sales of the first quarter of 2006.

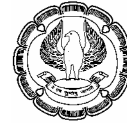
2. The increase in trend of sales has been applied to the sales of 2005 only, as the sales figure of the first quarter of 2006was already trend adjusted.

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.

[Ans. 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, 2006. Their business activities were interrupted until 31st December 2006, when normal trading conditions were re-established. M/s. Fortunate are 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, 2005 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 2005 and 2006 was as under :

	Rs.	*Rs.*	*Rs.*
2005......	65,000	80,000	95,000
2006......	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, 2006 and as a result of which the business was disorganised from 1st March to 31st July, 2006. 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 2005	40,00,000
Net profits for the year 2005	2,40,000
Insured standing charges	4,80,000
Uninsured standing charges	80,000
Turnover during the period of dislocation i.e. from 1-3-2006 to 31-7-2006	8,00,000
Standard turnover for the corresponding period in the preceding year i.e. from 1-3-2005 to 28-2-2006	20,00,000

9. On 31st December 2005, a fire damaged the premises of Shankar Ltd. and the business of the Company was disorganised until 31st March, 2006. 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, 2005 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, 2005 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 11

ADVANCED ISSUES IN PARTNERSHIP ACCOUNTS

UNIT - 1 : INTRODUCTION TO 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.
- Familiaralize with the two methods of maintaining Partners' Capital Accounts, namely Fixed Capital Method and Fluctuating Capital Method.
- Learn that interest on capital and drawings, salaries/commissions are to be shown in the Profit and Loss Appropriation Account and not in the Profit and Loss Account. 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.
- 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 technique of treating reserve balance on admission, retirement or death of a partner .
- See the technique of arriving at new profit-sharing ratio after admission, retirement or death of a partner .
- Learn the technique of keeping 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.

1.1 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;

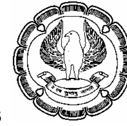
(viii) Rent to be paid to the partners whose premises are used for the purpose of business;

(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.

1.2 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 drawing (if agreed in the partnership deed);
- Salary to partners for service 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, 2006, 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 2006 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

Dr. **A's Capital Account** *Cr.*

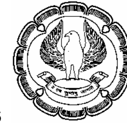
2006		Rs.	2006		Rs.
Dec. 31	To Cash (Drawings)	8,000	Jan. 1	By Cash	30,000
	To Balance c/d	33,800	Dec. 31	By Profit and Loss A/c	
				(Interest)	1,800
				By Profit and Loss A/c	
				(5/8 Profit)	10,000
		41,800			41,800
			2007		
			Jan. 1	By Balance b/d	33,800

B's Capital Account

2006		*Rs.*	2006		*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	6,000
				(3/8 Profit)	
		33,200			33,200
			2007		
			Jan. 1	By Balance b/d	23,200

Illustration 2

Ram and Rahim start business with capital of Rs. 50,000 and Rs. 30,000 on 1st January, 2005. 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

2005		*Rs.*	*2005*		*Rs.*
Dec.31	To Balance c/d	50,000	Jan. 1	By Cash	50,000
			2006		
			Jan. 1	By Balance b/d	50,000

Rahim's Capital Account

2005		*Rs.*	*2005*		*Rs.*
Dec. 31.	To Balance c/d	30,000	Jan. 1	By Cash	30,000
			2006		
			Jan. 1	By Balance b/d	30,000

Ram's Current Account

2005		*Rs.*	*2005*		*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
			2006		
			Jan. 1	By Balance b/d	5,230

Rahim's Current Account

2005		Rs.	2005		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 drawings	300		Interest	1,800
	To Balance c/d	6,770		By Profit and Loss A/c	
				Profit	10,470
		17,070			17,070
			2006		
			Jan. 1	By Balance b/d	6,770

1.3 PROFIT AND LOSS APPROPRIATION ACCOUNT

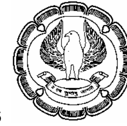
Profit and Loss Appropriation Account is prepared by a partnership firm to distribute the net profit among the partners in accordance with the partnership deed. Any interest on drawing is added to the net profit and thereafter out of such total profit, interest on partners' capital, salaries, commission, 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 2005 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 1-10-2005 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. 2005 @ 8%*	*Oct-Dec. 2005 @ 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* *Total*	*Jan-Sept.* *2005*	*Oct-Dec.* *2005*	
	Rs.	*Rs.*	*Rs.*
Net	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	3,38,250	1,24,000	4,62,250
in the profit sharing ratio			
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

1.4 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.

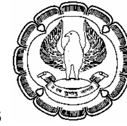
There are four methods for valuation of goodwill :

(1) Average profit basis,

(2) Super profit basis,

(3) Annuity basis, and

(4) Capitalisation basis.



1.4.1 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 :

1	*2*	*3*	*4 = 2 × 3*
Year	*Profit*	*Weight*	*Weighted Profit*
	Rs.		*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 number 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;

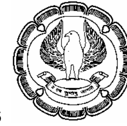
(e) Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

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	3000	.8696	2,608.80
2	3000	.7561	2,268.30
3	3000	.6575	1,972.50



4	3000	.5718	1,715.40
5	3000	.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 2002-2005 as follows :

Year	Profit
	Rs.
2002	1,20,000
2003	1,25,000
2004	1,30,000
2005	1,50,000

On 31.12.2005 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*	*Weight Rs.*	*Weighted Profit (Rs.)*
2002	1,20,000	1	1,20,000
2003	1,25,000	2	2,50,000
2004	1,30,000	3	3,90,000
2005	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

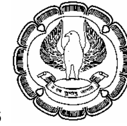
Value of Goodwill : Rs. 1,36,000 × 3 = Rs. 4,08,000

Method (2) : Super Profit Basis

Average Profit	Rs. 1,36,000
Normal Profit	
20% on Rs. 5,00,000	Rs. 1,00,000
	Rs. 36,000

Assumption : Goodwill is valued at 3 years purchase.

Value of Goodwill : Rs 36,000 × 3 = 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

1.4.2 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 showing 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.

* 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.

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 $= \frac{1}{6} \times$ Rs. 1,20,000 = Rs. 20,000(Cr.)

B $= \frac{1}{6} \times$ Rs. 1,20,000 = Rs. 20,000(Cr.)

C $= \frac{2}{6} \times$ Rs. 1,20,000 = Rs. 40,000(Dr.)

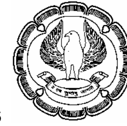
Example 2

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:

	Old Ratio	–	*New Ratio*	=	*Profit Sacrificing Ratio*
A	$\frac{1}{2}$	–	$\frac{1}{2}$	=	0
B	$\frac{1}{2}$	–	$\frac{2}{6}$	=	$\frac{1}{6}$

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. Another alternative is that goodwill is raised in the books of accounts of the firm crediting the partners' capital accounts in their old profit sharing ratio and then writing it off in the new profit sharing ratio.

Example 3

A, B & C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. They raised the goodwill Rs. 90,000 but they want to immediately write it off. Make the necessary journal entries.

Solution

Journal Entries

		Rs.	*Rs.*
Goodwill A/c	Dr.	90,000	
To A's Capital A/c			30,000
To B's Capital A/c			30,000
To C's Capital A/c			30,000
(Value of goodwill raised in the books on the occasion of change in profit sharing ratio and credited to partners in their old ratio 1:1:1)			
A's Capital A/c	Dr.	40,000	
B's Capital A/c	Dr.	30,000	
C's Capital A/c	Dr.	20,000	
To Goodwill A/c			90,000
(Goodwill written off in the new profit sharing ratio 4:3:2)			
Alternatively the following entry could be passed			
A's Capital	Dr.	10,000	
To C's Capital A/c			10,000

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 profit 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

Partner	*New Ratio*		*Old Ratio*		*Difference*
A	$\frac{7}{20}$	$-$	$\frac{4}{10}$	=	$-\frac{1}{20}$
B	$\frac{7}{20}$	$-$	$\frac{3}{10}$	=	$\frac{1}{20}$
C	$\frac{6}{20}$	$-$	$\frac{3}{10}$	=	0

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

Example 6

A, B, C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. For this purpose they raised the goodwill Rs. 90,000 but they want to immediately write it off. For this purpose, the following journal entries are necessary :

Goodwill A/c	Dr.	90,000	
To A's Capital A/c			30,000
To B's Capital A/c			30,000
To C's Capital A/c			30,000
(Value of goodwill raised in the books on the occasion of change in profit sharing ratio and credited to partners in their old ratio 1:1:1)			
A's Capital A/c	Dr.	40,000	
B,s Capital A/c	Dr.	30,000	
C's Capital A/c	Dr.	20,000	
To Goodwill A/c			90,000
(Goodwill written off in the new profit sharing ratio 4:3:2)			

Alternatively the following entry could be passed

A's Capital	Dr.	10,000	
To C's Capital A/c			10,000

In this case due to change in profit sharing ratio

A's gain is $\frac{4}{9} - \frac{1}{3} = \frac{1}{9}$

B's gain is $\frac{1}{3} - \frac{1}{3} = 0$

C's loss is $\frac{1}{3}-\frac{2}{9}=\frac{1}{9}$

So A should compensate to the extent of 1/9th of goodwill *i.e.,*

Rs. 90,000 × $\frac{1}{9}$ = 10,000

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

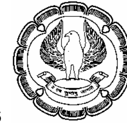
A's Capital A/c	Dr.	Rs. 15,000	
B's Capital A/c	Dr.	Rs. 15,000	
To C's Capital A/c			Rs. 30,000
(C's share of goodwill adjusted to existing partners' capital accounts in profit gaining ratio)			

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, 2005 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.
2002	67,200
2003	75,600
2004	72,000
2005	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 :

(i) Average Profit for three years, ending 30th June; before death:

	Rs.	*Rs.*
Year ending 30th June, 2003 :		
1/2 of 2002profits	33,600	
1/2 of 2003 Profits	37,800	71,400
Year ending 30th June, 2004 :		
1/2 of 2003	37,800	
1/2 of 2004 Profits	36,000	73,800
Year ending 30th June, 2005 :		
1/2 of 2004	36,000	
1/2 of 2005 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	39,960	

Adjustment entries for Goodwill

Journal

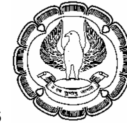
		Dr. *Rs.*	*Cr.* *Rs.*
Goodwill Account	Dr.	39,960	
To Capital Accounts			
Wise			15,984
Clever			11,988
Dull			11,988
(Goodwill, valued @ Rs. 39,960 adjusted in the capital accounts of partners on the death of Mr. Wise in the old profit sharing ratio)			
Clever's Capital Account	Dr.	19,980	
Dull's Capital Account	Dr.	19,880	
To Goodwill Account			39,960
(Goodwill written off between continuing parnters in the new profits sharing ratio)			

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 31.12.2005 , 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 2005 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 31.12.2005	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 2005	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	

Similarly in case of retirement of a partner, on the date of retirement goodwill is valued and adjusted through the capital accounts of partners.

1.5 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 show a decrease)		with the reduction in the value of 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 (of all partners including newly admitted partner)	Dr.	With the amount of revaluation
To Revaluation A/c		profit in the new profit sharing ratio.
or		
Revaluation A/c	Dr.	
To Capital A/cs (of all partners including newly admitted partners)		With the amount of revaluation loss in the new profit sharing ratio.

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 7

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, 2006 in 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, 2006 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 3/15and 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

2006			*Rs.*	*2006*		*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 Goodwill	5,000	5,000	3,000	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 Goodwill	6,000	6,000	3,000	–
					By Outstanding				
					Liabilities	1,000	-	-	–
					By Revaluation A/c	2,520	2,520	1,260	–
	24,120	23,120	10,560	5,000		24,120	23,120	10,560	5,000

Balance Sheet of M/s Dalal, Banerji, Mallick and Mistri as on 1-4-2006

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

1.5.1 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 8

A and B are in partnership sharing profits and losses equally. The Balance Sheet of M/s A and B as on 31-12-05 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 1-1-06 they agreed to take C as 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 1-1-06.

Solution

In the Books of M/s A, B and C

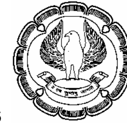
Journal Entries

		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)			
Goodwill A/c	Dr.	45,000	
To A's Capital A/c			22,500
To B's Capital A/c			22,500
(Inferred value of goodwill raised) in the books)			
A's Capital A/c	Dr.	15,000	
B's Capital A/c	Dr.	15,000	
C's Capital A/c	Dr.	15,000	
To Goodwill A/c			45,000
(Value of goodwill written off in the new profit sharing ratio)			
A's Capital A/c	Dr.	7,500	
B's Capital A/c	Dr.	7,500	
To Bank			15,000
(Amount of goodwill due to A and B withdrawn)			

Workings :

(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 Goodwill	15,000	15,000	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 Goodwill A/c	22,500	22,500	-
	67,500	67,500	60,000		67,500	67,500	60,000

Balance Sheet of M/s A, B & C as on 1-1-2006

Liabilities		*Rs.*	*Assets*	*Rs.*
Capital A/cs :			Sundry Fixed Assets	60,000
A	Rs. 45,000		Stock	30,000
B	Rs. 45,000		Bank	65,000
C	Rs. 45,000	1,35,000		
Sundry Creditors		20,000		
		1,55,000		1,55,000

1.6 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)	

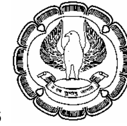
Now let us see how to deal with a situation where revaluation profit will not appear in the Balance Sheet.

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.	2000	
	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.	9000	
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.*
To X's Capital A/c	Dr.	2,400	
To Y's Capital A/c	Dr.	600	
To Z's capital A/c			3,000
(Adjustment entry for Z's share of reserve)			

1.6.1 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 9

Fairbrother, Greatbatch and Kristen were partners sharing profit and losses at the 2:2:1. Kristen wants to retire on 31-12-2005. Given below the Balance Sheet of the partnership as well as other information :

Balance Sheet as on 31-12-2005

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 31-12-2005 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)	Goodwill A/c	Dr.	50,000	
	To F's Capital A/c			20,000
	To G's Capital A/c			20,000
	To K's Capital A/c			10,000
	(Being the goodwill raised on K's retirement).			
(2)	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).			
(3)	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).			
(4)	Profit and Loss Adjustment A/c	Dr.	5,000	
	To Bills Receivable A/c			5,000
	(Loss arising out of dishonoured bill recorded).			
(5)	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).			

(6)	F's Capital A/c	Dr.	30,000	
	G's Capital A/c	Dr.	20,000	
	To Goodwill A/c			50,000
	(Writing off the value of goodwill in the new profit sharing ratio of the continuing partners).			
(7)	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).			
(8)	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 Goodwill	30,000	20,000	-	By Balance b/d	1,20,000	80,000	60,000
To Balance c/d	1,28,000	98,000	79,000	By Goodwill	20,000	20,000	10,000
				By P & L Adj. A/c	14,000	14,000	7,000
	–	–	–	By Reserve	4,000	4,000	2,000
	1,58,000	1,18,000	79,000		1,58,000	1,18,000	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.

1.7 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, 2006. 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 2005 can be taken as base for calculating 3½ months profit in 2006. If M/s. A, B & C earned Rs. 96,000 in 2005, 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 3½ months profit in 2006 is transferred to his Capital Account on death)			

Students are advised to see CPT study material chapter 8-unit 5 for details.

1.8 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, 2005. 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, 2006. 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

$$\text{C's share} - 28{,}000 \times \frac{1{,}20{,}000}{2{,}45{,}000} = \text{Rs. } 13{,}714$$

(ii) Interest at 6% p.a.

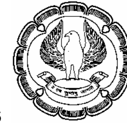
$$1{,}20{,}000 \times \frac{6}{100} \times \frac{3}{12} = \text{Rs. } 1{,}800$$

Since, (*i*) option is beneficial for C, he will necessarily go for his proportionate share in profits.

Illustration 10

Rohan, Sohan and Mohan were partners sharing profits and losses in the ratio of 2:2:1. Their Balance Sheet as on 1-1-2006 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



The firm had taken a Joint Life Policy for Rs. 1 lac, the premium amounts on which were charged to the Profit and Loss Account. On 1st July, 2006 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 1-1-2006.

The policy money was received on 31-12-2006 and Mohan's heirs were paid the total amount due on the same day. Current years (2006) 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. 33,000, 29,000, 35,000 and 66,217. The particulars regarding their drawings are given below :

	Upto 1-7-2006	April 1-7-2006
	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, 2006 assuming that the remaining partners did not retain Goodwill in their books.

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 1-7-2006**

Dr.							*Cr.*
	Rohan	*Sohan*	*Mohan*		*Rohan*	*Sohan*	*Mohan*
To Revaluation Loss of Fixed Assets	4,000	4,000	2,000	By Balance b/d	50,000	40,000	30,000
To Drawings	4,125	4,125	1,750	By Reserves	4,000	4,000	2,000
To Executors A/c	–	–	42,000	By Goodwill	20,000	20,000	10,000
To Balance c/d	74,000	64,000	–	By Profit and Loss Appn. A/c	8,125	8,125	3,750
	82,125	72,125	45,750		82,125	72,125	45,750

(f) **Application of Section 37 of the Partnership Act**

Either

(i) Interest of 42,000 $\times \frac{6}{100} \times \frac{6}{12}$ = Rs. 1,260

Or

(ii) Profit earned out of unsettled capital

$20{,}500 \times \frac{42{,}000}{(74{,}000 + 64{,}000 + 42{,}000)}$ = Rs. 4,783

(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. 4,783.

(h) **Profit and Loss Appropriation A/c for the IInd half**

Dr.				Cr.
		Rs.		Rs.
To Executors A/c		4,783	By Net Profit	20,500
To Rohan	7,858			
Sohan	7,859	15,717		
		20,500		20,500

(i) **Capital Accounts as on 31-12-2006**

Dr.					*Cr.*
	Rohan	Sohan		Rohan	Sohan
	Rs.	Rs.		Rs.	Rs.
To Drawings	5,000	5,000	By Balance b/d	74,000	64,000
To Goodwill w/off	25,000	25,000	By Profit & Loss Appn. A/c	7,858	7,859
To Balance c/d	91,858	81,859	By Joint Life Policy	40,000	40,000
	1,21,858	1,11,859		1,21,858	1,11,859

(j) **Executors Account**

Dr.			*Cr.*
	Rs.		Rs.
To Bank	66,783	By Mohan's Capital A/c	42,000
		By Profit & Loss Appn. A/c	4,783
		By Joint Life Policy	20,000
	66,783		66,783

(k) **Balance Sheet as on 31-12-2006**

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital Accounts			Fixed Assets	1,00,000	
Rohan	91,858		*Less* : Written down	10,000	
Sohan	81,859	1,73,717		90,000	
Creditors		35,000	*Less* : Depreciation	9,500	80,500
			Debtors		29,000
			Stock		33,000
			Cash and Bank		66,217
		2,08,717			2,08,717

Note: Students are advised to see CPT Study Material Chapter 8 for details.

Self Examination Questions

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, joint life policy, interest on capital, share in revalued assets and liabilities.
    (b) Capital, goodwill, joint life policy, 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, joint life policy, share in revalued assets and liabilities.

[Ans. 1. (i) (a); 2 (c); 3. (b); 4 (c); 5 (c); 6 (a); 7 (d); 8 (a); 9. (c); 10. (d)]

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

Long answer type questions

14. How is goodwill treated in the books of account on the retirement of a partner? Explain.

15. Explain various methods of valuation of goodwill.

16. Give the accounting treatment of goodwill at the time of admission of a partner under the following circumstances:

(a) Goodwill raised and written off.

(b) Goodwill adjusted through partners' capital accounts.

Practical problems

17. Ram and Rahim were working in partnership sharing profits equally. On 31st December, 2005 Ram decided to retire and in his place it was decided that Suresh, his son, would

be admitted as a partner from 1 January, 2006 and his share in profits would be one third.

Balance Sheet of the firm as at 31st December, 2005 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 31.03.2006 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 01.04.2006 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 31.3.2004: profit Rs. 20,000 (includes insurance claim received of Rs. 40,000).

For the year ended 31.3.2005: loss Rs. 80,000 (includes voluntary retirement compensation paid Rs. 1,10,000).

For the year ended 31.3.2006: 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 31.03.2006 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 01.04.2006 after the admission of Guru.

19. On 31st March, 2006, 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, 2006, 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. Joint life policy of the partners surrendered and cash obtained Rs. 60,000.
7. 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.
8. The total capital of the firm is to be the same as before retirement. Individual capital be in their profit sharing ratio.
9. Amount due to Ram is to be settled on the following basis:-

   50% on retirement and the balance

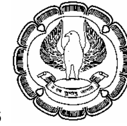
   50% within one year

   Prepare revaluation account, capital account of partners: Rahul & Rohit, loan account of Ram, cash account and balance sheet as on 1.4.2006 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 31.3.2006. Mr. Z died on 31st December, 2006. His account ha stop be settled under the following terms.

Balance sheet of Om & Co. as on 31.3.2006

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
31.3.2006	30,000
31.3.2005	20,000
31.3.2004	(10,000) Loss

Profit for the period from 1.4.2006 to 31.12.2006 shall be ascertained proportionately on the basis of average profits and losses of the preceding three years.

During the year ending on 31.3.2006 a car costing Rs. 40,000 was purchased on 1.4.2005 and debited to traveling expenses account on which depreciation is to be calculated at 20%p.a. This asset is to be brought into account at the 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 31.12.2006 assuming that other items of assets and liabilities remained the same.

UNIT - 2 : DISSOLUTION OF PARTNERHIP FIRMS

Learning Objectives

After studying this unit, you will be able to:

- go through the circumstances in which a partnership is dissolved.
- understand that on dissolution of a partnership all assets are sold out and all liabilities are discharged. Learn the accounting technique relating to disposal of assets and payment of liabilities.
- learn how to settle the partner's claims in case of surplus and how to raise money from partners in case of deficit.

2.1 INTRODUCTION

Apart from readjustment of rights of partners in the share of profit by way of change in the profit sharing ratio and admission of a new partner or for retirement/death of a partner, another important aspect of partnership accounts is how to close books of accounts in case of dissolution. In this Unit, we shall discuss the circumstances leading to dissolution of a partnership firm and accounting treatment necessary to close its books of accounts. Also we shall discuss the special problems relating to insolvency of partners and settlement of partnership's liabilities.

2.2 CIRCUMSTANCES LEADING TO DISSOLUTION OF PARTNERSHIP

A partnership is dissolved or comes to an end on:

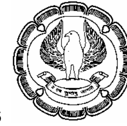
(a) the expiry of the term for which it was formed or the completion of the venture for which it was entered into;

(b) death of a partner;

(c) insolvency of a partner;

(d) retirement of a partner;

However, the partners or remaining partners (in case of death, insolvency or retirement) may continue to do the business. In such case there will be a new partnership but the firm will continue. When the business also comes to an end then only it will be said that the firm has been dissolved.



A firm stand dissolved in the following cases :

(i) the partners agree that the firm should be dissolved;

(ii) all partners except one become insolvent;

(iii) the business becomes illegal;

(iv) in case of partnership at will, a partner gives notice of dissolution; and

(v) the court orders dissolution.

The court has the option to order dissolution of a firm in the following circumstances :

(a) where a partner has become of unsound mind;

(b) where a partner suffers from permanent incapacity;

(c) where a partner is guilty of misconducting the business;

(d) where a partner persistently disregards the partnership agreement;

(e) where a partner transfers his interest or share to a third party;

(f) where the business cannot be carried on except at a loss; and

(g) where it appears to be just and equitable.

2.3 CONSEQUENCES OF DISSOLUTION

On the dissolution of a partnership, the assets of the firm, including goodwill, are realised and the amount is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards the capital contributed by partners is repaid and, if there is still surplus, it is distributed among the partners in their profit-sharing ratio. Conversely, after payment of liabilities of the firm and repayment of loans from partners, if the assets of the firm left over are insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit-sharing ratios. According to the provisions contained in Section 48 of the Partnership Act, upon a dissolution of partnership, the mutual rights of the partners, unless otherwise agreed upon, are settled in the following manner :

(a) Losses including deficiencies of capital are paid, first out of profits, next out of capital and, lastly, if necessary, by the partners individually in the proportion in which they are entitled to share profits.

(b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital have to be applied in the following manner and order :

   (i) in paying the debts of the firm to third parties;

   (ii) in paying to each partner rateably what is due to him from the firm in respect of

advances as distinguished from capital;

(iii) in paying to each partner what is due to him on account of capital; and

(iv) the residue, if any, to be divided among the partners in the proportion in which they are entitled to share profits.

The death or retirement of a partner would not result in the dissolution of the partnership, if the partnership agreement so provides (Section 42). In spite of it in the absence of an agreement to the contrary, the retiring partner or the representative of a deceased partner can recover his share in the partnership assets (including goodwill), after having them revalued on a proper basis as at the date of his ceasing to be a partner; appreciation or depreciation determined on such a revaluation is adjusted in his account before the amount due to him is paid.

The amount due to the retiring partner is liability of the firm except where a partnership agreement provides that upon the retirement or death of a partner his share in the assets of the firm will be taken over by the continuing partners in the proportion in which they were sharing the profits or losses of the firm. When the continuing partners take over the assets they also become personally liable to repay the amount due to the retiring partner. Such was the view taken in the well known case of *Elliott* vs. *Elliott.*

Students should also remember that :

(1) the retiring partner or the estate of the deceased partner is liable for the whole of the debts due by the firm at the date of retirement or death though, as between the partners they are responsible to pay only their respective share of liabilities [Section 42(2) of the Partnership Act].

(2) the retiring partner may also be held liable for debts contracted after his retirement, unless a notice of retirement is published as contemplated by the Law [Section 32(2) of the Partnership Act]; and

(3) the estate of a deceased or a bankrupt partner cannot be held liable for debts contracted by the firm after the death or bankruptcy, as the case may be. [Sections 34(2) and 35 of the Partnership Act].

Dissolution before expiry of a fixed term : A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund if the firm is dissolved before the term has expired.

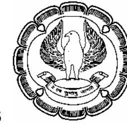
No claim in this respect will arise if :

(1) the firm is dissolved due to the death of a partner;

(2) the dissolution is mainly due to the partner's (claiming refund) own misconduct; and

(3) the dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it. [Section 50].

The amount to be repaid will be such as is reasonable having regard to the terms upon which



the admission was made and to the length of period agreed upon and that already expired. Any amount that becomes due will be borne by other partners in their profit- sharing ratio.

2.4 CLOSING OF PARTNERSHIP BOOKS ON DISSOLUTION

We will illustrate the required journal entries to be made for closing the books of a firm with the example given below :

Balance Sheet of Fast and Quick as at Dec. 31, 2005

Liabilities		*Rs.*	*Assets*		*Rs.*
Sundry Creditors		20,000	Plant and Machinery		40,000
Fast's Loan		10,000	Patents		6,000
General Reserve		10,000	Stock		25,000
Capitals :			Sundry Debtors	19,000	
Fast	30,000		*Less :* Prov. for bad debts	1,000	18,000
Quick	25,000	55,000	Cash		6,000
		95,000			95,000

Fast and Quick shared profits in the ratio of 3:2. On 1st January, 2006 the firm was dissolved. Fast took over the patents at a valuation of Rs. 5,000. The other assets realised as under :

		Rs.
Goodwill		15,000
Plant and Machinery		30,000
Stock		22,000
Sundry Debtors		18,500
	Total	85,500

The Sundry Creditors were paid off at a discount of 5%. The expense amounted to Rs. 3,500. The sSteps to close the books are given below :

I. Open a Realisation Account and transfer all assets except cash in hand or at bank at book values. Realisation Account is debited and the various assets are credited and thus closed. It should be remembered that Sundry Debtors and Provisions for Bad Debts Accounts are two separate accounts and the gross amount of debtors should be transferred. In the above example the entry will be :

Realisation Account	Dr.	90,000	
To Plant and machinery Account			40,000

To Patents Account			6,000
To Stock Account			25,000
To Sundry Debtors			19,000
(Transfer of various assets to the debit side of Realisation Account)			

II. Transfer of liabilities to outsiders and provisions and reserves against assets (e.g., Provision for Doubtful Debts) to the credit side of Realisation account. The accounts of the liabilities and provisions will be debited and thus closed. The entry should be at book figures. The entry will be :

		Rs.	*Rs.*
Sundry Creditors Account	Dr.	20,000	
Provision for bad Debts Account	Dr.	1,000	
To Realisation Account			21,000
(Transfer of liabilities to outsiders and provision against debtors to Realisation Account)			

Note : Accounts denoting accumulated losses or profits should not be transferred to the Realisation Account.

III. (i) The Realisation Account should be credited with the actual amount realised by sale of assets. This should take no note of the book figures. Of course, Cash (or Bank) Account will be debited. Thus :

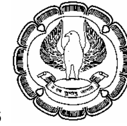
Cash Account	Dr.	85,500	
To Realisation Account			85,500
(Amount realised by sale of various assets).			

(ii) If a partner takes over an asset, his Capital Account should be debited and Realisation Account credited with the value agreed upon, Thus :

Fast's Capital Account	Dr.	5,000	
To Realisation Account			5,000
(Patents taken over by Fast at Rs. 5,000)			

IV. Expenses of dissolution or realisation of assets are debited to the Realisation Account and credited to Cash Account. Thus

Realisation Account	Dr.	3,500	
To Cash Account			3,500
(Payment of Expenses)			



V. (i) The actual amount paid to creditors should be debited to the Realisation Account and Cash Account is credited :

Realisation Account	Dr.	19,000	
To Cash Account			19,000
(Payment to Sundry Creditors, Rs. 20,000 less 5%)			

(ii) If any liability is taken over by a partner, his Capital Account should be credited and Realisation Account debited with the amount agreed upon.

VI. At this stage, the Realisation Account will show profit or loss. If the debit side is bigger, there is a loss; if the credit side is bigger, there is a profit. Profit or loss is transferred to the Capital Accounts of partners in the profit sharing ratio. In case of profit, Realisation Account is debited and Capital Accounts credited. The entry for loss is, naturally, reverse of this. The Realisation Account in the example given above shows a loss of Rs. 1,000 (see account below).

Fast's Capital Account	Dr.	600	
Quick's Capital Account	Dr.	400	
To Realisation account			1,000
(Transfer of loss to Capital Account in the ratio of 3:2)			

VII. Partner's Loans if any, should now be paid. The entry is to debit the Loan Account and credit Cash Account. Thus :

Fast's Loan Account	Dr.	10,000	
To Cash Account			10,000
(Repayment of Fast's Loan)			

VIII. Any reserve of accumulated profit or loss lying in the books (as shown by the Balance Sheet should be transferred to the Capital Account in the profit sharing ratio. Thus :

General Reserve	Dr.	10,000	
To Fast's Capital Account			6,000
To Quick's Capital Account			4,000
(General Reserve transferred to Capital Account in the ratio of 3:2)			

IX. At this stage the Capital Account will show how much amount is due to them or from them. The partner owing money to the firm will pay; Cash Account will be debited and his Capital Account credited and thus closed. Money owing to a partner will be paid to him; his Capital Account will be debited and the Cash Account credited. This will close the

Capital Accounts as well as the Cash Account. The entry in the above example is seen in the Capital Accounts below :

Fast's Capital Account	Dr.	30,400	
Quick's Capital Account	Dr.	28,600	
To Cash Account			59,000

(Amounts paid to partners on Capital Account).

LEDGER ACCOUNTS

Plant and Machinery Account

2006		*Rs.*	*2006*		*Rs.*
Jan. 1	To Balance b/d	40,000	Jan. 1	By Realisation A/c - Transfer	40,000

Patents Accounts

2006		Rs.	2006		Rs.
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realisation A/c - Transfer	6,000

Stock Account

2006		Rs.	2006		Rs.
Jan. 1	To Balance b/d	25,000	Jan. 1	By Realisation A/c - Transfer	25,000

Sundry Debtors Account

2006		*Rs.*	*2006*		*Rs.*
Jan. 1	To Balance b/d	19,000	Jan. 1	By Realisation A/c - Transfer	19,000

Provision for Bad Debts Account

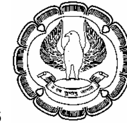
2006		*Rs.*	*2006*		*Rs.*
Jan. 1	To Realisation A/c Transfer	1,000	Jan. 1	By Balance b/d	1,000

Sundry Creditors Account

2006		*Rs.*	*2006*		*Rs.*
Jan. 1	To Realisation A/c Transfer	20,000	Jan. 1	By Balance b/d	20,000

Fast's Loan Account

2006		Rs.	2006		Rs.
Jan. 1	To Cash Account	10,000	Jan. 1	By Balance b/d	10,000



General Reserve Account

2006			Rs.	Rs.	2006		Rs.
Jan. 1	To Capital Account				Jan. 1	By Balance b/d	10,000
	Fast		6,000				
	Quick		4,000	10,000			
				10,000			10,000

Realisation Account

2006			Rs.	2006				Rs.
Jan.	To	Sundry Assets		Jan.	By Sundry Creditors			20,000
		Plant and Machinery	40,000		By Provision for Bad Debts			1,000
		Patents	6,000		By Cash Account-			
		Stock	25,000			assets realised		85,500
		Sundry Debtors	19,000		By Fast's Capital Account-			
	To	Cash Account-Exps.	3,500			patents taken over		5,000
	To	Cash Account-						
		Creditors paid	19,000		By	Loss to :		
						Fast	600	
						Quick	400	1,000
			1,12,500					1,12,500

Cash Account

2006		Rs.	2006			Rs.
Jan. 1	To Balance b/d	6,000	Jan. 1	By	Realisation A/c-Exps	3,500
	To Realisation b/d	85,500	Jan. 1	By	Realisation A/c-Creditors	19,000
			Jan. 1	By	Fast's Loan Acount	10,000
			Jan. 1	By	Fast's Capital A/c	30,400
			Jan. 1	By	Quick's Capital A/c	28,600
		91,500				91,500

Fast's Capital Account

2006		Rs.	2006		Rs.
Jan. 1	To Realisation A/c-Patents	5,000	Jan. 1	By Balance b/d	30,000
	To Realisation A/c-Loss	600	Jan. 1	By General Reserve	6,000
	To Cash Account	30,400			--------
		36,000			36,000

Quick's Capital Account

2006		Rs.	2006		Rs.
Jan. 1	To Realisation A/c-loss	400	Jan. 1	By Balance b/d	25,000
	To Cash Account	28,600		By General Reserve	4,000
		29,000			29,000

Note : If any of the assets is taken over by a partner at a value mutually agreed to by the partners, debit the partner's capital account and credit Realisation Account with the price of asset taken over.

(3) Pay off the liabilities, crediting cash and debiting the liability accounts, the difference between the book figure and the amount paid being transferred to the Realisation Account.

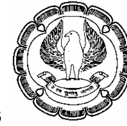
Note : Liabilities to outsiders may also be transferred to the Realisation Account. In that case, the amount paid in respect of the liabilities in cash should be debited to the Realisation Account, Cash Account being credited. If liability is taken over by a partner, Realisation Account should be debited and the Partners' Capital A/cs credited at the figure agreed upon.

(4) The balance of the Realisation Account will represent either the profit or loss on realisation. Divide it between the partners in the proportion in which they shared profits and losses. In the case of a loss, credit Realisation Account and debit various partners' Capital Accounts; follow the opposite course in the case of a profit.

(5) Pay off the partners' loans or advances which are separate from the capital (if any) contributed by them, after setting off against them any debit balance in the capital account of the concerned partner.

(6) The balance of the cash account at the end will be exactly equal to the balance of capital account, provided they are in credit; credit cash and debit the partners' capital account with the amount payable to them to close their accounts.

If the capital account of a partner is in debit, after his share of loss or profit has been adjusted therein, the firm will not have sufficient cash or assets to pay off the amounts due to the other partners, until the amount is repaid by the partner whose account is in debit. If however, the partner is insolvent, the amount will not be realised. In such a case, the deficiency may be



borne by the solvent partners in their profit-sharing ratio or according to the principle settled in the well known case of *Garner* vs. *Murray*. In the latter case, the deficiency would be borne by the solvent partners in proportion to their capitals and not in the proportion in which they share profits and losses.

2.5 CONSEQUENCES OF INSOLVENCY OF A PARTNER

If a partner goes insolvent then the following are the consequences :

1. The partner adjudicated as insolvent ceases to be a partner.
2. He ceases to be a partner on the date on which the order of adjudication is made.
3. The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.
4. The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication, and
5. The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.

2.6 LOSS ARISING FROM INSOLVENCY OF A PARTNER

When a partner is unable to pay his debt due to the firm he is said to be insolvent and the share of loss is to be borne by other solvent partners in accordance with the decision in the English case of Garner vs. Murray. According to this decision, solvent partners have to bear the loss due to insolvency of a partner and has categorically put that the normal loss on realisation of assets to be borne by all partner (including insolvent partner) in the profit sharing ratio but a loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio. The determination of capital ratio for this has been explained below. The provisions of the Indian Partnership Act are not contrary to *Garner* vs. *Murray* rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per deed should be applied.

Capital Ratio on Insolvency : *Capital Ratio* The partners are free to have either fixed or fluctuating capitals in the firm. If they are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary etc. are done through Current Accounts, which may have debit or credit balances and insolvency loss is distributed in the ratio of fixed capitals. But if capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts then Balance Sheet of the business shall not exhibit Current Accounts of the partners and capitals ratio will be determined after adjusting all the reserves and accumulated

profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and on drawings to the date of dissolution but before adjusting profit or loss on Realisation Account. If some partner is having a debit balance in his Capital Account and is not insolvent then he cannot be called upon to bear loss on account of the insolvency of other partner.

Insolvency all all Partners : When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances it is better not to transfer the amount of creditors to Realisation Account. Creditors may be paid the amount available including the amount contributed by the partners. The unsatisfied portion of creditor account is transferred to Capital Accounts of the partners in the profit sharing ratio. Then Capital Accounts are closed. In doing so first close the Partners' Capital Account which is having the worst position. The last account will be automatically closed.

Illustration 1

P, Q and R were partners sharing profits and losses in the ratio of 3 : 2 : 1, no partnership salary or interest on capital being allowed. Their balance sheet on 30th June, 2006 is as follows :

Liabilities		*Rs.*	*Assets*		*Rs.*
Fixed Capital			Fixed assets :		
P	20,000		Goodwill		40,000
Q	20,000		Freehold Property		8,000
R	10,000	50,000	Plant and Equipment		12,800
Current Accounts :			Motor Vehicle		700
P	500		*Current Assets*		
Q	9,000	9,500	Stock		3,900
Loan P		8,000	Trade Debtors	2,000	
Trade Creditors		12,400	*Less :* Provision	100	1,900
			Cash at Bank		200
			Misc. losses and Accounts		
			R's Current Account		400
			Profit and Loss Account		12,000
		79,900			79,900

On 1st July, 2006 the partnership was dissolved. Motor Vehicle was taken over by Q at a value of Rs. 500 but no cash passed specifically in respect of this transaction. Sale of other

assets realised the following amounts :

	Rs.
Goodwill	nil
Freehold Property	7,000
Plant and Equipment	5,000
Stock	3,000
Trade Debtors	1,600

Trade Creditors were paid Rs. 11,700 in fully settlement of their debts. The costs of dissolution amounted to Rs. 1,500. The loan from P was repaid, P and Q were both fully solvent and able to bring in any cash required but R was forced into bankruptcy and was only able to pay his creditors 1/3 of the amount due.

You are required to show :

(a) Cash and Bank Account,

(b) Realisation Account,

(c) Partners Fixed and Current Accounts.

Solution

Cash/Bank Acount

		Rs.		Rs.
To Balance b/d		200	By Realisation A/c-Creditors	11,700
To Realisation A/c-Freehold property		7,000	By Realisation A/c-Expenses	1,500
			By Loan P	8,000
Plant and Equipment		5,000	By Capital Q	7,200
Stock		3,000		
Trade Debtors		1,600		
To Capital Accounts :				
P	11,300			
R	300	11,600		
		28,400		28,400

Realisation Account

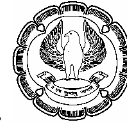
	Rs.			Rs.
To Goodwill	40,000	By Trade Creditors		12,400
To Freehold Property	8,000	By Provision for Bad Debts		100
To Plant and Equipment	12,800	By Bank :		
To Motor Vehicle	700	Freehold Property	7,000	
To Stock	3,900	Plant and Equip.	5,000	
To Sundry Debtors	2,000	Stock	3,000	
To Bank (Creditors)	11,700	Debtors	1,600	16,600
To Bank (Expenses)	1,500	By Q (Cr)		500
		By Capital Accounts : (Loss)		
		P	25,500	
		Q	17,000	
		R	8,500	51,000
	80,600			80,600

Capital Accounts

	P	Q	R		P	Q	R
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs
To Current A/c (Transfer)	5,500	—	2,400	By Balance b/d	20,000	20,000	10,000
To Realisation A/c (Loss)	25,500	17,000	8,500	By Current A/c (Transfer)	—	5,000	—
To Realisation A/c (Car)	—	500	—	By Bank	11,300	—	300
To R's Capital A/c (Deficiency)	300	300	—	By P & Q (Deficiency)	—	—	600
To Bank	—	7,200	—				
	31,300	25,000	10,900		31,300	25,000	10,900

Illustration 2

Amal and Bimal are in equal partnership. Their Balance Sheet stood as under on 31st March,



2006 when the firm was dissolved :

	Rs.		Rs.
Creditors A/c	4,800	Plant & Machinery	2,500
Amal's Capital A/c	750	Furniture	500
		Debtors	1000
		Stock	800
		Cash	200
		Bimal's drawings	550
	5,550		5,550

The assets realised as under :

	Rs.
Plant & Machinery	1,250
Furniture	150
Debtors	400
Stock	500

The expenses of realisation amounted to Rs. 175. Amal's private estate is not sufficient even to pay his private debts, whereas Bimal's private estate has a surplus of Rs. 200 only.

Show necessary ledger accounts to close the books of the firm.

Solution

In the books of M/s Amal and Bimal
Realisation Account

Dr.					*Cr.*
		Rs.			*Rs.*
2006			2006		
Mar. 31			Mar. 31		
To Sundry Assets :			By Cash A/c :		
Plant & Machinery	2,500		Plant & Machinery	1,250	
Furniture	500		Furniture	150	
Debtors	1,000		Debtors	400	
Stock	800		Stock	500	
Cash A/c-expenses	175				2,300

		By Partners' Capital A/c			
		Loss on realisation			
		Amal		1,337	
		Bimal		1,338	2,675
	4,975				4,975

Sundry Creditors Account

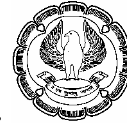
Dr.			*Cr.*
	Rs.		*Rs.*
2006		2006	
Mar. 31		Mar. 31	
To Cash A/c	2,525	By Balance b/d	4,800
" Deficiency A/c-transfer	2,275		------
	4,800		4,800

Cash Account

Dr.			*Cr.*
	Rs.		*Rs.*
2006		2006	
Mar. 31		Mar. 31	
To Balance b/f	200	By Realisation A/c-	
" Realisation A/c		expenses	175
- Sale of sundry assets	2,300	" Sundry Creditors A/c	2,525
" Biml's Capital A/c	200		-------
	2,700		2,700

Deficiency Account

Dr.			*Cr.*
	Rs.		*Rs.*
2006		2006	
Mar. 31		Mar. 31	
To Partners' Capital A/c		By Sundry Creditors A/c	2275
Amal	587		
Bimal	1688		
	2,275		2,275



Partners' Capital Account

Dr.					*Cr.*
	Amal	*Bimal*		*Amal*	*Bimal*
	Rs.			*Rs.*	
2006			2006		
Mar. 31			Mar. 31		
To Balance b/f	—	550	By Balance b/f	750	—
" Realisation A/c			" Cash A/c	—	200
- loss	1337	1338	" Deficiency		
			A/c- transfer	587	1,688
	1,337	1,888		1,337	1,888

Illustration 3

A ,B, C and D sharing profits in the ratio of 4:3:2:1 decided to dissolve their partnership on 31st March 2006 when their balance sheet was as under :-

Liabilities		*Rs.*	*Assets*	*Rs.*
Creditors		15,700	Bank	535
Employees Provident Fund		6,300	Debtors	15,850
Capital Accounts :-			Stock	25,200
A	40,000		Prepaid Expenses	800
B	20,000	60,000	Plant & Machinery	20,000
			Patents	8,000
			C's Capital A/c	3,200
			D's Capital A/c	8,415
		82,000		82,000

Following information is given to you :-

1. One of the creditors took some of the patents whose book value was Rs. 5,000 at a valuation of Rs. 3,200. Balance of the creditors were paid at a discount of Rs. 400 .
2. There was a joint life policy of Rs. 20,000 (not mentioned in the balance sheet) and this was surrendered for Rs. 4,500.
3. The remaining assets were realised at the following values :- Debtors Rs.10,800; Stock

Rs.15,600; Plant and Machinery Rs.12,000; and Patents at 60% of their book-values. Expenses of realisation amounted Rs. 1,500.

D became insolvent and a dividend of 25 paise in a rupee was received in respect of the firms claim against his estate. Prepare necessary ledger accounts.

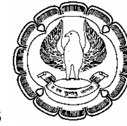
Solution

REALISATION ACCOUNT

		Rs.				Rs.
To Sundry Assets :-			By	Creditors		15,700
Debtors	15,850		By	Employee's Provident Fund		6,300
Stock	25,200		By	Bank A/c :-		
Prepaid Expenses	800			Joint Life Policy	4,500	
Plant & Machinery	20,000			Debtors	10,800	
Patents	8,000	69,850		Stock	15,600	
				Plant and Machinery	12,000	
To Bank (Creditors Rs.15,700				Patents		
Rs. 3,200-Rs. 400)		12,100		(60% of Rs. 3,000)	1,800	44,700
To Bank A/c Employee's (P.F)		6,300				
To Bank A/c (expenses)		1,500	By	Loss transferred to :-		
				A's Capital	9,220	
				B's Capital	6,915	
				C's Capital	4,610	
				D's Capital	2,305	23,050
		89,750				89,750

CAPITAL ACCOUNTS

	A	B	C	D		A	B	C	D
	Rs.	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.	Rs
To Bal . b/d	—	—	3,200	8,415	By Bal.b/d	40,000	20,000	—	—.
To Realisation A/c	9,220	6,915	4,610	2,305	By Bank (Recovery)	—	—	—	2,680
To D's Capital (Deficiency)	5,360	2,680	—	—	By A's Capital 2/3	—	—	—	5,360



To Bank	25,420	10,405	—	—	By B's Capital				
					1/3	—	—	—	2,680
					By Bank A/c	—	—	7,810	—
	40,000	20,000	7,810	10,720		40,000	20,000	7,810	10,720

BANK ACOUNT

	Rs.		Rs.
To Balance b/d	535	By Realisation A/c	12,100
To Realisation A/c	44,700	By Realisation A/c	6,300
To D's Capital A/c	2,680	By Realisation A/c	1,500
To C's Capital A/c	7,810	By A's Capital A/c	25,420
		By B's Capital A/c	10,405
	55,725		55,725

Working Note :- D's Loss will be borne by only A and B. C will bring his share of loss in cash.

Illustration 4

M/s X, Y and Z who were in partnership sharing profits and losses in the ratio of 2:2:1 respectively, had the following Balance Sheet as at December 31, 2005.

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital : X	29,200		Fixed Assets		40,000
Y	10,800		Stock		25,000
Z	10,000	50,000	Book Debts	25,000	
Z's Loan		5,000	*Less* : Provision	5,000	20,000
Loan from Mrs. X		10,000	Cash		1,000
Sundry Trade Creditors		25,000	Advance to Y		4,000
		90,000			90,000

The firm was dissolved on the date mentioned above due to continued losses. After drawing up the balance sheet given above, it was discovered that goods amounting to Rs. 4,000 have been purchased in November, 2005 and had been received but the purchase was not recorded in books.

Fixed assets realised Rs. 20,000; Stock Rs. 21,000 and Book Debt Rs. 20,500. Similarly, the creditors allowed a discount of 2% on the average. The expenses of realisation come to Rs. 1,080. X agreed to take over the loan of Mrs. X. Y is insolvent, and his estate is unable to contribute anything.

Give accounts to close the books; work according to the decision in *Garner* vs. *Murray.*

Solution

Realisation Account

			Rs.					Rs.
To	Sundry			By	Provision for Bad Debt			5,000
	Fixed Assets (transfer)		40,000	By	Cash			61,500
	Stock		25,000	By	Sundry Trade Creditors			
	Book Debts		25,000		(Discount)			580
To	Cash—Expenses		1,080	By	Loss :	X 2/5	9,600	
						Y 2/5	9,600	
						Z 1/5	4,800	24,000
			91,080					91,080

Sundry Trade Creditors

		Rs.			Rs.
To	Realisation A/c - Discount		By	Balance b/d	25,000
	@ 2% on Rs. 29,000	580	By	Sundry Capital Accounts	
To	Cash	28,420		(Purchase omitted)	4,000
		29,000			29,000

Z's Loan Account

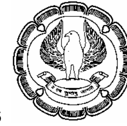
To Cash Account	5,000	By Balance b/d	5,000

Mrs. X's Loan Account

To X's Capital A/c - transfer	10,000	By Balance b/d	10,000

Cash Account

	Rs.		Rs.
To Balance b/d	1,000	By Sundry Trade Creditors	28,420
To Realisation A/c		By Realisation A/c - expenses	1,080



	Rs.		Rs.
assets realised	61,500	By Z's Loan	5,000
To X's Capital A/c*	9,600	By X's Capital A/c	34,300
To Z's Capital A/c*	4,800	By Z's Capital A/c	8,100
	76,900		76,900

*X and Z bring these amounts to make good their share of the loss on realisation. In actual practice they will not be bringing any cash; only a notional entry will be made.

Capital Accounts

	X	Y	Z		X	Y	Z
	Rs.	*Rs.*	*Rs.*		*Rs.*	*Rs.*	*Rs.*
To Sundry Trade				By Balance b/d	29,200	10,800	10,000
Creditors- omission	1,600	1,600	800				
To Balance c/d	27,600	9,200	9,200				
	29,200	10,800	10,000		29,200	10,800	10,000
To Advance		4,000		By Balance b/d	27,600	9,200	9,200
To Realisation A/c loss	9,600	9,600	4,800	By Mrs. X's Loan	10,000		
To Y's Capital A/c	3,300		1,100	By Cash	9,600		4,800
				By X's Capital A/c		3,300	
To Cash	34,300		8,100	By Z's Capital A/c		1,100	
	47,200	13,600	14,000		47,200	13,600	14,000

Note : Y's deficiency comes to Rs. 4,400 (difference in the two sides of his Capital Account); this has been debited to X and Z in the ratio of 27,600 : 9,200 *i.e.,* capital standing up just before dissolution but after correction of error committed while drawing up the accounts for 2005.

Illustration 5

Thin, 'Short' and 'Fat' were in partnership sharing profits and losses in the ratio of 2:2:1.

On 30th September, 2005 their Balance Sheet was as follows :

Liabilities		*Rs.*	*Assets*	*Rs.*
Capital Accounts :			Premises	50,000
Thin	80,000		Fixtures	1,25,000

Short	50,000		Plant	32,500
Fat	20,000	1,50,000	Stock	43,200
Current Accounts :			Debtors	54,780
Thin	29,700			
Short	11,300			
Fat(Dr.)	14,500	26,500		
Sundry Creditors		84,650		
Bank Overdraft		44,330		
		3,05,480		3,05,480

'Thin' decides to retire on 30th September, 2005 and as 'Fat' appears to be short of private assets, 'Short' decides that he does not wish to take over Thin's share of partnership, so all three partners decide to dissolve the partnership with effect from 30th September, 2005. It then transpires that 'Fat' has no private assets whatsoever,

The premises are sold for Rs. 60,000 and the plant for Rs. 1,07,500. The fixtures realise Rs. 20,000 and the stock is acquired by another firm at book value less 5%. Debtors realise Rs. 45,900. Realisation expenses amount to Rs. 4,500.

The bank overdraft is discharged and the creditors are also paid in full.

You are required to write up the following ledger accounts in the partnership books following the rules in *Garner* vs. *Murray* :

(i) Realisation Account ;

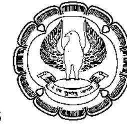
(ii) Partners' Current Accounts ;

(iii) Partners' Capital Accounts showing the closing of the firm's books.

Solution

Realisation Account

2005	*Rs.*	*2005*			*Rs.*
Sept. 30		Sept.30			
To Premises	50,000	By	Sundry Creditors		84,650
To Plant	1,25,000	By	Bank :		
To Fixtures	32,500		Premises	60,000	
To Stock	43,200		Plant	1,07,500	
To Debtors	54,780		Fixtures	20,000	



	Rs.		Rs.	Rs.
To Bank (Creditors)	84,650	Stock	41,040	
To Bank (Expenses)	4,500	Debtors	45,900	2,74,440
		Loss on Realisation transferred to Partners' Current A/cs		
		Thin	14,216	
		Short	14,216	
		Fat	7,108	35,540
	3,94,630			3,94,630

Partners' Current Accounts

2005		Thin Rs.	Short Rs.	Fat Rs.	2005		Thin Rs.	Short Rs.	Fat Rs.
Sept. 30	To Balance b/d	–	–	14,500	Sept. 30	By Balance b/d	29,700	11,300	–
	To Realisation	14,216	14,216	7,108		By Capital A/c Transfer	–	2,916	21,608
	To Capital A/c transfer	15,484	–	–					
		29,700	14,216	21,608			29,700	14,216	21,608

Partners' Capital Accounts

2005		Thin Rs.	Short Rs.	Fat Rs.	2005		Thin Rs.	Short Rs.	Fat Rs.
Sept., 30	To Current A/c	–	2,916	21,608	Sept., 30	By Balance b/d	80,000	50,000	20,000
	To Fat's Capital A/c Deficiency in the ratio of 8:5	990	618	–		By Current A/c (transfer)	15,484	–	–
	To Bank	94,494	46,466	–		By Thin & Short Capital A/cs			1,608
		95,484	50,000	21,608			95,484	50,000	21,608

Working Notes

(i) **Bank Account**

	Rs.		Rs.
To Realisation A/c	2,74,440	By Balance b/d	44,330
		By Realisation A/c (Creditors)	84,650
		By Realisation A/c (Expenses)	4,500
		By Thin's Capital A/c	94,494
		By Short's Capital A/c	46,466
	2,74,440		2,74,440

(ii) Fat's deficiency has been borne by Thin & Short in the ratio of their fixed capitals *i.e.,* 8:5 following the rule in *Garner* vs. *Murray*.

2.7 PIECEMEAL PAYMENTS

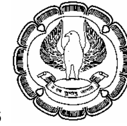
Generally, the assets sold upon dissolution of partnership are realised only in small instalments over a period of time. In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted. In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order in which the payment should be made.

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

Illustration 6

The following is the Balance Sheet of A, B, C on 31st December, 2005 when they decided to dissolve the partnership.

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors	2,000	Sundry Assets	48,500
A's Loan	5,000	Cash	500
Capital Accounts :			
A	15,000		
B	18,000		
C	9,000		
	49,000		49,000



The assets realised the following sums in instalments :

I	1,000
II	3,000
III	3,900
IV	6,000
V	20,100
	34,000

The expenses of realisation were expected to be Rs. 500 but ultimately amounted to Rs. 400 only.

Show how at each stage the cash received should be distributed between partners. They share profits in the ratio of 2:2:1.

Solution

First of all, the following table will be constructed to show the amounts available for distribution among the various interests.

Statement showing Realisation and Distribution of Cash Payments

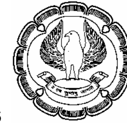
		Realisation	*Creditors*	*Partners' Loan*	*Partners' Capitals*
		Rs.	*Rs.*	*Rs.*	*Rs.*
1.	(After taking into account cash balance and amount set aside for expenses)	1,000	1,000		
2.		3,000	1,000	2,000	
3.		3,900		3,000	900
4.		6,000			6,000
5.	(including saving in expenses)	20,100			20,100
		34,000	2,000	5,000	27,000

To ascertain the amount distributable out of each instalment realised among the partners, the following table will be constructed.

Statement of Distribution on Capital Account

(1) Calculation to determine the mode of distribution of Rs. 900

		Total	A	B	C
		Rs.	Rs.	Rs.	Rs.
	Balance	42,000	15,000	18,000	9,000
	Less: Possible loss, should remaining assets prove to be worthless	41,100	16,440	16,440	8,220
		+ 900	– 1,440	+ 1,560	+ 780
	Deficiency of A's Capital written off against those of B and C in the ratio of their capital, 18,000 : 9,000 (*Garner* vs. *Murray*)			960	480
	Manner in which the first Rs. 900 should be distributed			+ 600	+ 300
(2)	*Distribution of Rs. 6,000*				
	Balance after making payment of amount shown in step (1)	41,100	15,000	17,400	8,700
	Less : Possible Loss assuming remaining asset to be valueless	35,100	14,040	14,040	7,020
	Balance available and to be distributed	6,000	960	3,360	1,680
(3)	*Distribution of Rs. 20,100*				
	Balance after making payment of amount shown in step (2)	35,100	14,040	14,040	7,020
	Less : Possible loss, assuming remaining assets to be valueless	15,000	6,000	6,000	3,000
	Manner of distribution of Rs. 20,100	20,100	8,040	8,040	4,020
	Summary :				
	Balance	42,000	15,000	18,000	9,000
	Total amounts paid	27,000	9,000	12,000	6,000
	Loss	15,000	6,000	6,000	3,000



2.7.2 Highest Relative Capital Method : According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off. This method is also called as proportionate capital method.

For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit-sharing ratio ; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called as their hypothetical capitals. The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital ; the resultant figure will be the amount of excess capital held by him. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained. The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

The illustration given above is now worked out according to this method.

		A	*B*	*C*
Capital	Rs.	15,000	18,000	9,000
Profit-sharing ratio		2	2	1
Capital divided by the profit-sharing ratio		7,500	9,000	9,000
Proportionate Capital of B and C, taking				
A's capital as the base	Rs.	15,000	15,000	7,500
Excess of actual over proportionate capital	Rs.	nil	3,000	1,500

This indicates that A should not get anything till Rs. 3,000 is paid to B and Rs. 1,500 is paid to C. Since capital of B and C are already according to their mutual profit-sharing ratio (2:1), they will share the available cash in this ratio.

After paying off creditors and A's loan, the available amount will be distributed as below in this method :

	Total	*A*	*B*	*C*
	Rs.	*Rs.*	*Rs.*	*Rs.*
Third Instalment	900	-	600	300
Fourth Instalment (*i*)	3,600	-	2,400	1,200
(*ii*)	2,400	960	960	480

Fifth Instalment		20,100	8,040	8,040	4,020
	Total	27,000	9,000	12,000	6,000

Total payment made to each partner will, of course be same under both the methods.

Illustration 7

The partners A, B and C have called you to assist them in winding up the affairs of their partnership on 30th June, 2005. Their Balance Sheet as on that date is given below :

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

(1) The partners share profit and losses in the ratio of 5:3:2

(2) Cash is distributed to the partners at the end of each month

(3) A summary of liquidation transactions are as follows :

July 2005

Rs. 16,500 - collected from Debtors ; balance is uncollectable.

Rs. 10,000 - received from sale of entire stock.

Rs. 1,000 - liquidation expenses paid.

Rs. 8,000 - cash retained in the business at the end of the month.

August 2005

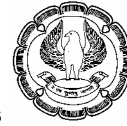
Rs. 1,500 – liquidation expenses paid. As part payment of his Capital, C accepted a piece of equipment for Rs. 10,000 (book value Rs. 4,000).

Rs. 2,500 – cash retained in the business at the end of the month.

September 2005

Rs. 75,000 – received on sale of remaining plant and equipment.

Rs. 1,000 – liquidation expenses paid. No cash retained in the business.



Required : Prepare a schedule of cash payments as of September 30, showing how the cash was distributed.

Solution

Statement showing distribution of cash

		Creditors		Capitals	
	Rs.	*Rs.*	*A(Rs.)*	*B(Rs.)*	*C(Rs.)*
Balance Due		17,000	55,000	37,500	31,500
July					
Balance available	6,000				
Realisation less expenses					
and cash retained	17,500				
Amount available and paid	23,500	17,000			6,500
Balance due		—	55,000	37,500	25,000
August					
Opening balance	8,000				
Expenses paid and					
balance carried forward	4,000				
Available for distribution	4,000				
Cash paid to 'B' and Equipment					
given to C.			—	4,000	10,000
(Excess paid to 'C' Rs. 7,333)			55,000	33,500	15,000
September					
Opening balance	2,500				
Amount realised less expenses	74,000				
Amount paid to partners	76,500		41,500	25,400	9,600
			13,500	8,100	5,400

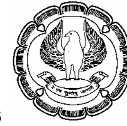
Working Note :

(i) **Highest Relative Capital Basis**

	A	B	C
	Rs.	Rs.	Rs.
Scheme of payment for July			
Balance of Capital Accounts	67,000	45,000	31,500
Less : Loans	12,000	7,500	—
	55,000	37,500	31,500
Profit sharing ratio	5	3	2
Capital Profit sharing ratio	11,000	12,500	15,750
Capital in profit sharing ratio taking A's Capital as base	55,000	33,000	22,000
Excess of C's Capital and B's Capital		4,500	9,500
Excess of C's Capital over B (9,500 – 3,000)			6,500

(ii) **Scheme of distribution of available cash :**

	A	B	C
Scheme of payment for September			
Balance of Capital Accounts	55,000	33,500	15,000
Profit Sharing Ratio	5	3	2
Capital/Profit sharing Ratio	11,000	11,167	7,500
Capital in profit sharing ratio taking C's Capital as base	37,500	22,500	15,000
Excess of A/s Capital and B's Capital	17,500	11,000	
Excess/Profit Sharing Ratio	3,500	3,667	
Excess in profit sharing Ratio taking A's excess as base	17,500	10,500	
Excess	–	500	–
Payment Rs. 500		(500)	
Balance of Excess	17,500	10,500	
Payment Rs. 28,000	(17,500)	(10,500)	



Balance	37,500	22,500	15,000
Payment (Rs.76,500 – Rs.28,500) Rs.48,000	(24,000)	(14,400)	(9,600)
Loss	13,500	8,100	5,400
Total Payment Rs. 76,500	41,500	25,400	9,600

Illustration 8

The firm of LMS was dissolved on 31.3.2005, at which date its Balance Sheet stood as follows:

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors	2,00,000	Fixed Assets	45,00,000
Bank Loan	5,00,000	Cash and Bank	2,00,000
L's Loan	10,00,000		
Capital			
L	15,00,000		
M	10,00,000		
S	5,00,000		
Total	47,00,000		47,00,000

Partners share profits equally. A firm of Chartered Accountants is retained to realise the assets and distribute the cash after discharge of liabilities. Their fees which are to include all expenses is fixed at Rs. 1,00,000. No loss is expected on realisation since fixed assets include valuable land and building.

Realisations are:

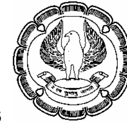
S.No.	Amount in Rs.
1	5,00,000
2	15,00,000
3	15,00,000
4	30,00,000
5	30,00,000

The Chartered Accountant firm decided to pay off the partners in 'Higher Relative Capital Method'. You are required to prepare a statement showing distribution of cash with necessary workings.

Solution

In the Books of M/s LMS
Statement of Piecemeal Distribution (Under Higher Relative Capital method)

Particulars	*Amount available*	*Creditors Loan*	*Bank*	*L's loan*	*Capital A/cs* *L*	*M*	*S*
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Balance due		2,00,000	5,00,000	10,00,000	15,00,000	10,00,000	5,00,000
1st Instalment (including cash and bank balances)	5,00,000						
Less: Liquidator's Expenses and fees	1,00,000						
	4,00,000						
Less: Payment to Creditors and repayment of Bank Loan in the ratio of 2:5	(4,00,000)	(1,14,286)	(2,85,714)	–	–	–	–
Balance Due	–	85,714	2,14,286	10,00,000	15,00,000	10,00,000	5,00,000
2nd Instalment	15,00,000						
Less: Payment to Creditors and repayment of bank loan in full settlement	(3,00,000)	(85,714)	(2,14,286)	–	–	–	–
	12,00,000	–	–				
Less: Repayment of L's Loan	(10,00,000)		(10,00,000)	–	–	–	–
	2,00,000						
Less: Payment to Mr. L towards relative higher capital (W.N. 1)	(2,00,000)				(2,00,000)	–	—
					13,00,000	10,00,000	5,00,000
Balance Due							



3rd Instalment	15,00,000			
Less: Payment to Mr. L towards higher relative capital (W.N. 2)	(3,00,000)	(3,00,000)		
	12,00,000	10,00,000		
Less: Payment to Mr. L & Mr. M towards excess capital (W.N. 1&2)	(10,00,000)	(5,00,000)	(5,00,000)	
	2,00,000	5,00,000	5,00,000	
Less: Payment to all the partners equally	(2,00,000)	(66,667)	(66,667)	(66,666)
		4,33,333	4,33,333	4,33,334
Balance due				
4th Instalment	30,00,000			
Less: Payment to all the partners equally	(30,00,000)	(10,00,000)	(10,00,000)	(10,00,000)
Realisation profit credited to Partners		5,66,667	5,66,667	5,66,666
5th Instalment	30,00,000			
Less: payment to all partners equally	(30,00,000)	10,00,000	10,00,000	10,00,000
Realisation profit credited to partners		15,66,667	15,66,667	15,66,666

Working Notes:

(i) Scheme of payment of surplus amount of Rs. 2,00,000 out of second Instalment:

	Capital A/cs		
	L	*M*	*S*
	Rs.	*Rs.*	*Rs.*

Balance (i)	15,00,000	10,00,000	5,00,000
Profit sharing ratio (ii)	1	1	1
Capital taking S's Capital (iii)	5,00,000	5,00,000	5,00,000
Excess Capital (iv) = (i) – (iii)	10,00,000	5,00,000	
Profit Sharing Ratio	1	1	
Excess capital taking			
M's Excess Capital as base (v)	5,00,000	5,00,000	
Higher Relative Excess (iv) – (iv)	5,00,000		

So Mr. L should get Rs. 5,00,000 first which will bring down his capital account balance from Rs. 15,00,000 to Rs. 10,00,000. Accordingly, surplus amounting to Rs. 2,00,000 will be paid to Mr. L towards higher relative capital.

(ii) Scheme of payment of Rs. 15,00,000 realised in 3rd Instalment:

- Payment of Rs. 3,00,000 will be made to Mr. L to discharge higher relative capital. This makes the higher capital of both Mr. L and Mr. M Rs. 5,00,000 as compared to capital of Mr. S.
- Payment of Rs. 5,00,000 each of Mr. L & Mr. M to discharge the higher capital.
- Balance Rs. 2,00,000 equally to L, M and S, i.e., Rs. 66,667 Rs. 66,667 and Rs. 66,666 respectively.

Self-Examination questions

Objective type questions

Pick up the most appropriate answer from the given options:

1. On the dissolution of partnership, profit or loss n realization should be divided among partners
   (a) in the ratio of their capitals.
   (b) in the same ratio in which they share profits.
   (c) equally.
   (d) None of the above.
2. An unrecorded asset realized at the time of dissolution is credited to
   (a) realization account.
   (b) revaluation account.

(c) capital accounts.

(d) cash account.

3. A liability taken over by a partner at the time of dissolution is credited to

(a) profit and loss account.

(b) partners' capital accounts.

(c) realization account.

(d) revaluation account.

4. Realization account is a

(a) nominal account.

(b) Real account.

(c) Personal account.

(d) None of the above.

5. As per Garner vs Muray rule, any losses arising due to capital deficiency of insolvent partners are to be divided among solvent partners

(a) in the ratio of capitals after adjusting realization losses or gains and accumulated profits and losses.

(b) in the ratio of capitals before adjusting realization losses or gains and accumulated profits and losses.

(c) in the ratio of capitals after adjusting accumulated profits and losses but before adjusting realization losses or gains.

(d) in the ratio of capitals after adjusting realization losses or gains but before adjusting accumulated profits and losses.

[Ans. 1. (b); 2 (a); 3. (b); 4. (a); 5. (a)]

Short answer type questions

6. Explain Garner Vs. Murray Rule.

7. What is realization account? How does it differ from revaluation account?

8. How should accounts be finally adjusted when all partners are insolvent? Explain in brief.

Long answer type questions

9. What do you mean by dissolution of a partnership firm? Give the entries required to close the books of the firm upon its dissolution.

10. How is debit balance of a partner's capital account is treated in the event of dissolution of firm. Explain with the help of an example.

Practical problems

11. P, Q and R carrying on business as merchants and sharing profits and losses in the ratio of 2:2:1, dissolved their firm as on December 31, 2005 on which date their Balance Sheet was as follows :

Liabilities		*Rs.*	*Assets*		*Rs.*
Sundry Creditors		20,300	Cash at Bank		4,800
Reserve		10,000	Stock		16,000
Joint Life Policy reserve		8,000	Debtors	10,000	
Capital Accounts :			*Less :* Provision	500	9,500
P	15,000		Joint Life Policy		11,000
Q	15,000		Premises		30,000
R	3,000	33,000			
		71,300			71,300

Note : There is a bill for Rs. 1,000 under discount. The bill was received from Z.

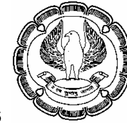
The assets except cash at bank was realised for Rs. 65,150 and joint Life Policy was surrendered at Rs. 11,300, Z proved insolvent and a dividend of 5% was received from his estate. Sundry creditors were paid Rs. 19,500 in full settlement. Expenses amounted to Rs. 3,000.

Prepare Realisation Account, Cash Account and the partners' Capital Accounts.

12. A, B, C were in partnership. On 1.1.2006 A becomes insolvent and the firm was dissolved. Capital A/c balances of the partners on that date were A Rs. 50,000, B Rs. 40,000 and C Rs. 10,000. Loss on realisation Rs. 80,000 A, B and C were sharing profits and losses at the ratio of 2:2:1. Find out the ratio at which loss arising out of C's insolvency is to be borne by A and B.

A, B, C and D are partners sharing 4:3:2;1. Their position statement was as follows:-

Liabilities	*Amount (Rs.)*	*Assets*	*Amount (Rs.)*
Bank Loan	25,000	Cash	11,500
Creditors	50,000	Building	49,000
A's Capital	30,000	Stock	60,000



B's Capital	20,000	C's Capital	3,500
		D's Capital	1,000
	1,25,000		1,25,000

The firm is dissolved. All assets realised Rs.87,000. Bank loan is settled at Rs.24,000 and Creditors for Rs.49,500. There were outstanding expenses for Rs.400 and were settled by paying Rs.300. The expenses on dissolution are Rs.800. D becomes insolvent and C paid only Rs.3,000. Prepare ledger accounts to close the books of the firm.

13. On 1st January 2003 A,B, and C commenced business in partnership sharing profit and losses in proportion of ½, 1/3,and 1/6 respectively. They paid into their Bank A/c as their

    Capital Rs.22,000 being Rs.10,000 by A, Rs.7,000 by B and Rs.5,000 by C. During the year they drew Rs.5,000, being Rs.1,900by A, Rs.1,700 by B and Rs.1,400by C.

    On 31st December, 2005 they dissolve their partnership. A taking up stock at an agreed valuation of Rs.5,000, B taking up furniture at Rs.2,000and C taking up debtors at Rs.3,000. After paying up their creditors, there remained a balance of Rs.1,000 at Bank. Prepare the necessary accounts showing the distribution of the cash at the Bank and of the further cash brought in by any partner as the case required.

14. Applying *Garner* vs. *Murray* rule close off the accounts of the firm, the Balance Sheet of which is given below. Partners were sharing profits equally.

Liabilities	*Rs.*	*Assets*	*Rs.*
Ram Pal's Capital	20,000	Plant & Machinery	12,000
Roy's Capital	10,000	Buildings	5,000
Trade Creditors	5,000	Trade Debtors	7,000
		Stock-in-trade	6,000
		Funny's Capital Account	5,000
	35,000		35,000

The assets were sold for Rs. 19,000 and expenses of the sale amounted to Rs. 1,000.

15. A, B and C have been suffering losses for many years and on December 31, when their balance sheet was drawn up as given below, they decided to dissolve up partnership. They shared profits in the ratio of 1/2,1/3,1/6.

Capital Accounts	*Rs.*	*Rs.*	*Fixed Assets*	*Rs.*
A	3,000		Goodwill	3,000
B	1,500		Fixture & Furniture	2,000

C	100	4,600	Leasehold Property	5,000
			Current Assets	
Current Accounts			Stock	10,000
A	500		Debtors	25,000
B	200		Cash	100
C (Debit)	200	500		
Current Liabilities & Provisions				
Trade Creditors		35,000		
Bank overdraft		5,000		
		45,100		45,100

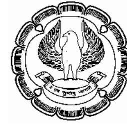
There was a contingent liability in respect of a suit filed against the partners for a sum of Rs. 1,000.

The furniture and fixtures realised Rs. 1,800 on auction. The leasehold property has only three years to run. A agreed to take it over for Rs. 400. The stock realised Rs. 9,000 and Debtors Rs. 20,000. In the balance of Debtors Rs. 5,000 was not bad, they were slow - paying. It was mutually agreed that A and B should equally take them over at their book values. The liabilities were discharged at book values. The suit was decided against the firm and the firm paid Rs. 1,000 to the complainant plus Rs. 80 on account of costs. A and B were of means, but C was insolvent and his estate paid dividend of 25 p. in the rupee.

Prepare Realisation Account and close off the books off the firm.

16. Following is the Balance Sheet of Alpha & Co. as on 31st December consisting of 3 partners, A, B and C. As per the Deed, their capitals are fixed and they share profits and losses equally.

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors	1,02,400	Bank Balance	5,500
Loans :		Debtors	96,060
A	30,000	Stock	64,000
B	12,000	Machinery	28,600
Current Accounts :		Land & Building	84,000
A	21,200	Current Account	9,940
B	2,500		



Capital Accounts :		
A	60,000	
B	40,000	
C	20,000	
	2,88,100	2,88,100

The firm was dissolved on the above said date. All assets other than the bank balance realised net Rs. 2,26,880. The partner C is insolvent. Show the realisation and division amongst the partners.

UNIT - 3 : AMALGAMATION, CONVERSION AND SALE OF PARTNERSHIP FIRMS

Learning Objectives

After studying this unit, you will be able to :

- ♦ understand the procedure for amalgamation of partnership firms.
- ♦ learn the accounting treatment when a partnership firm is converted in the form of a company.
- ♦ distribute the shares received as purchase consideration among the partners.

3.1 AMALGAMATION OF PARTNERSHIP FIRMS

The accounting procedures:

(a) Each firm should prepare a Revaluation Account relating to its own assets and liabilities and transfer the balance to the partners' capital accounts in the profit-sharing ratio.

(b) Entries for raising goodwill should be passed.

(c) Assets and liabilities not taken over by the new firm should be transferred to the capital accounts of partners in the ratio of their capitals.

(d) The new firm should be debited with the difference between the value of assets and liabilities taken over by it; the assets should be credited and liabilities debited.

(e) Partners' capital accounts should be transferred to the new firm's account;

The above steps will close the books of the old firm. To open the books of the new firm the following entries will be required;

Debit assets taken out at the agreed values

Credit the liabilities taken over, and

Credit individual partner's capital accounts with the closing balances in the erstwhile firm.

When one firm is merged with another existing firm, entries will be in the pattern of winding up in the books of the firm which has ceased to exist. The other firm will record the transaction as that of a business purchase.

Illustration 1

B and S are partners of S & Co. sharing profits and losses in the ratio of 3:1. S and T are partners of T & Co. sharing profits and losses in the ratio of 2:1.

On 31st October, 2006, they decided to amalgamate and form a new firm M/s. BST & Co. wherein B, S and T would be partners sharing profits and losses in the ratio of 3:2:1.

Their balance sheets on that date were as under :

Liabilities	*S & Co.*	*T & Co.*	*Assets*	*S & Co.*	*T & Co.*
	Rs.	*Rs.*		*Rs.*	*Rs.*
Due to X & Co.	40,000	–	Cash in hand	10,000	5,000
Due to S & Co.	–	50,000	Cash at bank	15,000	20,000
Other Creditors	60,000	58,000	Due from T & Co.	50,000	–
Reserve	25,000	50,000	Due from X & Co.	–	30,000
Capitals			Other Debtors	80,000	1,00,000
B	1,20,000	–	Stock	60,000	70,000
S	80,000	1,00,000	Furniture	10,000	3,000
T	–	50,000	Vehicles	–	80,000
			Machinery	75,000	–
			Building	25,000	
	3,25,000	3,08,000		3,25,000	3,08,000

The amalgamated firm took over the business on the following terms :

(a) Goodwill of S & Co. was worth Rs. 60,000 and that of T & Co. Rs. 50,000. Goodwill account was not to be opened in the books of the new firm, the adjustments being recorded through capital accounts of the partners.

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

(c) Provision for doubtful debts has to be carried forward at Rs. 4,000 in respect of debtors of S & Co. and Rs. 5,000 in respect of debtors of T & Co.

You are required to :

(i) Compute the adjustments necessary for goodwill.

(ii) Pass the journal entries in the books of BST & Co. assuming that excess/deficit capital (taking T's Capital as base) with reference to share in profits are to be transferred to current accounts.

Solution

(i) Adjustment for raising & writing off of goodwill :

	Raised in old profit sharing ratio				Written off in new ratio		Difference	
	S & Co.	T & Co.	Total					
	Rs.	Rs.	Rs.		Rs.		Rs.	
B	45,000	-	45,000	Cr.	55,000	Dr.	10,000	Dr.
S	15,000	33,333	48,333	Cr.	36,666	Dr.	11,667	Cr.
T	–	16,667	16,667	Cr.	18,334	Dr.	1,667	Dr.
	60,000	50,000	1,10,000		1,10,000			

Books of BST & Co.

Journal

			Dr.	Cr.
2006		Rs.	Rs.	
Oct. 31	Cash Account	Dr.	10,000	
	Bank Account	Dr.	15,000	
	T & Co.	Dr.	50,000	
	Sundry Debtors	Dr.	80,000	
	Stock Account	Dr.	60,000	
	Furniture Account	Dr.	10,000	
	Machinery Account	Dr.	90,000	
	Building Account	Dr.	50,000	
	To Provision for Doubtful debts			4,000
	To X & Co.			40,000
	To Sundry Creditors			60,000
	To B's Capital Account			1,65,750
	To S's capital Account			95,250
	(Sundry assets and liabilities of M/s S & Co. taken over at the values stated as per agreement dated.....)			

Cash Account	Dr.	5,000	
Bank Account	Dr.	20,000	
X & Co. Account	Dr.	30,000	
Sundry Debtors A/c	Dr.	1,00,000	
Stock Account	Dr.	70,000	
Furniture Account	Dr.	3,000	
Vehicles Account	Dr.	1,00,000	
To Provision for Doubtful Debts			5,000
To S & Co.			50,000
To Sundry Creditors			58,000
To S's Capital Account			1,43,333
To T's Capital Account			71,667
(Sundry assets and liabilities of M/s T & Co. taken over at the values stated as per agreement dated...)			
B's Capital Account	Dr.	10,000	
T's Capital Account	Dr.	1,667	
To S's Capital Account			11,667
(Adjustment in capital accounts consequent on raising goodwill of S & Co. for Rs. 60,000, T & Co. for Rs. 50,000 and writing off the same in the new ratio between B,S,T as per agreement)			
S & Co.	Dr.	50,000	
To T & Co.			50,000
(Mutual indebtedness of S & Co. and T & Co., cancelled on taking over of the two firms)			
B's Current Account	Dr.	54,250	
To B's Capital Account			54,250
(Amount credited to B's Capital to bring capital in profit-sharing ratio)			

S's Capital Account	Dr.	1,10,250	
To S's Current Account			1,10,250
(Excess amount in S's Capital Account transferred to S's Current Account to reduce the balance in capital accounts in accordance with the profit sharing ratio)			

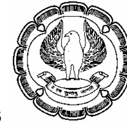
Working Notes :

(i) Balance of Capital Accounts on transfer of business to M/s BST & Co.

(a) S & Co.		*B's Capital*	*S's Capital*
	Rs.	*Rs.*	*Rs.*
As per Balance Sheet		1,20,000	80,000
Credit for Reserve		18,750	6,250
Profit on Revaluation	40,000		
Less : Provision for Doubtful debts	4,000	27,000	9,000
		1,65,750	95,250

(b) T & Co.		*S's Capital*	*T's Capital*
	Rs.	*Rs.*	*Rs.*
As per Balance Sheet		1,00,000	50,000
Credit for Reserve		33,333	16,667
Profit on Revaluation	20,000		
Less : Provision for Doubtful Debts	5,000	10,000	5,000
		1,43,333	71,667

(ii) Capital in the new firm	*B*	*S*	*T*
	Rs.	*Rs.*	*Rs.*
Balance as taken over	1,65,750	95,250	-
	-	1,43,333	71,667
	1,65,750	2,38,583	71,667
Adjustment for Goodwill	–10,000	+11,667	–1,667
	1,55,750	2,50,250	70,000



Total capital, Rs. 4,20,000* in the new ratio of 3:2:1, taking T's Capital as the basis	2,10,000		1,40,000		70,000
Transfer to Current Account	54,250	(Dr.)	1,10,250	(Cr.)	—

*T's Capital is Rs. 70,000 and it is 1/6 of total. The total therefore is Rs. 4,20,000.

Illustration 2

On 31st March 2006, Sri Raman acquires on payment of Rs. 80,000 the business of Messrs. Gupta and singh taking over at book value the following assets and liabilities :

	Rs.
Debtors	35,000
Furniture	3,000
Stock	46,000
Creditors	10,000

There was no change between 1st January, 2006 and 31st March, 2006 in the book value of the assets and liabilities not taken over.

The same set of books has been continued after the acquisition and no entries of the acquisition have been passed except for the payment of Rs. 80,000 made by Sri Raman.

From the following balance sheet and trial balance prepare Business Purchase Account, Profit and Loss Account for the year ended 31st December, 2006 and Balance Sheet at that date.

Balance Sheet as at December, 2005

Liabilities		*Rs.*	*Assets*	*Rs.*
Capital Accounts			Furniture	3,000
	Rs.		Investments	5,000
Sri Gupta	30,000		Insurance Policy	2,000
Sri Singh	20,000	50,000	Stock	40,000
Bank Loan		18,000	Debtors	30,000
Creditors		12,000		
		80,000		80,000

On 31st December 2006 the trial balance is :

	Rs.	Rs.
Stock	40,000	
Furniture	3,000	
Investment	5,000	
Insurance Policy	2,000	
Business Purchase Account	80,000	
Bank Loan		18,000
Capital :		
Gupta		30,000
Singh		20,000
Raman		30,000
Bank	3,000	
Debtors	48,000	
Creditors		15,000
Purchases	3,20,000	
Expenses	12,000	
Sales		4,00,000
	5,13,000	5,13,000

Closing Stock Rs. 50,000

Solution

Business Purchase Account

2006		Rs.			Rs.
Dec. 31					
To Balance b/d		80,000	By	Bank Loan	18,000
To Investments		5,000	By	Gupta's Capital A/c	30,000
To Insurance Policy		2,000	By	Singh's Capital A/c	20,000
			By	Goodwill	6,000
			By	Profit & Loss A/c (Balance figure, profit upto 31st March, 2006)	13,000
		87,000			87,000

Profit & Loss Account of Raman for the year ended 31st December, 2006

	Rs.		*Rs.*
To Opening Stock	40,000	By Sales	4,00,000
To Purchases	3,20,000	By Closing Stock	50,000
To Expenses	12,000		
To Business Purchase			
(Profit upto 31st March)	13,000		
To Net Profit			
Raman's Capital A/c	65,000		
	4,50,000		4,50,000

Balance Sheet of Raman as on 31st December, 2006

Liabilities		*Rs.*	*Assets*	*Rs.*
Raman's Capital A/c	30,000		Goodwill	6,000
Add : Profit	65,000	95,000	Furniture	3,000
Sundry Creditors		15,000	Stock in trade	50,000
			Sundry Debtors	48,000
			Cash at Bank	3,000
		1,10,000		1,10,000

Working Notes :

(1) *Goodwill*	*Rs.*
Value of Assets taken over	
Stock	46,000
Debtors	35,000
Furniture	3,000
	84,000
Less : Creditors	10,000
Net assets	74,000
Goodwill (Balancing figure)	6,000
Purchase Consideration	80,000

(2) *Increase in net assets upto 31st March 2006* :

	as on 1st January	as on 31st March
	Rs.	Rs.
Debtors	30,000	35,000
Stock	40,000	46,000
Furniture	3,000	3,000
	73,000	84,000
Less : Creditors	12,000	10,000
	61,000	74,000
Profit, equal to net increase	13,000	–
	74,000	74,000

3.2 CONVERSION OF PARTNERSHIP FIRM INTO A COMPANY

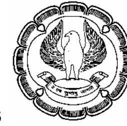
At times partnerships also are reconstructed like joint stock companies, with the help of creditors if they are satisfied that if by taking of further risk or forgoing a part of the debt, the chances of recovery of their loan and capital would improve.

It usually entails preparation of Reconstruction Account for determining the past losses which belong to old partners and writing them off to the debit of their capital accounts. If a creditor agrees to join as a partner the whole or only a part of the account standing to the credit of his loan account is transferred to his capital account. For the further development of the business, usually some fresh capital/loan is required. The amount of loan is placed to the credit of the party contributing the same on such terms and conditions as may have been agreed upon.

Illustration 3

The following is the Balance Sheet of Messrs A and B as on 31st March 2005 :

Liabilities		*Rs.*	*Assets*	*Rs.*
A's Capital	40,000		Land and Buildings	50,000
B's Capital	50,000	90,000	Stock	30,000
			Debtors	20,000
A's Loan		10,000	Investment	
General Reserve		10,000	6% Debentures in X Ltd.	20,000
Liabilities		20,000	Cash	10,000
		1,30,000		1,30,000



It was agreed that Mr. C is to be admitted for a fifth share in the future profits from 1st April 2005. He is required to contribute cash towards goodwill and Rs. 10,000 towards capital.

The following further information is furnished :

(i) The partners A and B shared the profits in the ratio 3:2.

(ii) Mr. A was receiving a salary of Rs. 500 p.m. from the very inception of the firm in 1988 in addition to share of profit.

(iii) The future profit ratio between A, B and C will be 3:1:1. Mr. A will not get any salary after the admission of Mr. C.

(iv) (a) The goodwill of the firm shall be determined on the basis of 2 years' purchase of the average profits from business of the last 5 years. The particulars of the profits are as under :

			Rs.
Year ended	31-3-01	Profit	20,000
Year ended	31-3-02	Loss	10,000
Year ended	31-3-03	Profit	20,000
Year ended	31-3-04	Profit	25,000
Year ended	31-3-05	Profit	30,000

The above profits and losses are after charging the salary of Mr. A. The profit of the year ended 31st March 2001 included an extraneous profit of Rs. 30,000 and the loss of the year ended 31st March 2002 was on account of loss by strike to the extent of Rs. 20,000.

(b) It was agreed that the value of the goodwill of the firm shall appear in the books of the firm.

(v) The trading profit for the year ended 31st March, 2006 was Rs. 40,000 before depreciation.

(vi) The partners had drawn each Rs. 1,000 p.m. as drawings.

(vii) The value of the other assets and liabilities as on 31st March, 2006 were as under :

	Rs.
Building (before depreciation)	60,000
Stock	40,000
Debtors	Nil
Investment	20,000

Liabilities	Nil

(viii) Provide depreciation at 5% on land and buildings on the closing balance and interest at 6% on A's loan.

(ix) They applied for conversion of the firm into a Private Limited Company. Certificate received on 1-4-2006. They decided to convert Capital A/cs of the partners into share capital in the ratio of 3 : 1 :1 on the basis of total Capital as on 31-3-2006. If necessary, partners have to subscribe to fresh capital or withdraw.

Prepare the Profit and Loss Account for the year ended 31st March, 2006 and the Balance Sheet of the company.

Solution

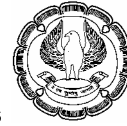
Messrs A, B and C

Profit & Loss A/c for the year ending on 31st March, 2006

		Rs.		*Rs.*
To	Dep. Building	3,000	By Trading Profit	40,000
To	Interest on A's loan	600	By Interest on Debentures	1,200
To	Net Profit to :			
	A's Capital A/c	22,560		
	B's Capital A/c	7,520		
	C's Capital A/c	7,520		
		41,200		41,200

Balance Sheet of the Company as on 1-4-2006

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital	1,59,120	Goodwill	39,600
Loan from A	10,600	Land & Building	57,000
		Investments	20,000
		Stock in Trade	40,000
		Cash	13,120
	1,69,720		1,69,720



Working Notes :

1. **Calculation of goodwill :**

	2001	2002	2003	2004	2005
	Year ended March, 31				
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Book Profits	20,000	– 10,000	20,000	25,000	30,000
Adjustment for extraneous profit 2001and abnormal loss 2002	– 30,000	+ 20,000	—	—	—
	– 10,000	+ 10,000	20,000	25,000	30,000
Add : Back remuneration of A	6,000	6,000	6,000	6,000	6,000
	– 4,000	16,000	26,000	31,000	36,000
Less : Debenture Interest being non-operating income*	1,200	1,200	1,200	1,200	1,200
	– 5,200	14,800	24,800	29,800	34,800
Total Profit from 2002 to 2005					1,04,200
Less : Loss for 2001					5,200
					99,000
Average Profit					19,800
Goodwill equal to 2 years′ purchase					39,600
Contribution from C, equal to 1/5					7,920

2. **Partners′ Capital Accounts**

	A	B	C		A	B	C
	Rs.	*Rs.*	*Rs.*		*Rs.*	*Rs.*	*Rs.*
To Drawings	12,000	12,000	12,000	By Balance b/d	40,000	50,000	—
To Balance c/d	80,320	65,360	13,440	By General Reserve	6,000	4,000	—
				By Goodwill	23,760	15,840	—
				By Bank	—	—	17,920
				By Profit & Loss A/c	22,560	7,520	7,520
	92,320	77,360	25,440		92,320	77,360	25,440

3. **Balance Sheet as on 31st March, 2006**

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
A's Capital		80,320	Goodwill		39,600*
B's Capital		65,360	Land & Building	60,000	
C's Capital		13,440	*Less* : Dep.	3,000	57,000
A's Loan	10,000		Investments		20,000
Add : Int. due	600	10,600	Stock-in-trade		40,000
			Cash (Balancing figure)		13,120**
		1,69,720			1,69,720

4. Conversion into Company

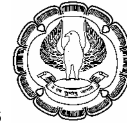
		Rs.
Capital :	A	80,320
	B	65,360
	C	13,440
Share Capital		1,59,120
Distribution of share :	A (3/5)	95,472
	B (1/5)	31,824
	C (1/5)	31,824

A should subscribe shares of Rs. 15,152 (Rs. 95,472 – Rs. 80,320) and C should subscribe shares of Rs. 18,384 (Rs. 31,824 – Rs. 13,440) B withdraws Rs. 33,536 (Rs. 65,360 – Rs. 31,824) subscribing to shares worth Rs. 31,824.

* It is shown in the books of the firm only to determine the closing capital of partners inclusive of goodwill before conversion.

** Also the closing cash balance can be derived as shown below :

	Rs.	*Rs.*
Trading profit (assume realised)		40,000
Add: Debenture Interest		1,200
Add: Decrease in Debtors Balance		20,000
		61,200
Less: Increase in stock	Rs. 10,000	
Less: Decrease in Liabilities	Rs. 20,000	30,000



Cash Profit		31,200
Add: Opening cash balance		10,000
Add: Cash brought in by C		17,920
		59,120
Less: Drawings	Rs. 36,000	
Less: Additions to Building	Rs. 10,000	46,000
		13,120

Illustration 4

P, Q and R were in partnership sharing profits and losses equally and their Balance Sheet was as follows as on 31st Dec., 2005.

tal			Cash		2,000
P	50,000		Stock		18,000
Q	40,000		Book Debts		7,500
R	30,000	1,20,000	Investments		12,500
			Factory:		
Creditors		7,000	Section I	32,000	
Staff Security Deposits		8,000	Section II	40,000	72,000
Staff Provident Fund		7,900			
Profit & Loss Account		5,100	Vehicles		28,000
			Fixed Bank Deposits of Staff Securities		8,000
		1,48,000			1,48,000

As proposals for expansion were being considered, R decided to retire and start a similar business, subject to the following terms :

(a) Stock was revalued at 20 per cent less and investments at 10 per cent less.

(b) A debt of Rs. 2,500 due to the firm was suspected to be bad; but since it was allowed at R's instance, R agreed to collect it himself, the firm, however, agreeing to value it at 10% less.

(c) One of the vehicles, fully depreciated but still in operation, was to be raised to its scrap value of Rs. 3,000 and given to R in part payment of his dues from the firm.

(d) R's salary as Marketing Chief was raised by Rs. 500 a month from 1st Jan., 2005, on the understanding that he would continue in the firm for at least three years from that date and that, if he retired within that period, he should return to the firm half of the additional

salary he drew since 1st Jan., 2005.

(e) The partnership agreement stipulated that any retiring partner going into similar business outside should pay the firm a consolidated payment of Rs. 9,000 at the time of retirement. The amount was to be shared between the continuing partners in the ratio of their capital before all adjustments for revaluations were given effect to.

As soon as the amount due from the firm to R was finally arrived at, P and Q, disposed of the investments whose market value at the time of sale stood at Rs. 12,000 and they introduced cash in equal amounts in such a way that not only was R's claim fully settled but the firm had a total cash balance of Rs. 7,000.

After settling R's account on retirement, P & Q decided on converting their business into a joint stock company. Negotiations were carried on with S & T, who agreed to join the business on the following conditions :

(i) Factory Section II being uneconomical, should be replaced by modern equipment which S & T will supply at a price of Rs. 65,000. S & T would buy up factory Section II at Rs. 35,000, the dismantling charges of Rs. 2,000 being borne by the firm of P & Q.

(ii) For the rest of their claims S & T would take equity shares in the new company.

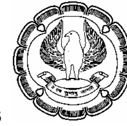
The P & Q Co. Ltd. would have an authorised capital of Rs. 2,00,000 divided into shares of Rs. 10 each. It was decided that P & Q would get equity shares at par for their capital account balanced. The shares other than those given to P & Q and S & T, were subscribed for by the public and paid up fully in cash.

You are required to show (*a*) the Capital Accounts of P, Q and R and Profit and Loss Adjustment Account in the firm's books (*b*) Balance Sheet of P and Q immediately on R's retirement and (*c*) the opening Balance Sheet of the P & Q Co. Ltd.

Solution

Profit and Loss Adjustment A/c

	Rs.		*Rs.*
To Stock	3,600	By Motor Vehicle	3,000
To Investment	1,250	By R's Capital (½ of Salary)	3,000
To Sundry Debtors	250		
To Profit to Partners' Capital A/c			
P	300		
Q	300		
R	300		
	6,000		6,000



Capital Accounts

	P	Q	R		P	Q	R
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Debtors			2,250	By Balance	50,000	40,000	30,000
To Motor Vehicle			3,000	By Profit & Loss A/c	1,700	1,700	1,700
To Profit & Loss Adj. A/c			3,000	By Profit & Loss Adjustment A/c	300	300	300
To P & R Capital A/c			9,000	By Investment A/c	375	375	
To Cash Bank			14,750	By Cash /Bank	3,875	3,875	
To Balance c/d	61,250	50,250		By R Capital A/c	5,000*	4,000*	
	61,250	50,250	32,000		61,250	50,250	32,000

* Rs. 9,000 brought in by R are credited to P and Q in the ratio of their fixed capital 50 :40.

	Rs.		Rs.
To Balance b/d	2,000	By R's Capital	14,750
To Investment A/c	12,000	By Balance c/d	7,000
To P's Capital A/c	3,875		
To Q's Capital A/c	3,875		
	21,750		21,750

(b) Balance Sheet of M/s P & Q (after R's Retirement)

Liabilities	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital		Cash		7,000
P	61,250	Stock		14,400
Q	50,250	Book Debts		5,000
Creditors	7,000	Factory		
Staff Security Deposit	8,000	I	32,000	
Staff Provident Fund	7,900	II	40,000	72,000
		Vehicles		28,000
		F.D with Banks		8,000
	1,34,400			1,34,400

M/s S & T A/c

To Factory II	35,000	By Plant & Machinery	65,000
To Share Capital (Balance)	30,000		
	65,000		65,000

(c) **Balance Sheet of P & Q Co. Ltd. as on 31st December, 2005**

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital 20,000 Equity			
Shares of 10 each fully paid	2,00,000		
(Issued for consideration other		Factory	32,000
than cash 14, 150 shares of		Plant & Machinery	65,000
Rs. 10 each)		Vehicles	28,000

(v) Shares received from the company as purchase consideration should be distributed among the partners in the profit-sharing ratio, care being taken to distribute the whole numbers only.

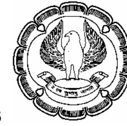
(vi) Final settlement should be in cash.

3.3.1 **Apportionment of shares amongst the partners** : Sometime an examination problem may require the students to suggest equitable basis for division of shares between the vendors, when they are partners, so as to preserve the rights as previously existed between them, that is, to maintain the same profit-sharing ratio and to preserve the priority in regard to repayment of capital.

Suppose A, B and C share profits and losses in the ratio 3 : 2 : 1 after allowing interest on capital @ 9% p.a. Their capitals on 31st December, 2005 were: A Rs. 50,000, B Rs. 30,000 and C Rs. 20,000. On 1st January, 2006 the business was converted into a limited company and was valued at Rs. 1,30,000. A scheme of capitalisation, whereby the mutual interest of partners may remain intact as far as possible is suggested below:

The total capital being Rs. 1,00,000 and the value placed on the business being Rs. 1,30,000 there is goodwill of Rs. 30,000 to be shared by the partners in the ratio of 3: 2:1 or A Rs. 15,000, B Rs. 10,000 and C Rs. 5,000. The capital will now be: A Rs. 65,000, B Rs. 40,000 and C Rs. 25,000.

Taking B's capital as the basis, A's capital should be Rs. 60,000, *i.e.* 40,000 × 3/2 and C's capital should be Rs. 20,000. Both A and C have Rs. 5,000 excess. Since interest on capital is meant to compensate those whose capital is in excess of proportionate limits and since in the case of partners it is an appropriation of profit, it will be proper to give 9% preference shares to A & C for Rs. 5,000 each and the remaining amount of Rs. 1,20,000 can be in the form of



equity shares to be divided among A, B and C in the ratio of 3 : 2 : 1. They will then share the company's profit in the ratio of 3 : 2 : 1 after allowing preference dividend.

Illustration 5

P, Q and R were carrying on business in partnership sharing profits and losses in the ratio of 5 : 4 : 3 respectively. The trial balance of the firm on 31st March, 2006 was the following :

		Rs.	*Rs.*
Plant and Machinery (Cost)		85,000	
Stock		64,200	
Sundry Debtors		66,500	
Sundry Creditors			84,700
Capital A/c :	P		63,000
	Q		42,000
	R		21,000
Current A/c	P	20,000	
A/c	Q	20,000	
A/c	R	15,000	
Depreciation on Plant and Machinery			25,000
Trading profit for the year			1,23,300
Cash at Bank		88,300	
		3,59,000	3,59,000

Interest on capital accounts at 5% p.a. on the amount standing to the credit of partners' Capital Accounts at the beginning of the year was not provided before preparing the above trial balance. On 31st March, 2006 they formed a Private Limited Co. with an authorised share capital of Rs. 2,00,000 in shares of Rs. 10 each to be divided in different classes to take over the business of partnership.

You are informed as under:

(1) Plant and Machinery is to be transferred at Rs. 66,000.

(2) Shares in the company are to be issued to the partners, at par, in such numbers and such classes as will give the partners, by reason of their share holdings alone, the same rights as regards interest on capital and the sharing of profits and losses as they had in the partnership. Valuation of goodwill is arrived at by this mode.

(3) Before transferring the business, the partners wish to draw from the partnership their profit to such an extent that the bank balance is reduced to Rs. 50,000. For this purpose sufficient profits of the year are to be retained in profit-sharing ratio.

(4) All assets and liabilities except plant and machinery and the bank balance are to the transferred at their value in the books of the partnership as on 31-3-2006.

You are required to prepare :

(a) Profit and Loss Account for the year ending 31-3-2006.

(b) A statement showing the number of shares of each class to be issued by the company to each of the partners and details of rights attaching to those shares.

Solution

(a) **M/s. P, Q & R**

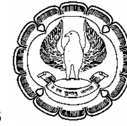
Profit and Loss Account for the year ending 31st March, 2006

	Rs.	*Rs.*		*Rs.*
To Interest on Capitals :			By Trading Profit	1,23,300
P	3,150			
Q	2,100			
R	1,050	6,300		
To Capital A/cs – Transfer of profit :				
P	48,750			
Q	39,000			
R	29,250	1,17,000		
		1,23,300		1,23,300

(*b*) Statement showing working of the number of shares to be issued M/s. P, Q and R.

(i) Purchase consideration :

	Rs.
Plant and machinery	66,000
Stock	64,200
Debtors	66,500
Cash at Bank	50,000
	2,46,700
Less:	



	Rs.
Sundry Creditors	84,700
Value of net assets, taken over by the Company	1,62,000

(ii) *Preference Shares* : Issue of 5% preference shares of Rs. 10 each to partners in lieu of their capital so that "interest" at 5% p.a. is received by them.

	Rs.
P	63,000
Q	42,000
R	21,000
	1,26,000

(iii) Purchase consideration being Rs. 1,62,000 the balance Rs. 36,000 is to be satisfied by issue of equity shares at Rs. 10 each fully paid, in the profit-sharing ratio.

	Rs.
P	15,000
Q	12,000
R	9,000
	36,000

Note : The question of preference/equity shares to be issued to P, Q and R can also be dealt with in the following manner :

	P	*Q*	*R*
	Rs.	*Rs.*	*Rs.*
Total amount due as capital	78,000	54,000	30,000
Amount according to the profit-sharing ratio, taking R's capital as the basis	50,000	40,000	30,000
Excess	28,000	14,000	Nil

P, Q and R respectively may be given equity shares for Rs. 50,000, Rs. 40,000 and Rs. 30,000 which enable them to divide profits of the company in the ratio of 5:4:3. P and Q may be respectively given 5% non-cumulative preference shares for Rs. 28,000 and Rs. 14,000. The above is based on the principle that the function of interest in case of partnership is to compensate those partners who contribute capital in excess of what is required as per profit sharing ratio.

Illustration 6

A and B carried on business as partners, sharing profits and losses equally.

The business was being carried on in two departments, called R and W. The following is the Balance Sheet as on 31st December, 2005 :

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Creditors :			Land and Building		
R. Deptt.	3,38,800		(at cost)		4,10,300
W. Deptt.	57,200	3,96,000	Fixtures (at cost less		
			depreciation)		11,000
Loans		26,400	Debtors :		
Bank Overdraft		1,96,900	R. Deptt.	1,40,800	
Capital Accounts :			W. Deptt.	2,37,600	3,78,400
A	5,78,600				
B	3,56,400	9,35,000	Stock-in Trade :		
			R. Deptt.	5,06,000	
			W. Deptt.	2,47,500	7,53,500
			Cash in hand		1,100
		15,54,300			15,54,300

As from 1st January, 2006 it was decided that the business should be taken over by two limited companies A & Co. Ltd. to take over R Department and B & Co. Ltd. to take over W. Department.

The lenders agreed to accept 7% preference shares of the companies as under :

A & Co. Ltd.	Rs. 15,840
B & Co. Ltd.	Rs. 10,560

A & Co. Ltd. took over the land and building, fixtures and cash and liability to bank, at book values. Stock-in-trade was taken over at book value. Partners were to be paid goodwill for R. Department Rs. 1,10,000 and for W. Department Rs. 88,000.

The whole of the purchase price was satisfied by allotment of fully paid equity shares as under :

A received shares of Rs. 5,22,500 in A & Co. Ltd. and balance in shares of B & Co. Ltd.

B received shares of Rs. 3,50,240 in B & Co. Ltd. and balance in shares of A & B Co. Ltd.

The formation expenses payable by respective companies were as under :

A & Co. Ltd.	Rs. 14,300
B & Co. Ltd.	Rs. 8,800

Bank overdraft was later settled at book value by A & Co. Ltd. out of proceeds of a loan of Rs. 2,20,000 raised on mortgage of land and building.

Both companies issued further equity shares as under for cash :

A & Co. Ltd.	Rs. 22,000
B & Co. Ltd.	Rs. 33,000

You are required to prepare the Balance Sheet of A & Co. Ltd. after taking into consideration the above transactions and to state the amount of shares allotted to A and B in both the companies.

Solution

Balance Sheet of A & Co. Ltd. as on January 1, 2006

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital		Goodwill	1,10,000
Equity shares of Rs...		Land and Building	4,10,300
each fully paid	6,49,660	Fixtures	11,000
7% Preference shares of		Current Assets :	
Rs. ... each fully paid	15,840	Debtors	1,40,800
Loan on Mortgage of		Stock	5,06,000
Land & Building	2,20,000	Cash	31,900
Current Liabilities :		Miscellaneous Expenses :	
Sundry Creditors	3,38,800	Preliminary Expenses	14,300
	12,24,300		12,24,300

Note : Profit on realisation is equal to the amount paid for goodwill as other assets have been taken over at book value.

Allotment of equity shares :

	A & Co. Ltd.	*B & Co. Ltd.*	*Total*
	Rs.	*Rs.*	*Rs.*
A	5,22,500	1,55,100	6,77,600

B	1,05,160	3,50,240	4,55,400
	6,27,660	5,05,340	11,33,000
For cash	22,000	33,000	55,000
	6,49,660	5,38,340	11,88,000

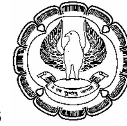
Working Notes:

(i) Capital Accounts

		A	B			A	B
		Rs.	*Rs.*			*Rs.*	*Rs.*
To	Shares in A Ltd.	5,22,500	1,05,160	By	Balance b/d	5,78,600	3,56,400
"	Shares in B Ltd.	1,55,100	3,50,240	"	Realisation	99,000	99,000
		6,77,600	4,55,400			6,77,600	4,55,400

(ii) Purchase consideration :

	A & Co.	*B & Co.*
	Rs.	*Rs.*
Debtors	1,40,800	2,37,600
Stock-in-trade	5,06,000	2,47,500
Land & Buildings	4,10,300	
Fixtures	11,000	
Cash	1,100	
Goodwill	1,10,000	88,000
A	11,79,200	5,73,100
Creditors	3,38,800	57,200
Loan	15,840	10,560
Overdraft	1,96,900	-------
B	5,51,540	67,760
A-B	6,27,660	5,05,340



(iii) **Cash A/c of A Ltd.**

	Rs.		Rs.
Balance taken over	1,100	Bank Overdraft	1,96,900
Equity Shares	22,000	Formation Exp.	14,300
Mortgage Loan	2,20,000	Balance	31,900
	2,43,100		2,43,100

Illustration 7

The following is the Balance Sheet as at 30th June, 2006 of L, P and Q, partners of a firm, sharing profits and losses equally:

Liabilities	*Rs.*		*Assets*	*Rs.*
Capital Accounts:			Plant and Machinery	42,000
L	20,000		Building	18,000
P	30,000		Motor Car	3,200
Q	5,000	55,000	Sundry Debtors	23,000
			Stock-in-trade	21,000
Current Accounts :			Bank Balance	1,800
L	16,000		Current Account :	
P	18,000	34,000	Q	7,800
Trade Creditors		17,600		
Provision for payments of excise duty		8,400		
Creditors for Expenses		1,800		
		1,16,800		1,16,800

The firm accepts an offer from X Co. Ltd., to take over the following assets at values given opposite to each:

	Rs.
Plant and Machinery	30,000
Building	40,000
Stock-in-trade	18,000

The Company agrees to discharge 75% of the consideration due in equity shares of Rs. 10 each to be allotted at a premium of Re. 1 per share. The balance of consideration will be

retained by the company, at an interest of 15% per annum, to be paid six months after the transfer is put through.

The firm realises its sundry debtors for Rs. 20,000; motor car is taken by partner L at an agreed value of Rs. 5,000 paid by him in cash; expenses of realisation met by the firm came to Rs. 500; the liability to excise duty was finally discharged at Rs. 10,000.

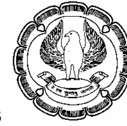
Q's private assets are worth Rs. 15,000 and his individual liabilities and debts amount to Rs. 18,000.

Record the above transactions in the books of the firm and close the books-assuming that the transactions were all put through on 1st July, 2006 Show the ledger accounts only. Rule in Garner vs. Murray is to be applied.

Solution

Realisation Account

			Rs.			*Rs.*
To	Sundry Assets:			By	X & Co.	88,000
	Plant & Machinery		42,000		(Purchase Consideration)	
	Building		18,000	"	Bank (Debtors)	20,000
	Motor Car		3,200	"	Bank (Motor Car)	5,000
	Sundry Debtors		23,000	"	Provision for Excise Duty	8,400
	Stock-in-trade		21,000	"	Creditors for exp.	1,800
"	Bank (Sundry Creditors)		17,600	"	Sundry Creditors	17,600
	Bank (Exp.)		500			
"	(Excise Duty)		10,000			
"	(Exp. Creditors)		1,800			
"	Net profit for Capital A/cs :					
	L	1233				
	P	1233				
	Q	1234	3,700			
			1,40,800			1,40,800



Bank Account

		Rs.	Rs.			Rs.
To	Balance b/d		1,800	By	Realisation A/c :	
"	Realisation A/c (Debtors)		20,000		Expenses	500
	(Car)		5,000		Excise Duty	10,000
"	Capital Accounts				Crs. for Exp.	1,800
	L	1240			Trade Creditors	17,600
	P	1860	3,100			
			29,900			29,900

Capital Accounts

		L	P	Q			L	P	Q
		Rs.	Rs.	Rs.			Rs.	Rs.	Rs.
To	Current Account (transfer)			7,800	By	Balance b/d	20,000	30,000	5,000
"	Q's Capital	626	940		"	Curent A/c.			
						Transfer	16,000	18,000	–
"	Balance c/d	37,847	50,153		"	Realisation A/c	1,233	1,233	1,234
					"	L's Capital A/c			626
					"	P's Capital A/c			940
					"	Cash	1,240	1,860	
		38,473	51,093	7,800			38,473	51,093	7,800
To	Shares in X & Co. Ltd.	28,390	37,610		By	Balance b/d	37,847	50,153	
"	X & Co. Ltd. (Bal. Fig.)	9,457	12,543						
		37,847	50,153				37,847	50,153	

Notes:

(i) Debit balance of Q Rs. 1,566 has been transferred to L & P in the ratio of fixed capital.

(ii) It has been assumed that L & P have brought cash for payment to creditors in fixed capital ratio.

(iii) Shares in X & Co., have been distributed in the ratio of the final balance standing to the credits of Partners' Capital Accounts.

Self Examination Questions

I Objective type questions

Choose the most appropriate answer from the given options:

1. The assets , liabilities and capital accounts of the amlgamaing partnership firm are closed by opening
   (a) Realization account.
   (b) Revaluation account.
   (c) New firm's account.
   (d) None of the above.
2. In case of amalgamation, profit/ loss on sale of the firm is ascertained by
   (a) Realization account.
   (b) Revaluation account.
   (c) New firm's account.
   (d) Profit and loss adjustment account.
3. Liabilities not taken over by the new firm (at the time of amalgamation) will be transferred to
   (a) Capital accounts.
   (b) Revaluation account.
   (c) New firm's account.
   (d) Profit and loss adjustment account

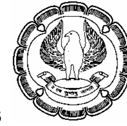
[Ans. 1 (c); 2. (a); 3. (a)]

Short answer type questions

4. Describe the accounting procedure in brief when two partnership firm are amalgamated to form a new firm.

Long answer type questions

5. What do you mean by amalgamation of firms? What entries are passed to close the books of the firms which are amalgamated?



6. How will you treat assets and liabilities not taken over by the new firm in the books of the amalgamated firm?

Practical problems

7. Mr. B and Mr. E are partners sharing Profits and Losses in the ratio of 3:2. On 30th September, 2005 they admit Mr. C as a partner, and the new profit ratio is 2:2:1. C brought in Fixtures Rs. 3,000 and cash Rs. 10,000, the goodwill being (i) B and E Rs. 20,000 and (ii) C Rs. 10,000 but neither figure is to be brought into the books.

   On 31st March, 2006, the partnership is dissolved, B retiring and the other two partners forming a company called BC Limited with equal capitals, taking over all remaining assets and liabilities, goodwill being agreed at Rs. 40,000 and brought into books of the company. B agrees to take over the business car at Rs. 3,700: Plant was sold for Rs. 3,000 being in excess of requirements. The profit of the two preceding years were Rs. 17,200 and Rs. 19,000 respectively and it was agreed that for the half year ended 30th September, 2005 the net profit was to be taken as equal to the average of the two preceding years and the current year.

   No entries has been made when C entered, except cash. No new book being opened by BC Company Ltd., B agreed to have Rs. 50,000 as loan to the company, secured by 12% Debentures. The following is the Trial Balance as on 31st March, 2006.

	Debit	*Credit*
	Rs.	Rs.
Capital Accounts:		
B		35,000
E		20,000
C		10,000
Drawing Accounts:		
B	6,000	
E	5,000	
C	2,800	
Debtors & Creditors	31,000	12,000

Plant (Book value of plant sold Rs. 4,000)	23,000	
Fixtures	7,000	
Motor Car	2,700	
Stock on 31st March, 2006	13,000	
Bank	16,300	
P & L A/c for the year		29,800
	1,06,800	1,06,800

Prepare :

(1) Goodwill Adjustment Account

(2) Capital Accounts of Partner

(3) Profit and Loss Appropriation Account

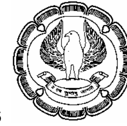
(4) Balance Sheet of BC Ltd. as on 31st March,2006.

8. Ram, Rahim and Robert are partners of the firm 'RR Traders' for the past 5 years. The partners decided to dissolve the firm consequent to insolvency of partner Robert in October, 2005. The Balance Sheet of the firm as on 31.10.2005 is furnished below. They share profits and losses equally:

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital Accounts:		Land and Building	5,00,000
Ram	4,50,000	Plant and Machinery	2,00,000
Rahim	4,50,000	Furniture and Fittings	50,000
Robert	2,00,000	Stock in Trade	3,00,000
General Reserve	2,10,000	Debtors	5,00,000
Creditors	2,90,000	Cash at Hand/Bank	50,000
	16,00,000		16,00,000

The partners Ram and Rahim decided to form a new firm 'RR Enterprises' and takeover all the assets and liabilities of the firm at values given below:

Land and Building	Rs. 3,50,000
Plant and Machinery	Rs. 1,50,000



Furniture and Fittings	Rs. 20,000
Stock in trade	Rs. 2,00,000

Debtors include Rs. 3,00,000 due from SK & Co. owned by Robert. (Nothing is recoverable from the said concern).

Other debtors can be recovered fully.

Prepare:

(i) Realisation account, Partners' capital accounts in the books of RR Traders; and

(ii) The Balance Sheet of RR Enterprises (immediately after commencement).

CHAPTER 12

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.

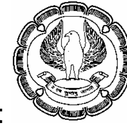
2. The computer or computers may be operated by the entity or by a third party.
3. The processing of financial information by the computer is done with the help of one or more computer software.
4. A computer software includes any program or routine that performs a desired function or set of functions 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)

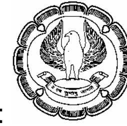
601 Bank Loan

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

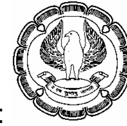
OTHER TAX (9000-9999)

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.

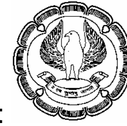
(c) A "detailed head" is often termed as an object classification. In the expenditure account being considered in the above example the main purpose of the detailed head is to control expenditure on an item to item basis and at the same time group the objects according to the nature. Example of such 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.

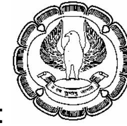
7. PREPACKAGED ACCOUNTING SOFTWARE

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

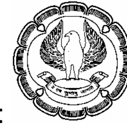
Profit and Loss Account

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 so*ftwares: 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:

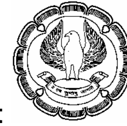
There are many accounting softwares available in the market. To choose the accounting software appropriate to the need of the organisation is a difficult task. Some of the criteria for selection could be the following:

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

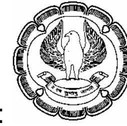
The disadvantages of an ERP are the following:

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:

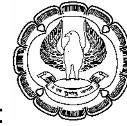
1. The amount of services provided and whether the same matches with the requirements.
2. The reputation and background of the vendor.
3. The comparative costs of the various propositions.
4. The assurance of quality.

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

CONCEPTUAL FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

The following is the text of the 'Framework for the Preparation and Presentation of Financial Statements' issued by the Accounting Standards Board of the Institute of Chartered Accountants of India.

INTRODUCTION

Purpose and Status

1. This Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Frameworks is to :

(*a*) assist prepares of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;

(*b*) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;

(*c*) assist the Accounting Standards Board in promoting harmonisation of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Accounting Standards;

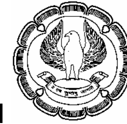
(*d*) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;

(*e*) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and

(*f*) provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

2. This Framework is not an Accounting Standard and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Framework overrides any specific Accounting Standard.

3. The Accounting Standards Board recognises that in a limited number of cases there may be a conflict between the Framework and an Accounting Standard. In those cases where there is a conflict, the requirements of the Accounting Standard prevail over those of the Framework. As, however, the Accounting Standards Board will be guided by the Framework in the development of future Standards and in its review of existing Standards, the number of cases of conflict between the Framework and Accounting Standards will diminish through time.



4. The Framework will be revised from time to time on the basis of the experience of the Accounting Standards Board of working with it.

Scope

5. The Framework deals with :

(*a*) the objective of financial statements;

(*b*) the qualitative characteristics that determine the usefulness of information provided in financial statements;

(*c*) definition, recognition and measurement of the elements from which financial statements are constructed; and

(*d*) concepts of capital and capital maintenance.

6. The Framework is concerned with general purpose financial statements (hereafter referred to as 'financial statements'). Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example, prospectuses and computations prepared for taxation purposes, are outside the scope of this Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.

7. Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

8. The Framework applies to the financial statements of all reporting enterprises engaged in commercial, industrial and business activities, whether in the public or in the private sector. A reporting enterprise is an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

Users and Their Information Needs

9. The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some fo their information needs. These needs include the following :

(*a*) *Investors*. : The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. They are also interested in information, which enables them to assess the ability of the enterprise to pay dividends.

(*b*) *Employees.* : Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information, which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.

(*c*) *Lenders.* : Lenders are interested in information, which enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

(*d*) *Suppliers and other trade creditors.* : Suppliers and other creditors are interested in information, which enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuance of the enterprise as a major customer.

(*e*) *Customers.* : Customers have an interest in information about the continunance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.

(*f*) *Governments and their agencies*. : Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.

(*g*) *Public*. : Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

10. While all the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As providers of risk capital to the enterprise, investoers need more comprehensive information than other users. The provision of financial

statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

11. The management of an enterprise has the responsibility for the preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this Framework. **THE OBJECTIVE OF FINANCIAL STATEMENTS**

12. The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

13. Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since (a) they largely portray the financial effects of past events, and (b) do not necessarily provide non-financial information.

14. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

Financial Position, Performance and Cash Flows

15. The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainity of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay laons, and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and cash flows of an enterprise.

16. The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and

cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

17. Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources.

18. Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financing and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

19. Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in a statement of profit and loss. Information about cash flows is provided in the financial statements by means of a cash flow statement.

20. The component parts of the financial statements are interrelated because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose nor to provide all the information necessary for particular needs of users.

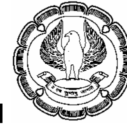
Notes and Supplementary Schedules

21. The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about business and geographical segments and the effect of changing prices on the enterprise may also be provided in the form of supplementary information.

UNDERLYING ASSUMPTIONS

Accrual Basis

22. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in



the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going Concern

23. The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used in disclosed.

Consistency

24. In order to achieve comparability of the financial statements of an enterprise through time, the accounting policieis are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

25. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

26. An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevence to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

Relevance

27. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

28. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

29. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicity forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statements of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

Materiality

30. The relevance of information is affected by its materiality. Information is material if its misstatements (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the items or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

Reliability

31. To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful Representation

33. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in

assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

34. Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recgonise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance Over Form

35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentation and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

Neutrality

36. To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

37. The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and cirumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate

understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality or reliability. Completeness

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

Comparability

39. Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different entereprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

40. An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

41. The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

42. Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

Constraints on Relevant and Reliable Information

Timeliness

43. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability.

Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the information need of users.

Balance between Benefit and Cost

44. The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefit derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

45. In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgement.

True and Fair View

46. Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information.

Elements of financial statements

47. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit and loss are income and expeneses. The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.

48. The presentation of these elements in the balance sheet and the statement of profit and loss involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Postion

49. The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows :

(a) An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

(b) A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

(c) Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

50. The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 81 to 97. In particular, the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion in paragraph 82 before an asset or liability is recognised.

51. In assessing whether an item meets the definition of an asset, liability or equity, consideration needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of hire purchase, the substance and economic reality are that the hire purchaser acquires the economic benefits of the use of the asset in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the hire purchase gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the hire purchaser's balance sheet.

Assets

52. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalent to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

53. An enterprise usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flows of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

54. The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be :

(*a*) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;

(*b*) exchanged for other assets;

(*c*) used to settle a liability; or

(*d*) distributed to the owners of the enterprise.

55. Many assets, for example, plant and machinery, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them and if they are controlled by the enterprise.

56. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obatined from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

57. The assets of an enterprise result from past transactions or other past events. Enterprises normally obtain assets by purchasing or producing them, but other transactions or events may also generate assets; examples include land received by an enterprise from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or other events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

58. There is a close association between incurring expenditure and obtaining assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an

item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet.

Liabilities

59. An essential characteristic of a liability its that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods an services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

60. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrecoverable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party.

61. The settlements of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by :

(*a*) payment of cash;

(*b*) transfer of other assets;

(*c*) provision of services;

(*d*) replacement of that obligation with another obligation; or

(*e*) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights. 62. Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade creditors (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

63. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

64. Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, funds contributed by owners, reserves representing appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustements may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

65. The creation of reserves is sometimes required by law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Reserves may also be created when tax laws grant exemptions from, or reductions in, taxation liabilities if transfers to such reserves are made. The existence and size of such reserves in information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

66. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.

67. Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applicable to corporate enterprises. For example, unlike, corporate enterprises in the case of such enterprises, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such enterprises.

Performance

68. Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income

and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements. The concepts are discussed in paragraphs 101 to 109.

69. Income and expenses are defined as follows :

(*a*) Income is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(*b*) Expenses are decreased in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

70. The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that need to be met before they are recgonised in the statement of profit and loss. Criteria for recognition of income and expenses are discussed in paragraphs 81 to 97.

71. Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. For example, it is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the enterprise to generate cash and cash equivalents in the future. When distinguishing between items in this way, consideration needs to be given to the nature of the enterprise and its operations. Items that arise from the ordinary activities of one enterprise may be extraordinary in respect of another.

72. Distinguishing between items of income and expense and combining them in different ways also permits several measures of enterprise performance to be displayed. These have differing degrees of inclusivenees. For example, the statement of profit and loss could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

73. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalities and rent.

74. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as a separate element in this Framework.

75. The definition of income includes unrealised gains. Gains also include, for example, those arising on the disposal of fixed assets. When gains are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

76. Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result in the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

77. The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the enterprise, as well as losses. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of goods sold, wages, and depreciation. They take the form of an outflow or depletion of assets or enhancement of liabilities.

78. Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

79. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of fixed assets. The definition of expenses also includes unrealised losses. When losses are recgonised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

Capital Maintenance Adjustments

80. The revaluation or restatement of assets and liabilities give rise to increases or decreases in equity. While these increases or decreases to meet the definition of income and expenses, they are not included in the statement of profit and loss under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 101 to 109 of this Framework.

RECOGNITION OF THE ELEMENTS OF FINANCIAL STATEMENTS

81. Recognition is the process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisifies the criteria for recognition set out in paragraph 82. It involves the depiction of the items in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit

and loss. Items that satisfy the recgonition criteria should be recognised in the balance sheet or statement of profit and loss. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

82. An item that meets the definition of an element should be recognised if :

(*a*) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and

(*b*) the items has a cost or value that can be measured with reliability.

83. In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraph 30. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The Probability of Future Economic Benefits

84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterizes the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable will be realised, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence, an expense representing the expected reduction in economic benefits is recognised.

Reliability of Measurement

85. The second criterion for the recognition of an item is that it possesses a cost of value that can be measured with reliability as discussed in paragraphs 31 to 38 of this Framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made, the item is not recognised in the balance sheet or statement of profit and loss. For example, the damages payable in a lawsuit may meet the definitions of both a liability and an expense as well as the probability criterion for recognition; however, if it is not possible to measure the claim reliably, it should not be recognised as a liability or as an expense.

86. An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 82 may qualify for recognition at a later date as a result of subsequent circumstances or events.

87. An item that possess the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and cash flows of an enterprise by the users of financial statements. Thus, in the example given in paragraph 85, the existence of the claim would need to be disclosed in the notes, explanatory material or supplementary schedules.

Recognition of Assets

88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

89. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

Recognition of Liabilities

90. A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of Income

91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decreaase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

92. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

Recognition of Expenses

93. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery).

94. Many expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneously or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

95. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recgonise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.

97. An expense is recognised in the statement of profit and loss in those cases also where a liability is incurred without the recognition of an asset, for example, in the case of a liability under a product warranty.

MEASUREMENT OF THE ELEMENTS OF FINANCIAL STATEMENTS

98. Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement.

99. A number of different measurement bases are employed to different degrees and in varying combination in financial statements. They include the following :

(*a*) Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(*b*) Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(*c*) Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is , the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

(*d*) Present value. Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

100. The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value. Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Concepts of capital and capital maintenance

101. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

102. The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the mainconcern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of Capital Maintenance and the Determination of Profit

103. The concepts of capital described in paragraph 101 give rise to the following concepts of capital maintenance :

(*a*) Financial capital maintenance. Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(*b*) Physical capital maintenance. Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

104. The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return on capittal and its return of capital; only inflows of assets in excess of amounts needed to maintain capital can be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income, the residual amount is a net loss.

105. The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain.

106. The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained its capital if it has as much capital at the end of

the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

107. Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

108. Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

109. The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements under the chosen model.

APPENDIX II

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.

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* 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*

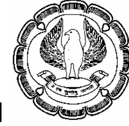
The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

(*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

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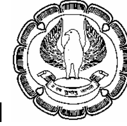
[1] This standard has been revised and titled as 'Construction Contracts.'



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 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

[2] Refer to Accounting Standards interpretation (ASI)2.

conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual 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

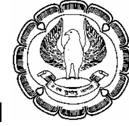
11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific 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, re-gardless 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*.

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

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* 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

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.

(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

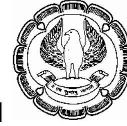
(c) rents collected on behalf of, and paid over to, the owners of properties.

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.

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* This standard has been revised in 2003, and titled as 'The Effects of Changes in Foreign 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.*

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

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* 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.

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.

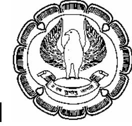
(g) Foreign exchange loss of 40 represents the reduction in the carrying amount of a short-term investment in foreign currency designated bonds arising out of a change in exchange rate between the date of acquisition of the investment and the balance sheet date.

(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

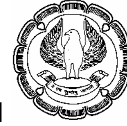
Notes to the cash flow statement

(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

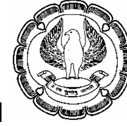
Out of 900, tax deducted at source on dividends received (amounting to 40) is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities (See Paragraph 34).

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 purposes234		
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 4 (REVISED) : CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

The following is the text of the revised Accounting Standard (AS) 4, 'Contingencies and Events Occurring after the Balance Sheet Date' issued by the Council of the Institute of Chartered Accountants of India.

This revised standard comes into effect in respect of accounting periods commencing on or after 1-4-1995 and is mandatory in nature.[1] It is clarified that in respect of accounting periods commencing

[1] 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

on a date prior to 1-4-1995, Accounting Standard 4 as originally issued in November, 1982 (and subsequently made mandatory) applies.

Introduction

1. This Statement deals with the treatment in financial statements of

(a) contingencies, and

(b) events occurring after the balance sheet date.

2. The following subjects, which may result in contingencies, are excluded from the scope of this Statement in view of special considerations applicable to them :

(a) liabilities of life assurance and general insurance enterprises arising from policies issued;

(b) obligations under retirement benefit plans; and

(c) commitments arising from long-term lease contracts.

Definitions

3. The following terms are used in this Statement with the meanings specified :

3.1 A *contingency*[2] is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

3.2 *Events occurring after the balance sheet date* are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

Two types of events can be identified :

(a) those which provide further evidence of conditions that existed at the balance sheet date; and

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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

[2] See footnote 1.

(b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Explanation

4. **Contingencies**

4.1 The term "contingencies" used in this Statement is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

4.2 Estimates are required for determining the amount to be stated in the financial statements for many ongoing and recurring activities of an enterprise. One must, however, distinguish between an event which is certain and one which is uncertain. The fact that an estimate is involved does not, of itself, create the type of uncertainty which characterises a contingency. For example, the fact that estimates of useful life are used to determine depreciation, does not make depreciation a contingency; the eventual expiry of the useful life of the asset is not uncertain. Also, amounts owed for services received are not contingencies as defined in paragraph 3.1, even though the amounts may have been estimated, as there is nothing uncertain about the fact that these obligations have been incurred.

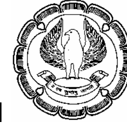
4.3 The uncertainty relating to future events can be expressed by a range of outcomes. This range may be presented as quantified probabilities, but in most circumstances, this suggests a level of precision that is not supported by the available information. The possible outcomes can, therefore, usually be generally described except where reasonable quantification is practicable.

4.4 The estimates of the outcome and of the financial effect of contingencies are determined by the judgment of the management of the enterprise. This judgment is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

5. ***Accounting Treatment of Contingent Losses***

5.1 The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

5.2 The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on information referred to in paragraph 4.4.



5.3 If there is conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.

5.4 A potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. Suitable disclosure regarding the nature and gross amount of the contingent liability is also made.

5.5 The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

5.6 Provisions for contingencies are not made in respect of general or unspecified business risks since they do not relate to conditions or situations existing at the balance sheet date.

6. Accounting Treatment of Contingent Gains

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

7. *Determination of the Amounts at which Contingencies are included in Financial Statements*

7.1 The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in financial statements.

7.2 In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the amount of contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progress of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

7.3 If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. An example of such contingencies may be the estimated uncollectable portion of accounts receivable. Another example of such contingencies may be the warranties for products sold. These costs are usually incurred frequently and experience provides a means by which the amount of the liability or loss can be estimated with reasonable precision although the particular transactions that may result in a liability or a loss are not identified. Provision for these costs results in their recognition in the same accounting period in which the related transactions took place.

8. **Events Occurring after the Balance Sheet Date**

8.1 Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

8.2 Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

8.3 Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date, but reflect circumstances which have occurred in the following period.

8.4 Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

8.5 There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.

8.6 Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (*e.g.,* destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

9. **Disclosure**

9.1 The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.

9.2 If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote (other than the circumstances mentioned in paragraph 5.5). If a reliable estimate of the financial effect cannot be made, this fact is disclosed.

9.3 When the events occurring after the balance sheet date are disclosed in the report of the approving authority, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Accounting Standard

(*The Accounting Standard comprises paragraphs 10-17 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'.)*

Contingencies

10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if :

(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and

(b) a reasonable estimate of the amount of the resulting loss can be made.

11. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote.

12. Contingent gains should not be recognised in the financial statements.

Events Occurring after the Balance Sheet Date

13. Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

14. Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.

15. Disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise.

Disclosure

16. If disclosure of contingencies is required by paragraph 11 of this Statement, the following information should be provided :

(*a*) *the nature of the contingency;*

(*b*) *the uncertainties which may affect the future outcome;*

(*c*) *an estimate of the financial effect, or a statement that such an estimate cannot be made.*

17. If disclosure of events occurring after the balance sheet date in the report of the approving authority is required by paragraph 15 of this Statement, the following information should be provided :

(*a*) *the nature of the event;*

(*b*) *an estimate of the financial effect, or a statement that such an estimate cannot be made.*

AS 5 (REVISED) NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES*

The following is the text of the revised Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, issued by the Council of the Institute of Chartered Accountants of India.

This revised standard comes into effect in respect of accounting periods commencing on or after 1-4-1996, and is mandatory in nature. It is clarified that in respect of accounting periods commencing on a date prior to 1-4-1996, Accounting Standard (AS) 5 as originally issued in November, 1982 (and subsequently made mandatory), will apply.

Objective

The objective of this Statement is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Statement requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items, within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

Scope

1. ***This Statement should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.***

2. This Statement deals with, among other matters, the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.

3. This Statement does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Definitions

4. The following terms are used in this Statement with the meanings specified :

Ordinary activities are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Net Profit or Loss for the Period

5. All items of income and expenses which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

6. Normally, all items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.

7. The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss :

(a) Profit or loss from ordinary activities; and

(b) Extraordinary items.

Extraordinary Items

8. Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

9. Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item.

10. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policy-holders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

11. Examples of events or transactions that generally give rise to extraordinary items for most enterprises are :—

- attachment of property of the enterprise; or

- an earthquake.

Profit or Loss from Ordinary Activities

12. When items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

13. Although the items of income and expense described in Paragraph 12 are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is sometimes made in the notes to the financial statements.

14. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with Paragraph 12 include :

(a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions.

Prior Period Items

15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

16. The term 'prior period items', as defined in this Statement, refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period *e.g.,* arrears payable to workers as a result of revision of wages with retrospective effect during the current period.

17. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight.

18. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Changes in Accounting Estimates

20. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves

judgments based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence, or the useful lives of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

21. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience, or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

22. Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

23. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in :

(a) the period of the change; if the change affects the period only; or

(b) the period of the change and future periods, if the change affects both.

24. A change in an accounting estimate may affect the current period only or both the current period and future periods. For example, a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

25. The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

26. To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

27. The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Changes in Accounting Policies

28. Users need to be able to compare the financial statements of an enterprise over a period of time in order not identify trends in its financial position, performance, and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

29. A change in an accounting policy should be made only if the adoption of a different accounting policy 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 presentation of the financial statements of the enterprise.

30. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance, or cash flows of the enterprise.

31. The following are not changes in accounting policies :

(a) the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions *e.g.,* introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement; and

(b) the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

32. Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

"33. A change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by paragraph 32

*of this Statement should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard. "**

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 AS26 '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;

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* The Council of the Institute of Chartered Accountants of India decided to add this paragraph after paragraph 32 of AS 5.

The above revision comes into effect in respect of accounting periods commencing on or after 1.4.2001.

(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.

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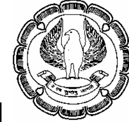
* This statement does not deal with the treatment of the revaluation difference which may arise when historical costs are substituted by revaluations.



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

(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.[*]

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[*] Refer to AS 5

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 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.

* Refer to AS11 (Revised 2003), "The Effects of Changes in Foreign Exchange Rates".

AS 7 (REVISED)[3] : 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 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 <u>construction contract</u> 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.

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[3] Revised in 2002

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

(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:

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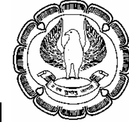
* See also ASI 29.



(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;

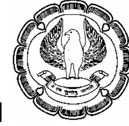
(c) relating to properties that are likely to be condemned or expropriated;

(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.*

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* 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

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.

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:

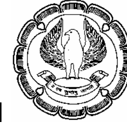
(amount in Rs. lakhs)

	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 Contract Costs incurred recognised	110	510	450	250	100	1,420

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.

[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.

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.

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:

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* * Refer to ASI 14.

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 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

€ 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.

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".

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 :

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[*] 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.

[£] 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.

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 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.

[€] See also ASI 2

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, 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

[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.

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 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

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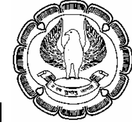
[2] It may be noted that this paragraph relates to "all expenses" incurred during the period. This expenditure would also include borrowing costs incurred during the said period. Since AS 16, Borrowing Costs, specifically deals with the treatment of borrowing costs, the treatment provided by AS 16 would 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.



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]

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[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

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.

[4]

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

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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.

[4] 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.

(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.

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

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* The marked portion of this paragraph has been withdrawn after issuance of AS16, 'Borrowing Costs'.

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.

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].

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

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[6] Refer footnote 3.

[*] From the date of AS 26 becoming mandatory for the concerned enterprises, paragraphs 37 and 38 stand withdrawn and hence not given here.

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.

ANNOUNCEMENT

AS 11 (Revised 2003): THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

(In this Accounting Standard, the standard portions have been set in ***bold italic*** *type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards[5].)*

Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates (revised 2003), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature[6] from that date. The revised Standard supersedes Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its

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[1]Attention is specifically drawn to paragraph 4.3 of the Preface, according to which accounting standards are intended to apply only to material items.

[6] This implies that, while discharging their attest function, it will be the duty of the members of the Institute to examine whether this Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from this Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable.

The following is the text of the revised Accounting Standard.

Objective

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be translated into the enterprise's reporting currency.

The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.

Scope

1. This Statement should be applied:

(a) in accounting for transactions in foreign currencies; and

(b) in translating the financial statements of foreign operations.

2. This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.*

3. This Statement does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Statement requires disclosure of the reason for

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* It may be noted that on the basis of a decision of the Council at its meeting held on June 24-26, 2004, an Announcement title "Applicability of Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction' has been issued. The Announcement clarifies that AS 11 (revised 2003) does not deal with the accounting of exchange difference arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. It has also been separately clarified that AS 11 (revised 2003) continues to be applicable to exchange differences on all other forward exchange contracts.

using that currency. This Statement also requires disclosure of the reason for any change in the reporting currency.

4. This Statement does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.
5. This Statement does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, Cash Flow Statements).
6. This Statement does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see paragraph 4(e) of AS 16, Borrowing Costs).

Definitions

7. *The following terms are used in this Statement with the meanings specified:*

Average rate is the mean of the exchange rates in force during a period.

Closing rate is the exchange rate at the balance sheet date.

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Exchange rate is the ratio for exchange of two currencies.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Foreign currency is a currency other than the reporting currency of an enterprise.

Foreign operation is a subsidiary[3], associate[4], joint venture[5] or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

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[3] As defined in AS 21, Consolidated Financial Statements.

[4] As defined in AS 23, Accounting for Investments in Associates in Consolidated Financial Statements.

[5] As defined in AS 27, Financial Reporting of Interests in Joint Ventures.

Forward exchange contract means an agreement to exchange different currencies at a forward rate.

Forward rate is the specified exchange rate for exchange of two currencies at a specified future date.

Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Net investment in a non-integral foreign operation is the reporting enterprise's share in the net assets of that operation.

Non-integral foreign operation is a foreign operation that is not an integral foreign operation.

Non-monetary items are assets and liabilities other than monetary items.

Reporting currency is the currency used in presenting the financial statements.

Foreign Currency Transactions

Initial Recognition

8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

   (a) buys or sells goods or services whose price is denominated in a foreign currency;

   (b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;

   (c) becomes a party to an unperformed forward exchange contract; or

   (d) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

9. *A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.*

10. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all

transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Reporting at Subsequent Balance Sheet Dates

11. At each balance sheet date:

(a) foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date;

(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and

(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

12. Cash, receivables, and payables are examples of monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items. The carrying amount of an item is determined in accordance with the relevant Accounting Standards. For example, certain assets may be measured at fair value or other similar valuation (e.g., net realisable value) or at historical cost. Whether the carrying amount is determined based on fair value or other similar valuation or at historical cost, the amounts so determined for foreign currency items are then reported in the reporting currency in accordance with this Statement. The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

Recognition of Exchange Differences[£]

13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15.

14. An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Net Investment in a Non-integral Foreign Operation

15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.

16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net

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[£] It may be noted that the Institute has issued in 2003 an Announcement titled 'Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates vis-à-vis Schedule VI to the Companies Act, 1956'. As per the Announcement, the requirement with regard to treatment of exchange differences contained in AS 11 (revised 2003), is different from Schedule VI to the Companies Act, 1956, since AS 11 (revised 2003) does not require the adjustment of exchange differences in the carrying amount of the fixed assets, in the situations envisaged in Schedule VI. It has been clarified that pending the amendment, if any, to Schedule VI to the Companies Act, 1956, in respect of the matter, a company adopting the treatment described in Schedule VI will still be considered to be complying with AS 11(revised 2003) for the purpose of section 211 of the act.

investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.

Financial Statements of Foreign Operations

Classification of Foreign Operations

17. The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".

18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

20. The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

    (a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;

    (b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;

(d) costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;

(e) the foreign operation's sales are mainly in currencies other than the reporting currency;

(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non-integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification.

Integral Foreign Operations

21. The financial statements of an integral foreign operation should be translated using the principles and procedures in paragraphs 8 to 16 as if the transactions of the foreign operation had been those of the reporting enterprise itself.

22. The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is

translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate. An adjustment may be required to reduce the carrying amount of an asset in the financial statements of the reporting enterprise to its recoverable amount or net realisable value even when no such adjustment is necessary in the financial statements of the foreign operation. Alternatively, an adjustment in the financial statements of the foreign operation may need to be reversed in the financial statements of the reporting enterprise.

23. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Non-integral Foreign Operations

24. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:

(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;

(b) income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.

25. For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate income and expense items of a foreign operation.

26. The translation of the financial statements of a non-integral foreign operation results in the recognition of exchange differences arising from:

(a) translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;

(b) translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and

(c) other changes to equity in the non-integral foreign operation.

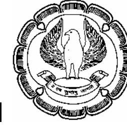
These exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

27. Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate in accordance with paragraph 24.

28. A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.

29. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of Interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognised as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.

30. When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise. When it is impracticable to do this, AS 21, Consolidated Financial Statements, allows the use of financial statements drawn up to a different reporting date provided that the difference is no greater than six months and adjustments are made for the effects of any significant transactions or other events that occur between the different reporting dates. In such a case, the assets and liabilities of the non-integral foreign operation are translated at the exchange rate at the balance sheet date of the non-integral foreign operation and adjustments are made when appropriate for significant



movements in exchange rates up to the balance sheet date of the reporting enterprises in accordance with AS 21. The same approach is used in applying the equity method to associates and in applying proportionate consolidation to joint ventures in accordance with AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures.

Disposal of a Non-integral Foreign Operation

31. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.

32. An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

Change in the Classification of a Foreign Operation

33. When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

34. The consistency principle requires that foreign operation once classified as integral or non-integral is continued to be so classified. However, a change in the way in which a foreign operation is financed and operates in relation to the reporting enterprise may lead to a change in the classification of that foreign operation. When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

All Changes in Foreign Exchange Rates

Tax Effects of Exchange Differences

35. Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22, Accounting for Taxes on Income.

Forward Exchange Contracts

36. An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

37. The risks associated with changes in exchange rates may be mitigated by entering into forward exchange contracts. Any premium or discount arising at the inception of a forward exchange contract is accounted for separately from the exchange differences on the forward exchange contract. The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate at the date of the inception of the forward exchange contract and the forward rate specified in the contract. Exchange difference on a forward exchange contract is the difference between (a) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled during the reporting period, and (b) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date.

38. A gain or loss on a forward exchange contract to which paragraph 36 does not apply should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss

for the period. The premium or discount on the forward exchange contract is not recognised separately.

39. In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Disclosure

40. An enterprise should disclose:

(a) the amount of exchange differences included in the net profit or loss for the period; and

(b) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

41. When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

42. When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

(a) the nature of the change in classification;

(b) the reason for the change;

(c) the impact of the change in classification on shareholders' funds; and

(d) the impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

43. The effect on foreign currency monetary items or on the financial statements of a foreign operation of a change in exchange rates occurring after the balance sheet date is disclosed in accordance with AS 4, Contingencies and Events Occurring After the Balance Sheet Date.

44. Disclosure is also encouraged of an enterprise's foreign currency risk management policy.

Transitional Provisions

45. On the first time application of this Statement, if a foreign branch is classified as a non-integral foreign operation in accordance with the requirements of this Statement, the

accounting treatment prescribed in paragraphs 33 and 34 of the Statement in respect of change in the classification of a foreign operation should be applied.

Appendix

Note: This Appendix is not a part of the Accounting Standard. The purpose of this appendix is only to bring out the major differences between Accounting Standard 11 (revised 2003) and corresponding International Accounting Standard (IAS) 21 (revised 1993).

Comparison with IAS 21, The Effects of Changes in Foreign Exchange Rates (revised 1993)

Revised AS 11 (2003) differs from International Accounting Standard (IAS) 21, The Effects of Changes in Foreign Exchange Rates, in the following major respects in terms of scope, accounting treatment, and terminology.

1. Scope

Inclusion of forward exchange contracts

Revised AS 11 (2003) deals with forward exchange contracts both intended for hedging and for trading or speculation. IAS 21 does not deal with hedge accounting for foreign currency items other than the classification of exchange differences arising on a foreign currency liability accounted for as a hedge of a net investment in a foreign entity. It also does not deal with forward exchange contracts for trading or speculation. The aforesaid aspects are dealt with in IAS 39, Financial Instruments: Recognition and Measurement. Although, an Indian accounting standard corresponding to IAS 39 is under preparation, it has been decided to deal with accounting for forward exchange contracts in the revised AS 11 (2003), since the existing AS 11 deals with the same. Thus, accounting for forward exchange contracts would not remain unaddressed untill the issuance of the Indian accounting standard on financial instruments.

2. Accounting treatment

Recognition of exchange differences resulting from severe currency devaluations

IAS 21, as a benchmark treatment, requires, in general, that exchange differences on transactions be recognised as income or as expenses in the period in which they arise. IAS 21, however, also permits as an allowed alternative treatment, that exchange differences that arise from a severe devaluation or depreciation of a currency be included in the carrying amount of an asset, if certain conditions are satisfied. In line with the preference of the Council of the Institute of Chartered Accountants of India, to eliminate alternatives, where possible, revised AS 11 (2003) adopts the benchmark treatment as the only acceptable treatment.

3. Terminology

Foreign operation

The revised AS 11 (2003) uses the terms, *integral foreign operation* and *non-integral foreign operation* respectively for the expressions "foreign operations that are integral to the operations of the reporting enterprise" and "foreign entity" used in IAS 21. The intention is to communicate the meaning of these terms concisely. This change has no effect on the requirements in revised AS 11 (2003). Revised AS 11 (2003) provides additional implementation guidance by including two more indicators for the classification of a foreign operation as a non-integral foreign operation.

AS 12 : ACCOUNTING FOR GOVERNMENT GRANTS

The following is the text of the Accounting Standard (AS) 12 issued by the Council of the Institute of Chartered Accountants of India on 'Accounting for Government Grants'.

The Standard comes into effect in respect of accounting periods commencing on or after 1-4-1992 and will be recommendatory in nature for an initial period of two years. Accordingly, the Guidance Note on 'Accounting for Capital Based Grants' issued by the Institute in 1981 shall stand withdrawn from this date. This Standard will become mandatory in respect of accounts for periods commencing on or after 1-4-1994.[1]

Introduction

1. This Statement deals with accounting for government grants. Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc.

2. This Statement does not deal with :

(i) The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature;

(ii) Government assistance other than in the form of government grants ; and

(iii) Government participation in the ownership of the enterprise.

Definitions

3. The following terms are used in this Statement with the meanings specified :

3.1 *Government* refers to government, government agencies and similar bodies whether local, national or international.

3.2 *Government grants* are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Explanation

4. The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period.

This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

Accounting Treatment of Government Grants

5. *Capital Approach versus Income Approach*

5.1 Two broad approaches may be followed for the accounting treatment of government grants : the 'capital approach', under which a grant is treated as part of shareholder's funds, and the 'income approach' under which a grant is taken to income over one or more periods.

5.2 Those in support of the 'capital approach' argue as follows :

(i) Many government grants are in the nature of promoters' contribution, *i.e.,* they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders' funds.

(ii) It is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs.

5.3 Arguments in support of the 'income approach' are as follows :

(i) Government grants are rarely gratuitous. The enterprise earns them through compliance with their conditions and meeting the envisaged obligation. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.

(ii) As income tax and other taxes are charges against income it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.

(iii) In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which

the grant relates.

5.4 It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants.

5.5 It is fundamental to the 'income approach' that government grants be recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs. Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption [*see* Accounting Standard (AS) 1, Disclosure of Accounting policies*).*

5.6 In most cases, the periods over which an enterprise recognises the costs or expenses related to a government grant are readily ascertainable and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses.

6. Recognition of Government Grants

6.1 Government grants available to the enterprise are considered for inclusion in accounts :

(i) where there is reasonable assurance that the enterprise will comply with the conditions attached to them ; and

(ii) where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

Mere receipt of a grant is not necessarily a conclusive evidence that conditions attaching to the grant have been or will be fulfilled.

6.2 An appropriate amount in respect of such earned benefits, estimated on a prudent basis, is credited to income for the year even though the actual amount of such benefits may be finally settled and received after the end of the relevant accounting period.

6.3 A contingency related to a government grant, arising after the grant has been recognised, is treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.[7]

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[7] Pursuant to AS 29, becoming mandatory in respect of accounting periods commencing on or afer 1.4.2004, all paragraphs of As 4 that deal with contingencies stand withdrawn

6.4 In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to income in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate [*see* Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting Policies][8].

6.5 Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognised in the income statement of the period in which it becomes receivable, as an extraordinary item if appropriate [*see* Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting policies].

7. Non-monetary Government Grants

7.1 Government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

8. Presentation of Grants Related to Specific Fixed Assets

8.1 Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or other- wise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

8.2 Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives.

8.3 Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the

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except to the extent they deal with impairment of assets not covered by other Indian Accounting Standard.

[8] 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'.

grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

8.4 Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a company, it is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, *e.g.,* 'Deferred government grants'.

8.5 The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an enterprise. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the statement of changes in financial position regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation.

9. Presentation of Grants Related to Revenue

9.1 Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

9.2 Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant. For the second method, it is argued that the expense might well not have been incurred by the enterprise if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading.

10. Presentation of Grants of the Nature of Promoters' Contribution

10.1 Where the government grants are of the nature of promoters' contribution, *i.e.,* they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, Central Investment Subsidy Scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

11. Refund of government grants

11.1 Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item [see Accounting Standard (AS) 5, Prior Period Extraordinary Items and Changes in Accounting Policies][1].

11.2 The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

11.3 The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, *i.e.,* where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

11.4 Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfilment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

12. Disclosure

12.1 The following disclosures are appropriate :

(*i*) the accounting policy adopted for government grants, including the methods of presentation in the financial statement;

(*ii*) the nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Accounting Standard

(*The Accounting Standard comprises paragraphs 13 to 23 of this Statement. The Standard should be read in the context of paragraphs 1 to 12 of this Statement and of the 'Preface to the Statements of Accounting Standards'.*)

13. Government grants should not be recognised until there is reasonable assurance that (i)

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[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 enterprise will comply with the conditions attached to them, and (ii) the grants will be received.

14. Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value. Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged. Grants related to non-depreciable assets should be credited to capital reserve under this method. However, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements.

15. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

16. Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds.

17. Government grants in the form of non-monetary assets, given at a concessional rate, should be accounted for on the basis of their acquisition cost. In case a non-monetary asset is given free of cost, it should be recorded at a nominal value.

18. Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related cost, should be recognised and disclosed in the profit and loss statement of the period in which they are receivable, as an extraordinary item if

appropriate [see Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting Policies][2].

19. A contingency related to a government grant, arising after the grant has been recognised, should be treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.

20. Government grants that become refundable should be accounted for as an extraordinary item [see Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting Policies][3].

21. The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount should be charged to profit and loss statement. The amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

22. Government grants in the nature of promoters' contribution that become refundable should be reduced from the capital reserve.

Disclosure

23. The following should be disclosed :

(i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;

(ii) the nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

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[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'.

[3] 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'.

AS 13* : ACCOUNTING FOR INVESTMENTS

Introduction

1. This statement deals with accounting for investments in the financial statements of enterprises and related diclosure 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'.

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* 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 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.

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

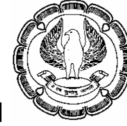
4. Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

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.

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.

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[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'.

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 categorywise (*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].

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;

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[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 cost, etc.). These cost formulae are the same as those specified in AS 2 in respect of Valuation of Inventories.

(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.

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;

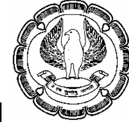
(c) Investment properties; and

(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.

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

* A limited revision to the standard has been mad I 2004, pursuant to ehich paragraphs 23 and 42 of the standard have been revised.

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."€

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.

€ 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:

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.

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.

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

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[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'.

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.

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 :*

[€] 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.

(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.

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.***

AS 16 : BORROWING COSTS

*(In this Accounting Standard, the standard portions have been set in **bold italic** type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards').*

The following is the text of Accounting Standard (AS) 16, 'Borrowing Costs', issued by the Council of the Institute of Chartered Accountants of India. This Standard comes into effect in respect of accounting periods commencing on or after 1-4-2000 and is mandatory in nature. Paragraph 9.2 and paragraph 20 (except the first sentence) of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', stand withdrawn from this date.

OBJECTIVE

The objective of this Statement is to prescribe the accounting treatment for borrowing costs.

SCOPE

1. ***This statement should be applied in accounting for borrowing costs.***

2. This Statement does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

DEFINITIONS

3. ***The following terms are used in this Statement with the meanings specified:***

***Borrowing costs** are interest and other costs incurred by an enterprise in connection with the borrowing of funds.*

*A **qualifying asset** is an asset that necessarily takes a substantial period of time[1] to get ready for its intended use or sale.*

4. Borrowing costs may include:

(a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

(b) amortisation of discounts or premiums relating to borrowings;

(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

(d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.[*]

5. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

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[1] See also Accounting Standards Interpretation (ASI)1.

[*] See also Accounting Standards Interpretation (ASI)1.

RECOGNITION

6. ***Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Statement. Other borrowing costs should be recognised as an expense in the period in which they are incurred.***

7. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation

8. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. when an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

9. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an enterprise is coordinated centrally or when a range of debt instruments are used to borrow funds at varying rates of interest and such borrowings are not readily identifiable with a specific qualifying asset. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is often difficult and the exercise of judgement is required.

10. ***To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.***

11. The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing

costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

12. ***To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.***

EXCESS OF THE CARRYING AMOUNT OF THE QUALIFYING ASSET OVER RECOVERABLE AMOUNT

13. When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

COMMENCEMENT OF CAPITALISATION

14. ***The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:***

(a) ***expenditure for the acquisition, construction or production of a qualifying asset is being incurred;***

(b) ***borrowing costs are being incurred; and***

(c) ***activities that are necessary to prepare the asset for its intended use or sale are in progress.***

15. Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset (see Accounting Standard 12, Accounting for Government Grants). The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

16. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

SUSPENSION OF CAPITALISATION

17. ***Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.***

18. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

CESSATION OF CAPITALISATION

19. ***Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.***

20. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

21. ***When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.***

22. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

DISCLOSURE

23. ***The financial statements should disclose:***

(a) the accounting policy adopted for borrowing costs; and

(b) the amount of borrowing costs capitalised during the period.

AS 19 : LEASES

(In this Accounting Standard, the standard portions have been set in ***bold italic*** *type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards'.)*

AS 19, 'Leases', issued by the Council of the Institute of Chartered Accountants of India. This Standard comes into effect in respect of all assets leased during accounting periods commencing on or after 1.4.2001 and is mandatory in nature from that date. Accordingly, the 'Guidance Note on Accounting for Leases' issued by the Institute in 1995, is not applicable in respect of such assets. Earlier application of this Standard is, however, encouraged.

In respect of accounting periods commencing on or after 1-4-2004, an enterprise which does not fall in any of the following categories need not disclose the information required by paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), of this Standard:

(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 evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(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.

In respect of an enterprise which falls in any one or more of the above categories, at any time during the accounting period, the Standard is applicable in its entirety.

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 paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), 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 paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), 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, in its entirety, from the current period. However, the corresponding previous period figures in respect of above paragraphs need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose the information required by paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e) should disclose the fact.

The following is the text of the Accounting Standard.[9]

OBJECTIVE

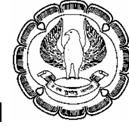
The objective of this Statement is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

SCOPE

1. This Statement should be applied in accounting for all leases other than:

(a) lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and

[9] AS 19 was originally made mandatory in its entirety, for all enterprises in respect of all assets leased during accounting periods commencing on or after 1.4.2001.



(b) *licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and*

(c) *lease agreements to use lands.*

2. This Statement applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, this Statement does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

DEFINITIONS

3. The following terms are used in this Statement with the meanings specified:

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

An operating lease is a lease other than a finance lease.

A non-cancellable lease is a lease that is cancellable only:

(a) *upon the occurrence of some remote contingency; or*

(b) *with the permission of the lessor; or*

(c) *if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or*

(d) *upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.*

The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

<u>Minimum lease payments</u> are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

(a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or

(b) in the case of the lessor, any residual value guaranteed to the lessor:

(i) by or on behalf of the lessee; or

(ii) by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

<u>Fair value</u> is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

<u>Economic life</u> is either:

(a) the period over which an asset is expected to be economically usable by one or more users; or

(b) the number of production or similar units expected to be obtained from the asset by one or more users.

<u>Useful life</u> of a leased asset is either:

(a) the period over which the leased asset is expected to be used by the lessee; or

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

<u>Residual value</u> of a leased asset is the estimated fair value of the asset at the end of the lease term.

<u>Guaranteed residual value</u> is :

(a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) *in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.*

Unguaranteed residual value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

Unearned finance income is the difference between:

(a) *the gross investment in the lease; and*

(b) *the present value of*

   (i) *the minimum lease payments under a finance lease from the standpoint of the lessor; and*

   (ii) *any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.*

Net investment in the lease is the gross investment in the lease less unearned finance income.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

(a) *the minimum lease payments under a finance lease from the standpoint of the lessor; and*

(b) *any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.*

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

4. The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

CLASSIFICATION OF LEASES

5. The classification of leases adopted in this Statement is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

6. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

7. Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by the lessor and the lessee.

8. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

9. Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

10. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 5 to 9 had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

LEASES IN THE FINANCIAL STATEMENTS OF LESSEES

Finance Leases

11. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

Example

(a) An enterprise (the lessee) acquires a machinery on lease from a leasing company (the lessor) on January 1, 20X0. The lease term covers the entire economic life of the machinery,

i.e. 3 years. The fair value of the machinery on January 1, 20X0 is Rs.2,35,500. The lease agreement requires the lessee to pay an amount of Rs.1,00,000 per year beginning December 31, 20X0. The lessee has guaranteed a residual value of Rs.17,000 on December 31, 20X2 to the lessor. The lessor, however, estimates that the machinery would have a salvage value of only Rs.3,500 on December 31, 20X2. The interest rate implicit in the lease is 16 per cent (approx.). This is calculated using the following formula:

$$\text{Fair value} = \frac{ALR}{(1+r)^1} + \frac{ALR}{(1+r)^2} + \ldots\ldots\ldots\ldots + \frac{ALR}{(1+r)^n} + \frac{RV}{(1+r)^n}$$

where ALR is annual lease rental,

RV is residual value (both guaranteed and unguaranteed),

n is the lease term,

r is interest rate implicit in the lease.

The present value of minimum lease payments from the stand point of the lessee is Rs.2,35,500.

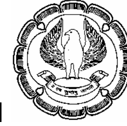
The lessee would record the machinery as an asset at Rs.2,35,500 with a corresponding liability representing the present value of lease payments over the lease term (including the guaranteed residual value).

(b) In the above example, suppose the lessor estimates that the machinery would have a salvage value of Rs.17,000 on December 31, 20X2. The lessee, however, guarantees a residual value of Rs.5,000 only.

The interest rate implicit in the lease in this case would remain unchanged at 16% (approx.). The present value of the minimum lease payments from the standpoint of the lessee, using this interest rate implicit in the lease, would be Rs.2,27,805. As this amount is lower than the fair value of the leased asset (Rs. 2,35,500), the lessee would recognise the asset and the liability arising from the lease at Rs.2,27,805.

In case the interest rate implicit in the lease is not known to the lessee, the present value of the minimum lease payments from the standpoint of the lessee would be computed using the lessee's incremental borrowing rate.

12. Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the



use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

13. If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated thereby distorting financial ratios. It is therefore appropriate that a finance lease be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments. At the inception of the lease, the asset and the liability for the future lease payments are recognised in the balance sheet at the same amounts.

14. It is not appropriate to present the liability for a leased asset as a deduction from the leased asset in the financial statements. The liability for a leased asset should be presented separately in the balance sheet as a current liability or a long-term liability as the case may be.

15. Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

16. Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Example

In the example (a) illustrating paragraph 11, the lease payments would be apportioned by the lessee between the finance charge and the reduction of the outstanding liability as follows.

	Year	Finance charge (Rs.)	Payment (Rs.)	Reduction in outstanding liability (Rs.)	Outstanding liability (Rs.)
Year 1	(January 1)				2,35,500
	(December 31)	37,680	1,00,000	62,320	1,73,180

Year 2	(December 31)	27,709	1,00,000	72,291	1,00,889
Year 3	(December 31)	16,142	1,00,000	83,858	17,031*

17. In practice, in allocating the finance charge to periods during the lease term, some form of approximation may be used to simplify the calculation.

18. A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in Accounting Standard (AS) 6, Depreciation Accounting. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

19. The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the lease term or its useful life, whichever is shorter.

20. The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is, therefore, inappropriate simply to recognise the lease payments payable as an expense in the statement of profit and loss. Accordingly, the asset and the related liability are unlikely to be equal in amount after the inception of the lease.

21. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[1], that sets out the requirements as to how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

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* The difference between this figure and guaranteed residual value (Rs. 17,000) is due to approximation in computing the interest rate implicit in the lease.

[1] AS 28, 'impairment of Assets', specifies the requirements relating to impairment of assets.

22. The lessee should, in addition to the requirements of AS 10, Accounting for Fixed Assets, AS 6, Depreciation Accounting, and the governing statute, make the following disclosures for finance leases:

(a) assets acquired under finance lease as segregated from the assets owned;

(b) for each class of assets, the net carrying amount at the balance sheet date;

(c) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

(d) contingent rents recognised as income in the statement of profit and loss for the period;

(e) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date; and

(f) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payments are determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

OPERATING LEASES

23. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

24. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line

basis unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis.

25. The lessee should make the following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

(b) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;

(c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

(d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payments are determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

LEASES IN THE FINANCIAL STATEMENTS OF LESSORS

Finance Leases

26. The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

27. Under a finance lease substantially all the risks and rewards incident to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal, i.e., net investment in the lease, and finance income to reimburse and reward the lessor for its investment and services.

28. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

29. A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment of the lessor outstanding in respect of the finance lease. Lease payments relating to the accounting period, excluding costs for services, are reduced from both the principal and the unearned finance income.

30. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

31. Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

32. The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

33. Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) the finance income over the lease term.

34. The sales revenue recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease

payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded as sales revenue is the present value so computed. The cost of sale recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased asset less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

35. Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged.

36. Initial direct costs are recognised as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or dealer's selling profit.

37. The lessor should make the following disclosures for finance leases:

- ***(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:***
  - ***(i) not later than one year;***
  - ***(ii) later than one year and not later than five years;***
  - ***(iii) later than five years;***
- ***(b) unearned finance income;***
- ***(c) the unguaranteed residual values accruing to the benefit of the lessor;***
- ***(d) the accumulated provision for uncollectible minimum lease payments receivable;***
- ***(e) contingent rents recognised in the statement of profit and loss for the period;***
- ***(f) a general description of the significant leasing arrangements of the lessor; and***
- ***(g) accounting policy adopted in respect of initial direct costs.***

38. As an indicator of growth it is often useful to also disclose the gross investment less unearned income in new business added during the accounting period, after deducting the relevant amounts

for cancelled leases.

OPERATING LEASES

39. The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

40. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

41. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised in the statement of profit and loss on a straight line basis over the lease term even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

42. Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred.

43. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 6, Depreciation Accounting.

44. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[2] that sets out the requirements for how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

45. A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

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[2] AS 28, ‘impairment of Assets’, specifies the requirements relating to impairment of assets.

46. The lessor should, in addition to the requirements of AS 6, Depreciation Accounting and AS 10, Accounting for Fixed Assets, and the governing statute, make the following disclosures for operating leases:

(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and

(i) the depreciation recognised in the statement of profit and loss for the period;

(ii) impairment losses recognised in the statement of profit and loss for the period;

(iii) impairment losses reversed in the statement of profit and loss for the period;

(b) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

(c) total contingent rents recognised as income in the statement of profit and loss for the period;

(d) a general description of the lessor's significant leasing arrangements; and

(e) accounting policy adopted in respect of initial direct costs.

SALE AND LEASEBACK TRANSACTIONS

47. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

48. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

49. If the leaseback is a finance lease, it is not appropriate to regard an excess of sales proceeds over the carrying amount as income. Such excess is deferred and amortised over the lease term in proportion to the depreciation of the leased asset. Similarly, it is not appropriate to regard a deficiency as loss. Such deficiency is deferred and amortised over the lease term.

50. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

51. If the leaseback is an operating lease, and the lease payments and the sale price are established at fair value, there has in effect been a normal sale transaction and any profit or loss is recognised immediately.

52. For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

53. For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with the Accounting Standard dealing with impairment of assets.

54. Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the significant leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

55. Sale and leaseback transactions may meet the separate disclosure criteria set out in paragraph 12 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

APPENDIX

Sale and Leaseback Transactions that Result in Operating Leases

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.

A sale and leaseback transaction that results in an operating lease may give rise to profit or a loss, the determination and treatment of which depends on the leased asset's carrying amount, fair value and selling price. The following table shows the requirements of the accounting standard in various circumstances.

Sale price established at fair value (paragraph 50)	Carrying amount equal tofair value	Carrying amount less than fair value	Carrying amount above fair value
Profit	*No profit*	*Recognise profit immediately*	*Not applicable*
Loss	*No loss*	*Not applicable*	*Recognise loss immediately*

Sale price below fair value (paragraph 50)			
Profit	No profit	Recognise profit immediately	No profit (note 1)
Loss not compensated by future lease payments at below market price	Recognise loss immediately	Recognise loss immediately	(note 1)
Loss compensated by future lease payments at below market price	Defer and amortise loss	Defer and amortise loss	(note 1)
Sale price above fair value (paragraph 50)			

Profit	Defer and amortise profit	Defer and amortise profit	Defer and amortise profit (note 2)
Loss	No loss	No loss	(note 1)

Note 1. These parts of the table represent circumstances that would have been dealt with under paragraph 52 of the Standard. Paragraph 52 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2. The profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value in accordance with paragraph 52.

AS 20 : EARNINGS PER SHARE*

*(In this Accounting Standard, the standard portions have been set in **bold italic** type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards'.)*

Accounting Standard (AS) 20, 'Earnings Per Share', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India.

An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share, should calculate and disclose earnings per share in accordance with this Standard from the aforesaid date. However, in respect of accounting periods commencing on or after 1-4-2004[1], if any such enterprise does not fall

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* A limited revision this standard has been made in 2004, pursuant to which paragraphs 48 and 51 of this standard have been revised.

[1]Originally, no exemption was available to an enterprise, which had neither equity shares nor potential equity shares which were listed on a recognised stock exchange in India, but which disclosed earnings per share. It is clarified that no exemption is available even in respect of accounting periods commencing on or after 1-4-2004 to enterprises whose

in any of the following categories, it need not disclose diluted earnings per share (both including and excluding extraordinary items) and information required by paragraph 48 (ii) of this Standard:

(i) Enterprises whose equity securities or potential equity securities are listed outside India and enterprises whose debt securities (other than potential equity securities) are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(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.

Where an enterprise (which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India but which discloses earnings per share) 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 the disclosure of diluted earnings per share (both including and excluding extraordinary items) and paragraph 48 (ii) of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

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equity shares or potential equity shares are listed on a recognised stock exchange in India. It is also clarified that this Standard is not applicable to an enterprise which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India and which also does not disclose earnings per share.

Where an enterprise (which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India but which discloses earnings per share) has previously qualified for exemption from the disclosure of diluted earnings per share (both including and excluding extraordinary items) and paragraph 48 (ii) 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, in its entirety, from the current period. However, the relevant corresponding previous period figures need not be disclosed.

If an enterprise (which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India but which discloses earnings per share), pursuant to the above provisions, does not disclose the diluted earnings per share (both including and excluding earnings per share) and information required by paragraph 48 (ii), it should disclose the fact.

The following is the text of the Accounting Standard.

OBJECTIVE

The objective of this Statement is to prescribe principles for the determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise. The focus of this Statement is on the denominator of the earnings per share calculation. Even though earnings per share data has limitations because of different accounting policies used for determining 'earnings', a consistently determined denominator enhances the quality of financial reporting.

SCOPE

1. This Statement should be applied by enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share should calculate and disclose earnings per share in accordance with this Statement. *

* See also ASI 12

2. In consolidated financial statements, the information required by this Statement should be presented on the basis of consolidated information[1].

3. This Statement applies to enterprises whose equity or potential equity shares are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed is not required to disclose earnings per share. However, comparability in financial reporting among enterprises is enhanced if such an enterprise that is required to disclose by any statute or chooses to disclose earnings per share calculates earnings per share in accordance with the principles laid down in this Statement. In the case of a parent (holding enterprise), users of financial statements are usually concerned with, and need to be informed about, the results of operations of both the enterprise itself as well as of the group as a whole. Accordingly, in the case of such enterprises, this Statement requires the presentation of earnings per share information on the basis of consolidated financial statements as well as individual financial statements of the parent. In consolidated financial statements, such information is presented on the basis of consolidated information.

DEFINITIONS

4. For the purpose of this Statement, the following terms are used with the meanings specified:

An equity share is a share other than a preference share.

A preference share is a share carrying preferential rights to dividends and repayment of capital.

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

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[1] AS – 21, 'Consolidated Financial Statements', specifies the requirements relating to consolidated financial statements.

***Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.*

5. Equity shares participate in the net profit for the period only after preference shares. An enterprise may have more than one class of equity shares. Equity shares of the same class have the same rights to receive dividends.

6. A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise. For this purpose, a financial asset is any asset that is

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

7. Examples of potential equity shares are:

(a) debt instruments or preference shares, that are convertible into equity shares.

(b) share warrants;

(c) options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

(d) shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

PRESENTATION

8. An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share

in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

9. This Statement requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

MEASUREMENT

Basic Earnings Per Share

10. Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period.

EARNINGS - BASIC

11. For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period.

12. All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless an Accounting Standard requires or permits otherwise *(see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies)*. The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

13. The amount of preference dividends for the period that is deducted from the net profit for the period is:

(a) the amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

(b) the full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

14. If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

Per Share - Basic

15. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

16. The weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time. It is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

Appendix I illustrates the computation of weighted average number of shares.

17. In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable , for example:

(a) equity shares issued in exchange for cash are included when cash is receivable;

(b) equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

(c) equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

(d) equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

(e) equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

(f) equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

18. Equity shares issued as part of the consideration in an amalgamation in nature of purchase are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued during the reporting period as part of the

consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

19. Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Appendix II illustrates the computations in respect of partly paid equity shares.

20. Where an enterprise has equity shares of different nominal values but with the same dividend rights, the number of equity shares are calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

21. Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

22. The weighted average number of equity shares outstanding during the period and for all periods presented should be adjusted for events, other than the conversion of potential equity shares, that have changed the number of equity shares outstanding, without a corresponding change in resources.

23. Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

(a) a bonus issue;

(b) a bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

(c) a share split; and

(d) a reverse share split (consolidation of shares).

24. In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. For example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

Appendix III illustrates the computation of weighted average number of equity shares in case of a bonus issue during the period.

25. The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. In a rights issue, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights. Where the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Appendix IV illustrates the computation of weighted average number of equity shares in case of a rights issue during the period.

DILUTED EARNINGS PER SHARE

26. For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

27. In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

(a) the net profit for the period attributable to equity shares is:

  (i) increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;

  (ii) increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

  (iii) adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

(b) the weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

28. For the purpose of this Statement, share application money pending allotment or any advance share application money as at the balance sheet, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

EARNINGS - DILUTED

29. For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to equity shareholders, as calculated in accordance with paragraph 11, should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders as calculated in accordance with paragraph 11;

(b) interest recognised in the period for the dilutive potential equity shares; and

(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

30. After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred

(or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in accordance with paragraph 11 is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

Appendix V illustrates the computation of diluted earnings in case of convertible debentures.

31. The conversion of some potential equity shares may lead to consequential changes in other items of income or expense. For example, the reduction of interest expense related to potential equity shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit sharing plan. For the purpose of calculating diluted earnings per share, the net profit or loss for the period is adjusted for any such consequential changes in income or expenses.

PER SHARE - DILUTED

32. For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares calculated in accordance with paragraphs 15 and 22, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

33. The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

34. Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the

end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

35. For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

36. Fair value for this purpose is the average price of the equity shares during the period. Theoretically, every market transaction for an enterprise's equity shares could be included in determining the average price. As a practical matter, however, a simple average of last six months weekly closing prices are usually adequate for use in computing the average price.

37. Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

(a) a contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

(b) a contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Appendix VI illustrates the effects of share options on diluted earnings per share.

38. To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of warrants or options.

DILUTIVE POTENTIAL EQUITY SHARES

39. Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

40. An enterprise uses net profit from continuing ordinary activities as "the control figure" that is used to establish whether potential equity shares are dilutive or anti-dilutive. The net profit from continuing ordinary activities is the net profit from ordinary activities (as defined in AS 5) after deducting preference dividends and any attributable tax thereto and after excluding items relating to discontinued operations[2].

41. Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

42. In considering whether potential equity shares are dilutive or anti-dilutive, each issue or series of potential equity shares is considered separately rather than in aggregate. The sequence in which potential equity shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Appendix VII illustrates the manner of determining the order in which dilutive securities should be included in the computation of weighted average number of shares.

43. Potential equity shares are weighted for the period they were outstanding. Potential equity shares that were cancelled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential equity shares that have been converted into equity shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting equity shares are included in computing both basic and diluted earnings per share.

RESTATEMENT

44. If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of

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[2] AS 24, 'Discontinuing Operations', specifies the requirements in respect of discontinued operations.

shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

45. An enterprise does not restate diluted earnings per share of any prior period presented for changes in the assumptions used or for the conversion of potential equity shares into equity shares outstanding.

46. An enterprise is encouraged to provide a description of equity share transactions or potential equity share transactions, other than bonus issues, share splits and reverse share splits (consolidation of shares) which occur after the balance sheet date when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions. Examples of such transactions include:

(a) the issue of shares for cash;

(b) the issue of shares when the proceeds are used to repay debt or preference shares outstanding at the balance sheet date;

(c) the cancellation of equity shares outstanding at the balance sheet date;

(d) the conversion or exercise of potential equity shares, outstanding at the balance sheet date, into equity shares;

(e) the issue of warrants, options or convertible securities; and

(f) the satisfaction of conditions that would result in the issue of contingently issuable shares.

47. Earnings per share amounts are not adjusted for such transactions occurring after the balance sheet date because such transactions do not affect the amount of capital used to produce the net profit or loss for the period.

DISCLOSURE

48. In addition to disclosures as required by paragraphs 8, 9 and 44 of this Statement, an enterprise should disclose the following:

(i) where the statement of profit and loss includes extraordinary items (within the meaning of AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies), the enterprise should disclose basic and diluted

earnings per share computed on the basis of earnings excluding extraordinary items (net of tax expense); and

(ii) (a) the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

(b) the weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

(c) the nominal value of shares along with the earnings per share figures[£]

49. Contracts generating potential equity shares may incorporate terms and conditions which affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether or not any potential equity shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to the net profit attributable to equity shareholders. Disclosure of the terms and conditions of such contracts is encouraged by this Statement.

50. If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Statement. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

51. An enterprise may wish to disclose more information than this Statement requires. Such information may help the users to evaluate the performance of the enterprise and may take the form of per share amounts for various components of net profit,. Such disclosures are encouraged. However, when such amounts are disclosed, the denominators need to be calculated in

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[£] A limited revision to AS 20 hs been made in 2004 thereby revising this paragraph.This paragraph

accordance with this Statement in order to ensure the comparability of the per share amounts disclosed. [£]

APPENDICES

Note : *These appendices are illustrative only and do not form part of the Accounting Standard. The purpose of the appendices is to illustrate the application of the Accounting Standard.*

Appendix I

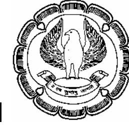
Example - Weighted Average Number of Shares

(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of Shares Issued	*No. of Shares Bought Back*	*No. of Shares Outstanding*
1st January, 20X1	Balance at beginning of year	1,800	-	1,800
31st May, 20X1	Issue of share for cash	600	-	2,400
1st Nov., 20X1	Buy Back of shares	-	300	2,100
31st Dec., 20X1	Balance at end of year	2,400	300	2,100

Computation of Weighted Average:

(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.



The weighted average number of shares can alternatively be computed as follows:

(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

Appendix II

Example – Partly paid shares

(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of Shares issued	*Nominal value of shares*	*Amount paid*
1st January, **20X1of the year**	Balance at beginning	1,800	Rs. 10	Rs. 10
31st October, **20X1**	Issue of Shares	600	Rs. 10	Rs. 5

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

(1800x12/12) + (300x2/12) = 1850 shares.

Appendix III

Example – Bonus Issue

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X0	Rs. 18,00,000
Net profit for the year 20X1	Rs. 60,00,000
No. of equity shares outstanding until 30th September 20X1	20,00,000
Bonus issue 1st October 20X1	2 equity shares for each equity share outstanding at 30th September, 20X1

	20,00,000 × 2 = 40,00,000
Earnings per share for the year 20X1	$\frac{\text{Rs. } 60,00,000}{(20,00,000 + 40,00,000)}$ = Re. 1.00
Adjusted earnings per share for the year 20X0	$\frac{\text{Rs. } 18,00,000}{(20,00,000 + 40,00,000)}$ = Re. 0.30

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 20X0, the earliest period reported.

Appendix IV

Example – Rights Issue

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit	Year	20X0 :	Rs. 11,00,000
	Year	20X1 :	Rs. 15,00,000
No. of shares outstanding prior to rights issue	5,00,000 shares		
Rights issue	One new share for each five outstanding (i.e. 1,00,000 new shares)		
	Rights issue price : Rs. 15.00		
	Last date to exercise rights: 1st March 20X1		
Fair value of one equity share immediately prior to exercise of rights on 1st March 20X1	Rs. 21.00		

Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights + total amount received from exercise}}{\text{Number of shares outstanding prior to exercise + number of shares issued in the exercise}}$$

$$\frac{(\text{Rs. } 21.00 \times 5{,}00{,}000 \text{ shares}) + (\text{Rs. } 15.00 \times 1{,}00{,}000 \text{ shares})}{5{,}00{,}000 \text{ shares} + 1{,}00{,}000 \text{ shares}}$$

Theoretical ex-rights fair value per share = Rs. 20.00

Computation of adjustment factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{Rs. } (21.00)}{\text{Rs. } (20.00)} = 1.05$$

Computation of earnings per share

	Year 20X0	Year 20X1
EPS for the year 20X0 as originally reported: Rs.11,00,000/5,00,000 shares	Rs. 2.20	
EPS for the year 20X0 restated for rights issue: Rs.11,00,000/(5,00,000 shares x 1.05)	Rs. 2.10	
EPS for the year 20X1 including effects of rights issue $\frac{\text{Rs. } 15{,}00{,}000}{(5{,}00{,}000 \times 1.05 \times 2/12) + (6{,}00{,}000 \times 10/12)}$		Rs. 2.55

Appendix V

Example - Convertible Debentures

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the current year	Rs. 1,00,00,000
No. of equity shares outstanding	50,00,000
Basic earnings per share	Rs. 2.00
No. of 12% convertible debentures of Rs. 100 each	1,00,000
Each debenture is convertible into	

10 equity shares	
Interest expense for the current year	Rs. 12,00,000
Tax relating to interest expense (30%)	Rs. 3,60,000
Adjusted net profit for the current year	Rs. (1,00,00,000 + 12,00,000 – 3,60,000) = Rs. 1,08,40,000
No. of equity shares resulting from conversion of debentures	10,00,000
No. of equity shares used to compute diluted earnings per share	50,00,000 + 10,00,000 = 60,00,000
Diluted earnings per share	1,08,40,000 / 60,00,000 = Rs. 1.81

Appendix VI

Example - Effects of Share Options on Diluted Earnings Per Share

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X1	Rs. 12,00,000
Weighted average number of equity shares outstanding during the year 20X1	5,00,000 shares
Average fair value of one equity share during the year 20X1	Rs. 20.00
Weighted average number of shares under option during the year 20X1	1,00,000 shares
Exercise price for shares under option during the year 20X1	Rs. 15.00

Computation of earnings per share

	Earnings (Rs.)	*Shares*	*Earnings per share*
Net profit for the year 20X1	Rs.12,00,000		

Weighted average number of shares outstanding during year 20X1		5,00,000	
Basic earnings per share			Rs. 2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value: (100,000 x 15.00)/20.00	*	(75,000)	
Diluted earnings per share	Rs.12,00,000	5,25,000	Rs. 2.29

**The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration {see para 37(b)}*

Appendix VII

Example - Determining the Order in Which to Include Dilutive Securities in the Computation of Weighted Average Number of Shares

(Accounting year 01-01-20XX to 31-12-20XX)

Earnings, i.e., Net profit attributable to equity shareholders	Rs. 1,00,00,000
No. of equity shares outstanding	20,00,000
Average fair value of one equity share during the year	Rs. 75.00
Potential Equity Shares	
Options	1,00,000 with exercise price of Rs. 60
Convertible Preference Shares	8,00,000 shares entitled to a cumulative dividend of Rs. 8 per share. Each preference share is convertible into 2 equity shares.

Attributable tax, e.g., corporate dividend tax	10%
12% Convertible Debentures of Rs. 100 each	Nominal amount Rs. 10,00,00,000. Each debenture is convertible into 4 equity shares.
Tax rate	30%

Increase in Earnings Attributable to Equity Shareholders on Conversion of Potential Equity Shares

	Increase in Earnings	*Increase in no. of Equity Shares*	*Earnings per Incremental Share*
Options			
Increase in earnings	Nil		
No. of incremental shares issued for no consideration {1,00,000 × (75 - 60) / 75}		20,000	Nil
Convertible Preference Shares			
Increase in net profit attributable to equity shareholders as adjusted by attributable tax [(Rs.8 × 8,00,000) + 10%(8 × 8,00,000)]	Rs.70,40,000		
No. of incremental shares {2 × 8,00,000}		16,00,000	Rs. 4.40
12% Convertible Debentures			
Increase in net profit {Rs. 10,00,00,000 × 0.12 x (1 - 0.30)}	Rs.84,00,000		
No. of incremental shares		40,00,000	Rs. 2.10

{10,00,000 × 4}

It may be noted from the above that options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (see para 42).

Computation of Diluted Earnings Per Share

	Net Profit Attributable (Rs.)	*No. of Equity Shares*	*Net Profit attributable Per Share (Rs.)*	
As reported	1,00,00,000	20,00,000	5.00	
Options		20,000		
	1,00,00,000	20,20,000	4.95	Dilutive
12% Convertible Debentures	84,00,000	40,00,000		
	1,84,00,000	60,20,000	3.06	Dilutive
Convertible Preference Shares	70,40,000	16,00,000		
	2,54,40,000	76,20,000	3.34	Anti-Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from Rs. 3.06 to Rs 3.34), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, diluted earnings per share is Rs. 3.06.

AS 26 : INTANGIBLE ASSETS*

Accounting Standard (AS) 26, 'Intangible Assets', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from

that date for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs.50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date.

Earlier application of the Accounting Standard is encouraged.

In respect of intangible items appearing in the balance sheet as on the aforesaid date, *i.e.,* 1-4-2003 or 1-4-2004, as the case may be, the Standard has limited application as stated in paragraph 99. From the date of this Standard becoming mandatory for the concerned enterprises, the following stand withdrawn:

(i) Accounting Standard (AS) 8, Accounting for Research and Development;

(ii) Accounting Standard (AS) 6, Depreciation Accounting, with respect to the amortisation (depreciation) of intangible assets; and

(iii) Accounting Standard (AS) 10, Accounting for Fixed Assets - paragraphs 16.3 to 16.7, 37 and 38.

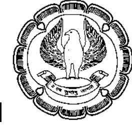
The following is the text of the Accounting Standard.

Objective

The objective of this Statement is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. This Statement requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The Statement also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

Scope

1. This Statement should be applied by all enterprises in accounting for intangible assets, except:

(a) intangible assets that are covered by another Accounting Standard;

(b) financial assets[10];

(c) mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources; and

(d) intangible assets arising in insurance enterprises from contracts with policyholders.

[£]This statement should not be applied in respect of termination benefits [*]also.

2. If another Accounting Standard deals with a specific type of intangible asset, an enterprise applies that Accounting Standard instead of this Statement. For example, this Statement does not apply to:

(a) intangible assets held by an enterprise for sale in the ordinary course of business (see AS 2, Valuation of Inventories, and AS 7, Accounting for Construction Contracts);

(b) deferred tax assets (see AS 22, Accounting for Taxes on Income);

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[10] A financial asset is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an ownership interest in another enterprise.

[£] Termination benefits are employee benefits payable as a result of either:

(a) an enterprise's decision to terminate an employee's employment before the normal retirement date;

(b) an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement)

[*] The council of the Institute decided to make a limited revision to As 26 in 2004, pursuant to which the last sentence has been added to paragraph 1.

(c) leases that fall within the scope of AS 19, Leases; and

(d) goodwill arising on an amalgamation (see AS 14, Accounting for Amalgamations) and goodwill arising on consolidation (see AS 21, Consolidated Financial Statements).

3. This Statement applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This Statement also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

4. In the case of a finance lease, the underlying asset may be either tangible or intangible. After initial recognition, a lessee deals with an intangible asset held under a finance lease under this Statement.

5. Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of contracts between insurance enterprises and their policyholders. Therefore, this Statement does not apply to expenditure on such activities. However, this Statement applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises. Accounting issues of specialised nature also arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares. Accordingly, this Statement does not apply to such items also.

Definitions

6. The following terms are used in this Statement with the meanings specified:

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

An asset is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Non-monetary assets are assets other than monetary assets.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

Depreciable amount is the cost of an asset less its residual value.

Useful life is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

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

Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An active market is a market where all the following conditions exist:

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.[11]

Carrying amount is the amount at which an asset is recognised in the balance sheet, net of any accumulated amortisation and accumulated impairment losses thereon.

Intangible Assets

7. Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

8. Not all the items described in paragraph 7 will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation (see paragraph 55).

9. Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

10. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under

[11] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

AS 10, Accounting for Fixed Assets, or as an intangible asset under this Statement, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Identifiability

11. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. Goodwill arising on an amalgamation in the nature of purchase represents a payment made by the acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets which, individually, do not qualify for recognition in the financial statements but for which the acquirer is prepared to make a payment in the amalgamation.

12. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

13. Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way. For example, if an intangible asset is acquired with a group of assets, the transaction may involve the transfer of legal rights that enable an enterprise to identify the intangible asset. Similarly, if an internal project aims to create legal rights for the enterprise, the nature of these rights may assist the enterprise in identifying an underlying internally generated intangible asset. Also, even if an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is

not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

15. Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

16. An enterprise may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The enterprise may also expect that the staff will continue to make their skills available to the enterprise. However, usually an enterprise has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training to consider that these items meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

17. An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets.

Future Economic Benefits

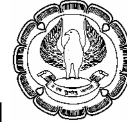
18. The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement of an Intangible Asset

19. The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the:

(a) definition of an intangible asset (see paragraphs 6-18); and

(b) recognition criteria set out in this Statement (see paragraphs 20-54).



20. An intangible asset should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

21. An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

22. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

23. An intangible asset should be measured initially at cost.

Separate Acquisition

24. If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

25. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

26. If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

Acquisition as Part of an Amalgamation

27. An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with Accounting Standard (AS) 14, Accounting for Amalgamations. Where in preparing the financial statements of the transferee company, the consideration is allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation, paragraphs 28 to 32 of this Statement need to be considered.

28. Judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

29. If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. In determining this amount, an enterprise considers the outcome of recent transactions for similar assets.

30. Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in an amalgamation in the nature of purchase if their objective is to estimate fair value as defined in this Statement and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

31. In accordance with this Statement:

(a) a transferee recognises an intangible asset that meets the recognition criteria in paragraphs 20 and 21, even if that intangible asset had not been recognised in the financial statements of the transferor; and

(b) if the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill (see paragraph 55).

32. Unless there is an active market for an intangible asset acquired in an amalgamation in the nature of purchase, the cost initially recognised for the intangible asset is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Acquisition by way of a Government Grant

33. In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources. AS 12, Accounting for Government Grants, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. AS 12 also requires that in case a non-monetary asset is given free of cost, it should be recorded at a nominal value. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Exchanges of Assets

34. An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10, Accounting for Fixed Assets.

Internally Generated Goodwill

35. Internally generated goodwill should not be recognised as an asset.

36. In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Statement. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

37. Differences between the market value of an enterprise and the carrying amount of its identifiable net assets at any point in time may be due to a range of factors that affect the value of the enterprise. However, such differences cannot be considered to represent the cost of intangible assets controlled by the enterprise.

Internally Generated Intangible Assets

38. It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition. It is often difficult to:

(a) identify whether, and the point of time when, there is an identifiable asset that will generate probable future economic benefits; and

(b) determine the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the enterprise's internally generated goodwill or of running day-to-day operations.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an enterprise applies the requirements and guidance in paragraphs 39-54 below to all internally generated intangible assets.

39. To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of this Statement.

40. If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

41. No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

42. This Statement takes the view that, in the research phase of a project, an enterprise cannot demonstrate that an intangible asset exists from which future economic benefits are probable. Therefore, this expenditure is recognised as an expense when it is incurred.

43. Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

44. An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

45. In the development phase of a project, an enterprise can, in some instances, identify an intangible asset and demonstrate that future economic benefits from the asset are probable. This is because the development phase of a project is further advanced than the research phase.

46. Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

47. To demonstrate how an intangible asset will generate probable future economic benefits, an enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets[12]. If the asset will generate economic benefits only in combination with other assets, the enterprise applies the concept of cash-generating units as set out in Accounting Standard on Impairment of Assets.

48. Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the enterprise's ability to secure those resources. In certain cases, an enterprise demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

49. An enterprise's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

50. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

51. This Statement takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Cost of an Internally Generated Intangible Asset

52. The cost of an internally generated intangible asset for the purpose of paragraph 23 is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria in paragraphs 20-21 and 44. Paragraph 58 prohibits reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports.

53. The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and

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[12] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

making the asset ready for its intended use. The cost includes, if applicable:

(a) expenditure on materials and services used or consumed in generating the intangible asset;

(b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;

(c) any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset; and

(d) overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocations of overheads are made on bases similar to those used in allocating overheads to inventories (see AS 2, Valuation of Inventories). AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the cost of a qualifying asset. These criteria are also applied for the recognition of interest as a component of the cost of an internally generated intangible asset.

54. The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use;

(b) clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and

(c) expenditure on training the staff to operate the asset.

Example Illustrating Paragraph 52

An enterprise is developing a new production process. During the year 20X1, expenditure incurred was Rs. 10 lakhs, of which Rs. 9 lakhs was incurred before 1 December 20X1 and 1 lakh was incurred between 1 December 20X1 and 31 December 20X1. The enterprise is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs. 5 lakhs.

At the end of 20X1, the production process is recognised as an intangible asset at a cost of Rs. 1 lakh (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X1). The Rs. 9 lakhs expenditure incurred before 1 December 20X1 is recognised as an e

xpense because the recognition criteria were not met until 1 December 20X1. This expenditure will never form part of the cost of the production process recognised in the balance sheet.

During the year 20X2, expenditure incurred is Rs. 20 lakhs. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs. 19 lakhs.

At the end of the year 20X2, the cost of the production process is Rs. 21 lakhs (Rs. 1 lakh expenditure recognised at the end of 20X1 plus Rs. 20 lakhs expenditure recognised in 20X2). The enterprise recognises an impairment loss of Rs. 2 lakhs to adjust the carrying amount of the process before impairment loss (Rs. 21 lakhs) to its recoverable amount (Rs. 19 lakhs). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in Accounting Standard on Impairment of Assets[13], are met.

Recognition of an Expense

55. Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

- ***(a)** **it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 19-54); or***
- ***(b)** **the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition (see AS 14, Accounting for Amalgamations).***

56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these

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[13] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);

(b) expenditure on training activities;

(c) expenditure on advertising and promotional activities; and

(d) expenditure on relocating or re-organising part or all of an enterprise.

57. Paragraph 55 does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Past Expenses not to be Recognised as an Asset

58. Expenditure on an intangible item that was initially recognised as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognised as part of the cost of an intangible asset at a later date.

Subsequent Expenditure

59. Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

(b) the expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

60. Subsequent expenditure on a recognised intangible asset is recognised as an expense if this expenditure is required to maintain the asset at its originally assessed standard of performance.

The nature of intangible assets is such that, in many cases, it is not possible to determine whether subsequent expenditure is likely to enhance or maintain the economic benefits that will flow to the enterprise from those assets. In addition, it is often difficult to attribute such expenditure directly to a particular intangible asset rather than the business as a whole. Therefore, only rarely will expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset result in additions to the cost of the intangible asset.

61. Consistent with paragraph 50, subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally purchased or internally generated) is always recognised as an expense to avoid the recognition of internally generated goodwill.

Measurement Subsequent to Initial Recognition

62. After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Amortisation

Amortisation Period

63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

64. As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset's useful life. Amortisation is recognised whether or not there has been an increase in, for example, the asset's fair value or recoverable amount. Many factors need to be considered in determining the useful life of an intangible asset including:

(a) the expected usage of the asset by the enterprise and whether the asset could be efficiently managed by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar types of assets that are used in a similar way;

(c) technical, technological or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the company's ability and intent to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the enterprise.

65. Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life will be short.

66. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

67. In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

(a) amortises the intangible asset over the best estimate of its useful life;

(b) estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss (see paragraph 83); and

(d) discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset (see paragraph 94(a)).

Examples

A. An enterprise has purchased an exclusive right to generate hydro-electric power for sixty years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least sixty years.

The enterprise amortises the right to generate power over sixty years, unless there is evidence that its useful life is shorter.

B. An enterprise has purchased an exclusive right to operate a toll motorway for thirty years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least thirty years.

The enterprise amortises the right to operate the motorway over thirty years, unless there is evidence that its useful life is shorter.

68. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

69. ***If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:***

(a) the legal rights are renewable; and

(b) renewal is virtually certain.

70. There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

71. The following factors, among others, indicate that renewal of a legal right is virtually certain:

(a) the fair value of the intangible asset is not expected to reduce as the initial expiry date approaches, or is not expected to reduce by more than the cost of renewing the underlying right;

(b) there is evidence (possibly based on past experience) that the legal rights will be renewed; and

(c) there is evidence that the conditions necessary to obtain the renewal of the legal right (if any) will be satisfied.

Amortisation Method

72. The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an

expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

73. A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

74. Amortisation is usually recognised as an expense. However, sometimes, the economic benefits embodied in an asset are absorbed by the enterprise in producing other assets rather than giving rise to an expense. In these cases, the amortisation charge forms part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see AS 2, Valuation of Inventories).

Residual Value

75. The residual value of an intangible asset should be assumed to be zero unless:

- ***(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or***
- ***(b) there is an active market for the asset and:***
  - ***(i) residual value can be determined by reference to that market; and***
  - ***(ii) it is probable that such a market will exist at the end of the asset's useful life.***

76. A residual value other than zero implies that an enterprise expects to dispose of the intangible asset before the end of its economic life.

77. The residual value is estimated using prices prevailing at the date of acquisition of the asset, for the sale of a similar asset that has reached the end of its estimated useful life and that has operated under conditions similar to those in which the asset will be used. The residual value is not subsequently increased for changes in prices or value.

Review of Amortisation Period and Amortisation Method

78. The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

79. During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the useful life may be extended by subsequent expenditure that improves the condition of the asset beyond its originally assessed standard of performance. Also, the recognition of an impairment loss may indicate that the amortisation period needs to be changed.

80. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. For example, it may become apparent that a diminishing balance method of amortisation is appropriate rather than a straight-line method. Another example is if use of the rights represented by a licence is deferred pending action on other components of the business plan. In this case, economic benefits that flow from the asset may not be received until later periods.

Recoverability of the Carrying Amount - Impairment Losses

81. To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets[14]. That Standard explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.

82. If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date

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[14] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

of acquisition, the impairment loss is recognised under Accounting Standard on Impairment of Assets and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition.

83. In addition to the requirements of Accounting Standard on Impairment of Assets, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

(a) an intangible asset that is not yet available for use; and

(b) an intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under Accounting Standard on Impairment of Assets and impairment losses recognised accordingly.

84. The ability of an intangible asset to generate sufficient future economic benefits to recover its cost is usually subject to great uncertainty until the asset is available for use. Therefore, this Statement requires an enterprise to test for impairment, at least annually, the carrying amount of an intangible asset that is not yet available for use.

85. It is sometimes difficult to identify whether an intangible asset may be impaired because, among other things, there is not necessarily any obvious evidence of obsolescence. This difficulty arises particularly if the asset has a long useful life. As a consequence, this Statement requires, as a minimum, an annual calculation of the recoverable amount of an intangible asset if its useful life exceeds ten years from the date when it becomes available for use.

86. The requirement for an annual impairment test of an intangible asset applies whenever the current total estimated useful life of the asset exceeds ten years from when it became available for use. Therefore, if the useful life of an intangible asset was estimated to be less than ten years at initial recognition, but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the impairment test required under paragraph 83(b) and also makes the disclosure required under paragraph 94(a).

Retirements and Disposals

87. An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

88. Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

89. An intangible asset that is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use. At least at each financial year end, an enterprise tests the asset for impairment under Accounting Standard on Impairment of Assets[15], and recognises any impairment loss accordingly.

Disclosure

General

90. The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

- *(a) the useful lives or the amortisation rates used;*
- *(b) the amortisation methods used;*
- *(c) the gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;*
- (d) a reconciliation of the carrying amount at the beginning and end of the period showing:
    - *(i) additions, indicating separately those from internal development and through amalgamation;*
    - *(ii) retirements and disposals;*
    - *(iii) impairment losses recognised in the statement of profit and loss during the period (if any);*
    - *(iv) impairment losses reversed in the statement of profit and loss during the period (if any);*
    - *(v) amortisation recognised during the period; and*
    - *(vi) other changes in the carrying amount during the period.*

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[15] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

91. A class of intangible assets is a grouping of assets of a similar nature and use in an enterprise's operations. Examples of separate classes may include:

(a) brand names;

(b) mastheads and publishing titles;

(c) computer software;

(d) licences and franchises;

(e) copyrights, and patents and other industrial property rights, service and operating rights;

(f) recipes, formulae, models, designs and prototypes; and

(g) intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.

92. An enterprise discloses information on impaired intangible assets under Accounting Standard on Impairment of Assets[16] in addition to the information required by paragraph 90(d)(iii) and (iv).

93. An enterprise discloses the change in an accounting estimate or accounting policy such as that arising from changes in the amortisation method, the amortisation period or estimated residual values, in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

94. The financial statements should also disclose:

(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;

[16] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

(b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole;

(c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and

(d) the amount of commitments for the acquisition of intangible assets.

95. When an enterprise describes the factor(s) that played a significant role in determining the useful life of an intangible asset that is amortised over more than ten years, the enterprise considers the list of factors in paragraph 64.

Research and Development Expenditure

96. The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

97. Research and development expenditure comprises all expenditure that is directly attributable to research or development activities or that can be allocated on a reasonable and consistent basis to such activities (see paragraphs 53-54 for guidance on the type of expenditure to be included for the purpose of the disclosure requirement in paragraph 96).

Other Information

98. An enterprise is encouraged, but not required, to give a description of any fully amortised intangible asset that is still in use.

Transitional Provisions

99. Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under paragraph 63 of this Statement and the period determined under paragraph 63 has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined under paragraph 63 has not expired on the date of this Statement coming into effect and:

(a) if the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.

(b) if the remaining period as per the accounting policy followed by the enterprise:

(i) is shorter as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

(ii) is longer as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.

100. Appendix B illustrates the application of paragraph 99.

Appendix A

This Appendix, which is illustrative and does not form part of the Accounting Standard, provides illustrative application of the principles laid down in the Standard to internal use software and web-site costs. The purpose of the appendix is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

I. Illustrative Application of the Accounting Standard to Internal Use Computer Software

Computer software for internal use can be internally generated or acquired.

Internally Generated Computer Software

1. Internally generated computer software for internal use is developed or modified internally by the enterprise solely to meet the needs of the enterprise and at no stage it is planned to sell it.

2. The stages of development of internally generated software may be categorised into the following two phases:

- Preliminary project stage, i.e., the research phase
- Development phase

Preliminary project stage

3. At the preliminary project stage the internally generated software should not be recognised as an asset. Expenditure incurred in the preliminary project stage should be recognised as an expense when it is incurred. The reason for such a treatment is that at this stage of the software project an enterprise can not demonstrate that an asset exists from which future economic benefits are probable.

4. When a computer software project is in the preliminary project stage, enterprises are likely to:

   (a) Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system.

   (b) Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.

   (c) Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software. Should the software run on a mainframe or a client server system.

   (d) Determine that the technology needed to achieve performance requirements exists.

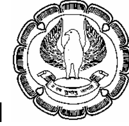
   (e) Select a consultant to assist in the development and/or installation of the software.

Development Stage

5. An internally generated software arising at the development stage should be recognised as an asset if, and only if, an enterprise can demonstrate all of the following:

   (a) the technical feasibility of completing the internally generated software so that it will be available for internal use;

   (b) the intention of the enterprise to complete the internally generated software and use it to perform the functions intended. For example, the intention to complete the internally generated software can be demonstrated if the enterprise commits to the funding of the software project;



(c) the ability of the enterprise to use the software;

(d) how the software will generate probable future economic benefits. Among other things, the enterprise should demonstrate the usefulness of the software;

(e) the availability of adequate technical, financial and other resources to complete the development and to use the software; and

(f) the ability of the enterprise to measure the expenditure attributable to the software during its development reliably.

6. Examples of development activities in respect of internally generated software include:

(a) Design including detailed program design – which is the process of detail design of computer software that takes product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.

(b) Coding which includes generating detailed instructions in a computer language to carry out the requirements described in the detail program design. The coding of computer software may begin prior to, concurrent with, or subsequent to the completion of the detail program design.

At the end of these stages of the development activity, the enterprise has a working model, which is an operative version of the computer software capable of performing all the major planned functions, and is ready for initial testing ("beta" versions).

(c) Testing which is the process of performing the steps necessary to determine whether the coded computer software product meets function, feature, and technical performance requirements set forth in the product design.

At the end of the testing process, the enterprise has a master version of the internal use software, which is a completed version together with the related user documentation and the training materials.

Cost of internally generated software

7. The cost of an internally generated software is the sum of the expenditure incurred from the time when the software first met the recognition criteria for an intangible asset as stated in paragraphs 20 and 21 of this Statement and paragraph 5 above. An expenditure which did not meet the recognition criteria as aforesaid and expensed in an earlier financial statements should not be reinstated if the recognition criteria are met later.

8. The cost of an internally generated software comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis to create the software for its intended use. The cost include:

(a) expenditure on materials and services used or consumed in developing the software;

(b) the salaries, wages and other employment related costs of personnel directly engaged in developing the software;

(c) any expenditure that is directly attributable to generating software; and

(d) overheads that are necessary to generate the software and that can be allocated on a reasonable and consistent basis to the software (For example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocation of overheads are made on basis similar to those used in allocating the overhead to inventories.

9. The following are not components of the cost of an internally generated software:

(a) selling, administration and other general overhead expenditure unless this expenditure can be directly attributable to the development of the software;

(b) clearly identified inefficiencies and initial operating losses incurred before software achieves the planned performance; and

(c) expenditure on training the staff to use the internally generated software.

Software Acquired for Internal Use

10. The cost of a software acquired for internal use should be recongised as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of this Statement.

11. The cost of a software purchased for internal use comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the software ready for its use. Any trade discounts and rebates are deducted in arriving at the cost. In the determination of cost, matters stated in paragraphs 24 to 34 of the Statement need to be considered, as appropriate.

Subsequent expenditure

12. Enterprises may incur considerable cost in modifying existing software systems. Subsequent expenditure on software after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the software to generate future economic benefits in excess of its originally assessed standards of performance; and

(b) the expenditure can be measured and attributed to the software reliably.

If these conditions are met, the subsequent expenditure should be added to the carrying amount of the software. Costs incurred in order to restore or maintain the future economic benefits that an enterprise can expect from the originally assessed standard of performance of existing software systems is recognised as an expense when, and only when, the restoration or maintenance work is carried out.

Amortisation period

13. The depreciable amount of a software should be allocated on a systematic basis over the best estimate of its useful life. The amortisation should commence when the software is available for use.

14. As per this Statement, there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. However, given the history of rapid changes in technology, computer software is susceptible to technological obsolescence. Therefore, it is likely that useful life of the software will be much shorter, say 3 to 5 years.

Amortisation method

15. The amortisation method used should reflect the pattern in which the software's economic benefits are consumed by the enterprise. If that pattern can not be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expenditure unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortisation of a software used in a production process is included in the carrying amount of inventories.

II. Illustrative Application of the Accounting Standard to Web-Site Costs

1. An enterprise may incur internal expenditures when developing, enhancing and maintaining its own web site. The web site may be used for various purposes such as promoting and advertising products and services, providing electronic services, and selling products and services.

2. The stages of a web site's development can be described as follows:

(a) Planning – includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences;

(b) Application and Infrastructure Development – includes obtaining a domain name, purchasing and developing hardware and operating software, installing developed applications and stress testing; and

(c) Graphical Design and Content Development – includes designing the appearance of web pages and creating, purchasing, preparing and uploading information, either textual or graphical in nature, on the web site prior to the web site becoming available for use. This information may either be stored in separate databases that are integrated into (or accessed from) the web site or coded directly into the web pages.

3. Once development of a web site has been completed and the web site is available for use, the web site commences an operating stage. During this stage, an enterprise maintains and enhances the applications, infrastructure, graphical design and content of the web site.

4. The expenditures for purchasing, developing, maintaining and enhancing hardware (e.g., web servers, staging servers, production servers and Internet connections) related to a web site are not accounted for under this Statement but are accounted for under AS 10, Accounting for Fixed Assets. Additionally, when an enterprise incurs an expenditure for having an Internet service provider host the enterprise's web site on it's own servers connected to the Internet, the expenditure is recognised as an expense.

5. An intangible asset is defined in paragraph 6 of this Statement as an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Paragraph 7 of this Statement provides computer software as a common example of an intangible asset. By analogy, a web site is another example of an intangible asset. Accordingly, a web site developed by an enterprise for its own use is an internally generated intangible asset that is subject to the requirements of this Statement.

6. An enterprise should apply the requirements of this Statement to an internal expenditure for developing, enhancing and maintaining its own web site. Paragraph 55 of this Statement provides expenditure on an intangible item to be recognised as an expense when incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria in paragraphs 19-54 of the Statement. Paragraph 56 of the Statement requires expenditure on start-up activities to be recognised as an expense when incurred. Developing a web site by an enterprise for its own use is not a start-up activity to the extent that an internally generated intangible asset is created. An enterprise applies the requirements and guidance in paragraphs 39-54 of this Statement to an expenditure incurred for developing its own web site in addition to the general requirements for

recognition and initial measurement of an intangible asset. The cost of a web site, as described in paragraphs 52-54 of this Statement, comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and preparing the asset for its intended use.

The enterprise should evaluate the nature of each activity for which an expenditure is incurred (e.g., training employees and maintaining the web site) and the web site's stage of development or post-development:

(a) Paragraph 41 of this Statement requires an expenditure on research (or on the research phase of an internal project) to be recognised as an expense when incurred. The examples provided in paragraph 43 of this Statement are similar to the activities undertaken in the Planning stage of a web site's development. Consequently, expenditures incurred in the Planning stage of a web site's development are recognised as an expense when incurred.

(b) Paragraph 44 of this Statement requires an intangible asset arising from the development phase of an internal project to be recognised if an enterprise can demonstrate fulfillment of the six criteria specified. Application and Infrastructure Development and Graphical Design and Content Development stages are similar in nature to the development phase. Therefore, expenditures incurred in these stages should be recognised as an intangible asset if, and only if, in addition to complying with the general requirements for recognition and initial measurement of an intangible asset, an enterprise can demonstrate those items described in paragraph 44 of this Statement. In addition,

(i) an enterprise may be able to demonstrate how its web site will generate probable future economic benefits under paragraph 44(d) by using the principles in Accounting Standard on Impairment of Assets[17]. This includes situations where the web site is developed solely or primarily for promoting and advertising an enterprise's own products and services. Demonstrating how a web site will generate probable future economic benefits under paragraph 44(d) by assessing the economic benefits to be received from the web site and using the principles in Accounting Standard on Impairment of Assets, may be particularly difficult for an enterprise that develops a web site solely or primarily for advertising and promoting its own products and services; information is unlikely to be available for reliably

[17] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

estimating the amount obtainable from the sale of the web site in an arm's length transaction, or the future cash inflows and outflows to be derived from its continuing use and ultimate disposal. In this circumstance, an enterprise determines the future economic benefits of the cash-generating unit to which the web site belongs, if it does not belong to one. If the web site is considered a corporate asset (one that does not generate cash inflows independently from other assets and their carrying amount cannot be fully attributed to a cash-generating unit), then an enterprise applies the 'bottom-up' test and/or the 'top-down' test under Accounting Standard on Impairment of Assets.

(ii) an enterprise may incur an expenditure to enable use of content, which had been purchased or created for another purpose, on its web site (e.g., acquiring a license to reproduce information) or may purchase or create content specifically for use on its web site prior to the web site becoming available for use. In such circumstances, an enterprise should determine whether a separate asset, is identifiable with respect to such content (e.g., copyrights and licenses), and if a separate asset is not identifiable, then the expenditure should be included in the cost of developing the web site when the expenditure meets the conditions in paragraph 44 of this Statement. As per paragraph 20 of this Statement, an intangible asset is recognised if, and only if, it meets specified criteria, including the definition of an intangible asset. Paragraph 52 indicates that the cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the specified recognition criteria. When an enterprise acquires or creates content, it may be possible to identify an intangible asset (e.g., a license or a copyright) separate from a web site. Consequently, an enterprise determines whether an expenditure to enable use of content, which had been created for another purpose, on its web site becoming available for use results in a separate identifiable asset or the expenditure is included in the cost of developing the web site.

(c) the operating stage commences once the web site is available for use, and therefore an expenditure to maintain or enhance the web site after development has been completed should be recognised as an expense when it is incurred unless it meets the criteria in paragraph 59 of the Statement. Paragraph 60 explains that if the expenditure is required to maintain the asset at its originally assessed standard of performance, then the expenditure is recognised as an expense when incurred.

7. An intangible asset is measured subsequent to initial recognition by applying the requirements in paragraph 62 of this Statement. Additionally, since paragraph 68 of the Statement states that an intangible asset always has a finite useful life, a web site that is recognised as an asset is amortised over the best estimate of its useful life. As indicated in paragraph 65 of the Statement, web sites are susceptible to technological obsolescence, and given the history of rapid changes in technology, their useful life will be short.

8. The following table illustrates examples of expenditures that occur within each of the stages described in paragraphs 2 and 3 above and application of paragraphs 5 and 6 above. It is not intended to be a comprehensive checklist of expenditures that might be incurred.

Nature of Expenditure	*Accounting treatment*
Planning • undertaking feasibility studies • defining hardware and software specifications • evaluating alternative products and suppliers • selecting preferences	Expense when incurred
Application and Infrastructure Development • purchasing or developing hardware	Apply the requirements of AS 10
• obtaining a domain name • developing operating software (e.g., operating system and server software) • developing code for the application • installing developed applications on the web server • stress testing	Expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44
Graphical Design and Content Development • designing the appearance (e.g., layout and colour) of web pages • creating, purchasing, preparing (e.g., creating links and identifying tags), and uploading information, either textual or graphical in nature, on the web site prior to the web site becoming available for use. Examples of content include information about an enterprise, products or services offered for sale, and topics that	If a separate asset is not identifiable, then expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44

subscribers access	
OPERATING • updating graphics and revising content • adding new functions, features and content • registering the web site with search engines • backing up data • reviewing security access • analysing usage of the web site	Expense when incurred, unless in rare circumstances it meets the criteria in paragraph 59, in which case the expenditure is included in the cost of the web site
Other • selling, administrative and other general overhead expenditure unless it can be directly attributed to preparing the web site for use • clearly identified inefficiencies and initial operating losses incurred before the web site achieves planned performance (e.g., false start testing) • training employees to operate the web site	Expense when incurred

Appendix B

This Appendix, which is illustrative and does not form part of the Accounting Standard, provides illustrative application of the requirements contained in paragraph 99 of this Accounting Standard in respect of transitional provisions.

Example 1 – Intangible Item was not amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 10 lakhs as on 1-4-2003. The item was acquired for Rs. 10 lakhs on April 1, 1990 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1990.

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of the intangible item of Rs. 10 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Example 2 – Intangible Item is being amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 8 lakhs as on 1-4-2003. The item was acquired for Rs. 20 lakhs on April 1, 1991 and was available for use from that date. The enterprise has been following a policy of amortising the item over a period of 20 years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1991.

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of Rs. 8 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Example 3 – Amortisation period determined under paragraph 63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is shorter.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 8 lakhs as on 1-4-2003. The item was acquired for Rs. 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 5 years on straight line basis. Applying paragraph 63, the enterprise determines the amortisation period to be 8 years, being the best estimate of its useful life, from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 2 years as per the accounting policy followed by the enterprise which is shorter as compared to the balance of amortisation period determined by applying paragraph 63, i.e., 5 years. Accordingly, the enterprise would be required to amortise the intangible item over the remaining 2 years as per the accounting policy followed by the enterprise

Example 4 – Amortisation period determined under paragraph 63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is longer.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 18 lakhs as on 1-4-2003. The item was acquired for Rs. 24 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 12 years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was

available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 9 years as per the accounting policy followed by the enterprise which is longer as compared to the balance of period stipulated in paragraph 63, i.e., 7 years. Accordingly, the enterprise would be required to restate the carrying amount of intangible item on 1-4-2003 at Rs. 16.8 lakhs (Rs. 24 lakhs – 3xRs. 2.4 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of Rs. 1.2 lakhs (Rs. 18 lakhs-Rs. 16.8 lakhs) would be required to be adjusted against the opening balance of the revenue reserves. The carrying amount of Rs. 16.8 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.

Example 5 – Intangible Item is not amortised and amortisation period determined under paragraph 63 has not expired.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 20 lakhs as on 1-4-2003. The item was acquired for Rs. 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the enterprise would be required to restate the carrying amount of intangible item at Rs. 14 lakhs (Rs. 20 lakhs – 3xRs. 2 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of Rs. 6 lakhs (Rs. 20 lakhs-Rs. 14 lakhs) would be required to be adjusted against the opening balance of the revenue reserves. The carrying amount of Rs. 14 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.

AS – 29 : PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004. This Standard is mandatory in nature from that date:

(a) in its entirety, 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 evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(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.

(b) in its entirety, except paragraph 67, for the enterprises which do not fall in any of the categories in (a) above but fall in any one or more of the following categories:

(i) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 40 lakhs but does not exceed Rs. 50 crore. Turnover does not include 'other income'.

(ii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 1 crore but not in excess of Rs. 10 crore at any time during the accounting period.

(iii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

(c) in its entirety, except paragraphs 66 and 67, for the enterprises, which do not fall in any of the categories in (a) and (b) above.

Where an enterprise has been covered in any one or more of the categories in (a) above and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from

paragraph 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) above for two consecutive years.

Where an enterprise has been covered in any one or more of the categories in (a) or (b) above and subsequently, ceases to be covered in any of the categories in (a) and (b) above, the enterprise will not qualify for exemption from paragraphs 66 and 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) and (b) above for two consecutive years.

Where an enterprise has previously qualified for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, but no longer qualifies for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, in the current accounting period, this Standard becomes applicable, in its entirety or, in its entirety except paragraph 67, as the case may be, from the current period. However, the relevant corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose the information required by paragraph 67 or paragraphs 66 and 67, as the case may be, should disclose the fact.

From the date of this Accounting Standard becoming mandatory (in its entirety or with the exception of paragraph 67 or paragraphs 66 and 67, as the case may be), all paragraphs of Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, that deal with contingencies (viz., paragraphs 1 (a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16), stand withdrawn.*

The following is the text of the Accounting Standard.

OBJECTIVE

The objective of this Statement is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The objective of this Statement is also to lay down appropriate accounting for contingent assets.

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* It is clarified that paragraphs of AS 4 that deal with contingencies would remain operational to the extent they deal with impairment of assets not covered by other Indian Accounting Standard.

SCOPE

1. This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

- *(a) those resulting from financial instruments[18] that are carried at fair value;*
- *(b) those resulting from executory contracts;*
- *(c) those arising in insurance enterprises from contracts with policy-holders; and*
- *(d) those covered by another Accounting Standard.*

2. This Statement applies to financial instruments (including guarantees) that are not carried at fair value.

3. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

4. This Statement applies to provisions, contingent liabilities and contingent assets of insurance enterprises other than those arising from contracts with policy-holders.

5. Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement. For example, certain types of provisions are also addressed in Accounting Standards on:

- (a) construction contracts (see AS 7, Construction Contracts);
- (b) taxes on income (see AS 22, Accounting for Taxes on Income);
- (c) leases (see AS 19, Leases); and
- (d) retirement benefits (see AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers).

6. Some amounts treated as provisions may relate to the recognition of revenue, for example where an enterprise gives guarantees in exchange for a fee. This Statement

[18] For the purpose of this Statement, the term 'financial instruments' shall have the same meaning as in Accounting Standard (AS) 20, Earnings Per Share.

does not address the recognition of revenue. AS 9, Revenue Recognition, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Statement does not change the requirements of AS 9.

7. This Statement defines provisions as liabilities which can be measured only by using a substantial degree of estimation. The term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Statement.

8. Other Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Statement. Accordingly, this Statement neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

9. This Statement applies to provisions for restructuring (including discontinuing operations). Where a restructuring meets the definition of a discontinuing operation, additional disclosures are required by AS 24, Discontinuing Operations.

DEFINITIONS

10. The following terms are used in this Statement with the meanings specified:

A provision is a liability which can be measured only by using a substantial degree of estimation.

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A contingent liability is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognised

because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made.

A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A restructuring is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.

11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

12. Provisions can be distinguished from other liabilities such as trade payables and accruals because in the measurement of provisions substantial degree of estimation is involved with regard to the future expenditure required in settlement. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees. Although it is sometimes necessary to estimate the amount of accruals, the degree of estimation is generally much less than that for provisions.

13. In this Statement, the term 'contingent' is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.

RECOGNITION

Provisions

14. A provision should be recognised when:

- *(a) an enterprise has a present obligation as a result of a past event;*
- *(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and*
- *(c) a reliable estimate can be made of the amount of the obligation.*

If these conditions are not met, no provision should be recognised.

PRESENT OBLIGATION

15. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

- (a) where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and
- (b) where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

Past Event

16. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed -- indeed the obligation may be to the public at large.

20. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

21. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted. Differences in circumstances surrounding enactment usually make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be

virtually certain of the enactment of a law until it is enacted.

Probable Outflow of Resources Embodying Economic Benefits

22. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Statement[19], an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

23. Where there are a number of similar obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

RELIABLE ESTIMATE OF THE OBLIGATION

24. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature involve a greater degree of estimation than most other items. Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is reliable to use in recognising a provision.

25. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 68).

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[19] The interpretation of 'probable' in this Statement as 'more likely than not' does not necessarily apply in other Accounting Standards.

CONTINGENT LIABILITIES

26. An enterprise should not recognise a contingent liability.

27. A contingent liability is disclosed, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote.

28. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made (see paragraph 14).

29. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in accordance with paragraph 14 in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

CONTINGENT ASSETS

30. An enterprise should not recognise a contingent asset.

31. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

32. Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

33. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.

34. Contingent assets are assessed continually and if it has become virtually certain that an

inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

MEASUREMENT

Best Estimate

35. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

36. The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

37. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22, Accounting for Taxes on Income.

RISKS AND UNCERTAINTIES

38. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

39. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

40. Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 67(b).

FUTURE EVENTS

41. Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

42. Expected future events may be particularly important in measuring provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

43. The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice usually makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

EXPECTED DISPOSAL OF ASSETS

44. Gains from the expected disposal of assets should not be taken into account in measuring a provision.

45. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

REIMBURSEMENTS

46. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is

virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

47. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

48. Sometimes, an enterprise is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the enterprise or pay the amounts directly.

49. In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

50. In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

51. As noted in paragraph 28, an obligation for which an enterprise is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

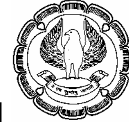
Changes in Provisions

52. Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

53. A provision should be used only for expenditures for which the provision was originally recognised.

54. Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.



APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

Future Operating Losses

55. Provisions should not be recognised for future operating losses.

56. Future operating losses do not meet the definition of a liability in paragraph 10 and the general recognition criteria set out for provisions in paragraph 14.

57. An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An enterprise tests these assets for impairment under Accounting Standard (AS) 28, Impairment of Assets.

Restructuring

58. The following are examples of events that may fall under the definition of restructuring:

    (a) sale or termination of a line of business;

    (b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

    (c) changes in management structure, for example, eliminating a layer of management; and

    (d) fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

59. A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in paragraph 14 are met.

60. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.

61. An enterprise cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Accounting Standard (AS) 28, Impairment of Assets.

62. A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the enterprise.

63. A restructuring provision does not include such costs as:

 (a) retraining or relocating continuing staff;

 (b) marketing; or

 (c) investment in new systems and distribution networks.

 These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

64. Identifiable future operating losses up to the date of a restructuring are not included in a provision.

65. As required by paragraph 44, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

DISCLOSURE

66. For each class of provision, an enterprise should disclose:

 (a) the carrying amount at the beginning and end of the period;

 (b) additional provisions made in the period, including increases to existing provisions;

 (c) amounts used (i.e. incurred and charged against the provision) during the period; and

 (d) unused amounts reversed during the period.

67. An enterprise should disclose the following for each class of provision:

 (a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

 (b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major

assumptions made concerning future events, as addressed in paragraph 41; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

68. Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured under paragraphs 35-45;

(b) an indication of the uncertainties relating to any outflow; and

(c) the possibility of any reimbursement.

69. In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of paragraphs 67 (a) and (b) and 68 (a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

70. Where a provision and a contingent liability arise from the same set of circumstances, an enterprise makes the disclosures required by paragraphs 66-68 in a way that shows the link between the provision and the contingent liability.

71. Where any of the information required by paragraph 68 is not disclosed because it is not practicable to do so, that fact should be stated.

72. In extremely rare cases, disclosure of some or all of the information required by paragraphs 66-70 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

APPENDIX A

Tables - Provisions, Contingent Liabilities and Reimbursements

The purpose of this appendix is to summarise the main requirements of the Accounting Standard. It does not form part of the Accounting Standard and should be read in the context of the full text of the Accounting Standard.

PROVISIONS AND CONTINGENT LIABILITIES

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable.		
There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.	There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.	There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.
A provision is recognised (paragraph 14). Disclosures are required for the provision (paragraphs 66 and 67)	No provision is recognised (paragraph 26). Disclosures are required for the contingent liability (paragraph 68).	No provision is recognised (paragraph 26). No disclosure is required (paragraph 68).

Reimbursements

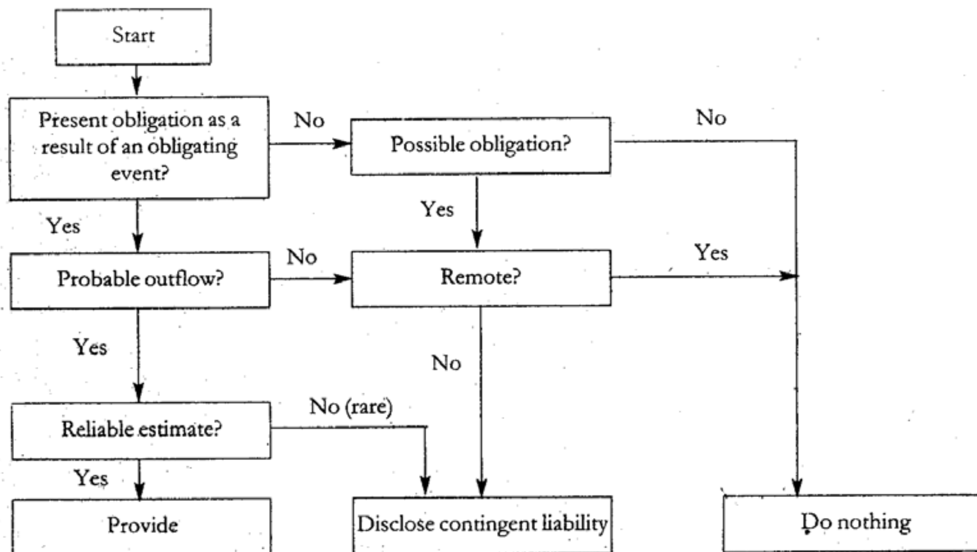
Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.	The obligation for the amount expected to be reimbursed remains with the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.	The obligation for the amount expected to be reimbursed remains with the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.

The enterprise has no liability for the amount to be reimbursed (paragraph 50).	The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability (paragraphs 46 and 47).	The expected reimbursement is not recognised as an asset (paragraph 46).
No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement (paragraph 67(c)).	The expected reimbursement is disclosed (paragraph 67(c)).

Appendix B

Decision Tree

The purpose of the decision tree is to summarise the main recognition requirements of the Accounting Standard for provisions and contingent liabilities. The decision tree does not form part of the Accounting Standard and should be read in the context of the full text of the Accounting Standard.



Note: in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date (paragraph 15 of the Standard).

APPENDIX C

Examples: Recognition

This appendix illustrates the application of the Accounting Standard to assist in clarifying its meaning. It does not form part of the Accounting Standard.

All the enterprises in the examples have 31 March year ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets - this aspect is not dealt with in the examples.

The cross references provided in the examples indicate paragraphs of the Accounting Standard that are particularly relevant. The appendix should be read in the context of the full text of the Accounting Standard.

EXAMPLE 1: WARRANTIES

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date (see paragraphs 14 and 23).

Example 2: Contaminated Land - Legislation Virtually Certain to be Enacted

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 March 2005 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

Present obligation as a result of a past obligating event - The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the costs of the clean-up (see paragraphs 14 and 21).

EXAMPLE 3: OFFSHORE OILFIELD

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

Present obligation as a result of a past obligating event - The construction of the oil rig creates an obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (see paragraph 14). These costs are included as part of the cost of the oil rig. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

EXAMPLE 4: REFUNDS POLICY

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of refunds (see

paragraphs 11, 14 and 23).

EXAMPLE 5: LEGAL REQUIREMENT TO FIT SMOKE FILTERS

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2005. The enterprise has not fitted the smoke filters.

(a) At the balance sheet date of 31 March 2005

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters (see paragraphs 14 and 16-18).

(b) At the balance sheet date of 31 March 2006

Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14 and 16-18).

Example 6: Staff Retraining as a Result of Changes in the Income Tax System

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

EXAMPLE 7: A SINGLE GUARANTEE

During 2004-05, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2005-06, the financial condition of Enterprise B deteriorates and at 30 September 2005 Enterprise B goes into liquidation.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 March 2005.

Conclusion - No provision is recognised (see paragraphs 14 and 22). The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (see paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - At 31 March 2006, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion - A provision is recognised for the best estimate of the obligation (see paragraphs 14 and 22).

Note: This example deals with a single guarantee. If an enterprise has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefit is probable (see paragraph 23). Where an enterprise gives guarantees in exchange for a fee, revenue is recognised under AS 9, Revenue Recognition.

EXAMPLE 8: A COURT CASE

After a wedding in 2004-05, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2005, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable.

However, when the enterprise prepares the financial statements for the year 31 March 2006, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusion - No provision is recognised (see definition of 'present obligation' and paragraph 15). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation (paragraphs 14-15).

EXAMPLE 9A: REFURBISHMENT COSTS - NO LEGISLATIVE REQUIREMENT

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

EXAMPLE 9B: REFURBISHMENT COSTS - LEGISLATIVE REQUIREMENT

An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in example 9A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

Appendix D

Example: Disclosures

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.

An example of the disclosures required by paragraph 67 is provided below.

EXAMPLE 1 WARRANTIES

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the balance sheet date, a provision of Rs. 60,000 has been recognised. The following information is disclosed:

A provision of Rs. 60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years of the balance sheet date.

An example is given below of the disclosures required by paragraph 72 where some of the information required is not given because it can be expected to prejudice seriously the position of the enterprise.

EXAMPLE 2 DISCLOSURE EXEMPTION

An enterprise is involved in a dispute with a competitor, who is alleging that the enterprise has infringed patents and is seeking damages of Rs. 1000 lakhs. The enterprise recognises a provision

for its best estimate of the obligation, but discloses none of the information required by paragraphs 66 and 67 of the Statement. The following information is disclosed:

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of Rs. 1000 lakhs. The information usually required by AS 29, Provisions, Contingent Liabilities and Contingent Assets is not disclosed on the grounds that it can be expected to prejudice the interests of the company. The directors are of the opinion that the claim can be successfully resisted by the company.

Appendix E

Note:This Appendix is not a part of the Accounting Standard. The purpose of this appendix is only to bring out the major differences between Accounting Standard 29 and corresponding International Accounting Standard (IAS) 37.

Comparison with IAS 37, Provisions, Contingent Liabilities and Contingent Assets (1998)

The Accounting Standard differs from International Accounting Standard (IAS) 37, Provisions, Contingent Liabilities and Contingent Assets, in the following major respects:

1. Discounting of Provisions

IAS 37 requires that where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation. On the other hand, the Accounting Standard requires that the amount of a provision should not be discounted to its present value. The reason for not requiring discounting is that, at present, in India, financial statements are prepared generally on historical cost basis and not on present value basis.

2. Onerous Contracts

IAS 37 requires that if an enterprise has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision. For this purpose, IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

It is decided that in respect of onerous contracts, on which IAS 37 is applicable, present obligation should not be required to be recognised. This is because recognition of estimated loss in case of an onerous contract amounts to recognition of loss of future periods in the current year's profit and loss account thereby distorting the operating results of the current year. Further, it may not be

feasible to determine, in all cases, whether a particular contract is onerous or not because which costs are unavoidable may be a matter of subjective judgement. Accordingly, the provisions of IAS 37 relating to onerous contracts including the definition of 'onerous contract' have been omitted from the Accounting Standard.

3. Constructive obligation and Restructurings

IAS 37 deals with 'constructive obligation' in the context of creation of a provision. The effect of recognising provision on the basis of constructive obligation is that, in some cases, provision will be required to be recognised at an early stage. For example, in case of a restructuring, a constructive obligation arises when an enterprise has a detailed formal plan for the restructuring and the enterprise has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. It is felt that merely on the basis of a detailed formal plan and announcement thereof, it would not be appropriate to recognise a provision since a liability can not be considered to be crystalised at this stage. Further, the judgment whether the management has raised valid expectations in those affected may be a matter of considerable argument.

In view of the above, the Accounting Standard does not deal with 'constructive obligation'. Thus, in situations such as restructuring, general recognition criteria are required to be applied.

4. Contingent Assets

Both the Accounting Standard and IAS 37 require that an enterprise should not recognise a contingent asset. However, IAS 37 requires certain disclosures in respect of contingent assets in the financial statements where an inflow of economic benefits is probable. In contrast to this, as a measure of prudence, the Accounting Standard does not even require contingent assets to be disclosed in the financial statements. The Standard recognises that contingent asset is usually disclosed in the report of the approving authority where an inflow of economic benefits is probable.

5. Definitions

The definitions of the terms 'legal obligation', 'constructive obligation' and 'onerous contract' contained in IAS 37 have been omitted from the Accounting Standard, as a consequence to above departures from IAS 37. Further, the definitions of the terms 'provision' and 'obligating event' contained in IAS 37 have been modified as a consequence to above departures from IAS 37. In the Accounting Standard, the definitions of the terms 'present obligation' and 'possible obligation' have been added as compared to IAS 37 with a view to bring more clarity.

Limited Revision to Accounting Standard (AS) 29,

Provisions, Contingent Liabilities and Contingent Assets

The Council of the Institute of Chartered Accountants of India has decided to make the following limited revisions of Accounting Standard (AS) 29, Provisions, Contingent Liabilities and Contingent Assets.

Paragraphs 1, 3 and 5 of AS 29 have been decided to be modified as under (modifications are shown as underlined):

Scope

1. This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

(a) those resulting from financial instruments that are carried at flair value;

(b) those resulting from executory contracts, except where the contract is onerous;

(c) those arising in insurance enterprises from contracts with policy-holders; and

(d) those covered by another Accounting Standard."

"3. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Statement does not apply to executory contracts unless they are onerous."

"5. Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement. For example, certain types of provisions are also addressed in Accounting Standards on:

(a) construction contracts (see AS 7, Construction Contracts);

(b) taxes on income (see AS22, Accounting for Taxes on income);

(c) leases (see AS 19, Leases). However, as AS 19 contains no specific requirements to deal with operating leases that have become onerous, this Statement applies to such cases; and

(d) retirement benefits (see AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers).

Pursuant to the above limited revision, paragraph 2 of Appendix E (dealing with comparison of AS 29 with IAS 37) to AS 29 stands withdrawn. Consequently, the numbering of subsequent paragraphs of Appendix E is also changed.

The limited revision comes into effect in respect of accounting periods commencing on or after April 1, 2006.

As a consequence to the Limited Revision to AS 29, Accounting Standards Interpretation (ASI) 30 has been issued.

APPENDIX III

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) 1

Substantial Period of Time

Accounting Standard (AS) 16, Borrowing Costs

ISSUE

1. Accounting Standard (AS) 16, Borrowing Costs, defines the term 'qualifying asset' as "an asset that necessarily takes a substantial period of time to get ready for its intended use or sale".

2. The issue is what is the meaning of the expression 'substantial period of time' for the purpose of this definition.

CONSENSUS

3. The issue as to what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale should be considered.

4. The following assets ordinarily take twelve months or more to get ready for intended use or sale unless the contrary can be proved by the enterprise:

i. assets that are constructed or otherwise produced for an enterprise's own use, e.g., assets constructed under major capital expansions.

ii. assets intended for sale or lease that are constructed or otherwise produced as discrete projects (for example, ships or real estate developments).

5. In case of inventories, substantial period of time is considered to be involved where time is the major factor in bringing about a change in the condition of inventories. For example, liquor is often required to be kept in store for more than twelve months for maturing.

BASIS FOR CONCLUSION

6. Paragraph 6 of AS 16 provides that *"Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Statement. Other borrowing costs should be recognised as an expense in the period in which they are incurred"*.

This paragraph recognises that borrowing costs should be expensed except where they are directly attributable to acquisition, construction or production of a qualifying asset. To qualify for capitalisation of borrowing costs, the asset should take a long period of time to get ready for its intended use or sale.

7. Paragraph 5 of AS 16 gives examples of manufacturing plants, power generation facilities etc. as qualifying assets. In these cases, normally a period of more than twelve months is required for getting them ready for their intended use. Therefore, a rebuttable presumption of a period of twelve months is considered "substantial" period of time.

8. Paragraph 5 of AS 16 provides, inter alia, that *"inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets." Paragraph 12 of Accounting Standard (AS) 2, Valuation of Inventories, provides that "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".* It is only in exceptional cases, where time is a major factor in bringing about change in the condition of inventories that borrowing costs are included in the valuation of inventories.

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) 10

Interpretation of paragraph 4(e) of AS 16

Accounting Standard (AS) 16, Borrowing Costs

ISSUE

1. Paragraph 4 (e) of AS 16, 'Borrowing Costs', provides that borrowing costs may include "exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs".

2. The issue is which exchange differences are covered under paragraph 4 (e) of AS 16.

CONSENSUS

3. Paragraph 4 (e) of AS 16 covers exchange differences on the amount of principal of the foreign currency borrowings to the extent of difference between interest on local currency borrowings and interest on foreign currency borrowings. For this purpose, the interest rate for the local currency borrowings should be considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings. If the difference between the interest on local currency borrowings and the interest on foreign currency borrowings is equal to or more than the exchange difference on the amount of principal of the foreign currency borrowings, the entire amount of exchange difference is covered under paragraph 4 (e) of AS 16.

The Appendix to this Interpretation illustrates the application of the above requirements.

BASIS FOR CONCLUSIONS

4. Enterprises often borrow in foreign currency at a lower interest rate as an alternative to borrowing locally in rupees, at a higher rate. However, the likely currency depreciation and resulting exchange loss often offset, fully or partly, the difference in the interest rates. In such cases, the exchange difference on the foreign currency borrowings to the extent of the difference between interest on local currency borrowing and interest on foreign currency borrowing, is regarded as an adjustment to the interest costs. This exchange difference is, in substance, a borrowing cost. In case of an enterprise, which instead of borrowing locally at a higher interest rate, borrows in foreign currency on the basis that the interest cost on foreign currency borrowings as adjusted by the exchange fluctuations, is expected to be less than the interest cost of an equivalent rupee borrowing, it is not appropriate to consider only the explicit interest cost on the foreign currency borrowing as the borrowing costs. In such a case, to the extent the exchange differences are regarded as an adjustment to the interest costs, as explained above, the same should also be considered as borrowing costs and accounted for accordingly with a view to reflect economic reality. Accordingly, such an exchange difference is covered under AS 16.

5. The explicit interest cost, including exchange difference thereon, if any, is covered under paragraph 4 (a) of AS 16, which provides that borrowing costs may include interest and commitment charges on bank borrowing and other short term and long term borrowings. Accordingly, the intention of paragraph 4(e) of AS 16 is to cover exchange differences on the amount of the principal of the foreign currency borrowings. Further, since paragraph 4 (e) uses the words 'to the extent that they are regarded as an adjustment to interest costs', the entire exchange difference on principal amount is not covered by paragraph 4 (e). Since, the difference between

interest on local currency borrowings and interest on foreign currency borrowings, is regarded as an adjustment to the interest costs, only the exchange difference to the extent of such difference is covered by paragraph 4 (e) of AS 16. The entire exchange difference on the principal amount is regarded as an adjustment to the interest cost only in a situation where the difference between interest on local currency borrowings and interest on foreign currency borrowings is equal to or more than the exchange difference.

APPENDIX

Note: *This appendix is illustrative only and does not form part of the Accounting Standards Interpretation. The purpose of this appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning.*

Facts:

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 20X3, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X3, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at March 31, 20X4, is Rs. 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 20X3.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

i. Interest for the period = USD 10,000 x 5%x Rs. 48/USD = Rs. 24,000/-

ii. Increase in the liability towards the principal amount = USD 10,000 x (48-45) = Rs. 30,000/-

iii. Interest that would have resulted if the loan was taken in Indian currency = USD 10000 x 45 x 11%). = Rs. 49,500

iv. Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 49,500 - Rs. 24,000 = Rs. 25,500

Therefore, out of Rs. 30,000 increase in the liability towards principal amount, only Rs. 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings (covered by paragraph 4(a) of AS 16) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 25,500. Thus, Rs. 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining Rs. 4,500

would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of Rs. 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings i.e., Rs. 34,500 (Rs. 58,500 - Rs. 24,000) is more than the exchange difference of Rs. 30,000. Therefore, in such a case, the total borrowing cost would be Rs. 54,000 (Rs. 24,000 + Rs. 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11.

Accounting Standards Interpretation (ASI) 12
Applicability of AS 20 Accounting Standard (AS) 20,

Earnings per Share Issue

[Pursuant to the issuance of this Accounting Standards Interpretation, General Clarification (GC) – 1/2002, issued in March 2002 stands withdrawn.]

ISSUE

1. Whether companies which are required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20.

CONSENSUS

2. Every company, which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

BASIS FOR CONCLUSIONS

3. AS 20, 'Earnings Per Share', has come into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20.

4. Part IV of Schedule VI to the Companies Act, 1956, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

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'.

Accounting Standards Interpretation (ASI) 30

Applicability of AS 29 to Onerous Contracts

Accounting Standard (AS) 29, Provisions, Contingent Liabilities and Contingent Assets

ISSUE

1. An 'onerous contract' is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The issue is how the recognition and measurement principles of AS 29 should be applied to the 'onerous contracts' covered within its scope.

CONSENSUS

2. If an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision as per AS 29.

3. For a contract to qualify as an onerous contract, the unavoidable costs of meeting the obligation under the contract should exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

4. The amount of provision in respect of an onerous contract should be measured by applying the principles laid down in AS 29. Accordingly, the amount of the provision should not be discounted to its present value.

The Appendix to this Interpretation illustrates the application of the above requirements.

BASIS FOR CONCLUSIONS

5. Paragraph 14 of AS 29 provides as follows:

   "14. A provision should be recognized when:

   (a) an enterprise has a present obligation as a result of a past event;

   (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

   (c) a reliable estimate can be made of the amount of the obligation.

   If these conditions are not met, no provision should be recognized."

Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore, there is no obligation. Other contracts established both rights and obligations for each of the contracting parties. Where events make such a contract onerous, a liability exists, which is recognized.

In respect of such contracts the past obligating event is the signing of the contract, which gives rise to the present obligation. Besides this, when such a contract becomes onerous, an outflow of resources embodying economic benefits is probable.

6. Recognition of losses with regard to onerous contracts relating to items of inventory are recognized, under AS 2, Valuation of Inventories, by virtue of the consideration of the net realizable value. Further, the recognition of losses in case of onerous construction contracts is dealt with in AS 7, Construction Contracts. Therefore, it is inappropriate if in case of onerous contracts to which AS 29 is applicable, the provision is not recognized.

Appendix

Note: This appendix is illustrative only and does not form part of the Accounting Standards Interpretation. The purpose of this appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning.

An enterprise operates profitably from a factory that it has leased under an operating lease. During December, 2005 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

Present obligation as a result of a past obligating event – When obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – When the lease becomes onerous, an outflow of resources embodying economic benefits is probable. (Until the lease becomes onerous, the enterprise accounts for the lease under AS 19, Leases).

Conclusion – A provision is recognized for the best estimate of the unavoidable lease payments.